Pandemic Crisis and Financial Stability

Edited by Christos V. Gortsos
and Wolf-Georg Ringe

EBI European Banking Institute

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* Cover page: *The Plague of the Philistines at Ashdod* (1661) by Pieter van Hale.

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

Athens and Hamburg, May 2020

Christos Gortsos

Georg Ringe

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a. Foreword

Edouard Fernandez-Bollo

The pandemic crisis linked to the COVID-19 virus is unprecedented, both as regards the velocity of its spread and its potential global impact. Few of us guessed anything about the coming dangers when the Chinese Government made its first announcement on 31 December 2019. It was not until February this year that economic forecasters began adjusting their predictions, at that point only mildly, based on the impact on China and the earlier experience with SARS. Only at the end of February did the world begin to realise the truly global economic impact of the situation, following the developments in Europe and the United States. The markets were very seriously disturbed over the first weekend in March, both those for key commodities like oil and those related to foreign currencies and financial assets. It must be underlined that after this turmoil, the reaction of the authorities was swift and massive. First at the central bank level, which succeeded in stopping the financial panic, but also at the political level: the strict measures taken to fight the spread of the virus were accompanied by the launch of massive support programmes to help manage the impact on the real economy.

These monetary and fiscal measures, which have played a key role in stabilising the financial systems, have also been complemented by decisive actions at the level of the regulatory/supervisory framework: important temporary

measures have been taken to increase the resilience of the financial system in the face of this largely unexpected pressure. ECB Banking Supervision, in particular, has adapted its framework in order to allow both financial intermediaries and supervisors to concentrate on the immediately essential firefighting tasks. It has also encouraged the use of all of the flexibility embedded in the accounting and prudential regulations to mitigate possible excessive pro-cyclical effects.

Financial intermediaries have suffered three immediate shocks and must prepare for two extremely significant further challenges. The spread of the crisis had an immediate impact on activities linked to the markets, and it triggered precautionary reactions on the part of the clients (drawing on facilities, for instance) and counterparties of financial intermediaries (reducing market funding). At the same time, there was the operational impact of the challenges of keeping financial operations and services running in the midst of the pandemic. These shocks have thus far been adequately absorbed thanks to the measures taken.

Beyond this first phase, however, lies the formidable challenge of the pandemic's economic impact, which is largely yet to materialise. Given the unprecedented nature of this crisis, this impact is rather complicated to measure today. It will depend mostly on the ability to restart economic activities while continuing to contain health risks to the population adequately. The figures published by international organisations are staggering: the baseline IMF scenario in April 2020 points to a 3 % contraction of the economy in 2020, far more severe than that during the 2009 financial crisis, with particularly acute shocks in specific sectors. All country-specific forecasts available at the beginning of May, however, point to a deeper recession. In April, the International Labor Organization

underlined that 1.25 billion workers, around 38 % of the global workforce, are active in the sectors most exposed to the present crisis. Reducing the scarring effects of the recession and ensuring the rapid pace of recovery once the pandemic fades is thus essential.

In this context, there are high expectations that financial intermediaries should not only withstand the shock, which this time around is clearly not endogenous to the financial system but also be an active part of the solution by supporting efforts against the recessive factors brought upon the real economy by the pandemic risk. For instance, IMF projections of a substantial recovery in 2021 (5.8 %) are subject not only to a continuation of the current extraordinary policy support but also to adequate renegotiations of loans granted by banks to households and firms while maintaining a transparent assessment of credit risk. More generally, this means that all financial intermediaries should be able to actively serve the economy while preserving the resilience and robustness of the financial system – as a supervisor let me emphasise that we should not forget, even for a moment, this basic principle of fostering financial resilience. The improvement in resilience since the last crisis is, of course, a precondition for being able to play a decisive role in the present one. And particularly in Europe, given the structural challenges to sustainability that the region's financial system already faced before the crisis, this means being able to use this emergence situation to improve the robustness of the diverse business models. In this context, I am personally convinced that it will be essential to ensure that the financial system in Europe emerges from this period of stress more integrated and with improved management of the costs and pricing of risks and increased awareness of its societal responsibilities.

To address this two-pronged challenge of fostering the recovery and increasing structural resilience, we urgently need fresh ideas to adapt our framework and practices. I am therefore thrilled to present a first outstanding contribution to this task by the European Banking Institute. It is remarkable already for its swiftness and adaptation to our current restricted circumstances in the areas of communication and collaboration. But most importantly, it is exceptional thanks to the quality of the contributors, combining academic excellence and first-hand knowledge of the practical issues of financial stability. Finally let me add that the breadth of the subjects presented here, from more technical analyses of some of the measures taken to mitigate the effects of the crisis to more general and overarching concerns about values and economic governance, will give the reader a truly global view of the issues we are facing, and which require decisive and collective European action. I very much welcome this excellent academic contribution of the EBI to the current policy debate.

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

b. Foreword

Elke König

The opening months of 2020 are in stark contrast to those of 2019. This time last year, certain commentators were flagging a slowdown in economic activity as a cause for concern, but few could have predicted the arrival of COVID-19. We do not know how long the pandemic will last, nor how quickly the economy will recover. COVID-19 and its economic impact in the medium term is a very large 'known-unknown'. Certainly, there are going to be challenges, but I am an optimist by nature, which is perhaps unusual for a regulator, as we are tasked with always erring on the side of caution.

Under guidance from regulators, Europe's banking industry, and indeed the global banking industry has achieved a lot in resolution planning in recent years, and it is in all of our interests that this work continues.

Since the beginning, the SRB has worked closely with many authorities, such as National Resolution Authorities, the European Central Bank, the European Commission, but also our international counterparts. Unlike the situation at the start of the 2007/8 financial crisis, we have a resolution framework and international cooperation in place, and I am sure that they will deliver positively no matter what is ahead of us. Indeed, in this publication, there are many fine examples of the expertise existing nowadays, when trying to chart the way forward, ensuring financial stability, for the good of our people.

Europe's financial authorities are monitoring and addressing the challenges due to the COVID-19 pandemic. The SRB toolbox is sufficient to address failing banks, and I firmly believe that the current resolution framework is fit for purpose – though of course, nothing is so good that it cannot be improved.

For our part, the SRB is adopting a pragmatic and common-sense approach as and when required. For example, on the issue of existing MREL binding targets, the SRB takes a forward-looking approach to banks that may face difficulties meeting those targets, before new decisions as part of the 2020 resolution cycle take effect. Our focus is on these 2020 decisions and targets, and we ask banks to continue their efforts to provide the necessary data on MREL for the upcoming cycle.

This approach provides banks with the flexibility they may need during these unusual times, while at the same time treating all players equally. We are committed to ensuring that short-term operational constraints do not prevent banks from lending to households, business and the real economy while at the same time ensuring that banks make progress on the journey towards resolvability.

There is much discussion too about further public aid to be considered if and when banks get under financial stress. This also includes a discussion of so-called 'precautionary recapitalisation of banks'. This tool was used once in 2017 and triggered then some reflection to clarify and tighten it. This tool is available within the legal framework, but only under strict conditions. It should not be given to banks without a sound business model simply to address legacy issues. I would be extremely concerned at any attempt to turn it into a 'bail-out in disguise'. Even if the nature of the current crisis prompts extraordinary taxpayer support to the real economy, we should

not have the taxpayer standing up for non-viable banks in a way that undermines the resolution framework.

The extraordinary situation created by the COVID-19 pandemic reminds us how important it is to achieve progress on reforms at the EU level. The instability now facing us means that we need to move forward on a range of files, including a common deposit insurance scheme, the operationalisation of the common backstop, a solution for liquidity in resolution, the completion of the Capital Markets Union, and better alignment between resolution and insolvency, including a liquidation regime for banks and a harmonised procedure for withdrawing a banking licence. The European Commission states in its Spring 2020 Economic Forecast1: 'A deep and uneven recession [and] an uncertain recovery'. Such a prediction should be the urge required to act and complete the Banking Union for once and for all. The completion of the Banking Union would in itself also account for an efficient response to the unfolding crisis by allowing bank lending to circulate on a truly cross-border basis. This would thus increase the cushion for those businesses and households most impacted by COVID-19. We need a united and timely response to the effects of COVID-19.

There can be no doubt but that there are difficult times ahead. While COVID-19 forces us to do our best to stay apart physically, it is by working together that we will be able to overcome these economic challenges. COVID-19 does not stop at the border, and neither should our response to the economic fallout from the pandemic.

Elke König is Chair of the Single Resolution Board.

[1] ec.europa.eu/commission/presscorner/detail/en/ip_20_799.

c. Foreword

Thomas Gstädtner

The coronavirus (COVID-19) crisis is, in many ways, unchartered territory. As Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, put it recently: 'We have a monster mash-up of the Great Depression in size, the crash of 1987 in speed, and the 9-11 attack in terms of fear.' It may be difficult to draw comparisons with past events but, when it comes to the economic impact, the numbers speak for themselves. For 2020, the IMF is predicting the global economy to shrink by 3 %, the advanced economies by 6.1 %, and the economies of the euro area by as much as 7.5 %, with the European Commission expecting a eurozone recession of 7.7 %. The level of unemployment provides another picture of the depths of this downturn and its speed. In the United States, the number of jobless benefits claims reached 30 million within weeks of the start of the crisis. In contrast, Germany witnessed 10 million applications for short-term employment (Kurzarbeit) – more than three times the number of claims than during the 2008-09 financial crisis – have been received. At this stage of the coronavirus crisis, it is not possible to determine whether the effects of the lockdown will turn out to be even worse than any of the predictions and whether we will see a V-shaped, U-shaped or L-shaped recovery in the economy.

On the positive side, it was impressive how fast supervisors, central banks and public authorities responded to this crisis.

Central banks across the globe moved emphatically to preserve financial stability through international cooperation. In Europe, the ECB has put in place a set of monetary policy measures to mitigate the impact of the coronavirus pandemic on the euro area economy. More specifically, it launched its €750 billion pandemic emergency purchase programme (PEPP), which aims to lower borrowing costs and increase lending in the euro area. Moreover, the ECB has further eased the conditions of the targeted longer-term refinancing operations (TLTRO III) and launched a series of new pandemic emergency longer-term refinancing operations (PELTROs) to follow the longer-term refinancing operations (LTROs) conducted since March. All three categories of refinancing operation aim to provide further liquidity to banks and the real economy. Finally, the ECB has increased the amount of money that banks can borrow by easing collateral standards, thereby expanding the list of assets that banks can use as collateral, and by reducing the haircut on collateral accepted.

From a supervisory perspective, the ECB has temporarily asked banks to take advantage of all regulatory flexibility allowed by the Capital Requirements Regulation in using capital and liquidity buffers under stressed circumstances, including full usage of the Pillar 2 Guidance and the re-composition of the quality of capital for the Pillar 2 Requirement. Additionally, European banking supervision has granted more flexibility in the application of the unlikely-to-pay classification for borrowers who are recipients of ad hoc governmental guarantees or for whom moratoria have been enacted. Furthermore, loans that have government guarantees and turn non-performing will receive more favourable treatment in terms of coverage requirements. European banking supervision is also giving banks more flexibility regarding supervisory timelines,

deadlines and procedures. All these measures will help euro area banks focus on playing their vital role as lenders during this extraordinary period.

On the regulatory side, the European Banking Authority (EBA) first of all is encouraging supervisory authorities to use all regulatory flexibility in capital for liquidity requirements. The EBA also issued a statement making clear that the public and private moratoria, in response to the coronavirus pandemic, do not have to be automatically classified as forbearance measures, as in IFRS 9 and the definition of default. Finally, the EBA has proposed changes to the calculation of additional value adjustments in order to avoid a strong pro-cyclical effect on these adjustments due to the extreme levels of volatility in the current environment. The European Commission, for its part, is complementing many of the ECB's and EBA's measures and is now working on specific amendments to the Capital Requirements Regulation that aim, among other things, to mitigate the impact of IFRS 9, to bring forward a revised supporting factor for small and medium-sized enterprises, and to postpone the date for applying the leverage ratio to 1 January 2023.

Looking at all those measures, it needs to be seen whether they are sufficient to ensure that the economic crisis does not evolve into a financial crisis like the one in 2008-09. Seen from the perspective of the banking sector, however, the situation is very different from the one in 2008. Banks' capital levels are by far higher than ten years ago and, by and large, banks have been very successful in reducing their levels of non-performing loans. Does this now mean that supervisors and regulators can ease up given the measures already taken? By no means! The scale of the recession in the real economy, despite all the measures taken by the Member States individually and jointly

through a number of initiatives (the European Stability Mechanism, European Investment Bank guarantees and SURE – Europe-supported short-time work), will take its toll also in the financial services industry in the form of higher volumes of non-performing loans and lower liquidity and capital ratios. It also becomes clear that the link between banks and 'their' sovereigns is still alive. This link is usually seen as negative by markets, if and when either the banks or the states – and in the worst case both – are perceived as particularly weak. Taking this into account, it is patent that there is still a way to go in creating a proper European banking union, also from a regulatory perspective. A true banking union, however, would be an essential requisite to mitigate the risk that an idiosyncratic crisis involving several banking institutions were to evolve via their sovereign into a proper systemic crisis affecting financial stability in the euro area and beyond. Research for several federal states (e.g. the United States and Canada) emphasises the importance of integrated capital and credit markets as shock absorbers in a currency union. Such buffers help to ensure that institutions' financial risks remain idiosyncratic rather than becoming systemic. Therefore, work on completing the banking union and creating a proper capital market union should be a key priority. Achieving these goals would also – and this seems to be a focal point in the current policy discussion – create a stronger and more stable basis for the decentralised fiscal policy that was agreed in the Treaty of Maastricht.

I am delighted that the European Banking Institute is publishing its first eBook titled 'Pandemic crisis and financial stability'. This edition gathers together a body of research on the coronavirus crisis from many different academics across Europe. It reflects the different opinions in Europe on the topics

currently being debated and aims to enrich the discussion in this field.

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SECTION I: THE BROAD PICTURE

1 Is the European Union going to help us overcome the COVID-19 crisis?

Danny Busch[1]

1. Introduction

In the blink of an eye, the coronavirus (COVID-19) has completely paralysed the world economy. Restaurants, hotels, bars, theatres, cinemas and concert halls have closed their doors and their income has dried up. Events have been cancelled, and the aviation and tourism industries have come to an almost complete standstill. Demand for oil has largely dried up. As businesses in the directly affected sectors have suddenly ceased

[1] My thanks are due to Bart Bierens, Seraina Grünewald, Arthur van der Hurk, Marije Louisse, Mirik van Rijn, and Victor de Srière for their valuable comments on previous versions of this article. The present version of this article was completed on 10 May 2020. No account could be taken of developments since that date.

to generate income, they are no longer able to pay their employees, banks, landlords and suppliers, throwing the economy into a downward spiral. This in turn is reducing tax revenue, putting extra pressure on government finances. The consequent uncertainty has caused extreme volatility in the financial markets.

The lockdown restrictions are currently being cautiously lifted again, but the economic impact will be felt for a long time to come. A deep global recession seems inevitable. This is in any event the provisional analysis of the International Monetary Fund (IMF), as it believes the global economy will shrink this year by 3 % and the economy of the eurozone by 7.5 %. This would make it the worst crisis since the 1930s, and for Europe possibly the worst crisis ever.[2] And this is just the mild scenario, predicated on the IMF's assumption that the pandemic will gradually recede in the second half of this year (despite the fact that many leading virologists expect a second and even a third wave of the coronavirus).[3] The European Central Bank (ECB) now expects the eurozone economies to contract by between 5 % and 15 %.[4]

Feverish consultations are under way at all levels of our globalised world order to decide on measures to tackle this unprecedented crisis. As always, a great deal of consultation

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[2] Matina Stevis-Gridneff and Jack Ewing, 'EU is Facing Worst Crisis Ever. Watch Out, World.' *The New York Times* (6 May 2020).

[3] IMF, 'World Economic Outlook, April 2020: The Great Lockdown' (14 April 2020). <www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020>. See, for example, *HLN*, 'Duitse autoriteit op vlak van infectieziekten verwacht tweede en derde besmettingsgolf' (German infectious diseases authority expects second and third wave of infections) (<www.hln.be/nieuws/buitenland/duitse-autoriteit-op-vlak-van-infectieziekten-verwacht-tweede-en-derde-besmettingsgolf~a00e92c8/>).

[4] See *FD* 24 April 2020, '*Coronacrisis deelt mokerslag uit aan economie*' (Corona crisis delivers sledgehammer blow to the economy).

and advice is being provided at the international level, for example by the World Health Organisation (WHO) and at the meetings of the G20 and G7. The IMF and its sister organisation the World Bank are providing concrete financial support as well. The IMF's current lending capacity is USD 1,000 billion. No fewer than 189 countries are members of the IMF. Over 100 countries have already applied for emergency financial aid.[5] The World Bank focuses largely on providing aid to Africa and developing countries elsewhere, and has currently made a maximum of USD 160 billion available.[6]

No matter how mind-boggling these amounts may be, the concrete actions are being taken mainly at national level. Examples are the various forms of financial support for businesses and people currently sitting at home jobless, as well as tax payment deferrals.[7] According to IMF estimates, national governments have already spent about USD 8,000 billion on containing the crisis, and this amount is certain to rise as the

[5] See Kristalina Georgieva, 'Confronting the Crisis: Priorities for the Global Economy' IMF Speech (9 April 2020) <www.imf.org/en/News/Articles/2020/04/07/sp040920-SMs2020-Curtain-Raiser>; <www.linkedin.com/feed/news/half-of-countries-seek-imf-loans-4811820/> (16 April 2020); Kristalina Georgiev, 'IMF Adds Liquidity Line to Strengthen COVID-19 Response' (15 April 2020) IMF Statement <www.imf.org/en/News/Articles/2020/04/15/pr20163-imf-adds-liquidity-line-to-strengthen-covid-19-response>.

[6] See World Bank, 'The World Bank Group Moves Quickly to Help Countries Respond to COVID-19' (2 April 2020) <www.worldbank.org/en/news/feature/2020/04/02/the-world-bank-group-moves-quickly-to-help-countries-respond-to-covid-19>.

[7] For an overview of the measures taken by the European Union (EU) and its Member States, see <www.esrb.europa.eu/home/coronavirus/html/index.en.html> (17 April 2020); for a list of the measures worldwide, see: <www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19> (17 April 2020).

various national rounds of emergency support are now following one another in quick succession.[8]

Governments are not shunning unconventional measures to finance all their additional expenditure. For example, the Bank of England has already switched to monetary financing.[9] In other words, the British central bank is lending money to the British government to finance measures to combat the coronavirus crisis. Normally, the United Kingdom would have to borrow money for this by selling government bonds to the investing public through the capital markets. Monetary financing is highly controversial, since it increases the total amount of money in circulation. In extreme cases, this can lead to hyperinflation of the kind that affected Zimbabwe (2006-2009) and Venezuela (since 2018). Monetary financing can also undermine the independence of the central bank.[10]

And what action has the European Union (EU) taken to deal with the coronavirus crisis? Public health and national security may be areas of national policy, but a lot of hard work is also going on at the European level. But, as ever, this is being done in typical Brussels fashion. That is to say, much is done in a process of trial and error, and the really important decisions are put off until the pressure becomes so great that they have to be taken to avert disintegration of the Union. The obvious

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[8] See Georgieva (n 5).

[9] See <www.gov.uk/government/news/hm-treasury-and-bank-of-england-announce-temporary-extension-of-the-ways-and-means-facility> (9 April 2020). The Bank of England is also taking all kinds of other measures to deal with the coronavirus crisis; see: <www.bankofengland.co.uk/coronavirus>. It should be noted that monetary financing is now spreading rapidly throughout the world. See, for example, *FD* 29 April 2020, 'Ook Indonesië doe nu aan monetaire financiering' (Indonesia too now engaged in monetary financing).

[10] See *FD* 9 April 2020, '*Britse centrale bank gaat bestrijding coronacrisis direct financieren*' (British central bank to finance anti-coronavirus crisis measures directly).

comparison is to the eurozone debt crisis (2009-2012), although then the process of taking important European decisions proved excruciatingly slow. Clearly, however, this was another 'sink or swim' moment for the EU, or in any event for the eurozone. Unlike its British counterpart, the ECB does not have the power to directly finance national governments or the EU by purchasing government bonds as soon as they are issued[11], but it was and still is able to do something very similar. The ECB managed to save the euro in 2012 by declaring that it was willing to buy government bonds of the eurozone countries on a massive scale through the secondary markets (this was the famous 'whatever it takes' pronouncement of the then ECB president Mario Draghi[12]). The ECB actually started implementing this policy in 2015.[13] In this way, interest rates on these government bonds were kept under control, and the government deficits run up as a result of the massive financial support for ailing national banking sectors could continue to be financed by the eurozone countries on reasonable terms through the issuance of government bonds. Since then, the ECB has never actually stopped its indirect purchases of eurozone government bonds. On 24 March, the ECB decided to take matters a stage further by waiving certain restrictions imposed by previous asset purchase programmes, on this occasion to ensure that the Member States were able to continue financing their massive support programmes during the pandemic (the

[11] See Article 123 (1) of the Treaty on the Functioning of the European Union (TFEU).

[12] See, <ecb.europa.eu/press/key/date/2012/html/sp120726.en.html>(26 July 2012).

[13] For a list of all the asset purchase programmes, see: <ecb.europa.eu/mopo/implement/omt/html/index.en.html>.

Pandemic Emergency Purchase Programme (PEPP), which is dealt with below in section 12).[14]

The procedure adopted by the ECB for this type of asset purchase programme is roughly as follows. In cooperation with the national central banks of the eurozone, it purchases government bonds on the secondary market from the commercial banks, which in turn buy them from their government upon issuance. Not only does this keep interest rates on government bonds low, but it also creates room on commercial bank balance sheets to issue new loans to businesses and households. In this way, the ECB hopes to stimulate economic activity and raise the rate of inflation up to its target figure of just under 2 %. This constitutes price stability, which is the main objective of the monetary policy with which the ECB is charged.[15] That, at any rate, is the theory, but it by no means goes unchallenged, because there remains considerable doubt about the effectiveness of this type of asset purchase programme.[16]

Be that as it may, the Court of Justice of the European Union (CJEU) confirmed, in response to requests from the German Constitutional Court (*Bundesverfassungsgericht*) for a preliminary ruling on previous asset purchase programmes, that they are, in principle, permitted, basically because their primary purpose is maintaining price stability. The mere fact that such

[14] See ECB, 'ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)' (18 March 2020) <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html>; Decision (EU) 2020/440 of the ECB of 24 March 2020.

[15] See Articles 119 (2) and 127 (1) of the TFEU.

[16] For more about this, see, e.g., Wim Boonstra, 'Over kwantitatieve verruiming, monetaire financiering en helikoptergeld' (23 June 2016) <economie.rabobank.com/publicaties/2016/juni/over-kwantitatieve-verruiming-monetaire-financiering-en-helikoptergeld/>.

purchase programmes also provide economic support for the eurozone countries does not necessarily mean that they violate the monetary financing prohibition. In its final judgment in the Gauweiler case, the German Constitutional Court had accepted – albeit reluctantly – this judgment of the CJEU, and many hoped that it would do the same in the Weiss case.[17] However, things turned out differently, because on 5 May 2020 the Constitutional Court ruled that the ECB had exceeded its mandate by initiating an asset purchase programme known as the Public Sector Purchase Programme (PSPP), or alternatively as the Quantitative Easing (QE) Programme, in 2015. The German Constitutional Court arrived at this judgment, in brief, because the underlying ECB decision was not assessed sufficiently rigorously by reference to the European principle of proportionality. The Constitutional Court has given the ECB three months in which to adopt a new decision based on better reasoning. If the ECB fails to do so, the *Bundesbank* will no longer be allowed to participate in the PSPP.[18] This is a historic ruling because it is the first time the German Constitutional Court has declared a judgment of the CJEU to be ultra vires.[19] This means that the long dormant power struggle between the

[17] See CJEU judgment of 16 June 2015, C-62/14 (Gauweiler); CJEU 11 December 2018, C-493/17 (Weiss). In these cases, CJEU was asked to consider whether EU organs, including the ECB, had acted ultra vires. For more about this, see: Victor de Serière, 'Enkele opmerkingen over EU crisismaatregelen', *Ondernemingsrecht* 2020/IX; Victor. de Serière, 'Het Bundesverfassungsgericht en de Europese Banken Unie', Ondernemingsrecht 2019/172 (both with further references).

[18] BVerfG, *Urteil des Zweiten Senats vom 06. Mai* BVG2020 BV, Rn. 116 et seq., see <www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/DE/2020/05/rs20200505_2bvr085915.html>.

[19] But it is not the first time that a national supreme or constitutional court has declared a judgment of the CJEU ultra vires. See Daniel Sarmiento, *Requiem for Judicial Dialogue – The German Federal Constitutional Court's judgment in the Weiss case and its European implications*, p. 13, <eulawlive.com/weekend-edition/weekend-edition-no16/>.

German Constitutional Court on the one hand and the CJEU and the ECB on the other has now flared up in all its intensity. If the ECB complies with the Constitutional Court's request, this will undermine not only the independence of the ECB, but also the supremacy of the CJEU. Generally speaking, the CJEU never comments on judgments of national courts, but following the judgment delivered by the German Constitutional Court it issued a press release on 8 May, in which it recalled that (i) preliminary rulings of the CJEU are binding on national courts, and (ii) the CJEU alone has jurisdiction to rule that an act of an EU institution is contrary to EU law, as the unity of the EU legal order and legal certainty would otherwise be placed in jeopardy.[20] Shortly afterwards the European Commission announced that it considers infringement proceedings against Germany.[21] The ruling of the Constitutional Court in any event also calls into question the legitimacy of the recently started PEPP (see section 12 below).

Another point that should be noted here is the rapid creation of the European Banking Union (EBU) in response to the eurozone crisis. This meant that the significant banks in the eurozone were placed under the direct prudential supervision of the ECB (first pillar of the Banking Union). In the event of their failure, a European authority (the Single Resolution Board or SRB) is responsible for their orderly resolution (second pillar).[22] Had it not been for the eurozone crisis, this historic transfer of competences from the national to the European level would never have occurred. So a crisis can also result in greater

[20] Press release following the judgment of the German Constitutional Court of 5 May 2020 (No 58/20) (8 May 2020).
[21] See <ec.europa.eu/commission/presscorner/detail/en/y STATEMENT_20_846> (10 May 2020).
[22] For more about this, see, for example, Danny Busch and Guido Ferrarini, *European Banking Union* (2nd ed., OUP 2020) (with further references).

centralisation. It is not for nothing that the idea of Eurobonds now features prominently once again on the European political agenda. But there are also important differences between the present crisis and the eurozone crisis. The eurozone crisis had its origins in the 2008 financial crisis, which subsequently impacted national governments and the rest of the economy. By contrast, the current crisis is a healthcare crisis, which is engulfing the economy as a whole, including the financial sector. Moreover, according to the IMF, the losses are now much greater than in 2008.[23]

What follows is a discussion of the most noteworthy measures taken or yet to be taken by the EU to combat the coronavirus crisis. Basically, the measures fall into the following categories: (i) flexible application of EU rules that could hinder Member States in their strenuous efforts to save their national economies (sections 2 to 4); (ii) a financial support package put in place by the EU itself (sections 5 to 11), (iii) monetary action by the ECB (section 12) and (iv) action by European financial regulators, including the ECB (albeit in its capacity of banking regulator rather than monetary authority) (section 13)[24]. This is followed by some comments on the impact of the coronavirus crisis on the intended completion of the European Banking Union (section 14), the plans for a European capital market union (section 15), Brexit (section 16) and the EU climate plans (section 17). Lastly, I make some concluding remarks (section 18).

[23] See IMF (n 3).

[24] As regards the various measures dealt with below in sections 2-13, see also: Christos Gortsos, 'The EU policy response to the current pandemic crisis through the lens of the Eurogroup Report of 9 April 2020: overview and assessment' (21 April 2020) <ssrn.com/abstract=3579010>; de Serière, Enkele opmerkingen (n 17).

2. Relaxation of the Stability and Growth Pact (SGP)

In the 1997 Stability and Growth Pact (SGP), EU Member States agreed that their national budgets should always be in balance. Eurozone Member States agreed on stricter rules to ensure the stability of the euro. After all, eurozone countries in which public sector deficits rise will have to pay higher interest rates on their government bonds, thereby possibly weakening the euro due to excessive inflation. Specifically, it was agreed that a budget deficit should not exceed 3 % of gross domestic product (GDP) and the total public debt should not exceed 60 % of GDP. It is no secret that these rules are regularly breached. Sanctions can then be imposed, for example in the form of a fine, but in practice this never happens.[25] Usually, the European Commission (and the other eurozone countries) make do with issuing a warning, making recommendations and, above all, engaging in a lot of grumbling. So on that score, anyway, there seems little cause for disquiet. Moreover, no matter how strict the budget rules may be in theory, they can be temporarily suspended in periods of severe economic difficulty for the euro area or the Union as a whole. Given the gravity of the coronavirus crisis, this is undoubtedly now the case. On 20 March, the European Commission therefore announced that in its view the conditions for activating this general escape clause had been met.[26] And on 9 April, the Eurogroup signalled its agreement.[27] Member States thus have the requisite flexibility, even under the SGP, to support the national economy.

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[25] See Articles 121, 126 and 136 of the TFEU and the accompanying Protocol (No. 12). There is also a certain amount of secondary legislation.

[26] EC, 'Communication from the commission to the council on the activation of the general escape clause of the Stability and Growth Pact' (Communication) COM(2020) 123 final.

[27] See points 19-21 of the Eurogroup's press release of 9 April 2020 (<www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-

3. Relaxation of EU rules on State aid

But these are not the only EU rules with which Member States are currently having to contend. In the absence of an adequate EU budget, the bulk of the financial aid must be provided by the Member States themselves. This inevitably brings EU State aid rules into play.[28] To ensure that national governments can act swiftly and know what is allowed during the coronavirus crisis, the European Commission published a specific temporary State aid framework (Temporary Framework) on 19 March, setting out, among other things, what measures do *not* constitute prohibited State aid in the current circumstances: (i) liquidity support for businesses that does not exceed EUR 800,000; (ii) state guarantees on bank loans to businesses; (iii) direct state loans to businesses at reduced interest rates; (iv) the provision of short-term export credit insurance by the state if such cover is no longer available from private insurers.[29]

On 4 April the Temporary Framework was extended to include the following types of measures that do *not* constitute State aid: (i) support for coronavirus-related research and development (vaccines and medicines); (ii) support for the construction and upscaling of testing facilities; (iii) support for the production of vaccines and medicines; (iv) targeted support in the form of deferral of tax payments and/or suspensions of social security contributions; (v) support in the form of wage subsidies for

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the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/>). The Eurogroup is an informal consultative body consisting of the finance ministers of the 19 eurozone countries. On 9 April, however, the Eurogroup met 'in its inclusive format', in other words augmented by the finance ministers of the non-eurozone Member States. For more about this, see Gortos (n 24).

[28] See Articles 107-109 TFEU.

[29] See EC, 'Communication from the commission – Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' (Communication) COM(2020) 1863 final.

employees.[30] On 8 May the Commission extended the scope of the Temporary Framework still further to allow for the recapitalisation of ailing companies, albeit subject to strict conditions.[31] Since in times of crisis the main concern is safeguarding the national interest rather than the smooth functioning of the internal market, it seems certain that, despite this relaxation, the European rules on State aid rules will not always be fully complied with during the crisis. Moreover, the fact that the northern Member States have deeper pockets than their southern neighbours means that the inequality is bound to increase.[32] It should be noted, by the way, that the Commission is currently handling applications under State aid rules with unprecedented speed and applying the rules in a generous spirit.[33]

4. Relaxation of EU rules on public procurement

Member States are currently making every effort to purchase face masks, protective gloves, ventilators and other medical supplies on a large scale in order to tackle the pandemic. In doing so, they must comply with European rules on public procurement. To enable governments to act quickly and know what is and what is not permitted, the European Commission published guidance on 1 April to explain how the EU public

[30] EC, 'Communication from the Commission Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' (Communication) 2020/C 112 I/01.

[31] EC, 'Communication from the Commission - Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' (Communication) C(2020) 3156 final.

[32] See *FD* 1 May 2020, '*Brussel vreest groeiende kansenongelijkheid voor Zuid-Europese bedrijven*' (Brussels fears growing inequality of opportunity for south European businesses).

[33] For the ever longer list of coronavirus-related State aid decisions, see: <ec.europa.eu/competition/state_aid/what_is_new/covid_19.html>.

procurement framework can be used as flexibly as possible in this emergency.[34]

5. Coronavirus Response Investment Initiative (CRII)

All the EU measures I have described above are intended to facilitate the provision of State aid at national level as much as possible. In addition, the EU is deploying its own resources to combat the crisis (which are, of course, paid for indirectly by the Member States). First, there is the Coronavirus Response Investment Initiative (CRII), which has been in force since 1 April. This allows EUR 37 billion of cohesion policy funding to be used to tackle the consequences of the coronavirus crisis. In addition, the scope of the EU Solidarity Fund has been broadened to such an extent that it can also be used in public health crises. Since 1 April the worst affected countries have thus been given access to additional financial assistance of up to EUR 800 million for 2020.[35] On 2 April, the Commission made proposals to allow EU funds to be used even more flexibly (CRII+), for instance by (i) enabling transfers between cohesion policy funds, categories of region and policy objectives, (ii) waiving the obligation for national co-financing, and (iii) supporting the most vulnerable in society, for example by providing food packages.[36] CRII+ entered into force on 24 April.[37]

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[34] EC, 'Communication from the Commission - Guidance from the European Commission on using the public procurement framework in the emergency situation related to the COVID-19 crisis' (Communication) 2020/C 108 I/01.
[35] See <ec.europa.eu/regional_policy/en/newsroom/coronavirus-response/>.
[36] See <ec.europa.eu/regional_policy/en/newsroom/news/2020/04/04-02-2020-coronavirus-response-investment-initiative-plus-new-actions-to-mobilise-essential-investments-and-resources>.
[37] See <www.consilium.europa.eu/en/press/press-releases/2020/04/22/covid-19-more-flexibility-for-deploying-eu-budget-money/?utm_source=dsms-

6. Emergency Support Instrument (ESI) and rescEU medical equipment capacity

But more European support is being prepared. The European Commission wishes to support health care directly in the Member States – something which has also been welcomed by the Eurogroup.[38] The Commission intends to make available for this purpose a sum of EUR 3 billion from the EU budget, of which EUR 2.7 billion will be spent through re-activation of the Emergency Support Instrument (ESI) and EUR 300 million through the rescEU medical equipment capacity. The Commission is encouraging the individual Member States to help maximise the effectiveness of these instruments. Individuals and foundations can also contribute to this, possibly through crowdfunding. The Commission will use the funds for a variety of purposes, including (i) central procurement and distribution of medical supplies such as face masks and respiratory equipment, (ii) transport of medical equipment and patients in cross-border regions, (iii) construction of mobile field hospitals. In the medium and long term, the Commission intends to use the funds to increase coronavirus testing capacity and fund coronavirus research.[39]

7. Eurobonds and corona bonds

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auto&utm_medium=email&utm_campaign=COVID-19%3a+More+flexibility+for+deploying+EU+budget+money>.

[38] Point 14 of the Eurogroup press release of 9 April 2020 (*supra*, n 27).

[39] The underlying draft legislation and other relevant information can be accessed at <ec.europa.eu/commission/presscorner/detail/en/qanda_20_577> (2 April 2020). See also the Commission's contribution to the Coronavirus Global Response Pledging Event: EC, 'Coronavirus Global Response: €7.4 billion raised for universal access to vaccines' (4 May 2020) <ec.europa.eu/commission/presscorner/detail/en/ip_20_797>.

As already noted, just as in 2012 during the eurozone crisis, the idea of Eurobonds once again features prominently on the European political agenda, albeit this time in the form of 'corona bonds'. Eurobonds are bonds issued jointly by the euro countries. The participation of very creditworthy countries such as Germany and the Netherlands would mean that the interest on such bonds would be relatively low and therefore attractive to south European countries such as Italy and Spain. The north European countries have so far always blocked the issuance of Eurobonds. Not only would they then have to pay a higher interest rate than on their own government bonds, but they would also be exposed to the tax risks of other countries. This is because if one of the participating countries defaults on its repayment or interest obligations, the other eurozone countries would be saddled with these costs.

Corona bonds are a specific form of Eurobonds because they are limited in time, scope and type of expenditure. The issuance of corona bonds would allow countries such as Italy and Spain to borrow money at a lower interest rate than by issuing their own government bonds. South European countries could only use the proceeds from such an issuance to finance national measures designed to mitigate the damage caused by the pandemic, such as financial support for businesses. Although the Eurogroup finally managed, with the utmost difficulty, to reach agreement on a support package in the evening of 9 April, corona bonds were not part of it. The Netherlands, Germany, the Baltic States, Finland and Austria were unwilling to agree to this proposal. So does this mean that the idea of corona bonds is definitely off the table? Certainly not, because countries such as Italy and France have decidedly not yet given up their fight to introduce corona bonds. Moreover, the Eurogroup final statement contains an ominous reference to 'innovative

financial instruments'. The Dutch Minister of Finance Wopke Hoekstra maintains that this is in any event not a reference to Eurobonds, but, according to his French counterpart Bruno Le Maire, the only innovative instrument that does not yet exist is joint debt.[40] In other words, in typical Brussels fashion, the truly sensitive decisions have been postponed until some future date. See section 11 below.

8. Pandemic Crisis Support

If the main components of the support package decided by the Eurogroup on 9 April are not Eurobonds, what are they? First, the conditions on which eurozone countries can borrow money through the European Stability Mechanism (ESM) have been partially relaxed. Countries that need money can borrow it from the ESM without conditions, as long as it is used for healthcare. The southern countries, led by Italy, also wanted to be able to borrow money without conditions to aid the recovery of their economies after the pandemic ends, but this is allowed on the usual conditions only if the borrower promises to reform its economy. A country drawing on the ESM can borrow an amount of 2 % of its GDP at end-2019. If all 19 eurozone countries were to use the ESM credit line, the total amount available for healthcare (Pandemic Crisis Support) would be EUR 240 billion.[41] However, the northern countries will not

[40] See Bert van Slooten, 'Dit zijn de winnaars en verliezers van het Europees akkoord'(10 April 2020) <nos.nl/artikel/2330008-dit-zijn-de-winnaars-en-verliezers-van-het-europees-akkoord.html?utm_campaign=Brussel%20Inside&utm_medium=email&utm_source=Revue%20newsletter>.

[41] Point 16 of the Eurogroup press release of 9 April 2020 (*supra*, n 27); <www.esm.europa.eu/content/europe-response-corona-crisis>; <www.consilium.europa.eu/nl/press/press-releases/2020/05/08/eurogroup-statement-on-the-pandemic-crisis-support/> (8 May 2020).

avail themselves of this credit line because they do not need it.[42] And whether the southern eurozone countries will draw on this credit line remains to be seen. In his first statement about the support package to his national parliament, Italy's Prime Minister Giuseppe Conte said that he would not apply for ESM support and would continue to press for Eurobonds.[43]

9. Pan-European Guarantee Fund

The second main component of the Eurogroup's support package is a pan-European guarantee fund of EUR 25 billion created by the European Investment Bank (EIB). A total of EUR 200 billion in entrepreneurial loans can be provided under this fund. This is in addition to the EUR 40 billion already made available by the EIB on 16 March. The EIB formally approved the operationalisation of the new guarantee fund on 16 April. It is primarily (but not exclusively) intended to support small and medium-sized enterprises (SMEs) in the EU. The credit granted on the basis of these guarantees is to be provided, in part, through the intermediary of the national banking sector and the national authorities (national promotional institutions).[44]

10. Support to mitigate Unemployment Risks in an Emergency (SURE)

The third main component of the Eurogroup's support package is a fund of EUR 100 billion for short-time working and

[42] See <www.esm.europa.eu/sites/default/files/issuer_comment_-_european-stability-mechanism-esm_-_24apr20.pdf>.
[43] See <www.getrevue.co/profile/Brusselinside/issues/brussel-inside-de-lijdensweg-238427?utm_campaign=Issue&utm_content=view_in_browser&utm_medium=email&utm_source=Brussel+Inside> (12 April 2020).
[44] Point 15 of the Eurogroup press release of 9 April 2020 (n 27); for further information, see <www.eib.org/en/about/initiatives/covid-19-response/index.htm> (16 April 2019).

unemployment benefit. Social security is, in fact, a national competence, but because the coronavirus crisis is an 'exceptional occurrence' within the meaning of Article 122 (2) of the TFEU, the EU may nevertheless provide financial assistance. On 2 April, the European Commission made a proposal on this legal basis for a 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'.[45] SURE works roughly as follows. Affected Member States can borrow money through this fund on favourable terms. Part of the fund, equal to 25 % of the loans granted, is covered by guarantees issued by the Member States, which contribute in line with their share in the EU's GDP. This proposal too was welcomed by the Eurogroup on 9 April, although the final statement does emphasise that it is a temporary measure and should not be seen as the prelude to a European social security system.[46]

11. Recovery Fund

The support package agreed by the Eurogroup on 9 April and confirmed by the European government leaders at their special summit on 23 April[47] thus amounts in total to a maximum of EUR 540 billion, but little if any use is likely to be made of the EUR 240 billion that can theoretically be lent through the ESM (see section 8). This leaves an amount of EUR 300 billion.

[45] EC, 'Proposal for a 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) COM(2020) 139 final.

[46] See point 17 of the Eurogroup press release of 9 April 2020 (n 27).

[47] See <www.consilium.europa.eu/en/press/press-releases/2020/04/23/conclusions-by-president-charles-michel-following-the-video-conference-with-members-of-the-european-council-on-23-april-2020/>.

While that may sound a lot, in reality it is little more than a drop in the ocean. The financial situation is becoming increasingly acute, especially for southern eurozone countries such as Italy, Spain and Greece. So much so, in fact, that they may possibly be unable to overcome the coronavirus crisis on their own. Their national debt was already high and is now rising further at breathtaking speed (although this is also true, of course, of the northern countries). Despite the ECB's Pandemic Emergency Purchase Programme (PEPP) (see section 12 below), the interest rates that these Member States have to pay on their government bonds are still rising,[48] while their tax revenues will continue to fall as the economy slumps. Moreover, these countries depend for a considerable part of their GDP on tourism, and tourists are staying away for the time being. Not only because they are currently not welcome on account of the lockdowns, but also out of fear of the virus. Another factor is the impact of the crisis on the incomes of the hordes of holidaymakers from the northern Member States, many of whom will stay away for that reason as well.[49] The Eurogroup too is aware of this, which is why the final statement included a passage that a European reconstruction fund (Recovery Fund) should be created. The Eurogroup remains vague about the exact legal structure, the relationship with the new European multiannual budget (2021-2027) and, especially, the manner of

[48] *FD* 18 April 2020, '*Renteverschillen lopen op, Europese aanpak ontbreekt'* (Interest rates rising. European approach lacking); FD 22 April, '*Forse renteopslag Italië wekt massale interesse beleggers'* (Big Italian interest rate hike arouses massive interest among investors).

[49] See Eline de Zeeuw, 'Zo kijken de vijf populairste Europese vakantielanden naar komende zomer' (19 April 2020) <nos.nl/artikel/2330959-zo-kijken-de-vijf-populairste-europese-vakantielanden-naar-komende-zomer.html>.

financing. And, as already noted, the final statement contains a reference to the use of 'innovative financial instruments'.[50]

The knives were already out in the run-up to the summit of European government leaders on 23 April. European Commissioner Valdis Dombrovskis announced in the German business newspaper *Handelsblatt* that the European Commission was contemplating the idea of a reconstruction fund of EUR 1,500 billion. This short-term fund would have to raise money on the capital markets through bonds guaranteed by the eurozone countries. The fund could then lend the money on favourable terms to those Member States that need it to restore their corona-ravaged economies.[51] France is one of the countries that endorses this plan.[52] In a non-paper issued prior to the summit, Spain put forward the idea that the Recovery Fund should provide grants rather than loans to Member States in need so as to avoid raising their national public debt to excessive levels. It argued that the fund should be financed through the issue of perpetual EU debt, i.e. through bonds that never have to be redeemed and on which only interest is payable.[53]

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[50] Point 15 of the Eurogroup press release of 9 April 2020 (n 27).

[51] Ruth Berschens, 'Schlimmer als nach der Finanzkrise – EU plant billionenschweren Wiederaufbaufonds' *Handelsblatt* (14 April 2020) (Worse than after the financial crisis - EU plans multi-billion dollar reconstruction fund); *FD* 15 April 2020, '*Brussel broedt op groot 'wederopbouwfonds' via uitgifte eurobonds'* (Brussels brooding on the idea of a large 'reconstruction fund' through issuance of Eurobonds).

[52] *FD* 18 April 2020, '*Renteverschillen lopen op, Europese aanpak ontbreekt'*.

[53]See Carlos E. Cué and Bernardo de Miguel, 'Spain proposes a €1.5 trillion coronavirus recovery fund financed through perpetual EU debt' *El Paìs* (20 April 2020) <english.elpais.com/politics/2020-04-20/spain-proposes-a-15-trillion-coronavirus-recovery-fund-financed-through-perpetual-eu-debt.html>.

After the summit, the government leaders announced that (i) they were working to establish a recovery fund, (ii) they recognised the urgency of it, (iii) the fund should be of sufficient size, (iv) the fund should be targeted towards the sectors and geographical parts of Europe most affected, and (v) the Commission should now come up with concrete proposals.[54] At the press conference after the summit, Commission President Van der Leyen immediately announced that she wanted to raise at least EUR 1,000 billion in loans through the capital markets, with the Member States being required to guarantee the loans. It is still unclear how these amounts should be channelled to the affected Member States (loans, grants or some hybrid form). The Commission promises to put forward concrete plans in May, at which point it will become clear whether it has managed to devise an approach that meets with the approval of both the northern and the southern Member States.[55]

12. Pandemic Emergency Purchase Programme (PEPP)

As already noted in the introduction, the ECB began the PEPP, a new asset purchase programme, on 24 March, on this occasion to ensure that the massive COVID-19 support operations mounted by the Member States could continue to be financed. As the ECB is purchasing the government bonds on the secondary market from the commercial banks, this is also creating lending capacity on the balance sheets of commercial banks for the provision of new loans to businesses and

[54] See <www.consilium.europa.eu/en/press/press-releases/2020/04/23/conclusions-by-president-charles-michel-following-the-video-conference-with-members-of-the-european-council-on-23-april-2020/> (23 April 2020).
[55] See *FD* 24 April 2020, '*Brussel wil de markt op om coronacrisis te bestrijden*' (Brussels wants to enter the market to combat the coronavirus crisis).

households.[56] As already noted, significant doubts remain as to the effectiveness of this type of asset purchase programme. Although this is indeed a way of creating lending capacity on the balance sheets of commercial banks, it is to be hoped that they will lend only to parties that are essentially creditworthy, for one thing because they may otherwise be in danger of breaching their duty of care on account of imprudent lending (overextension of credit).[57] Naturally, however, the situation may be very different if the loans are fully covered by government guarantees. In any event, the creditworthiness of many businesses and households in the eurozone is in a parlous state as a consequence of the crisis, despite all the financial support offered by the Member States and the EU. According to the IMF, it is quite possible that lending may be impaired by a global credit crunch if the pandemic does not fade away in the

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[56] See <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html> (18 March 2020); Decision (EU) 2020/440 of the ECB of 24 March 2020. To ensure that banks can continue to lend money to the real economy, the ECB has also relaxed the conditions on which banks, in turn, can borrow money from the ECB. See <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200312_2~06c32dabd1.en.html> (12 March 2020); <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200312_1~39db50b717.en.html> (12 March 2020); <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200407~2472a8ccda.en.html> (7 April 2020); <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200422_1~95e0f62a2b.en.html> (22 April 2020); Guideline (EU) 2020/XX of the ECB 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). See on the package of monetary measures taken by the ECB: P.R. Lane, 'The monetary policy response to the pandemic emergency' (*ECB Blog*, 1 May 2020) <www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200501~a2d8f514a0.en.html>.

[57] For more information about banks' duty of care and the overextension of credit, see, for example: Danny Busch, 'The Future of the Special Duty of Care in the Dutch Financial Sector' (April 2020) EBI Working Paper No. 63 (<papers.ssrn.com/sol3/papers.cfm?abstract_id=3586931>), section 5.4 (iii).

second half of this year, as assumed in the IMF's baseline scenario.[58]

Be that as it may, the PEPP's current maximum size is EUR 750 billion and the programme is available, for the time being, until the end of 2020. It is important to note that certain restrictions that applied to previous purchase programmes have been waived in the case of the PEPP. The absence of these restrictions is precisely why the ECB's PEPP decision is even more vulnerable to new legal proceedings brought before the German Constitutional Court. This is because the Constitutional Court, in its judgment of 5 May, held that one of the reasons why the PSPP, which was the subject of the litigation, did not circumvent the European prohibition on monetary financing was because these restrictions were observed in that programme.[59] It remains to be seen whether the Constitutional Court decides otherwise in any proceedings regarding the PEPP, given that this programme's express purpose is to deal with the economic impact of the coronavirus crisis.

Whatever the case, according to the ECB decision on the PEPP, the purchase of government bonds no longer has to take place in a neutral manner, in other words more or less in proportion to the size of the eurozone economies.[60] This suggests that the ECB could purchase mainly Italian, Greek and Spanish government bonds because those are the countries in greatest

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[58] See IMF (n 3); *FD* 15 April 2020, *'IMF vreest voor kredietcrisis als virus aanhoudt*' (IMF fears credit crisis if pandemic continues).

[59] BVerfG, *Urteil des Zweiten Senats vom 06. Mai* BVG2020 BV, Rn. 216 et seq. <www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/DE/2020/05/rs20200505_2bvr085915.html>.

[60] See <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html> (18 March 2020); recital (5) and Article 5 , paragraphs 2 and 3 of Decision (EU) 2020/440 of the ECB of 24 March 2020.

need. Moreover, the ECB is now also willing to buy Greek sovereign bonds, despite their junk-rating.[61]

Another noteworthy relaxation is that the ECB no longer considers itself bound by the self-imposed limit that it may not purchase more than a third of a country's total sovereign debt and no more than a third of the outstanding amount per bond.[62] Whether this relaxation will find favour with the German Constitutional Court remains to be seen. The ECB had previously imposed these limits on itself in order to avoid becoming a blocking minority in the event of a bondholder vote on a possible debt restructuring. The position is as follows. In economic terms, a restructuring amounts to a partial cancellation of sovereign debt. If the ECB cancels sovereign debt, it violates the prohibition on direct monetary financing.[63] After the problems with Greece in 2013, it was decided that government bonds issued by the eurozone countries should contain a restructuring clause. Clauses of this kind (collective action clauses[64]) provide that a given percentage (often 33 %) of the outstanding amount of the bond constitutes a blocking minority. So if the ECB holds 33 % or more of this type of debt, it may not agree to a proposed restructuring since this would constitute a breach of the prohibition on monetary financing. This would therefore block the restructuring. However, market

[61] See recital (7) and Article 3 of Decision (EU) 2020/440 of the ECB of 24 March 2020.
[62] See recital (6) and Article 4 of Decision (EU) 2020/440 of the ECB of 24 March 2020.
[63] See Article 123 (1) of the TFEU.
[64] As regards collective action clauses, see: Victor de Serière, 'Een korte verhandeling over pari passu clausules en collective action clauses' (A brief consideration of *pari passu* clauses and collective action clauses), in: Danny Busch & Marco.P. Nieuwe Weme (eds), *Christels Koers*, (SOR 79) (Kluwer 2013) 647.

parties do expect the ECB to adhere to the 33 % limit as much as possible in order to avoid problems.[65]

In brief, these are fairly far-reaching relaxations compared with previous asset purchase programmes and it is very debatable whether they will meet with the approval of the German Constitutional Court. But quite apart from this, the PEPP is not a miracle cure, not only because banks will hopefully lend money only to basically creditworthy parties (see above), but also because the interest that Member States such as Italy have to pay on their government bonds will still continue to rise.[66]

13. Measures taken by EU financial regulators

13.1. General

The European financial regulators too are trying to do their bit to fight the coronavirus crisis. I am primarily referring here to the ECB in its capacity of prudential supervisor of significant banks in the eurozone, and also to the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). I would note here that, in practice, the EBA, ESMA and EIOPA carry out little, if any, actual supervision of financial institutions, and instead mainly assist in the creation of European financial supervision

[65] See *FD* 6 April 2020, '*Limieten ECB bieden kansen*' (ECB limits provide opportunities). See also: Sebastian Grund, 'The Legality of the European Central Bank's Pandemic Emergency Purchase Programme' (March 2020) Delors Institute Policy Brief <papers.ssrn.com/sol3/papers.cfm?abstract_id=3558677>. He argues that abandoning the 33% limit need not be a problem (p. 9 et seq.).

[66] *FD*, 18 April 2020, 'Renteverschillen lopen op, Europese aanpak *ontbreekt'* (Interest rates rising. European approach lacking); FD 22 April, 'Forse renteopslag Italië wekt massale interesse beleggers' (Big Italian interest rate hike arouses massive interest among investors).

law, while also providing authoritative but often formally non-binding interpretations of that law. I will confine myself here to mentioning a few notable measures that have been taken so far.

13.2. Capital requirements, non-performing loans and international accounting rules

On 12 March, the ECB announced in a press release that banks were permitted temporarily to hold lower capital buffers. On the same day, the EBA indicated that the ECB and the national bank regulators in the EU would have to be flexible in applying the capital requirements.[67] Not much later (on 20 March), the ECB announced further relaxations, such as favourable prudential treatment of non-performing loans if covered by government guarantees and flexible application of the IFRS 9 international accounting rules.[68] The EBA and ESMA issued advice along similar lines a few days later.[69] As a result of all these measures, the banks are theoretically able to extend more credit to

[67] See ECB, 'ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus' (12 March 2020) <www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html>; <eba.europa.eu/eba-statement-actions-mitigate-impact-covid-19-eu-banking-sector> (12 March 2020). On 16 April the ECB also temporarily relaxed the capital requirements for market risk. See <www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200416~ecf270bca8.en.html>. On this point, see *FD* 16 April 2020, 'De ECB versoepelt kapitaalseisen zakenbanken' (The ECB relaxes capital requirements for commercial banks).

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

[69] See EBA, 'Statement on the application of the prudential framework regarding Default, Forbearance and IFRS9 in light of COVID-10 measures' (25 March 2020) (downloadable at <eba.europa.eu/coronavirus>); ESMA, 'Accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9' (ESMA32-63-951).

businesses and households than would normally be the case.[70] But, once again, it is to be hoped that banks will lend only to parties that are basically creditworthy, although things may be different if the loans are fully covered by government guarantees. In addition, the banks' balance sheets must continue to give a true and fair view of the financial position. By letter of 1 April, the ECB asked the significant eurozone banks, when applying the international accounting rules, to take into account a potential rebound of the economy in 2020.[71] Financial reporting specialists warn that guidance of this kind from regulators is extremely dangerous because IFRS 9 requires banks to predict their own financial health, and that of the money they lend, by reference to independent macroeconomic measures such as GDP or unemployment rates.[72] Be that as it may, the various measures taken by the European financial regulators were confirmed on 28 April and elaborated in an Interpretative Communication issued by the European

[70] See ECB (n 67); 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>. On 17 March the Dutch central bank (DNB) issued a press release announcing two measures designed to sustain lending to the real economy. First, the systemic buffers would be lowered, from the current 3% of global risk-weighted exposures to 2.5% for ING, 2% for Rabobank and 1.5% for ABN AMRO. And, second, the introduction of a floor for mortgage loan risk weighting would be postponed. The capital released as a result should enable the banking sector to continue lending to households and businesses. See <www.dnb.nl/nieuws/nieuwsoverzicht-en-archief/persberichten-2020/dnb387870.jsp> (17 March 2020); <www.dnb.nl/consumenten/corona/index.jsp#>. For more information on this, see: Bart Joosen and Kitty Lieverse, 'De coronacrisis en de versoepeling van de prudentiële eisen voor banken' *Ondernemingsrecht* 2020/VIII.

[71] See p. 5 of the ECB's letter of 1 April 2020 (SSM-2020-0154), <www.bankingsupervision.europa.eu/press/letterstobanks/html/index.en.html>.

[72] See *FD* 16 April 2020, '*Boekhoudregel moet buigen voor crisis*' (Accounting rule must yield to crisis).

Commission.[73] On the same day the Commission published a proposal for a Regulation to relax the EU banking rules in connection with the coronavirus crisis.[74]

13.3. Dividend distribution, share buybacks and bonuses

In addition to all these relaxations, the ECB, EBA and Commission are urging banks to suspend dividend distributions, share buybacks and bonuses. Here too, the idea is that this will release capital to support the real economy in these difficult times (but see previous section).[75] The financial sector seems to be heeding these calls.[76]

13.4. Postponement of various supervision deadlines

Anyone who works in the financial sector knows just how much time and effort goes into complying with the increasingly complex web of financial supervision law, mostly emanating from the EU. For example, there is a long laundry list of reporting obligations with which financial institutions must

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[73] COM(2020) 169 final.

[74] EC, 'Proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards adjustments in response to the COVID-19 pandemic' (Proposal) COM(2020) 310 final.

[75] ECB, 2020/C 102 I/01 (27 March 2020); EBA, 'Statement on dividends distribution, share buy backs and variable remuneration' (31 March 2020) <eba.europa.eu/coronavirus>. COM(2020) 169 final (28 April 2020) (at point 4). EIOPA has urged insurers and reinsurers to do the same, EIOPA, 'EIOPA statement on dividends distribution and variable remuneration policies in the context of COVID-19' (2 April 2020) <www.eiopa.europa.eu /content/eiopa-statement-dividends-distribution-and-variable-remuneration-policies-context-covid-19_en> . DNB issued similar appeals on 27 March and 2 April. See <www.toezicht.dnb.nl/7/50-238213.jsp> (banks); <www.toezicht.dnb.nl/7/50-238217.jsp> (insurers).

[76] See Anna Menin, ' ECB financial supervisor calls on banks to cut bonuses due to coronavirus' (31 March 2020) <www.cityam.com/ecb-financial-supervisor-calls-on-banks-to-cut-bonuses-due-to-coronavirus/>.

comply, not only in relation to national and European regulators, but also in relation to the financial markets. The coronavirus crisis has increased the pressure on staff. Things are not fundamentally different in the financial sector. Staff who are still healthy have to do not only their own work but also of their sick colleagues, while their own productivity decreases due to all the lockdown measures, such as working from home while looking after children. And the crisis is also generating a lot of extra work. European financial regulators have therefore postponed numerous supervision deadlines to relieve pressure in the financial sector wherever possible, thereby allowing the sector to focus on its core activities.[77]

13.5. Curbs on short selling

In times of crisis, the volatility of the financial markets sometimes encourages investors to speculate on falling share prices by selling short. Now this is happening once again. And if investors go short on a large scale, share prices may fall extra

[77] See, for example, (i) ECB (n 57); (ii) ESMA, 'ESMA postpones the publication dates of the annual transparency calculations for non-equity instruments and for the quarterly systematic internaliser data for non-equity instruments other than bonds' (9 April 2020) (ESMA70-155-9817); (iii) EBA (n 60); EBA, 'Further actions to support bank's focus on key operations: postponed EBA activities' (25 March 2020) (downloadable at <eba.europa.eu/coronavirus>); (iv) EIOPA, 'EIOPA, 'statement on actions to mitigate the impact of Coronavirus/COVID-19 on the EU insurance sector' (17 March 2020) (EIOPA 20-137); EIOPA, 'Recommendations on supervisory flexibility regarding the deadline of supervisory reporting and public disclosure – coronavirus / COVID-19' (20 March 2020) (EIOPA-BoS-20/236); DNB has announced similar measures. See, for example, (1) <www.toezicht.dnb.nl/7/50-238204.jsp> (insurers); (2) <www.dnb.nl/nieuws/dnb-nieuwsbrieven/nieuwsbrief-pensioenen/nieuwsbrief-pensioenen-april-2020/index.jsp> (pension funds); (3) <www.toezicht.dnb.nl/7/50-238233.jsp> (banks). The same is true of the Dutch financial markets regulator AFM: <www.afm.nl/nl-nl/professionals/nieuws/2020/mrt/afm-schort-uitvragen-deels-op-tot-1-juni>.

sharply. European financial market supervisor ESMA can prohibit short selling throughout Europe in the event of exceptional market circumstances.[78] And national regulators can prohibit short selling in their own Member State for the same reason.[79] So far, the competent regulatory authorities in Spain, Italy, France, Belgium, Greece and Austria have done so.[80] As yet, ESMA sees no reason to introduce an EU-wide ban on short selling. However, it has lowered the threshold for reporting net short positions to supervisors to ensure that developments can be monitored even more closely than usual.[81]

14. Completion of the European Banking Union

The coronavirus outbreak probably spells trouble for some important ongoing European projects. For example, the EBU is not yet complete as the third pillar – an EU-funded Deposit Guarantee Scheme (DGS) – is not yet in place. Under the existing European Deposit Guarantee Directive, 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 guarantee fund. Each Member State has (or should have) set up such a fund, which is jointly financed by the banks in that Member State. The idea now is for the financing of the DGS within the eurozone to be raised to the European level.[82] But the response

[78] See Article 28 of Regulation (EU) No 236/2012 (Short Selling Regulation)
[79] See Article 20 of Regulation (EU) No 236/2012.
[80] See <www.esma.europa.eu/about-esma/covid-19>.
[81] See ESMA70-155-9546 (16 March 2020).
[82] For the Commission's initial proposal, see EC, 'Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme' (Proposal) COM(2015) 586 final. For more information, see: Veerle Colaert, 'European Deposit Insurance System (EDIS): third pillar of the Banking Union or dead end?' in: Danny Busch and Guido Ferrarini (2020).

from the Netherlands and Germany in particular has been lukewarm. 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 indicated that they will only agree to an EU-funded DGS if the non-performing loans (NPLs) on the balance sheets, particularly of the south European banks, are reduced to an acceptable level. As Spain, Italy and Portugal were well on the way to reducing the size of the NPLs on their banks' balance sheets, there was some prospect of introducing the third pillar of the EBU. However, the coronavirus outbreak has caused the volume of NPLs on bank balance sheets across Europe to rise sharply again. Unfortunately, Greece has made insufficient progress in cleaning up bank balance sheets, and the current crisis has now added to the problems. An EU-funded DGS therefore seems further away than ever. However, a crisis can also result in greater centralisation. Greek central bank president Stournaras has already called for the establishment of a European bad bank to which all non-performing exposures should be transferred.[83] Whether this form of European solidarity is feasible remains to be seen.

15. The European Capital Markets Union

The plans for a European Capital Markets Union (CMU) are intended to make it easier to marry supply and demand for capital in Europe, especially across borders. This can be done through the intermediary of a bank, the capital markets or

[83] See *FD*, 19 April 2020, 'Greek central bank president advocates creation of a European bad bank'; *FD* 22 April 2020, '*Moet politiek ingrijpen om banken van giftige leningen af te helpen*?' (Must politicians intervene to help banks jettison toxic debts?). For more about NPLs, see: Emilios Avgouleas 'The EU framework dealing with non-performing exposures'; in:Danny Busch Guido Ferrarini (2020).

alternative channels such as crowdfunding. In addition, more non-bank funding reduces dependence on the traditional banking sector, allowing economic shocks to be absorbed more effectively. The theory is splendid, but as matters stand a European capital markets union is unfortunately proving by no means easy to achieve.[84] Of course, this project had already been badly affected by Brexit, because the City of London – Europe's financial heart – is no longer participating. Now the coronavirus crisis has added to the woes. Investors and the business community are being hit hard. And if investors have capital available, there is a good chance that they would prefer to invest it in their own country rather than elsewhere in Europe. After all, in times of uncertainty, people still opt to stay close to home.

16. Brexit

Brexit was already causing the United Kingdom to slip into recession, but the coronavirus outbreak means that the economic consequences are likely to be even more dramatic. According to the UK Office for Budget Responsibility (OBR), the economy may shrink by 35 % in the second quarter of this year, the largest contraction in the UK economy since the Second World War.[85] Naturally, the European Union too is currently suffering from the disastrous consequences of the coronavirus outbreak. Both parties therefore have every incentive to conclude a favourable future trade deal. Unfortunately, time is running out. The parties have until 31

[84] For more about this, see Danny Busch, 'Capital Markets Union', in: Federico Fabbrini and Marco Ventoruzzo (eds), *Research Handbook on EU Economic Law* (Edward Elgar 2019) 474; Danny Busch, Emilios. Avgouleas and Guido Ferrarini, *Capital Markets Union in Europe* (OUP 2018) (both with further references).

[85] See <obr.uk/coronavirus-reference-scenario/> (14 April 2020).

December of this year to conclude a trade deal, unless they decide by 1 July 2020 to extend the current transition period for a maximum of one or two years.[86] However, extension would not appear to be an option for the British. Moreover, the negotiations are reported to have reached total deadlock.[87]

17. The European climate plans

The European Union has launched ambitious climate plans. According to the action plan on sustainable finance, the financial sector must play a key role in this green transition by bringing together supply and demand for green capital.[88] However, as the current crisis has reduced the amount of capital available generally (see section 15), less capital is also available for the transition to a greener society. This applies not only to the private sector, but certainly also to the national governments and the EU. Implementation of the climate plans is likely to be delayed by the coronavirus crisis. This is particularly tragic

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[86] See <www.consilium.europa.eu/en/press/press-releases/2020/02/25/eu-uk-relations-council-gives-go-ahead-for-talks-to-start-and-adopts-negotiating-directives/> (with links to the underlying documents).

[87] See <nos.nl/artikel/2331613-zorg-en-teleurstelling-bij-eu-over-opstelling-britten-in-brexitgesprekken.html> (24 April 2020).

[88] See the Green Deal presented by the Commission on 10 December 2019 (COM (2019) 640 final) and the proposal dated 4 March 2020 for a 'European Climate Law' (COM (2020)80 final). The action plan on sustainable finance was launched by the previous European Commission, namely on 8 March 2018 (COM (2018) 97 final); for the present position, see <ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_nl> and also Victor de Serière, 'Toekomstmuziek of utopie: kan de overheid voorschrijven dat de financiële sector meer substantieel bijdraagt aan het bereiken van klimaatdoelstellingen? Een overzicht', *Ondernemingsrecht* 2020/12; Danny Busch, Guido Ferrarini and Arthur van den Hurk, 'The European Commission's Sustainable Finance Action Plan', in: Frits-Jost Beekhoven van den Boezem, Corjo Jansen & Ben Schuijling (eds), *Sustainability and Financial Markets* (WoltersKluwer 2019).

since a link may exist between climate change and the outbreak of pandemics.[89] A delay in the realisation of the climate plans would therefore be unacceptable. However, two rather more positive notes may perhaps be made. First, the coronavirus crisis may help us to realise that a video link, despite all its limitations, works quite well, and that flying around the world for face-to-face meetings is not really necessary. And, second, the massive State aid provided by governments to their corporate sector (e.g. KLM-Air France) gives them the opportunity to impose green conditions.[90]

18. Conclusion

This overview shows that the European Union is doing its best to make a worthwhile contribution to tackling the coronavirus crisis. As always, however, this is being done in typical Brussels fashion, and primary responsibility for tackling the crisis lies with the Member States themselves. It is also clear that the crisis has once again laid bare the divisions between north and south in Europe. These divisions are particularly apparent in relation to the issue of financing the European recovery fund and the power struggle that has now flared up between the German Constitutional Court on the one hand and the CJEU and the ECB on the other. Hard times lie ahead for the EU, and the situation is exacerbated by the attritional Brexit negotiations and the need to face up to the challenges posed by other

[89] That link is in any event assumed 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_en>.

[90] See *FD* 25 April 2020, '*Wegen Nederland en Frankrijk scheiden zich bij Air France-KLM*' (Air France-KLM: parting of the ways for the Netherlands and France). See also Dirk Schoenmaker, 'A green recovery' (*Bruegel blog*, 6 April 2020) <www.bruegel.org/2020/04/a-green-recovery/>.

nationalist forces within Europe and by various external threats such as President Trump's 'America First' policy (although the President may be tripped up by his handling of the coronavirus crisis) and China's economic emergence (although that may be somewhat slowed by the pandemic).[91] Whatever happens, the EU seems likely to be scapegoated by certain political forces in both northern and southern Europe for all the misery caused by the huge economic slump triggered by the crisis. Naturally, the risk of disintegration is ever present in times of crisis, but it is to be hoped that the EU will, as always, succeed in preventing this at the eleventh hour. To be continued.

[91] For more about this, see D. Busch, *NJB* (2019), p. 1116 ff.

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2 COVID-19 and European banks: no time for lawyers

Wolf-Georg Ringe[1]

1. Introduction

'This time is different.' The joke that we still remember from the 2008 global financial crisis[2] has some more truth to it during the present-day pandemic crisis. This time may really be different. This time, the crisis does not start as a banking crisis that is responsible for a deep recession in the economy as a whole. This time, the blame is not on greedy bankers who were accused of being unable to oversee the risks that they had entered into. No, this time, the shock comes from an unforeseeable virus that affected the real economy. Still, banks are affected by the crisis in three ways.

First, there is a fear that banks may be affected by spillover effects from the real economy. The expected contraction in GDP will most likely be more substantial and come faster than during the 2008 financial crisis. It is also likely to trigger a more immediate impact on non-performing loans (NPLs), as entire

[1] The cut-off date for information included in this article is 9 May 2020.
[2] Reinhart, Carmen M., and Kenneth, S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press 2009).

economies are being shut down. This, in turn, may trigger a serious deterioration of the European banking sector.

The second aspect is that banks are desperately needed to keep the real economy afloat. To this end, European banks are being drawn – by governments, regulators, client expectations, and peer pressure – into actively lending and helping businesses and households stay alive for as long as possible during the pandemic and its aftermath. Further, banks and other financial institutions are essential to distribute public-sector financing and to provide temporary financial relief to their clients. To that end, regulators are encouraging banks to use liquidity and capital buffers and provide relief to them also in the implementation of accounting laws and NPL recognition.

Finally, in the third stage, after the most serious phase of the pandemic will have ended, banks will very likely be expected to take a leading role in helping rebuild the economic recovery of the continent. This will mean that they will be expected to provide new credit to the real economy and to bring businesses (back) to the primary capital markets to raise debt and equity. To be able to perform that role, banks will need to be in a solid prudential and financial position that avoids any additional government-driven intervention.

These three different challenges are currently triggering a plethora of initiatives and policy responses. Given the emergency of the situation, many interventions are extraordinary and extreme both in their substance and in their time frame. Naturally, this triggers and will trigger a heated legal debate over the configuration of these measures; particularly within the fragile context of EU legislation. This short contribution does two things. First, it sketches the special situation of banks during the COVID-19 crisis in the European Union, ranging from emergency measure to keep them alive to

the expectation that the financial sector is key of the solution of keeping real-economy firms and households afloat. Secondly, I develop the argument that the time for insisting on legalistic points and doubts is misguided in the present situation. In an emergency, economic necessities, political decisiveness, and speediness of the decision-making process are paramount and must take precedent over legal objections.

2. Rescuing banks

Let us first consider the inherent weakness of the European banking sector itself. As the pandemic hit the financial sector, European banks were still suffering from a range of legacy issues from the past, notably the near collapse following the 2008 crisis and the ensuing sovereign debt crisis. This resulted in many years of low profitability of European banks, in particular in comparison to their worldwide peers.[3] To be sure, the European banking sector is substantially more robust today than in 2008. Banks have built up significantly more robust capital and liquidity positions than in 2008 on the back of many policy and regulatory measures undertaken following the financial crisis.

Still, the current economic shock poses a number of serious risks for the financial sector. European banks in particular had already been facing several challenges before and might therefore be more vulnerable than international peers. This does not only refer to weak profitability levels, but also to high corporate leverage and loosening covenant requirements which had been a source of worry already way before 2020. For example, wholesale lending books are likely to cause the

[3] Bank for International Settlements (BIS), 'Effects of Covid-19 on the banking sector: the market's assessment' BIS Bulletin (May 2020) 5 (graph 4).

biggest impact. Banks will first recognise an uplift in risk-weighted assets (due to riskiness of their portfolios) and probably many covenant breaches; defaults may be expected in the coming weeks and months. The real impact on European banks' capitalisation levels, however, is difficult to assess at the time of writing, since GDP forecasts and scenarios are still frequently updated. The contraction in GDP is likely to be more substantial and more concentrated in time than during the global financial crisis. It is also likely to trigger a more immediate impact on non-performing loans (NPLs), since entire business sectors are being shut down without much pre-warning.

NPLs are expected to increase at a faster pace than in last crisis, given that the expected fall in GDP is expected to be much larger, concentrated in time and broad based (households, micro, small and medium enterprises and corporates are all taking a hit and many economic sectors are going to be affected simultaneously). The emergence of NPLs tends to lag GDP growth by 12-18 months, but this time the reaction function could be steeper as entire economies across the world have come to a sudden stop.[4]

In addition, many banks across the eurozone are still holding large portfolios of NPLs from the last crisis (despite making some progress over the past years). The plans to further divest these are also likely to be disrupted by the coronavirus crisis.

It is in this context that an unprecedented wave of emergency measures was initiated to safeguard both the real economy (firms and households) and banks directly. Central to them, on

[4] Still, this increase is likely to be more concentrated in some sectors and could potentially be reversed, if GDP growth recovers in 2021. This seems the most likely scenario if containment measures are effective at eventually halting the virus spread and policy support measures are swiftly implemented to mitigate the economic fallout.

the EU level, was the launch of a new ECB bond buying programme, continuing the many initiatives underway for the past several years. The new Pandemic Emergency Purchase Programme (PEPP) covers private and public sector securities and has a total volume of €750 bn, running at least until the end of 2020. Different from its predecessors, PEPP handles the capital key of national central banks in a more flexible manner, allowing it to help in a more targeted way where the need is greatest. Further, PEPP grants a waiver of the eligibility requirements for Greek government bonds. The ECB has also decided to expand the range of eligible assets under its 2016 Corporate Sector Purchase Programme (CSPP) to non-financial commercial paper, making all commercial papers of sufficient credit quality eligible for purchase under CSPP.

A string of initiatives target the financial sector more directly. The ECB is preparing plans to create a European 'Bad Bank' to remove NPLs from European banks' balance sheets.[5] Reportedly, ECB officials have already held high-level talks with their counterparts in the European Commission to take these plans forward. However, the Commission is opposed to the idea, on the one hand due to State aid concerns, on the other because this may violate the bank resolution framework. Indeed, the BRRD restricts governments from setting up bad banks except as part of an official resolution process. Still, proponents of the bad bank idea hope to make it acceptable under state-aid rules by requiring that the toxic loans would have to be sold into the market after a fixed time period, with the power to recoup any losses from the lenders themselves.

[5] Martin Arnold and Javier Espinoza, 'ECB pushes for eurozone bad bank to clean up soured loans' *Financial Times* (19 April 2020).

Even if this plan does ultimately not succeed, policy makers are preparing alternatives to allow Member States to inject equity capital into domestic banks, should the situation worsen. This is very reminiscent of the wave of bank bailouts still fresh on our memories from the financial crisis. The problem is that lawmakers have sought to close that hole by introducing a mandatory bail-in before taxpayer money is spent on the banks. However, it is now becoming apparent that the great promise made by the governments from the financial crisis, to 'never again' rescue banks with public money, may not be honoured in the corona crisis. Some individual financial institutions, but also governments, are urging that the strict conditions for State aid be relaxed as a precautionary measure and at the same time to soften the BRRD's rules on winding down failing banks.[6] The European Commission is reportedly considering steps into this direction. The Temporary Framework on State aid (see below) already reactivates a post-financial crisis guideline: 'To the extent [liquidity recapitalisations or impaired asset measures] address problems linked to the COVID-19 outbreak, they 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'[7].

One additional issue is not even on many observers' horizon yet. As is well known, the global financial crisis has had a special European sequel in that it morphed into a severe sovereign debt crisis. As a consequence, European banks

[6] Cerstin Gammelin and Markus Zydra, 'Banken wollen laxere Regeln für Staatshilfen' *Süddeutsche Zeitung* (22 April 2020) <www.sueddeutsche.de/wirtschaft/coronakrise-banken-haftung-1.4885108>.
[7] European Commission, *Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak* [2020] OJ C91 I/1 para 7.

experienced further losses through heavy exposures to their sovereigns. Even though policy makers have responded by erecting the European Banking Union, a repetition of this 'doom loop' cannot be entirely excluded at this stage: the intertwining of the government's financial health and that of the banks, with fears about each reinforcing concerns about the other. One problem is that the Banking Union is famously incomplete, and in particular a single deposit insurance has not been achieved.[8] Further, recent months have seen a worrying increase of banks purchasing their national governments' debt, amplifying their vulnerability to broader national troubles. By February 2019, Italian banks had increased their holdings of Italian government bonds by 14 percent over the previous year.[9] Accordingly, March 2020 saw a dramatic increase in sovereign bond yields yet again. Nevertheless, the prompt policy intervention of the ECB and the policy packages put in place by national authorities have so far provided support to both banks and sovereigns.

3. Ensure lending to the real economy

The second task that policy makers are taking in view is, simply put, to ensure that banks keep lending to the real economy to mitigate the general economic fallout. Moreover, much reduced lending levels would create a vicious circle of more bankruptcies and higher losses on loans that would come back to hit the banks themselves. Regulators and central bankers

[8] Jeffrey N. Gordon and Wolf-Georg Ringe, 'Bank Resolution in the European Banking Union: A Transatlantic Perspective on What it Would Take' (2015) 115 Columbia Law Review 1297.

[9] Moody's, 'Italian banks' high domestic sovereign exposure increases capital volatility' (10 April 2019), available at <www.moodys.com/research/Moodys-Italian-banks-high-domestic-sovereign-exposure-increases-capital-volatility--PBC_1164762>.

have confirmed that the banking system is key to their plans to combat the virus's impact on consumers and businesses. To this end, a vast array of measures and initiatives have been adopted.

The Achilles Heel of the policy response is that the ECB has barely room to manoeuvre in terms of direct monetary policy, as policy since rates are already at zero or below. This is different in the United States, where the Federal Reserve announced in mid-March to cut its benchmark interest rate to near zero.

Instead, the ECB has focused on other fields of activity. For example, it has urged banks to keep lending to firms and households, to use their capital and liquidity buffers and to draw down on easily saleable assets such as sovereign bonds. The European banking sector has built up a significant amount of buffers since the last crisis to allow banks to withstand crisis situations like the current one. The relaxation of these capital and liquidity buffers should even be considered if it means getting closer to the regulatory minimums that firms must keep to weather economic downturns. The expectation is to free up €120bn of capital — which could be used to absorb losses or to potentially finance up to €1.8 trillion of lending. Andrea Enria, chairman of the SSM, has said that these capital and liquidity buffers are designed to support the economy expressly in such adverse situations,[10] reiterating the long-held view that banks should be less rigid in adhering to post-crisis rules when corporate Europe desperately needs funding. Relaxation of the capital buffers does not improve the capital position of banks per se. However, flexibility by the regulators limits the potential

[10] Andrea Enria, Interview with El Confidencial (20 April 2020), available at <www.bankingsupervision.europa.eu/press/interviews/date/2020/html/ssm.in200420~66c91bbfbb.en.html>.

stigma associated with using these buffers, and the possible negative market reactions.

Further, an unprecedented broadening of credit guarantee instruments has been announced by various Member States, as well as by EU institutions, including the ECB. Such guarantees can help to take some of the increased credit risk off banks' balance sheets and provide capital relief at the same time. The ECB has announced that loans which become non-performing and are under public guarantees would benefit from preferential prudential treatment in terms of supervisory expectations about loss provisioning.

In March, the ECB ordered all of the 117 eurozone banks it supervises to freeze dividend payments and share buybacks until at least October, a move it said would allow them to preserve €30bn of capital. The SSM has also warned financial institutions to exercise 'extreme moderation' on their bonus payments this year and threatened to adopt regulation if banks failed to show restraint.[11]

In light of the crisis, the European Commission has also relaxed its State aid framework, which normally restricts subsidies and government payments towards firms. The Commission was quick to adopt a 'Temporary Framework' in March 2020, based on TFEU Article 107(3)(b). Under the Temporary Framework, Member States can provide support measures to businesses facing sudden liquidity shortages in the form of public guarantees and subsidised interest rates.[12] (European Commission 2020). Since then, the Commission has waved

[11] Martin Arnold, 'ECB financial supervisor urges banks to cut back on bonuses' *Financial Times* (London, 31 March 2020), available at <www.ft.com/content/24740ddb-7cc8-4a3a-8fbe-616ea9b4ac7d>.

[12] European Commission, *Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak* [2020] OJ C91 I/1.

through billions in such emergency government relief measures. Amongst many other things, this includes vast amounts of state guarantees for loans taken by companies from banks, and safeguards for banks that channel State aid to the real economy.

Minor additional points concern the European Banking Authority (EBA)'s decision to postpone the 2020 stress tests of the banking sector to 2021. EBA has also stated that, for 2020, it will only carry out an additional EU-wide transparency exercise with the aim of ensuring the availability of updated information on banks' exposures and asset quality. This is designed to allow banks to focus on their main business and their involvement with the economy. In a similar vein, the schedule for inspections and investigations has been relaxed. The ECB has announced that individual initiatives will be discussed and agreed upon on a case-by-case basis, aiming at alleviating the supervisory burdens on banks' operations to the maximum extent possible.

4. Rebuilding the Economy

Let us take a look into the future. Once this current pandemic is over—hopefully, in the not too distant future—banks will have another important role to play. It is almost certain that the banks – notably the systemically-important financial institutions (Sifis) that inherently display more financial muscle – will be expected to take a leading role in financing Europe's economic rebuild. This should happen by providing fresh credit to firms (alongside public-sector development banks) and, for those which are equipped to do it, by bringing businesses to the primary capital markets to raise debt and equity.

To be able to perform that role without any problems, European banks will need to be in adequate prudential and financial shape

and not force supervisors to consider intervening. This, despite the expected drop in top-line revenues and, in a second stage, a sharp rise in loan-loss provisions to catch up with the new asset-quality realities on the ground. Currently most large European banks display sufficient capacity in terms of excess capital and liquidity as well as in regulatory buffers. Let us hope they can keep it this way.

As we have seen, banks play a crucial role in policymakers' focus. They may either be the problem of or the solution to the pandemic, highlighting their key role in shaping the economy and keeping firms afloat. The flurry of policy measures to fight the economic consequences from the pandemic have been implemented at a remarkable speed, and with unmatched decisiveness both by central banks, legislatures and governments.

But there is a pitfall to all of this: the legal framework in which these measures have been taken is complicated. As we have seen, tough action was needed and has been delivered by actors on the EU level such as the ECB, EBA and the European Commission. Alongside this, Member State governments are in the driver's seat for national rescue measures. Local authorities may take additional action. It is natural that such a jungle of competences leads to rivalries, questions of legal authority and challenges over crisis-fighting powers.

This has resulted in a great number of legal challenges to the various rescue programmes. Courts had and have to decide over the legality of such measures, and it is to be expected that countless lawyers will be busy with bringing further courtroom action over the next months. In what follows, I will argue, however, that the law does and must step back in emergency situations such as the one at hand.

4.1. Legal challenges

Expect legal challenges and problems to shoot up like mushrooms from all sides.

Consider, first, potential challenges to the ECB's direct market intervention. The first weeks of PEPP asset purchases showed that the programme is effective, with bonds spreads between the countries hardest hit by COVID-19 and those with fewer cases gradually returning to normal levels. Still, PEPP remains controversial. The key question is whether the ECB is acting within the limits of its mandate – to ensure price stability – or whether the programme is state financing in disguise. Some members of the ECB's Governing Council have also voiced concerns that the risks of limitless bond purchases could outweigh the potential benefits. The new bond-buying programme is yet another exceptional measure standing in the line of many plans adopted since 2008, the legality of which has always been contested. This makes PEPP a likely target for fresh legal challenge before the CJEU. And indeed, in the wake of the recent decision of the German Constitutional Court to partly question the proportionality of a previous ECB bond-buying programme,[13] the victorious opponents of ECB activity have announced to consider challenging also the present PEPP version.[14]

Another very controversial area is the revised framework on State aid. Similar to the crisis in 2007-09, the current Commission has significantly relaxed the State aid framework

[13] Bundesverfassungsgericht, decision of 5 May 2020 (2 BvR 859/15 and others), available in English at <www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2020/05/rs20200505_2bvr085915en.html>.

[14] Arnold, Martin, and Guy Chazan, 'Germany's ECB critics toast courtroom success' Financial Times (8 May 2020).

which, in normal times, is designed to prevent Member States from subsidising domestic firms. The massive scale of current rescue operations under the 'Temporary Framework' for domestic firms carried out by many EU Member States runs directly contrary to the State aid prohibition.

This is particularly problematic when it comes to pumping money into the banking sector: The new bank resolution framework, and in particular the rules on bail in, seek to prohibit government rescue operations for financial institutions unless private creditors first bear some of the losses. Yet the current massive rescue programme has been discussed as being in conflict with this principle. Critics argue that the new framework was supposed to respond to the lessons from the global financial crisis and now fails its first serious test. Supporters maintain that the bail-in framework was never written for a non-financial crisis resulting from a pandemic.

Other examples for controversies abound. The plan to erect a European 'Bad Bank', as sketched above, is legally very controversial and may violate both competition law principles as well as the BRRD. Issuing common Eurobonds, now termed 'Corona bonds', has been an eternal battle and might violate the 'no bail-out' clause in the European Treaty. The agreement to activate the European Stability Mechanism (ESM) to lend to Member States practically without any conditionality might be challenged in court because the ESM Treaty requires strict conditionality. The list can be continued forever.

4.2. Vulnerability of the EU legal system

Why is it that so many parts of the large rescue package have or will come under fire? To be sure, legal challenges against extreme measures are pervasive and will probably be launched

everywhere. But the particular nature of the EU legal order makes it particularly vulnerable against legal attacks.

Consider, for example, the objective of the European Union. At the outset, its mission is to foster cross-border integration and to build a Single Market across nations. In that, the EU has been a remarkable success story. But at the same time, the EU is not a crisis fighter. Institutions have remained weak and are subject to what Member States allow them to do. For example, the principle of conferred powers involves that EU bodies must act within the competences granted to them by the EU Treaties. Moreover, case law from the European Court, in particular the notorious *Meroni* doctrine, limit the possibility to set up new agencies or bodies at the EU level and to equip them with discretionary powers. All of this results in a situation where the market is well-integrated and pan-European, but market supervision and control remains in the hands, at best, of powerless federal institutions.

All of this came to the fore during the financial crisis and is haunting the EU to this day. True, some progress has been made – setting up the banking union, for example –, but even this has happened on constitutionally shaky grounds. The only EU actor with broad powers, the ECB, has repeatedly come under attack, mostly for its bond-buying programmes, and has been attacked of acting outside of its mandate.

5. Flexibility of the law

And yet, the legal system in the EU has been surprisingly flexible in the past, in particular in the eye of a great crisis. To understand this, it is worth exploring in some more detail 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 policy-makers, regulators and supervisors has always been to put economic necessities over formal legal problems. As The Economist put it in 2016, 'Given a choice between financial stability and the rule book, ditch the rule book'.[15]

The genesis of the EU financial market framework is full of such examples. Amongst the most well-known is the attitude towards the famous Euro convergence criteria, which have constantly been violated by several eurozone Member States, famously once including both heavyweights France and Germany. Yet, the various sanctions—the Treaty's Excessive Deficit Procedure and the separate Stability and Growth Pact—have never been properly used. Member States have been very creative over time in convincing the EU institutions that violations of the criteria were due to exceptional circumstances, hardship, or internal crisis. Conversely, the Commission has mostly found it inappropriate to intervene for political reasons. In sum, the convergence criteria are now predominantly seen as political tools, not as a pure legal instrument.

The 2007-09 global financial crisis brought the weakness of the EU legal framework to the fore. Nowhere better can this be better observed than when looking at the conflict between EU State aid rules and bank bail-outs. The massive scale of taxpayer-financed rescue operations for domestic banks carried out by many EU Member States ran directly contrary to the prohibition to support local firms because of market distortion risks. However, faced with an unprecedented risk of a global

[15] The Economist, 'The Rule of Flaw' (12 May 2016), <www.economist.com/leaders/2016/05/12/the-rule-of-flaw>.

meltdown, the EU institutions had no other choice than to rubber-stamp all those bail-outs, using the exceptions and loopholes provided by Treaty framework. The many decisions and communications on State aid during the crisis arguably bent State aid rules to the point of 'almost no recognition'. Expect a similar development during the present COVID-19 crisis.

Another major crisis player, acting in a grey area then and now, has been the ECB. Arguably, the ECB was the only EU institution in aftermath of 2008 with serious powers and who was willing to use them. It has intervened numerous times during the crisis, starting with the traditional monetary policy tool of adjusting interest rates, over the so-called Long-Term Refinancing Operations for banks (LTRO) since 2008, to direct interventions in the securities market. The latter included a number of programmes, inter alia the Securities Markets Programme (SMP) of 2010, a purchase programme for bank-issued covered bonds in 2011, and the announcement of the controversial 'Outright Monetary Transactions' (OMT) in 2012 with the famous announcement by ECB President Mario Draghi to do 'whatever it takes' to preserve the Euro. This triggered legal challenge in Germany as being beyond the ECB's mandate. The challenge was ultimately unsuccessful, but the ECB's actions have been widely criticised by legal scholars as violating the rule of law and the EU Treaties. Tellingly, economists have underscored the pressing need for ECB activity. The ECB went on to embark on an impressive quantitative easing programme in 2015, which was cleared by the ECJ, but recently partly criticised by the German Constitutional Court.[16] Part of the problem is that the ECB itself

[16] See *supra*.

is not able to mitigate imbalances in competitiveness within the eurozone. Ultimately, it can only buy time.

Similar criticism was voiced against the creation of the European Stability Mechanism (ESM), a European bailout fund with a maximum 'firepower' of €500 bn. The mandate of the ESM was only to provide rescue operations for EU Member States that were in financial difficulties. Direct payments to banks were not allowed before the completion of the Banking Union. Another legal challenge was launched against the legality of the ESM, arguing that it violated the 'no bail-out' clause specified in TFEU Article 125. Although the CJEU ultimately upheld the constitutionality of the ESM, many commentators believed that it was erected on shaky grounds. The ESM is now part of the large COVID-19 rescue package and will be lending to some of the countries most severely affected by the pandemic.

6. Reason to worry?

The more important question is this: Does the relaxation of legal principles in the name of economic and political goals give cause for concern? This may certainly be so from a rule of law perspective. In particular the German Government has been seeking to establish a rules-based culture in the EU financial market and discourages every attempt to insert some flexibility into the system out of fear that the entire system might be undermined. This explains the long tradition of German officials to oppose almost all the initiatives discussed above, with the ECB probably being their most obvious target.

Another view stands in stark contrast to this position. A number of scholars have argued that it is the precise genius of a legal framework to be flexible in exceptional crisis situations. For example, some have argued that a conflict between a legal

principle and financial necessities tends to be resolved by suspending the full force of the law.[17] It is here that power rather than law becomes salient. In the context of the global financial crisis, the malleability of the legal framework has proved critical for avoiding a complete financial meltdown. This is substantially different from the Great Depression of the 1930s, where the Federal Reserve's refusal to buy any assets apart from those which were stipulated in legal rules contributed to the system's collapse. Seen in that light, we should be grateful to have a flexible legal system – which can even fight a pandemic when it has to.

7. Conclusion

Banks are everywhere in this crisis. Banks may heavily suffer from this real-world crisis, but they may also be part of the solution. EU policymakers have so far taken tough action on all fronts, weathering banks against the storm, ensuring that they continue to lend to the real economy, and preparing them for their post-crisis role. As hard as it is to accept this, the law must step back and allow this. Lawyers are not in the driver's seat during a crisis of that scale, nor should they.

[17] Katharina Pistor, 'A legal theory of finance' (2013) 41 Journal of Comparative Economics 315.

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3 The COVID-19 crisis and financial regulation

Eddy Wymeersch[1]

1. The Corona infection: general considerations

There is not much doubt that the ongoing Corona crisis is a '*major disruptive event for the global economy*'[2] and one of the most challenging pandemics in our lifetime.[3] Many other disasters have preceded it. Just to name a few, the catastrophic damages inflicted by the black death[4], or by the Spanish flu[5], caused terrible human suffering and social destruction. More recently, Sars, HIV, Ebola are also known top killers. And the list of viruses is pages and pages long.[6]

However, there are several things different with Corona: starting in China, it is very contagious and became a worldwide

[1] The cut-off date for information included in this article is 19 May 2020.

[2] See BCBS, 'Covid-19 statistical resources', <www.bis.org/ifc/covid19.htm>.

[3] See for example Claudio Borio and Fernando Restoy, 'Reflections on regulatory responses to the Covid-19 pandemic' (2020) FSI Briefs No 1 <www.bis.org/fsi/fsibriefs1.pdf>.

[4] This list could also include plague, pestilence, or bubonic plague, which has killed around 75 to 200 million deaths.

[5] The 1918 influenza was quite severe to individuals around 17 to 50 years old, having killed around 100 million victims.

[6] See Wikipedia, 'List of virus species', <nl.wikipedia.org/wiki/Lijst_van_virussen>.

plague within two months. At first, the infection is not visible, but surprisingly even then very contagious. Within a couple of weeks, people become very ill, have to be hospitalised, put in intensive care and several ten thousand died, often in terrible circumstances, while those who recovered will have to rehabilitate for months. There are still no antidotes, nor any effective cure. Natural immunity seems to be relative, and there is a fear we may be confronted by a second wave of infection later in the fall. The personal cost or burden has also been impressive: in many countries, a mandatory lockdown is applied, locking up parents, grandparents, children, not always in very harmonious circumstances. Sports and physical exercise are possible on an individual basis, or outside, but under restrictive conditions. The economic fallout is also impressive, and still unknown at the moment of writing: large and small firms, if they survive under the pressure of their debts will have difficulty to make a living after having reopened. Thousands of people have been dismissed, often without a salary, exposed to poverty[7]. Other have been put on partial redundancy, with a meagre income, living on credit. The rest of us is locked down in front of a computer or holds his telephone in continuous stand by. When the economy starts up again, we will see the damage which this crisis has caused, not only in human lives – very considerable indeed – but also in a moral position, broken marriages, you name it. It will be several months before we will

[7] See, among the many papers on this topic, Niall McCarthy, 'The coronavirus pandemic could push half a billion people into poverty' *Statista* (9 April 2020) <www.statista.com/chart/21382/poverty-levels-due-to-a-coronavirus-recession/>; and Daniel Gerszon Mahler and others, 'The impact of COVID-19 (Coronavirus) on global poverty: Why Sub-Saharan Africa might be the region hardest hit' *World Bank Blogs* (20 April 2020) <blogs.worldbank.org/opendata/impact-covid-19-coronavirus-global-poverty-why-sub-saharan-africa-might-be-region-hardest>.

be able to restore ourselves to our previous levels of ambition, of activity, and of happiness. Will all this be over after the summer? Specialists tell us that it will take a long time to develop an antidote, and therefore the only approach is to wait until the effect of the virus diminishes, and in many cases disappears. But those who are cured face many months of rehabilitation. But there is hope.

2. What has been the effect of the coronavirus in the financial sector

In the markets, the epidemic has created instability and fear. Investors had just suffered a considerable downfall of 2019 when a new wave of insecurity knocks in. In the past, general epidemics have not had a strong impact on stock exchange prices; two exceptions are Zika[8], and Ebola[9] after three months. For Corona, this might be much longer.[10]

This crisis continues to cause a lot of damage and raises fundamental concerns about the future: focusing on the financial sector, we do not know yet how many financial institutions will have to be 'resolved' whether as bankrupt, insolvent or ready to be absorbed. Hopefully, many will find additional funding whether public funds or more rarely from private investors. Fortunes will have been destroyed, and investment funds are confronted with greater outflows than they have ever seen, raising questions about their survival or liquidation. Liquidity is already a key element in the new financial world, in other words, the role of the central bankers

[8] 6.1% after 1 month, but then upwards again.
[9] Ebola was at – 12.9%.
[10] See, for a comparative research, Scott R Baker and others, 'The Unprecedented Stock Market Impact of COVID-19' (2020) NBER Working Paper No. 26945 <www.nber.org/papers/w26945>.

will be crucial. They do receive support from the political world, which is willing to make considerable sums available to restore the economy and avoid even worse destruction.

The Corona pandemic has triggered an impressive number of initiatives, coming from all sectors of society, creating a new sense of social consciousness.[11] In this paper, we want to focus on the consequences in the financial field, especially on the actions undertaking by the financial regulatory authorities essentially with a view of maintaining financial stability and ensure the adequate provision of services to the population. Researching the measures adopted by different authorities active in the field, one can only be impressed by the very intense activity this crisis has triggered. The number of measures, decisions, recommendations, and guidelines developed by the regulators is worldwide innumerable as can be witnessed by some comparative tables developed, i.e. by the Financial Stability Board and the European Systemic Risk Board.[12]

In the European Union, measures of different kinds have been adopted, or are proposed by the Commission, the Council, and the Parliament, by the different financial authorities, especially

[11] See, for lists of Covid-19 related measures, ESRB, 'Policy measures in response to the COVID-19 pandemic' <www.esrb.europa.eu/home/coronavirus/html/index.en.html>; 'Covid-19 policy measures' lists 788 measures the EU institutions and the national authorities have adopted, with possible relevance to the Covid-19 subject. Also FSB, 'COVID-19 pandemic: Financial stability implications and policy measures taken' (15 April 2020) <www.fsb.org/2020/04/covid-19-pandemic-financial-stability-implications-and-policy-measures-taken/>, and the proposals for ending the COVID time; EBI, 'EBI Report on the 'Pandemic Crisis-related' Economic Policy and Financial Regulation Measures: International, EU and Euro Area Levels (standing as of 24 April 2020)' <ebi-europa.eu/wp-content/uploads/2020/04/EBI-Covid-Report-as-of-24.04.2020.pdf>.

[12] See ESRB (n 11).

the ECB and the ESRB, while the regulatory authorities EBA, ESMA, and EIOPA have published opinions on the ongoing developments, guidelines on the application of the existing regulations, and in some cases, suggested new regulations. These initiatives have moreover to be analysed on the background the initiatives and actions in which the national supervisory authorities have clarified the application of the existing regulations in a COVID-19 context, taking into account provisions of national law. The outcome is an additional layer of regulation, dealing with a very wide range of subjects.

3. Financial regulation in COVID-19 times

The purpose of the present paper is to outline some of the measures the financial authorities have been adopting to deal with the effects of this crisis, first in terms of the general organisation of their activities under the COVID-19 restrictions, secondly pointing to the measures dealing with systemic or general risk, further as far as the individual financial sectors are concerned, limited to the measures adopted by the European authorities – and thirdly the changes which have been allowed in the relations between the individual institutions and their clients. For reasons of lack of space and time, two workstreams have not been included: the exceptional additional funding decisions, although these are of course of prime importance. Further, the very numerous statements adopted by the national regulatory authorities will also not be analysed.

Initiatives dealing with the COVID-19 crisis are numerous, on the one hand coming from the international financial institutions, on the other at the level of the European Union. Innumerable other actions have been adopted by the EU

national regulators or supervisors, often pursuant to the Union bodies' recommendations.

3.1. Statements by International Financial Institutions

According to their remit, the international financial institutions pay great attention to the consequences of this crisis and this from different angles. Systemic risk is thereby one of their core points of interest, but also the orderly organisation of the interaction between these institutions and the regional authorities, which has been the subject of extensive opinions and recommendations.

The G-20 Finance Ministers and Central Bank Governors were among the very first to draw attention and called for cooperation to mitigate the risks.[13]

The OECD secretary-general[14] summarised his organisation's objectives in a very broad perspective calling attention to the future of our lives, which is probably going to be quite different from the present one. Healthcare, jobs, and education systems will be top priorities, to be conceived to reduce social inequalities and the vulnerability of an increasing number of populations while relating these ideas to the ecological impact of our activities. Competition and global markets are instruments to that end. The future will have to be different, but the protection of our planet is our first responsibility. A joint

[13] G20, 'Statement on Covid-19' (6 March 2020) <g20.org/en/media/Documents/G20%20Statement%20on%20COVID-19%20-%20English.pdf>.

[14] See his message of 22 April 2020: '…the recovery should not only provide income and jobs but also has broader goals, integrating strong climate and biodiversity actions and building resilience', OECD, 'An inclusive, green recovery is possible: The time to act is now' (22 April 2020) <www.oecd.org/coronavirus/en/>. For many, ESG (environmental, social and governance) will also be part of the recovery agenda.

action plan should be launched[15]. These objectives lay at the basis of the crisis-related intervention of most of the other international institutions.

The IFM[16] is focusing more on its role of financing economies, having secured $1 trillion lending capacity to support its members while about $100 billion is available for meeting emergency calls, among others from the poorest countries.[17] A standstill of debt service for the world's poorest countries is being considered, along with the World Bank.

The World Bank[18] stated the main aim of its planned efforts is to help country clients: 'protect the poorest and most vulnerable households, to support business and save jobs, and to help developing countries implement emergency health operations and strengthen economic resilience.'

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[15] OECD, 'Coronavirus (COVID-19): Joint actions to win the war' <www.oecd.org/about/secretary-general/Coronavirus-COVID-19-Joint-actions-to-win-the-war.pdf>.

[16] See the address by Kristalina Georgieva, 'Confronting the Crisis: Priorities for the Global Economy By Kristalina Georgieva' *IMF* (9 April 2020) <www.imf.org/external/mmedia/view.aspx?vid=6148313391001>, focusing on the negative impact of this crisis, and the massive government support. Georgieva added a four point recovery plan, including reducing stress to the financial system and avoidance of contagion. See also IMF, 'Extension of Consultation Cycles Due to COVID-19 Pandemic' (1 May 2020) <www.imf.org/en/Publications/Policy-Papers/Issues/2020/05/01/Extension-of-Consultation-Cycles-Due-to-COVID-19-Pandemic-49391>.

[17] In a later statement, date May 6, 2020, the IMF claimed $20 Tr public investment for the next two decades for improved healthcare systems. Management of projects has to be improved, 1/3 of funds for public infrastructure is lost to inefficiencies. Vitor Gaspar, W. Raphael Lam, Mehdi Raissi, 'Fiscal Policies for the Recovery from COVID-19 *IMFBlog* (6 May 2020) <blogs.imf.org/2020/05/06/fiscal-policies-for-the-recovery-from-covid-19/>.

[18] The World Bank, 'Decisive Action in an Unprecedent Crisis' (17 April 2020) <www.worldbank.org/en/news/feature/2020/04/17/decisive-action-in-an-unprecedented-crisis>.

The Bank for International Settlement (BIS) labelled the Coronavirus pandemic as a major disruptive event for the global economy.[19] From its side, it warned for a liquidity shortage, as credit may be restricted under the expected circumstances. Opinions of the boards related to the BIS (FSB, BCBS, IAIS) contain the details about the group's future action. The policy responses should serve the financial system's soundness: this applies to regulatory decisions, such as restrictions on remuneration and dividends.[20]

Different instruments will be used to pursue these objectives: information is to be monitored and shared, the supply of financing to the real economy is to be sustained, when needed by using the flexibility available in the existing standards, and further by reducing operational burdens, temporarily or by delaying deadlines thereby providing flexibility. The FSB (Financial Stability Board) defines its mission in the present crisis as providing a rapid and coordinated response to the real economy, maintaining financial stability, and minimising the risk of market fragmentation. But in the present crisis, to sustain the flow of credit amidst declining growth and manage heightened risks, as COVID-19 unfolds, will be a challenging task. In the meantime, regulatory reforms should be not be abandoned.

The FSB[21] formulated the principles of its future action along five lines of action which are shared by many of the other authorities:

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[19] See Borio and Restoy (n 3). Several BIS research papers have already being published on the COVID-19 implications: BIS, <www.bis.org/topic/coronavirus/research.htm>.

[20] See Borio and Restoy (n 3).

[21] FSB, 'FSB publishes a report on international cooperation to address the financial stability implications of COVID-19' (15 April 2020)

- Sharing information on a timely basis;
- Sustaining the supply of financing to the real economy, using the flexibility of existing financial standards;
- Reducing operational burdens for firms and authorities to allow them to deal with COVID-19;
- No rolling back of regulatory reforms;
- Coordinating with standard-setting bodies the future unwinding of the temporary measures taken.

Further, more specific points of action were formulated for a later date.[22]

In one of its statements, the FSB advises on actions to ensure continuity of critical financial functions.[23]

In the banking field, the Basel Committee on Banking Supervision (BCBS) noted that the standards in place have significantly strengthened the resilience of the banking system. Members have the flexibility to undertake further measures if needed to alleviate the crisis. They may support the provision of loans by banks to the real economy while facilitating banks' ability to absorb losses in an orderly manner. But using capital resources to support the real economy and absorb losses should

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<www.fsb.org/2020/04/fsb-publishes-report-on-international-cooperation-to-address-the-financial-stability-implications-of-covid-19/>.

[22] Financial Stability Board (n 10), citing i.e. the channeling of funds to the real economy; the ability of obtaining US dollar funding, particularly in emerging markets; the effective management of liquidity risk by financial intermediaries, such as investment funds; and the management by intermediaries (esp. by CCPs) of evolving counterparty risks.

[23] FSB, 'FSB members take action to ensure continuity of critical financial services functions' (2 April 2020) <www.fsb.org/2020/04/fsb-members-take-action-to-ensure-continuity-of-critical-financial-services-functions/>. By way of example: limited number of essential personnel are required to be on-site; appropriate of keeping branches and call centers open; insurance service; risk management; supporting financial operations, such as staffing data and security operations centers; and supporting third-party providers who deliver core service; processing claims under government support programmes.

take priority over discretionary distributions. The timeline for outstanding standards will be extended, and this to provide banks and supervisors additional capacity to respond to the crisis.

IAIS[24] also stated that it will review its 2020 timelines, i.e. to adjust the timeline for the data collection for the Insurance Capital Standard (ICS), and other work with FSB, and will postpone data collection for the insurance capital standard and the development of guidance through supporting material.

As to the securities markets, IOSCO[25], due to the lockdown, has also been obliged to suspend its activities in its Madrid office, but will continue to coordinate on a remote basis with standard-setting bodies and the Financial Stability Board, on 'the application of the standards, and ensure that financial markets will remain open and functional throughout this difficult period'.[26] It has also been obliged to postpone its annual conference in Dubai. Activities have been redeployed to subjects mainly related to COVID-19. Among the regulatory matters, it published views on the application of accounting

[24] IAIS, 'IAIS Executive Committee takes steps to address impact of COVID-19 on the insurance sector (27 March 2020) <www.iaisweb.org/page/news/press-releases//file/89387/27-march-2020-media-release-iais-executive-committee-takes-steps-to-address-impact-of-covid-19-on-the-insurance-sector>.

[25] Coordinating with other standard setting bodies such as BCBS, IAIS and Committee on Payments and Market Infrastructures.

[26] IOSCO, 'Securities regulators coordinate responses to COVID-19 through IOSCO' (25 March 2020) <www.iosco.org/news/pdf/IOSCONEWS559.pdf> ; IOSCO redeployed its resources to focus primarily on matters that are directly impacted by COVID-19, especially market-based finance is most exposed to heightened volatility, constrained liquidity and the potential for pro-cyclicality. See also IOSCO, 'IOSCO reprioritizes its work program to address impact of COVID-19' (8 April 2020) <www.iosco.org/news/pdf/IOSCONEWS562.pdf>.

standards under the crisis[27]: while pointing to the importance of consistent application and enforcement of high-quality accounting standards even in the present crisis, it referred to the flexibility many standards allow by applying professional judgment. Government-backed relief programmes will influence the assessment of the impact of these measures and whether there is a significant increase in credit risk affecting the assessment, and the measurement of the ECLs will be further studied. These issues should be considered in the relating disclosures. IOSCO decided, along with BCBS, to extend the deadline by one year for the final preparation phase of the margin requirements for non-centrally cleared derivatives.[28]

3.2. Statements by the European Financial Regulators

The measures adopted by the European Authorities since the spread of the corona infection have a considerable influence on the national authorities, the institutions and the markets in Europe. Regulatory standards have been discussed by the different regulatory or supervisory authorities as many have a direct influence on the activities and the financial position of the financial institutions. Initiatives adopted at the European level are generally in line with initiatives supported by international bodies.

A. Standard-setting bodies adapt to the COVID-19 crisis

[27] IOSCO, 'IOSCO Statement on Application of Accounting Standards during the COVID-19 Outbreak' (03 April 2020) <www.iosco.org/news/pdf/IOSCONEWS561.pdf>.

[28] Basel Committee and IOSCO, 'Basel Committee and IOSCO announce deferral of financial implementation phases of the margin requirements for non-centrally cleared derivatives' (3 April 2020) <www.iosco.org/news/pdf/IOSCONEWS560.pdf>.

As is the case for the international bodies, European standard-setting bodies had to suspend their activities due to the lockdown, as live meetings could not further take place but were replaced by virtual ones. This has affected the activities of both the supervisory bodies and the supervised entities in many respects, leading to certain adaptation of applicable regulations. It has not very much slowed down the activity of these bodies who have been very active in developing the most urgent measures to deal with the crisis.

According to the first series of measures, the European regulatory and supervisory authorities issued decisions, guidelines or other types of measures, aiming essentially at mitigating the impact of the corona crisis on certain activities of the authorities and by the institutions subject to their jurisdiction. This approach is found in the measures adopted by the ECB's Supervisory board, by the European Banking authorities, by ESMA and EIOPA. The first statements or decisions were adopted around the beginning of March 2020. In several of these statements, the due date of regulatory obligations was differed, often until the time that the crisis would be over. The number of measures of all kinds is very high and has been listed in a few consolidated overviews, some including the additional national measures.[29] In many cases, the European Supervisory Authorities have not yet published consolidated versions of their statements, rendering research more difficult. Moreover, new decisions are published regularly. In banking practice, the volume and breadth of these Corona-motivated statements call for quite some attention.

[29] See European Banking Institute (n 11); ESRB (n 11).

ESMA developed a wide programme relating to the application of the rules on securities markets in the COVID-19 context.[30] The number of items on which it took position is impressive, and many of its positions reflect the same concerns as the two other ESAs. Some of these items will be included in this overview.

B. Legal Diversity of the authorities' statements

The legal nature of these statements is quite diverse and depends on the authority which has adopted the measure: so, e.g. is the ECB within the context of the SSM entitled to adopt 'regulations, guidelines or general instructions' to competent national authorities.[31] In other cases, the authority of the body issuing the statement will be decisive in obtaining implementation, see the BCBS banking standards. In many cases, the statements do not refer to the legal nature of the decision of the authority. As a consequence, it is unclear how the enforcement by the Commission or by the ESAs will be ensured, and as a consequence, differences between the Member States will be unavoidable, endangering the level playing field. Also, legal enforcement will be unclear, if at all possible.

In the context of COVID-19, the European authorities, e.g. the ESAs, have published their position in many different formats.[32]

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[30] ESMA, 'COVID-19' <www.esma.europa.eu/node/90557>; see also ESMA, 'Guidelines and technical standards' <www.esma.europa.eu/convergence/guidelines-and-technical-standards>; ESMA technical standards, see ESMA41-140-79, 6 May 2020.

[31] Article 6(5)(a) SSM Regulation.

[32] For the period 11 March to 6 May, 27 announcements were made relating to its COVID-19 work. These relate to recommendations, requirements, opinions on NCAs positions, declarations, statements, guidance, opinions, updates, supervisory expectations, postponements, Q&As, reminders.

According to ESMA, e.g., guidelines serve to ensure a common, uniform and consistent implementation, and also aim to achieve a convergent approach in the supervision, leading to improved investor protection (consumer outcomes). Some of these instruments are binding on a *comply and explain* basis.[33] For the Commission, the guidelines or the recommendations defined by the Commission allow the EU institutions to make their views known and to suggest a line of action without imposing any legal obligation on those to whom it is addressed. They have no binding force. But some provisions of EU law may lead to different outcomes. See, e.g. is the ECB bound to comply with the EBA guidelines and recommendations.[34] Each of these instruments has to be analysed on their own, taking into account the context in which they are used, and this notwithstanding the name under which they are used.

FSB,[35] as a supranational entity, has no formal legal authority[36] and its decisions, standards[37] or rather recommendations have no legal force, but moral suasion, peer pressure, as well as the quality of its opinions which reflect worldwide consensus on

[33] ECB, 'ECB "comply or explain" responses to EBA guidelines and recommendations' <www.bankingsupervision.europa.eu/legalframework/regulatory/compliance/html/index.en.html>.

[34] Article 4(3) SSM Reg; but these binding regulatory and implementing technical standards are generally formalised as Commission regulations.

[35] FSB acts as a coordinating body; its policies are not legally binding, See FSB, 'Work of the FSB' <www.fsb.org/work-of-the-fsb/>.

[36] IOSCO is a membership organisation, and can exercise some pressure on its members e.g. by refusing access to cooperation tools; see IOSCO, 'Enhanced Multilateral Memmorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information' (2016) <www.iosco.org/about/pdf/Text-of-the-EMMoU.pdf>.

[37] See FSB, 'Key Standards for Sound Financial Systems' <www.fsb.org/work-of-the-fsb/about-the-compendium-of-standards/key_standards/>, priority implementation and presenting minimum requirements for good practice.

financial stability, are drivers for coherent implementation across sectors and jurisdictions.[38] ESRB may develop supervisory actions, e.g. warnings or recommendations[39] to EU members states, to the ESAs[40] or to the national supervisors, who will inform the ESRB about their follow-up. The warnings are confidential, but the ESRB can release them publicly, informing the addressees in advance.[41]

The scope of this regime covers the entire field in which financial supervision is exercised: some measures are uniform interpretations of concepts already used in EU regulation.[42]

C. Postponing implementation or delaying rulemaking

The considerable additional workload resulting from the crisis along with the widespread lockdown led to the fear that the

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[38] These BCBS standards are non-binding high-level principles. Members are expected but not obliged to undertake efforts to implement them e.g. through domestic regulation. The 'core principles of banking supervision' are addressed to the national supervisory bodies, and distinguish 'essential' criteria from 'additional criteria'. See BIS, 'Core principles for effective banking supervision' (14 September 2012) <www.bis.org/publ/bcbs230.htm>.

[39] See articles 16, 17 and 18, ESRB Reg.; Marco Lo Duca and others, 'A new database for financial crises in European countries' (2017) Occasional Paper Series No. 13 / July 2017 <www.esrb.europa.eu/pub/pdf/occasional/esrb.op13.en.pdf>; see Eilis Ferra and Kern Alexander, 'Can Soft Law Bodies Be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemimc Risk Board' (2010) European Law Review 751.

[40] European Supervisory Authorities, i.e. European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority. The article 458 CRR subjects measures adopted by a Competent National Authority to a procedure involving the European institutions, EBA and ESRB.

[41] Article 18, ESRB Reg.

[42] See ECB, Regulation (EU) 2020/533 of the European Central Bank of 15 April 2020 on the extension of deadlines for the reporting of statistical information (ECB/2020/23) by delegation by the Governing Council to the Executive Board.

ESAs, and the National Competent Authorities as well, would be overloaded with existing regulatory duties but also with obligations or formalities to follow up on existing or new requirements. Therefore, in many of the crisis-related statements a provision was included providing for flexibility as to non-urgent work, to postpone the fixed dates for the submission of statements and reports, or with a view of avoiding to invest time in information which may only become relevant at a later stage. This feature is found in many of the statements of the EBA, as well as those of ESMA and to a lesser extent of EIOPA.

Mitigating the regulatory burden for banks and institutions is also a frequently used approach. The underlying reasoning is generally the same, i.e. to avoid that the sudden effect of the corona crisis would excessively affect the banks, weaken their financial position and their operations, and could not effectively be followed up by the financial authorities. Therefore, the obligations of the banks or other financial intermediaries were mitigated, or the due dates postponed, allowing them to adapt their priorities in favour of serving their clients. Several of the published opinions make a call on the supervisory bodies to adopt a ‘reasonable and affordable’ policy. The authorities considered that postponing some of the ongoing rulemaking activities might have prevented them from paying sufficient attention to the consequences, in their field of competences, of the COVID-19 crisis. One also notices reluctance from some authorities to introduce new or alternative requirements. Due to the overwhelming character of the crisis and the difficulties in living up to the regulatory obligations, this approach can be considered as a reasonable answer to an unknown situation, benefiting the different constituents of the financial system.

The FSB decided to delay its activities on the final two implementation phases of the margin requirements for non-centrally cleared derivatives by one year.[43]

The implementation of the Basel III standards, originally planned for December 2017, was postponed by decisions of the Group of Central Bank Governors and Heads of Supervision (GHOS) to 1 January 2023. Accompanying transitional arrangements for the output floor have been extended to 1 January 2028.[44]

ESMA[45] has adopted many statements dealing with the COVID-19 effect and the impact on the regulatory system for which it is responsible. It has published the timeline for the application of the different regulatory requirements[46] stating that national regulators may apply forbearance towards issuers who need to delay publication of financial reports beyond the statutory deadline. At the same time, the statement underlines that issuers should keep their investors informed of the expected publication delay, reminding that requirements under the Market Abuse Regulation still apply.

ESMA[47] expects competent authorities not to prioritise their supervisory actions towards counterparties, entities responsible

[43] Basel Committee and IOSCO (n 28).
[44] See BIS, 'Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to Covid-19' (27 March 2020) <www.bis.org/press/p200327.htm>.
[45] ESMA (n 30), lists the numerous decisions and action ESMA undertook, also listing the actions of the NCAs.
[46] ibid.
[47] ESMA, 'Public Statement, Actions to mitigate the impact of COVID-19 on the EU financial markets – postponement of the reporting obligations related to securities financing transactions under the Securities Financing Transactions Regulation and under Markets in Financial Instruments Regulation' (26 March 2020)

for reporting and investment firms in respect of their reporting obligations pursuant to SFTR or MIFIR, regarding SFTs concluded between 13 April 2020 and 13 July 2020, and SFTs subject to backloading under SFTR, and to generally apply their risk-based approach in the exercise of supervisory powers in their day-to-day enforcement of applicable legislation in this area in a proportionate manner. The postponement until July 2020 would also ensure alignment of the reporting and supervisory practices in the EU.

IAIS[48] considered that as insurers generally are well capitalised, following more advanced risk management and achieving greater resilience, some of its activities could be scheduled for a longer timeline.[49] It further adopted a statement that it will review the 2020 timelines, especially for data collection for the Insurance Capital Standard while supporting material will be postponed. The June 2020 Committee meetings and Global Seminar scheduled for Seattle were postponed and later cancelled.

IOSCO[50] also decided to pause or delay some of its work in 2020 in order to redirect its resources to focus on the multiple challenges securities markets regulators are addressing[51] to the extent these are directly impacted by the virus. It reconsidered its work plan for 2020, to avoid work becoming obsolete, to be able to take account of lessons learned. Work undertaken jointly with BCBS will be delayed: it would have focused on market-

<www.esma.europa.eu/sites/default/files/library/esma80-191-995_public_statement.pdf>.

[48] IAIS (n 24).

[49] See ibid, such as the holistic framework for the mitigation of systemic risk in the global insurance sector, work undertaken with FSB. Also, the timelines for data collection will be adjusted to 31 October 2020.

[50] IOSCO (n 26).

[51] As a result of the COVID-19 crisis, 8 April 2020

based finance, which is much exposed to heightened volatility, constrained liquidity and the potential for pro-cyclicality, including investment funds, and margin and other risk management aspects of central clearing for financial derivatives and other securities.[52] Work on Artificial Intelligence and Machine Learning by market intermediaries and asset managers will be delayed, along with other market-related items.

D. Flexibility in the application of standards by EU standard setters

Flexibility in the application of standards, or other legal obligations is an important and practical instrument in alleviating the supervised firms from the burden imposed by the regulation or the supervisory authorities at the moment the firms are confronted with a very harsh, even life-threatening menace. In the COVID-19 situation, this was especially the case as all business activity was locked down, both at the supervisory side and at the business side. Almost all EU authorities have published their view on flexibility, very often reminding that while the legal obligations have to be met in a strict way, at the same time that proportionality between requirements and the financial interest at stake allowing the legal obligation to be implemented at a later time, or that other conditions may be waived or agreed.

Flexibility may relate to the information obligations by financial firms towards the supervisory authorities, national and indirectly European. It may also relate to the substantive obligations. Often, these two are often interrelated.

[52] See the final preparation phases of the margin requirements for non-centrally cleared derivatives, to be delayed by one year in agreement with BCBS; Basel Committee and IOSCO (n 28).

i. Flexibility in regulatory disclosures

In several statements, the European regulatory bodies have accepted flexibility in the application of a standard and this to allow the banks to contribute to the continuity of the banking business. In many cases, flexibility related to the obligations of the NCAs, especially in terms of reporting to the European level. This flexibility relates to several aspects of the functioning of the ESAs, and indirectly of the banks. These positions will shield the NCAs against supervisory action from the ESAs.

A structural approach is found in an ECB regulation allowing the delegation to the ECB's Supervisory Board providing for the extension of the deadlines for the reporting of Statistical Information[53] or for granting flexibility for the pillar three disclosures, the remittance dates being extended by one month until May 2020[54]. The precise period will be determined by the national supervisor, paying attention to the bank's liquidity position.

EBA has clarified in general terms how far its member authorities can grant flexibility with respect to certain regulatory obligations of the banks. This flexibility will allow both banks and regulators to deal with the reporting obligations during the period of the lockdown, which will last about the months of March to May of June 2020.

EBA[55] pointed to the importance of disposing on the due date of the key prudential information on capital, risks, liquidity, and

[53] Regulation (EU) 2020/533 of the European Central Bank of 15 April 2020.
[54] EBA, 'Statement on supervisory reporting and Pillar 3 disclosures in light of COVID-19' (31 March 2020) <eba.europa.eu/eba-provides-additional-clarity-on-measures-mitigate-impact-covid-19-eu-banking-sector>.
[55] ibid.

the financial position of institutions. However, delayed submission for data included in the EBA reporting framework may be justified in these extraordinary crisis circumstances but only for submissions for March to end of May. For the pillar three disclosures, EBA encouraged flexibility, referring with respect to some additional disclosures to the need of resolution authorities to assess the institution's risk profile in the context of the COVID-19 outbreak. For reporting in the resolution context, a delay of one month was mentioned. The precise period will be determined by the individual supervisor, paying attention to the bank's liquidity position. In a later statement, EBA announced its intention to also delay reporting for the first FRTB-SA figures to September 2021.[56] The forthcoming BCBS-EBA Quantitative Impact Study based on June 2020 data was announced as being cancelled.[57]

EBA gives an overview of the actions undertaken by national governments and EU bodies addressing the systemic impact of COVID-19.[58] Future flexibility will be granted by EBA, in order to allow NCAs to focus on key operations, with respect to

[56] EBA, 'EBA provides further guidance on the use of flexibility in relation to COVID-19 and calls for heightened attention to risks' (24 April 2020) <eba.europa.eu/eba-provides-further-guidance-use-flexibility-relation-covid-19-and-calls-heightened-attention-risks>.

[57] EBA, 'EBA provides additional clarity on measures to mitigate the impact of COVID-19 on the EU banking sector' (31 March 2020) <eba.europa.eu/eba-provides-additional-clarity-on-measures-mitigate-impact-covid-19-eu-banking-sector>.

[58] EBA, 'Our response to Coronavirus (Covid-19)' <eba.europa.eu/coronavirus>, listing the measures until 4 May 2020 On most of these topics, EBA released separate statements. Among the benefits of its policy decisions, it mentioned support of lending to the real economy, high standards of conduct, consumer protection and tackling crime; on these topics see *infra*.

a series of information requirements allowing that the input from the banks is delayed.[59] These relate to:

- Extension of the deadlines of ongoing public consultations by two months;
- Postpone all public hearings or run them by teleconference;
- Extend remittance date for funding plans data;
- Extend the remittance date for the QIS - Quantitative Impact Study – planned to be based on December 2019 data.[60]

EIOPA has also issued a recommendation on supervisory flexibility as to deadlines for reporting and disclosures by insurance companies.[61] It makes a 'call to action for insurers and intermediaries to support and assist consumers', and, i.e. consider the interest of consumers by exercising flexibility where reasonable and practicable. It further draws attention to the difficulty that due to the widespread pandemic, the pooling of risks necessary for insurance may be difficult to achieve, as imposing a retroactive coverage of claims not envisaged within contracts could create material solvency risks and ultimately threaten policyholder protection and market stability.

In its general programme, ESMA reminded that due to the lockdown of the activities in several securities authorities, programmes had to be postponed, or due dates for reports

[59] See EBA, 'EBA provides clarity to banks and consumers on the application of the prudential framework in light of COVID-19 measures (25 march 2020) <eba.europa.eu/eba-provides-clarity-banks-consumers-application-prudential-framework-light-covid-19-measures>.
[60] ibid.
[61] EIOPA, 'Call to action for insurers and intermediaries to mitigate the impact of Coronavirus/COVID-19 on consumers' (1 April 2020) <www.eiopa.europa.eu/content/call-action-insurers-and-intermediaries-mitigate-impact-coronaviruscovid-19-consumers_en>.

extended.[62] On disclosures, ESMA urged issuers to disclose to the markets significant information related to the impact of the COVID-19 crisis, with an assessment of the business prospects, the financial situation and performance.

With respect to the publications by fund managers, ESMA issued a 'supervisory expectation' that NCAs adopt a risk-based approach and not prioritise supervisory actions for late reporting. A similar approach has been adopted for certain MIFID/MIFIR mandated reporting statements. In the field of short selling, ESMA decided to temporarily lower the notification thresholds of net short positions holders of 0.1 % or more of issued capital and to notify the NCA.

A comparable flexibility regime would be allowed for European Public Investment Funds.[63]

ii. Flexibility in substantive requirements

The ECB, considering the available capital and liquidity buffers, allows banks temporarily to operate below the capital level as defined in Pillar 2, but also below the capital conservation buffer and the liquidity coverage buffer.[64] The

[62] ESMA (n 30), dealing with business continuity, market disclosures, financial reporting. See also ESMA decision, 16 March 2020, ESMA70-155-9546.

[63] See ESMA, 'ESMA sets out supervisory expectations on publications for investment funds periodic reports' (09 April 2020) <www.esma.europa.eu/PRESS-NEWS/ESMA-NEWS/ESMA-SETS-OUT-SUPERVISORY-EXPECTATIONS-PUBLICATION-INVESTMENT-FUNDS-PERIODIC> ; and a comparable subject: Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1303/2013 and Regulation (EU) No 1301/2013, as regards specific measures to provide exceptional flexibility for the use of the European Structural and Investment Funds in response to the COVID-19 outbreak, COM(2020) 138 final.

[64] ECB, 'ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus' (12 May 2020)

Countercyclical Capital Buffer may be reduced to enhance the effect of these provisional reductions. In a later stage, it announced the launch of a major extension of its assets purchase programme, thereby providing more liquidity at a moment when liquidity was in great demand.[65]

It also decided to modulate the conditions for targeted longer-term refinancing operations (TLTRO III). In that context, it decided to provide immediate liquidity support to banks and to safeguard money market conditions, by granting additional longer-term refinancing operations conditions (LTROs), by a fixed rate tender with full allotment, maturing 24 June 2020.

EBA has further clarified its definition of default under the moratoria and forbearance regimes, and the recognition of expected credit losses under IFRS 9 for determining which information can be considered reasonable and supportable information as foreseen under IFRS 9, also considering the

<www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html>; See for a national approach, Nikolai de Koning and Floortje Nagelkerke, 'COVID-19: DNB measures for LSIs in reaction to coronavirus' *Norton Rose Fulbrights* (23 March 2020) <www.regulationtomorrow.com/the-netherlands/covid-19-dnb-measures-for-lsis-in-reaction-to-coronavirus/>.

[65] The ECB decided to launch a EUR 750 billion Pandemic Emergency Purchase Programme (PEPP), to expand the range of eligible assets under the corporate sector purchase programme (CSPP) and to ease the collateral standards. All kinds of assets under the existing programmes will be included, and also Greek bonds 18 March 2020, ECB, 'ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)' (18 March 2020) <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html>. The programme is considered controversial and was indirectly part of the controversy at the German Constitutional Court.

expected nature of the shock.[66][67] In later Guidelines, it clarified the circumstances in which a moratorium will not classify as forbearance or distressing restructuring, provided the measure is based on the national law or on an industry-wide initiative and applied broadly to the relevant institutions.[68] EBA published guidance on the criteria to be fulfilled by legislative and non-legislative moratoria applied before 30 June 2020. The aim of these Guidelines is to clarify the requirements for public and private moratoria, which if fulfilled, will help avoid the classification of exposures under the definition of forbearance or as defaulted under distressed restructuring.[69]

EIOPA makes a 'call to action for insurers and intermediaries to support and assist consumers', and, i.e. consider the interest of consumers by exercising flexibility where reasonable and

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[66] EBA, 'Statement on the application of the prudential framework regarding Default, Forbearance and IFRS9 in light of COVID- 19 measures' (25 March 2020) <eba.europa.eu/eba-provides-clarity-banks-consumers-application-prudential-framework-light-covid-19-measures>. More detailed guidance was published on the criteria to be fulfilled by legislative and non-legislative moratoria applied before 30 June 2020. This will help to avoid the classification of exposures under the definition of forbearance or as defaulted under distressed restructuring.

[67] Andrea Enria, 'IFRS 9 in the context of the coronavirus (COVID-19) pandemic' *ECB-PUBLIC* (01 April 2020) <www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2020/ssm.2020_letter_IFRS_9_in_the_context_of_the_coronavirus_COVID-19_pandemic.en.pdf>; Enria letter states the position for the three ESAs.

[68] EBA, 'EBA publishes Guidelines on treatment of public and private moratoria in light of COVID-19 measures' (02 April 2020) <eba.europa.eu/eba-publishes-guidelines-treatment-public-and-private-moratoria-light-covid-19-measures>; see also 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/eba-publishes-guidelines-treatment-public-and-private-moratoria-light-covid-19-measures>. Institutions granting payment moratoria should provide relevant information to their competent authorities, specific disclosure requirements to the public being published at a later point in time.

[69] ibid.

practicable.[70] It further draws attention to the difficulty that due to the widespread pandemic, the pooling of risks necessary for insurance may be difficult to achieve, as imposing a retroactive coverage of claims not envisaged within contracts could create material solvency risks and ultimately threaten policyholder protection and market stability.

iii. Flexibility for Risk assessment and risk management

a. Risk warnings – short selling

ESMA, on the basis of macroeconomic data and its information on the markets in the EU, published a risk dashboard,[71] dealing with the different segments of its overall oversight, pointing, i.e. to the risk of a global recession in 2020 and volatile markets, on the basis of macroeconomic data and its information on the markets in the EU.

Short selling speculates on the drop in the share price and therefore may contribute to the volatility in the markets. Therefore, considering the present crisis, ESMA has adopted several risks reducing measures,[72] such as opinions agreeing to the renewal of the emergency restrictions on short selling and on similar transactions in certain Member States.[73]

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[70] EIOPA (n 61).

[71] ESMA, 'ESMA Risk Dashboard Risk up-date' (2 April 2020) <www.esma.europa.eu/sites/default/files/library/esma50-165-1107_risk_update.pdf> 15 May 2020.

[72] ESMA (n 30).

[73] ESMA, 'ESMA issue positive opinions on short selling bans by Austrian FMA, Belgian FSMA, French. AMF, Greek HCMC and Spanish CNMV' (15 April 2020) <www.esma.europa.eu/press-news/esma-news/esma-issues-positive-opinions-short-selling-bans-austrian-fma-belgian-fsma> ESMA, 'Opinion of the European Securities and Markets Authority of 15 April 2020' <www.esma.europa.eu/sites/default/files/library/esma70-155-9848_opinion_on_fma_emergency_measure_under_the_ssr.pdf>. See a

b. *Relief to debtors*

The Eurogroup[74] stated that the Member States have so far committed to providing liquidity support for sectors facing disruptions and companies facing liquidity shortages, consisting of public guarantee schemes and deferred tax payments. The four objectives are the flexibility of the rules, use of the EU budget, providing funds through different projects, activation of monetary policy by, e.g. the PPPP and collateral easing, and support to financial stability, i.e. by a release of the capital buffers. These objectives would be implemented through a whole range of initiatives,[75] some dealing directly with support to debtors.[76]

The Commission from its side submitted a 'banking package to facilitate lending in the response of Covid-19'.[77]

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proposed emergency measure by the Autorité des marches financiers under Section 1 of Chapter V of Regulation (EU) No 236/2012.

[74] European Council, 'Report on the comprehensive economic policy response to the COVID-19' *Press Releases* (9 April 2020) <www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/>.

[75] To be mentioned: SURE which a temporary loan-based instrument for financial assistance to protect employment. The EU would granted Loans on favorable terms to Member States to allow them to protect workers and jobs, see European Council (n 74).

[76] Among which budgetary flexibility, emergency support, i.e. for healthcare; EIB funding for companies and SMEs, safety nets for interstate support Recovery fund, Multinannual Financial Framework ,and a roadmap for recovery. See European Council (n 74).

[77] European Commission, 'Banking package to facilitate lending to households and businesses in the EU' (28 April 2020) <ec.europa.eu/info/publications/200428-banking-package-communication_en>; European Commission, 'State aid: Commission adopts Temporary Framework to enable Member States to further support the economy in the COVID-19 outbreak' (19 March 2020) <ec.europa.eu/commission/presscorner/detail/en/IP_20_496>.

c. *Adapting the conditions for collateral*

The ECB[78] decided certain measures for the increase of the bank lending capacity to companies and households by easing the collateral conditions. First, to increase bank funding for loans to corporates and households, it will adopt temporary collateral easing by the acceptance as collateral of loans with lower credit quality, loans to non-ECB accepted debtors, and foreign-currency loans. This will be part of an extension of the Additional Credit Claim frameworks.

The second measure consists of lowering the threshold for domestic credit from 0 % to 25 %, facilitating the use as collateral of loans from small corporate entities. The maximum share of unsecured debt instruments issued by any banking group in another credit institution's collateral pool would increase from 2.5 to 10 %; a waiver of minimum credit quality requirement for marketable debt instruments issued by Greece as collateral for Eurosystem credit operations.

Thirdly, a general reduction of collateral valuation haircuts by a fixed factor of 20 % of the collateral, and adjust some of the haircut parameters applied to non-marketable assets.

The ECB introduced measures for improving the bank liquidity and money market activity.[79] It also addressed the impact of

[78] Isabel Schnabel, 'The ECB's response to the COVID-19 pandemic' ECB (16 April 2020) <www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200416~4d6bd9b9c0.en.html>; ECB, 'ECB announces package of temporary collateral easing measures' (7 April 2020) <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200407~2472a8ccda.en.html>.

[79] ECB (n 64).

ratings to mitigate the impact of possible rating downgrades on collateral availability.[80]

E. Accounting matters: Accounting for relief measures under IFRS 9

Among the topics which raise considerable interest of the financial authorities is the application of the accounting standard IFRS 9 on 'Financial Instruments, financial assets or financial liabilities', which have to be accounted for at fair value. This issue is of special relevance with respect to the valuation of a bank's assets, its loans, or other claims on its clients or other market participants which might become impaired due to the COVID-19 crisis. As due to the crisis, the solvency of many large and small companies is under pressure, the valuation of these credits may have to be adapted and this in line with the IFRS standard 9. Both future and incurred losses should be considered, the first as the Expected Credit Losses (ECL). They may have a significant influence on the bank's credit risk and position under the capital requirements.

Statements specifically relating to COVID-19 have been published by several financial supervisory bodies, who after analysing the subject, have concluded to a rather flexible approach. The IFRS foundation pointed to the importance of using all reasonable and supportable information to provide more forward-looking information about loan losses[81].

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[80] ECB, 'ECB takes steps to mitigate impact of possible rating downgrades on collateral availability' (22 April 2020) <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200422_1~95e0f62a2b.en.html>.

[81] IFRS, 'Application of IFRS 9 in the light of the coronavirus uncertainty' (27 March 2020) <www.ifrs.org/news-and-events/2020/03/application-of-ifrs-9-in-the-light-of-the-coronavirus-uncertainty/>.

In 'Measures to reflect the impact of COVID-19'[82], the Basel Committee deals with accounting for Expected Credit Losses, when these losses are related to COVID-19[83]. The BCBS first analysed the impact of sovereign guarantees, for which the general rules of the Basel framework should be applied.[84] For loans defaulted or for past-due loans, the moratorium period granted by public or banking institutions in the Covid-19 context can be excluded from the default period, provided the amounts are likely to be paid after the moratorium period. For expected loss accounting in a COVID-19 context, an individual loss assessment will be needed, on the basis of the scant information of today. Relief measures should not automatically result in exposures moving from twelve months ECL into a lifetime ECL. Further, the BCBS agreed to amend the transitional for expected loss accounting.

The Basel Committee also pointed to the mitigating effect of the support measures introduced by different public institutions to reduce the impact of COVID-19. This factor allows the standard not to be applied mechanistically, but with the flexibility inherent to the framework.[85]

IOSCO confirmed its strong commitment to the consistent application and enforcement of IFRS, critical for the proper functioning of the capital markets, especially in times of

[82] Basel Committee, 'Measures to reflect the impact of Covid-19' (April 2020) <www.bis.org/bcbs/publ/d498.pdf>; see also Raihan Zamil, 'Expected loss provisioning under a global pandemic' (2020) FSI Briefs No 3 <www.bis.org/fsi/fsibriefs3.pdf>.

[83] See Basel Committee (n 82), dealing with treatment of extraordinary support measures related to Covid-19, excluding payment moratorium periods (public or granted by banks on a voluntary basis) relating to the Covid-19 outbreak, credit loss accounting (IFRS 9), and transitional measures.

[84] Reference is made to CRE22 and CRE32 of the Basel Framework.

[85] See Expected loss accounting in: BIS (n 82).

uncertainty. It welcomed the IASB educational materials for the application of ECL.[86]

The ECB[87], considering the available capital and liquidity buffers temporarily allows banks to operate below the capital level as defined in Pillar 2, but also below the capital conservation buffer and the liquidity coverage buffer. The Countercyclical Capital Buffer may be reduced to enhance the effect of these provisional measures.

With respect to moratoria on repayment of loans and their impact on the calculation of expected credit losses, ESMA provided guidance to issuers and auditors on the application of IFRS 9 Financial Instruments.[88] These relief measures consist of moratoria on repayment of loans, over forms of business support targeted at individual firms or specific industries (e.g. for liquidity purposes) or may take the form of renegotiations, rollovers or rescheduling of cash-flows that might or might not have an impact on the net present value of these cash-flows. Different aspects are analysed, such as: a significant increase of credit risk, the estimation of ECLs, public guarantees on issuers' exposures and transparency issues. Issuers should consider whether the COVID disruption and the related support

[86] IOSCO (n 27); European Commission, 'Consumer Protection Cooperation Network' <ec.europa.eu/internal_market/scoreboard/performance_by_governance_tool/consumer_protection_cooperation_network/index_en.htm>, stopping scams and tackling unfair business practices on online platforms in the context of the Coronavirus outbreak in the EU; European Commission, 'Scams related to COVID-19' <ec.europa.eu/info/live-work-travel-eu/consumers/enforcement-consumer-protection/scams-related-covid-19_en>.

[87] ECB (n 64); de Koning and Nagelkerke (n 64).

[88] ESMA, 'Accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9' (25 March 2020) <www.esma.europa.eu/document/accounting-implications-covid-19-outbreak-calculation-expected-credit-losses-in-accordance>.

constitute sufficient justification to correct the finding of an increase in risk and have to disclose their judgement on this matter.

ESMA has further issued a number of recommendations or guidelines on the disclosure of expected credit losses (ECL) dealing with moratoria on loans.[89]

F. Accounting matters: Accounting for relief measures under IFRS 9

i. Customer and investor protection

In the COVID-19 context, customer protection has focused first on the general provisions in the EU regulation, but more specifically, on the payment services. The Commission issued a Common Position of the Consumer Protection authorities[90] calling attention to unfair or illegal practices mainly on online platforms, such as scams, or advertising for unsupported claims certain medicines or other products prevent or cure a COVID-19 infection, pressure selling techniques or excessive pricing.

With a view of defending the protection of consumers and the orderly functioning of payment services, EBA[91] urged institutions to act in the interest of the consumer, in particular with respect to payments and debits: full information disclosure, especially on potential charges and costs, transparency and clarity of terms and conditions; additional or new charges to be assessed from a legal and reputational perspective; and for e-payments, especially in stores, respect of sanitary precautions,

[89] ESMA (n 88).
[90] European Commission (n 86).
[91] EBA, 'EBA Statement on consumer and payment issues in light of COVID19' (25 march 2020) <eba.europa.eu/eba-provides-clarity-banks-consumers-application-prudential-framework-light-covid-19-measures>.

and preference for contactless e-payments. New provisions on customer authentication requirements will be postponed.

In a widely framed statement, EBA[92], taking a pragmatic and flexible approach to the application of the prudential framework, related its views to the priority of consumer protection, especially in the context of the crisis-related financial difficulties. Defaulting clients have to be assessed individually. But in case of general debt moratoria by government decision, there is no automatic classification in default, forborne or non-performing loan. Individual assessments should be a priority. Some reporting obligations for payment service providers were temporarily lifted.

At the same time, IAIS welcomed efforts for fair treatment of customers, i.e. in terms of disclosure and efficient claim processing.[93] It facilitates global coordination on policyholder protection, including from the angle of financial stability.[94]

ii. Crime prevention

One of the side effects of the COVID-19 crisis is the emergence of certain forms of criminality. The financial authorities are directly involved in some parts of this subject.

Several statements pointed to the greater exposure to crime,[95] although other reports point to the change in criminal behaviour

[92] EBA (n 59).

[93] See IAIS (n 24), such as the holistic framework for the mitigation of systemic risk in the global insurance sector, work undertaken with FSB. Also, the timelines for data collection will be adjusted.

[94] IAIS, 'IAIS facilitates global coordination on financial stability and policyholder protection during Covid-19 crisis' (07 May 2020) <www.iaisweb.org/news/press-release-iais-facilitates-global-coordination-on-financial-stability-and-policyholder-protection-during-covid-19-crisis>.

[95] Europol, 'Beyond the pandemic – How COVID-19 will shape the serious and organised crime landscape in the EU' (30 April 2020)

as people have to stay inside. The fear of increased criminality of certain types was analysed by Europol, especially mentioning cyber criminality, different types of fraud, and on the longer term, increased abuse in the AML field, with transfers to tax heavens, cryptocurrencies, loan fraud. As measures to prevent money laundering and terrorist financing (ML/TF) remain crucial in these challenging times, the EBA calls on competent authorities to support financial institutions' ongoing efforts by sharing information on emerging ML/TF risks, setting clear regulatory expectations.[96]

The Commission made a call on platforms to stop scams and unfair practices.[97] More violent crimes have since appeared, including domestic violence.[98]

iii. Environmental policies

<www.europol.europa.eu/publications-documents/beyond-pandemic-how-covid-19-will-shape-serious-and-organised-crime-landscape-in-eu>; Graham Farrell and Nick Tilley, 'Coronavirus: How crime changes during a lockdown' *The Conversation* (2 April 2020) <theconversation.com/coronavirus-how-crime-changes-during-a-lockdown-134948> ; UN Office on Drugs and Crime, 'Coronavirus disease (COVID-19) - UNODC updates' <www.unodc.org/unodc/en/covid-19.html>, mentioning i.e. violence against women and girls, trafficking in persons; See also the warning for so-called 'Over ceo-fraude' *Financieel Dagblad* <fd.nl/dossier/ceo-fraude>.

[96] In the meantime the Commission has proposed a plan to deal with AML in a more structural way. See European Commission, 'Commission steps up fight against money laundering and terrorist financing' (7 May 2020) <ec.europa.eu/commission/presscorner/detail/en/ip_20_800>.

[97] European Commission (n 86).

[98] UN Office on Drugs and Crime (n 95), mentioning i.e. violence against women and girls, trafficking in persons.

Although environmental policies belong to the top priority of the European bodies, including the relationship with finance,[99] in the field of banking regulation, the interest from the banking authorities has been rather limited. The relationship of the COVID-19 infections and the environmental matter is, although indirect, much more important.[100] It is in the field of air pollution that the indirect effect is most clearly visible everywhere, especially in the largest city centres and this due to changes in different sorts of pollutants, which may bring us somewhat closer to a decarbonised, sustainable economy that many have been advocating for decades.[101] Food shortages or widespread drought may also be mentioned in this context.

The Commission has set up a Technical expert group on sustainable finance, which intends to deal with developing tools for a sustainable recovery in the COVID-19 context.[102]

iv. Moderation of remuneration

COVID-19 has also triggered a discussion on the distribution of dividends, remuneration of directors, and and its effect on the

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[99] EU Technical Expert Group on Sustainable Finance, 'Sustainable recovery from the Covid-19 pandemic requires the right tools' (27 April 2020) <ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200426-sustainable-finance-teg-statement-recovery_en.pdf>, developing i.e. an EU Green Bond Standard; methodologies for EU climate benchmarks and disclosures for benchmarks; and guidance to improve corporate disclosure of climate-related information.

[100] Marthan Henriques, 'Will Covid-19 have a lasting impact on the environment?' BBC (27 March 2020) <www.bbc.com/future/article/20200326-covid-19-the-impact-of-coronavirus-on-the-environment>.

[101] See United National Environment Programme, 'COVID-19 updates from the United Nations Environment Programme' <www.unenvironment.org/covid-19-updates>.

[102] EU Technical Expert Group on Sustainable Finance (n 99). Among the topics announced: developing a taxonomy, a Green Bond standard, climate benchmarks, and corporate disclosure of climate-related information.

financial stability of the bank, its qualification for public support, and the relationship to the use of fiscal revenues.[103]

The financial authorities at different levels have made statements that due to the consequences of the COVID-19 crisis on the financial position of the banks themselves, it would not be indicated to distribute profits or other advantages, as these distributions would weaken the financial position of the bank, and undermine its defences in case of a longer and deeper crisis. Different forms of distributions were mentioned: dividends, bonuses, share buybacks, and all other forms of granting advantages against no equivalent benefit for the bank.

ECB invited banks not to pay dividends at least until October 2020 in order to support lending and absorb losses.[104] Share buybacks should be dealt with similarly. EBA has also called firms to check the rules on remuneration on the background of solid and effective risk management.[105] If needed a larger part can be postponed and distributed in a higher number of own shares, the effect of which would not affect the financial position of the bank. The ECB has also granted significant capital relief to banks which are expected to support the economy and not to increase dividend distributions or variable remunerations.[106]

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[103] Julia Anderson and others, 'The fiscal response to the economic fallout from the coronavirus' *Bruegel* (06 May 2020) <www.bruegel.org/publications/datasets/covid-national-dataset/>.
[104] ECB, 'ECB asks banks not to pay dividends until at least October 2020' (27 March 2020) <www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200327~d4d8f81a53.en.html>.
[105] Jean-Philippe Svoronos and Rastko Vrbaski, 'Banks' dividends in Covid-19 times' (2020) FSI Briefs No 6 <www.bis.org/fsi/fsibriefs6.pdf>.
[106] ECB (n 64).

The EBA[107] urged banks to follow prudent remuneration policies, both in dividend and other remuneration formats. Capital relied on, in the context of COVID-19, should not be used for distributions. If distributions of share buybacks are legally required, these should be submitted to the competent authority. Also, banks should review their remuneration policies, practices and awards to ensure that they are consistent with and promote sound and effective risk management. ESMA and its banking and insurance counterparts have asked banks and insurers to suspend dividends during the crisis and reconsider paying bonuses, but so far, there has been no formal guidance for asset managers.

EIOPA has released several statements on remuneration. In April 2020, it 'urged that in the current juncture (re)insurers temporarily suspend all discretionary dividend distributions and share buybacks aimed at remunerating shareholders, and this at consolidated level'. Also, the variable part is to be set at a conservative level and considered for postponement.[108] It has also published a call for (re)insurers to review their current remuneration policies, practices and rewards, and this mainly with a capital protection objective.

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[107] EBA, 'Statement on dividend distribution, share buybacks and variable remuneration' (31 March 2020) <eba.europa.eu/eba-provides-additional-clarity-on-measures-mitigate-impact-covid-19-eu-banking-sector>; EBA (n 58).

[108] EIOPA, 'EIOPA statement on dividends distribution and variable remuneration policies in the context of COVID-19' (02 April 2020) <www.eiopa.europa.eu/content/eiopa-statement-dividends-distribution-and-variable-remuneration-policies-context-covid-19_en>; EIOPA, 'EIOPA statement on actions to mitigate the impact of Coronavirus/COVID-19 on the EU insurance sector' (17 March 2020) <www.eiopa.europa.eu/content/eiopa-statement-actions-mitigate-impact-coronaviruscovid-19-eu-insurance-sector_en>.

Listed companies have, in many cases, suspended or even abandoned their dividend distributions, pursuant to the ECB recommendations.[109] The European Commission has criticised dividend distributions by companies receiving State aid.

v. Private Law Aspects

The private law aspects of the covid-19 crisis are numerous. In the economic fields, they mainly relate to the measures adopted at the national level. This is also the case for the consequences in the financial sector. European level measures often are based on soft law instruments, while the binding measures are based on pre-existing binding European powers.

The measures adopted at national level are numerous and often are of a binding nature. The most interventionist measure has been the lockdown, putting social and economic life at a standstill. For business firms the effects have been dramatic, often destructive. The lockdown has questions about suspension or termination of labour relations and related indemnities, the effects on the rental of business properties, but also on the insolvency consequences of the termination of many other economic activities. The effect on credit and other financial relations will often be governed by contractual clauses, and if not by national legal provisions. In company law, the organisation of meetings, and the exercise of voting rights on a remote basis raises new questions. A central concern is the qualification of the lockdown as 'force majeure' and what are in practice the legal and financial consequences of it.

[109] According to the European Banking Federation, most large European banks have agreed to suspend 2019 dividend payment and have curtailed bonus schemes. See EBF, 'EBF supports Covid-19 update on EU banking package' (28 April 2020) <www.ebf.eu/ebf-media-centre/ebf-supports-covid-19-update-on-eu-banking-package/>.

G. Banking Risk and risk management

The ECB[110] adopted temporary measures addressing the rating downgrades due to COVID-19, as these affect the availability of collateral. This decision is part of the support to liquidity operations, for which these assets are used as collateral. The eligibility criteria for marketable assets and issuers, which fulfilled the minimum criteria which were decided by the CRAs in accordance with the minimum quality requirements – as set in accordance with the collateral easing package of 7 April 2020 - will be grandfathered as long as the rating stays above a certain credit quality. This decision will stabilise the risk profile of the bank thereby avoiding procyclical developments.

ESMA has cautioned rating agencies dealing with countries and companies over knee-jerk downgrades in a pandemic, followed by a snap-back in the economic activity once restrictions on people's movements will be lifted.[111]

Using capital and liquidity buffers, banks will be allowed to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G), the capital conservation buffer (CCB) and the liquidity coverage ratio (LCR). The ECB expects that this appropriate relaxation of the countercyclical capital buffer (CCyB) will be followed up by the national macroprudential authorities. Additional Tier 1 or Tier 2 instruments, will be allowed to meet the Pillar 2 requirements.

H. Financial Stability and systemic risk

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[110] ECB (n 80).

[111] Huw Jones, 'EU watchdog cautions rating agencies over knee-jerk downgrades in pandemic' *Reuters* (9 April 2020) <www.reuters.com/article/health-coronavirus-eu-regulator/eu-watchdog-cautions-rating-agencies-over-knee-jerk-downgrades-in-pandemic-idUSL5N2BX383>.

Building on the statement on COVID-19 pandemic, the FSB further detailed its analysis of financial stability measures to be adopted. These constitute a multilayer programme for opening the real economy while safeguarding financial stability. Among these measures, one can cite, different types of information sharing[112], market volatility, continuity measures, including government measures to maintain continuity, assessing financial risks and vulnerabilities.[113] One chapter would look at the long term with: re-prioritisation of the FSB work programme: with the effect of the crisis on the Non-Bank Financial Institutions (NBFI), the efficiency of the cross-border payments, and the resolution of CCPs would rank high in the list. This list of priorities is different from the 2019 list which was planned to be discussed at the Riyadh G-20 meeting in 2020: FinTech, Global Stablecoins, cross border payment systems and interest rate benchmarks.[114]

The European Systemic Risk Board (ESRB) [115] called attention to the important synergies between fiscal, monetary and regulatory policies. It listed a number of issues of significant

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[112] Such as Lending and credit support, and Funding and liquidity support.

[113] FSB (n 21); FSB (n 11).

[114] See FSB, 'FSB sets out 2020 work programme' (17 December 2019) <www.fsb.org/2019/12/fsb-sets-out-2020-work-programme/>. A similar list of topics was submitted to the G20 Finance ministers (11 April 2020) mentioning that the initial stresses in the banking system have disappeared but that new challenges have become visible the non-bank finance, but no major difficulties have become forward. Also, it was noted that market infrastructures, including CCPs have performed well. For a comparison; see Practising Law Financial Services, 'COVID-19: FSB works to address financial stability risks and reprioritises 2020 work programme' (02 April 2020) <uk.practicallaw.thomsonreuters.com/w-024-8312>.

[115] ESRB (n 11); see also EBI (n 11). ESRB, 'The General Board of the European Systemic Risk Board held its 37th regular meeting on 2 April 2020' (9 April 2020) <www.esrb.europa.eu/news/pr/date/2020/html/esrb.pr200409~a26cc93c59.en.html>.

present value among which: market illiquidity and implications for asset managers and insurers; liquidity risks arising from margin calls; the impact of procyclical downgrades and the system-wide restraints on dividend payments, share buybacks and other payouts. It also published a list of systemic risk related measures adopted by the different EU or national financial authorities in the context of dealing with COVID-19; this list represents a stark contrast with a list of vulnerabilities discussed by the General board two months earlier.[116] Finally, it published the schedule of events which will be cancelled or postponed in 2020 as a result of the pandemic.[117]

In coordination with EU and national authorities, the ESRB composed a series of data relating to the evolution of recent systemic measures in the Member States: certain Member States having provisionally reduced the Countercyclical capital buffer in the context of the present crisis. Another list identifies the Member States applying to the mitigating CRD provision on 'accumulation of Countercyclical Capital Buffer' with systemic risk buffers. For systemically important institutions[118] - G-SIIs and Other systemically important institutions (O-SIIs), the application of the CRD provision on 'accumulation of these buffers with systemic risk buffers' also may lead to reducing the weight of the requirement. The ESRB regularly published a

[116] ESRB (n 11); see also ECB, 'All Years' <www.ecb.europa.eu/ecb/legal/date/previous/html/index.en.html> , containing all relevant measures adopted since 1992, listing the 788 measures the EU institutions and the national authorities have adopted, with possible relevance to the Covid-19 subject.

[117] ESRB, 'Schedule of events' <www.esrb.europa.eu/news/schedule/html/index.en.html>.

[118] G-SIIs and, subject to national discretion, other systemically important institutions (O-SIIs).

Risk Dashboard,[119] which further contains, i.e. the list of Member States where systemic risks in the real estate sector and not harmonised macroprudential measures are applied.[120] A similar list was published by the ECB.

EBA[121] listed a number of COVID-19 related areas where National supervisors and financial institutions should pay strong attention to risks:

- Adjust the capital impact by amending its standards on prudent valuation;
- EBA highlights the flexibility in the prudential requirements; for banks using internal VaR models, a pragmatic approach to SREP assessments in 2020;
- Digital operational resilience.' adequate ICT capacity and security risk management;
- Clarity on the prudential application of the definition of default and forbearance as well as how the EBA Guidelines on legislative and non-legislative moratoria on loan repayments apply to securitisations;

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[119] ESRB risk dashboard, 19 March 2020 which is a 'set of set of quantitative indicators, not an early warning system'. See also: ESRB, 'The ESRB risk dashboard: an overview' (9 April 2020), analyzing the principal systemic risk indicators and financial market conditions, comparing the pre and post Covid-19 developments. Special attention to banks, insurance and investment funds and other institutions. ECB, 'Macroprudential measures taken by national authorities since the outbreak of the coronavirus pandemic' <www.ecb.europa.eu/pub/financial-stability/macroprudential-measures/html/index.en.html>; see ESRB (n 11): 'Covid-19 policy measures' listing the 788 measures the EU institutions and the national authorities have adopted, with possible relevance to the Covid-19 subject.

[120] See ESRB, 'Opinion of the European Systemic Risk Board of 6 February 2020 regarding Dutch notifications of stricter national measure based on article 458 of Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (ESRB/2020/21)' <www.esrb.europa.eu/pub/pdf/other/esrb.opinion200311_measureart458~ff400c0788.en.pdf?08ee5487a7953b46f29213118271abb8>.

[121] EBA (n 57).

- Adjust the capital impact by amending its standards on prudent valuation;
- The EBA also intends to delay reporting for the first FRTB-SA figures to September 2021;
- Highlights the flexibility in the prudential requirements available to competent authorities for banks using internal VaR models;
- Pragmatic approach to SREP assessments in 2020; most material risks and vulnerabilities driven by the crisis;
- Digital operational resilience;
- Clarity on the prudential application of the definition of default and forbearance.

EIOPA has also issued a recommendation on supervisory flexibility on deadlines for reporting and disclosure by insurance companies.[122] In the context of a widespread pandemic, it thereby calls attention to the pooling of risks necessary for insurance which may be difficult to achieve: 'imposing retroactive coverage of claims not envisaged within contracts could create material solvency risks and ultimately threaten policyholder protection and market stability'.

It contain the list of measures adopted by the different EU national authorities in the context of dealing with COVID-19[123]

With respect to the publications by fund managers issues a 'supervisory expectation' that NCA adopts a risk-based approach and not prioritise supervisory actions for late reporting. A similar approach has been adopted for certain MIDIF/MIFIR mandated reporting statements. In the field of

[122] EIOPA (n 61).
[123] See ESRB (n 11): 'Covid-19 policy measures' listing the 788 measures the EU institutions and the national authorities have adopted, with possible relevance to the Covid-19 subject.

short selling, holders of 0.1 % or more of issued capital have to notify the NCA.

4. Conclusion and further outlook

The attention given by the international, European and national authorities to the consequences of the corona crisis is fully in line with the challenges. The first indications of the possible consequences on the economic system justify this approach: apart from the – considerable - short term disruption in the economies, crisis to be transformative, and likely to touch on many segments of our societies. It is still too early to identify which evolutions will be predominant, but in general terms, a certain dis-internationalisation of our economic and financial system seems likely. The shock inflicted to people's psychology, and to their lifestyle will also reflect this fundamental tendency and probably incite them to greater prudence, to a more long-term view, and to a different, maybe more modest lifestyle, e.g. in the field of travel or foreign holidaying. Many segments of society will feel the consequences of this psychological and behavioural shift. Along with the expectation of an effective vaccine, the awareness of the need to dispose of effective health coverage may rank highest among the survivors of the COVID-19. Even the highly developed Western European public health systems were at the limits of their capacities. Up to now, for many office workers, the lockdown has been a discovery of an alternative working habit: no personal meeting, no endless committees, a more concentrated and more relaxed environment. Is this the working place of the future? A certain distancing from colleagues may be the result. More homework is also less office space: for large organisations, this may mean less square meter/per person office space, and perhaps fewer high rise

towers? All this hinges on the availability of high performing internet systems: will 5G be the winner of this race? Private travel is already suffering: politicians already urge us to stay in our home country. Will this lead to more ignorance of foreign lifestyle, even to an adversarial attitude to foreigners?

It is still too early to assess the impact of the COVID-19 pandemic on the financial system and its different segments. The early signals, limited to the first quarter of 2020, point to a considerable impact on the economy, and indirectly on the banking system, especially under the form of loan losses. But the pension funds have also been severely touched, as well as the collective investment funds, the money market funds in particular. In the markets, volatility closely follows the infections trend, so that only a few of the trading floors have to be closed.[124] The response of the international and European financial authorities[125] has been immediate and massive: the financial regulators and supervisors[126] mainly delivered protective measures, as an immediate and massive response to the crisis. On the one hand, they had to ensure continuity of their

[124] Luca Enriques, 'Stock Exchange Shutdowns in the Time of Coronavirus' Oxford Business Law Blog (12 March 2020) <www.law.ox.ac.uk/business-law-blog/blog/2020/03/stock-exchange-shutdowns-time-coronavirus>, on closures mainly related to option exchanges. In most exchanges, the turnover exceeded the previous months.

[125] The present analysis is limited to these categories. Many more Covid-19 based measures have been adopted by other regional or state authorities. One should also mention the numerous statement by the US and the European national authorities. Even the implementation of the Shareholder rights directive has been the subject of initiatives to postpone its implementation: see Didier Reynders, Helena Dalli, and Salla Saastamoinen, 'Joint trade association letter on the impact of COVID-19 on the further implementation of the Shareholder Rights Directive II' (9 April 2020) <www.ebf.eu/wp-content/uploads/2020/04/Joint-Trade-Association-letter-on-SRDII-and-COVID-19_internal.pdf>.

[126] Apart from massive financial interventions which are not analysed here: see under Covid-19 for the numerous initiatives.

supervisory and monitoring functions, their offices being closed due to the generally imposed lockdown, while on the other, they gave instructions to limit the negative consequences on the financial system, especially on the individual financial institutions, and their business clients. In a second phase, they indicated the limits within which they would accept a flexible interpretation of the regulatory obligations, thereby allowing the banks' clients to adapt to the downturn in the economy.

These actions should be appreciated and will have reduced the immediate major implosion. From the information available early May 2020, the financial sector has performed not so badly as could be feared, and this notwithstanding the lockdown. But the more long-term effects will only come to light later in 2020 when the effect of the economic standstill has translated into the overall economic results, and this also in the institutions' financials.[127]

Most of the measures adopted by the financial authorities in the first two months of the COVID-19 crisis aimed at limiting the destructive consequences on people's health, avoid further outbreaks mainly by imposing lockdowns. But more structural changes will not be avoided. The role of the banks in the payments systems is likely to change due to the more intensive use of contactless payment, even at local stores. This will reduce the use of banknotes even more, as is already the case in some jurisdictions.[128] In support of the increasingly widespread

[127] EU GDP for the period Jan-April has lost 3.4%; see for a more speculative exercise Simon Mair, 'What will the world be like after coronavirus? Four possible futures' (30 March 2020) <theconversation.com/what-will-the-world-be-like-after-coronavirus-four-possible-futures-134085>.

[128] See for an overview Henk Esselink and Lola Hernández, 'The use of cash by households in the euro area' (2017) ECB Occasional Paper Series No 201 <www.ecb.europa.eu/pub/pdf/scpops/ecb.op201.en.pdf>; According to the National Bank of Belgium, modern banknotes first appeared in the 17th

‘internet-based e-commerce’, electronic payments are indispensable tools to ensure the effectiveness of the transactions and their prompt payment. With the widespread lockdown, this has insured businesses and consumers to continue to deal as before, even on a cross border basis. The takeover of internet-based retail is having an undeniable effect on the distribution market, where more and more traditional chains are losing market share and many local shops already being confronted with financial difficulties, or worse. Will the COVID-19 have accelerated the demise of the big shopping centres, as seems to be the case in the US? And will the numerous local businesses and shops be able to survive?

In the credit markets, tensions were mainly due to the loss of position, due to the lockdown, as many independents saw their income disappear. At the European level, recommendations for flexibility in dealing with these cases have been published by the financial supervisors. More importantly, however, are the flexibility measures adopted by ECB to keep the interest rates low,[129] thereby, creating pre-crisis incentives for spending and investment. The ECB adopted collateral measures aimed at facilitating the lending capacity for corporates and households.[130] At the national level, several central banks put in place packages providing for payments suspension for non-

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century in Sweden as a solution to the acute shortage of suitable means of payment. In 1661, the king granted the private banker, Johan Palmstruch, the sole rights of issue of non-interest-bearing banknotes – kreditivsedlar. See National Bank of Belgium, ‘Banknotes’ <www.nbbmuseum.be/en/collections/banknotes>.

[129] See insurers agreeing an MOU for the reinsurance of private short-term credit; National Bank of Belgium, ‘Support measure in the context of Covid-19: the State temporarily reinsures short-term trade credits’ (22 April 2020) <www.nbb.be/en/articles/support-measure-context-covid-19-state-temporarily-reinsures-short-term-trade-credits>.

[130] ECB (n 79).

financial firms, professionals and non-profit organisations, state guarantee schemes and for state guarantee relating to credit granted by banks and other institutions.[131]

At the same time, massive amounts were made available to the economic systems, both for rescuing large enterprises – e.g., airlines – but also for helping small businesses and individuals to keep ends meet. Support came not only from governments and public institutions, but also from many non-profit organisations, and rich individuals.

It remains unclear what on the longer term, will be the consequences of this crisis for banking or for the financial system as a whole: one could expect a higher degree of concentration due to failure of banks which were too weakly capitalised or had a too risk-sensitive loan portfolio. For many of these, the support measures adopted by the central banks will have offered a welcome – although often provisional – solution. In the US investment fund sector, the first failures have already been mentioned.

Up to now, no COVID-19 related far-going regulatory changes have been proposed to the present financial system and to the regulatory framework it supports. The previously ongoing regulatory work has continued, obviously with some delay. It seems inevitable that there will be some significant changes, due to changes in the market structure, to mergers or takeovers of banks, or even to insolvencies. What are the fields in which we can prepare for dealing with macro incidents like the COVID-19, in which the future of our population and our economies would be at stake.

[131] National Bank of Belgium, 'Summary of Covid-19 economic measures' <www.nbb.be/en/summary-covid-19-economic-measures>.

There are several levels at which the reflection can be started, dealing both with the financial sector and the society in general. More risk awareness in society, in general, is needed. This would include not only financial or industrial risks. Healthcare should be a key objective: better control of the health environment in which the population is living is an objective of continuous follow-up. Incidents like the presence of different viruses should be strictly monitored and where applicable, fought against with all available means. This implies understanding the underlying reasons that cause these big crises, e.g. for climate change. Prevention is better than a cure.

It will be up to the governments and the economic actors to undertake the necessary action to avoid similar tragedies to occur again. This implies stricter governance, with more refined technical expertise, pursuing dedicated research into the causes and remedies of the pandemic, resulting in general into a more risk-conscious attitude. A formal system of risk governance and management should be developed not only in the private sector, but also at the government level. Effective cooperation will be necessary. Therefore, besides the systemic risk boards specialised in finance, a separate structure should be set up dealing with global health and environmental risks.

As far as the financial world is concerned, responses can be found in a more widely defined risk management, conceived as not only covering the risks within the bank itself, or in its local financial system, but also covering the wider environment which might influence developments in the bank or its operational, business or legal environment. This wider analysis will not only be focusing on the so-called micro or contagion risks – the specific risks flowing from the activity of the institution – but also on the often undefined macro dimension with which the bank may one day be confronted. So better

preparation for major health crises would be welcome, including attentive scanning for other viruses or calamities and attempts to develop vaccines or antidotes. While the medical infrastructure has generally proved sufficient, it was not up to coping with the numerous patients in case of a pandemic; the same applies to the elderly homes. Healthcare should be a key objective, winning over money.

Another widespread concern is the food shortage, due to the excessive drought experienced in several parts of the world, or due to the locust plague in East Africa;[132] not to talk about climate change. The COVID-19 crisis has taught us that internet communication is of the utmost importance in case physical mobility is reduced. However, are the systems used today up to speed, is the quality of sound and image sufficient, can a multiparty discussion be effectively pursued even over a longer period of time? Connectivity should be improved in 24 hours/day perspective. At the same time, alternatives to lockdown should be planned. These are a few of the risks to be addressed.

Banking groups should be able to develop risk management systems, which would allow institutions to continue functioning in a regular way, independent of the type of risk. Stricter governance with clear definitions of competences and duties, but also some more modesty in term of remuneration may be useful elements in strengthening accountability, especially in widespread crisis situations. Placed in front of a financially weaker clientele, institutions will be held to a higher degree of

[132] See e.g. Catherine Byaruhang, 'How do you fight a locust invasion amid coronavirus?' *BBC News* (25 April 2020) <www.bbc.com/news/world-africa-52394888>.

responsibility, and accountability, but also to a higher standard of care. The risk of abuse should not be underestimated.[133]

Today, among the already predicted consequences of the crisis are an impressive drop in GDP in many parts of the world, as economic production and activity will have collapsed. Unemployment is rising to considerable levels, leaving many people without any or insufficient income, or even in plain poverty. This will lead to further defaults, ultimately leading to a big recession.[134] This evolution cannot avoid having consequences on the political systems. There are some indications that some political regimes are tempted to use the stronger anti-virus measures to introduce some reforms which would enable them to exercise stronger power, even changing the political regime, and this to their advantage; some even fear for our democratic systems.

More risk awareness in society, in general, is needed. This should not only include financial or industrial risks, but also better control of the health environment in which the population is living. Incidents like the presence of different viruses should be strictly followed up and where applicable, fought against with all available means.

Societal risk awareness should be at the same level as risk awareness for the financial institutions, or large industrial firms.

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[133]See e.g. Jennifer E Story and. Michaela Rogers, 'Coronavirus lockdown measures may be putting older adults at greater risk of abuse' *The Conversation* (11 May 2020) <theconversation.com/coronavirus-lockdown-measures-may-be-putting-older-adults-at-greater-risk-of-abuse-137430>.

[134] The Brussels Times, 'EU faces recession and economic uncertainty in 2020' (07 May 2020) <www.brusselstimes.com/all-news/eu-affairs/110061/eu-faces-recession-and-economic-uncertainty-in-2020/>; The EU might face a possible drop of real GDP of 7.5% in 2020.

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4 Cultural reforms in Irish banks. Walking the walk during the COVID-19 pandemic

Blanaid Clarke[1]

1. Introduction

This chapter considers whether the previous global shock to hit the banking sector, the Global Financial Crisis in 2008 ('the GFC'), and more particularly the governance reforms which it engendered, underlines the sector's response to the economic crisis which the COVID-19 pandemic has wrought. It will focus on the position of the Irish retail banks and the changes to culture and behaviour which were introduced since then.

The GFC has been attributed to a number of factors including inadequate financial services regulation and supervision, excessive borrowing, risky investment products, a lack of transparency and corporate governance failings.[2] The most

[1] The cut-off date for information included in this article is 6 May 2020.

[2] See, e.g., Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (2011), Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (2009), European Commission, *Report of the [De Larosière] High*

immediate response in the EU was to strengthen the prudential framework and the recovery and resolution regimes. As a result, the banks are in a stronger position in terms of capital and liquidity to withstand the current economic tsunami. The regulatory focus then turned to governance and cultural issues within the banks. The Capital Requirements Directive 2013/36/EU ('CRD IV') requires banks to have robust governance structures and arrangements in place to promote sound and effective risk management.[3] Competent authorities in their annual supervisory reviews are tasked with ensuring that this is the case and including within their scope corporate culture and values.[4] Standards of fitness and probity were also prescribed for directors to ensure their suitability.[5] In this area, progress may have been slower, and the 2019 Supervisory Review and Evaluation Process indicated that governance remains a risk area of particular supervisory concern, highlighting inter alia the limited effectiveness of management bodies and weaknesses in internal controls. Mark Carney, the then Governor of the Bank of England, observed that progress risks being 'overshadowed by a crisis of legitimacy' caused by incidents of misbehaviour and cultural failures across the world since the GFC.[6] These included the fixing of LIBOR by major

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Level Group on Financial Supervision in the EU (2009) and Grant Kirkpatrick 'The corporate governance lessons from the financial crisis' (2009) *OECD Journal: Financial Market Trends* 61.

[3] Directive 2013/36/EU, article 74(1).

[4] Directive 2013/36/EU, article 98(7).

[5] Directive 2013/36/EU, article 91(1). See also ESMA and EBA, *Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU*, EBA/GL/2017/12.

[6] Mark Carney 'Policy Panel: Investment and Growth in Advanced Economies' (Remarks at the 2017 ECB Forum on Central Banking, Sintra, 28 June 2018) <www.bankofengland.co.uk/speech/2017/policy-panel-investment-and-growth-in-advanced-economies>.

banks across the world, mis-selling payment protection insurance in UK banks and money laundering investigations involving Danish, Swedish, and German banks. Although the *2020 Edelman Global Trust Barometer* revealed increasing levels of trust in financial services over the last eight years, it still remained low at 56 %, and the sector was the last in the nine industry sectors examined.[7]

In Ireland, the effects of the GFC were particularly severe and rescuing the banks alone cost the State an estimated €41.7 billion, plus an additional €1 billion annually to service the interest on the debt.[8] Three government commissioned reports and one Parliamentary Banking Inquiry report have been published on the Irish banking crisis, and the consensus is that although it bore 'the clear imprint of global influences', it was in crucial ways 'home-made'.[9] It involved a property bubble, compounded by: an exceptional concentration of lending largely for commercial property purposes; poor supervision; weak corporate governance; and inadequate risk management and controls.[10] In relation to the latter, the Banking Inquiry criticised the decisions of bank boards, managers and advisors to pursue risky business practices to protect their market share and increase profits with undue consideration or appreciation

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[7] Edelman Trust Barometer 2020: Global Report <cdn2.hubspot.net/hubfs/440941/Trust%20Barometer%202020/2020%20Edelman%20Trust%20Barometer%20Global%20Report.pdf?utm_campaign=Global:%20Trust%20Barometer%202020&utm_source=Website>.

[8] The Comptroller and Auditor General, *Report on the Accounts of the Public Services 2018.*

[9] Klaus Regling and Max Watson, *A Preliminary Report on the Sources of Ireland's Banking Crisis* 5, (Government Publications Office, 2010) <inquiries.oireachtas.ie/banking/wp-content/uploads/2014/12/Regling-Watson-May-2010.pdf>.

[10] See further Blanaid Clarke and Niamh Hardiman, 'Crisis in the Irish Banking System' in Sue Konzelmann (ed) *Banking Systems in the Crisis: The Faces of Liberal Capitalism*. (Routledge, 2012).

for the consequences of their actions.[11] Unfortunately, since then, further examples of misbehaviour have come to light. The manner in which the banks treated retail customers on valuable tracker-mortgages since 2010 led to an examination by the regulator, the Central Bank of Ireland ('CBI'), and subsequently to the payment of €683 million in redress and compensation to over 40,000 affected customers.[12] Enforcement investigations are ongoing, and already one of the banks has been fined for regulatory breaches with the CBI's Director of Enforcement noting 'Where firms fail to protect their customers' best interests, our response will be robust and the consequences will be serious.'[13]

It is important to note at the outset that the current economic crisis caused by the COVID-19 pandemic ('the COVID Crisis') differs in significant ways from the GFC. Firstly, it is likely to be even more financially devastating than the GFC. The International Monetary Fund has predicted that the global economy will contract sharply by -3 % in 2020 and in the euro area countries, the contraction is projected at -7.5 %.[14] Ireland is an open economy, and the CBI has estimated that Irish real GDP could decline by around 8 % in 2020 with the unemployment rate reaching a peak of around 25 % in the

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[11] Joint Committee of Inquiry into the Banking Crisis, *Report of the Joint Committee of Inquiry into the Banking Crisis* (2016) <inquiries.oireachtas.ie/banking/volume-1-report/>.

[12] Central Bank of Ireland, *Final Report of the Tracker Mortgage Examination* (July 2019) <www.centralbank.ie/news-media/press-releases/press-release-final-tracker-report-16-july-2019>.

[13] Central Bank of Ireland, 'Public Statement Relating to Enforcement Action Against Permanent TSB plc' (19 July 2019) <www.centralbank.ie/docs/default-source/news-and-media/legal-notices/settlement-agreements/public-statement-relating-to-enforcement-action-against-permanent-tsb-p-l-c.pdf?sfvrsn=2>.

[14] IMF, *World Economic Outlook April 2020* <www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020>.

second quarter of 2020.[15] Secondly, the COVID Crisis is a health crisis as well as an economic crisis. The objective of the initial public policy response related to the former, ensuring the hospital systems were not overwhelmed and the 'curve is flattened' whilst seeking to protect economies. In most European countries this involved putting them into a form of temporary cold-storage. The duration of the COVID Crisis will depend to a large extent on the progress of the virus, the development of vaccine and therapeutic treatments and the availability of effective testing capacities – all of which are difficult to predict at this time. This means in turn that, as the European Commission has acknowledged, 'the danger of a deeper and more protracted recession is very real'.[16] Thirdly, and of particular importance in the context of this chapter, unlike the GFC, the banks have an opportunity to be part of the solution at this stage rather than part of the problem.

Part II of the chapter will examine the sources of bank culture and the importance of defining, establishing and embedding an appropriate culture and value system within banks. Part III sets out a brief review of stakeholder theories, the purpose of banks and their responsibilities to their customers and the wider community. Part IV will analyse the changes which have taken place in Irish banking culture since the GFC and consider whether a customer-focused culture might be said to be reflected in their recent actions. As has been noted, 'an avowed

[15] Central Bank of Ireland, *Quarterly Bulletin No.2 of 2020* <www.centralbank.ie/publication/quarterly-bulletins/quarterly-bulletin-q2-2020>.

[16] European Commission, *Spring 2020 Economic Forecast* (May 2020) <ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/spring-2020-economic-forecast-deep-and-uneven-recession-uncertain-recovery_en>.

commitment to higher standards may mean little in itself without something to back it up'.[17]

2. Bank culture

An important feature in restoring trust in the banks and their leaders is signalling trustworthiness and one of the mechanisms for doing this is by developing and communicating a strong ethical culture.[18] 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; higher levels of customer satisfaction and loyalty; and improved reputation. Research also suggests that once a particular culture is known or even perceived to exist, it is difficult to persuade people of change especially if the culture is viewed as being based on ignorance, recklessness and hubris.[19] This is important given the fact the GFC and many of the bank scandals since then revealed evidence of these characteristics in the banks and their managers.

Culture is determined and guided to a large extent by a firm'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:

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[17] William Blair and Clara Barbiani 'The Beauty of Ethics: Towards Re-Establishing Trust in the Financial Sector' (2019) 6 *Pensamiento Social* 79.
[18] Reinhard Bachmann, Nicole Gillespie and Richard Priem, 'Repairing Trust in Organizations and Institutions: Toward a Conceptual Framework' (2015) 36 *Organization Studies* 1123.
[19] Guy Claxton, David Owen and Eugene Sadler-Smith, 'Hubris in leadership: A peril of unbridled intuition?' (2015) 11 *Leadership* 57.

integrity; openness; ethics; regulatory compliance and respect; and a focus on reducing the potential for harm. Since the GFC, there has been an increased emphasis on risk and Andrea Enria, Chair of the Supervisory Board of the European Central Bank ('ECB') noted 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.[20]

While an institution engenders such a culture in a variety of ways, including embedding a strong set of values and adhering to ethical or behavioural guidelines, organisational leadership is key. Boards must accept responsibility for establishing the company's purpose and defining and articulating its values and strategy. These 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-cut legal requirements.[21] The Basel Committee's *Corporate Governance Principles for Banks* advise senior management to develop a written code of ethics or a code of conduct in order to 'foster a culture of honesty and accountability to protect the interest of its customers and shareholders'.[22] The behaviour of boards and senior managers must then be seen to be consistent with these values and ethics if they are to successfully set the 'tone from

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[20] 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 in Ireland, Dublin, 20 June 2019) <www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp190620~f9149fe258.en.html>.

[21] G30, *G30 Banking Conduct and Culture Report: Banking Conduct and Culture: A Permanent Mindset Change* (2018) 5 <group30.org/images/uploads/publications/G30_Culture2018_FNL3lo-compressed.pdf>.

[22] See <www.bis.org/bcbs/publ/d328.pdf>.

the top'. The European Commission is considering whether corporate culture could and should be taken into consideration as part of the fit and proper assessment.[23] Such a move would be welcomed. Boards are also responsible for ensuring that the bank's desired values are embedded and continually reinforced and for identifying ethical failings and taking decisive and early action. A key part of this is ensuring that good behaviour which aligns with the bank's stated values is incentivised and rewarded, and poor behaviour is discouraged and not rewarded. This is important because research in behavioural ethics has shown that human responses are highly dependent upon situational and social pressures. There must be a culture not only of doing the right thing but of being able to speak up in a supportive environment to report incidents of poor behaviour secure in the knowledge that they will be addressed. Boards are responsible too for ensuring that effective systems and controls are in place to identify such misbehaviour. Although board support is key, setting the cultural tone is the responsibility of all managers and employees. The G30 in 2018 warned that:

> Only by making culture stewardship a permanent and integral part of how business is conducted [at all levels of the organisations] will organisations avoid culture fatigue and backsliding.[24]

Regulators are becoming increasingly aware of the need to examine how ethical considerations are factored into the behaviour of the banks in order to guard against misconduct. In 2018, the CBI published a report *Behaviour and Culture of the Irish Retail Banks* undertaken in collaboration with the Dutch

[23] European Commission, *Public Consultation Document Implementing the Final Basel III Reforms in the EU* (October 2019) <ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-basel-3-consultation-document_en.pdf>.
[24] *G30 Banking report* (n 21) 11.

Central Bank setting out the outcome of a series of reviews undertaken in the five main Irish retail banks. The report concluded that the banks had made varying degrees of progress in reinforcing the consideration of the consumer interest. However, it found that there was not a sufficient collective understanding of what 'consumer focus' means and what behaviour it requires and that such a focus was not properly embedded in the banks' structures, processes and systems. It proposed the introduction of a new Individual Accountability Framework to include conduct standards for regulated financial services providers and employees, a Senior Executive Accountability Regime, akin to the UK's Senior Managers Regime, and enhancements to the existing Fitness & Probity Regime. While the banks prepared action plans to respond to the failings identified by the CBI, the latter reiterated earlier this year that one of the key risks remains the lack of a consumer-focused culture within the financial services sector.[25] One positive development which demonstrated the commitment of the retail banks to improving bank culture was the funding and establishment last year of the Irish Banking Culture Board ('IBCB'). Its board constitutes senior individuals from the five retail banks, six non-banking directors with experience in consumer financial services, a financial services union director, a CEO and an independent chairman. The IBCB's objective is to rebuild trust in the sector through promoting a change in behaviour and overall culture leading to an environment in which 'ethical behaviour lies at the heart of banking, values are

[25] Central Bank, *Consumer Protection Outlook 2020* (March 2020) <www.centralbank.ie/docs/default-source/regulation/consumer-protection/consumer-protection-outlook-report/consumer-protection-outlook-report-2020.pdf?sfvrsn=4>.

restored, and reputation for competence is rediscovered.'[26] On the basis of two extensive surveys of stakeholders and bank employees, the IBCB identified nine key priorities for 2019-2020: 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. All of these priorities remain relevant and will contribute to the proper treatment of stakeholders during the COVID-19 Crisis.

3. Corporate social responsible and the purpose of banks

In evaluating how banks have responded to the COVID Crisis, it is important to consider their role in society, the tools available to allow them to play this role and the challenges they face. One of the key questions that has dominated corporate governance scholarship over the last hundred years is: in whose interests should the company be run? The shareholder primacy norm advocates that companies be operated in the interests of shareholders. A broader stakeholder theory, by contrast, suggests that they should be operated in the interests of a wider group of stakeholders including employees, customers, suppliers, local communities, and society at large.[27] The former

[26] Opening Statement of Mr. Justice John Hedigan, Chair of The Irish Banking Culture Board, at the Oireachtas Finance Committee 1 October 2019 <www.irishbankingcultureboard.ie/opening-statement-of-mr-justice-john-hedigan-chair-of-the-irish-banking-culture-board-at-the-oireachtas-finance-committee/>.

[27] See for example Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Virginia Law Review 247, Lynn Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy' (2002) 75 Southern California Law Review 1189, Stephen Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm' (1993) 50 Washington & Lee Law Review 1423.

theory is generally attributed to an essay in 1970 by Milton Friedman entitled 'The Social Responsibility of Business is to Increase its Profits'.[28] In a seminal article entitled 'The End of History for Corporate Law', Hansmann and Kraakman suggested 'a widespread normative consensus that corporate managers should act exclusively in the economic interests of shareholders'. [29] However, the academic community remains divided, and the conversation continues. The debate might be said to have re-ignited in 2018 when Larry Fink, CEO of BlackRock in his annual letter to CEOs stated:

> Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.[30]

In a move considered as highly significant, in August 2019, members of the Business Roundtable of the largest US companies committed publicly to protect the interests of all their stakeholders, not only shareholders. This year, Fink drew the obvious connection between social responsibility and shareholder return, explaining:

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[28] Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits' *New York Times* (13 September 1970, Sunday Magazine, 32). A fascinating article suggests that Friedman was merely reflecting the prevailing thinking of the time (Brian Cheffins, 'Stop Blaming Milton Friedman!' (2020) University of Cambridge Faculty of Law Research Paper *No. 9/2020* <ssrn.com/abstract=3552950>).

[29] Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2000) Yale Law School Working Paper No. 235 <ssrn.com/abstract=204528>.

[30] Larry Fink, 'A sense of Purpose' (17 January 2018) <corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/>.

> a company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders…. actions that damage society will catch up with a company and destroy shareholder value. By contrast, a strong sense of purpose and a commitment to stakeholders helps a company connect more deeply to its customers and adjust to the changing demands of society. Ultimately, purpose is the engine of long-term profitability. [31]

This emphasis on profit, albeit long term profit, might be classified as a form of enlightened shareholder value.[32] Global companies heard the same message at the World Economic Forum this year, and 140 of the world's largest companies agreed to *The Davos Manifesto 2020* which described as the purpose of a company 'to engage all its stakeholders in shared and sustained value creation.'[33] Edward Rock attributes this current focus on redefining corporate purpose to political dysfunction stemming from the GFC, governmental failures, and legislative inaction in addressing societal issues such as climate change, poverty and inequality.[34] Companies, especially multinationals, are being pressed to take responsibility to work with governments and civil society to address big global challenges which cannot be solved by governments alone or by business or civil society alone.[35] Jaap Winter argues that:

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[31] Larry Fink, 'A Fundamental Reshaping of Finance' (14 January 2020) <www.blackrock.com/hk/en/larry-fink-ceo-letter>.

[32] David Millon, 'Enlightened Shareholder Value, Social Responsibility, and the Redefinition of Corporate Purpose Without Law' (2010) Washington & Lee Legal Studies Paper No. 2010-11 <ssrn.com/abstract=1625750>.

[33] WEF, *Compact for Responsive and Responsible Leadership: The Davos Manifesto 2020* <www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution/>.

[34] Edward Rock, 'For Whom is the Corporation Managed in 2020?: The Debate Over Corporate Purpose' (May 2020) <ssrn.com/abstract=3589951>.

[35] Interview with Klaus Schwab, *Financial Times* (14 January 2020).

> If corporations want to reconnect with society, they will have to be explicit about their ultimate objective, what value they will add to society. Generating shareholder value should not be the objective of this process, but a consequence.[36]

In a subsequent paper written since the COVID-19 outbreak, Winter states 'if ever there was a time that society needs business to take responsibility beyond its own immediate financial success, that time is now'.[37]

It is submitted, the role of banks is even more clear-cut. Although not subject of the same level of academic debate as non-banks in this context, Klaus Hopt has argued recently that for banks, stakeholder governance has prevailed over shareholder governance.[38] In making this argument, he refers to empirical evidence that banks practising shareholder-oriented governance styles fared less well than banks with less shareholder-prone boards and less shareholder influence. The Basel Committee's *Corporate Governance Principles for Banks*[39] has acknowledged the crucial role banks play '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 too has

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[36] Jaap Winter, 'Dehumanisation of the Large Corporation' (January 2020) <ssrn.com/abstract=3517492>.

[37] Jaap Winter, 'Addressing the Crisis of the Modern Corporation: The Duty of Societal Responsibility of the Board' (April 2020) <ssrn.com/abstract=3574681>.

[38] Klaus Hopt, 'Corporate Governance of Banks and Financial Institutions: Economic Theory, Supervisory Practice, Evidence and Policy' (2020) European Corporate Governance Institute - Law Working Paper No. 507/2020 <ssrn.com/abstract=3553780>.

[39] The Basel Committee on Banking Supervision, 'Corporate Governance Principles for Banks' (July 2015) 3 <www.bis.org/bcbs/publ/d328.pdf>.

emphasised its expectation that banks 'act in their customers' best interests in tandem with fulfilling their prudential obligations.'[40] If conflicts exist between different stakeholders, the Basel Committee is clear that shareholders' interests should be secondary to depositors' interests.[41] A group of senior UK bankers and financial services professionals in their 2016 report *Banking on Trust* acknowledged this hierarchy. They accepted that following the GFC, banks had work to do to convince people that they can be trusted 'to be safe and responsible custodians of clients' money' and to 'put customers back at the heart of the business model'. The challenge was for banks 'to demonstrably exercise a duty of care to those they serve'.[42] As the next section of the chapter discusses, the COVID Crisis provides such an opportunity.

4. COVID-19 crisis

There is now an immediate and pressing need for banks to support their retail and commercial customers and the communities at large. Their ability to provide this support has been strengthened by the actions of the ECB. Banks were given permission to use various liquidity and capital buffers which the ECB estimated could potentially finance up to €1.8 trillion of lending within the EU.[43] The ECB also introduced supervisory

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[40] Central Bank of Ireland, Behaviour and Culture of the Irish Retail Banks (July 2018) 20. <www.centralbank.ie/docs/default-source/publications/corporate-reports/behaviour-and-culture-of-the-irish-retail-banks.pdf?sfvrsn=2>.

[41] BCBS Principles (n 39) 3.

[42] Banking Futures Working Group, *Banking on Trust Engaging to Rebuild a Healthy Banking Sector: Report on the Banking Futures Consultation* (2016) 5 <www.meteos.co.uk/wp-content/uploads/BankingFutures-Report-1-February-2016.pdf>.

[43] ECB, 'ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus' (20 March 2020)

flexibility regarding the treatment of non-performing loans[44] although further flexibility will be required as the timetable to resolve arrears remains overlytight. It is worth noting however that while the ECB's asset purchase programmes and targeted lending operations have had a positive effect on bank liquidity and market financing conditions, and together with the negative deposit facility rate, have led to increased lending volumes, they have also had a negative effect on bank profitability.[45]

Having identified the important social function played by banks and their need to consider stakeholders and the wider public interest, we might consider how well their actions in the last three months has demonstrated a recognition of this higher purpose and a commitment to the values they espouse. Many of the banks have engaged in social activism. This would include the contribution of €2.4m by AIB to Trinity College Dublin's immunology project tackling COVID as well as the donation by Bank of Ireland of €1m in emergency funding to communities with urgent needs arising from the COVID pandemic. These are significant and commendable actions. Whilst they might be said to fall outside the banks' business operations, they are consistent with the stated values of the banks.

When examining the measures taken by the banks as part of their business operations, we would expect to identify actions which benefit a wider group of stakeholders but which also

<www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html>.

[44] EU and national regulators have indicated that flexibility will guide their supervisory approaches, <eba.europa.eu/eba-provides-further-guidance-use-flexibility-relation-covid-19-and-calls-heightened-attention-risks>.

[45] ECB, '*The Euro Area Bank Lending Survey – First quarter of 2020*' (28 April 2020) <www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2020q1~17a1b2b7d2.en.html#toc2>.

benefit shareholders and would not be inconsistent with the shareholder primacy norm. These would include actions, for example, which lead to reputational gain or increase customer loyalty and which would be in keeping with the enlightened shareholder value norm described above. One might also hope to find actions which are taken to protect stakeholders for the sake of their relevant interests themselves in response to what John Parkinson described as 'a supposed moral imperative that may conflict with profit maximisation'.[46] These actions would involve uncompensatable costs which would not improve shareholder returns – stakeholderism in its truest form.

In March, the five Irish retail banks and the Banking & Payments Federation Ireland ('BPFI'), their representative body announced a joint plan to support businesses and personal customers impacted by the COVID-19 pandemic stating that 'we will play our part at this critical time'.[47] The announcement stated that the banks were working collaboratively to ensure that 'continuity of service plans are in place, that critical functions can continue, and that staff remain available to continue to service customers'. This plan was welcomed by the IBCB as a demonstration that the banks 'recognise their responsibilities as financial pillars in our society with a critical role to play in the present and future of the Irish economy'.[48] Despite reduced margins, low growth prospects and falling share prices, banks have indeed stepped up to play a key role in supporting their

[46] John Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company* Law (Oxford University Press 1995).

[47] Banking & Payments Federation Ireland (18 March 2020) <www.bpfi.ie/news/banks-set-joint-plan-support-businesses-personal-customers-impacted-covid-19-pandemic/>.

[48] IBCB, 'Irish Banking Culture Board welcomes agreement from banks on COVID-19 measures' (18 March 2020) <www.irishbankingcultureboard.ie/irish-banking-culture-board-welcomes-agreement-from-banks-on-covid-19-measures/>.

customers and especially small and medium size enterprises by extending credit to customers facing financial strains.[49] They are also acting as conduits for Governmental financial support to businesses. All the banks have dedicated web pages and bank staff to provide information on COVID-19 supports and tailored solutions. Overdraft facilities and mortgage and loan payment breaks are available, and the latter has been designed to ensure customers' credit records will not be negatively affected. By the end of April, over 65,000 mortgage payment breaks and over 22,000 SME payment breaks had been granted.[50] In addition, priority banking hours in branches and priority phone lines have been introduced for elderly and vulnerable customers, and the BPFI has produced a guide to help those cocooning at home to manage their money.

These are important contributions and although costly in the short-term will build trust and begin perhaps to restore the reputation of the banks. However, transparency and clear communications are key at a time like this and customers must be made aware in advance of the terms of any renegotiated deals and what their repayments will be once the break is over. The IBCB has called on its member banks to communicate clearly and transparently with their customers how fees and charges associated with unpaid direct debits, unauthorised overdraft fees would be treated.[51] It stated, 'How we as individuals and

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[49] An ECB survey conducted between 19 March and 3 April 2020 revealed an upward impact of the COVID-19 pandemic on firms' loan demand, largely driven by emergency liquidity needs (ECB lending survey (n 45)).

[50] BPFI, 'BPFI members confirm Payment Break extension from three months to six months for those directly impacted by Covid-19' (30 April 2020) <www.bpfi.ie/news/bpfi-members-confirm-payment-break-extension-three-months-six-months-directly-impacted-covid-19/>.

[51] IBCB, 'How the banks act now will determine how they are perceived in the future' (6 April 2020) <www.irishbankingcultureboard.ie/how-the-banks-act-now-will-determine-how-they-are-perceived-in-the-future/>.

companies treat those who rely on us during these difficult times will impact on our reputations and trust levels for many years to come.' Banks must avoid any actions which might lead to claims of profiteering or sharp practice. In the UK, the Financial Conduct Authority stated that it had received 'credible reports' of a small number of banks failing to treat their corporate clients fairly when negotiating new or existing debt facilities and using their lending relationship to exert pressure on corporate clients to secure roles on lucrative equity mandates.[52] While there have been no reports of similar egregious actions in Irish banks, the line between applying the usual business model and profiteering is a fine one in the eyes of the public. One Irish bank was criticised by a number of politicians and the popular press for imposing standard quarterly charges in respect of the accounts of customers who had lost their jobs during the COVID-19 crisis.[53] The bank responded by announcing the temporary deferment of such charges for SMEs.

In moves that involve a more immediate effect on shareholders' return and bring the shareholder versus stakeholder model into sharper focus, EU banks were asked by the ECB not to pay dividends or buy back shares at least until October 2020.[54] In its Recommendation, the ECB stated that it was essential that banks conserve capital to support the real economy and absorb losses and that this 'should take priority at present over discretionary dividend distributions and share buy-backs.'[55]

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[52] FCA, 'Ensuring fair treatment of corporate customers preparing to raise equity finance' (28 April 2020) < www.fca.org.uk/publication/correspondence/dear-ceo-ensuring-fair-treatment-corporate-customers-preparing-raise-equity-finance.pdf>.

[53] *Irish Examiner* 31 March 2020.

[54] Recommendation of the European Central Bank of 27 March 2020 on dividend distributions during the COVID-19 pandemic and repealing Recommendation ECB/2020/1 (2020/C 102 I/01).

[55] Ibid, recital 1.

The ECB also indicated an expectation that shareholders would 'join this collective effort'. At the time of writing, three of the Irish banks had announced they would suspend dividend payments. This could be seen as the triumph of the true form of stakeholderism as such steps are not without their costs to pension funds, charities and other savers, who depend on dividends as a source of steady income. Capital conservation is relevant too in the context of bonus pay. Remuneration has been described as one of the most politically controversial culture-related issues.[56] In the aftermath of the GFC, it was recognised that pay had become a driver for excessive risk-taking and short-termism. CRD IV thus regulated both the structure and quantum of remuneration. It gave remuneration committees responsibility for the preparation of remuneration decisions[57] requiring them to consider in doing so 'the long-term interests of shareholders, investors and other stakeholders in the institution and the public interest'[58]. The remuneration principles set out in CRD IV provide further detail on the development of a remuneration policy which should be aligned with an institutions' risk appetite, values and long-term interests.[59] Although senior executives at a number of UK banks[60] have published their intention to take pay cuts in solidarity with the customer, the Irish banks have not yet made statements on this point. In a pre-emptive move, Andrea Enria has warned European banks to exercise 'extreme moderation'

[56]Huw Macartney, *The Bank Culture Debate: Ethics, Values and Financialization in Anglo-America* (Oxford University Press, 2019) 18.
[57] Directive 2013/36/EU, article 93(2).
[58] Directive 2013/36/EU, article 95(2).
[59]Directive 2013/36/EU, article 92(2).
[60] David Crow, 'HSBC, StanChart and Lloyds drop executive bonuses' *Financial Times* (New York 8 April 2020).

on their bonus payments this year, threatening to intervene if they failed to show restraint.[61]

5. Conclusion

While it is not possible to determine definitively that the current actions of the banks are attributable to their commitments to improved corporate culture and customer-focused behaviour, there appears to have been a marked improvement in the behaviour of the banks during the COVID Crisis. Banks are 'walking the walk' after years of 'talking the talk'.

It is heartening to see banks step up to the mark and demonstrate their commitment to their customers and the wider community, living the values in a real and demonstrable manner. This is likely to become more difficult in coming months. Although banks faced into the Covid Crisis with stronger balance sheets, they will encountersignificant challenges in continuing to support their retail and corporate clients during a recession and to provide liquidity even as credit losses mount. In addition, as noted earlier, there are significant societal challenges which will require the co-operation of all corporate players. For example, global warming is projected to be approaching 1.2C above pre-industrial levels, and despite the current reduction of new emissions, the concentration of greenhouse gases in the atmosphere remains a huge concern. As many commentators have noted, the COVID Crisis could present an opportunity to rebuild our economies and to make better choices in so doing. It is noteworthy that there has been a marked difference in the debate surrounding the decisions which needed to be made in the COVID Crisis from previous debates on climate change where scientists have been ignored or discredited. The UK Met

[61] *Financial Times* Interview 31 March 2020.

Office stated, 'A reliance and trust in science to inform action from governments and society to solve a global emergency are exactly the measures needed to seed in plans to solve the next crisis facing mankind: climate change.'[62] Clearly, there will be challenges along the way. There is a possibility that scientists will once again fall into disrepute – there are already signs in a number of countries of politicians seeking to shift the blame onto scientists for their own inadequate or untimely responses. There will also be demands from some sectors of the community to get the economy moving as quickly as possible and without the costs or burdens perceived to flow from environmental regulation. Another concern which has been expressed is that social responsibility will overshadow environmental responsibility in the immediate aftermath of the COVID Crisis. The necessary current focus on the 'S' component of ESG may divert attention from the 'E' component. This would be unfortunate as all elements of ESG are equally important in the long run.

It is submitted that banks have a fundamental role to play in this context through the manner they conduct their own businesses and their support for the sustainable practices of their customers and through their influence in shaping public policy. In the COVID Crisis, banks have demonstrated their ability to exercise their social licence, and a reversion to business as usual would be unforgivable. Investors, of course, need to be rewarded for their investments and the return of dividends and share buy-backs will, in time, be appropriate. However, banks have taken up the mantle of cultural leadership and must not relinquish it. The renowned English historian, G. M. Trevelyan, summed up the revolutionary movements of the mid-nineteenth

[62] Jonathan Watts, 'Meteorologists say 2020 on course to be hottest year since records began' *Guardian* (27 April 2020).

century by noting ‘1848 was the turning point at which modern history failed to turn.’ We must ensure that the same is not said about the post COVID period.

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5 Mothballing the economy and the effects on banks

Matthias Lehmann[1]

1. Introduction

The COVID-19 pandemic is creating unprecedented challenges for societies and the economy. As a result, the state as the ultimate holder of the power is making a comeback. Around the world, legislators and governments have intervened on different levels.

2. The tree-level model of state responses to COVID-19

At a 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, in order 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 fallout a lockdown produces. As a result of the measures taken, social and economic life has ground to a halt.

[1] Many thanks to Amy Held, Katharina Heller, Stefan Hoffmann, Saskia Marx, Miriam Reiter, Jonas Schürger, Max Wilden and Patrick Wittum for helpful comments. The cut-off date for information included in this article is 19 May 2020.

At a second level, the state tries to limit the negative effects of the measures adopted at the first level by attempting to 'pause' or 'deep-freeze' 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 repaying capital? What if the creditor is itself in dire straits?

Some techniques used for mothballing are as follows: (1) the rules on insolvency have been relaxed, e.g. the liability for wrongful trading[2] or the duty of companies' directors to apply for the opening of an insolvency procedure[3]; (2) 'moratoria' or 'repayment holidays' have been introduced for vulnerable debtors of loans, such as consumers or microenterprises[4]; (3) sanctions for not meeting contractual obligations have been mitigated or excluded, for instance by banning the eviction of tenants for failure to pay the rent.[5] 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,

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[2] See, for example, Corporations Act 2001 (Australia), sec 588GAAA, as amended 2020.

[3] 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*), Art 1 sec 1.

[4] See for example *4. COVID-19-Gesetz* (Austria), 4 April 2020 (*Austrian COVID-19 Act*), Art 37 sec 3; *German COVID-19 Act*, Art 5 sec 3.

[5] See for example *Austrian COVID-19 Act*, Art 37 sec 1; *German COVID-19 Act*, Art 5 sec 2.

[6] 'Chinese new year extended to contain spread of Coronavirus' (*BBC*, 27 January 2020) <www.bbc.co.uk/programmes/w172wyb155yx99x>.

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 here as the ultimate insurance provider for every part of society. In this context also, important decisions need to be made. Which industries or companies should be bailed out, and on what terms? Who is to 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 table below.

	First Level	**Second Level 2**	**Third Level**
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: • bail-outs • 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 the economy to the new conditions. In comparison, the Coronavirus crisis is both extremely urgent and of 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. Some European countries merely have imposed limitations on short selling activities in order to avoid the worst reactions to the pandemic.[7] But this merely confirms the general trend: financial markets continue unbridled.

[7] See ESMA, 'ESMA issues positive opinions on short-selling bans by five jurisdictions' (15 April 2020) <www.esma.europa.eu/press-news/esma-news/esma-issues-positive-opinions-short-selling-bans-austrian-fma-belgian-fsma>.

Equally, banks are continuing to function. Though branches have been closed, online banking and ATMs remain available. Activity in wholesale banking and the provision of credit has not merely continued but has 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, 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. Banks thus now have partly become mere pass-through entities for the distribution of capital from the state to society.

4. A hard hitting test on banks' resilience

Besides implementing state programmes on 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 the aftermath of the global financial crisis.[8] The quality of the

[8] For an overview, see IMF, 'Global Financial Stability Report, October 2018: A Decade after the Global Financial Crisis: Are We Safer?' (October 2018) <www.elibrary.imf.org/view/IMF082/25319-9781484375594/25319-9781484375594/ch02.xml>; FSB, 'Implementation and Effects of the G20 Financial Regulatory Reforms, 3 July 2017 3rd Annual Report' <www.fsb.org/wp-content/uploads/P030717-2.pdf>.

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 taxpayers will bear the brunt of a bank failure. All of this makes the banking sector more robust in times of crises, 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.[9] They have also cautioned against handing out generous bankers' bonuses.[10]

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 functioning of the financial system.[11] In terms of risk classification, the COVID-19 crisis can be categorised as a 'common shock' that is not rooted in the financial system, but

[9] 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 63, 30.3.2020, p. 1.

[10] 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) <www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-statement-on-deposit-takers-approach-to-dividend-payments-share-buybacks-and-cash-bonuses>.

[11] On the notion of systemic risk, see Olivier De Bandt and Philipp Hartmann, 'Systemic Risk: A Survey' (2000) ECB Working Paper No. Series 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.

is exogenous to it. It is true that one of the functions of capital requirements precisely is to shield banks against exogenous shock.[12] 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 is 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 hitherto hidden correlation between them.
- Third, the crisis was hard to foresee. Only a few expected in January 2020 that a global 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.

- 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.

[12] 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).

- Third, due to the lack of foreseeability, rating models and other methods of gauging risk are failing. There is simply insufficient data on the disease due to its unprecedented nature and proportions. The most recent comparable pandemic, the Spanish flu, occurred in 1918-19. 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 2 equally have a particularly negative impact on the banking sector. Most loans have been written by banks. This means that emergency legislation suspending repayments hits them hard. The state is granting relief through mothballing but the bill is being footed by the banking system.

To ease the burden on banks, states have taken the unusual step to relax capital requirements. Countercyclical risk buffers have been reduced, often to zero.[13] Other risk management measures, such as the qualitative market risk multiplier,[14] have also been relaxed. Scheduled stress tests have been suspended until

[13] See for example Central Bank of Ireland, 'Statement: Central Bank of Ireland' (18 March 2020) <www.centralbank.ie/news/article/press-release-statement-central-bank-of-ireland-18-march-2020>.

[14] See ECB, 'ECB Banking Supervision provides temporary relief for capital requirements for market risk' (16 April 2020), <www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200416~ecf270bca8.en.html>.

2021,[15] while planned reforms to strengthen regulation have been postponed.[16]

All of these measures take the immediate pressure from the banking book. Yet they only allow credit institutions to deplete their own funds. They do nothing to strengthen the banks' capital base.

5. The 'bail-in' regime is unsuitable for this crisis

The double-attack of the on-going 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 avoid precisely this: the need for the state to bail out the banking sector.[17] They were created as a response to the 'too big to fail' conundrum, which meant that taxpayer money had to be spent on banks in order to avoid a deepening of the crisis. The underlying idea of resolution regimes was that this should not happen in the future:

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[15] See for example 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>.

[16] BCBS, 'Basel Committee and IOSCO announce deferral of final implementation phases of the margin requirements for non-centrally cleared derivatives' (3 April 2020) <www.bis.org/press/p200403a.htm>.

[17] See EU Bank Recovery and Resolution Directive Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, [2014] OJ L 173/190; and Title II of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act 2010, Publ. L. 111–203, 124 Stat. 1376.

moral hazard should be avoided at all cost; bankers should no longer be able to privatise gains and socialise losses.[18]

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 actions. It is not the consequence of their risky behaviour or opaque transactions.

Furthermore, the state now places additional strain on the bank's balance sheets. In order to achieve macroeconomic goals, regulators are actively interfering with commercial 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.[19] 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.[20] 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 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 the result of their actions in the public interest as demanded by regulators.

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[18] See G20 Leaders's Statement, Pittsburgh, 24-25 September 2009, no 13; see also FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, 15 October 2014, Preamble.

[19] BCBS, 'Basel Committee sets out additional measures to alleviate the impact of Covid-19' (3 April 2020) <www.bis.org/press/p200403.htm>.

[20] Stephen Morris, David Crow and Matthew Vincent, 'BoE Warns Bank Loan Reserves Risk Choking Business Funding' (26 April 2020) <www.ft.com/content/75767049-edfb-4074-942c-f9ce4d07f861>.

It follows that the application of the bail-in tool, a core feature of the resolution regimes, will not always be appropriate in the current crisis. The more that decisions were taken in the public interest and on the behest of financial regulators, the less it is justified to make shareholders and creditors bear the brunt of the bank's demise. It can therefore not be categorically excluded that the state as the ultimate insurer intervenes at the third level to save credit institutions 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 of the reasons for the failure; the law is not interested in how the failure came about. Even the (in)famous rule on 'precautionary recaps'[21] is too stringent to allow COVID-19 relief because it is limited to institutions that are not failing or likely to fail.

This rigid 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 urgently be changed. It must be made clear that states may bailout banks which 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 these banks have been encouraged by regulators to use their capital for the distribution of new loans.

The change requires the introduction of a crucial dividing line in resolution law. A distinction needs to be made between banking crises that are the result of the risk-taking decisions of the banking institutions themselves, and those that have been

[21] Art 32(4)(d) BRRD.

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 of the European Union). A similar exception must also be included in 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.

5. The future: banking after the COVID-19

The COVID-19 crisis is another forceful demonstration of the intimate connection between states and banks. It 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 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.[22]

A number of authors do not see this development as worrying, but rather applaud it. They support the application of certain principles of utilities law, such as democratic governance, or

[22] John M Schiff, 'Is Basel Turning Banks into Public Utilities?' (2015) 3 Journal of Financial Perspectives 04.

fair and equal fee setting, to banks.[23] In their view, credit institutions should no longer be private property.[24]

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 can be raided by regulators 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 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

[23] 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 equality).

[24] White (n 23) 1268 ('Banks are not private property.').

need to resume their role as the prime decision-maker on a questions such as to whom 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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SECTION II: FISCAL RESPONSE

6 European economic governance and the pandemic: Fiscal crisis management under a flawed policy process

Christos Hadjiemmanuil[1]

1. The economic fallout from the pandemic and the national fiscal responses

The COVID-19 pandemic has caused a global collapse of economic activity. The shock, which affects both the supply and the demand sides of the real economy, propagates through several mutually reinforcing channels. The sudden discontinuation of many productive activities, the significant practical and administrative impediments to cross-border trade, and the disruption of international value chains are met by a sharp fall in consumer demand. The latter is partly due to reduced income flows, but also reflects behavioural adaptations at the individual-actor level, induced by the new-found fear of social contact, loss of consumer confidence in the face of a very negative current outlook, and massive uncertainty as to the time and nature of the hoped-for exit. The lockdowns imposed by

[1] The cut-off date for information included in this article is 19 May 2020.

governments on the grounds of public health[2] significantly accelerate and deepen the economic effects of the blow.

Being the primary epicentre of the pandemic during March and April 2020, the euro area has fared exceptionally badly. In the first quarter of 2020, the area's GDP shrank by 3.8 % – the largest recorded drop since the start of the Eurostat's statistical series in 1995, which already exceeds the worst phase of the Global Financial Crisis.[3] The second quarter promises to be even worse. As of the time of writing (8 May 2020), the situation raises major concerns regarding the ability of a very large part of the businesses sector to survive and, indirectly, for the starting point and trajectory of an eventual recovery.[4]

The pandemic's unprecedented and immediate economic fallout has triggered equally dramatic and instantaneous responses in the economic policy area. Convinced that, in view

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[2] Alexander Chudik, M Hashem Pesaran, and Alessandro Rebucci, 'Voluntary and Mandatory Social Distancing: Evidence on COVID-19 Exposure Rates from Chinese Provinces and Selected Countries' (2020) NBER Working Paper 27039 <www.nber.org/papers/w27039>.

[3] Eurostat, 'Preliminary Flash Estimate for the First Quarter of 2020: GDP Down by 3.8% in the Euro Area and by 3.5% in the EU' (News Release 74/2020, 30 April 2020). Significantly, the quarter includes many weeks before the pandemic's European eruption.

[4] By late April 2020, the Eurozone Purchasing Managers' Index (PMI) (an indicator produced by IHS Markit which records how firms' business activity has changed over the previous month, with a reading below 50 indicating that a majority of firms reported deterioration) crashed to 13.5, from an already very low 29.7 in March. This was by far the lowest reading since the index invention in July 1998. The slump was significantly below economists' consensus estimates. When compared to GDP data, the PMI index suggested that the euro area economy is presently contracting at a quarterly rate of around 7.5%. IHS Markit, 'HIS Markit Flash Eurozone PMI: Unprecedented Collapse of Eurozone Economy amid Virus Lockdown' (News Release, 23 April 2020) <www.markiteconomics.com/Public/Home/PressRelease/b9c4af250a8e40efabbb1b120b368e6f>.

of the potential scale of the crisis, the fiscal systems' automatic stabilisers (that is, the countercyclical effect of taxation and unemployment insurance regimes) would be patently insufficient, governments and central banks on both sides of the Atlantic have sought to alleviate the rapidly deteriorating situation by launching very-large-scale and frontloaded support programmes, both monetary and fiscal. In this environment of extreme urgency, macroeconomic decision-makers have abandoned their typically cautious and gradualist approach, and long-held dogmas (and sometimes, legal rules) underpinning macroeconomic decision-making in normal times have been pushed to the wayside to permit interventions of rather radical and unorthodox nature.

Significantly, the support packages primarily aim, not as much to boost demand *per se* (as a classical demand-management policy would try to do), but to provide a protective shield for firms and their employees through the crisis, thus preserving the economy's productive base for the day after. This is attempted by providing ample and subsidised liquidity to cash-strapped enterprises, maintaining the workforce in place through furloughs and short-time employment (*Kurzarbeit*) schemes,[5] and preventing widespread insolvencies, including through legal interventions (such as moratoria, regulatory forbearance, etc.). An added benefit of this strategy is that it averts –or, at least, postpones– the financial reckoning of the pandemic's real effects, which could very easily lead to a generalised and overwhelming banking and financial crisis.

[5] By end-April 2020, a fifth of the five biggest European economies' total workforce had applied for wage support under the respective national programmes; Martin Arnold, 'Furlough Schemes Tapped by 30m Workers' Financial Times (Europe edn, 29 April 2020) 2.

The costs of the fiscal support packages are monumental. Staggering amounts have already been committed by the governments of developed countries.[6]

In the US, the various fiscal measures adopted in March and April 2020 amount in total to $1.94 trillion of immediate fiscal impulses, $0.56 trillion of deferrals of payments to the state, and $0.56 trillion of other liquidity and guarantee measures.[7] With the caveat that it is highly dubious to add up grants with capital injections and liquidity supporting measures of various descriptions and dissimilar length and terms, such as guarantees, loans, and deferrals of payments due, one observes that the headline value of the combined fiscal backstops has already reached a level of no less than $3 trillion. This is equivalent to 14 % of the US's 2019 GDP of $21.42 trillion, without counting the Fed's drastic monetary interventions, which include vast market-based liquidity-supporting securities purchases. Additional fiscal measures are under discussion in the US Congress.

In Germany, a series of fiscal measures announced by the Federal government in March 2020 provide immediate fiscal impulses of €236 billion (largely in the form of direct grants to,

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[6] For details on ten EU Member States, the US, and the UK, see Julia Anderson and others, 'The Fiscal Response to the Economic Fallout from the Coronavirus' (*Bruegel* dataset, update of 6 May 2020) <www.bruegel.org/publications/datasets/covid-national-dataset/>.
Information on the measures taken by each Member State can be found: in the table prepared by the European Commission, 'Policy Measures Taken Against the Spread and Impact of the Coronavirus – 6 April 2020' <ec.europa.eu/info/sites/info/files/coronovirus-policy-measures-6-april_en_1.pdf>; and in a data base (in the form of spreadsheet) of policy measures at both the European and the national levels maintained by the European Systemic Risk Board (ESRB), 'Measures Taken in Response to Coronavirus (COVID-19) Pandemic' (update of 13 May 2020), <www.esrb.europa.eu/home/coronavirus/html/index.en.html>.

[7] Anderson and others (n 6).

and capital injections in, enterprises, but also by way of income-support to households and public-health expenditures), €500 billion of deferrals of tax payments, and €1,322 billion of guarantees and loans (to be extended through the state-owned development bank KfW and the newly established Economic Stabilisation Fund (Wirtschaftsstabilisierungsfonds, or WSF[8]).[9] In this case, the measures' combined headline value of €2.05 trillion is equivalent to 60 % of the country's 2019 GDP of €3.43 trillion, or 17.2 % of euro area's GDP of €11.90 trillion. Even if one excludes the liquidity-enhancing measures and guarantees, the immediate assistance by way of grants and other fiscal expenditures alone, which hits the budgetary balance immediately, amounts to 6.9 % of the national GDP. Interestingly, the unprecedented scale of the fiscal intervention, which the Federal Minister of Finance Olaf Scholz dubbed 'a big bazooka' and the Economy Minister Peter Altmaier described as 'the most comprehensive and effective assistance and guarantees there have ever been in a crisis', places in evident, and openly acknowledged, jeopardy Germany's heretofore unflinching commitment to the so-called '*schwarze Null*' ('black zero') policy of zero fiscal deficits.[10]

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[8] Gesetz zur Errichtung eines Wirtschaftsstabilisierungsfonds (Wirtschfaftsstabilisierungsfondsgesetz – WStFG) von 27.03.2020, BGBl I 2020, 543. See Michael Juenemann, Johannes Wirtz, Pascal Leitmann, 'COVID-19: Germany Establishes Economic Stabilisation Funds' (Bird & Bird law firm news article, April 2020) <www.twobirds.com/en/news/articles/2020/germany/covid-19-germany-establishes-economic-stabilisation-funds>.

[9] Anderson and others (n 5).

[10] Guy Chazan and Sam Fleming, 'Germany Wields 'Bazooka' in Fight Against Coronavirus' *Financial Times* (London, 13 March 2020) <www.ft.com/content/1b0f0324-6530-11ea-b3f3-fe4680ea68b5>; and amended print version, 'Germany Deploys "Protective Shield"' *Financial Times* (Europe edn, 14 March 2020), 3.

The ability of most other Member States to mimic the German approach is limited, however. The countries of the European South, overburdened as they are with high public debts, lack the fiscal space to launch large-scale programmes of fiscal expansion. The additional debt obligations that need to be incurred for this purpose places their credibility in peril, threatening their access to the market. Unfortunately, these countries include Italy and Spain, that is, the two large Member States that the first, and probably most destructive, wave of the pandemic hit most harshly, with devastating effects for their populations and economies.

We cannot be certain that in the long run the economic repercussions of the pandemic will be limited, or even concentrated, in these countries, since the second-order economic effects are not directly associated to the huge stress placed on their public health and welfare provision systems in the first phase. Still, there are other reasons to believe that the economic downturn will be expressed in disproportionately pronounced manner in the countries of the European South as a group. The behavioural modifications necessitated by the pandemic are not evenly distributed across activities.[11] They hit with particular force the provision of physical services, in contrast to manufacturing. The high dependence of Southern economies on services, including cross-border tourism, does not bode well for them. Moreover, the structure of the Southern economies is different from that of the North, with a much higher prevalence of very small and small enterprises. Such enterprises cash position and ability to weather long-term disruptions and liquidity pressures tend to be more limited than

[11] Miklós Koren and Rita Pető, 'Business Disruptions from Social Distancing' (2020) 2 *Covid Economics: Vetted and Real-Time Papers* 13 <cepr.org/sites/default/files/news/CovidEconomics2.pdf>.

that of large corporations, while the delivery and the monitoring of the utilisation of any public support becomes more complex as the number of recipients increases and their size decreases. In other words, the shock may be symmetric, but the economic impact can be highly asymmetric, depending initially on non-economic epidemiological factors, but in the long run on the economic structure of the various Member States. In any event, what is undoubted, is that the ability of governments to launch an effective fiscal response is highly asymmetric.

The predicament of the euro area's least fiscally and economically resilient countries thus hugely aggravates the problem of the fiscal response to the pandemic. The dilemma faced by them is unenviable and, absent a credible European-level solution, could lead them to an impasse: they could either select to prioritise the retention of fiscal credibility by seeking not to grossly trespass their budgetary constraints, in the hope that this will enable them to retain market access – but this would probably be self-defeating, since their debt sustainability, and thus market access, depends not only on their volume of net debt, but also on their GDP, whose unavoidably dismal outlook would become even worse as a result of such a fiscal policy; or they could take the plunge and give full priority to the effort to sustain their real economies with public money, thus accepting the immediate risk of yet another sovereign debt crisis.

As things stand at the time of writing, the unconventional monetary policy operations of the ECB have prevented any significant stress in the European sovereign debt markets and, in an environment of zero or negative interest rates, Southern governments remain able to raise new debt at low cost. However, the spreads of Southern bonds over the German Bund have increased substantially from their pre-pandemic levels; and on 28 April Italy, which has adopted a robust expansionary

stance and is considered to be more politically unstable and less cooperative than the rest, suffered a sudden downgrade to a single notch above 'junk' by one of the three global credit rating agencies, Fitch,[12] suggesting that attacks by 'bond vigilantes' cannot be excluded even at this hour in the absence of a credible path for both the medium and the long run.

In view of the above, it is evident that a European fiscal response to the economic dislocation from the pandemic based on parallel and uncoordinated national support actions is not fit for the purpose. Three concerns stand out:

- An uneven and insufficient fiscal response at national level, purely due to their divergent pre-pandemic fiscal space and credibility, will be detrimental, not only domestically, but also for Europe as a whole. As a result of huge economic interdependence, the predicament of certain Member States can drag down the GDP of their Northern trading partners, due to their heavy reliance on cross-border demand, and create the conditions for more anaemic long-term growth prospects for the euro area.
- Without a credible European backstop, a further deterioration of the fiscal position of the least resilient Member States would revive the risk of a fully-fledged sovereign debt crisis. Even if such a crisis were prevented in the short- to medium-run, the fragility of national public finances will perpetuate for decades and in aggravated form what is already a major handicap for the euro area as a whole, which places it at a considerable disadvantage relative to the other major economies.
- The uneven fiscal capacity of the various Member States can reshape the single market, too, through the state-aid channel.

[12] Fitch Ratings, 'Rating Action Commentary: Fitch Downgrades Italy to "BBB-"; Outlook Stable' (28 April 2020) <www.fitchratings.com/research/sovereigns/fitch-downgrades-italy-to-bbb-outlook-stable-28-04-2020>.

> Indeed, the fiscally strong governments of the North can support their enterprises through the crisis in a manner that their Southern counterparts cannot hope to match. This has direct implications for the survival prospects of their respective businesses and their ability to benefit from the recovery. This raises the prospect that otherwise justifiable public interventions will lead to a major and highly regressive bending of the single market's playing field.

For all these reasons, in so far as Europe's fiscal response is concerned, the whole cannot be a simple sum of the national parts. Potentially, a lack of coordination and mutual assistance could put the European project itself in peril

2. Monetary and economic responses at the EU level

At the European level, the response has been substantial, but not yet equal to the task.

2.1. European Central Bank

On the monetary side, the ECB has taken substantial action, and stands ready to adopt further measures as necessary,[13] in order to mitigate the fallout, ensure the effective transmission of its monetary policy in the new circumstances, and support the financial sector's continuing provision of credit to the real economy in the euro area.

- The central bank has retained its already very low official interest rates unchanged (at 0.00 % for the main refinancing operations, 0.25 % for the marginal lending facility, and -0.50 % for the deposit facility) and has provided forward

[13] ECB, 'ECB Statement' (Press Release, 18 March 2020).

guidance to the effect that these will remain at their present or even lower level until the recovery.[14]

- It has also decided to relax substantially, temporarily, its eligibility criteria for the acceptance of collateral in its monetary operations.[15]
- To support the liquidity of the banking system and its provision of lending to the real economy, it has extended its programme of longer-term refinancing operations (LTROs)[16] and has recalibrated and eased the conditions of the substantial third targeted LTRO (TLTRO III) programme.[17]
- It has also entered into new US dollar and euro swap lines with other central banks, in order to secure the uninterrupted provision of US liquidity to euro area banks[18] and euro liquidity to non-euro-area European ones.[19]
- Most critically, the ECB has now expanded massively its asset purchase programmes, under which it purchases outright securities issued by both the private and the public sector, thus ensuring their continuing market access at attractive prices. In addition to the prolongation of pre-

[14] ECB, 'Monetary Policy Decisions' (Press Release, 12 March 2020); and ECB, 'Monetary Policy Decisions' (Press Release, 30 April 2020).

[15] ECB, 'ECB Announces Measures to Support Bank Liquidity Conditions and Money Market Activity' (Press Release, 12 March 2020); and ECB, 'ECB Announces Package of Temporary Collateral Easing Measures' (Press Release, 07 April 2020).

[16] ECB, 'ECB Recalibrates Targeted Lending Operations to Further Support Real Economy' (Press Release, 30 April 2020).

[17] ECB, 'ECB Announces Easing of Conditions for Targeted Longer-Term Refinancing operations (TLTRO III)' (Press Release, 12 March 2020).

[18] ECB, 'Coordinated Central Bank Action to Enhance the Provision of Global US Dollar liquidity' (Press Release, 15 March 2020); and ECB, 'Coordinated Central Bank Action to Further Enhance the Provision of US Dollar Liquidity' (Press Release, 20 March 2020).

[19] ECB, 'ECB and Danmarks Nationalbank Reactivate Swap Line to Provide Euro Liquidity' (Press Release, 20 March 2020); ECB, 'ECB and Hrvatska Narodna Banka Set Up Swap Line to Provide Euro Liquidity' (Press Release, 15 April 2020); and ECB, 'ECB and Bulgarian National Bank Set Up Swap Line to Provide Euro Liquidity' (Press Release, 22 April 2020).

> existing programmes and the increase in the volumes of planned purchases, it has launched a new temporary programme, the Pandemic Emergency Purchase Programme (PEPP), with an impressive size of €750 billion.[20] Significantly, following a confusing initial remark, the ECB has made clear its readiness to accommodate the bonds of the euro area's most pressed countries over and above the usual proportional allocations of purchases based on each country's share of its capital key.[21]

The ECB's exceptionally accommodative monetary interventions are certainly beneficial, serve to ensure market stability, and provide economic policy-makers with precious time and room for manoeuvre. Even so, practical reasons relating to the monetary policy's potential overburdening and domination by fiscal considerations, in conjunction with well-known legal constraints –namely, the existing Treaty limits to the ECB's mandate and permissible actions,[22] as well as the

[20] ECB, 'ECB Announces €750 Billion Pandemic Emergency Purchase Programme (PEPP)' (Press Release, 18 March 2020); ECB Decision (EU) 2020/440 of 24 March 2020 on a temporary pandemic emergency purchase programme (ECB/2020/17) [2020] OJ L91/1; and ECB, 'ECB Announces New Pandemic Emergency Longer-Term Refinancing Operations' (Press Release, 30 April 2020).

[21] ECB President Christine Lagarde's remark at the ECB's monthly news conference of 12 March 2020 to the effect that the central bank was 'not here to close spreads'; and subsequent statement to the CNBC, according to which the ECB is 'committed to avoid any fragmentation in a difficult moment for the euro area' and 'will use the flexibility embedded in the asset purchase programme, including within the public sector purchase programme ... to avoid dislocations in bond markets'; Christine Lagarde & Luis de Guindos, 'Introductory Statement' (ECB Press Conference, 12 March 2020) <www.ecb.europa.eu/press/pressconf/2020/html/ecb.is200312~f857a21b6c.en.html>, with special note containing Lagarde's CNBC statement.

[22] Consolidated version of the Treaty on the Functioning of the European Union [2016] OJ C202/47 (TFEU), art 127(1).

prohibition of monetary financing[23]– suggest that, on their own, such interventions cannot provide a long-term corrective to the euro area's problems of public financial management.

If the uncoordinated fiscal responses of the individual Member States are insufficient to cushion the blow and quite likely self-defeating, and the ECB alone cannot provide a fully efficient and legitimate solution at the EU level, the question necessarily turns to the third potential component of the overall response to COVID-19's economic fallout, namely, the actions of the European political institutions in the field of economic governance and public financial management. In this regard, one must distinguish between the capacity and the willingness of the European Commission and the European Parliament, on the one hand, and the Eurogroup and the European Council, on the other, to provide a credible and comprehensive answer.

2.2. European Parliament

As the European Parliament lacks the institutional capacity to initiate budgetary or legislative actions, its role in this context is unavoidably limited. The disruption to its operations due to the cessation of physical meetings eroded its ability to play a leading role in shaping the European response. Its main contribution up till now has been symbolically very powerful, but in terms of practical outcomes not decisive, intervention in the form of a long resolution adopted on 17 April 2020 in plenary session and with the support of a large majority of MEP (that is, 395 votes in favour, 171 against with 128 abstentions).[24]

[23] TFEU, art 123(1). See also Case C- 62/14 Peter Gauweiler and Others v Deutscher Bundestag [2015] ECLI:EU:C:2015:400; Case C- 493/17 Heinrich Weiss and Others [2018] ECLI:EU:C:2018:1000.

[24] European Parliament resolution of 17 April 2020 on EU coordinated action to combat the COVID-19 pandemic and its consequences (2020/2616(RSP)).

The resolution calls for a 'massive recovery and reconstruction package for investment to support the European economy after the crisis' which should be financed by the EU on the basis of an increased long-term budget (multiannual financial framework, or MFF), existing EU funds and financial instruments, as well as 'recovery bonds guaranteed by the EU budget'.[25] It further calls for increased burden-sharing in the form of a permanent European unemployment reinsurance scheme[26] and, with more direct relevance to the pandemic, an 'EU COVID-19 Solidarity Fund' of at least €50 billion to support the efforts of healthcare sectors in all Member States during the current crisis, as well as future investments aimed at making healthcare systems more resilient and focused on those most in need.[27]

2.3. European Commission

Of more immediate practical impact have been the numerous steps taken in March and April 2020 by the European Commission. Several of the European Commission's initial actions involved emergency measures of primarily non-economic nature. These included the coordination of national attempts to contain contagion through the imposition of border controls and travel and transport restrictions, or to secure supplies of critical medicines and equipment by means of export prohibitions – measures which were frequently in conflict with the principles of the single market; the joint public procurement of critical medical supplies; the provision of emergency assistance to hard-pressed public health systems; the provision of support for research and development relating to COVID-19

[25] ibid, point 19.
[26] ibid, point 37.
[27] ibid, point 28.

treatments, diagnostic tests, and vaccines; the provision of guidance to the Member States, recommending the vetting of foreign direct investment by third-country entities, in order to protect Europe's strategic assets; and the countering of disinformation.

The European Commission, however, has also been mindful of the economic and fiscal aspects of the response. It has issued two main communications on the matter,[28] alongside numerous more narrowly focused communications and legislative proposals.[29] In this context, one must distinguish between two categories of measures and proposals, that is: (a) measures enabling temporary derogations from existing legal and procedural requirements of EU law, including those imposing directly or indirectly constraining fiscal decision-making at the national level; and (b) measures of financial assistance, with direct budgetary implications at the European level.

(a) Temporary derogations from EU norms. The most notable element of the former category involves a dramatic relaxation of the Treaty-based constraints on national public finances and,

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[28] European Commission, 'Coordinated Economic Response to the COVID-19 Outbreak' (Communication) COM(2020) 112 final; and European Commission, 'Coronavirus Response: Using every available euro in every way possible to protect lives and livelihoods' (Communication) COM(2020) 143 final.

[29] Detailed lists of the various European Commission measures of economic nature can be found in: European Parliament, Directorate-General for Internal Policies, 'EU/EA Measures to Mitigate the Economic, Financial and Social Effects of Coronavirus: State-of-Play 27 April 2020' (European Parliament In-Depth Analysis PE 645.723, 27 April 2020) <www.europarl.europa.eu/RegData/etudes/IDAN/2020/645723/IPOL_IDA(2020)645723_EN.pdf>; and European Banking Institution (EBI), 'EBI Report on the "Pandemic Crisis-related" Economic Policy and Financial Regulation Measures: International, EU and Euro Area Levels (standing as of 1 May 2020)', pt I.B <ebi-europa.eu/wp-content/uploads/2020/04/EBI-Covid-Report-as-of-01.05.2020.pdf>.

in particular, the prohibition of excessive deficits, as operationalised by the Stability and Growth Pact (SGP) and the relevant secondary legislation. This was achieved through the *activation, for the first time ever, of the SGP's so-called 'general escape clause'*, which, in order to provide a modicum of flexibility to the EMU's fiscal regime, enables the Council, acting on a recommendation by the European Commission, to deviate from parts of the SGP's prescriptions in the event of 'a severe economic downturn in the euro area or in the Union as a whole'.[30] In this manner, the European Commission, with the approval of the Council, removed a key legal impediment to the ability of national governments to support their economies by incurring for this purpose substantial deficits.[31]

Another major development under this category concerns the relaxation of the EU's State aid regime. In this area, the European Commission has full institutional competence, which

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[30] Regulation (EC) 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1997] OJ L209/1, as amended, arts 5(1), tenth subpara, 6(3), third subpara, 9(1), tenth subpara, and 10(3), third subpara (in relation to the SGP's 'preventive arm'); and Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure [1997] OJ L209/6, as amended, arts 3(5), third sentence, and 5(2), third sentence (in relation to the SGP's 'corrective arm'). For detailed analysis, see Angelos Delivorias, 'The "General Escape Clause' Within the Stability and Growth Pact: Fiscal Flexibility for Severe Economic Shocks' (European Parliament Briefing PE 649.351, March 2020) <www.europarl.europa.eu/RegData/etudes/BRIE/2020/649351/EPRS_BRI(2020)649351_EN.pdf.

[31] European Commission, 'Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact' (Communication) COM(2020) 123 final; and Council, 'Statement of EU Ministers of Finance on the Stability and Growth Pact in Light of the COVID-19 Crisis' (Press Release 173/20, 23 March 2020) <www.consilium.europa.eu/en/press/press-releases/2020/03/23/statement-of-eu-ministers-of-finance-on-the-stability-and-growth-pact-in-light-of-the-covid-19-crisis/pdf>.

it has used to adopt a *very liberal Temporary Framework for State aid measures*.[32] Originally announced on 19 March 2020 and amended twice since (on 3 April and 8 May), the Temporary Framework authorises to give to enterprises liquidity support in a variety of ways. The permissible forms of aid include: direct grants, selective tax advantages, or advance payments of up to €800,000 per company; public guarantees for bank loans; subsidised interest rates for loans; guarantees and loans channelled through credit institutions or other financial institutions (which are considered as direct aid to the banks' customers, not to the banks themselves); provision of short-term export credit insurance; aid for COVID-19-relevant research and development; investment aid for testing and upscaling infrastructures; investment aid for the production of COVID-19-relevant products; targeted deferrals of tax and/or social security contributions; and targeted wage subsidies for employees, to avoid lay-offs.[33] In contrast to such forms of liquidity support, initially, the Temporary Framework did not apply to the recapitalisation of enterprises with public funds. After conducting discussions with the Member States during April,[34] however, on 8 May the European Commission decided to extend its ambit in that direction. Accordingly, Member States are now entitled to notify recapitalisation schemes or individual aid measures. In the former case, aid to a single

[32] European Commission, 'Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' (Communication) C(2020) 1863 final, [2020] OJ C91 I/1, as amended by C(2020) 2215, [2020] C112 I/1, and C(2020) 3156 final, [2020] *OJ C164/13* ('Temporary Framework').

[33] C(2020) 1863 final, [2020] OJ C91 I/1, as amended by C(2020) 2215, [2020] C112 I/1, paras 21–43.

[34] European Commission, 'Coronavirus: Commission Statement on Consulting Member States on Proposal to Further Expand State aid Temporary Framework to Recapitalisation Measures' (9 April 2020), <ec.europa.eu/commission/presscorner/detail/en/statement_20_610>.

company in excess of €250 million will require separate notification and will be assessed individually. The amendment further enables Member States to provide liquidity assistance in the form of subordinated debt at favourable terms.[35] While forms of State aid not covered by the Temporary Framework remain subject to the usual State aid rules, this too provides possibilities for the approval of public support schemes. To accommodate the utilisation of these possibilities, the European Commission has expedited its procedures for approval.

In combination, the activation of the general escape clause and the Temporary Framework are essential prerequisites for the national COVID-19-related fiscal measures. In particular, the permissive approach to State aids avoids the wholesale destruction of businesses, both large and small, and shelters most of the productive capacity of the private sector, as necessary for the eventual recovery. At the same time, the newly permitted forms of actions are precisely those that could lead the financially weaker Member States to the precipice. Accordingly, these states will be reluctant to use them aggressively. In contrast, the fiscally strong countries can use them with gusto. The overall result of the uneven and selective application of State aids could thus be to tilt the single market permanently – and for that matter, in a most regressive and unjustifiable way.[36]

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[35] Temporary Framework, new text of para 26 (on liquidity support in the form of subordinated debt) and new paras 44–85 (on recapitalization measures), as inserted by C(2020) 3156 final, [2020] *OJ C164/13*.

[36] For a list of the State aid measures already notified and approved since the eruption of the COVID-19 crisis, see European Commission, 'Coronavirus Outbreak – List of Member State Measures Approved under Article 107(2)b TFEU, under Article 107(3)b TFEU and under the Temporary State Aid Framework' (13 May 2020) <ec.europa.eu/competition/state_aid/what_is_new/State_aid_decisions_TF_and_107_2_b_and_107_3_b.pdf>.

The provision of temporary *regulatory relief to the banking sector* also falls under this category of initiatives, but is not of direct relevance for the purposes of the present contribution.[37]

(b) Financial assistance. Insofar as the second category of measures is concerned, that is, those involving the direct provision of financial support by the Union itself, the European Commission sought to mobilise all resources available, always within the narrow legal and financial confines of the EU budget. Given the constraints, it is not surprising that the total size of relevant interventions is not particularly impressive.

In particular, as early as mid-March 2020 the European Commission put together a financing package, dubbed *'Coronavirus Response Investment Initiative' (CRII)*, intended to provide liquidity to small and medium-sized enterprises, labour markets, and the healthcare system. The CRII proposed to redirect to the new priority areas all unspent amounts from European structural and investment funds. Initially, this involved (a) €8 billion of pre-allocated but unspent EU cohesion money, which EU countries were now allowed to spend, rather than reimbursing to the EU budget, and (b) another €29 billion of unallocated amounts in the EU budget.[38] On 2 April, the

[37] See European Commission, 'Interpretative Communication on the application of the accounting and prudential frameworks to facilitate EU bank lending: Supporting businesses and households amid COVID-19' (Communication) COM(2020) 169 final; and European Commission, 'Proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards adjustments in response to the COVID-19 pandemic' COM(2020) 310 final.

[38] 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) [2020] OJ L99/5.

package was expanded. Now under the rubric 'CRII plus', it allowed (c) Member States to redeploy to the new uses €28 billion of non-yet-utilised amounts from the Structural Funds (European Regional Development Fund and European Social Fund) of the 2014–20 MFF,[39] and directed (d) €800 million from the EU Solidarity Fund to the Member States most severely affected by the pandemic.[40] In this manner, the CRII's total envelope reached €65.8.[41]

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[39] European Commission, 'Proposal for a Decision of the European Parliament and of the Council amending Decision (EU) 2020/265 as regards adjustments to the amounts mobilised from the Flexibility Instrument for 2020 to be used for migration, refugee inflows and security threats, for immediate measures in the framework of the COVID-19 outbreak and for reinforcement of the European Public Prosecutor's Office' COM(2020) 171 final.

[40] European Commission, 'Proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) No 2012/2002 in order to provide financial assistance to Member States and countries negotiating their accession to the Union seriously affected by a major public health emergency' COM(2020) 114 final.

[41] See also European Commission, 'Technical adjustment in respect of special instruments for 2020 (Article 6(1)(e) and (f) of Council Regulation No 1311/2013 laying down the multiannual financial framework for the years 2014-2020)' (Communication) COM(2020) 173 final; European Commission, 'Proposal for a Council Regulation activating the emergency support under Council Regulation (EU) 2016/369 of 15 March 2016 and amending its provisions in respect of the COVID-19 outbreak' COM(2020) 175 final; European Commission, 'Draft Amending Budget No 2 to the General Budget 2020, Providing emergency support to Member States and further reinforcement of the Union Civil Protection Mechanism/rescEU to respond to the COVID-19 outbreak' COM(2020) 170 final, definitely adopted on 17 April 2020, [2020] OJ L126/67; Council Regulation (EU, Euratom) 2020/538 of 17 April 2020 amending Regulation (EU, Euratom) No 1311/2013 laying down the multiannual financial framework for the years 2014-2020 as regards the scope of the Global Margin for Commitments [2020] OJ L119 I/1; Decision (EU) 2020/547 of the European Parliament and of the Council of 17 April 2020 on the mobilisation of the Contingency Margin in 2020 to provide emergency assistance to Member States and further reinforce the Union Civil Protection Mechanism/rescEU in response to the COVID-19 outbreak [2020] OJ L125/5; Regulation (EU) 2020/558 of the European Parliament and of the Council of 23 April 2020 amending

In addition to CRII, on 6 April the European Commission launched a *financing programme in cooperation with the EIB Group*, whereby a European Commission guarantee of €1 billion would enable the European Investment Fund (EIF) to raise €8 billion, from which it would co-finance with local banks and other financial intermediaries who are in close contact with businesses at least 100.000 European small and medium-sized enterprises.[42] This was only a first step towards a much more ambitious plan, in accordance to which the EIB Group is expected to deliver up to €200 billion of loans to companies across Europe. This is intended to occur through a €25 billion European guarantee fund, whose creation was approved by the EIB Board of Directors on 16 April and which will be underwritten by the Member States in proportion to their shareholding in the EIB and/or other institutions. On the back of the guarantees, the EIB Group may scale up its lending to the envisioned level.[43]

As things currently stand, the most important and innovative plank of the European Commission's schemes for financing the

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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 [2020] OJ L130/1; and Regulation (EU) 2020/559 of the European Parliament and of the Council of 23 April 2020 amending Regulation (EU) No 223/2014 as regards the introduction of specific measures for addressing the outbreak of COVID-19 [2020] OJ L130/7.

[42] European Commission, 'Coronavirus: Commission and European Investment Fund (Part of EIB Group) Unlock €8 Billion in Finance for 100,000 Small and Medium-sized Businesses' (Press Release IP/20/569, 6 April 2020) <ec.europa.eu/commission/presscorner/detail/en/ip_20_569>.

[43] European Investment Bank (EIB), 'EIB Group Establishes EUR 25 Billion Guarantee Fund to Deploy New Investments in Response to COVID-19 Crisis' (Press Release, 16 April 2020) <www.eib.org/en/press/all/2020-100-eib-group-establishes-eur-25-billion-guarantee-fund-to-deploy-new-investments-in-response-to-covid-19-crisis>.

management of the COVID-19 crisis its so-called *'Support mitigating Unemployment Risks in Emergency' (SURE) initiative*, a legislative proposal for a short-time employment reinsurance scheme.[44] Building on earlier ideas for the establishment of a permanent pan-European unemployment insurance framework, which have not yet made progress due to the resistance of several Northern Member States, the European Commission now proposes a purely temporary instrument with a related, but not identical focus, namely, the provision of financial support to the Member States in relation to the coverage of the direct costs of national schemes under which firms reduce their employee's working hours, instead of laying them off, with the state providing to the employees' income support. Over and above their social objectives, such schemes are explicitly designed to avoid human-capital-destroying redundancies during the economic downturn, thus preserving the private sector's productive capacity and providing a vital launching pad for the recovery. The proposed assistance to the most will take the form of loans with a total value of up to €100 billion,[45] which the Union will grant on favourable terms to the most cash-strapped Member States. The European Commission intends to finance the SURE instrument by issuing bonds in the markets, with the proceeds used to make back-to-back loans to those states.[46] To ensure that its borrowing will take place at low cost and will be compatible with the EU budgetary rules, the contingent liabilities (that is, the risk) relating to the recipient Member States' potential default will need to be backed by €25

[44] European Commission, 'Proposal for a 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' COM(2020) 139 final (the 'draft SURE Regulation').
[45] ibid, art 5.
[46] ibid, arts 3–4.

billion of guarantees that all Member States will commit to the EU budget in proportion to their share in EU's GDP.[47]

Based on the initiatives outlined above, one can draw the conclusion that, during the first two months of the crisis, the European Commission acted in a timely, generally coherent, and decisive manner. It contributed in major ways to Europe's collective economic response, facilitating, and complementing the national stimuli. In particular, its initiatives reinforced the message of the ECB's monetary policy decisions, providing a strong signal of the Union's readiness to come to the support of the most hard-pressed countries, thus soothing investor nervousness and averting any significant negative developments in the public debt markets. Even so, the European Commission's attempts to provide direct financial assistance have already exhausted the narrow limits within which it can provide relief out of resources available under the strict and inflexible norms governing the Union's public financial management and, more precisely, the EU budget.[48]

3.4. Eurogroup and European Council

In contrast to the essential and largely coherent contributions of the ECB and the European Commission, until now the deliberations of the Eurogroup and the European Council have not been heartening. The two bodies have been unable to achieve upfront agreement on an effective joint safety net, able to ensure all Member States against the downside risks of a stoppage of yet unknown duration, and, more importantly, on a credible public financing strategy for jumpstarting the economic recovery of the whole of the euro area once the health

[47] ibid, art 11.
[48] TFEU, arts 310–324.

crisis is over. If anything, their workings were soon bogged down by unusually acrimonious conflicts that raise the prospect of yet another period of muddling through, with potentially more catastrophic effects than that of the previous decade's sovereign debt crisis.

From the pandemic's European outbreak to the end of April, each of the two bodies met four times, always by videoconference. Every Eurogroup meeting took place in inclusive format, that is, with the participation of the finance ministers of non-euro-area countries, in preparation of the next European Council. This should enable the Eurogroup to take the leading role in forging a pan-European economic policy response to the crisis.

In practice, as the idea of unlimited fiscal support to the struggling economies had by that point gained universal acceptance amongst policy-makers at the national level,[49] relegating to the side-lines the prior insistence of certain Northern countries on strict budgetary discipline in accordance with the SGP, for about two weeks in March the ministers did not have any difficulty in presenting a united front. Thus, up till the European Council's second videoconference on 17 March, the various meetings of the finance ministers and the leaders: endorsed the fiscal support programmes of national governments and recommended their further expansion as necessary in view of the developing situation; approved the various steps taken by the ECB and the European Commission; and asked the European Commission and the European banking supervisors (EBA, ECB) to, in effect, suspend temporarily the normal EU frameworks for national fiscal management, State aids, and banking prudential regulation, using for this purpose

[49] On Germany, see section 1 (text to nn 8–9).

all ‘flexibility’ allowed in the relevant rules, in order to accommodate the national stimuli.[50] As already discussed, the European Commission, being no less alarmed than the governments, was quite happy to carry out the latter task.

The united front presented by Europe started cracking before long, as the rapid deterioration of the health crisis, which made lockdowns and their grave economic consequences unavoidable, promised to increase tremendously the price tag of the national support measures, the risk that Italy, which the pandemic had engulfed with devastating effect, and possibly the other Southern members of the euro area might eventually require financial support by their European partners, could no longer be ignored. The search for a European safety net stumbled immediately on the adamant opposition of certain Northern governments to any proposal for direct or indirect fiscal transfers between countries or the joint issuance of debt – prospects that, regardless of their intrinsic merits, are anathema to their domestic audience.

Under pressure from France, Italy, and Spain, the debate on additional forms of emergency support for euro area states began in earnest in Eurogroup’s third videoconference on 24 March 2020. During this session, the finance ministers’ broadly agreed’ to resort to the considerable firepower of the European

[50] Eurogroup, ‘Statement on the Situation with COVID-19’ (Council, Statements and Remarks 122/20, 4 March 2020); ‘Conclusions by the President of the European Council Following the Video Conference on COVID-19’ (Council, Statements and Remarks 138/20, 10 March 2020); Eurogroup, ‘Statement on COVID-19 Economic Policy Response’ (Council, Statements and Remarks 160/20, 16 March 2020); Eurogroup, ‘Remarks by Mário Centeno Following the Eurogroup Meeting of 16 March 2020’ (Council, Statements and Remarks 161/20, 16 March 2020); and European Council, ‘Conclusions by the President of the European Council Following the Video Conference with Members of the European Council on COVID-19’ (Council, Statements and Remarks 164/20, 17 March 2020).

Stability Mechanism (ESM) to finance potential funding gaps arising from the national crisis management efforts.[51] In reality, however, this 'broad agreement' was neither final nor unqualified. In fact, there was general acceptance of the idea that the ESM should make available to all euro area countries credit lines of up to 2 % of their GDP under a new temporary instrument, the Pandemic Crisis Support instrument, based on the existing Enhanced Conditions Credit Line (ECCL); but the precise terms and scope of the proposed instrument were the subject of vigorous contestation. Even though Germany proved to be flexible on the matter, the Netherlands, supported by Austria, adopted a particularly hard and uncooperative stance. The ministers from these self-styled 'frugal' countries[52] remained unperturbed by the risk of yet another sovereign debt crisis that would destabilise, and possibly destroy, the euro area; the true reasons for their stance may have less to do with a principled evaluation of the merits of the proposal than with domestic political considerations and the knowledge that the PSPP programme launched by the ECB provided in practice an alternative and quite an effective line of defence. In any event, in addition to maintaining that the ESM's intervention was

[51] Eurogroup, 'Remarks by Mário Centeno Following the Eurogroup Videoconference of 24 March 2020' (Council, Statements and Remarks 180/20, 24 March 2020); and letter from Eurogroup President Mário Centeno to European Council President Charles Michel (24 March 2020) <www.consilium.europa.eu/media/43059/letter-peg-to-pec-24032020.pdf>.

[52] Immediately prior to the eruption of the COVID-19 pandemic, the governments of the Netherlands and Austria together with those two non-euro-area countries, Sweden and Denmark, had formed an alliance against any increase in the size of the EU budget; Prime Ministers Sebastian Kurz of Austria, Mark Rutte of the Netherlands, Mette Frederiksen of Denmark, and Stefan Lofven of Sweden, 'The "Frugal Four" Advocate a Responsible EU Budget' *Financial Times* (European edn, 16 February 2020) 17.

premature and should only be contemplated as a last resort,[53] Dutch Minister of Finance Wopke Hoekstra insisted that any ESM lending should be accompanied by the usual reform programme imposing policy conditions – a prospect rejected vehemently by Italy, with the support of the great majority of the Eurogroup, as well as on the permissible uses of the ESM's loan money. The preponderant view was that the instrument should entail no, or merely nominal, conditionality ('appropriate standardised terms, on the basis of an up-front assessment by the institutions'); but the final decision was postponed. For the time being, the ministers asked the European Commission to bring forward further proposals based on the EU budget resources, possibly with additional contributions by the Member States. Explicit reference was made in this context to the SURE unemployment reinsurance proposal, which the European Commission was at that point finalising.

Rather than focusing on the terms of access to the ESM, the following day the governments of France, Italy, Spain, Portugal, Greece, Belgium, Ireland, Slovenia, and Luxembourg jointly called for a one-off issuance of 'a common debt instrument issued by a European institution to raise funds on the market on the same basis and to the benefit of all Member States, thus ensuring stable long term financing for the policies required to counter the damages caused by this pandemic'.[54]

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[53] Jim Brunsden and Sam Fleming, '"Broad Support" for Deploying Eurogroup Bailout Fund' *Financial Times* (London, 25 March 2020) <www.ft.com/content/6c8269ec-6e10-11ea-89df-41bea055720b>.

[54] Letter from French President Emmanuel Macron and Prime Ministers Sophie Wilmès of Belgium, Kyriakos Mitsotakis of Greece, Leo Varadkar of Ireland, Giuseppe Conte of Italy, Xavier Bettel of Luxemburg, António Costa of Portugal, Janez Janša of Slovenia, and Pedro Sánchez of Spain to European Council President Charles Michel (25 March 2020) <www.governo.it/sites/new.governo.it/files/letter_michel_20200325_eng.pdf>.

The proposal raised immediately the strong objections of Germany, which has always opposed the mutualisation of national public debts through the joint issuance of bonds. The fact that the instruments now proposed, which was immediately and mockingly described as 'Corona bonds', would be issued only once and would be limited to COVID-19-related expenditures did not make much difference, since this could be seen as a first step towards the regularisation of Eurobonds – a step too far for the majority of the German public (especially if it had to be recognised openly).

As a result, the European Council's videoconference of 26 March was exceptionally conflictual.[55] With the opposing blocks now more finely balanced than in the Eurogroup's debate 48 hours earlier, the leaders made scant progress. While ritually declaring that they 'acknowledge the gravity of the socio-economic consequences and will do everything necessary to meet this challenge', in practice they could only agree to refer the matter back to the Eurogroup without providing any guidance and to mandate the Presidents of the European Council and the European Commission to start work on a roadmap for the exit from the lockdowns and the restart of social and economic activities.[56]

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[55] Financial Times, 'EU Leaders Clash Over Coronavirus Response' *Financial Times* (London, 27 March 2020) <www.ft.com/content/c3e4db7e-c45a-4113-9bf6-d5d5580fa0ba>. Immediately afterwards, President Michel described revealingly the proceedings as 'an extremely dense, intense and productive political exchange'; European Council, 'Remarks by President Charles Michel after the Video Conference of the Members of the European Council on COVID-19' (Council, Statements and Remarks 187/20, 26 March 2020). Upon the completion of the videoconference, Dutch Prime Minister Mark Rutte state there were 'no circumstances' under which the Netherlands would accept eurobonds.

[56] European Council, 'Joint Statement of the Members of the European Council' (23 March 2020), points 12–20 and para following point 22.

For two weeks following the leaders' videoconference, the environment remained tense. The domestic political temper in key countries indicated perplexity and some ambivalence regarding the best way forward.[57] On the intergovernmental plane, there was acrimony. Most notably, remarks made by Dutch Finance Minister Hoekstra, who called the European Commission to investigate why certain countries did not have fiscal buffers sufficient to see them through the crisis, thus clearly implying that the pandemic's main victims, Italy and Spain, had only themselves to blame for their fiscal predicaments, drew the ire of Portuguese Prime Minister António Costa, who savaged Hoekstra's statement as 'repulsive' and 'senseless'. Hoekstra was thus forced to apologise publicly for his phrasing's 'lack of empathy'.[58] Even so, in the next Eurogroup videoconference of 7 April, Hoekstra, despite finding himself in a small minority, continued to hold out on the issue of conditionality that should accompany any loans by the ESM.[59] Following long hours of heated discussions, the meeting was adjourned without being able to produce even a formal statement.

While the squabbling was going on, the sharp deterioration of economic conditions was pushing the costs of national support measures to skyrocket, climbing in just three weeks from 1 % to 3 % of GDP,[60] creating a sense of urgency and increasing the

[57] Mehreen Khan, 'Dutch PM Faces Protest Over Bonds Veto' *Financial Times* (Europe edn, 2 April 2020) 2; Guy Chazan, 'Crisis Spurs German Rethink of Eurobonds' *Financial Times* (Europe edn, 7 April 2020) 2; Miles Johnson, Sam Fleming, and Guy Chazan, 'The Risk of Losing Italy' *Financial Times* (Europe edn, 7 April 2020) 15.
[58] Khan (n 57).
[59] Mehreen Khan, Sam Fleming, and Guy Chazan, 'Dutch Blamed for Failure to Strike Crisis Loans Deal', Financial Times (9 April 2020) 2.
[60] The size of government-provided liquidity facilities also rose, from 10% to 16% of GDP. Eurogroup, 'Report on the Comprehensive Economic Policy

pressure for a credible and coherent policy response. Moreover, alternative proposals and views were seeing the light, some of which provided ideas and rhetorical frames that could facilitate a compromise. Most notably, on 1 April 2020, the French government produced a two-page non-paper with ideas on 'possible instruments to ensure financial stability and economic recovery'.[61] Setting the conceptual ground for subsequent attempts to formulate a mutually acceptable policy solution, the French non-paper presented its recommended policies as a set of four complementary and mutually reinforcing 'options', which included '(i) the pandemic response through the ECCL instrument, (ii) new EIB instruments, (iii) a European unemployment insurance scheme, and (iv) an economic recovery fund to support the recovery once the sanitary part of the crisis will have receded, based on the joint issuance of debt instruments to mutualise the cost of the crisis, which is no one['s] responsibility'.[62] The first three elements corresponded to already existing initiatives, which (subject to the Dutch and Austrian reservations regarding the ESM's activation) had already gained general acceptance; the fourth relaunched in more precise and more politically palatable terms the nine governments' proposal for common debt issuance. This was now reconceptualised as a complement, rather than alternative, to the ESM's provision of emergency assistance; it was specifically linked to the financing of the recovery phase, with its growth-enhancing potential, thus clearly distinguishing it

Response to the COVID-19 Pandemic' (Council, Press Release 223/20, 9 April 2020), paras 5–6.

[61] French government, 'Non-Paper on Possible EU and EA Instruments to Ensure Financial Stability and Economic Recovery' (unsigned and undated paper submitted to the European Council Presidency on 1 April 2020) <www.politico.eu/wp-content/uploads/2020/04/FR-nonpaper-Covid-european-response_clean.pdf>.

[62] ibid.

from the funding gaps opened by the unrecoverable expenditures incurred by national governments to provide support through the crisis itself; and it was reframed as a pan-European fund, in order to avoid the reflexive political reactions induced by the use of the monikers' Eurobonds' and 'corona bonds', but also it also to pacify fears that the money would be used indiscriminately to replenish the coffers of Southern governments.[63]

Parallel to the French initiative, the Presidents of the European Council and the European Commission utilised their mandate regarding the roadmap for exiting the crisis to push for the integration of the contemplated COVID-19-related financial instruments in the existing institutional structures, and primarily the EU budget.[64] ESM Managing Director Klaus Regling also sought to keep at least the short-term response within his institution, on the ground that the implementation of an

[63] Nonetheless, more detailed presentation of the French proposal on the website of the French Ministry of Economy and Finance indicate a more 'generous' stance regarding the recovery fund's intended uses, which, according to that source, should cover 'le financement des mesures liées à la crise et des mesures de reprise', both of which must be mutualised and gradually reimbursed by the Member States according to a pre-established contribution key; French Republic, Ministère de l'Économie et des Finances, DG Trésor, 'Questions-Réponses sur l'Action Européenne et le Fonds de Relance Proposé par la France' (17 April 2020) <www.tresor.economie.gouv.fr/Articles/2020/04/17/covid-19-quelles-reponses-de-l-europe-a-la-crise#questions>.

[64] For statements to this effect by European Council President Michel, see European Council, 'Press Release Following the Videoconference between President Charles Michel and Presidents von der Leyen, Lagarde and Centeno' (Press Release 198/20, 31 March 2020); and European Council, 'Press Release Following the Video Conference of 6 April between Presidents Michel, von der Leyen, Lagarde and Centeno' (Press Release 213/20, 6 April 2020).

alternative mechanism would lead to delay and uncertainty.[65] In combination, these developments organised the policy debate around certain general concepts and institutional forms, while implicitly but effectively excluding alternative proposals. In this way, they structured the agenda and terms of subsequent negotiations and inserted an element of path dependency.

By the time the Eurogroup's videoconference resumed on 9 April, the Dutch resistance had crumbled. Everybody now consented to the establishment of temporary ESM credit lines in the form of the Pandemic Crisis Support instrument, which should operate the primary emergency safety net for sovereigns,[66] even though the exact term sheet was not finalised and significant aspects (including the permissible uses,[67] cost,

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[65] ESM, 'Transcript of Klaus Regling's Interview for the Financial Times' (31 March 2020) <www.esm.europa.eu/interviews/transcript-klaus-reglings-interview-financial-times>.

[66] Letter from Eurogroup President Mário Centeno to European Council President Charles Michel (Council document ecfin.cef.cpe(2020)2308814, 10 April 2020) <www.consilium.europa.eu/media/43300/200410_peg-centeno-letter-to-pec-michel_covid.pdf>.

[67] In this regard, the Eurogroup agreed that 'euro area Member States requesting support would commit to use this credit line to support domestic financing of direct and indirect healthcare, cure and prevention related costs due to the COVID 19 crisis'; Eurogroup, 'Report on the Comprehensive Economic Policy Response to the COVID-19 Pandemic', para 16. The inclusion of 'indirect' and 'prevention-related' costs leaves open the exact delimitation of the instrument, possibly in an attempt to facilitate agreement by means of intentional obfuscation and 'constructive ambiguity'. The unresolved disagreement was evident in the remarks made after the completion of the videoconference by Eurogroup President Centeno and Dutch Finance Minister Hoekstra. Centeno had this to say: 'my interpretation, as President, is that the average Euro Area Member State affected by the COVID-19 crisis should be able to identify expenditures directly or indirectly related to healthcare, cure and prevention amounting to 2% of GDP'; Eurogroup, 'Remarks by Mário Centeno Following the Eurogroup Videoconference of 9 April 2020' (Council, Statements and Remarks 224/20, 9 April 2020). For his part, Hoekstra's view was much more stringent and patently dismissive of the two clauses that he had co-signed just minutes ago:

and length of any borrowings under the instrument) remained open for further elaboration. With regard to pending initiatives, the Eurogroup expressed support for the European Commission's SURE initiative, which by this stage had been formally tabled.[68] On this issue, however, one must note that the promised rapid activation of the initiative actually stumbled on Finland's insistence on proper parliamentary approval of the national guarantees required to enable the European Commission to raise the necessary funds by way of borrowing, something impossible to ensure immediately due to the lockdown.[69] This was followed by the demand of many Northern Member States for European Commission clarifications on the guarantees.[70] This is yet another example of the distance that separates the endorsement in principle of European policies from their actual execution – a matter of great concern, which makes one sceptical of the likely success of the eventual recovery plans too, if these must be filtered through the disjointed, idiosyncratic, and occasionally over-politicised national procedures of the various Member States, which bring

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'There was a strong desire by the Netherlands to help out on healthcare [spending] as it is related to coronavirus. But for every euro that is spent on the economy, the normal rules apply; for example, if you have a shop that has shut down because of the virus'; Sam Fleming and Mehreen Khan, 'Eurozone Countries Strike Emergency Deal on Coronavirus Rescue' *Financial Times* (London, 10 April 2020) <www.ft.com/content/b984101a-42b8-40db-9a92-6786aec2ba5c>.

[68] Draft SURE Regulation (n 44); Eurogroup, 'Remarks by Mário Centeno Following the Eurogroup Videoconference of 9 April 2020'.

[69] Hans von der Burchard, 'Finland Puts Brakes on EU Unemployment Scheme' (*Politico.eu*, 17 April 2020) <www.politico.eu/article/finland-puts-brakes-on-commissions-unemployment-scheme>.

[70] The request was reportedly submitted by Austria, Germany, the Czech Republic, Denmark, Latvia, Lithuania, the Netherlands and Sweden; Lili Bayer, Hans von der Burchard, and Bjarke Smith-Meyer, 'EU Struggles to Unite on Economic Reboot' (*Politico.eu*, 21/22 April 2020) <www.politico.eu/article/recovery-fight>.

into the picture, alongside the national governments, additional institutional players with veto rights.

The compromise on the abovementioned issues allowed the Eurogroup to complete its overall report on the economic policy response to the pandemic, thus fulfilling the mandate received from the European Council a fortnight earlier.[71] The report noted the extraordinary scale of the measures already taken at a national level and declared the willingness of governments to adopt further fiscal measures as necessary[72]; recapitulated the steps already taken at European level[73] or in preparation[74]; and identified certain key parameters of a strategy seeking to kick-starting Europe's economy.[75] Specifically, the ministers envisaged the creation of a Recovery Fund that would finance investment 'in line with European priorities and ensuring EU solidarity with the most affected Member States'. They were in agreement that the fund should be 'temporary, targeted and commensurate with the extraordinary costs of the current crisis', should 'help spread [these costs] over time through appropriate financing', and should finance appropriate programmes 'through the EU budget'; they nonetheless asked the European Council to provide guidance on the legal and practical modalities, including the fund's exact sources of financing and relation to the EU budget.[76] The ministers further

[71] Eurogroup, 'Report on the Comprehensive Economic Policy Response to the COVID-19 pandemic'.
[72] ibid, paras 4–7.
[73] ie, the full use of the flexibility of the SGP and the State aid regime, the use of the EU budget, the resolute monetary action by the ECB, and the regulatory relief offered to the financial sector; ibid, paras 8–11.
[74] ie, the European Commission's CRII plus and SURE initiatives, the EBI's business financing initiatives, and the ESM's Pandemic Crisis Support; ibid, paras 13–17.
[75] ibid, paras 18–22.
[76] ibid, para 19.

agreed that the EU's forthcoming 2021-27 MFF must play a 'central role' in the economic recovery, thus signalling convergence on the notion of a large increase in the size of the EU budget.[77] They finally pointed to the parallel workstream on the production of a broader roadmap and action plan that the European Council had assigned to the Presidents of the European Council and of the European Commission,[78] which should presumably guide the investments to be financed by the new European instruments.

Significantly, the presentation of the Eurogroup's conclusions replicated the French four-part schema, but with an important modification:

- the first three elements (i.e., the European Commission's SURE initiative, the EIB business financing plans, and the ESM's Pandemic Crisis Support) were now conceptualised as a triad of 'safety nets' for workers, businesses, and sovereigns, respectively, with a combined value of no less than €540 billion,[79] which should be set up immediately, while
- the fourth (i.e., the newly proposed Recovery Fund) was showcased separately, as the key financial support of the recovery strategy, with a necessarily longer-term perspective.[80]

[77] ibid, para 20.
[78] ibid, para 21.
[79] ie, €100 billion for SURE; some €200 for the EIB financing plans, including leverage from private financial institution; and €240 billion for the ESM's Pandemic Crisis Support (which was calibrated at 2% of GDP). For reasons discussed in due course, the accuracy of these figures is doubtful; see section 3 (text to n 123).
[80] Letter from Centeno to Michel (n 66). See also Eurogroup, 'Remarks by Mário Centeno Following the Eurogroup Videoconference of 9 April 2020'; and European Council, 'Statement by the President of the European Council Charles Michel Following the Agreement of the Eurogroup' (Council, Press Release 225/20, 10 April 2020).

Even more effective than the French non-paper, this 'three-plus-one' framing of the pillars of the European economic response to the COVID-19 helps to disconnect, rhetorically and politically, the quest for 'innovative' financing instruments – that is, for the common issuance of instruments that unavoidably are Eurobonds in all but name– from the covering of the immediate crisis-related fiscal gaps of particular states (notwithstanding the fact that SURE involves a modicum of joint debt issuance). Instead, it links the possibility of joint issuance with the growth-enhancing investments of the recovery period, thus making it potentially more palatable to the Northern public and increasing the ground for compromise.

The Eurogroup's agreement was met with strong negative reactions in Italy, where it was perceived as a failure to make progress with Eurobonds, while also pushing the country towards a dreaded ESM programme with heavy conditionality.[81] Elsewhere, as the financing of the proposed Recovery Fund by means of joint borrowings appeared inevitable, attention gradually turned to the manner in which the fund should provide assistance, that is, whether this should take the form of grants, as requested by France,[82] Italy, Spain and

[81] Sam Fleming and Davide Ghiglione, 'Backlash in Rome over Eurozone Deal' *Financial Times* (Europe edn, 11–12 April 2020) 2. Italian Prime Minister Giuseppe Conte threatened to veto the conclusions of the forthcoming European Council, if he did not get his way on joint debt issuance; Hans von der Burchard and Paola Tamma, 'Italy's Conte Threatens to Derail EU Summit Over Corona Bonds' (*Politico.eu*, 10 April 2020) <www.politico.eu/article/italys-conte-threatens-to-block-next-eu-summit-over-eurobonds>.

[82] French President Emanuel Macron made a weighty public intervention in this sense; Victor Mallet and Roula Khalaf, 'Macron Warns EU Will Unravel Unless Block Embraces Financial Solidarity' *Financial Times* (Europe edn, 17 April 2020) 1; and full transcript of that related interview that Macron gave

their many allies, or loans, as Germany and the 'frugals' insist. All eyes were on the next European Council videoconference, which was scheduled to take place two weeks later.

In the run-up to this event, the Presidents of the European Commission and the European Council presented the requested roadmap in two distinct segments, the first of which focused on the lifting of the lockdowns and the phased resumption of economic and social activities,[83] while the second was specifically concerned with the recovery strategy.[84] Expecting that the three safety nets of the Eurogroup's package will be up and running by 1 June 2020,[85] the two Presidents do not address them in their recovery plan. Instead, they focus on the need for a 'Marshall-Plan type investment effort to fuel the recovery and modernise the economy',[86] as one of the four key areas of

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to the Financial Times on 14 April 2020 <www.ft.com/content/9667bd73-a809-497e-a3ca-8781c0549901>.

[83] The resumption of activities, including the lifting of travel restrictions, would take place as soon as the spread of the pandemic had passed its peak, thus enabling the passage from general measures of social distancing to targeted ones, as necessary until an effective treatment or vaccine will be found. Communication by European Commission President Ursula von der Leyen and European Council President Charles Michel, 'Joint European Roadmap towards Lifting COVID-19 Containment Measures' (17 April 2020) <ec.europa.eu/info/files/communication-european-roadmap-lifting-coronavirus-containment-measures_en>.

[84] European Council President Charles Michel and European Commission President Ursula von der Leyen, 'A Roadmap for Recovery: Towards a More Resilient, Sustainable and Fair Europe' (21 April 2020) <www.consilium.europa.eu/media/43384/roadmap-for-recovery-final-21-04-2020.pdf>.

[85] European Council, 'Invitation Letter by President Charles Michel to the Members of the European Council Ahead of Their Video Conference on 23 April 2020' (Council, Press Release 242/20, 21 April 2020).

[86] 'A Roadmap for Recovery' (n 84) 4.

European action identified in their plan.[87] The investment effort will rely on public investment, both at European and national levels, leveraged by private money. The projects receiving assistance will need to support the European Green Deal, the digital transition, and the circular economy, and other EU policies.[88]

Regarding the Recovery Fund's place in the institutional framework, the plan insists that recovery financing must be based on the forthcoming EU MFF. The latter must be adapted to the effects of the crisis on particular regions and sectors; it must simultaneously serve to support national recovery plans, as well as sustained investment in the EU's strategic objectives; and it must be able to tap market financing. The plan also stresses the complementary role that the EIB group, as the largest public investment bank in the world, must play by providing finance at favourable rates. For the rest, the European investment effort's scale, specific objectives, timeframe, and form are left open for elaboration by the European Commission.[89]

The recovery plan establishes four guiding principles for the recovery effort, two of which are directly relevant to the issue of financing: the avoidance of an asymmetric recovery; and the need for a flexible approach, which can evolve over time, depending on the course of the pandemic.[90] The first principle recognises the different position in which the Member States find themselves:

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[87] The other three are: a fully functioning and revitalised Single Market; a global recovery strategy; and a functioning system of governance, ensuring full respect for European values and the rule of law; ibid, 3–5.
[88] ibid, 4.
[89] ibid.
[90] ibid, 2.

> Not all have suffered in the same way, not all have the same leverages to use and not all regions will be able to restart their economies quickly. The EU's recovery plan must, therefore, be based on solidarity, cohesion and convergence. We must ensure a level playing field for all.[91]

By necessary implication, the principle requires that both the geographic allocation of the Recovery Funds' assistance and the form of deployment of the available funds must help to re-establish the economic balance between the Member States, rather than condemning the most hardly hit countries in overindebtedness, thus intensifying their fiscal predicament, increasing divergence and inequality in the single market, and turning EMU into a regressive policy straightjacket.

Contrary to the expectations and despite receiving the reports that it had requested from the Eurogroup and the two Presidents a month ago, during its fourth videoconference of 23 April 2020 the European Council declined to take any decisions regarding the Recovery Fund.[92] Following President Michel's recommendations, the leaders confined themselves to welcoming the two Presidents' recovery plan and recognising the need and urgency of a fund of 'sufficient magnitude, targeted towards the sectors and geographical parts of Europe most affected, and dedicated to dealing with this unprecedented crisis',[93] without seeking to give guidance on its form or sources of financing. They thus avoided a direct confrontation on the

[91] ibid.

[92] European Council, 'Conclusions of the President of the European Council Following the Video Conference of the Members of the European Council, 23 April 2020' (Council, Statements and Remarks 251/20, 23 April 2020).

[93] 'Invitation Letter by President Charles Michel to the Members of the European Council Ahead of Their Video Conference on 23 April 2020'; and 'Conclusions of the President of the European Council Following the Video Conference of the Members of the European Council, 23 April 2020'.

issues pitting France and the whole of the European South against Germany and its allies, namely, the scale of the intervention and, most importantly, the use of the Fund's resources to make grants or loans.[94] Instead, they delegated to the European Commission the task of identifying the needs and devising acceptable compromise solutions, including by clarifying the link between the Recovery Fund and the MFF. They recognised, however, that the latter would need to be adjusted in view of the new situation.[95]

The European Council's continuing division and reluctance to reach decisions that could alleviate the prospective burden of the most vulnerable Member States unsettled bond investors. As already mentioned, on 28 April 2020, Italy suffered a sudden downgrade by Fitch.[96] Once more, it was the ECB's policies which helped to stabilise the situation.[97]

As of the time of writing of this contribution (8 May 2020), the European Commission has not yet come forward with proposals on the recovery fund and the revised proposal for the 2021-27 MFF.[98] Up till now, the only indication is a leaked internal note of the European Commission, prepared in advanced of the European Council's 23 April videoconference, according to which,

> All told, the new proposals will be able to generate at least [2000] billion of investment and expenditure; heavily

[94] Sam Fleming and Mehreen Khan, 'EU Fails to Settle Recovery Fund Rifts' *Financial Times* (Europe edn, 25-26 April 2020) 2.
[95] 'Conclusions of the President of the European Council Following the Video Conference of the Members of the European Council, 23 April 2020'.
[96] Fitch Ratings (n 12).
[97] Tommy Stubbington and Martin Arnold, 'Investors Bet on ECB Action after Italy's Downgrade', *Financial Times* (Europe edn, 30 April 2020) 8.
[98] The publication of the revised draft MFF was initially expected on 6 May 2020, but actually delayed.

> frontloaded and geared at recovery and resilience. This plan will be financed through a temporary Recovery Instrument (RI) as well as the MFF own resources system. The RI will be a time limited and targeted Instrument based on Article 122.1 which will allow the Union to raise up to EUR 320bn on the markets to finance key policies and Instruments to support the Recovery through Union Programmes.[99]

Depending on how soft these numbers are, this could imply a budget of a different order than the original proposal of May 2018, which envisaged commitments of €1,135 billion (in 2018 prices), or 1.11 % of EU27 GNI, and €1,105 billion in payments (in 2018 prices), or 1.08 % of EU27 GNI.[100]

For the moment, greater progress has been achieved with regard to the finalisation of the ESM's Pandemic Crisis Support instrument. Agreement on the features and standardised terms of the latter was reached in the Eurogroup on 8 May 2020.[101] It is thus confirmed that the temporary instrument will provide to every euro area Member State assistance calibrated at around 2 % of its respective 2019 GDP.[102] Each facility granted will have an initial availability period of 12 months, which can be extended twice for six-month periods. Any loans out of a

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[99] Leaked internal memo of the European Commission <g8fip1kplyr33r3krz5b97d1-wpengine.netdna-ssl.com/wp-content/uploads/2020/04/MFF-pitch-_clean.pdf>, referred to by Bjarke Smith-Meyer, 'Commission Officials Plan €2T Post-Coronavirus Recovery Package' (*Politico.eu*, 23 April 2020) <www.politico.eu/article/document-commission-officials-plan-e2t-post-coronavirus-recovery-package>.

[100] European Commission, 'A Modern Budget for a Union that Protects, Empowers and Defends: The Multiannual Financial Framework for 2021-2027' (Communication) COM(2018) 321 final.

[101] Eurogroup, 'Eurogroup Statement on the Pandemic Crisis Support' (Press Release 292/20, 8 May 2020).

[102] ibid, point 3. Non-euro area Member States do not have resort to ESM facilities, but can access the European Commission's Balance of Payments (BoP) Facility, in pursuance of TFEU, art 143.

country's facility will have a maximum average maturity of 10 years and favourable pricing, with interest payable at a rate reflecting the ESM's own cost of funding plus 10.5 basis points (as margin and annual service fees), and a one-off payment of 25 basis points at the start (as up-front service fee).[103] To speed up the process,[104] the European Commission, acting in cooperation with the ECB and the ESM, has already conducted preliminary assessments on debt sustainability, financing needs and financial stability risks, which show that all countries meet the criteria for borrowing from the ESM; these will be confirmed by the institutions as soon as the relevant country has made a request for assistance.[105] It should be noted, however, that this does not exempt the requests for assistance under the Pandemic Crisis Support from the need to receive approval by the other ESM members (that is, the other euro area countries) in accordance with their respective national procedures.[106] As for the main point of contestation, conditionality, the Eurogroup concluded that requesting countries will merely commit to using their credit line 'to support domestic financing of direct and indirect healthcare, cure and prevention related costs due to the COVID 19 crisis.'[107] To document this commitment, an individual Pandemic Response Plan will be prepared on the basis of a standardised template. The institutions' surveillance of countries' compliance will be light, will not entail ad hoc on-

[103] 'Eurogroup Statement on the Pandemic Crisis Support' (n 101), point 6.
[104] Treaty establishing the European Stability Mechanism (2 February 2012), as amended (ESM Treaty), art 13.
[105] European Commission, 'Remarks by Commissioner Gentiloni at the Eurogroup Press Conference' (SPEECH/20/842, 8 May 2020); and 'Eurogroup Statement on the Pandemic Crisis Support' (n 101), point 6.
[106] Eurogroup, ibid, point 10.
[107] ibid, points 3–4; and Eurogroup, 'Remarks by Mário Centeno Following the Eurogroup Videoconference of 8 May 2020' (Statements and Remarks 293/20, 8 May 2020). On the significance of this phrasing, see above (n 68).

site missions, and will be based on a streamlined reporting and monitoring framework.[108] On this basis, and always subject to the smooth completion of the national procedures necessary for the adoption of new ESM instruments, governments are now expected to gain access to the significant resources already available in the ESM no later than June 2020. The deadline for requests for assistance under the Pandemic Crisis Support is 31 December 2022, but this can be moved forward or back by the ESM Board of Governors (that is, the members of the Eurogroup) upon a proposal of the ESM Managing Director, depending on the course of the COVID-19 crisis.[109]

3. Contours of a 'second-best' European response

The examination of the various initiatives undertaken up to this point (8 May 2020) in relation to the fiscal management of the COVID-19 crisis shows that the ECB and the European Commission were able to take rapid, concrete, and substantial steps within their respective fields of competence and (very unequal) financial capacity. In contrast, proceedings in the Eurogroup (or, in effect, the full panel of Member States' ministers of finance, since all Eurogroup meetings have convened in 'inclusive format') and, especially, in the European Council (which is theoretically expected to provide political leadership and guidance) have been rather reactive, slow-moving, and inconclusive. The obvious reason is the split between countries relating to the form of financing of the crisis-

[108] 'Eurogroup Statement on the Pandemic Crisis Support' (n 101), points 4–5; and letter from European Commission Executive Vice-President Valdis Dombrovskis and European Commissioner Paolo Gentiloni to Eurogroup President Mário Centeno (7 May 2020) <www.ansa.it/documents/1588869912685_lettera.pdf>.
[109] 'Eurogroup Statement on the Pandemic Crisis Support' (n 101), point 7.

fighting and recovery efforts and, more recently, the deployment of funds by way of loans or grants.

This course of events is not surprising if one considers that, at the European level as elsewhere, policy formation is not a process of pure rational design, based on scientifically informed and evidenced-based considerations, but rather a more primal process of positioning and negotiation, through which the various participating parties seeks to promote their frequently conflicting interests and visions, under the influence of different values and frameworks of interpretation. On this account, agreement on any particular policy proposal can only be reached if each participant subjectively concurs on its desirability (at least in comparison to the available alternatives) or, more likely, if the decision-making procedure (voting mechanism) does not provide to outvoted dissenters the ability to veto the decision or defect from its implementation. From this perspective, an effective pan-European response to the fiscal problems caused by the pandemic depends, not only on its substantive theoretical merits, but also on its feasibility, as determined by its political acceptability and the legal and procedural constraints binding the decision-making process. In the case in hand, however, these constraints tend to preclude the adoption of any meaningful and effective solutions.

As we have already seen, the design of the European response naturally centres on three key issues: the calibration of the required intervention; its sources of funding; and the manner of deployment of the available resources.

Despite the many uncertainties, the current consensus view –or, at least, the presumed view of the European Commission– is that the European recovery effort will require public financial assistance at the range or in excess of €1 trillion, that is, 7 % or

more of EU's pre-COVID-19 GDP.[110] The exceptionally bleak reassessment of European economies' outlook published by the European Commission on 6 May 2020, according to which, even if the national and European measures already taken manage to cushion the immediate impact of the crisis and preserve most of the economy's existing capacity intact, the EU GDP will suffer a contraction of 7.5 % in 2020, followed by a rebound of only 6 % in 2021,[111] leads to similar conclusions. The contraction is projected to affect the individual Member States unevenly, with Greece suffering the worst fall in GDP (-9.7 %) and Luxembourg and Poland coming out best in relative terms (-5.4 % and -4.3 %, respectively).[112] Assuming that macroeconomic forecasting can still provide meaningful information in the midst of so many unknowns, the evidence suggests that the depression will be much deeper than originally expected and that the recovery will be gradual (U-shaped, rather than V-shaped). This gives short shrift to the idea that moderate and incremental interventions at the EU level will be enough.

Significantly, the €1 trillion calibration only concerns the expenditures associated with recovery, that is, is the amount that

[110] Asked on 23 April what amount of money might be available, European Commission President Ursula von der Leyen answered that 'we're not talking about billion, we're talking about trillion'; Fleming and Khan (n 94). Soon afterwards, Economy Commissioner Paolo Gentiloni mentioned an even higher sum of €1.5 trillion, or upwards of 10.5% of EU GDP, that should be available as early as September 2020; Laura Kayali, 'Gentiloni: A €1.5T EU Recovery Fund Should Be ready by Mid-September' (*Politico.eu*, 26 April 2020) <www.politico.eu/article/gentiloni-a-e1-5t-eu-recovery-fund-should-be-ready-by-mid-september>.

[111] European Commission, 'European Economic Forecast, Spring 2020' (2020) European Economy, Institutional Papers 125, 1–2.

[112] ibid, 1, Table 1. This confirms the possibility mentioned above (section 1) that the economic repercussions of the COVID-19 crisis may not coincide geographically with its biological impact or the devastation caused on public health systems.

the EU will use to finance the European Recovery Fund and related initiatives, thus excluding any national contributions to the investment effort, or the (notional) €540 billion of the three safety nets discussed earlier.[113] Assuming that this is not a rhetorical gimmick of bureaucratic institutions, to be met by means of dubious projections and double counting, but reflects a real target for hard-money fiscal funding, how can the EU cover its new funding requirements? Over the past two months, official negotiators, academics, and other experts have put forward a wide spectrum of proposals, some of which we have already come across. A non-exhaustive and somewhat impressionistic list includes the following alternatives:

- *Reallocation of existing EU budgetary appropriations, without a substantial increase of the MFF.* This solution would satisfy the frugals' pre-COVID-19 insistence on a small budget, but would be both patently inadequate for the task at hand and politically explosive, due to its evident distributional consequences.
- *Significantly increased EU budget, funded with a higher level of national contributions based on gross national income (GNI) and/or an expansion of EU's other 'own resources'.* While own resources are the Treaty-prescribed source of funding for the EU budget,[114] past experience suggests that many Member States will refuse to accept a substantial increase in their current payments to the EU. It is thus more than probable that the limits of political tolerance will be reached long before the proposed increase reaches the height necessary for the recovery effort. Moreover, any payment to the EU out of current national budgetary resources reduces by the exact same amount the firepower of the paying state: in the recovery phase, this may be a self-defeating strategy. Accordingly, of itself, an increased EU budget financed in

[113] Section 2.D (text to n 78).
[114] TFEU, art 311, second para.

this manner would not suffice, and could only serve as part of a mixed solution, source of transfer payments, and/or facilitator of leverage by way of borrowing.

- *Significantly increased EU budget, funded by borrowing by the European Commission.* This could only be feasible on the back of Member State guarantees, or if a new budgetary regime were introduced, allowing the EU budget to incur deficits on the cover of income streams to be generated over several MFFs on the basis of the obligation of Member States to reimburse the Union, or of newly created own resources. This is effectively a proposal for Eurobonds in all but name. Even if a symbolically appropriate repackaging could overcome that objection, the need for mutual guarantees or reimbursement commitments could prevent its adoption!
- *Recovery Fund set up as a separate legal person (SPV), funded by debt issued in its own name.*[115] This is similar to the previous alternative, albeit under a different institutional structure. It conceivably presents operational advantages, due to specialisation and a clear mission; but it cannot avoid the aforementioned objections regarding its funding.
- *Issuance of EU perpetual bonds (or consols).* Proposed by the Spanish government just days before the last European Council, this alternative would seek to finance the Recovery Fund by means of jointly issued perpetual instruments.[116] This would merely oblige the Union to pay interest at a fixed annual rate, with the principal becoming repayable only if and when the Union chose to redeem them. The lack of an obligation to redeem would put to rest almost every objection relating to the mutualisation of debts and fiscal transfers.[117]

[115] As in the French government's non-paper (n 61).

[116] Spanish government, 'Spain's non-paper on a European recovery strategy' (19 April 2020) <g8fip1kplyr33r3krz5b97d1-wpengine.netdna-ssl.com/wp-content/uploads/2020/04/Spain-.pdf>.

[117] In the Spanish proposal, even the residual joint and several liability of the Member States for the interest payments would disappear by endowing the EU with sufficient new own resources in the form of European taxes; ibid.

As interest rates are currently near zero, and bound to stay there for a period of time more than sufficient for the completion of the proposed issuance, the fixed annual payments of interest on the consols would likely be particularly low, and the burden much lighter than that of the substantial increase of national contributions to the budget currently contemplated.[118] Other advantages would be that these instruments would not create actual or contingent obligations for the Member States, thus leaving their national debt-to-GDP ratios unaffected. The only question here is whether the market has sufficient appetite for such instruments, and at exactly what rate of interest. It should be noted that, despite its evident attraction and its provenance from one of the largest Member States, this rather innovative (or, actually, given its exceptionally long historical pedigree,[119] neo-antiquarian) approach to public finance was completely disregarded in the official debates, possibly due to its exoticism and to the other aspects of the Spanish proposal.

- *ESM borrowing to fund back-to-back low-cost loans to the Member States.*[120] This solution, which has been already applied to provide the Pandemic Crisis Support safety net for sovereigns, leverages the European support assistance with private money; but it is wholly dependent on the provision by Member States of sufficient guarantees in favour of the ESM. This renders it unattractive to the frugal Member States as a source of large-scale and long-term financing for other countries' investment needs; and it simultaneously has

[118] George Soros, 'The EU Should Issue Perpetual Bonds' (*Project Syndicate*, 20 April 2020) <www.project-syndicate.org/commentary/finance-european-union-recovery-with-perpetual-bonds-by-george-soros-2020-04>.
[119] ibid.
[120] Aitor Erce, Antonio Garcia Pascual, and Ramon Marimon, 'The ESM Can Finance the COVID Fight Now' (VoxEU.org, 6 April 2020) <voxeu.org/article/esm-can-finance-covid-fight-now>.

upfront negative implications for the government accounts of fiscally weaker countries.

- *'Corona bonds'.* As originally envisaged,[121] these should involve the mutual issuance of debt instruments in order to finance COVID-19-related expenditures incurred by the crisis-hit countries, irrespectively of their share of the obligations created under the instruments. Politically, this has proven to be a non-starter. The proposal also raises clear issues of moral hazard, which have not been adequately addressed, since the discussion did not move beyond the basic concept. For all intents and purposes, 'Corona bonds' of this type is no longer in the discussion, having been superseded by the more balanced French proposal for the Recovery Fund.
- *Financing of the recovery effort with a one-off or time-limited special taxation.* The earmarked special tax could take the form of a wealth tax[122] or (to avoid the considerable collection difficulties) of a one-off levy on all financial assets held with EU financial institutions.[123] Levied on the same terms and at the same rate across the EU, it could be structured either as an EU own resource or as national budgetary revenue. While very attractive conceptually, the imposition of a uniform tax of this type is likely to meet the strong resistance of powerful stakeholders, leading to its vetoing by the particular Member States.
- *Direct EIB financing, leveraged with private money, of enterprises.* The EIB Group's current business financing plans[124] could conceivably be expanded to encompass the

[121] Section 2.D (text to n 53).
[122] Camille Landais, Emmanuel Saez, and Gabriel Zucman, 'A Progressive European Wealth Tax to Fund the European COVID Response' (*VoxEU.org*, 3 April 2020) <voxeu.org/article/progressive-european-wealth-tax-fund-european-covid-response>.
[123] Daniel Gros, 'A Corona Financial Solidarity Levy' (*VoxEU.org*, 22 April 2020) <voxeu.org/article/corona-financial-solidarity-levy>.
[124] Section 2.C (text to nn 41–42).

whole post-pandemic investment effort, or any similar public-private financing scheme, would have certain advantages. In particular, it would bypass the EU and national treasuries, thus avoiding many of the legal problems inherent to public financing; it would not be open to the accusation of moral hazard; and it would alleviate the perceptions of 'injustice' that could be generated if EU budgetary resources were allocated, as they should, with complete disregard for considerations of '*juste retour*'. As we have seen, however, such a solution is once more possible only with the benefit of Member States' guarantees. Moreover, it is likely to involve extensive use of soft numbers and double-counting, since the ability of the EIB to leverage its own intervention with complimentary private finance in the post-pandemic period cannot be taken for granted, while the inclusion of private loans towards the recovery supports headline number is spurious and misleading, since many of these loans are likely to be available to European enterprises regardless of EIB's participation.

- *Quasi-monetary financing of the Recovery Fund.* Some experts think that the solution lies in the ECB's outright purchasing of joint very-long-term EU instruments, which the central bank would then keep on its balance sheet until it decides on monetary grounds to dispose of them by selling them in the open market.[125] An oblique reference in the Spanish government's non-paper, according to which, in conjunction with the issuance of EU consols, the ECB 'should continue to play a key role to ensure financial stability through liquidity and other measures' might be read to imply that the central bank should serve as 'buyer of last resort', with very similar effects.[126] Evidently, these

[125] Francesco Giavazzi and Guido Tabellini, 'Covid Perpetual Eurobonds: Jointly Guaranteed and Supported by the ECB' (*VoxEU.org*, 24 March 2020) <voxeu.org/article/covid-perpetual-eurobonds>.
[126] Spanish government (n 116).

proposals raise issues of compatibility with the Treaty prohibition of monetary financing.

- *Exclusive reliance on ECB interventions.* In one variation of the 'buyer of last resort' notion, it has been proposed that a European fiscal intervention is altogether unnecessary and that the recovery can be supported by fiscal programmes at the national level, as long as the ECB stands ready to ensure any fiscally stressed country's continuing market access and to stabilise the prices of its debt.[127] Presented as a realistic alternative to the joint-debt proposals, whose failure due to political factors it preordains, this is a highly complacent proposal, since it takes for granted that, despite an already overburdened monetary policy and the considerable legal constraints, the ECB may continue to provide indefinitely a corrective to EMU's institutional asymmetries and economic dysfunctions, and still be able to pursue fully effectively its primary, and less controversial, responsibilities.
- *Full monetisation of the fiscal funding gaps.* At an extreme, the European response to the pandemic crisis could conceivably be based on pure and simple monetisation of the necessary fiscal expenditures through the creation by the ECB and allocation to the Member States of newly created money balances (so-called 'helicopter money'). An academic proposal to this effect has opened an extensive public debate.[128] As an ingenious means of avoiding the stricture of the Treaty prohibition of monetary financing, it has been suggested that the ECB could make direct distributions to the

[127] Roberto Perotti, 'The European Response to the Covid-19 Crisis: A Pragmatic Proposal to Break the Impasse' (*VoxEU.org*, 21 April 2020) <voxeu.org/article/european-response-covid-19-crisis-pragmatic-proposal>.

[128] Jordi Galí, 'Helicopter Money: The Time is Now', in Richard Baldwin and Beatrice Weder di Mauro (eds), *Mitigating the COVID Economic Crisis: Act Fast and Do Whatever It Takes* (London: CEPR Press, 2020), 57–61. See also Olivier Blanchard and Jean Pisani-Ferry, 'Monetisation: Do Not Panic' (*VoxEU.org*, 10 April 2020) <voxeu.org/article/monetisation-do-not-panic>.

> Member States by way of dividends[129]; but this path would be equally likely to meet the ire of objectors. Being by nature untargeted, monetisation would serve to finance national budgets indiscriminately and in proportion the ECB's capital key, rather than in accordance with the effects of the pandemic and the recovery's investment needs. In one intervention, the Governor of the Banque de France has suggested an alternative approach to 'helicopter money', according to which the ECB would provide direct support to companies in the form of grants of newly created money. This, however, was put forward as a 'theoretical example', not an actual proposal.[130]

To recapitulate, in view of the current estimates of the scale of the required intervention, certain otherwise credible funding proposals must be rejected as inadequate for the purpose. At the same time, the salient features of some other alternatives render them unrealistic and guarantee that they will meet insurmountable opposition on economic, political, or legal grounds. From a narrow public financing perspective, consols and monetisation might appear as the most attractive solutions. But they rest on untested hypotheses; and monetisation has evident and potentially grave drawbacks. Both solutions might meet strong resistance, including for the wrong reasons, such a bureaucratic fear of the unknown and dislike of radical regime changes. In any event, their legitimacy critically depends on

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[129] Sony Kapoor and Willem Buiter, 'To Fight the COVID Pandemic, Policymakers Must Move Fast and Break Taboos' (*VoxEU.org*, 6 April 2020) <voxeu.org/article/fight-covid-pandemic-policymakers-must-move-fast-and-break-taboos>.

[130] François Villeroy de Galhau, 'De l'Action d'Urgence Face à la Crise, aux Premières Réflexions sur l'Après-Crise' (speech to the Section de l'économie et des finances of the Conseil économique social et environnemental, Paris, 8 April 2020) <www.banque-france.fr/intervention/cese-de-laction-durgence-face-la-crise-aux-premieres-reflexions-sur-lapres-crise>

open and direct engagement at EU level with the substantive and legal impediments, including, in the case of monetisation in the form of ECB purchase of the joint EU instruments, the need for a highly improbable amendment of the TFEU's prohibition of monetary financing. Accordingly, leaving aside the very controversial issue of indirect monetisation, which cannot receive proper attention here, the set of realistic alternatives (that is, those amongst the effective solutions on which intergovernmental agreement is conceivably attainable, if any such exist) essentially boils down to a moderate increase of the EU 2021-27 MFF combined with one or another variation of the concept of joint debt raising.

In ascending order of likely duration, the latter could include: EU budgetary debt (Eurobonds) repayable within the horizon of the next MFF; special large-scale issues of ESM bonds with longer maturity; or EU long- or very-long-term debt (including, at the limit, consols). It must be stressed that duration is key to the practical success of any joint debt-based solution. One reason is the inability of fiscally weak countries to simultaneously rebuild their economies and meet their obligations regarding the repayment of the new EU debts in the foreseeable future. Their saddling with additional short- or medium-term obligations would increase very significantly their repayment and refinancing difficulties, and thus the chances of a fiscal accident; being aware of this situation, market players could act pre-emptively at first sight of stress, making debt crises self-fulfilling. In contrast, the financing of the common recovery effort on a very-long basis would provide reassurance to the markets. Without granting to private investors a shred of legal priority, a very long-term repayment horizon would play a similar role in their eyes, since the repayment of the existing and many forthcoming national bond

issues held by them would precede temporally the relevant countries' payment obligations relating to the jointly issued instruments. The problem of debt sustainability would thus be neutralised.

For all the substantive merits of a solution based on very-long-term joint debt issuance, however, its adoption is far from guaranteed. More generally, any alternative promising to provide sufficient firepower and a suitable timeframe remains in effect hostage to relevant Treaty norms and/or applicable approval procedures that give dissenting governments the power to block it. Without entering into details, depending on its exact configuration, any meaningful solution will collide with some of the following:

- the inflexible and restrictive Treaty norms on economic governance, especially the no-monetary-financing[131] and no-bail-out[132] clauses of the chapter on economic policy, whose effect is moderated only by the possibility of mutual assistance in the exceptional circumstances of Article 122 TFEU;
- the highly prescriptive EU budgetary norms,[133] which, as a result of their insistence on discreet MFF periods,[134] budgetary financing (almost) exclusively from own resources,[135] and, most importantly, strict adherence to the notion that the EU budget should always be balanced (principle of equilibrium),[136] impede long-term borrowing for the purpose of financing current expenditure by way of grants to states or businesses;

[131] TFEU, art 123(1).
[132] TFEU, art 125(1).
[133] TFEU, arts 310–324.
[134] TFEU, art 312(1).
[135] TFEU, art 311, second para.
[136] TFEU, art 310(1), third subpara..

- the unanimity requirement for the adoption of the EU MFF[137];
- the decision-making rules of the ESM Treaty, which require for all important decisions unanimity of the national finance ministers ('mutual agreement' in the ESM Board of Governors) or, in the case of emergency situations, an extreme supermajority (a qualified majority of 85 % of the votes cast)[138]; and
- the practical need for national guarantees to back almost all types of joint debt issuance.

Even though this legal framework does not preclude the lawful adoption of carefully designed versions of the various alternatives,[139] it creates an exceptionally tight straightjacket for policymaking.

Overall, the decisional framework increases each government's practical ability to hold out even in situations where a proposed solution has the support of a large majority of the Member States, the European Commission, and/or the European Parliament. In other words, it effectively creates an inordinate number of veto players.[140] To the extent that their capacity to block decisions is understood by their domestic audiences, the latter's intransigence increases further. This can lead to a major schism between the Member States, threatening Europe's survival.

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[137] TFEU, art 312(2), first subapra, second sentence.
[138] ESM Treaty, arts 4(3)–(4) and 5(6).
[139] See Julian Pröbstl, 'ESM Loans or Coronabonds: A Legal Analysis from the German Perspective' (*VoxEU.org*, 4 April 2020) <voxeu.org/article/legal-perspective-esm-loans-and-coronabonds>.
[140] Defined as 'actors whose agreement is necessary for a change of the status quo'; George Tsebelis, *Veto Players: How Political Institutions Work* (Princeton, NJ: Princeton University Press, 2002), 19.

In the present conjuncture, the ability of certain countries to block decisions in the European Council, the Eurogroup, and the ESM, that is, the key intergovernmental fora for economic and fiscal decision-making, could obstruct convergence on an effective European funding solution, leading leaders and the European Commission to adopt, instead, an economically ineffectual but politically necessary compromise position. To avoid continuing muddling through and hiding behind obfuscations and soft numbers, it is thus necessary to confront the final, and possibly most crucial, parameter of the competing proposals, namely, the deployment of the Recovery Fund's resources.

For reasons expounded above, the bias of the usual forms of European assistance programmes (such as the typical ESM or BoP facilities) in favour of short-term liquidity-enhancing lending must be resisted as unfit for the recovery strategy's purposes, because, following a brief initial respite, it could eventually aggravate the situation of weaker states. This could be solved by offering assistance in the form of grants, but these are anathema to the Northern governments, due to their openly redistributory nature. As agreement on a more profound reform of the European system of economic governance, no matter how desirable, is currently effectively impossible, it becomes necessary for the Southern governments to yield on this essential point.

In short, the feasibility of an effective compromise, or second-best solution, comes to depend on an ability to take on board to a certain extent the other side's concerns. Tentatively, one could think of two ways out of the impasse:

- France and its allies (representing the majority of the euro area's Member States) could accept that the assistance to governments to be provided in the form of loans, not grants;

in this case, however, they should insist on the loans' very long duration. The prospect of eventual reimbursement could help to pacify political objections of Germany and the frugal countries, while the long-term character of the relevant obligations could protect the recipient countries' fiscal sustainability.

- Alternatively, they could recognise that grants (and to a lesser extent long-term loans) to governments raise justifiable objections, not so much due to the strong feelings of the public opinion in Northern countries against fiscal transfer as such, but because this form of assistance raises real moral hazard issues, to the extent that an opportunistic government could use the money to subsidise non-investment-related expenditures, thus covering its budgetary funding gap, thus softening its budgetary constraints and avoiding necessary reforms and adjustments. Accordingly, it could be accepted that the implementation of the recovery plans' investment strategy should take place through the direct provision of investment support to eligible businesses in a centralised fashion, that is, by European institutions (as already happens in the case of financing by the EIB Group). This could be key both to the acceptance of the solution and to the avoidance of abuse.

To conclude, a middle solution, which could be accepted by the popular opinions of both the North and the South would involve very-long-term debt-issuance by either the ESM or the European Commission, enabled by either a revision of the rules pertaining to the EU budget or, more likely, by the Member States' provision of the necessary guarantees. The proceeds from the sale of the joint bonds should be used to provide very-long-term back-to-back loans to cash-strapped governments, over and above the proportional allocation limits suggested by each MS's contribution to the ECB key or the euro area's GDP, or to fund a centrally planned and implemented pan-European. With regard to the former alternative, if the principal's

repayment schedule is sufficiently backloaded (thanks to generous grace periods) and the interest payments are low (thus avoiding a substantial increase of the debt repayment obligations of the recipient countries in the meantime), the end result might not be ideal, but could at least prevent the worst-case scenario of another sovereign debt crisis.

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7 What recovery fund for Europe? (For a dedicated equity line for business, and sound fiscal policy)

Marco Lamandini, Guido Ottolenghi & David Ramos Muñoz[1]

1. Introduction

Models of leadership are driven by extraordinary people, but equally often by extraordinary circumstances calling for extraordinary measures. Mario Draghi's highly consequential FT article of 25 March 2020 noted that 'the challenge we face is how to act with sufficient strength and speed to prevent the recession from morphing into a prolonged depression, made deeper by a plethora of defaults leaving irreversible damage'[2].

This Covid-19 crisis may not be a 'war' in the full sense of the word, but the economic downturn driven by government lockdown and economic shutdown responses may resemble a 'post-war-like' reconstruction effort and may result in a Great Depression. Such a scenario may seem overly pessimistic, but it is quite possible. The solution, any solution, might involve a

[1] The cut-off date for information included in this article is 15 May 2020.

[2] Mario Draghi, 'Draghi: we face a war against coronavirus and must mobilise accordingly' *Financial Times* (25 March 2020) <www.ft.com/content/c6d2de3a-6ec5-11ea-89df-41bea055720b>.

significant increase in public spending, or at least in the declared commitment of public bodies to sustain the economy. Confronted by the outcome of forced and prolonged lockdowns, no private actor, however large, could act as a backstop to the system, and even States alone barely could in some cases. Only the Union offers a sufficiently safe bet. A belated strategy could turn a severe downturn into a human tragedy, with unpredictable consequences to our democracies and the European project in the first place. It is, therefore, necessary to timely devise several complementary responses to make the most efficient use of the Union's and Member States' balance sheets and this is precisely what European institutions and Member States have committed to do in the last month. Allow us to say preliminary that a successful outcome requires, in our opinion, not only good technical solutions but also a cultural approach where public engagement and political activity regain the trust and respect of the people after decades of disenchantment. This is for sure a long-term goal, and its scope far exceeds the purpose of this contribution, but a declared commitment on this matter is an essential starting point because communities, just as markets, are built on trust before anything else. We believe that there is no better time than now for a thorough and sincere reconsideration of the many derailments of the past and for a fresh and new course of action. A course of action inspired by an ethics of moderation, where every effort to restrain wrongdoings is made, but also to avoid the criminalisation of human errors (a fundamental ingredient of moral and material progress). A time when every attempt to dole out rent and eliminate the inherent risk of respectable entrepreneurship should raise the eyebrows of every European citizen.

Having this in mind, let us turn to the EU proposals currently on the table: the initial Eurogroup meeting of 9 April resulted in an agreement on the need for flexibility in EU rules, and the use of the EU budget, a welcoming attitude towards the resolute action by the ECB in bond purchasing, and financial supervisors on applying capital rules in a flexible manner, and additional actions, including emergency support, strengthening EIB activities, etc[3]. Reading between the lines, however, one can detect the rift between Member States: no one seemed to object to the use of already committed funds, but as far as new resources were concerned, Member States seemed all too happy to let others, i.e. the ECB, and private banks, through more lenient prudential requirements, pick up the tab, while, more concrete proposals, such as SURE, the Recovery Fund, or even the EIB new activities, were either insufficiently funded, or too succinctly sketched. Unsurprisingly, this was not nearly enough, and new meetings were needed. The leaked Spain's non-paper on a European recovery strategy of 19 April 2020[4], provided more clear contours, or at least a first basis for discussion of the tentative political agreement of end-of-24 April point towards a comprehensive EU strategy based upon (a) EU liquidity support to national expenditures to counteract the impact of COVID-19, as agreed by the Eurogroup on 9

[3] Eurogroup, 'Report on the comprehensive economic policy response to the COVID-19 pandemic' (9 April 2020) <www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/>.

[4] 'Spain calls for €1.5tn EU recovery fund to 'protect internal market' *Financial Times* (Madrid, 21 April 2020) <www.ft.com/content/cd27d7da-e6e9-4aa8-ab63-5b51f36d124c>. See also Martin Sandbu, 'The merits of Spain's proposed recovery fund are irrefutable' *Financial Times* (21 April 2020) <www.ft.com/content/69b90ec0-83d5-11ea-b872-8db45d5f6714>. Spain's non-paper (19 April 2020) <issuu.com/prisarevistas/docs/spanish_non-paper_on_eu_economic_re_e3a10e64de074d>.

April 2020 (precautionary ESM Credit Line up to 250 billion; a guarantee fund of 200 billion from the EIB; a SURE programme within the EU budget to finance up to 100 billion short term employees' schemes), (b) a revised Multiannual Financial Framework for 2021-2026 and (c) an EU Recovery Fund. The measures to be finally agreed will require a combination of the intricacies of the EU budget and financial and legal creativity as to the financial instrument to be deployed

2. Post pandemic support for businesses: shfting attention from debt to equity

In a short discussion paper[5], published few days ahead of the Eurogroup meeting of 9 April 2020, we called for a savvy use of established legal and financial schemes in devising the needed recovery measures, including backstop recovery measures for businesses, to face the worst-case scenario, should

[5] Marco Lamandini, Guido Ottolenghi, and David Ramos Muñoz, '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/>. Consonant views were also voiced, in parallel, from influential economists: compare Arnoud Boot, Elena Carletti, Hans-Helmut Kotz, Jan Pieter Krahnen, Loriana Pelizzon, and Marti Subrahmanyam, 'Corona and Financial Stability 3.0: Try equity -risk sharing for companies, large and small' (March 2020) *SAFE Policy Letter No. 81* <safe-frankfurt.de/fileadmin/user_upload/editor_common/Policy_Center/SAFE_Policy_Letter_No_81_final4.pdf>; *Id.*, 'Corona and Financial Stability 4.0: Implementing a European Pandemic Equity Fund' (April 2020) *SAFE Policy Letter No. 84* <safe-frankfurt.de/fileadmin/user_upload/editor_common/Policy_Center/SAFE_Policy_Letter_84_final2.pdf>; Giorgio Gobbi, Francesco Palazzi, and Anatoli Segura, 'Unintended effects of loan guarantees during the Covid-19 crisis'(15 April 2020) *Vox, CEPR Policy Portal* <voxeu.org/article/unintended-effects-loan-guarantees>.

it materialise (as we hope not). Our goal was to suggest measures that, in such a worst-case scenario, could turn into a viable backstop with as little execution risk and legal complexity as possible, and with minimum moral hazard.

One of our key messages was not only to emphasise the importance of support via *equity* for all those businesses that are credibly sound and solvent (or better, were at least so at the outbreak of the pandemic, based upon a careful assessment of their balance sheets as of 31 December 2019) and may become unviable due to the losses associated to the prolonged inactivity (and loss of turnover) caused by the restrictions imposed for the containment of the pandemic, but also to start discussing the technical details for a sound implementation of such programme. In our view implementing details are what really matter, because they are key to simultaneously preserve free market and private enterprise, notwithstanding the magnitude of the public intervention, and the credibility of a long term exit strategy from these public investments, in line with sound fiscal policy. We started by emphasising that a fundamental objective of European action not sufficiently present in the European policy landscape at the time was that of rebalancing the financial structure of those European businesses which are going to ask for recovery financial support away from debt and towards equity, and – building on the experience of past measures, like those implemented to support financially constrained banks in response to the financial crisis - we discussed the merit of a large scale use of one or more financial vehicles and hybrids securities to contribute emergency equity to businesses financially and economically affected by the lockdown in response to the pandemic.

3. Matching finance and law and the engineering of the basic idea

Some national initiatives seem to bear this out. The German *Bundestag* adopted on 27 March 2020 legislative measures establishing, in response to the COVID-19 crisis, an Economy Stabilization Fund, engineered along the lines of the past programme set up in 2008 to tackle the banking crisis. The German Fund has been equipped with €600 billion firepower, of which €100 billion are earmarked for recapitalisation measures, by way of participation in subordinated debt instruments, hybrid bonds, silent partnerships, convertible bonds, and direct equity investments. Meanwhile, in the academic and policy debate we see an increasing chorus of voices[6] asking for EU and/or national post-COVID-19 initiatives in support of businesses to be channelled via fair equity, in order to help businesses absorb their upcoming losses

[6] Compare for instance, in addition to the authors mentioned in footnote 4, Assonime, 'Proposal for the establishment of an Italian Recapitalisation Fund for Businesses in the Wake of the Covid-19 Crisis' (16 April 2020); Fabrizio Balassone, Audizione Banca d'Italia, Commissioni Riunite VI e X Camera dei Deputati, (Rome, 27 April 2020); Giovanni Sabatini, Audizione Associazione Bancaria Italiana, Commissione Industria Senato (29 April 2020) (these proposals were, to some extent, translated into law by Article 29 of the law decree adopted by the Italian government on 13 May 2020). Compare also Merryn Somerset Webb, 'There is a way to solve the Covid-19 bailout problem. Might we all be better off if government loans were fast converted into equity?' *Financial Times* (1 May 2020) <www.ft.com/content/1eaec3b2-8b90-11ea-a01c-a28a3e3fbd33>; Marco Bresolin, 'Paolo Gentiloni: "Recovery Fund da 1000 miliardi per fermare la spirale del debito"' *La Stampa* (13 May 2020) <www.lastampa.it/topnews/primo-piano/2020/05/13/news/paolo-gentiloni-recovery-fund-da-1000-miliardi-per-fermare-la-spirale-del-debito-1.38836357>; Ursula G. von der Leyen, 'Speech by President von der Leyen at the European Parliament Plenary on the new MFF, own resources and the Recovery Plan' (13 May 2020) <ec.europa.eu/commission/presscorner/detail/en/SPEECH_20_877>.

without managerial responsibility, due to the coronavirus lockdown, as the way to persuade them to stay open. However, the implementing details of such proposals, albeit inspired by a shared philosophy, differ. Boot and others, for example, call for outright cash transfers to firms with a temporary, elevated corporate profit tax as a form of conditional payback. In its most recent version, the Boot's proposal is grounded on a European Pandemic Equity Fund (EPEF) and offers a detailed description of the ways relevant for its operationalisation.

Our proposal shares much of the same rationale, and namely (i) the pooling of resources through a coordinated EU-wide strategy; (ii) a legal structure that implements that strategy, and reconciles it with other competing needs, and (iii) a clear roadmap with an 'exit' strategy. Yet, the legal and financial implementation details are different. In our view, a downward delegation of the EPEF's exit strategy to fiscal policy impinges upon domestic fiscal burdens and relies on uneven fiscal approaches and enforcement actions across Member States, an asymmetry that can be exacerbated by the already existing tensions at a social and political level. To mitigate these factors and minimise the execution risk associated with them, we advocate a solution that builds on already established legal and financial tools. This would also offer the advantage of sounding quite familiar to institutional investors and other participants in international capital markets, thus reducing transaction costs, facilitating (maybe in a second stage) private sector participation and competition in offering equity solutions and enhancing trust.

This, we hope, may facilitate the necessary coalescing of public and private funding efforts. We call for (i) the initial pooling of EU and national resources, i.e. those of the EU Recovery Fund, of the EIB and those of similar national recovery funds or of

development banks, because this would combine an infrastructure with adequate standing, expertise and, as to EIB and development banks, accepted track-record on (financial and social) returns with a sufficiently large financial firepower to make a difference. Second, (ii) we advocate crystalising such pooled resources in one or more dedicated special purpose vehicle (SPV) or a closed-end, umbrella fund, initially funded by the public funds of the European Recovery Fund, EIB and national recovery funds and development banks, but eventually open to international investors. Third, (iii) such vehicle should provide (quasi) equity to businesses based on their balance sheet as of 31 December 2019 with a clear exit strategy.

4. The implemtentation details.

It is against that background that we must now look at the way such an initiative to provide equity for businesses affected by the COVID-19 crisis could successfully liaise with the EU Recovery Fund, which has only been agreed by European leaders at the level of its general features, but whose technical details are currently under discussion. We look at this from the asset-side and liability-side of the Recovery Fund. In Spain's non-paper of 19 April 2020, it is suggested that the Recovery Fund should have a size 'robust [enough] in order to have a macroeconomic impact and offset the negative impact of the current crisis. Most experts estimate it at […] €1 to €1.5 trillion.' The financing should be ready by 1 January 2021 the document continues, and the 'full implementation of the three instruments' that constitute the 'triple safety net of around €500

billion for states, companies and workers' should be completed by 1 June 2020.[7]

An important factor that cannot be stressed enough, and that reluctant Member States do not seem to grasp fully, is that the pooling of resources around a legally tested structure is key if some unwelcome hurdles are to be avoided. The concept of unlawful State aid is based on the notion of aid 'granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition'.[8] Currently, the European Commission has adopted a Temporary Framework on State-Aid measures, which grants flexibility to the Member States.[9] Yet, it would only be a matter of time before the differences in fiscal capacity would begin to create the market distortions (between companies, and between the banks used to channel Member States' aid) that the provision is supposed to ban. At some point, the motley patchwork of diverging state funding schemes would embody the definition of 'distortion', and it would only take a single complaint to cast a large shadow of doubt on the whole framework.

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[7] Spain's Non-paper on a European Recovery Strategy (n 4). See also Carlos E. Cué and Bernardo De Miguel, 'Spain proposes a €1.5 trillion coronavirus recovery fund financed through perpetual EU debt' *El País* (20 April 2020) <english.elpais.com/politics/2020-04-20/spain-proposes-a-15-trillion-coronavirus-recovery-fund-financed-through-perpetual-eu-debt.html>.

[8] Article 107 (1) of of the Treaty on the Functioning of the European Union (TFEU), OJ C 326.

[9] European Commission, 'Communication from the Commission on Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' (19 March 2020) C(2020) 1863 final. This framework was later amended by European Commission, 'Communication from the Commission on Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' (3 April 2020) C(2020) 2215 final.

EU funds are not subject to the same restrictions.[10] Although the Court of Justice has not questioned the nature of 'state funds' of measures co-funded by EU sources,[11] the key seems to be on the Member State's 'discretion' to use the funds, in contrast with funds 'directly awarded' by the Union, the European Investment Bank, or the European Investment Fund, with no discretion on the part of the national authorities, including prominent examples such as the EU programme for the Competitiveness of Small and Medium-Size Enterprises (COSME).[12] Furthermore, the EIB and EIF offer their experience in the intricacies (and possible improvements) of managing the different levels of co-decision (between Member States' and EU levels) and the State-aid implications in each case.[13] In turn, there is already a successful example of a fund (namely the European Investment Fund) legitimately established by the EIB, according to Article 28 of its Statute, [14]

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[10] For an excellent summary of the issue, see Phedon Nicolaides, *State Aid and EU funding: Are they compatible?* (April 2018) Policy Department for Budgetary Affairs Directorate General for Internal Policies of the Union PE 621.778 < www.europarl.europa.eu/RegData/etudes/IDAN/2018/621778/IPOL_IDA(2018)621778_EN.pdf>.

[11] See, e.g. Case C245/16 *Nerea SpA v Regione Marche* [2017], EU:C:2017:521 (European Regional Development Fund).

[12] Commission Notice on the notion of State aid as referred to in Article 107(1) TFEU, C/2016/2946 *OJ C 262, para. 60. This is also supported by Recital 26 of* Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (General Block Exemption Regulation), OJ L 187/1.

[13] See, for example, the Joint statement by Joaquín Almunia, European Union Commissioner for Competition, and Werner Hoyer, President of the European Investment Bank (EIB), on *State aid matters in relation to the activities of the EIB Group* (21 January 2014) <ec.europa.eu/competition/state_aid/modernisation/joint_statement_en.pdf>.

[14] Article 28 of the EIB Statute states: 'The Board of Governors may, acting unanimously, decide to establish subsidiaries or other entities, which shall

as a specialist provider of risk finance to benefit small and medium-sized enterprises (SME) across Europe. If, as we surmise, the COVID-19 funding will need an unprecedented commitment of resources, it seems better and more expedient, to scale up existing infrastructure built on solid legal grounds, than to declare an open bar on public funds, and hope that everyone looks the other way or it is not raided by the more expedients.

Furthermore, it would be possible to benefit from the EIB/EIF expertise and advisory, while granting the necessary autonomy to this one-off and exceptional financial effort. As the EIB Statute allows for the creation subsidiaries or other entities with separate legal personality and financial autonomy, so should also provide the future Statute of the European Recovery Fund because these elements that can be used to grant the requisite flexibility associated with the new challenges.

Consistently with our focus on equity support to European business post-economic shutdown, we discuss here our preferred course of action to make use of the (estimated) €500billion Recovery Fund's ammunition for companies and, therefore, on the instruments designed to maximise the effectiveness of the equity-support programme, once the most immediate liquidity needs of businesses are provisionally satisfied by the liquidity bridge currently offered by banks' loans backed by state guarantees.

a) On the asset-side, we posit that the use of public funds to provide equity to COVID-19 affected businesses should be legally engineered through the issuance, by the businesses

have legal personality and financial autonomy.' <www.eib.org/attachments/general/statute/eib_statute_2020_03_01_en.pdf> . This was the provision used to create the EIF.

entering the programme, of hybrid securities or quasi capital (capital instruments like Additional Tier 1 instruments for banks according to Article 52 CRR[15] could be used as a blueprint, with all due adjustments)[16]. These could also be issued to convert into quasi-equity banks' loans and emergency liquidity injections backed by state guarantees according to EU and national initiatives already adopted. In our view, these securities should be perpetual, should provide an initial return based on the profits of the business, and have priority over shares. The returns should also be cumulative (to the extent permitted by IAS32), and calculated in a way to ensure, if the business is profitable in the next 10-15 years, to fully amortise

[15] 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, as amended.

[16] Instruments carrying for instance the following features could be considered as a reasonable basis for further reflections: (a) the instruments are perpetual and the provisions governing them include no incentive for the institution to redeem them; (b) where the provisions governing the instruments include one or more call options, the option to call may be exercised at the sole discretion of the issuer [provided that upon repayment the issuer remains solvent], and not before five years after the date of issuance; (c) distributions under the instruments meet the following conditions: (i) they are paid out of distributable items; (ii) the provisions governing the instruments give the institution full discretion at all times to cancel the distributions on the instruments for an unlimited period and on a non-cumulative basis, and the institution may use such cancelled payments without restriction to meet its obligations as they fall due; (iii) cancellation of distributions does not constitute an event of default of the institution; (iv) the cancellation of distributions imposes no restrictions on the institution;(d) the instruments do not contribute to a determination that the liabilities of an institution exceed its assets, where such a determination constitutes a test of insolvency under applicable national law; (e) the provisions governing the instruments require that, upon the occurrence of a trigger event, the principal amount of the instruments be written down on a permanent or temporary basis or the instruments be converted to common equity; (f) the provisions governing the instruments include no feature that could hinder the recapitalisation of the institution.

the original contribution economically and pay a fair market rate. This would also reconcile the need to support businesses with the need to align such support with applicable State aid provisions through the paid-out returns,[17] and after such 10-15 years period, a floating rate at fair market conditions with a right of the borrower to repay and 'be free'. The hybrid instruments should be transferable, to facilitate the entry of private or other actors, and should also be convertible into common shares upon request of the holder if at the end of the 10-15 years period they are not, economically, fully amortised, and the conversion rate should be calculated by actualising the original (quasi) equity investment and the expected interest rate flows less its paid-out returns and appraising the company at its book value at the time of conversion. Considering the origin of the crisis, the conversion rate may also include a surcharge for conversion, as an indirect contribution of fiscal policy to losses which could not be fully recovered through the ordinary course of business over the 10-15 years period. We argue therefore that the design should be based on existing legal instruments, should provide real support to worthy companies, should be accessible after scrutiny but without excessive red tape, and yet it must be sufficiently costly to the entrepreneur that when accessing it companies are aware that they will not escape repaying their communities of the burden that public bodies (i.e. future

[17] Although EU funds do not fall within the definition of 'State' aid, financial rules emphasize the need for 'consistency' with the spirit of State aid rules. Recital (141) of 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 states that: 'Financial instruments and budgetary guarantees should only be implemented if there is no risk of distortion of competition in the internal market or inconsistency with State aid rules.'

generations) are now taking upon themselves to sustain economic activities.

The programme should also allow the early redemption or buy-back by the company, in whole or in part, of the hybrid at any time, to prevent risks of dilution for existing and committed shareholders, at the conversion value plus a fair premium (set however in an amount below usual market rates, to take due account of the origin of the crisis and thus to incorporate a fair contribution of fiscal policy). Specificities aside, the conclusion is simple: we see a role for governmental, EU and national, action to stabilise and normalise the situation via more equity, but under fair market conditions and with a clear market exit. Financial ingenuity would immensely help, in our view, all along the road. The EIB/EIF blueprint and expertise can also offer extremely valuable insights on how to implement these instruments, assisting the EU Recovery Fund in implementing its safety net of around €500 billion for companies and in leveraging the same, via one or more dedicated financial vehicles. There will be the need to tailor all details of these instruments as flexible as possible depending on all relevant circumstances: for example, they will likely be different when recipients are SMEs (a likely occurrence for Italy and Spain) or major listed companies or national champions (as it seems to be more likely in Germany and France). It is also the occasion to enforce better and more transparent disclosure of company accounts in Member States where this is not yet required, with a beneficial impact on the future pan-European M&A market for SMEs and for the further development of the Capital Market Union for SMEs.

Currently, a growing number of entrepreneurs are given the morally hazardous message that if they struggle to keep doing business, they are exposed to losses, legal risks, credit risks and

union hostility, while if they close down the state will give them a free hand, through free grants, when reopening time comes. Our proposal introduces a fair cost for the entrepreneur to access public assistance and induces, in our view, more balanced thinking. At the same time, if the financial vehicle used to implement this programme is an umbrella fund and is large enough to acquire, with one or more (sector-specific) compartments, holdings in pan-European listed companies financially constrained by the economic downturn and with others (sector-specific) compartments holdings in European small and medium enterprises (SMEs) across all major industrial sectors, it may easily turn out to act (i) as an unprecedented internal market and Capital Markets Union accelerator, because part of its engagement with the supported business would entail fostering growth (domestic and cross border) via mergers with other complementary businesses also participated by the fund and/or more complementary access to capital markets, all along the listing escalator. In turn, this would also immensely help in mentoring the transition of the European industry towards the ambitious targets of its announced (and already funded) New Deal. We are well aware that any entity vested with such tasks is not devoid of problems since a Recovery Fund and one or more EU or state umbrella funds or special purpose vehicles funded by the same might prove slow and exceedingly bureaucratic in responding for instance to the applications of millions of SMEs. Also because once active, the leadership position of such funds will carry huge political power and may excite the appetites of those less apt to manage them wisely. For this reason, we also suggest the use of innovative and credible governance to some extent mirroring that of central banks, capable of ensuring independence from any undue political influence and in this way warranting sound and sustainable policies vis-à-vis

competing economic interests which would pose a time-inconsistency problem similar to that faced by central bankers. We also suggest that a reasonably wise and lucky selection of leaders for this daunting task might also turn into an extraordinary opportunity for Europe to tap into European citizens formed and forged through a Union minded business and financial engagement.

b) As to the liability-side, we understand that, in the current political debate, it is gaining consensus that the Recovery Fund should build its financial firepower by issuing, in turn, perpetual or long term EU debt, 'backed by the existing legal mechanisms to fund the EU budget underpinning the triple-A rating of the European institutions' (as the Spain non-paper puts it). We agree with this, but we also posit that, as briefly anticipated above, if the EU Recovery Fund, once financed, instead of providing direct capital injections or free grants to businesses (we broadly consider the latter quite unwarranted and likely to raise moral hazard and competitive distortions but for exceptional circumstances), (i) could join forces also with EIB /EIF, national recovery funds, and Development banks, and (ii) would channel all available funds to support businesses, through one or more (controlled or participated) umbrella fund(s) or special purpose vehicle(s) – by underwriting at least most of the junior tranche of the units or securities issued by the same - this would significantly leverage its firepower and would also offer an opportunity to minimise the fiscal cost of the programme (and therefore also the special tax programme associated thereto). Indeed, we believe that mezzanine and senior tranches of such European strategic vehicle(s), in their size, could easily double or triple public funds' endowment via the junior tranche and, being backed by the holdings in vast

sectors of the European industry, may become attractive investments for many long-term institutional investors.

Judging by past experiences, such vehicle(s), if patiently and adequately managed, may prove, in the long run, quite profitable. This would morph an unprecedented, targeted issuance of perpetual or long-term European debt from a potential threat to sound fiscal policy into a unique, mid-to-long-term opportunity for Europe, to jumpstart, fuel and foster a much-needed European industrial reorganisation. This should be done in line with the principles of a fully-fledged market economy, by gently providing the right incentives to 'nudge' the backbone of European economic activities, giant infrastructural national champions and SMEs and micro-businesses alike, towards a more balanced debt-to-equity ratio, accelerated growth and internal market cross border consolidation, large scale access to capital markets and, as also noted by the Spain non-paper, transition to sustainability, without indulging in any unnecessary expropriation or limitation of all key attributes of free enterprise. Under no circumstances, these instruments, and their holders, should be allowed to crowd out the sound entrepreneurial activities of the continent. In other words, it is an essential component of this programme that capital contributions to companies should be priced to avoid those better competitors who need not access such public help are pushed out of their market by less efficient companies in the same sector. Free enterprise must remain the only beacon which can help Europe and the Member States alike in navigating these unchartered waters towards a much safer destination. While, unfortunately, we still do not know much about the virus and the real economic consequences of the actions taken by governments worldwide to respond to it, we must take this emergency to learn lessons of future preparedness

for similar, or not so similar, crisis in the future, because once we use, as we must, in the current circumstances all the financial firepower available to our generation imposing a significant fiscal cost on next generations, we must also be aware that lockdowns should hopefully never happen again. A good recipe for this is to develop enough knowledge for better deliberations quickly and to prepare for the worst economically with savvy. A positive side effect might also be that these measures happen to create the conditions for the reshoring of at least some manufacturing activities into Europe, and that, through the inevitable, better inside business knowledge they will transfer to European institutions, they might credibly help in devising more proportionate regulatory responses, with far less costly red-tape.

A crisis should always bear better ideas for the future. Most of all, in the face of the economic downturn originated by the largest worldwide political intervention in the economic and personal freedoms after Second World War, we must maintain our sober rationality and courageous humanity, and a very distinct sense of memory and justice, to dispel the risk that the damages inflicted on private businesses by this crisis (and the political responses to it) may set the table (i) for new, undesirable experiments in planned economy, which may well be the largest in European history or (ii) for highly emotional fiscal profligacy. We must think of solutions that are proportionate and reasonable, fiscally sound and industrially effective, that revert us from the withdrawing from life and that direct us to newly and vigorously embrace life and business with full control of our personal and economic liberties, and a vigorous sense of industrious and responsible, individual and collective, resilience

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8 THE EU fiscal response to the COVID-19 crisis and the Banking sector: risks and opportunities

Luís Silva Morais[1]

1. A new type of systemic crisis: introductory remarks

1.1. Introductory remarks and overview of analytical framework

1.1.1. Not much longer than a decade after the great financial crisis of 2007-2008 (GFC), which in the EU prolonged and evolved into a sovereign debt crisis, intertwined with a banking

[1] 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 information included herein is 1 May 2020. Subsequent developments are only briefly mentioned when these present exceptional importance as is the case of the 5 May Judgement of the German Constitutional Court. See Bundesverfassungsgericht – BVerfG, Judgment of the Second Senate of 05 May 2020 – 2 BvR 859/15 – , paras (1-237).

crisis,[2] and shortly after we have commemorated last year the momentous anniversary of the second decade of the Euro, a new and dramatic international economic crisis has unexpectedly erupted. This 2020 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. The latter is complicated by 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, which have led, in my view, to *an actual transformation of the nature of the EMU after the last crisis*, have equipped it better to cope with the current turmoil. Avoiding either too much optimism or too much pessimism, and aiming towards *realism*, which should be the cornerstone of the reaction to a widespread crisis, we are in a better position to tackle this crisis (at EU level). At the same time though (somehow paradoxically), we are in a worse position to cope with it (at worldwide level), in 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 GFC, in the aftermath of the failure of the Lehman Brother in 2008, a

[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' (2016) Briefing by the European Parliament Research Service <www.europarl.europa.eu/RegData/etudes/BRIE/2016/583806/EPRS_BRI(2016)583806_EN.pdf>; Philip Lane, 'The European Sovereign Debt Crisis' (2012) 26(3) Journal of Economic Perspectives 49; Damiano Sandri and Ashoka Mody, 'The Eurozone Crisis: How Banks and Sovereigns Came to Be Joined At the Hip' (2011) IMF Working Paper.

coordinated international response was somehow achieved at the level of a landmark London G20 summit. That response led 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.[3] Contrasting with this precedent, as duly emphasised by some of the key political protagonists of this G20 response, no comparable coordinated response at that level is occurring in the context of the current crisis. However, at this critical moment, in which coordinated efforts to find a vaccine and conciliate sanitary measures, besides agreeing on a joint approach to the use of government spending to boost growth, would be more necessary than ever.[4]

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 incomplete roadmap, to a *set of reforms of the structure and governing principles of the EMU*. These 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 lockdown and avoid its evolution towards an actual depression. In fact, one of the key issues this Article purports to asses is the extent to which the previous reform and transformation of *EMU, and the related processes of building the European*

[3] On the G20 response to the GFC, see, inter alia, Andrew Cooper and Colin Bradford Jr., The G20 and the Post-Crisis Economic Order, (2010) CIGI G20 Paper No. 3; 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).

[4] See on this Gordon Brown, 'In the coronavirus crisis, our leaders are failing us' *The Guardian* (London, 13 March 2020) <www.theguardian.com/commentisfree/2020/mar/13/coronavirus-crisis-leaders-failing-gordon-brown>.

Banking Union, have actually gone far enough to frame a proper and balanced European response to the crisis.

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 for decisive answers to the current crisis in terms of monetary and fiscal policy. The critical answer to be found is to establish if the undeniable changes undergone by 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*.[5] To phrase it in a slightly different manner, what is at stake is to evaluate if the changes underfone by EMU structures to ensure 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 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.'[6] 'Reality never disappoints' us, to quote the Spanish writer and theologian

[5] I refer here to a concept of idea of *stabilisation* 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 by or experiencing severe financial difficulties. On this idea of *stabilisation function* see, inter alia, Jorge Nunez Ferrer and Cinzia Alcidi, 'Should the EU budget have a stabilization function?' (May 2018) CEPS Policy Contribution; Alfred Katterl and Walpurga Koehler-Toeglhofer, 'Stabilization and shock absorption instruments in the EU and the euro area –the status quo' (2018) OeNB Monetary Policy & the Economy Q2/18 87.

[6] See Daniel Gros, 'A fiscal shock absorber for the eurozone? Lessons from the economics of insurance' (CEPR Policy Portal, 19 March 2014 <voxeu.org/article/ez-fiscal-shock-absorber-lessons-insurance-economics>.

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 (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 with the rather intractable debate on EU *mutualisation* of debt and related fiscal responsibilities or commitments (*lato sensu*),[7] 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 '*Bundesverfassungsgericht*' in Germany) has led the ECB to develop what in effect represents

[7] See for the general terms of such debate on mutualisation, Alfredo Arahuetes and Gonzalo-Gómez Bengoechea, 'Debt mutualisation, inflation and populism in the Eurozone' (April 2018) ARI 45/2018; Agnes Bénassy-Quéré, and others, 'Reconciling risk sharing with market discipline: A constructive approach to euro area reform' (2018) CEPR Policy Insight, no. 91 <www.bruegel.org/2018/01/reconciling-risk-sharing-with-market-discipline-a-constructive-approach-to-euro-area-reform/>.

an *atypical form of mutualisation*. That is in the form of *quantitative easing*, through which 'a shared liability (cash) is swapped for the sovereign bonds of individual euro-zone countries'[8]. 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 a too conceptual discussion should be avoided at all costs on a *one way out model of EU fiscal response to the crisis* with an overemphasis on accepting *mutualisation* and on an *explicit, direct and pure model of burden-sharing* in a new type of *fiscal union* built overnight.

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 this sector will be foreseeably affected by this economic recession. In fact, the particular nature of this crisis entails undeniable risks for the functioning of the European banking sector but also opportunities for its further transformation in the course of the overall restructuring it was still enduring when entering 2020. That is, with a view to the gradual and incomplete implementation of the various building blocks of the Banking Union, in connection with a new normative Banking Package,[9] and a much uncertain and nebulous Capital Markets Union (*infra*, section 4.).

[8] See, stating that view to which I largely subscribe with the caveat referred *supra*, The Economist, *Why the Euro is more durable than it looks* (25 April 2020).

[9] 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).

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 recently underlined by the former ECB President Mario Draghi, inevitably induce a serious recession, with the risk of it 'morphing into a prolonged depression, made deeper by a plethora of defaults leaving irreversible damage'.[10]

The key outstanding doubt under the current conditions will be 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 a difficulty 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.[11]

Actually, the current crisis arises from two cumulative economic shocks – a *demand-side* and a *supply-side shock*, but to make matters even more complicated the demand-side shock now produced by the pandemic is of an entirely different nature

[10] See Mario Draghi, 'We face a war against coronavirus and must mobilise accordingly' *Financial Times* (25 March 2020), available at <www.ft.com/content/c6d2de3a-6ec5-11ea-89df-41bea055720b>.

[11] That is, because activities in the banking sector are 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.

than the one, which occurred in the preceding crises (including the GFC).

In the previous European crisis, and as it commonly 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 current situation 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).

At the same time a supply-side shock occurred on account of a drastic reduction of the availability of the labour force, due 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 wherever 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.

In fact, if it is true that the high level of interdependence between banks makes them particularly prone to *systemic risk*,[12]

[12] 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, 'A

broadly understood as referring to the risk of economic instability becoming so widespread to impair the functioning of whole economic sector or sub-sectors,[13] this type of 'fragility' is not necessarily limited to banks and the financial system.[14]

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). If we consider the three key manifestations or dimensions of *systemic risk*, encompassing *contagion risk*, risks of *macro shocks originating simultaneous problems*, and risks of the *unravelling of balances that have built over time*,[15] 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

European Framework for Macro-Prudential Oversight' in Eddy Wymeersch, Klaus Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A post-crisis analysis* (OUP 2012).

[13] See on these and related notions of *systemic crisis*, ECB, *Financial Stability Review* (December 2009), 134. See also Olivier de Bandt and Philipp Hartmann, 'Systemic risk: A survey' (November 2000) ECB Working Paper Series, No. 35.

[14] 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 Alexander Kern, 'Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board' (June 2011) University of Cambridge Legal Studies Research Paper Series 6.

[15] On these manifestations or dimensions of *systemic risk*, see, inter alia, Jon Danielsson, Hyun Son Shin and Jean-Pierre Zigrand, 'Modelling financial turmoil through endogenous risk' (VOX Columns, 11 March 2009). See also Jon Danielsson, *Global Financial Systems – Stability and Risk* (Pearson Education 2013).

South-East Asia and China). This is particularly visible in sectors like electronic communications and digital technologies, but by no means limited to these as a growing number of economic sectors is relying more heavily on 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 crisis.

As such, a proper assessment of the *systemic risks* forces operating in this crisis – *outside the financial system* – will involve new analytical tools oriented towards the collection and comprehensive evaluation of data on firm-level networks[16] (which, in time and depending on the now unforeseeable duration and extension of the crisis, 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*,[17] the COVID-19 shock is absolutely *exogenous*. However, this does not mean that a potential for *endogenous risk amplification* will not come to exist within the financial sector (and particularly the banking

[16] See on this Jonathan William Welburn and others, *Systemic Risk: It's Not Just in the Financial Sector* (Rand Corporation, Santa Monica, 2020) <www.rand.org/pubs/research_briefs/RB10112.html>.

[17] See on this characterization and distinction, Jon Danielsson and Hyun Song Shin, 'Endogenous risk', in *Modern Risk Management —A History* (Risk Books 2002).

sub-sector), although the trigger is, at the start, an exogenous shock.[18] In a nutshell, it is of paramount importance to prevent too prolonged and intense exogenous risks – originating in the rest of the economy and 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.[19]

Accordingly, it will be vital that a timely mix of monetary and financial policy measures at the EU level (as briefly discussed *infra*, in section **3.**) properly ensure a limited duration and intensity of the exogenous risks arising from the recession in various economic sectors. At the same time, they should ensure 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.

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 emphasised by Mario Draghi, 'banks (…) extend across the entire economy and can create money instantly by allowing overdrafts or opening credit facilities'.[20] Through that contribution banks would be diluting the adverse image arising from the kind of negative management culture that has been

[18] See on these possibilities, Jon Danielsson, Robert Macrae, Dimitri Vayanos and Jean-Pierre Zigrand (2020), 'The coronavirus crisis is no 2008' (*VOX CEPR Policy Portal*, 26 March 2020).
[19] That is especially in the EU in spite of the significant and undeniable progress arising from regulatory reform and the building of the Banking Union and related instruments.
[20] See (n 10).

perceived by society in general from the last crisis.[21] 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, however, it is difficult to predict how the pendulum will 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.

2. The EU economic response to the crisis within the constraints of an unfinished EMU: Has the transformation of key policy principles of EMU gone far enough?

2.1. Key policy principles of EMU – setting the scene

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 in his recent farewell speech he stated that the two decades of monetary union, beside a momentous anniversary, corresponded more to an occasion to reflect than to celebrate.[22] 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 -

[21] See on this perspective, emphasising that 'most banks should aim for a fundamental shift in the overall mindset and culture', G30, 'Banking conduct and culture: A permanent mindset change' (2018) <group30.org/images/uploads/publications/aaG30_Culture2018.pdf>.

[22] See Mario Draghi,'Farewell Remarks' (Frankfurt am Main, 28 October 2019) available at: <www.ecb.europa.eu/press/key/date/2019/html/ecb.sp191028~7e8b444d6f.en.html>.

but also to assess its limitations or, above all, its persisting risks and how to overcome them.[23] That is especially relevant when these are subject, once more and sooner than was 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 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: The first lesson concerns monetary policy and the way that policy may have called to face deflationary forces, requiring, as such, *flexibility in the toolbox of instruments to fulfil the mandate of the ECB*, albeit 'without ever exceeding the limits of the law'.[24] 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, taking stock of where we are now and where we may be heading in light of recent developments, in the post-crisis years, and bearing in mind the ability of this institutional structure to withstand a new shock of a different nature.

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[23] See on this analysis and balance, in which this part of the present article also relies, Luis Silva Morais, 'The structuring principles of the Economic and Monetary Union' (15 November 2019) Banco de Portugal – Report of the Conference: The Euro 20 years on, 55. Available at: <www.bportugal.pt/sites/default/files/anexos/pdf-boletim/reportconference20yearseuro.pdf>.

[24] Quoting here literally from Mario Draghi, although the legal debate is far from being closed and may, on the contrary, have entered in a new critical stage.

2.1.2. Against this background, I purport, in this short article, 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[25] 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).

Focusing on this institutional perspective of EMU, I would recall an expression coined by one of the founding fathers of this Union, Padoa-Schioppa, who suggestively referred to the risk of an '*institutional loneliness*' of the ECB.[26] 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 from a banking crisis evolving towards a sovereign debt crisis. Accordingly, the initial institutional fabric of EMU

[25] 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, see Jean-Victor Louis, 'A Monetary Union for Tomorrow?' (1989) 26 Common Market Law Review 301, 302.

[26] See, on this Tommaso Padoa-Schioppa, *The Road to Monetary and Economic Union in Europe: The Emperor, the Kings and the Genies* (Oxford University Press, 1999).

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 cases at the European Court of Justice (ECJ) and at the German Constitutional Court ('*Bundesverfassungsgericht*'). As well, beside this judicial scrutiny, other challenges in terms of democratic legitimacy of the whole process will be considered.

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 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. Policy principles underlying the initial EMU project – Have these been transformed ex post?

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 filling 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 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 overall financial stability*.[27] 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).

Starting from this key acknowledgment, it manifestly exceeds the limited purview of this article to dwell in detail with the building of the European Banking Union in the context of the *asymmetries* I have been referring to as regards the original EMU.

[27] See on this, inter alia, Pierre Schlosser, 'Resisting a European Fiscal Union: The Centralized Fragmentation of Fiscal Powers During the Euro Crisis' (PhD thesis, EUI 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, Johannes Lindner and Marion Salines, 'Explaining the Sudden Creation of a Banking Supervisor for the Euro Area' (2017) 24 Journal of European Public Policy 1135.

Suffice is to state that given the *two initial policy principles* I have been systematically referring to as *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 risks 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[28] (still not launched and about which the political debated has been relaunched, notably by Germany, in the last quarter of 2019[29]).

[28] 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, Rose Lastra (2013) 'Banking Union and Single Market: Conflict or Companionship?' (2013) 36 Fordham International Law Journal 1189; Jens-Hinrich Binder, 'The European Banking Union: Rationale and Key Policy Issues' in Jens-Hinrich Binder and Christos Gortsos (eds), *Banking Union: A Compendium* (Nomos 2016); 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 Journal of Common Market Studies 529.

[29] 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 on this Olaf

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.

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.

Scholz, 'Position Paper on the Goals of the Banking Union' (November 2019) Bundesministerium der Finanzen non-paper <prod-upp-image-read.ft.com/b750c7e4-ffba-11e9-b7bc-f3fa4e77dd47>. See, also Luis Garicano, 'Two proposals to resurrect the Banking Union: the Safe Portfolio Approach and SRB+' (December 2019) Paper prepared for ECB Conference on 'Fiscal Policy and EMU Governance'.

As regards to 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 programme of the ECB)[30] and the December 2018 '*Weiss*' ruling on the ECB Public Sector Purchasing Programme (PSPP) (*which, differently from OMT programme, has actually been implemented*).[31]

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 '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 *Bundesverfassungsgericht* (German Constitutional Court). In fact, already in the the last quarter of 2019 a group of German academics had tried (unsuccessfully) to reopen hearings in the case concerning the ECB *Public Sector Purchasing Programme* (PSPP), due to the then adopted ECB decision of resuming bond purchases for an indefinite period as

[30] See ECJ ruling 'Peter *Gauweiler and Others v Deutscher Bundestag*', of 16 June 2016, case C-62/14.
[31] See ECJ ruling 'Heinrich Weiss and Others', of 11 December 2018, case C-493/17.

from 1 November 2019[32]. But, more importantly, the *Bundesverfassungsgericht* finally delivered its 5 May judgement on PSPP, which, although rejecting the plaintiffs' claims that PSPP violated the EU ban on monetary financing of governments, casted new clouds of doubts and legal uncertainty. More specifically, it ruled that the ECB had not adequately applied a *proportionality test* to such Programme and gave the ECB three months to justify its bond-buying.

Again, it manifestly exceeds the limited purview of this article to critically analyse this 5 May judgement of the *Bundesverfassungsgericht*[33] to which, nevertheless, I shall briefly come back (*infra*, **2.3.**) pondering its potential repercussions on the new 750 billion Euros *Pandemic Equity Purchase Programme* of the ECB (PEPP) in the context of the current 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 national level*, such *distinction* has been blurred with a *movement towards the supranational level, which will be of*

[32] I refer here to the then pending case of the *Bundesverfassungsgericht* in the proceedings '*Expanded Asset Purchase Programme of the European Central Bank*', already quoted supra, and to the oral Hearing held in such case on 30 and 31 July 2019.

[33] I am referring here to the already quoted *5 May Judgement of the German Constitutional Court* ('*Bundesverfassungsgericht*') - BVerfG, Judgment of the Second Senate of 05 May 2020 - 2 BvR 859/15 - paras. (1-237). *As per an initial footnote, supra (1), this Judgement is exceptionally taken into account, going beyond the cut-off date for information included in this article, but the is no room here for a deeper analysis of the Judgment (just come out as per the conclusion of this article).*

paramount importance to ensure an adequate response to the current 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 *Bundesverfassungsgericht*), 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 change of the Treaty, somehow overcoming the traditional *Meroni* doctrine.[34] 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.[35]

Referring to this *Pringle* jurisprudence it is worth emphasising here the *extent to which some fundamental changes of the qualitative nature and structure of EMU have actually been possible outside a formal overall Treaty change procedure*.

[34] 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.
[35] See *Pringle* ruling of ECJ, of 27 November 2012, Case C-370/12.

In theory, the Treaties set the limits for secondary law such as the so called 'Six-Pack'1 or the 'Two-Pack'2 regulations.[36] 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 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* (TESM).

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

[36] More specifically, I am referring here, to the *EU six-pack* relating to the following regulations and guidelines: On fiscal policy, Regulation 1175/2011 amending Regulation 1466/97 On the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies; Regulation 1177/2011 amending Regulation 1467/97 On speeding up and clarifying the implementation of the excessive deficit procedure*;* Regulation 1173/2011 On the effective enforcement of budgetary surveillance in the euro area*;* Directive 2011/85/EU On requirements for budgetary frameworks of the Member States. On macroeconomic imbalance, Regulation 1176/2011 On the prevention and correction of macroeconomic imbalances (laying out the details of the macroeconomic imbalance surveillance procedure and covers all EU Member States); Regulation 1174/2011 On enforcement action to correct excessive macroeconomic imbalances in the euro area (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 473/2013 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*;* Regulation 472/2013 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.

formal introduction of a third paragraph into Article 136 TFEU, stating that the eurozone Member States might establish a stability mechanism.

In the *Pringle* case, effectively the ECJ accepted that there might be an overlap between_economic and monetary policies and started to abandon the initial policy principle I referred to 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 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), emphasising 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*. It thereby also underlined 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*).[37] 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 involving *multiple elements of financial assistance to Member-States* (particularly in the euro area), as very briefly envisaged *infra*, section **3.**

[37] 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 Common Market Law Review 805.

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*.[38] Rather it is 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 that close to the core of *national fiscal sovereignty* and subject, to high standards of democratic accountability. In order to ensure full use of these competences at EU level, through 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 a mere formal concern).

[38] Notably with the 30 July 2019 ruling of the *Bundesverfassungsgericht* on the transfer of supervisory tasks to the ECB/SSM, which will not be specifically covered here.

2.3. Policy principles of EMU effectively transformed ex post and European response to COVID-19

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-19 shock through a temporary programme to purchase up to EUR 750 billion in public and private sector securities until the 'crisis phase' of the COVID-19 pandemic is over, but at least until the end of 2020. The PEPP represents, therefore, a logical 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 programmes 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 Programme. The ECB removed the limit to buy no more than 33 % of any country's bonds, and is equipping itself with the authority to essentially purchase unlimited amounts of sovereign debt, up to the €750 billion limit, emphasising 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).[39]

In spite of this apparent positive reply of monetary policy, the aforementioned judgement of 5 May 2020 of the *Bundesverfassungsgericht* 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 *Bundesverfassungsgericht* 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 will be unavoidable. In fact, even if the ECB decides to comply with the Judgement requirements and produces complementary justification of its actions, and even if that is hypothetically accomplished in a simpler form through disclosure of economic documentation supporting PSPP, there may be an inherent element of contradiction between such justification and the actual economic effects at stake. That is particularly true for 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 a consolidation of the previous '*Weiss*' jurisprudence, duly asserting, in the

[39] See in general as regards the PEPP, Decision (EU) 2020/440 of the ECB of 24 March 2020 on a temporary pandemic emergency purchase programme (ECB/2020/17, [2020] OJ L91/1) and related ECB statements.

process, the ECJ as the only legal body able to determine if an EU institution violated EU law.

At another level, our second positive reply to the core question delineated as the initial *leitmotif* 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* – 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. The EU fiscal response to the COVID-19 crisis: can it follow the monetary pillar?

3.1. Overall perspective

If monetary policy, as reinterpreted in the wake of the last crises, seems to provide for the moment an effective response at the level of EMU to the current shock (notwithstanding the elements of uncertainty brought about by the aforementioned *Bundesverfassungsgericht* judgment), the same cannot be assumed as regards the fiscal pillar of EMU.

Ideally, within the transformation of the governance and overall structures of EMU (characterised *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 may still be depending predominantly on interventions - made possible by a swift and unprecedented activation of the general escape clause of the Growth and Stability Pact -[40] 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 materialises as regards the fiscal effort between the various Member States, new powerful forces will 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 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 the solution may 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.

[40] See European Commission, 'Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact' (Communication) COM (2020) 123 final.

3.2. Fiscal response to the COVID-19 crisis – a mixed approach

3.2.1. Accordingly, such a *mixed approach* may combine **(i)** the short time introduction of new innovative loan programmes modelled on the concept of the predecessor of the ESM (i.e. 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 and based on article 122 of the TFEU[41]); (ii) the use of the ESM, diluting as much as possible conditionality and related stigma for applying Member States; (iii) involvement on a large scale of the European Investment Bank (EIB) in the EU financial response package; and (iv), within a larger time horizon and in the context of the incoming decisions on the *seven-year EU budget*, the establishment of a recovery fund oriented towards restarting the economy.

We live in volatile times and there is no purpose in developing here an extensive characterization of a catalogue of EU fiscal responses that events are bound to make quickly obsolete. What is relevant is to stress the overall model for such fiscal reaction within the latitude of a *fiscal stabilization function* that has emerged, however incomplete, from the previous process of *transformation of EMU*.

The first two instruments (SURE and use of ESM, swiftly adapted to the new circumstances) may provide an urgent protection to financially more fragile Member States with favourable conditions of preferential interest rates and, at the

[41] See EC, 'Proposal for a 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 for a Council Regulation) COM(2020) 139 final.

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 is essential that the financial cap of SURE is not too low, so that sizeable loans may be at stake. Also, in turn, the financial structuring of the mechanism has to strike 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 (providing an urgent response, SURE could in time evolve, as contemplated by Vandenbroucke *et al*. towards a permanent European unemployment benefit scheme).[42]On the other hand, it is also essential that possible new credit lines within the ESM should correspond to very long-term loans with extremely diluted conditionality (essentially corresponding to the commitment of applying the resources in COVID-19 related initiatives), and without the surveillance regime normally associated with other ESM credit lines, so as to avoid any stigma for Member States applying to it.[43]

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 option (involvement of EIB and establishment of a recovery fund) may provide an answer that avoids the conceptual traps of a protracted and politically toxic discussion on debt

[42] See Sofia Fernandes and Frank Vandenbroucke 'SURE: A welcome lynchpin for a European unemployment re-insurance' (April 2020) Notre Europe Jacques Delors Institute, Technical Report. <institutdelors.eu/wp-content/uploads/2020/04/PP251_SURE_Fernandes-Vandenbrouck_200417_EN.pdf>.

[43] On issues pertaining to a larger firepower of ESM, adjusting its financial structure, see, inter alia, Agnès Bénassy-Quéré and others, '*A proposal for a Covid Credit Line*' (*VOX CEPR Policy Portal*, 21 March 2020).

mutualisation and corresponding moral hazard (as the one proposed by a group of German economists, in the form of temporary Eurobonds ('*Corona*

bonds') which would involve the implementation of a common debt instrument at the eurozone level[44]).

As regards the EIB group, the creation of a *Pan-European Guarantee fund* in response to COVID-19 will enable the EIB, in partnership with local lenders and national promotional institutions, to decisively reinforce its support to SMEs and corporates in general in the real economy. Furthermore, the resources thus obtained, combined with resources from other EU funds, may lead to other forms of *financial engineering* in 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.

Lastly, the future establishment of a recovery fund within the negotiations of the seven year EU budget (duly reinforced)[45] would also reinforce the panoply of such forms of *fiscal/financial engineering* - with the decisive element of avoiding further critical increase of Member States debt - fully exploring the potentialities of future equity-like funding mechanisms, and supporting investment necessary to ensure repair and recovery actions.[46]

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[44] See Michael Hüther and others, Europe must demonstrate financial solidarity (30 March 2020) German Economic Institute.

[45] See on this Massimo Motta and Martin Peitz, 'The EU recovery fund: An opportunity for change' (*VOX CEPR Policy Portal*, 30 April 2020).

[46] On the potentialities of equity-like funding mechanisms, supported by EU resources on an innovative basis, see, inter alia, Arnoud Boot and others, 'Coronavirus and financial stability 3.0: Try equity – risk sharing for companies, large and small' (*VOX CEPR Policy Portal*, 3 April 2020).

4. The consequences of the COVID-19 crisis and the European banking sector

4.1. The banking sector and the pandemic shock – a time of risks and opportunities?

4.1.1. - As aforementioned, the European banking sector, considering inter alia the mechanisms of monetary transmission related to it, is bound to play a fundamental role in the economic responses to the current exogenous shock. Conversely, as also emphasised in the first part of this article, it is absolutely essential 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 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 characterised 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, as underlined *supra*, 2.2.2.).

It manifestly exceeds the limited purview of this article to review such vast array of measures (namely of the SSM, SRB, EBA, ESRB, in conjunction with the Commission).[47] [48] So the

[47] For a good overview on this array of measures and actions see European Parliament, 'Banking Union: Corona Crisis Effects' (April 2020) European Parliament, Economic Governance Support Unit (EGOV) available at <www.europarl.europa.eu/RegData/etudes/BRIE/2020/645719/IPOL_BRI(2020)645719_EN.pdf>.

[48] See also for a comprehensive view of the measures at stake EBI, 'EBI Report on the 'Pandemic Crisis-related' Economic Policy and Financial Regulation Measures: International, EU Area Levels' (as of 1 May 2020) (available at <ebi-europa.eu/> and updated on a weekly basis). *Henceforth, as*

purpose here is only to tentatively apprehend the key trends and forces at play as regards the banking sector and perceive the mix of positive and negative dynamics unlashed by the COVID-19 crisis.

As a starting point to ponder the situation of the banking sector, it is worth considering the data included in the recent publication by the EBA's Risk Dashboard for the fourth quarter of 2019.[49] Although the recent release still concerns the data for the fourth quarter of 2019, in which the effects of Covid-19 outbreak were not yet manifest, it provides anyway a succinct short-term outlook for several risk measures. These outline potential vulnerabilities of the banking sector with a particular emphasis, on the one hand, on *asset quality and credit risk*, and, on the other hand, on *potential liquidity risks*. On the contrary, ahead of the COVID-19 crisis, capital ratios and asset quality of banks in EU had improved (although the return on equity had further worsened). Naturally, the materialization of those risks and any build-up of other financial pressures on banks will depend on the duration and intensity of the shock in the real economy (which are still extremely difficult to assess at the current stage).

4.1.2. - Within this context, and seeking an overall view of both the current constraints and the foreseeable perspectives, we may consider, on the negative side, a triangle of chief risks for the functioning of the banking sector and, conversely, on the

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.

[49] I refer here to EBA, 'Risk Dashboard – Data as of Q4 2019' (14 April 2020) <eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/Risk%20dashboard/Q4%202019/882137/EBA%20Dashboard%20-%20Q4%202019.pdf>.

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) credit risk, affecting or even reversing 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 prevailing exceptional circumstances; and (iii) potential imbalances in the functioning of the Banking Union arising from the fact that financial support measures or financial stabilisation tools addressed to banks 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, and (iii) a renewal of management culture, more client-oriented, 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. Banking sector and key risks to be overcome?

4.2.1. – One of the critical challenges confronting banks in the coming weeks and months will indeed involve increasing credit

risks and the way to balance adequately the management of such risks against the pressing needs of continuous support to the economy. A balance has actually been tried through the EBA guidelines 'on legislative and non-legislative moratoria on loan repayments in the light of the Covid-19 crisis'[50], 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 recent *Banking Package* adopted in 28 April 2020 by the Commission,[51] namely in its *Communication on the application of the accounting and prudential frameworks to facilitate EU bank lending*. There, inter alia, special leeway is advocated for in the assessment of a significant increase in credit risk (SICR), somehow discounting for, 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* are also 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. Furthermore, the *Guidelines* also help 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*

[50] EBA, 'Guidelines on legislative and non-legislative moratoria on loan repayments in the light of the Covid.19 crisis' (2 April 2020).

[51] I refer here to the European Commission, 'Interpretative Communication on the application of the accounting and prudential frameworks' (Interpretive Communication) COM (2020) 169 final, and to the 'Proposal for a Regulation amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards adjustments in response to the COVID-19 pandemic' (Proposal for a Regulation) COM(2020) 310 final.

on additional supervisory measures in the COVID-19 pandemic[52] 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 now introduced, in a scenario of more prolonged distress for key sectors of the economy (and 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 increasingly difficult. That is not least, because banks might have to focus more on managing existing credit lines of potentially distressed borrowers rather than extending new lending[53]).

Also important, to tackle the tensions related with the new levels of credit risk and potential credit losses are the measures adopted by the SSM as regards 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.[54]

As a further element to ease the tensions here at stake, we should mention the second component of the Commission's *Banking Package* of 28 April 2020: the *Proposal of Regulation amending the EU Capital Requirements Regulation (CRR)* as

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[52] See EBA, 'Statement on additional supervisory measures in the Covid-19 pandemic' (22 April 2020).

[53] As duly noted in the aforementioned EBA Risk Dashboard, especially in its short-term Outlook for different risk measures.

[54] See on this ECB, 'ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus' - <www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html>. See also EC, Interpretative Communication (n 51) point 2.

previously adjusted in 2019, to incorporate the last elements of the finalised Basel III framework.[55] This includes 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. That is with a view to provide some extra leeway for the banks to further support the economy in the exceptional context of the ongoing crisis).

But, ultimately, it has to be acknowledged that all this complex balancing exercise to cope with increased credit risks without discontinuing banking support to the real economy will largely depend on the actual duration and intensity of the *demand and supply shocks* described *supra*, 1.2.1. and 1.2.2**.**

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 will be to calibrate and to monitor a temporary flexible supervisory framework. This will imply, inter alia, for the SSM – in articulation with national supervisors, the EBA and also the SRB – to permanently adjust the *Supervisory Review and Evaluation Process* (SREP) in the course of 2020, and probably the following year, in order to timely apprehend and prioritize unfolding risks for individual banks and their effective capacity to cope with such risks. That also involves a permanent focus in pondering successive hypothetical shocks and corresponding vulnerabilities that may

[55] See EC Proposal (n 51).

affect differently various individual banks, *something which is not made easier by the convenience of easing the daily compliance constraints on supervised banks*.

If, understandably, the SSM is temporarily suspending or delaying the implementation of multiple supervisory decisions[56] and somehow relieving the pressure on the implementation of banks' ongoing plans for reducing past NPLs that will inevitably involve a *trade-off* with the need for enhanced scrutiny of new emerging risks, which will be rendered even more complicated with the passing of time and the accumulation of financial tensions.

Furthermore, other layers of flexibility, i.e. concerning green light for supervised banks to operate below the level of capital defined by the Pillar 2 guidance and making full use of their capital buffers for as long as necessary, taking stock of large liquidity buffers built over recent years,[57] are undoubtedly justified in the present context. However, 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).

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

[56] As acknowledged by the Chair of SSM, Andrea Enria, in its Opinion piece, 'How European Banking Supervision can help fight the economic consequences of the coronavirus outbreak in Europe' *Les Echos, Expansión, Frankfurter Allgemeine Zeitung, Philelefteros, La Stampa and Ta Nea* (30 March 2020).

[57] Considering here again aspects brought forward by Enria n (n 56).

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 (particularly if the crisis is a more prolonged one). 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*).[58]

4.3. Banking sector and new opportunities ahead

4.3.1. – The aforementioned risks are conversely entangled with positive opportunities of transformation for the banking sector, although it is 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 new pressures towards digital financial innovation may push

[58] I refer here to the 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), [2016] OJ C216/1 and to the more recent 20 March 2020 'Communication on the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, (Communication) [2020] OJ C91 I/1.

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.[59]

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*).[60]

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 market incentives to *banking consolidation*. In fact, while it is widely acknowledged that significant hurdles remain in the EU

[59] On these possible trends see, inter alia, James Eyers and James Frost 'How the coronavirus will change banking' The Australian Financial Review (30 March 2020). See also Douglas W Arner and others, 'Digital Finance & the Covid-19 Crisis' (2020) University of Hong Kong Faculty of Law Research Paper No. 2020/017.

[60] 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, Luis Silva Morais, *Joint Ventures and EU Competition Law* (Hart Publishing, Oxford, 2013).

as regards further banking consolidation for a variety of reasons that EBA had recently analysed (right before the irruption of the COVID-19 shock),[61] 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*).

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 GFC. This potentially virtuous effect will also be enhanced in a scenario of widespread voluntary compliance of the supervisory recommendations addressed to banks in order not to distribute dividends to shareholders for the 2019 and 2020 annual reporting periods, and also to refrain from share buy-backs aimed at remunerating shareholders.[62]

If, hopefully, all such 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

[61] See Anna Gardella, Massimiliano Rimarchi and Davide Stroppa, 'Potential Regulatory Obstacles to Cross-Border Mergers and Acquisitions in the EU Banking Sector' (February 2020) EBA Staff Paper Series, no. 7.

[62] See 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, [2020] OJ C102 I/1; See also EC, Interpretative Communication (n 51) point 4.

pendulum will swing the other way, towards a negative materialization of the risks now impeding on the banking sector.

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SECTION III: BANKING REGULATION

9 Global pandemic crisis and financial stability

Filippo Annunziata & Michele Siri

1. Background

The COVID-19 crisis has significant effects on many banks in the Banking Union and multiple impacts on the capital markets side.[1] While there are widespread interventions targeted to ensure that the banking sector maintains credit flowing to the economy and citizens without undermining its overall soundness, there also sign of intensification of regulatory intervention on the financial markets. Among other developments to monitor in the current crisis, there is the interplay between the banking regulation and the capital markets legislation. In this chapter, we wish to focus on some recent developments affecting the supervision and regulation of the EU capital markets having an impact on banks and other financial institutions.

[1] Association for Financial Markets in Europe, 'Initial Impact of COVID-19 on European Capital Markets' par. 7 (April 2020) <www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Impact%20of%20COVID-19%20on%20European%20Capital%20Markets-2.pdf>. The cut-off date for information included in this article is 18 May 2020.

2. Short selling regulation and listed banks

The strategy of short selling has long been criticised for igniting volatility during times of stress, while some complain that short-sellers profit from the misery of investors. Short selling is a practice widely used by hedge funds and involves managers borrowing shares and then selling them, hoping to buy them back later at a lower price. During the Great Financial Crisis of 2008, several hedge funds made fortunes shorting banks including Northern Rock and many other continental financial institutions, ultimately harming the economy and societies as a whole. Immediately after the Lehman collapse, the investors' doubts in the soundness of banks brought down the prices of their shares. At that time, the Securities and Exchange Commission (SEC) banned short-selling of shares in banks and financial companies in the US.[2] The ban was quickly imitated by the majority of other countries.[3]

In the wake of this current turmoil, listed companies and investors had become concerned that short-sellers were amplifying selling pressure during the pandemic shock to global markets. A number of regulators across the globe have thus responded to recent market volatility by introducing temporary short-selling bans and market restrictions.[4] Among EU

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[2] Marco Pagano, 'Should We Ban Short Sales in a Stock Market Crash?' (Oxford Business Law Blog, 13 Mar 2020) <www.law.ox.ac.uk/business-law-blog/blog/2020/03/should-we-ban-short-sales-stock-market-crash>. For a comprehensive analysis, see Luca Enriques and Marco Pagano, 'Emergency Measures for Equity Trading: The Case Against Short-Selling Bans and Stock Exchange Shutdowns', in this volume at chapter 13.

[3] Alessandro Beber and Marco Pagano, 'Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis' (2013) 68(1) Journal of Finance 343 <onlinelibrary.wiley.com/doi/epdf/10.1111/j.1540-6261.2012.01802.x>.

[4] ESMA, Press Releases on 'positive opinions on short selling bans' (March and April, 2020) <www.esma.europa.eu/search/site/covid%20short%20selling>.

securities markets regulators, Austria, Belgium, France, Greece, Italy, and Spain have temporarily banned short-selling of financial instruments since the outbreak of the coronavirus crisis. This intervention is considered necessary to address instability in capital markets and affect the financial and banking listed companies primarily.[5]

A different stance has been taken by the UK FCA, arguing that markets have to remain open and orderly, so they can continue to perform their essential role in supporting businesses, governments, jobs and the broader economy. In line with the standard practice, FCA has followed those bans, where requested, in respect of shares for which relevant European National Competent Authorities (NCAs) are responsible. The FCA has not introduced such a ban, nor has the United States or any other major financial market. Aggregate net short-selling activity reported to FCA has been low as a percentage of total market activity and has decreased in the coming days. A great many investment and risk management strategies rely on the ability to take 'long' and 'short' positions. These benefit a wide range of ordinary investors, including the pension funds for employees of companies and local government.

Under this perspective, short selling is a critical underpinning of liquidity provision.[6] The loss of these benefits would need to be carefully balanced before determining that any intervention to prevent short selling was appropriate. In this respect, the bans

[5] ESMA, Press Releases 'Non-renewal and termination of short selling bans by Austrian FMA, Belgian FSMA, French AMF, Greek HCMC, Italian CONSOB and Spanish CNMV' (18 May 2020) <www.esma.europa.eu/press-news/esma-news/esma-–-non-renewal-and-termination-short-selling-bansaustrian-fma-belgian-fsma>.

[6] AIMA, FIA, MFA, WFE, 'Joint associations letter to French authorities on short selling' (13 May 2020) <www.aima.org/resource/joint-industry-letter-to-frenchauthorities-on-short-selling-restrictions.html>.

on short-selling impact liquidity. Keeping markets open is clearly important (insofar investors are not misled), and the current legislation foresees instruments to deal with unwarranted price movements, like circuit breakers.[7]

The costs of the short-selling ban on financials appear to outweigh the benefits.[8] With specific regard to banks a paper published by the ESRB in 2018[9], moreover concludes that short-selling bans are even counterproductive. The paper indicates that short-selling bans are not associated with greater bank stability. In fact, the estimates, even controlling for the endogeneity of the bans, point to the opposite result, namely that bans on short sales tend to be correlated with a higher probability of default, greater return volatility and steeper stock price declines, particularly for banks. A further study conducted in the US shows that the 2008 ban on short sales failed to slow the decline in the price of financial stocks; in fact, prices fell markedly over the two weeks in which the ban was in effect and stabilised once it was lifted. Similarly, following the downgrade of the US sovereign credit rating in 2011—another notable period of market stress—stocks subject to short-selling

[7] Sereina Neva Gruenewald, Alexander F. Wagner, and Rolf H. Weber, 'Short Selling Regulation after the Financial Crisis - First Principles Revisited' (2010) 7(2) International Journal of Disclosure and Regulation 108 <ssrn.com/abstract=1439652>.

[8] Luca Enriques, 'Stock Exchange Shutdowns in the Time of Coronavirus' (Oxford Business Law Blog, 12 Mar 2020) <www.law.ox.ac.uk/business-law-blog/blog/2020/03/stock-exchange-shutdowns-time-coronavirus>; and Alderighi, Stefano and Pedro Gurrola-Perez, What does academic research say about short-selling bans? WFE Research (April 2020) <www.world-exchanges.org/storage/app/media/ research/Studies_Reports/WFE%20short-selling%20research%20paper %20FINAL2%2029.04.20.pdf>.

[9] Alessandro Beber, Daniela Fabbri, Marco Pagano, and Saverio Simonelli, 'Short-Selling Bans and Bank Stability' (January 2018) ESRB Working Paper Series No 64 <www.esrb.europa.eu//pub/pdf/wp/esrb.wp64.en.pdf>.

restrictions performed worse than stocks free of such restraints.[10]

Even with specific reference to distressed banks, the EU Short Selling Regulation shall require more effective enforcement as a recent paper[11] demonstrates investigating into the *Monte dei Paschi di Siena* case. Analysing the manner in which the European Regulation has been applied to restrict hedge funds from short-selling the stock of Monte dei Paschi di Siena, evidence has emerged to reconsider the powers granted to the market supervisor to effectively impede the circumvention of the temporary ban on short selling.

Apart from the effect on liquidity and markets performance, the recent events have proven the limits of the EU financial supervision framework. In ESMA's view, speculative conducts may jeopardise the orderly functioning and integrity of the EU financial markets, to the point of putting at risk the stability of the EU Financial System.[12] Such concern derives from the circumstance that the current adverse situation is showing the clear risk that the downward price trend may undermine the price formation mechanism. The ongoing substantial selling pressure and unusual volatility in the price of shares may

[10] Robert H. Battalio, Hamid Mehran, and Paul H. Schultz, 'Market Declines: Is Banning Short Selling the Solution?' (1 September 2011) FRB of New York Staff Reports no. 518 <ssrn.com/abstract=1939884>.

[11] Marco Dell'Erba and Giovanni Patti, 'The Monte dei Paschi Affaire. Distressed Banks and the European Regulation on Short Selling' (6 April 2018) 12(4) Capital Markets Law Journal 510 <ssrn.com/abstract=3157858>.

[12] See ESMA, 'ESMA Decision of 16 March to require natural or legal person who have net short positions to temporarily lower the notification thresholds of net short positions in relation to the issued shares capital of companies whose shares are admitted to trading on a regulated market above a certain threshold to notify the competent authorities in accordance with point (a) of Art. 28(1) of Regulation (EU) No 236/2012 of the European Parliament and of the Council', ESMA70-155-9546, par. 1.

ultimately compromise the financial system (*i.e.* financial intermediaries, markets and market infrastructures) capability of withstanding shocks and unravelling of financial imbalances. In such a situation, indeed, market participants may take - or better, have taken - new short positions in order to profit from further price falls.

In light of the above, on 16 March 2020, ESMA issued a Decision addressing the necessity for NCAs and ESMA itself to be aware of 'the net short positions that market participants have entered into in relation to shares admitted to trading on a regulated market, given the recent exceptional developments in financial markets'. The outbreak of the COVID 19 pandemic, therefore, led ESMA to temporarily require those holders of net short positions in shares traded on an EU RM notify the relevant competent NCA details of any such position if the position reaches or exceeds 0.1 % of the issued share capital.[13] Such additional transparency obligation - together with the occasional and temporary ban of short selling actions - constitutes a precautionary action that is essential for authorities to monitor developments on the markets. In particular, this measure can support more stringent actions, if required, to ensure financial stability and investors protection.

Considering the EU financial markets as a whole, while there is some increase in net short-selling positions, there is no indication that at this stage, short selling is negatively impacting on the proper functioning of markets. However, ESMA, together with NCAs, will continue to monitor developments in this area and to act, where necessary. However, the divergence

[13] Such intervention powers are provided for in Art. 28 of 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 defaults swaps [2012] OJ L86/1 - in exceptional circumstances.

between NCA early intervention bans has created headaches for investors and traders trying to navigate a patchwork of rules. Given the differences between national rules, the rebalancing and risk adjusting has been not possible as it should be optimal in a single capital market. A remarkable sign of fragmented markets is a further recall of the need for European action to reassess the recent ESAs Review.[14] Thus, the effectiveness and the level playing field of the European regulatory framework on short selling remains a central question for future research.

3. Exchange-Traded Funds regulation and financial stability risks

One of the current shock-propagating factors, especially in less liquid markets, could become the inherent price timing and rebalancing mismatch in ETFs. By the nature of their design, such factors as diversifying basket composition and multiple rebalancing properties in regular times act as safety valves and protect from herding behaviour. With a compound growth rate in assets of around 20 % per annum since 2008, ETFs are by some margin the fastest-growing segment of the asset management business. These funds are now on the radar of both global and country regulators and are being examined from a variety of perspectives. Global risk regulators focus primarily on the potential for ETFs to cause systemic problems. Meanwhile, local regulators often prioritise investor protection. In May 2017, Ireland's Central Bank (ICB) also launched a review of ETFs, calling for greater scrutiny of how the industry works and whether the existing regulatory guidelines were

[14] Karel Lannoo, 'Can Europe's finance sector resist COVID-19?' (20 March 2020) ECMI Commentary no 63 <www.eurocapitalmarkets.org/sites/default/files/can_europes_finance_sector_resist_covid-19_ecmi_commentary.pdf>.

adequate for an instrument it called ‘the most important product development the investment fund industry has seen in the past 20 years’.

Given the rapid increase in the ETF popularity and market size that is currently estimated slightly above 6 trillion USD, it could become a substantial shock transmission channel. Moreover, ETFs are particularly popular when accessing developing, restricted and less liquid markets, which by nature are less liquid during stress episodes, as a result adding shock propagating capacity.

At the same time, the broader use of ETFs may also come with a growing potential for transmission and amplification of risks in the financial system. This special feature focuses on two such channels arising from (i) liquidity risk in ETF primary and secondary markets and (ii) counterparty risk in ETFs using derivatives and those engaging in securities lending. While ETFs still only account for a small fraction of investment fund asset holdings, their growth has been strong, suggesting a need for close monitoring from financial stability and regulatory perspective, including prospective interactions with other parts of the financial system.[15] Liquidity and counterparty risks identified in this special feature could be addressed by either enhancing currently applicable frameworks or by developing an ETF-specific regulatory framework.

As an example, under current circumstances, market volatility has led some fixed-income funds to trade at a discount to the net asset value. As volatility in fixed-income markets has risen in response to the coronavirus pandemic, it has triggered severe

[15] Michael Grill, Claudia Lambert, Philipp Marquardt, Gibran Watfe, and Christian Weistroffer, ‘Counterparty and liquidity risks in exchange-traded funds’ (2018) Financial Stability Review, European Central Bank vol. 2 <ideas.repec.org/a/ecb/fsrart/201800023.html#download>.

price dislocations across bond ETFs. If investors start to lose faith in ETFs, this could generate much more selling, causing a downward spiral in liquidity. At the time of COVID-19 turmoil, ETFs are on the radar of both global and country regulators and are being examined from a variety of perspectives. Global risk regulators focus primarily on the potential for ETFs to cause systemic problems. Meanwhile, local regulators should prioritise investor protection. Further research is required to provide evidence of the effectiveness and feasibility of a more holistic regulatory and supervisory approach to these actors of the contemporary financial markets.

4. EU Regulated Markets and shareholder reporting obligations

As EU Regulated Markets (RM) are hit by the COVID-19 crisis, and a general decrease in prices is on-going, there is a cry for greater efficiency and transparency in qualified holdings in listed companies. Such disheartening scenario has required the European Securities and Markets Authority (ESMA), together with National Competent Authorities (NCAs), to closely monitor developments on markets, because of the lingering impact of the COVID-19 outbreak on EU RM.

In view of such a situation, some EU Member States have strengthened the internal Transparency regime of the market for corporate control, aiming at full investors' protection from the current EU RM swings. Such intervention is consistent with the indications and the rationale of the Transparency Directive (TD), issued in 2004 and revised in 2013 (Directive 2013/50/EU), that aims at ensuring market transparency through a regular flow of disclosure of periodic and on-going regulated information and the dissemination of such information to the public. Regulated aspects consist, inter alia,

in the disclosure of corporate ownership, referred to notification obligations of significant holdings of voting rights.[16]

Although the TD purposes are also focused on the establishment of 'a harmonised regime for notification of major holdings of voting rights',[17] the EU legislator is fully aware of the existence of differences in ownership concentration in the Union, therefore providing that the EU Member States 'should continue to be allowed to set stricter obligations […] with regard to the content, the process and the timing of the notification, and to be able to require additional information regarding major holdings […]'.[18] In particular, according to the TD, Member States 'should also be able to continue to apply laws, regulations or administrative provisions adopted in relation to takeover bids, merger transactions and other transactions affecting the ownership or control of supervised companies'.[19]

Within such legal framework, the most pervasive intervention in this regard is undoubtedly the Italian one, where extraordinary measures have been adopted, introducing a temporary reduction in the thresholds that trigger disclosure obligations under the EU Transparency regime, and/or under national legislation. More specifically, Consob (the Italian Securities Authority) has adopted two measures[20] which, in the context of the new powers given to the Authority by the Italian 'Business Decree',[21] provide for a regime of enhanced

[16] The transparency regime set out in the TD also refers to the information to be disclosed pursuant to the Market Abuse Directive (2003/6/EC).
[17] Recital (12) of Transparency Directive.
[18] *Ibidem*.
[19] *Ibidem*.
[20] See Consob, Resolutions n. 21326 and 21327 of 9 April 2020, *only in Italian* <www.consob.it/web/area-pubblica/bollettino/documenti/bollettino2020/d21326.htm> and <www.consob.it/web/area-pubblica/bollettino/documenti/bollettino2020/d21327.htm>.
[21] Law-Decree n. 23 of 8 April 2020.

transparency as regards both (i) the obligation to disclose significant shareholdings in specific Italian companies listed on the Stock Exchange, and (ii) the 'declaration of intentions' in the event of the acquisition of investments in listed companies, as required by the so-called 'anti-invasion rule'.

Both measures are applicable for three months (unless early revocation), - *i.e.* until 11 July 2020 - to 104 companies listed in Italy (the list is attached to the Resolutions), identified according to the criterion of the shareholder base spread, with the exception of listed companies under legal control, *i.e.* those where a shareholder holding 50 % of the capital plus at least one share is already present.

In brief, in connection with the obligation to disclose significant shareholdings, Consob established the following additional thresholds, the passing of which triggers the communication obligations:[22] (i) an additional 1 % threshold for companies that do not qualify as 'SME having a widespread shareholders base';[23] and (ii) an additional 3 % threshold for companies qualifying as 'SMEs having a widespread shareholders base'.[24]

This provision repealed the previous Resolution of 17 March 2020[25] which had introduced a similar obligation concerning 48 companies, identified according to a double criterion, *i.e.*: (i) the 'high market value'; and (ii) the 'widespread shareholder base'.[26] The 'Business Decree' has ruled out the 'high market value', and therefore expanded the range of application of the new

[22] See Art. 120, par. 2-*bis* of the Italian '*Financial Consolidated Law*' ('TUF').
[23] Such threshold was previously set at 3%.
[24] Such threshold was previously set at 5%.
[25] Resolution n. 21304.
[26] See Art. 120, par. 2-*bis* of the Italian '*Financial Consolidated Law*' ('TUF'), as formulated before the 'Business Decree.'

disclosure obligations, which are now applicable to issuers having a broad shareholders base, regardless of their market value.[27] Italian law also contemplates, since 2018, the duty to issue a 'declarations of intentions'. According to Art. 120, par. 4-*bis* TUF, investors must, in fact, disclose, when exceeding a specific threshold in the capital of a listed company, their investment objectives for the following six months. For a period of 3 months, this duty shall now apply when the first threshold of 5 % is reached (ordinarily, the threshold is 10 %)[28].

The aforementioned measures are clearly linked to takeover legislation, and to anti-hostile takeovers measures in particular. The aim is evidently that of protecting national 'jewels' from the risks of predatory attacks by hostile bidders. Greater transparency means anticipated detection of potential hostile bidders and anticipation of defensive measures. These enhanced transparency rules are also interconnected with the reinforced 'golden powers' introduced in some EU countries in response to the COVID 19 crisis.

5. 'Golden powers' legislation and financial infrastructures

Ahead of the application of the Regulation (EU) 2019/452 of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union (FDI screening

[27] The toughening of the shareholder reporting obligations, carried out in order to better face the markets issues arising from the health emergency due to COVID-19, has been currently introduced only in the Italian Transparency regime through Consob interventions. In this regard, it is worth noting that some Member States, such as the Czech Republic and Portugal, already provided for lower thresholds compared to the previous Italian regime, corresponding to 1 and 2%, respectively. Some other legislations, such as Austria, rather states the 3% as the lowest percentage, provided that this threshold is specified in the company by-laws.

[28] Further disclosure is required above the thresholds of 10, 20 and 25%.

Regulation), and in light of the COVID-19 emergency, the European Commission recently called upon the Member States to make full use of FDI screening mechanism 'to take fully into account the risks to critical health infrastructures, the supply of critical inputs, and other critical sectors as envisaged in the EU legal framework', and, where no screening mechanism is currently in place, 'to set up a full-fledged screening mechanism'.[29] As noted in the said Communication from the Commission, among the possible consequences of the current economic shock is an increased potential risk to strategic industries, by no means limited to healthcare-related industries. The capacity of these industries to respond to the needs of EU citizens has to be carefully balanced with the EU's openness to foreign investments. Closing boundaries is, therefore, becoming an issue not just of public health, but also of protecting National economies, and 'golden powers' are temporarily serving the function of 'golden shields'.[30]

The impact of reinforced 'golden powers' on FMIs and intermediaries is far from being clear. However, the response of some Member States to the COVID-19 crisis may shed some light on the actual scope of the FDI screening Regulation and leave a permanent mark for the future. The FDI screening Regulation covers foreign direct investments from third countries, *i.e.* those investments 'which establish or maintain

[29] European Commission, 'Guidance to the Member States concerning foreign direct investment and free movement of capital from third countries, and the protection of Europe's strategic assets, ahead of the application of Regulation (EU) 2019/452' (Communication), C(2020) 1981 final. The said Communication of 25 March 2020 followed the previous Communication from the European Commission of 13 March 2020. See, European Commission, 'Coordinated economic response to the COVID-19 Outbreak' (Communication), COM(2020) 112 final.

[30] Fabio Bassan, 'Prime note prospettiche sul Golden Power applicato a banche e assicurazioni' (20 April 2020) <dirittobancario.it>.

lasting and direct links between investors from third countries including State entities, and undertakings carrying out an economic activity in a Member State’. The Regulation applies to all sectors of the economy and empowers Member States to review investments within its scope on the grounds of security or public order.

In determining whether a foreign direct investment is likely to affect security or public order, Recital (13) of the Regulation highlights the importance of taking into account the effects of foreign investments on 'critical infrastructures', described as infrastructures ‘the disruption, failure, loss or destruction of which would have a significant impact in a Member State or in the Union’. Against this background, art. 4(1)(a) explicitly includes among critical infrastructures ‘financial infrastructures’.

The inclusion of financial infrastructures in the scope of the Regulation raises difficult questions about the extent to which rules on golden powers are applicable to FMIs and Financial Institutions, on the one hand, and the delineation of competences between prudential supervisors and Government agencies, on the other hand. In the absence of a definition of ‘financial infrastructures’ for the purpose of foreign investments screening, one may indeed wonder whether all institutions falling within the scope of financial regulation may be qualified as ‘critical infrastructures’.

The difficulties raised by this question may be well understood by considering market infrastructures. While there is little doubt that RM, as defined by Art. 4(1), n. 21, MiFID II, are ‘critical infrastructures’, the answer remains somewhat unclear for multilateral trading facilities (MTF) and organised trading facilities (OTF). Even if RM and MTF serve effectively the same organised trading functionality, MTF can also be operated

by investment firms. This feature clearly blurs the lines between trading venues and financial intermediates and triggers the question of whether MTF falls outside the said notion of ‘critical infrastructures’. The answer becomes even more delicate in relation to OTF if one considers that the definition of OTF captures all types of organised execution and arranging of trading which does not correspond to the functionalities or regulatory specifications of existing venues and that the execution of orders on an OTF is carried out on a discretionary basis. In the same vein, one may question whether central counterparties, clearing and settlement houses, and central securities depositary qualify as 'critical infrastructure', despite the fact that the role they serve nowadays is that of standard service providers.

6. Extension of ‘golden powers’ on listed banks, and insurance companies

An even greater difficulty may arise if one shifts attention to financial intermediaries: do banks, asset management companies, investment firms, payment service providers fall within the notion of ‘financial infrastructure’? Is the classification between significant and non-significant credit institutions relevant to the definition of ‘critical infrastructures’? The FDI screening Regulation leaves these questions open.[31]

As anticipated, the COVID-19 crisis has triggered a rush towards national screening systems on foreign investments. This process shows interesting effects on the extent to which ‘golden powers’ may affect financial intermediaries, especially

[31] Filippo Annunziata, ‘Infrastrutture finanziarie e controllo degli investimenti esteri’ in Giulio Napolitano (ed), *Il controllo sugli investimenti esteri diretti* (Il Mulino 2020).

banks and insurance companies. On the one hand, the inclusion of these kinds of entities within the notion of critical infrastructures appears to be consistent with the statements released by EBA, EIOPA, and ECB that urged banks and insurance companies to follow prudent dividend and other distribution policies and use the capital for ensuring continuous financing to the economy.[32] More specifically, according to the European Authorities' view, it is essential to guarantee the continuity of credit and insurance services provided by these entities. In this perspective, the inclusion of financial intermediaries within the notion of critical infrastructures represents a bulwark safeguarding the ability of these sectors to perform their crucial role of supporting the real economy amid the COVID-19 outbreak. On the other hand, some Member States, especially Spain and Italy, promptly modified their national regime on foreign investment screenings to include financial infrastructures among strategic infrastructures.

In particular, Spanish Royal Decree-Law 8/2020, of 17 March, on urgent extraordinary measures to address the economic and social impact of COVID-19, suspended the regime on the deregulation of foreign direct investments in Spain and provided for a comprehensive screening discipline. The list of factors that might affect security or public order mentioned by the new provision corresponds largely to those envisaged in the FDI screening Regulation and explicitly includes ‘financial infrastructures’. A governmental authorisation is now required for direct and indirect investments by residents outside the EU and the EFTA when investors come to hold a stake equal to or greater than 10 per cent of the share capital of Spanish strategic

[32] See, e.g., European Central Bank, ‘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.

companies, or when, as a result of a corporate operation, act or legal transaction, investors gain effective participation in the management or control of the said companies.[33]

New temporary provisions have also been introduced in Italy with the above-mentioned Law Decree 23/2020, of 8 April 2020.[34] The resulting legal framework aims at increasing public oversight over foreign acquisitions by: (i) empowering the Government to initiate the screening procedure *ex officio* if investors fail to comply with the notification requirement; and (ii) extending the notification requirement to acquisitions by intra-European investors that come to hold a stake equal to or greater than 10 % of the share capital of strategic companies, where the investment exceeds the threshold of one million euro, and to acquisitions by non-European investors that come to hold a stake equal to or greater than 10 % of strategic companies, as well as to any subsequent acquisition exceeding 15 %, 20 %, 25 % and 50 %. A notification is also required in relation to mergers and joint ventures in which a foreign partner is investing in Italian strategic assets, and to corporate transactions that may change the target company's ownership structure or purpose, or cause the winding up of the target company's business; (iii) expanding the list of factors that might affect security or public order to those envisaged by the FDI screening Regulation and explicitly mentioning among 'financial infrastructures' banking and insurance sectors.

As a result, banks and insurance companies are temporarily subject to golden power rules and must notify the Government when qualified acquisitions or transactions occur. The new provisions are clearly interconnected with the above-mentioned

[33] See Art. 7 bis Ley 19/2003 sobre régimen jurídico de los movimientos de capitales y de las transacciones económicas con el exterior.
[34] See arts. 15-16 Law Decree 23/2020, of 8 April 2020.

rules on disclosure obligations. The reduction in the thresholds that trigger disclosure obligations increases the overall transparency level and fosters the ability of Government agencies to promptly assess whether a given foreign investment is likely to affect security and public order. In turn, comprehensive and informed screening is crucial in order to assure that 'golden powers' are exercised in full compliance with the principle of proportionality, especially in times where exceptional circumstances justify an increase in public oversight.

These new rules, even though temporary, may leave a permanent mark for the future, and also pose delicate problems of combination with rules that, in the financial sector, govern the notification and authorisation of qualified holdings. Amongst other issues, the role of prudential supervisors - traditionally entrusted with the control over the acquisition of qualified holdings - needs now to be assessed, and coordinated, with that of the Government and/or of its agencies involved in the foreign investment's notification procedures. In this regard, Recital (39) of the FDI screening Regulation merely points out that the Regulation 'does not affect Union rules for the prudential assessment of acquisitions of qualifying holdings in the financial sector, which is a distinct procedure with a specific objective'. We believe, however, that this is not just an issue of coordination between different procedures that might be at stake, but also that of combining quite different approaches in tackling foreign investments in the financial sector. On the one hand, that of the prudential supervisor (more biased towards ensuring the safe and prudent management of the institution) and, on the other, that of the Government, clearly inspired by a more protectionist approach. These difficulties are then reinforced by the fact that both procedures require a complex

interplay between European Institutions and national agencies. The drafting and implementation of inter-institutional agreements are therefore desirable, in order to assure a uniform framework for screening foreign investments.

7. Final remarks

Risks have grown enormously over the past decade in the non-bank finance sector. A new crisis – even unexpected for its origin – could further fragment the internal market. A European-wide action is needed to ensure the resilience and efficiency of the capital markets. A wider-angle examination of the entire regulatory landscape is indeed vital because the economy depends on functioning markets, and markets are intertwined with banks.

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10 Balancing macro- and micro-prudential powers in the SSM during the COVID-19 crisis

Bart P.M. Joosen[1]

1. Introduction

As a result of the Corona crisis, we have returned to an era in which policies and far-reaching measures developed by regulators are published through press releases. The adage 'emergency breaks law' applies here. The status quo reminds us of the 2008's financial crisis and the following European sovereign debt crisis.[2] The financial sector and citizens must thereby trust that the measures and (policy) rules will have the

[1] This contribution is written using parts of a Dutch language publication I wrote together with Prof. Kitty Lieverse and as published in April 2020. This is particularly the case for parts of paragraph 1 and 2. This contribution has been finalised on 5 May 2020 and any further developments after this date have not been considered when drafting the text.

[2] The famous EBA press release of 8 December 2011 will still be fresh in the minds of many. See European Banking Authority, 'The EBA publishes Recommendation and final results of bank recapitalization plan as part of coordinated measures to restore confidence in the banking sector' (8 December 2011) <eba.europa.eu/the-eba-publishes-recommendation-and-final-results-of-bank-recapitalisation-plan-as-part-of-co-ordinated-measures-to-restore-confidence-in-the-banking>.

effect they intend. In the current COVID-19 crisis, none of us has been given much time to think and weigh up all the options.

For the time being, the far-reaching measures taken after the 2008's financial crisis to make banks resilient to extreme shocks appear to be bearing fruit. This also applies to the shift in emphasis to putting customer interests first. In any case, European banks have confidently taken up the gauntlet to help business and the real economy. Instead of the industry, so often criticised during the financial crisis of 2008 that sighed under the new and stricter regime, we now see banks acting as the institutions for which they are intended, or as many like to see them perform. Namely, to support customers and society in difficult times. Let us hope that the financial sector can continue to offer this role and that the corona crisis will not cause extreme adverse effects, which will also put the financial sector in difficulty.

What is also striking here is the fragmentation of information that comes to us and the various complex messages that are issued by the European authorities and supervisors in the Member States. In any case, I am putting my finger on the sore spot: in Europe, we are still far from central control and a uniform and harmonised approach for the financial sector. The recent developments in respect of prudential supervision of banks after the COVID-19 crisis emerged demonstrate that this also seems to be the case for the Single Supervisory Mechanism (SSM). The SSM purports to achieve such a centralised and harmonised approach on matters of prudential supervision of banks established in the Member States of the European Monetary Union (the 'Member States'). As will be explained, notwithstanding these firm intentions of the European policy makers, the exercise of powers by the ECB and authorities in

the Member States produced a very fragmented set of measures and dispersed result as regards capital requirements.

Based on the core considerations of the SSM, the ECB '[….] should take full account of the relevant macroeconomic conditions in Member States, in particular the stability of the supply of credit and facilitation of productive activities for the economy at large.'[3] It is particularly with a view on the stability of the supply of credit to the real economy that the recent measures of both the ECB and the national competent authorities in the Member States (NCAs) to address the COVID-19 crisis have been taken. ECB's intervention as outlined further in this contribution could be qualified as relating to the microprudential rules and the NCAs interventions to macroprudential rules. Albeit that there is a thin line between the types of measures, as we will discuss.

This contribution discusses the relationship between the measures taken by the ECB in the context of its powers and authorities vested upon it pursuant to the arrangements in the SSM and the measures taken by the NCAs of the Member States. How do the different measures relate towards each other? In which manner do the macroprudential measures taken at the level of banks in the Member States require further scrutiny by the ECB? Is there a reason to apply the corrective measures at macroprudential level that ECB can take pursuant to the SSM Regulation?

2. Liquidity and the temporisation of the prudential measures

[3] Recital (18) of Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, (the 'SSM-Regulation').

Banks are currently very confident in limiting the impact of the COVID-19 crisis on the sector and its resilience. This is reinforced by the rapid announcements of prudential supervisors at both European level and in the Member States of a series of relaxation of prudential requirements for banks. This easing aims to 'free up capital' so that banks will be able to complete the bridging measures for the real economy without having to deal with capital requirements. Banks will have to finance this extra space on the capital markets first, in order to be able to pass it on to businesses. There is a bottleneck here. Liquidity in global capital markets has dried up, certainly, when the first signs of a truly global pandemic became imminent.

The same phenomena as in 2008 are evident, with the mutual confidence of participants in the financial markets declining significantly. This means that banks will be reluctant to lend to each other, and that institutional investors will not just step into the hole to provide liquidity. Where the 2008's financial crisis had an immediate impact on the real economy and led to a crisis of unprecedented magnitude in Europe, the reverse is now threatening. The financial sector risks a collapse because of the real economy.

This article is not about the liquidity support that the ECB offers to the banking sector. However, in introducing my argument about the ECB's relaxation of capital requirements, I would like to briefly point out that the ECB provides very significant liquidity support to the banking sector. This was achieved through the expansion of the so-called 'Longer-Term Refinancing Operations' (LTRO).[4] This will enable banks to

[4] See European Central Bank, 'ECB announces measures to support bank liquidity conditions and money market activity' (12 March 2020) <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200312_2~06c32dabd1.en.html>.

participate in the (extended) medium-term financing tenders made available by the ECB, in support of banks' liquidity needs. The provisional calendar for this tender operation runs until the end of June 2020 and therefore provides air to the sector for approximately three months. The ECB notes that at the time of the release of the measure on 12 March 2020, there has been no evidence of pressurised liquidity in banks or a faltering money market. However, public reports after 12 March 2020 indicate that this is likely to have changed. Therefore, the measure taken by the ECB was introduced at the right time.

This also explains the relaxations that regulators have quickly announced for banks, concerning liquidity management. It also defines the period during which those easing measures will be necessary. Although supervisors underline their temporary nature, I estimate that the new rules will be necessary well into 2021 to avoid major problems in the banking sector. At the same time, supervisors in the Member States are bringing various signals forward in this area. The ECB, whose measures will be discussed in more detail in paragraph 3, appears to have a horizon of approximately one year. Instead, in order to meet the prudential requirements, NCAs assumes that the easing will last longer. Section 4 discusses this point in detail.

3. ECB measures in the context of the COVID-19 Crisis

3.1. Introduction

On 12 March 2020, together with the announcement of the expansion of the LTRO, the ECB announced the relaxation of certain prudential rules for the banking sector, at least for the

significant banks directly supervised by the ECB.[5] The measures boil down to exempting significant banks from a number of capital requirements that apply to them and revising the forward-looking capital requirements in the form of so-called 'Pillar 2 Guidance' rules. Finally, the ECB also announced some relief from the Liquidity Coverage Ratio (LCR) requirements.

3.2. Capital Conservation Buffer

Firstly, the relaxed rules mean that one part of the Pillar 1 requirements, the so-called capital conservation buffer (CCB) of 2.5 %, may be undershot. CCB buffers are part of the combined buffer requirements as applicable based on article 129 CRD IV[5] and are their requirements are harmonised across the European Union. A CCB buffer requirements' relief means that with a growing portfolio of loans (or an increase of the risk weighted density of the portfolio), no additional capital needs to be held to meet the CCB requirement.

The CCB is a non-risk-weighted capital requirement and its application depends on the assessment of the Total Risk Exposure Amount (TREA), which relies on article 92(3) CRR.[6] After TREA amount's definition, a non-risk weighted additional buffer requirement applies of 2.5 % of the amount itself. In other words, if the risk weighting of certain assets of

[5] 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. Text with EEA relevance.

[6] 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. Text with EEA relevance.

the bank changes, this has no direct impact on the CCB (which is calculated as a fixed percentage without re-assessing risk weights of the bank's assets or off balance sheet exposures), but an indirect impact.

Dropping the 2.5 % CCB requirement aims at accommodating the growth of the loan portfolio. This measure will enable banks to pursue a broader lending policy. The CCB was introduced in 2013 because of the implementation of Basel III in Europe and is referred to as a capital requirement that 'banks save in good times in case bad times come'. The ECB also points out precisely this background in the press release of 12 March 2020.

3.3. Pillar 2-Guidance Capital

Another ECB measure concerns the delay in the development of the Pillar 2 Guidance capital. It aims to strengthen the capital base of banks in view of risks that may arise in the future, but that have no foundation in the existing organisation or existing business operations. As a result, these risks have not been incorporated into the existing capital requirements for banks yet. The Pillar 2 Guidance capital in fact focuses on a future capital requirement, which takes into account, for example, the expected growth of the bank. So, where the regular 'Pillar 1 requirement'[7] and the Pillar 2-Required requirement are related to the existing organisation and the assessment of the risks arising from that organisation, the Pillar 2 Guidance capital will aim at hedging the future capital needs.

The ECB has now given banks the freedom to realize the Pillar 2 Guidance capital less quickly. This creates space to use extra

[7] The Pillar 1 requirements could be defined as the requirements following from article 92 CRR together with the combined buffer requirements of article 128 *et seq.* CRD IV.

capital for lending. In particular, this guide might be an extremely cautious step by the ECB to deviate as little as possible from the existing capital requirements for banks. In fact, a capital requirement is 'sacrificed' mainly related to a future development, which has not yet manifested, and which is not related to the existing organisation of the bank. In any case, the ECB measure with regard to the Pillar 2 Guidance rules is a real compensation, because it provides relief from the capital requirements that would apply under normal circumstances.

3.4. Relief Qualitative Capital Requirements

With regard to the Pillar 2 requirements, (i.e. the additional capital surcharge imposed by the supervisory authority), the ECB has now adopted the measure that this capital requirement may also be met with instruments of a 'lower' quality level, for example with Tier 2 capital, being bank medium-term subordinated loans. This also provides some relief, as banks will then become less dependent on raising CET1 capital for their financing, given the current situation in capital markets.

This relaxation of the rules is a policy shift from the ECB where the current requirements to meet Pillar 2 capital with Common Equity Tier 1 instruments (CET1) only originates from determination, as a result of the Supervisory Review and Evaluation process (SREP) using the powers contained in article 104 CRD IV. Based on this ECB policy, SREP capital of significant institutions must be filled in with CET1 instruments. This brings forward a measure that was initially scheduled to come into effect in January 2021, as part of the latest revision of the CRD IV.[8]

[8] See the new article 104a (4) CRD IV.

Because of the discretionary nature of the SREP framework, the ECB could use its powers in this respect to apply the policy change, albeit that this is to be considered as a temporary measure, and this policy-based discretion will be replaced by the mandatory rules becoming applicable from 1 January 2021.

3.5. Liquidity Coverage Ratio

Finally, the ECB has also proposed a concrete measure with regard to meeting liquidity standards.[9] This means that banks would adhere to a lower liquidity ratio than allowed in normal circumstances. It concerns an intervention in the arrangements for the so-called Liquidity Coverage Ratio (LCR). These schemes oblige banks to maintain a sufficient stock of liquid assets to meet an outflow of liquidity in a stressed situation (within a thirty-day horizon). The ECB's published statement does not indicate the extent to which the ECB is prepared to pull the LCR ratio lever. However, the ECB has stated that in particular, it will take a flexible approach when approving LCR restoration plans which banks are legally required to submit when breaching the LCR requirement.[10] For this reason, the impact of this measure remains unforeseeable.

4. NCA measures in the context of the COVID-19 Crisis

4.1. Introduction

[9] Reflecting a strong recommendation of the industry. See European Banking Federation, 'EBF call for European measures to face COVID-19 outbreak', (11 March 2020) <www.ebf.eu/ebf-media-centre/ebf-calls-for-european-measures-to-face-covid-19-outbreak/>.

[10] See SSM, 'FAQs on ECB supervisory measures in reaction to the coronavirus', (3 April 2020) <www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320_FAQs~a4ac38e3ef.en.html>.

Clearly, the relaxation of certain prudential requirements as discussed in the previous paragraph apply to significant institutions for which the ECB has the exclusive power and authority to adopt its policies and determination of rules. However, based on the current arrangements in the SSM, certain measures of prudential supervision have remained to be the power and authority of the NCAs as concerns significant institutions. This follows from the division of tasks and responsibilities as set out in article 5 of SSM Regulation. That is, the distinction between prudential capital requirements based on microprudential rules[11], for which the ECB has the powers and authority[12], and the requirements based on macroprudential rules or rules addressing systemic risks, for which in the SSM the NCAs retained powers and authority.

Typically, the latter concerns the determination of the Member State specific countercyclical buffer (CCYB)[13], the assessment of institutions in respect of their systematic importance and setting the buffer rates for such institutions (G-SII-buffer or O-SII Buffer)[14] and determining the application of the systemic risk buffer ('SRB')[15].

In a recent overview published by the ECB on 15 April 2020[16], a complete specification of the policies adopted in the 19 participating Member States of the combined buffer

[11] This concerns the Pillar 1 requirements based on article 92 CRR and the CCB of article 129 CRD IV and the Pillar 2 requirements as set out in articles 104 and 104a CRD IV.
[12] See article 4(1) (d) SSM Regulation.
[13] Based on articles 130 and 135 *et seq* CRD IV.
[14] Based on article 141 CRD IV.
[15] Based on articles 133-134 CRD IV.
[16] See European Central Bank, 'ECB supports macroprudential policy actions taken in response to coronavirus outbreak', (15 April 2020) <www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200415~96f622e255.en.html>.

requirements[17] is given.[18] This overview is based on the information requirement imposed on the NCAs to report to the ECB (the intention to) apply countercyclical buffer rates, and any other measures aimed at addressing systemic or macroprudential risks. The ordinary notification period requires the dispatch of a notification from the NCA 10 days prior to the introduction of the requirement, with a possible objection issued by the ECB against such introduction.

The ECB overview also gives an indication which Member States introduced revised policies or requirements as regards the 'combined buffers' in the context of the COVID-19 crisis. This concerns eleven Member States as follows (in alphabetical order):

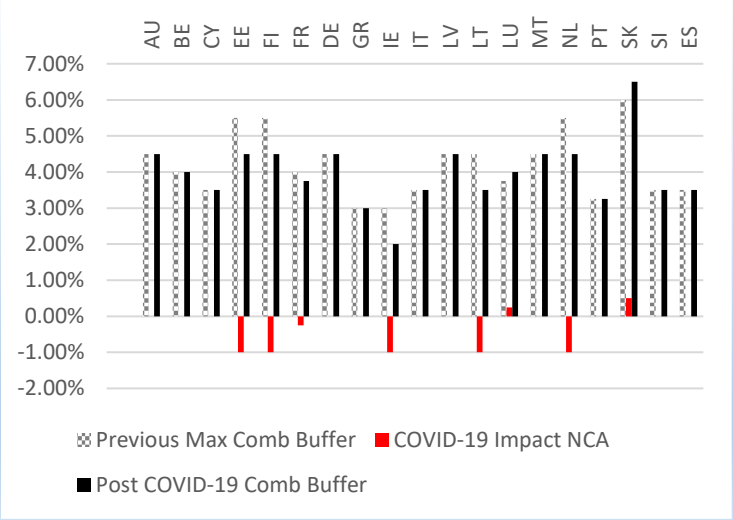
- *Belgium*, amending the announced to be introduced CCYB rate from 0.5 % to 0 % with the effect that the actual combined buffer requirements do not change;
- *Cyprus*, postponing the remaining phasing in by 12 months of the O-SII Buffer with the effect that the actual combined buffer requirements do not change;
- *Estonia*, reducing the SRB rates applicable to the entire sector from 1 % to 0 %;

[17] The use of the expression *combined buffer* in this overview should be considered to cover for all the four types of buffers, being the CCB, the CCYB, the G-SII-buffer or OSII-buffer and the SRB, that together represent the combined buffer requirements as defined in article 128 CRD IV. However, as has been explained in the previous paragraph, based on the arrangements between the ECB and the NCA's of the Member States, it is the ECB who actually has been turning the CCB knob as concerns the significant institutions, although in theory, and based on the somewhat unclear provisions of article 5(1) SSM Regulation, the determination of the applicable rates for the CCB is to be concerned a power of the Member States (which may have delegated such power to the NCAs concerned).

[18] See European Central Bank, 'Macroprudential measures taken by national authorities since the outbreak of the coronavirus pandemic', (14 April 2020) <www.ecb.europa.eu/pub/financial-stability/macroprudential-measures/html/index.en.html>.

- *Finland*, reducing the O-SII Buffer for one bank and reducing the SRB rates applicable to the entire sector from 1 % to 0 %;
- *France*, revoked decision on announced CCYB and release of implemented CCYB, with the effect that the CCYB is now set at 0 % and with the effect that the actual combined buffer requirements do not change;
- *Germany*, amending the CCYB to revoke the decision on announced CCYB with the effect that the actual combined buffer requirements do not change;
- *Ireland*, amending the CCYB to 0 % (from 1 %);
- *Lithuania*, amending the CCYB to 0 % (from 1 %);
- *Luxembourg*, amending the CCYB from 0.25 % to 0.50 %;
- *Slovakia*, increasing the CCYB to 2 % (from 1.5 %);
- *The Netherlands*, reducing the O-SII rate for one bank, reducing the SRB rate for three other banks and postponement of announced measure as to the floor on risk weights of domestic mortgage loan exposures of IRB banks pursuant to the article 458 CRR procedure.

In a diagrammatic overview, the effect of the COVID-19 measures for the combined buffer levels can be displayed as follows (with the exception of institution specific Pillar 2-Guidance capital and the ECB measure concerning the CCB). Taking the highest rates applicable in the Member State to display the pre-COVID-19 requirements and taking into account the maximum relief (so using the upper rates of reduction proposed in the context of the COVID-19 crisis):



This overview shows that six Member States (Estonia, Finland, France, Ireland, Lithuania and the Netherlands) opted for an actual decrease of the aggregate combined buffer rate at percentages from 0.25 % to 1 %. Two jurisdictions (Belgium and German) postponed the introduction of the CCYB as announced in 2019, but with an effect that the other combined buffer requirements remain unaltered. Two Member States (Slovakia and Luxemburg) opted for the increase of the CCYB. As regards the Netherlands, the true effect of the changes to the combined buffer requirements is difficult to assess, as the measures taken by the Dutch Central Bank are mixed up in amending the D-SIB buffer rate for one bank and the SRB for three other banks. In the communications of the Dutch Central Bank it is unclear, however, which rate reduction applied for which bank, as the measures have been presented under the summary of 'reduction of systematic buffer' thus combining the

communication on the reduction to address both the O-SII and SRB.[19]

In general, it may furthermore be noted that the decrease of combined buffer requirements may even be more significant if significant banks, established in Member States, would opt to apply the relaxation of the CCB as announced by the ECB. In one jurisdiction (being Ireland), supposing the optimal use of the CCB underscoring up to 2.5 %, this would even result in a (hopefully theoretical) negative combined buffer requirement.

In the further paragraphs, the specific measures taken as regards the different buffers will be discussed in more detail.

4.2. Countercyclical capital buffer

Among the seven euro area countries with positive CCYB rates, authorities in France, Ireland and Lithuania reduced the CCYB to 0 %. Those in Belgium and Germany revoked the CCYB activations announced in 2019. These adjustments reduce requirements for all banks with exposures to these countries. This means that the measures taken are indifferent whether it concerns a significant institution or a less-significant institution. In addition, the measures are neutral as regards the country of establishment of the bank concerned. The CCYB operates based on the risk positions held in the relevant Member States, whether held in the domestic banking book of banks established in that Member State or whether the positions are held by banks established in other Member States. This is due to existing reciprocity arrangements, which require banks from other jurisdictions to apply the same capital requirement to their

[19] For the Netherlands, the 'average' impact of the buffer-reduction of 1% has been taken into account, although reductions appear to be introduced for a small subset of the banks established in the Netherlands only, in a bandwidth of 0.5%-1.5%.

exposures in the country applying the CCYB. According to the ECB in its communication of 15 April 2020, euro area banks have seen their requirements reduced by the CCYB reductions in Denmark, Hong Kong, Iceland, Norway, Sweden, and the United Kingdom.

In any event, it can be noted that most of the Member States have opted to introduce relaxation as regards the combined buffer requirements by means of adjustments to the CCYB, whether by lowering existing rates or by postponing announcements of the introduction of the applicability of the CCYB in the relevant Member State. It is remarkable that, in deviation from the procedural requirements as set out in CRD IV, such rate adjustments have been introduced with more or less immediate effect, with no phasing out being proposed. This is in clear deviation from the ordinary procedures as set forth in the CRD IV text, which require a gradual phasing in and out of the CCYB requirement.

4.3. Systemic risk buffer

The authorities in Estonia and Finland have reduced the SRB to a rate of 0 % from the prevailing buffer rate of 1 %, while the authority in the Netherlands reduced the existing 3 % rate, for three institutions, to rates between 0.5 % for the largest bank to 1.5 % for the smallest domestic systemically important bank. This different outcome of the rate reduction is noteworthy, as it demonstrates the very different application of the powers by the authorities in the different Member States. While most of the Member States apply the SRB as a sector wide measure to address certain systemic risks within the Member States domestic economy, the Dutch authorities have from the outset applied the SRB as a correction to the G-SIII and O-SII Buffers,

so as to be able to surpass the bandwidth defined in the provision of article 141 CRD IV for G-SIII and O-SII Buffers.

What purports to be a macroprudential tool for authorities in the Member States to address the development of long term non-cyclical systemic risks in certain parts of the economy (with the default scenario of addressing 'housing bubbles' being presented by most Member States to justify the introduction of the SRB[20]), has been applied by a few Member States (including the Netherlands) to address other risks or concerns. The potentially far-reaching consequences of the application of the discretionary powers of the NCAs that propose the introduction of the SRB is embedded in a complex notification and approval process by the European institutions.[21] The missing link in that approval process, in my view, is the involvement of the ECB if the imposition of the SRB relates to significant institutions subject to its direct supervision.

The very different levels of the combined buffer requirements in the Member States as displayed in the diagram set out above are particularly caused by the dispersed application of this discretionary power by the Member States' NCAs. In my view, the SRB rules are one of the main contributors to the very different levels of combined buffer requirements as they apply in the Member States. The wide ranging discretionary powers of the NCAs to apply or, as we now have seen, disapply the SRB or to reduce the buffer rate with significant steps (in the

[20] See the notification suite as published by the ESRB. European Systemic Risk Board, 'Systemic risk buffer', (12 August 2019) <www.esrb.europa.eu/national_policy/systemic/html/index.en.html>. The ESRB explains the rationale of this buffer (a typical European measure not based on Basel Committee standards) as follows 'The systemic risk buffer […] aims to address systemic risks of a long-term, non-cyclical nature that are not covered by the Capital Requirements Regulation'.

[21] See the provisions of articles 130 and 135 *et seq* CRD IV.

context of the COVID-19 crisis even with immediate effect), is a counterproductive element for the intentions to achieve harmonisation and the creation of a level playing field for banks in Europe (or at least in the eurozone).

4.4. Other Systemically Important Institution (O-SII) bufferSystemic risk buffer

In combination with the reductions in the SRB, Finland and the Netherlands also decided to lower the O-SII Buffer for one bank each. According to the ECB, these reductions prevent the O-SII Buffers from limiting the reductions in the SRB, given the interactions between the two requirements stipulated in Article 131 CRD IV. The ECB refers to the provision of article 131(14) second paragraph CRD IV where there is a requirement to apply the highest outcome of the O-SII Buffer or the SRB and not to accumulate requirements.[22] For the institutions in Finland it ensures that the combined structural buffers (SRB and O-SII Buffers) are effectively reduced by 1 % of the TREA. But the exact impact for the measures taken by The Netherlands cannot be measured. This adds up to the lack of harmonised application of the combined buffer rules as may be observed in this respect.

4.5. Postponing the phase-in or intrioduction of announced measures

Cyprus announced that it will delay the phase-in of O-SII Buffers by one year, while the Netherlands postponed the introduction of capital surcharges on domestic mortgage loan exposures under Article 458 of the Capital Requirements Regulation (CRR). The first measure (delay of the introduction

[22] The provision reads as follows 'Where an institution, on an individual or sub-consolidated basis is subject to an O-SII buffer and a systemic risk buffer in accordance with Article 133, the higher of the two shall apply'.

of the O-SII Buffer requirement) cannot be aligned with the implementation requirements of the CRD IV provisions, where O-SII Buffers, if there is an assessment that a bank qualifies as O-SII, should have been introduced on a fully loaded basis yet. The question arises whether this particular measure taken by Cyprus complies with European Union law.

The latter measure as taken by the Netherlands concerns the introduction of a 'capital floor' for the largest banks in the Netherlands in respect of certain residential real estate exposures. The need for the Dutch authorities to apply this very specific provision of article 458 CRR may be explained by the fact that other measures that this NCA could take to address macroprudential concerns based on the existing provisions of CRR and CRD IV apparently had been exhausted.

The relevant introduction of a 'capital floor' would have been only applicable to a few Internal Rating Based-banks in the Netherlands, which, in my view blurs the underlying rationale of the macroprudential powers given to the NCAs. Application of article 458 CRR in this case, may be considered to introduce a microprudential measure, rather than a macroprudential one. It puzzles me, why the Dutch authorities have not considered the introduction of CCYB measures instead, to address the subject matter of the perceived development of a housing bubble.[23]

5. Commentary

[23] The other suitable measure that authorities can take to address long-term non-cyclical macroeconomic concerns is the imposing of the SRB, but as we have seen, this particular measure has been applied by the Dutch authorities for other objectives, and this tool was no longer available in the macroprudential toolkit.

The approach of ECB and the supervisors in the Member States differs considerably. The NCAs policies appear to be aimed at solving the problems in the medium term. The ECB's measures are more focused on the shorter term. The qualification ‘incentives’ is more appropriate for the ECB's measures than for the NCAs. This relates to two factors in my view. It concerns the absolute levels of the relaxation and the implementation of the capital relief.

As concerns the absolute levels, the ECB policy to release the banks to meet the CCB requirements has an immediate effect and an immediate lowering of the capital requirements for banks originating lending transactions to the real economy. The fact that the available cushion of 2.5 % is to be used to the fullest extent (and in a manner consistent with the rationale of the CCB), produces in all likelihood the most significant freefall of capital, and hence the most widened up ability for banks to support the real economy. The macroprudential relief offered by the NCAs differs from 0.0 % (for those Member States delaying the introduction of the CCYB, the O-SSII Buffer or the article 458 CRR capital floor measure) to up to 1 % (for those Member States that decided to lower the SRB or O-SII Buffer).

As concerns the implementation, one could applaud the policy promoted by the ECB to anticipate on the forthcoming changes of CRD IV as concerns the qualitative requirements for capital to be maintained to meet the Pillar 2 Required capital levels. In view of the turbulence on the capital markets as we have seen recently, and the fact that bank’s will be facing even more constraints to raise CET1 capital at this point in time, my view is that the ECB policy in respect of the composition of the Tiers to meet Pillar 2 Required capital is a very effective and very appropriate measure. Furthermore, in view of the differences in

application of the relaxation of capital requirements by the Member States, a very blurred outcome is produced for the banking industry in the Member States. Some of the NCAs decided to apply relaxation on a sector wide basis (this is particularly the case for Member States that relaxed the CCYB) whilst other Member States only introduced relaxation for a handful of banks.

My main concern and point of critics concerns the excessively dispersed outcome of the measures taken by the ECB on the one hand and the NCAs on the other hand. We must note that the ECB obviously only could introduce policies for the significant banks in respect of which it bears the exclusive powers and responsibilities. Whether or not less-significant institutions established in the Member States will be obtaining the same relaxation of rules depends on the nature of the macroprudential measures taken by the Member States as noted hereabove. In theory, in some Member States relaxation of the rules only applies for the larger banks, whilst the smaller banks (that may also assist the real economy by providing loans to the small and medium-sized enterprises, which constitute their typical clients) are not benefiting from the relief measures.

It may be considered that the consequences of the corona crisis for the financial sector will lag for more than a year, if not longer. I hope that the very far-reaching consequences for public health will be over shortly, but I estimate that the job for the financial sector will only start after that. First, the shrapnel will have to be picked up from ailing companies that, despite all the support measures, ultimately failed. This will also have consequences for the financial sector, given its involvement in lending. Subsequently, a recalibration of the relaxed prudential requirements will have to take place in order to achieve a ‘recovery to the old state’. It should also be hoped that

politicians and policymakers (and regulators) will not forget the exceptional circumstances in which we were in this first half of 2020. I recommend that reasonable and realistic transitional arrangements be introduced to oblige banks to restore their capital requirements back to pre-corona crisis ratios.

The current provision of article 5(1) SSM Regulation needs to be reconsidered. To achieve a truly harmonised and uniform application of prudential supervision on all banks in the Member States, the ECB should be given the power to apply the microprudential and macroprudential measures for banks to the fullest extent, for significant banks and less-significant ones. The stress test of the COVID-19 crisis demonstrates that the system of division of powers between the ECB and the NCAs as embedded in the SSM produces obstructive results for the SSM in accordance with its objectives.

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11 The application of the EU banking resolution framework amidst the pandemic crisis

Christos V. Gortsos[1]

1. Introduction

(1) The current pandemic crisis is an unprecedented, extraordinary challenge, eventually the greatest since the Great Depression during the 1930s, with severe social and economic consequences around the globe. EU Member States and EU institutions have already taken in this respect numerous measures and undertaken initiatives with a threefold aim: deal with health emergency needs, support economic activity and employment, and prepare the ground for recovery. In certain cases, the mobilisation of funds has been immediate, while the establishment of new instruments and funds requires the activation of procedures which, under the current conditions and for the sake of effectiveness, should be completed soon. The

[1] The cut-off date for information included in this article is 10 May 2020. The author wishes to thank Bart Joosen, Christina Livada and an anonymous reviewer for their valuable comments and suggestions.

duration of the measures taken and planned is variable: while some are earmarked for the duration of the crisis and would be discontinued thereafter, others have a medium- to longer-term horizon. There is a combination of extensive fiscal stimuli, emergency liquidity and monetary policy measures of central banks, including the European Central Bank (ECB) within the Eurosystem, on the application of both their interest rate and their balance-sheet policies, and measures relating to the application of banking micro- and (mainly) macro-prudential regulations.

In the latter field, the ECB, within the Single Supervisory Mechanism (SSM), and the EBA have activated (and framed) elements of 'flexibility' embedded in the framework governing the related aspects, in order to allow credit institutions to provide funding to firms and households exposed to financing pressures under relatively looser regulatory restrictions.[2] In this respect, noteworthy is the critical importance of the capital and liquidity buffers built-up by credit institutions on the basis of the regulatory framework developed since the recent (2007-2009) global financial crisis, which are currently available to

[2] For an overview of the measures taken and the initiatives undertaken in the EU as of 14 April 2020, see Christos V. Gortsos, 'The EU Policy Response to the Current Pandemic Crisis through the Lens of the Eurogroup Report of 9 April 2020: Overview and Assessment (Cut-Off Date: 14 April 2020)' (2020) <ssrn.com/abstract=3579010>. Several of these measures and initiatives are discussed in detail in the other contributions to this volume. For a comprehensive global review, see, inter alia, the Yale Program on Financial Stability's 'COVID-19 Financial Response Tracker' updated on a constant basis (available at: <docs.google.com/spreadsheets/d/1s6EgMa4KGDfFzcsZJKqwiH7yqkhnCQtW7gI7eHpZuqg/edit#gid=0>).

allow them to effectively contribute to the short- and longer-term financing of economic activity and recovery in the EU.[3]

(2) Less attention has been paid to the application, amidst the crisis, of the framework governing the resolution of credit institutions. Nevertheless, this solvency crisis management framework, which is also a by-product of the global financial crisis and (with the exception of one Member State) has not been tested under conditions of a systemic crisis, is an element of primary importance, since the probability that it will be widely activated amidst the current crisis and in its wake is definitely higher. This article briefly sheds light on this issue, by reviewing selected aspects of the resolution planning framework (under Section 2) and (mainly) the resolution action framework (Sections 3-5).

2. Application of the resolution planning framework

(1) The EU banking resolution framework is laid down in Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014[4] (the 'Bank Recovery and Resolution

[3] In this respect, the quarterly Risk Dashboard of the European Banking Authority (EBA) of 14 April 2020, which covers data of the 4th quarter of 2019 and summarises the main risks and vulnerabilities in the EU banking sector, notes that, ahead of the current crisis, EU banks' capital ratios and asset quality have improved, even though return on equity has worsened. See EBA, 'EU banks sail through the Corona crisis with sound capital ratios' (14 April 2020) <eba.europa.eu/eu-banks-sail-through-corona-crisis-sound-capital-ratios>.

[4] 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 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 Text with EEA relevance OJ L 173, 12.6.2014, pp. 190-348.

Directive' or BRRD) and the delegated and implementing acts adopted on the basis of its provisions. For the euro area also applicable is Regulation (EU) No 806/2014 of the same institutions of 15 July 2014[5] (SRMR), establishing the European Single Resolution Mechanism (SRM) and a European Single Resolution Fund (SRF), which constitutes the main legal basis of the second pillar of the Banking Union. On the basis of Commission Communication of 24 November 2015 'Towards the completion of the Banking Union',[6] which laid down a legislative 'banking package' concerning the amendment of several legislative acts relating to the Banking Union, the BRRD and the SRMR were amended by Directive (EU) 2019/879 (BRRD II) and Regulation (EU) 2019/877[7] (SRMR II) of the same institutions of 20 May 2019; the new provisions will apply (in principle) as of January 2021. The provisions of all these legislative acts govern both resolution planning and resolution action.

(2) In the context of monitoring the situation related to the pandemic crisis in the euro area and its impact on the financial

[5] 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 and amending Regulation (EU) No 1093/2010 OJ L 225, 30.7.2014, pp. 1-90.

[6] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions 'Towards the completion of the Banking Union' COM (2015) 587 final.

[7] Respectively: Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC OJ 150, 7.6.2019, pp. 296-344; Regulation (EU) 2019/877 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 806/2014 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms (Text with EEA relevance.) OJ 150, 7.6.2019, 226-252.

system, the Chair of the Single Resolution Board (SRB or Board), Elke König made three interventions in respect to the application of the resolution planning framework. On 1 April, a letter was addressed to banks under the Board's remit 'on potential operational relief measures related to the COVID-19 outbreak', coupled by a note entitled: 'An extraordinary challenge: SRB actions to support efforts to mitigate the economic impact of the COVID-19 outbreak'. A week later, on 8 April, the application of the framework governing the minimum requirement for own funds and eligible liabilities (MREL) was addressed in another note entitled 'COVID-19 crisis: the SRB's approach to MREL targets'.[8] All three interventions were supportive of the measures taken by the ECB in order to help credit institutions in ensuring continuity of business and services for their customers. The Board also presented its approach in view of the uncertainty and disruption caused to the economy by the crisis, setting out its remit on potential operational relief measures, its actions to support efforts to mitigate the economic impact of the crisis and its dealing with MREL targets. The author views this approach as based on two complementary pillars: 'preservation of financial stability' and 'flexibility in the application of the resolution framework'.

(3) In relation to the *first pillar*, the Board boldly states that the progress made in recent years on resolution planning in order to make credit institutions resolvable and the (related) build-up of

[8] See, respectively: SRB, 'Letter to banks under the SRB's remit on potential operational relief measures related to the COVID-19 outbreak' (1 April 2020) <srb.europa.eu/en/node/965>; Elke König, 'An extraordinary challenge: SRB actions to support efforts to mitigate the economic impact of the COVID-19 outbreak' (*SRB's Blog*, 1 April 2020) <srb.europa.eu/en/node/966>; Elke König, 'COVID-19 crisis: the SRB's approach to MREL targets' (*SRB's Blog*, 8 April 2020) <srb.europa.eu/en/node/967>.

MREL are important tools to maintain a strong banking sector supporting the economic recovery and to preserve financial stability amidst the pandemic crisis; thus, the ongoing focus on these aspects should not be compromised. Under the *second pillar*, the Board supports credit institutions with operational relief measures, applying a pragmatic approach and considering, if necessary, to postpone less urgent information or data requests related to the upcoming 2020 resolution planning cycle, expecting nevertheless that credit institutions will identify mitigating actions in order to continue progress towards resolvability. In the same vein, and taking account of the fact that credit institutions' build-up of MREL continues to be key to resolvability, it states its aim to assess the potential impact on transition periods needed for this build-up and provided clarity on its flexible approach, committing to ensure that short-term MREL constraints will not prevent credit institutions' lending activities. In particular:

on the one hand, as regards existing binding targets, as set out in the 2018 and 2019 resolution planning cycles, the Board expressed its intention to take a 'forward-looking approach' to credit institutions that may face difficulties meeting those targets before new decisions (with intermediate targets) take effect, without compromising on their actual enforcement;

on the other hand, as part of the 2020 resolution planning cycle, including the changes to the 2020 MREL decisions under the new resolution framework (in accordance with the BRRD II and the SRMR II[9]), new MREL targets will be set in line with the transition period under SRMR II (i.e. setting the first binding

[9] See new Articles 45m BRRD and 12k SRMR (on transitional arrangements), inserted by Article 1 of the BRRD II (point (17)) and the SRMR II (point (6)).

intermediate target for compliance by 2022 and the final one by 2024).

An interesting inconsistency problem arising in this context, which will have to be fixed, is that the MREL decisions to be published in early 2021 should, in principle, be based on data concerning the economic year 2019. This reference point, nevertheless, will most probably be inaccurate since the pandemic crisis will have a negative impact on credit institutions' balance sheets if compared to those of 2019.

3. Resort to resolution action and application of the bail-in resolution tool: some concerns

(1) An important resolution aspect, not dealt with in the above-mentioned Board's interventions, is that of the implementation, during the current crisis, of the framework relating to resolution action. As a consequence of this crisis, the rate of non-performing loans (NPLs), which during the last years has, on average, significantly decreased,[10] is expected to increase again across the board (and in certain cases exponentially) in almost all Member States (including within the euro area).[11]

[10] This is mainly attributable to the introduction of the Council Action Plan of July 2017 on Non-Performing Loans and the accommodating macroeconomic conditions. European Council, 'Banking: Council sets out action plan for non-performing loans' (11 July 2017) <www.consilium.europa.eu/en/press/press-releases/2017/07/11/banking-action-plan-non-performing-loans/>. It is noted, however, that the existing stock of NPLs, created as a by-product of the global financial crisis or the subsequent fiscal crisis in the euro area, still varies significantly among Member States. The ECB 'Guidance to banks on non-performing loans' of May 2017 lays down best practices, which constitute the supervisory expectation of the SSM. ECB, 'Guidance to banks on non-performing loans' (March 2017) <www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf>.

[11] State guarantees provided in respect to certain categories of loans 'may' prove a mitigating factor, depending of course on their level, as well as on the

It is noted in this respect that the flexibility currently provided to credit institutions to prolong the periods for the classification of loans as non-performing[12] is justified in terms of supporting the financing of the fragile real sector of the economy at this first phase of the pandemic crisis. It nevertheless entails the risk of accumulation of problems after the lapse of the 'moratorium' period, the extent of which will vary both among Member States (depending on the depth and the duration of the current and upcoming economic recession) and among credit institutions per Member State (depending on the composition of their loan portfolio, mainly in relation to the exposures on individuals and companies in sectors most severely affected).

(2) In view of such a development, a proposal on the establishment of a European Asset Management Company ('bad bank'), which would be set up in order to absorb a significant stock of NPLs, is currently being discussed.[13] However, given that discussions are at an early stage and this new entity would not become operational within the short-term horizon (if a decision could be reached at all in view of the

fiscal conditions in the Member State concerned at the time they would eventually be called.

[12] See in this respect mainly: SSM, 'ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus' (12 March 2020) <www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html>; 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>.

[13] This could resemble the US Troubled Asset Relief Program (TARP) established by the Emergency Economic Stabilization Act of 2008 amidst the global financial crisis (and in particular the US subprime mortgage crisis). A similar proposal was made in 2017 by the (then) Chair of the EBA, Andrea Enria, which nevertheless has not been put forward.

diverging approaches defended[14]), and given the market limitations for their effective securitisation, the probability cannot be underestimated that the first condition for resolution, i.e. the 'failing or likely to fail' criterion, referred to in Articles 32(1) BRRD and 18(1) SRMR, may be met by a significant number of credit institutions, and eventually concurrently, from the end of this year onwards, especially if (or, in certain cases, when) the existing stock of capital buffers will have been exhausted.[15]

In that respect, the Board's concerns on the need to continue the build-up of MREL is more than legitimate, especially when taking account of the fact that the stock of bail-inable instruments under the MREL requirements may still, on average, be sub-optimal. On the other hand, a sensitive issue also arises for the shorter-term horizon: in which way, amidst such a generalised social and economic crisis, decisions on the resolution or, if the public interest criterion is not met, the winding-up of unviable credit institutions can, under a pragmatic approach, be taken simultaneously for several credit institutions, and in particular in the hardest-hit Member States and regions therein. Evidently, this concern does not apply to *ad hoc* cases of bank unsound management or manifest

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

[15] On the failing or likely to fail criterion and the other two conditions for resolution under EU law, namely the criterion of the reasonable prospect for effective alternative private sector measures or supervisory action, and the 'public interest' criterion, see Christos V. Gortsos, *The Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF) – Legal aspects of the second main pillar of the European Banking Union* (5th edition, 2019) pp. 205-215 <ssrn.com/abstract=2668653>.

violation of banking regulation (even though, admittedly, the line between such management and violations, on the one hand, and failure due to the pandemic crisis, on the other, may be thin).

(3) Even more importantly, scepticism arises in respect of the potential application of the bail-in resolution tool (either on a stand-alone basis ('open-bank' bail-in) or in combination with a 'gone-concern' resolution tool) as laid down in Articles 43-62 BRRD and in Article 27 SRMR, by virtue of which, inter alia, non-excluded deposits, i.e. deposits over 100,000 euros per depositor per credit institution, would – alongside other liabilities – be written down or converted into capital.[16] The author considers that such a decision, in relation (at least) to the deposits of companies (of any size), could have severe pro-cyclical effects to the detriment of economic as well as financial stability, since loans of depositors affected by the application of

[16] On the provisions of EU law governing the bail-in tool, see by way of mere indication Christos Hadjiemmanuil, 'Bank Stakeholders' Mandatory Contribution to Resolution Financing: Principle and Ambiguities of Bail-in', in *ECB Legal Conference 2015 – From Monetary Union to Banking Union, on the way to Capital Markets Union: New opportunities for European integration*' (European Central Bank, 2015a) pp. 225-248 <ssrn.com/abstract=2688953>; Seraina Grünewald, 'Legal challenges of bail-in', in *ECB Legal Conference 2017 – Shaping a new legal order for Europe: a tale of crises and opportunities* (European Central Bank, 2017) pp. 287-310 <www.ecb.europa.eu/pub/pdf/other/ecblegalconferenceproceedings201712.en.pdf>; Matthias Haentjens, 'Selected Commentary on the Bank Recovery and Resolution Directive' in Gabriel Moss QC, Bob Wessels, and Matthias Haentjens (eds), *EU Banking and Insurance Insolvency*, (Second edition, Oxford University Press 2017) Chapter IV, pp. 240-252; Tobias H. 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; Wolf-Georg Ringe and Jatine Patel, 'The Dark Side of Bank Resolution: Counterparty Risk through Bail-in' (2019) European Banking Institute Working Paper Series no.31 <ssrn.com/abstract=3314103>.

the bail-in tool would, probably, become non-performing.[17] In addition, and notwithstanding the political repercussions involved, a bail-in of deposits (even only uncovered ones) may negatively affect confidence in the banking system and the Single Euro Payments Area, to the extent that corporates will have a disincentive to centralise payments through a single bank account (if this is not already the case).

(4) As a consequence of all these concerns, resort to the provision of State aid to ailing credit institutions, which still remains, albeit conditionally, an option, may under the current circumstances become more frequent than aimed in the regulatory framework shaped after the global financial crisis. This aspect is discussed more analytically in the following Section 4.

4. The three alternatives for the provision of public financial support and their potential application

4.1. The ESM direct recapitalisation instrument (DRI)

(1) The direct recapitalisation instrument (DRI) of the European Stability Mechanism (ESM), which has been operational since 8 December 2014,[18] is governed by the Guideline of the ESM

[17] This may be caused either because the depositor has been granted loans by the credit institution that has been resolved or due to overall liquidity problems arising from the conversion into equity or the writing down of her/his/its deposits.

[18] ESM, 'ESM direct recapitalisation adopted' (12 December 2014) <www.esm.europa.eu/press-releases/esm-direct-bank-recapitalisation-instrument-adopted>. On this instrument, see ESM, 'FAQ on the ESM direct bank recapitalisation instrument' (2014) <www.esm.europa.eu/sites/default/files/2014-12-08_faq_dri_archived.pdf>; Christos Hadjiemmanuil, 'Bank Resolution Financing in the Banking Union' (2015b) LSE Law Society and Economy Working Papers 6/2015 pp. 29-34 <ssrn.com/abstract=2575372>; Danny Busch, Mirik Rijn, and Marije Louise,

Board of Directors 'on Financial Assistance for the Direct Recapitalisation of Institutions' (DRI Guideline).[19] The DRI is available to credit institutions which are of 'systemic relevance'[20] or pose a serious threat to financial stability under the following additional conditions: *first*, the beneficiary credit institution is (or is likely in the near future to be) in breach of the capital requirements established by the ECB within the SSM; *second*, it is unable to attract sufficient capital from private sector sources to resolve its capital shortfall; and *third*, the contribution of the private sector by application of the 'bail-in' resolution tool is not expected to address the capital shortfall fully.[21] A burden-sharing scheme determines the contribution of the requesting ESM Member to the recapitalisation operation.[22]

The DRI can only be granted under strict conditionality, accompanied by a Memorandum of Understanding (MoU), addressing both the sources of difficulties in the financial sector and, where appropriate, the overall economic situation of the

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'How Single is the Single Resolution Mechanism?' (2018) European Banking Institute Working Paper Series 2019 – no. 30 pp. 19-20 <papers.ssrn.com/sol3/papers.cfm?abstract_id=3309189>.

[19] ESM, 'Guideline on Financial Assistance for Direct Recapitalization of Institutions' (8 December 2014) <www.esm.europa.eu/sites/default/files/20141208_guideline_on_financial_assistance_for_the_direct_recapitalisation_of_institutions.pdf>.

[20] Systemic relevance can refer to either systemically important institutions falling into the main criteria laid down in the Guideline, or to other institutions, not necessarily cross-border, whose insolvency could have a significant negative impact on the financial system because of adverse market circumstances or financial stress.

[21] DRI Guideline, Article 3(1); the conditions laid down in Article 8(3) for the application of 'bail-in' are identical to those laid down in the BRRD (Articles 43-62). The DRI cannot be used for the purpose of precautionary recapitalisation (ibid Article 8(1)); on this form of recapitalisation, see below, under C.

[22] ibid Article 9.

requesting ESM Member.[23] In principle, it must be conducted against the acquisition of common shares, which satisfy the requirements laid down in Articles 28-29 of 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 (…)'[24] (CRR) on Common Equity Tier 1 (CET1) instruments.

(2) In view of these strict conditions attached and in particular of the fact that bail-in is a prerequisite, it is not expected that this instrument, which never has been used since its introduction,[25] will be a priority option.

4.2. The Government Financial Stabilisation Tools (GFSTs)

(1) The Government Financial Stabilisation Tools (GFSTs), governed by Articles 37(10) and 56-58 BRRD as tailor-made for systemic crises, are a second alternative. GFSTs constitute 'extraordinary public financial support' to credit institutions[26] and their use may be activated at Member States' discretion. Taking into account that one of the resolution objectives under the BRRD (and the SRMR as well) is the protection of public funds by minimising reliance on extraordinary public financial

[23] ibid Article 4.
[24] OJ L 176, 27.6.2013, pp. 1-337.
[25] See ESM, 'Lending toolkit' (2020), <www.esm.europa.eu/assistance/lending-toolkit>.
[26] In accordance with Article 2(1), point (28) BRRD, 'extraordinary public financial support' means State aid within the meaning of Article 107(1) TFEU or any other public financial support at supra-national level, which, if provided for at national level, would constitute State aid, and is provided in order to preserve or restore the viability, liquidity or solvency of (inter alia) a credit institution (almost identical is the definition of the term in Article 3(1), point (29) SRMR).

support,[27] resort to GFSTs is subject to the following strict conditions:

First, support through GFSTs may be provided to a credit institution (only) 'in the very extraordinary situation of a systemic crisis'.[28] The wording of this definition also covers what the author defines as 'structural financial crises', during which the conditions for resolution may be met concurrently by several credit institutions due to a severe economic crisis, the causes of which are not attributable to unsound management on the part of credit institutions. It is reasonable to argue that this may become the case in some Member States during the current crisis.

Second, shareholders and creditors, including uncovered depositors, should bear losses, before taxpayers are called upon to contribute to loss absorption and recapitalization, by contributing an amount equal to at least 8 % of the total liabilities (including own funds) of the credit institution under resolution, in accordance with Articles 59-62 BRRD.[29]

Third, use of GFSTs is also conditional upon prior and final approval by the Commission under the EU State aid framework,[30] and in particular the Commission Banking

[27] ibid Article 31(2), point (c).
[28] ibid Article 37(10).
[29] ibid Article 56(1), first sentence, with reference to Article 37(10), point (a). Pursuant to Article 1, point (14)(b) BRRD II, the uncertainty as to whether or not the 8% contribution by creditors should also impact covered depositors has been resolved, by replacing in Article 37(10), point (a) the words 'eligible liabilities' with the words 'bail-inable liabilities' (this term is defined (under the amended point (71) of Article 1) to mean the liabilities and capital instruments that do not qualify as Common Equity Tier 1 (CET1), Additional Tier 1 or Tier 2 instruments of an institution and that are not excluded from the scope of the bail-in tool pursuant to Article 44(2)).
[30] ibid Article 56(1), first sentence, with reference to Article 37(10), point (b), and recital (57), second sentence. On the financing of resolution actions and

Communication of 2013, which was adopted to support measures in favor of credit institutions in the context of the global financial crisis.[31]

Fourth, GFSTs may only be used as a 'last resort', upon determination that other resolution tools[32] have been assessed and exploited to the maximum extent practicable whilst preserving financial stability.[33]

Fifth, the credit institution receiving the support must meet all three conditions for resolution and, in addition, the determination has been made that the application of regulatory tools would not suffice to avoid a 'significant adverse effect' on the financial system; to protect the public interest if emergency liquidity assistance has previously been given to the credit institution by the central bank; *or* to protect the public interest

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EU State aid rules, see Seraina Grünewald, *The Resolution of Cross-Border Banking Crises in the European Union – A Legal Study from the Perspective of Burden Sharing* (2014) (International Banking and Finance Law Series, Volume 23, Wolters Kluwer Law & Business, Kluwer Law International, The Netherlands) pp. 126-134; Agnieszka Smoleńska, 'Overview of State Aid in the Financial Sector and Bank Resolution' in World Bank Group (ed), *Understanding Bank Recovery and Resolution in the EU: A Guidebook to the BRRD* (World Bank Group, Finance & Markets, Financial Sector Advisory Center 2017) Annex 3 pp. 168-175 <documents.worldbank.org/curated/en/100781485375368909/Understanding-bank-recovery-and-resolution-in-the-EU-a-guidebook-to-the-BRRD>.

[31] [2013] OJ C 216/1. With regard to this condition, recital (57), first sentence BRRD provides that when the Commission undertakes the assessment of State aid (under Article 107 TFEU) of a GFST, it must separately assess two aspects: whether the notified GFST does not infringe any 'intrinsically linked provisions' of EU law, including those relating to the minimum loss absorption requirement of 8% under Article 37(10); and whether there is a very extraordinary situation of a systemic crisis justifying resorting to the them.

[32] In the author's view, the use of the phrase 'other resolution tools' is not appropriate, since *de facto* GFSTs are not resolution tools but rather an alternative source for resolution funding.

[33] BRRD, Article 56(3).

if public equity support has previously been given to the credit institution through the relevant tool (governed by Article 58).[34]

(2) Even though GFSTs are tailor-made for systemic crises,[35] it is very probable that their use during the current pandemic crisis will be limited, since the contribution of the private sector by application of the 'bail-in' resolution tool is present in this case as well.[36] Since GFSTs constitute a mix of bail-out with bail-in within the resolution framework established by the BRRD, the author has argued that this mix may become 'poisonous' in so far as the transfer to the private sector of Member States' holding(s) in the credit institution(s) concerned 'as soon as commercial and financial circumstances allow' may be delayed, undermining the ultimate goal of preserving private ownership in the banking system, while concurrently the (above-mentioned) negative effects of bail-in of deposits (even if only uncovered ones)[37] are present in this case as well.[38]

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[34] ibid Article 56(4). The use of GFSTs should be fiscally neutral in the medium term (ibid recital (58)). It is noted that Articles 56-58 have not been amended by the BRRD II.

[35] For a more detailed analysis of this instrument, see Christos V. Gortsos, 'A poisonous (?) mix: Bail-out of credit institutions combined with bail-in of liabilities under the BRRD – The use of 'government financial stabilization tools' (GFSTs)' (2016) Paper presented at the Workshop of the Financial and Monetary Law Working Group of the European University Institute <ssrn.com/abstract=2876508>; see Haentjens (n 16), pp. 252-254; Dieter Huber, 'The Government Stabilization Tools' in World Bank Group (ed), *Understanding Bank Recovery and Resolution in the EU: A Guidebook to the BRRD* (World Bank Group, Finance & Markets, Financial Sector Advisory Center 2017) Chapter 19 pp. 136-138 <documents.worldbank.org/curated/en/100781485375368909/Understanding-bank-recovery-and-resolution-in-the-EU-a-guidebook-to-the-BRRD>.

[36] Transposition of Articles 56-58 is a national discretion and some Member States have not made use of it.

[37] See above Section III, under (3).

[38] See Gortsos (n 35) pp. 21-22.

4.3. 'Precautionary recapitalisation'

(1) Precautionary recapitalisation of credit institutions provided for in Articles 32(4), point (d)(iii) BRRD and 18(4) SRMR is a strong candidate for the granting of public financial support amidst the current crisis.[39] In particular, the SRMR provides that, if the extraordinary public financial support required takes any of three specific forms laid down therein[40] in order to remedy a 'serious disruption' in the national economy and preserve financial stability, the resolution regime is not activated; precautionary recapitalisation is the third form thereof. Even though in principle Member States' guarantees for equity claims are in principle prohibited,[41] it is defined as support granted by means of an injection of own funds or purchase of capital instruments 'at prices and on terms that do not confer an advantage upon the credit institution'.

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[39] The analysis below is based on Article 18 SRMR, which in substance (albeit not in procedural terms) are identical to those of Article 32 BRRD. On this form of public financial support, see by mere indication Busch, Rijn and Louise (n 18) pp. 24-28 (also discussing (pp. 28-29) the case of the Italian credit institution Monte dei Paschi di Siena S.p.A.); Jens-Hinrich Binder, 'Resolution: Concepts, Requirements and Tools' in Jens-Hinrich Binder and Dalvinder Singh (eds), *Bank Resolution: The European Regime* (Oxford University Press, 2016) Chapter 2 Section 2.3.2 <ssrn.com/abstract=2499613>; Dominik Freudenthaler and Pamela Lintner, 'Conditions for Taking Resolution Action and the Adoption of a Resolution Scheme' in World Bank Group, *Understanding Bank Recovery and Resolution in the EU: A Guidebook to the BRRD* (World Bank Group, Finance & Markets, Financial Sector Advisory Center 2017) Chapter 14 104-110 <documents.worldbank.org/curated/en/100781485375368909/Understanding-bank-recovery-and-resolution-in-the-EU-a-guidebook-to-the-BRRD>. On this case of the Monte dei Paschi di Siena, see also Christos Hadjiemmanuil, 'Monte dei Paschi: A Test for the European Policy Against Bank Bailouts' (*Oxford Business Law Blog*, 2 May 2017) <www.law.ox.ac.uk/business-law-blog/blog/2017/05/monte-dei-paschi-test-european-policy-against-bank-bailouts>.

[40] SRMR, Article 18(4), first sub-paragraph, point d(i)-(iii).

[41] ibid recital (57), ninth sentence.

Precautionary recapitalisation is subject to the following strict conditions,[42] upon fulfilment of which, however, the credit institution concerned would not be deemed to be failing or likely to fail,[43] and hence the first condition for resolution would not be met:

first, the credit institution concerned must be solvent;

second, the recapitalisation must be precautionary, temporary and proportionate to remedy the consequences of the serious disruption and may not be used to offset losses that the credit institution has incurred or is likely to incur in the near future;

third, the support measures provided must be limited to injections necessary to address a capital shortfall established in stress tests, asset quality reviews or equivalent exercises conducted by the ECB, the EBA or national authorities; it is noted, however, that on 12 March the EBA decided to postpone

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[42] SRMR, Article 18(4), second sub-paragraph.

[43] A credit institution is deemed to be in such a situation if one or several of the circumstances laid down in Article 18(4), first sub-paragraph (points (a)-(d), respectively) SRMR is met. EBA, 'Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU' <www.eba.europa.eu/documents/10180/1156219/EBA-GL-2015-07_EN_GL+on+failing+or+likely+to+fail.pdf>. It further specify the first three of these circumstances, which are referred to as 'objective elements'. Their assessment is carried out in the 'Supervisory Review and Evaluation Process' (SREP), which is governed by the EBA Guidelines of 19 July 2018. EBA, 'Guidelines on the revised common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing' <eba.europa.eu/documents/10180/2282666/Revised+Guidelines+on+SREP+%28EBA-GL-2018-03%29.pdf>. These guidelines were adopted on the basis of Article 107(3) of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 of 26 June 2013 (OJ L 176, 27.6.2013, pp. 338-436, 'Capital Requirements Directive IV'[43] or CRD IV). This constitutes the clearest indication of the link between the supervisory and the resolution functions.

the 2020 EU-wide stress test exercise to 2021;[44] hence, due to this operational relief, such stress tests will not be available, at least across the board;

fourth, neither the circumstances leading to an assessment that a credit institution is failing or likely to fail nor the circumstances referred to in Article 21(1) (with regard to the exercise of the power to write down or convert capital instruments) are present at the time this public support is granted to the credit institution;[45] and

fifth, such support measures are limited to injections necessary to address a capital shortfall established in stress tests, asset quality reviews or equivalent exercises conducted by the ECB, the EBA or national authorities, if applicable, confirmed by the competent authority.[46]

Another condition is the recapitalisation's approval by the Commission under EU State aid rules, and in particular under the provisions of the 2013 Banking Communication. These include the conversion of subordinated debt into equity

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[44] See EBA, 'EBA statement on actions to mitigate the impact of COVID-19 on the EU banking sector' (12 March 2020) <eba.europa.eu/sites/default/documents/files/document_library/General%20Pages/Coronavirus/EBA%20Statement%20on%20Coronavirus.pdf>.

[45] SRMR, Article 18(4), third sub-paragraph.

[46] Such supervisory powers of the ECB are based on Article 4(1), point (f) of the SSM Regulation (Council Regulation (EU) No 1024/2013 of 15 October 2013, OJ L 287, 29.10.2013, pp. 63-89), and those of the EBA on Article 32(2) of its founding Regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010, OJ L 331, 15.12.2010, pp. 12-47), as in force. On the basis of Article 32(4) (fourth sub-paragraph) BRRD, the EBA adopted on 22 September 2014 Guidelines. See EBA, 'Guidelines on the types of tests, reviews or exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive' (22 September 2014) <www.eba.europa.eu/documents/10180/821335/EBA-GL-2014-09+%28Guidelines+on+Public+Support+Measures%29.pdf>.

('burden sharing'), unless the exception to this requirement, as laid down in point (45) of that Communication, is met.[47] This burden-sharing solution is, nevertheless, less stringent than the one under resolution with the use of GFSTs, because no contribution is required on the part of senior creditors (including uncovered depositors). Consequently, even though precautionary recapitalisation does not trigger the resolution of the credit institution concerned, it nevertheless results in a State aid case; it is different from the GFSTs regime in that respect as well, since it consists in the provision of State aid *outside the resolution framework*.

(3) In accordance with the most recent Commission's Communication of 20 March 2020 on the 'Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak', as in force,[48] the (just above-mentioned) exception laid down in point (45) of the 2013 Banking Communication is deemed to be applicable if two conditions are met: *first*, a credit institution would need extraordinary public financial support[49] in the form of liquidity,

[47] On the relation between the principle of proportionality and the application of the bail-in to subordinated debtholders in application of the Banking Communication, see Case C-526/14 *Tadej Kotnik and Others v Državni zbor Republike Slovenije* [2016] ECLI:EU:C:2016:570.

[48] *European Commission, 'Communication from the Commission Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak 2020/C 91 I/01' OJ C 91 I, 20.3.2020, pp. 1-9.* This Communication has already been amended twice: on 3 April, to extend this Temporary Framework to cover support for research, testing and production relevant in the fight against the pandemic crisis (OJ C 112I, 4.4.2020, pp. 1-9) and on 8 May 2020. See European Commission, '*Communication from the Commission* Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' <ec.europa.eu/competition/state_aid/what_is_new/sa_covid19_2nd_amendment_temporary_framework_en.pdf>.

[49] In the meaning of Article 2(1), point (28) BRRD and Article 3(1), point (29) SRMR (see above in Section 4, under B (1)).

recapitalisation or impaired asset measure *due to* this outbreak; and *second*, it is assessed that the conditions for precautionary recapitalisation are met and that such measures address problems *linked to* the outbreak.[50]

5. On the common backstop

(1) The pandemic crisis will eventually also accentuate *the* most important missing element of the framework governing EU banking resolution, namely the absence of a common backstop to the Board on the basis of Article 74 SRM.[51] This provides that the Board should contract for the SRF financial arrangements (including, if possible, public ones) regarding the immediate availability of 'additional financial means' to be used in accordance with Article 76 on the SRF's mission if the *ex-ante* and *ex-post* contributions raised under Articles 70-71 are not sufficient to meet the SRF's obligations.

(2) Even though since 1 January 2016 a 'Public Bridge Financing Arrangement' is in place,[52] which currently covers

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[50] Commission Communication (March 2020), point 7, as amended by point (17) of the (see n 48) second amendment to the Communication of 8 May.

[51] On the case for establishing this common backstop, see by way of mere indication Dirk Schoenmaker, 'On the need for a fiscal backstop to the banking system' (2014) Duisenberg School of Finance DSF Policy Paper No 44 <www.dsf.nl/wp-content/uploads/2014/10/DSF-Policy-Paper-No-44-On-the-need-for-a-fiscal-backstop-to-the-banking-system.pdf>; Dirk Schoenmaker, 'A macro approach to international bank resolution' (2017) Bruegel Policy Contribution Issue no 20 <www.bruegel.org/wp-content/uploads/2017/07/PC-20-2017-100717.pdf>; Pierre Schlosser, 'Still Looking for the Banking Union's Fiscal Backstop' in Franklin Allen, Elena Carletti, Joanna Gray and Mitu Gulati (eds), *The changing geography of finance and regulation in Europe* (European University Institute (EUI) 2017) pp. 163-178.

[52] European Council, 'Statement on Banking Union and bridge financing arrangements for the Single Resolution Fund' (8 December 2018) <www.consilium.europa.eu/en/press/press-releases/2015/12/08/ statement-

temporary financing shortfalls in the SRF through (harmonised) Loan Facility Agreements (LFAs) signed with each participating Member State, the common backstop, which on the basis of the most recent political decisions will be provided by an enhanced ESM, has not yet been established. The Euro Summit meeting of 14 December 2018 endorsed the Eurogroup's terms of reference for its operationalisation, upon the condition that sufficient progress would have been made in risk reduction, as well as the Eurogroup's term sheet on the further development, by reform, of the ESM and asked the Eurogroup to prepare, by June 2019, the necessary amendments to the ESM Treaty, including on the common backstop.[53]

However, this task has not been achieved yet,[54] even though the risk reduction measures, as envisaged in the Commission legislative 'banking package', including the SRMR II and the BRRD II[55] (as well as the CRD IV and the CRR), have already been adopted. In this respect, a major concern arises from the fact that the ESM is currently working towards establishing a 'Pandemic Crisis Support' instrument, which will become available to all euro area Member States during the pandemic

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by-28-ministers-on-banking-union-and-bridge-financing-arrangements-to-srf/>.

[53] Euro Summit meeting (14 December 2018), Statement, points 1 and 2. Euro Summit, 'Euro Summit meeting' (14 December 2018) <www.consilium.europa.eu/media/37563/20181214-euro-summit-statement.pdf>. The terms of reference and the term sheet are annexed to the Statement of the Eurogroup's Report of 4 December 2018. (available at: <www.consilium.europa.eu/media/37268/tor-backstop_041218_final_clean.pdf and <www.consilium.europa.eu/media/37267/esm-term-sheet-041218_final_clean.pdf>).

[54] See Euro Summit meeting (13 December 2019), Statement, point 2. Euro Summit, 'Euro Summit meeting' (13 December 2019) <www.consilium.europa.eu/en/press/press-releases/2019/12/13/statement-of-the-euro-summit-13-december-2019>.

[55] See above in Section 2, under (1).

crisis in order to support domestic financing of direct and indirect healthcare, cure and prevention costs related to the pandemic; access granted would be 2 % of the respective Member State's GDP as of end-2019 (i.e. up to EUR 380 billion), as a benchmark.[56] Under these conditions, the possibility cannot be excluded that the establishment of the common backstop will be further delayed.

6. Concluding remarks and modest assessments

(1) The pandemic crisis may trigger policy decisions relating to banking solvency crisis management, which in the aftermath of the global financial crisis and the euro area fiscal crisis would, in principle, not have been acceptable. The (Single Resolution) Board presented its approach in view of the uncertainty and disruption caused to the economy by the crisis, which is based on two pillars, namely preservation of financial stability and flexibility in the application of the resolution framework.[57] On the other hand, the implementation, during the crisis, of the framework relating to resolution action remains an aspect to be further analysed. It is evidently premature to assess to what extent resolution action will be undertaken in relation to credit institutions which will meet the 'failing or likely to fail' criterion, an aspect of significant concern from the end of this year onwards due to an expected rise in the rate of NPLs as a consequence of the severe economic downturn. It is also questionable whether, at least temporarily and on a generalised basis, the bail-in resolution tool will *de facto* become 'non-preferable' as an instrument in the arsenal of resolution authorities when they take resolution action because of the

[56] See Gortsos, Ch.V. (2020), *op. cit*., pp. 15-16.
[57] See Section 2 above.

amplifying effect of the tool for (already) distressed individulas and businesses in the real economy.[58]

The potential application of any of the three alternatives for the provision of public support to ailing credit institutions is also an issue of concern. In this respect, of particular interest is whether the conditions for resorting to precautionary recapitalisation will be interpreted in a flexible (and hence broader) way in order to accommodate to the needs arising amidst the current crisis.[59] Finally, it is noted that the adoption of the common backstop to the Board for the SRF,[60] which is long overdue, may be further delayed due to the primary focus of the ESM on the operationalisation of the 'Pandemic Crisis Support' instrument, which will absorb a significant amount of its funds (estimated to a least EUR 380 billion). This would be regrettable, since the existence of this backstop may prove extremely imperative in the forthcoming turbulent months (and especially by next year).

(2) The author takes as a given that the ultimate public policy objective, namely the preservation of financial stability, should not (and is not expected to) be compromised. Taking into account the existing set of tools available in order to achieve that goal and considering that any major amendments to the relevant existing regulatory framework, even if those were to be considered appropriate, will not take place at least in the medium term, he argues that the effectiveness of policy reaction under the current conditions will be tested against one benchmark: how the triggers embedded in the framework to activate these tools will be used, in view of the necessary flexibility that has to be (and is being) applied. The burden falls

[58] See Section 3 above.
[59] See Section 4 above.
[60] See Section 5 above.

both on banking supervisory authorities, which will have to make appropriate use of all their supervisory and early intervention powers, including their powers in relation to mergers and acquisitions in the banking sector, and adequately assess the occurrence of ‘failing or likely to fail’ conditions, as well as on banking resolution authorities, which will have to take delicate decisions once the first resolution condition is met by credit institutions (on top of their power to make this determination themselves).

The duration of the pandemic crisis, which in contrast to the global financial crisis of 2007-2009 was undoubtedly not triggered by the financial system, and its economic impact cannot be determined as yet, given that we are currently just in its first phase and there seem to be several ‘unknown unknowns’. However, it is quite reasonable to consider that in the medium-term (and probably no longer) it may have a heavy negative impact on the banking sector (on a global scale, and not only in the EU) and lead to extensive corporate restructurings therein.

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12 Lending activity in the time of coronavirus

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TOC: 1. Preface – 2. The most relevant measures adopted by national legislators within the Commission's legal framework on State aid – 3. The measures adopted by regulators and supervisory authorities (Basel Committee, EBA, ECB) – 4. The exceptional rules to cope with COVID-19 crisis did not result in a radical change in the bank's lending policies - 5. Conclusion: We need a European vehicle to manage bad loans and more flexible rules

1. Preface

At the dawn of the COVID-19 crisis, many national legislators and European institutions approved measures that have a significant impact on banking activity to cope with the crisis.

The regulatory initiatives adopted by the European authorities (DG-Competition, EBA and ECB) and national legislators aim at pursuing objectives which are not always easy to reconcile: sustaining business activities that are suffering a prolonged lockdown and guaranteeing financial stability.

The objective to support firms is at centre stage of the many initiatives taken by European authorities and national governments to mitigate the negative impact on the economy of the coronavirus contagion. Indeed, lockdowns of firms and the dramatic decline of the product demand due to the majority of customers forced to stay at home in compliance with public

[1] The cut-off date for information included in this article is 19 May 2020.

orders involve both supply and demand shocks. It will lead to an economic fallout that many economists deem will be the worst recession since the Great Depression the world experienced in the 1930s.

Within this context, politicians, commentators and authorities are aware of the crucial role of the banking system. Indeed, on the one hand, the reduction of credit due to the doubts of banks over debtors' ability to repay their obligations could amplify the negative effects of the supply and demand shocks. On the other hand, ensuring enough credit lines to firms, small businesses as well as corporations, may mitigate the effects of an economic downturn. Banks are called upon to carry out traditional banking business, which is essential for the well-functioning of modern economic systems. Despite this, we cannot disregard the fact that lending activity has always been a very difficult job, most notably in times of recession. Furthermore, only a decade from the last global financial crisis has passed and banks have not yet completed their balance-sheets repairs, notwithstanding the progress in the reduction of the total amount of the non-performing loans.[2]

Against this background, the paper will try to understand strengths and weaknesses of the legal provisions adopted by European and national legislators and measures approved by authorities to favour banks' financial support for industrial companies.

Four legal sources are relevant: decrees enacted by national Governments granting the ailing firms moratoriums of payments on instalments and interest for loans and States'

[2] See EC, 'Communication from the Commission - Fourth Progress Report on the reduction of non-performing loans and further risk reduction in the Banking Union' (Communication) COM(2019) 278 final.

guarantees on new loans made; decisions of the DG Competition of the EU Commission taken under the Temporary Framework for State aid measures to support the economy during the current COVID-19 outbreak (2020/C 91 I/01), approving State aids measures adopted by Member States to remedy a serious disturbance in the economy of a Member State (in line with Article 107(3)(b) TFEU); regulatory authorities' (Basel Committee and EBA) explanations and guidelines providing clarity to banks and consumers on the application of prudential and supervisory measures to support lending to the real economy; and ECB 'Banking Supervision temporary capital, liquidity and operational relief measures' to ensure that significant institutions are able to continue to support the real economy.

This paper is divided in five sections. After this introduction, section two is dedicated to the description of the measures established by the national governments taken in accordance with the temporary framework on State aid approved by the European Commission. Section three reviews the measures taken by regulators and supervisors, distinguishing between actions aimed at removing regulatory obstacles that could prevent national aid measures from being fully effective and supervisory measures aimed at allowing banks to have wider margins to grant credit. Section four provides a first assessment of the potential impact of all the governments and authorities initiatives. Section five concludes with two proposals for the time when the peak of the COVID-19 crisis will have passed but the banking system will have to wade through the unchartered waters of a global recession.

2. The most relevant measures adopted by national legislators within the Commission's legal framework on State aid

Three tools have been adopted by a large number of Member States: moratoriums on existing loans, State guarantees on new loans granted by banks and subsidised interest rates for new loans channelled through credit institutions or other public financial institutions.

The measures are tailored to face the liquidity needs of those undertakings forced into unexpected lockdown of their business activities, in compliance with the limits established by the EU Commission within the State Aid Temporary Framework. The Framework clearly establishes this objective: 'Well-targeted public support is needed to ensure that sufficient liquidity remains available in the markets, to counter the damage inflicted on healthy undertakings and to preserve the continuity of economic activity during and after the COVID-19 outbreak.' Although the guarantee may relate to both investment and working capital loans, there are stringent limits to the loan amounts with a maturity beyond 31 December 2020. Less stringent limits to the amounts of the guaranteed loans are established only for a loan with a shorter maturity, namely until 31 December 2020. Another limit is the duration of the guarantee (at a maximum of six years). Moreover, the guarantee may be granted to undertakings that were not in difficulty on 31 December 2019, but that faced difficulties or entered into difficulty thereafter as a result of the COVID-19 outbreak. Similar limits are provided for aid in the form of subsidised interest rates for loans.

The limits are reasonable considering the need to respect the severe parameters set out by the Commission in order to avoid the distortion of the correct functioning of the common market.

The exclusion of firms 'in difficulty' seems to be particularly appropriate, considering the legal notion of firms in difficulty referred to in the Temporary Framework.[3] Firms in difficulty are indeed companies where more than half of their capital, as shown in the company accounts, has disappeared as a result of accumulated losses or undertakings subject to collective insolvency proceedings or who fulfil the criteria under their domestic law for being placed in collective insolvency proceedings at the request of their creditors.

Is the role of banks in this context limited to channelling State aid to firms? To answer this question a careful reading of the Commission's communication on the Temporary Framework is useful. The Commission expressly states that the aid in the form of public guarantees and reduced interest rates through credit institutions is directly targeted at undertakings facing a sudden liquidity shortage. Nevertheless, the aid may also constitute an indirect advantage to the credit institutions and for this reason, the Commission adds that it is appropriate to introduce certain safeguards in relation to the possible indirect aid in favour of the credit institutions to limit undue distortions to competition. In any case, because such indirect aid does not have the objective of preserving or restoring the viability, liquidity or solvency of the credit institutions, it cannot be considered an extraordinary financial support according to the BRRD (Bank Recovery and Resolution Directive; 2014/59) which would trigger the resolution of banks. This part of the Communication shows the Commission's awareness that the specific function conferred upon banks by the national Governments overlaps

[3] In difficulty within the meaning of the General Block Exemption Regulation as defined in Article 2 (18) of the Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty, OJ L 187 of 26.6.2014, p. 1.

with their typical job of financing businesses. On the one hand, banks replace the public administration in verifying whether firms meet the conditions established by law to obtain the State-guaranteed loans and, on the other hand, they carry out their normal business, that is, granting credit to firms. The combination of the two functions may give rise to distortions in the bank's performance. Should banks also consider the creditworthiness of the firm to grant the loan or should they only rely on the existing public guarantees? If the first option is the correct interpretation of the law, banks would be required to conduct a very complex assessment, which may cause a time lag not compatible with the need of liquidity of firms. In the second case, banks would be put in an awkward situation because, in the case where the loan is not reimbursed, notwithstanding the public guarantee there could be a negative impact on the bank's balance sheets (see on this point section 3).

The extraordinary measures described above have a short-time horizon. But the effects of the pandemic on the economic system are likely to have long-term effects. Indeed, in the short term the legislative provisions enacted by many Governments to support households and firms, like moratoriums and suspensions of mortgage payments for the purchase of houses as well as interventions to support household incomes and business continuity of companies, will have the effect of containing, even to a significant extent, the flow of impaired loans. In the medium term, credit quality will depend on the duration of the recession and the speed of the recovery. Banks that have provided liquidity to companies, assisted by the State guarantee, will not be able to abruptly cut the granted credit lines which will have to be valued both from an accounting

point of view and from the point of view of capital provisions according to the normal supervisory rules.

3. The measures adopted by regulatory and supervisory authorities (Basel Committee, EBA, ECB)

To gain a better picture of the measures adopted by the regulatory and supervisory authorities it is important to have a deeper understanding, firstly, of the interplay of these measures with those established by governments in the short term and, secondly, what the impact of the decisions of supervisory authorities could be over the medium-long term for banks.

The Basel Committee, the European Banking Authority (EBA) and the ECB produced documents, guidelines and adopted specific rules to assess the impact of the measures implemented by governments based on the current regulatory framework and to establish temporary capital, liquidity and operational relief measures to banks to boost their capacity to finance the economic system.

In April 2020, the Basel Committee published a document entitled 'Measures to reflect the impact of COVID-19', aimed at interpreting the impact of extraordinary measures to alleviate the financial and economic impact of the COVID-19 fallout on the current legal framework. In this context, 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. To this end the Committee clarified that when determining a bank's credit risk requirement for loans that are subject to sovereign guarantees, the relevant sovereign risk weight should be used (that differentiates sovereigns according

to the rating for debt securities). Then banks calculating their capital requirements should take account of the risk-mitigating effect of the collateral, according to the general principles established by the Accord (CRE22 and CRE32of the Basel Framework). Furthermore, the Committee, premising that the Basel Framework applies higher capital requirements to loans that are categorised as past due or defaulted, has agreed that payment moratorium periods (public or granted by banks on a voluntary basis) relating to the COVID-19 outbreak can be excluded by banks from the counting of days past due loans (if payments on the loans are past due by more than 90 days). In addition, Basel Committee recommended that banks which have not yet done so make use of the transitional regime introduced with the entry into force of IFRS 9, provided precisely for the purpose of mitigating the impact on the regulatory capital of unexpected events. This transitional regulation has also been modified by the Basel Committee to allow jurisdictions that want to make use of it to dilute the impacts of the new value adjustments over a longer period and with more favorable mechanisms than those currently envisaged. To be implemented in Europe, this modification will require an intervention to the Regulation governing the prudential requirements of banks and investment firms (Regulation (EU) No. 575/2013).[4]

During the months of March and April, the EBA published several communications calling upon the competent authorities to make use of the full flexibility provided for in the existing regulation and to establish guidelines containing a number of interpretative aspects on the functioning of the prudential

[4] See Paolo Angelini, Giorgio Gobbi, *Hearing of the Bank of Italy before the Parliamentary Commission of Inquiry into the banking and financial system*, 15 April 2020.

framework in relation to the classification of loans in default, the identification of forborne exposures, and their accounting treatment.

The EBA clarified that generalised payment delays due to legislative initiatives and addressed to all borrowers do not lead to any automatic classification in default, forborne or unlikely to pay. Individual assessments of the likeliness of repayment should be prioritised. Furthermore, the EBA made clear that payment moratoriums do not trigger classification as forbearance or distressed restructuring if the measures taken are based on the applicable national law or on an industry or sector-wide private initiative agreed and applied broadly by the relevant credit institutions. Anyway, guidelines recall that institutions must continue to adequately identify those situations where borrowers may face longer-term financial difficulties and classify exposures in accordance with the existing regulation. The requirements for identification of forborne exposures and defaulted obligors remain in place. The EBA also highlighted that when applying the IFRS 9 international accounting standard, institutions are expected to use a certain degree of judgement and distinguish between borrowers whose credit standing would not be significantly affected by the current situation in the long term, and those who would be unlikely to restore their creditworthiness.

The EBA approach establishing to what extent the application of national laws imposing a payment moratorium could have an impact on the classification of exposures seems rather conservative. The governmental measures are only an element that banks should take into account when classifying exposure and their accounting treatment. Banks are not exempt from

ordinary assessments on the probability of repayment of loans and on the creditworthiness of the companies financed.

On 12 March 2020 the ECB announced 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. Some of these measures are complementary to those taken by governments to ensure that they are fully effective without encountering obstacles in the current constraints established by the prudential regulation of banks. To this end, the ECB has introduced supervisory flexibility regarding the treatment of non-performing loans (NPLs), in particular to allow banks to fully benefit from guarantees and moratoriums put in place by public authorities to tackle the current distress.

First, the ECB declared that, on a temporary basis, it will exercise flexibility regarding the classification of debtors as 'unlikely to pay' when banks call on public guarantees granted in the COVID-19 pandemic context. The ECB will also exercise a certain amount of flexibility regarding loans under COVID-19 related public moratoriums. Second, loans which become non-performing and are under public guarantees will benefit from preferential prudential treatment in terms of supervisory expectations about loss provisioning. The decisions adopted by the ECB allow the measures established by the national Governments to unfold their effects to the maximum extent. Nevertheless, the supervisory actions point out that the moratoriums on the repayment of loans have only a limited and temporary effect on the classification of loans according to the rules on *non-performing loans*. Therefore, the risks do not disappear from bank balance sheets due to the magic wand contained in the measures adopted by national governments. The latter measures have the effect, as a result of the suspension

of payments, of postponing the correct classification of the receivables; on the other hand, the public guarantee mitigate the impact on the banks' assets of a possible failure of borrowers to repay the loans guaranteed by the States in the peak of the coronavirus crisis.

Moreover, in the short term, supervisory authorities have 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 will benefit from relief in terms of the composition of capital for Pillar 2 requirements. Furthermore, banks are allowed to operate temporarily below the level of capital defined by the Pillar 2 guidance and the capital conservation buffer.

One last recommendation to banks from the ECB tries to balance the need to favour the capacity of banks to finance the real sector with the need to preserve the robustness of the bank's capital. Indeed, on 27 March 2020, the ECB updated its recommendation to banks on dividend distributions. To boost banks' capacity to absorb losses and support lending to households, small businesses and corporations during the COVID-19 pandemic, they should not pay dividends for the financial years 2019 and 2020 until at least October 1, 2020.

It is very difficult to forecast the impact that this crisis could have on the stability of the banking system. In any case, the ECB underlined that in the medium-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 a certain degree of flexibility is acceptable - indeed necessary -

in extraordinary times, but it cannot become the standard in ordinary times.

4. The exceptional rules to cope with COVID-19 crisis did not result in a radical change in the banks' lending policies

To summarize, regulatory and supervisory authorities adopted a wide range of flexibility in applying regulatory standards and in interpreting the impact of government measures in terms of risk-reducing effect for accounting purposes and capital requirements.

Despite this effort, an overview of the rules issued by governments, by the Commission for State aid and by supervisors does not suggest that banks' activity has changed radically as compared to the past. Banks could apply more flexible classification and accounting standards to assess the probability of default of firms; the measures relaxing capital constraints enlarge banks' possibilities to expand credit lines to firms. Public guarantees do not transform banks into a mere channel for making financial resources available to companies. The bank's lending activities remains based on the assessment of the creditworthiness of the firm financed.

Even in the time of COVID-19, the granting of credit must be based on verification of the firm's ability to repay the loan. The assessment of the impact, both in the short-term and in the medium-term, of the forced lockdown caused by COVID-19 and of what may happen going forward on the capacity of the firm's recovery remains with the bank.

This interpretation limits the capacity of the extraordinary aid measures taken by governments to face the firm's liquidity shortfall, but reduces the risk that the industrial crisis will be

transmitted to banks with dramatic consequences in terms of financial stability. The recession will in any case have an impact on financial stability in the medium term, but to cope with this problem, namely the large amount of non-performing loans as a result of the COVID-19 crisis, we need to study extraordinary tools that should be put in place at the European level (see next section).

The answer to the firm's request to get available financial resources in a short time, however, is not to make the banks the government's *longa manus*. On the contrary, banks should have strong incentives to carry out their business in the most efficient way, reducing the bureaucratic burdens in granting credit and focusing on assessing the economic prospects of the company financed in the medium and long-term. To boost economic growth in the European market, where bank-oriented systems prevail, it is crucial that banks will establish '…long-term stable relationships with the companies financed which on the one hand target the medium-term profitability of the companies and on the other can benefit from reliable information from the latter'.[5]

5. Conclusion: We need an European vehicle to manage bad loans and more flexible rules

The euro area banking market has been integrated to some degree, although this process involved to a limited extent the retail banking sector. Therefore, we need to find a European

[5] Ignazio Angeloni, 'ECB should turn to the supervisory forbearance' (March 2020) LUISS SEP Policy Briefs 7/2020 <sep.luiss.it/sites/sep.luiss.it/files/ECB%20should%20turn%20to%20supervisory%20forbearance.pdf>.

solution to cope with the dramatic increase of the level of non-performing loans (NPLs) to which the recession following the COVID-19 crisis will undoubtedly give rise. However, the public interventions described above to mitigate the negative impact on the economy of the COVID-19 crisis have been arranged at the national level, although authorised by the Commission under the Temporary Framework for State aid.

In 2017, the European Commission and the Council recognised the need to set up an action plan for NPLs in Europe.[6] On July 11, 2017, the Council agreed that measures to address existing stocks of NPLs and prevent a further accumulation of NPLs in the future would be beneficial for the EU as a whole. However, due to the large variation within the EU of ratio of NPLs to total bank loans, the European institutions did not find the way to a compromise on a European mechanism to tackle this issue. The case for action to develop an efficient secondary market in Europe for NPL transactions was very clearly highlighted, but no Pan-European solution was proposed.[7]

The need for a comprehensive response to clean up legacy assets of the 2007-2009 global crisis has already been supported in 2017 in a paper signed, inter alia, by the Chair of the EBA and two other staff members of the EBA. The paper proposed a possible European scheme, which could have consisted of a single Asset Management Company (AMC), or of a coordinated blueprint for government-sponsored AMCs. Banks could have transferred some agreed segments of their NPLs to the AMC at their 'real economic value,' different from their 'market value,'

[6] Council of the European Union, 'Report of the FSC Subgroup on Non-Performing Loans' 9854/17 EF 113 ECOFIN 481.

[7] See Emilios Avoguelas 'The EU Framework dealing with non-performing exposures. Legal and economic analysis, in Danny Bush and Guido Ferrarini (eds.) *Banking Union* (2nd ed., OUP 2020).

under due diligence from the AMC and accompanied by full data sets available to potential investors. Aimed at addressing the inter-temporal pricing problem by overcoming market liquidity issues, the proposal provided a mechanism to ensure that if the 'real economic value' would have not been achieved within a limited timeframe or the assets would have remained unsold, the bank would have taken the full market price hit.

Considering the upcoming recession that will follow the COVID-19 pandemic, the need to address the issue of the burden of NPLs in the banks' balance sheet is urgent. This time, the different degree of legacy issues (namely, related to the level of non-performing loans) present in the various national banking systems cannot be an obstacle to the process of setting up a solution at the European level. As noted in other fields, such as that of medical research for a vaccine, pandemics require collective action. National responses, i.e. State aid to the national banking sector, will not be enough to limit the impact of the recession that will affect the European banking market as a whole, although not in a homogenous manner, and to preserve financial stability.

For these reasons, I believe it would be very useful to develop the proposal elaborated in 2017 at the EBA to set up at the European level an asset management company (European Asset Management Company – EAMC) to acquire and manage a large amount of non-performing loans from European banks with a long-term recovery prospective. The company's capital could be provided by a European public entity (in the case it will be set up, by the Recovery Fund currently on the Commission's table); more financial resources could be collected on the market through the issue of long-term securities. This vehicle, not aiming at short-term profit prospectives, could offer to banks wishing to sell packages of bad loans conditions which

are more advantageous than those that could be offered by a private company. Technical aspects of the proposal regarding the price of the assets transfer or regarding a mechanism to limit future potential losses for the EAMC, as well as contractual arrangements to avoid the mutualisation or risk sharing, could be further detailed.

Considering that the mechanism envisaged implies public support to the banks due to the difference between the market prices and the prices at which the assets will be transferred to the EAMC, two more issues should be discussed: the application of the Bank Recovery and Resolution Directive (BRRD) and the application of the State aid control.

On the first issue, the BRRD clearly establishes that a credit institution shall be deemed as failing or likely to fail if extraordinary public financial support is required (article 32(4). Considering that article 32(4) of the BRRD refers to an extraordinary financing directed at a specific institution and not at a public intervention from which a significant number of intermediaries can benefit, we can exclude the application of that rule to the transfer of assets to the EAMC. In addition, mechanisms to exclude insolvent banks from the EAMC's scope of operation can be established.

On the second issue, we believe that the integration process made in Europe requires a reflection on the application of the State aid rules. In particular, European lawmakers should discuss the need for severe application of the State aid control framework in the case of the use of European financial resources, decided at the European level to deal with a threat to the financial stability of the European market. European bodies are institutionally free from national bias, and hence do not require a specific State aid control, such as that in place to prevent Member States from distorting the level playing field in

the euro area. The European legislature has not given much weight to this issue so far. Indeed, even in the case of financial assistance provided by the ESM for the recapitalization of a financial institution of an ESM Member State, according to current rules, it shall be provided in accordance with State aid provisions (Article 15 of the ESM Treaty) even though the intervention is decided by a European body. That is, because it 'is indispensable to safeguard the financial stability of the euro area as a whole and of its Member States' (Article 3 of the ESM Treaty). The need for collective European action required by the coronavirus crisis makes a new approach on State aid controls urgent. This perspective will facilitate the setting up of a European vehicle to manage NPLs.

The second weakness emerging from the legal picture described in the previous section is that the coronavirus pandemic exacerbates a problem already embedded in the EU legal sources regulating banking activity: the lack of flexibility of the rules due to the choice of the European legislature to fix, at the legislative level, a detailed framework for prudential supervisory purposes. This is a crucial point, which delays the prompt adaptation of prudential rules to crisis situations, aimed at mitigating their pro-cyclical nature. Two examples are helpful to clarify the problem.

A first significant case, already mentioned above, concerns the transitional regime introduced with the entry into force of IFRS 9, provided precisely for the purpose of mitigating the impact on the regulatory capital of unexpected events. The Basel Committee's proposal to dilute the impacts of the new value adjustments over a longer period and with a more favorable mechanism than those currently envisaged, in Europe it requires amendments to Capital Requirement Regulation (Reg. 575/2013). The second relevant case is that of the new

framework for the prudential treatment of NPLs. The Council decided 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, amending Regulation (EU) 575/2013. The same standards were established by the ECB few months earlier within a Guidance to banks. Should the COVID-19 crisis require some degree of flexibility in the application of these standards, the ECB guidelines could quickly change, while Regulation 575 requires a long process of reform involving the Commission, Council and European Parliament.

Precisely for the reasons outlined above, on 28 April 2020 the Commission proposed a few targeted ‘quick fix’ amendments to the EU’s banking prudential rules (the Capital Requirements Regulation) in order to maximise the banks’ ability to lend and absorb losses related to the coronavirus pandemic. The Commission proposed 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, by treating public guarantees granted during this crisis more favourably, by postponing the date of application of the leverage ratio buffer and by modifying the way of excluding certain exposures from the calculation of the leverage ratio.

What does ‘quick fix’ mean? How long will the process to approve these amendments to the current legal framework take? The ‘quick’ reaction from the Commission, in its role as legislator, is very welcome, but it highlights how difficult it is to adapt the current regulatory framework very rapidly to changes that can suddenly and unexpectedly occur in the real economy, as is the case with the COVID-19 crisis. Having

inflexible rules codified by law, meaning within the European legal framework directives and Council Regulations, will help to achieve a level playing field among different legal and market systems. But they also create obstacles, which can be hard to overcome, when there is the need, as is the case of the current crisis, to adapt the rules to new scenarios. The use of delegated legal acts to establish a detailed regulatory picture and an extensive use of the interpretative powers of European authorities, like the EBA, will favour a more flexible legal framework that will grant regulatory authorities the possibility to promptly react to crises such as the one we are currently experiencing.

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SECTION IV: CAPITAL MARKETS REGULATION

13 Emergency measures for equity trading: the case against short-selling bans and stock exchange shutdowns

Luca Enriques & Marco Pagano[1]

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.[2] During the financial crises of 2008-09 and 2011-12, these pressures led to the adoption of short-selling bans. During the present crisis, a number of European national securities regulators, with the approval of the European Securities and

[1] The cut-off date for information included in this article is 19 May 2020.

[2] See Luca Enriques, 'Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View', (2009) 4 University of Pennsylvania Journal of International Law 1147-51.

Markets Authority (ESMA), reinstated such bans.[3] 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.[4] 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 sale?

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 a 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 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-

[3] See *infra* n 13.

[4] See Alexandra Andhov, 'Covid-19: Should We Close Stock Exchanges?' (Oxford Business Law Blog, 24 April 2020) <www.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) <www.bloomberg.com/news/newsletters/2020-03-27/money-stuff-everyone-could-use-a-little-break> (discussing the issue).

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. More recently, during the sovereign debt crisis of 2011-12, regulators in most eurozone countries have 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 destabilising 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'.[5] 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'.[6] Similarly, in 2012 the Spanish stock market regulator (CNMV) explained its decision to retain the ban introduced in 2011 arguing that '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

[5] SEC, 'SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets', SEC Press Release 2008-211 (19 September 2008) <www.sec.gov/news/press/2008/2008-211.htm>.

[6] FSA, 'Short Selling', Discussion Paper 09/1 (February 2009) <www.sbai.org/wp-content/uploads/2016/04/fsa_short_ selling_2009.pdf>.

markets'.[7] 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 destabilise 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 and, hence, we avoid the destabilising 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 also to try to calculate such true valuations, so as to buy undervalued securities and sell overvalued ones. But 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 from preventing 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 make banks more stable. In a 2013 article by one of us and Alessandro Beber,[8] we analysed daily data on 16,491 shares in 30 countries between January 2008 and June 2009. Our results

[7] 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) <www.cnmv.es/loultimo/prorroga%201%20nov_en.pdf>.

[8] Alessandro Beber and Marco Pagano, 'Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis' (2013) 68 Journal of Finance 343.

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.[9]

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-sale bans are estimated to be even

[9] Alessandro Beber, Daniela Fabbri, Marco Pagano and Saverio Simonelli, 'Short-Selling Bans and Bank Stability' (January 2018) ESRB Working Paper Series No 64 <ssrn.com/abstract=2710371>.

more destabilising for the financial institutions whose share are banned.

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. 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 suppresses not only the negative information that short-sellers initially bring to the market but also the positive one 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 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, and also on this account price discovery will be impaired.

The conclusion is therefore well summarised 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 financials) 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 for three months, while other regulators started with a one-month ban and extended it for another month before it elapsed.[12] As required by the Short-Selling Regulation,[13] ESMA authorised all of the bans[14] and, prior to that, temporarily

[10] Rachelle Younglai, 'SEC Chief Has Regrets over Short-selling Ban' (Reuters, 31 December 2008) <www.reuters.com/article/us-sec-cox/sec-chief-has-regrets-over-short-selling-ban-idUSTRE4BU3GG20081231>.

[11] See Philip Stafford, Laurence Fletcher, and David Keohane, 'Europe Extends Short-Selling Bans despite Hedge Fund Pressure' *Financial Times* (15 April 2020) <www.ft.com/content/d615a15d-c524-4383-b829-4f1a244db28a>.

[12] ibid.

[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), Art. 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) <www.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) <www.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) <www.esma.europa.eu/press-news/esma-news/esma-issues-positive-opinions-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

required holders of net short positions in shares traded on a European Union regulated market to notify the relevant national competent authority if the position reaches or exceeds 0.1 % of the issued share capital after the entry into force of the decision.[15] By raising the costs of holding a net short position of that size, such 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. A bunch of men shouting and feverishly passing each other sheets of papers[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

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Financial Securities and Markets Authority under Section 1 of Chapter V of Regulation (EU) No 236/2012' (18 March 2020) <www.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) <www.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) <www.esma.europa.eu/press-news/esma-news/esma-requires-net-short-position-holders-report-positions-01-and-above>.

[16] As famously epitomised in the orange juice futures trading scene at the end of *Trading Places* (see <www.youtube.com/watch?v= obAoPP1bdIM>).

[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 eg Steven Zeitchik, 'With Stock-exchange Floor Closed, Traders and Investors Grapple with Uncertainty' *Washington Post* (8 April 2020)

trading shares is panic selling. Is that an even better reason for shutting down stock markets, as, among others, some high-profile Italians politicians suggested in March 2020?

Reassuringly, back then the Italian Government ignored the suggestion and the Italian securities regulator, Consob, 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 that of shares. Think of an investor who holds both Italian equity and Italian Treasury bonds in their portfolio. If they assume that, COVID-19 will 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 want to reduce their exposure to the country. And if they were not allowed to sell the equity, to compensate for that they would sell more Treasury bonds, thereby contributing to the rise in their interest rate. Should Italy then also ban Treasury bond trading? Treasury bonds are traded outside Italy as well. A shutdown limited to domestic trading venues would only drain the bonds'

<www.washingtonpost.com/business/2020/04/08/with-stock-exchange-floor-closed-traders-investors-grapple-with-uncertainty/>.

[19] Consob, Press Release (9 March 2020) <www.consob.it/web/consob-and-its-activities/news-in-detail/-/asset_publisher/kcxlUuOyjO9x/content/ press-release-9-march-2020-hp/718268>.

liquidity and hence make it more onerous for the state to issue new bonds (something the Italian state does every few weeks). It would thus lead to the Government (hence, Italian taxpayers) having to pay higher interest rates in the attempt of stopping downward speculative pressures on the equity market. To put it another way, an attempt to curb the losses of the minority of Italian citizens who are invested in shares[20] would be 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 have bought shares directly but also for those who have done so via mutual funds: how can an asset manager accept withdrawal requests if it cannot sell the assets in the fund's portfolio and it is impossible to determine their value? In all likelihood, the asset manager would make use of its 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. In the present circumstances, for how long should stock exchanges be closed? The problem being coronavirus, a few days would make no difference, as the experience in Sri Lanka and the Philippines in mid-March showed.[21] Should they

[20] The Italian pension system is pay-as-you-go and Italian pension funds' exposure to Italian equity at the end of 2018 was negligible (€1.2 billion) (COVIP, Relazione per l'anno 2018 (2019) 9, <www.covip.it/?cat=35>), or 0.22 percent of the Italian stock exchange capitalization at the same date (source: <www.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

stay closed until the end of lockdowns? Until levels of economic uncertainty go back to 'normal'?[22]

To have an impact, stock exchange shutdowns would likely have to go on for weeks and weeks. If you suppress investors' liquidity needs for such a long period, the downward pressure once the stock exchange reopens will be even stronger. Worse, were the stock exchange shutdown not to involve all or a great majority of world stock exchanges (which is highly unlikely), the precedent would be established that the stock exchange of a given country may shut down for weeks in the case of an emergency: investors, both domestic and offshore, would have to factor in a new kind of illiquidity risk, which will make it less attractive to hold shares listed on that stock exchange and will, therefore, require investors to rebalance their portfolios. Again, when 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

Pandemic', *South China Morning Post* (24 March 2020) <www.scmp.com/business/markets/article/3076643/trade-or-halt-vexing-question-confounding-global-markets-stock> (reporting that the Colombo and the Manila stock exchanges shut down for a few days in mid-March and recorded heavy losses on the day the reopened).

[22] At the time of post-Lehman temporary bans on short-selling (2008-09), Consob's commissioners were convened, before they elapsed, to decide whether to extend them. They repeatedly renewed them, in the fear that, otherwise, Consob would be held politically liable should downward pressures on prices resume. The dynamics will be the same today for countries that have introduced temporary short-selling bans and would be the same for those that shut down markets altogether. It is, or would be, difficult for securities regulators, should positive developments in the fight against the virus and in economic conditions not materialise soon enough (as everyone hopes), to decide that short-selling, or trading altogether, should resume. Hence, political considerations play against a rapid return to trading rules normality.

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's clarified,[23] individual regulators in Europe lack the power to shut down an entire stock exchange. Even a shutdown through an emergency law by a national Government would be unlikely to apply to trading activity on trading venues, where that country's shares could well continue trading: an extraterritorial ban would likely be against EU rules, impossible to enforce, or 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.

[23] See Consob (n 19).

As regards both short-selling bans and stock exchange shutdowns, the old saw ‘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 fashion he would be making money out of the misfortune of his patients?

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14 Restrictions on Shareholder's Distribution in the COVID-19 Crisis: Insights on Corporate Purposes

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1. General overview

In this period of crisis, there have been a number of different types of interventions as well as pressure towards companies aimed at discouraging, and even prohibiting, dividends distribution and shares buyback.

Such a tendency, although with different forms and modalities, has similarly emerged in almost every jurisdiction and has involved any economic sector, including, with some peculiarities, banks, insurance companies and, more in general, financial intermediaries subject to prudential supervision.

By looking at the different measures adopted so far, it is firstly worth highlighting that in the legislative acts which have been passed to support enterprises, it is often requested that if the companies requiring the aid overcome a dimensional threshold,

[1] The cut-off date for information included in this article is 7 May 2020.

they shall not distribute capital to their shareholders. This is the case for the acts adopted in many EU Member States (e.g. Italy[2], France[3], Germany[4]) as well as in the United States[5]. Despite some differences concerning the forms of the public support which is provided to access credit facilities, such acts are similar in that the possibility to benefit from these facilities is subject to the requiring companies' explicit commitment to avoid any dividends distribution and shares buyback for a certain period.

Secondly, even companies that have not requested public support, nevertheless, have been significantly pressured to suspend shareholders' distributions both in the form of dividend payouts and shares buyback. Particularly, such pressure has emerged on the markets after that a number of institutional

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[2] See art. 2, par. 1, lett. i), *Decreto Legge* 8 April 2020 no. 23 on '*Misure urgenti in materia di accesso al credito e di adempimenti fiscali per le imprese, di poteri speciali nei settori strategici, nonché interventi in materia di salute e lavoro, di proroga di termini amministrativi e processuali*' <www.gazzettaufficiale.it/eli/id/2020/04/08/20G00043/sg>.

[3] See the official document by the French government, '*Engagement de responsabilité pour les grandes entreprises bénéficiant de mesures de soutien en trésorerie*' <www.economie.gouv.fr/files/files/PDF/2020/covid-faq-termes-references-dividendes.pdf>, regarding the requests for public financial support under *Loi* no. 2020-289 of 23 March 2020 on '*Finances rectificative pour 2020*' <www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000041746298&dateTexte=&categorieLien=id>. See also Arrêté of 23 March 2020 'accordant la garantie de l'Etat aux établissements de crédit et sociétés de financement en application de l'article 6 de la loi n° 2020-289 du 23 mars 2020 de finances rectificative pour 2020'<www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000041746813&dateTexte=20200409>.

[4] See § 25, par. 3, *Gesetz zur Errichtung eines Wirtschaftsstabilisierungsfonds (Wirtschaftsstabilisierungsfondsgesetz – WStFG)* of 27 March 2020, <www.bgbl.de/xaver/bgbl/start.xav#__bgbl__%2F%2F*%5B%40attr_id%3D%27bgbl120s0543.pdf%27%5D__1588781504703>.

[5] See Title IV, Subtitle A, sec. (4003), H.R.748 'The Coronavirus Aid, Relief, and Economic Security (CARES) Act' – Public Law no. 116-136 of 27 March 2020, <www.congress.gov/bill/116th-congress/house-bill/748>.

investors pushed listed companies to reconsider the dividends distribution proposals, which they had prepared before the outbreak of the pandemic, in light of the prevailing interest to preserve capital integrity. Many companies, therefore, have decided to align with these expectations[6], by withdrawing or amending the dividends distribution proposals that had been previously put forward. In contrast, the companies that decided to proceed with dividends distribution anyway had to face criticism and justify their choice to the market[7].

Lastly, with regard to companies operating in the European Union financial sector, particularly banks and insurance companies, the pressure to avoid dividends distribution and shares buyback has been advanced by several authorities, which, without formally introducing a legal ban, have either recommended careful attention in so doing or explicitly encouraged to suspend at least temporarily any decision thereof. In the insurance sector, this is the case of the EIOPA's

[6] See Attracta Mooney and Stephen Morris, 'Investors step up pressure on companies to slash dividends' *Financial Times* (25 March 2020) <www.ft.com/content/fbb0817c-6ebe-11ea-89df-41bea055720b>; see 'Dividends: pay me later' *Financial Times* (27 March 2020) <www.ft.com/content/e6bec80a-ee9b-4510-bb3a-ce0e46c2d743>; see 'Dividends: the new lightning rod for political anger' *Financial Times* (3 April 2020) <www.ft.com/content/f5415884-fc36-4e28-b9e7-87ef4dcc8034>; see Financial Times, 'French markets regulator backs extension of short-selling ban' *Financial Times* (7 April 2020) <www.ft.com/content/08264895-80b0-4951-b79b-c25dff098bbe>.

[7] See 'Tesco urged to pay dividend despite coronavirus' *Financial Times* (7 April 2020) <www.ft.com/content/80fe61c1-3a24-4237-adba-24970ad794f7>; see 'Tesco/UK dividends: welcome to the witch trials' *Financial Times* (8 April 2020) <www.ft.com/content/031a7993-3ba5-4af9-a564-6f1b89ef131a>, and 'Tesco defends dividend payout amid warnings over profits hit from coronavirus' *Financial Times* (8 April 2020) <www.ft.com/content/4719c92c-ab17-4852-92e6-533c682611f4>.

Statements of 17 March 2020[8] and of 2 April 2020[9], followed by specific statements by the national competent authorities of the Member States,[10] as well as of an analogous statement by the UK Prudential Regulation Authority.[11] However, it is in the banking sector that the European supervisory authorities' pressure – unlike what happened on the other side of the

[8] See EIOPA, 'Statement on actions to mitigate the impact of Coronavirus/COVID-19 on the EU insurance sector of 17 March 2020' <www.ivass.it/media/eiopa/documenti/2020/EIOPA_statement_on_actions_to_mitigate_the_impact_of_Coronavirus_COVID-19_on_the_EU_insurance_sector_EN.pdf>.

[9] Seee EIOPA, 'Statement on dividends distribution and variable remuneration policies in the context of COVID-19 of 2 April 2020' <www.eiopa.europa.eu/sites/default/files/publications/statement-on-dividend-distribution-april2020.pdf>.

[10] See, e.g.: in Italy, Istituto per la vigilanza sulle assicurazioni, *IVASS raccomanda alle imprese estrema prudenza nella distribuzione dei dividend*, Press release (30 March 2020), <www.ivass.it/media/avviso/covid-dividendi/?com.dotmarketing.htmlpage.language=1>; in France, L'Autoritè de contrôle prudential et de résolution, *L'ACPR appelle les organismes d'assurance sous sa supervision à s'abstenir de distribuer un dividend*, Press release (Paris, 3 April 2020) <acpr.banque-france.fr/sites/default/files/medias/documents/20200403_communique_presse_dividendes_assurances.pdf>; in the Netherlands, the similar appeal issued by the De Nederlandsche Bank (DNB) on 2 April 2020 <www.toezicht.dnb.nl/7/50-238217.jsp>.

[11] See UK Prudential Regulation Authority, *PRA Statement on decision by insurance companies to pause dividends* of 8 April 2020, <www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-statement-on-decision-by-insurance-companies-to-pause-dividends>.

Atlantic[12] – has been particularly vigorous.[13] Following EBA's Statement of 12 March 2020, recalling the need to follow prudent dividend and other distribution policies,[14] most prudential supervisory authorities have communicated general expectations and have also engaged in bilateral dialogues with a view to either limiting or suspending dividends distribution or share buybacks.[15] These measures have then received further

[12] So far the FED has taken note of the voluntary decision made by the main banks to suspend the shares buyback programmes, but it has not taken a formal position and more in general has not intervened in order to limit or discourage the dividends distribution. The approach taken so far, however, has raised criticisms and it came out that even within the FED such a choice is not unanimously supported; see 'Fed Gives Banks a Break to Keep Markets Calm, Asking for Little in Return' *The New York Times* (15 April 2020) <www.nytimes.com/2020/04/15/business/economy/fed-banks-dividends-virus.html>; see, Matt Egan, 'Banks' big, fat dividends are under fire as profits plunge' (CNN Business, 14 April 2020) <edition.cnn.com/2020/04/14/investing/bank-dividends-recession/index.html>; see Matt Egan, 'Janet Yellen: It's time to stop bank dividends. They need the cash for the crisis' (CNN Business, 6 April 2020) <edition.cnn.com/business/live-news/dow-stock-market-today-040620/h_9f02f117961fd854c96bd1277b05fa9e>.

[13] 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 and Rastko Vrbaski, 'Banks' dividends in Covid-19 times' (May 2020) FSI Briefs No 6 <www.bis.org/fsi/fsibriefs6.pdf>. For a more general survey of the measures taken or yet to be taken by EU to combat the coronavirus crisis see Christos Gortsos, *The EU Policy Response to the Current Pandemic Crisis through the Lens of the Eurogroup Report of 9 April 2020: Overview and Assessment* (Cut-Off Date: 14 April 2020) (April 14, 2020) <ssrn.com/abstract=3579010>; Danny Busch, 'Is the European Union Going to Help Us Overcome the COVID-19 Crisis?' (2 May 2020), in *European Banking Institute Working Paper Series – no. 64*.

[14] See European Banking Autority, *EBA Statement on actions to mitigate the impact of COVID-19 on the EU banking sector*, Press release (12 March 2020) <eba.europa.eu/sites/default/documents/files/document_library/General%20Pages/Coronavirus/EBA%20Statement%20on%20Coronavirus.pdf>.

[15] On the role of prudential policy in the context of the Covid-19 crisis, see Mathias Drehmann, Marc Farag, Nicola Tarashev, and Kostas Tsatsaronis, 'Buffering Covid-19 losses – the role of prudential policy' (24 April 2020) BIS Bulletin n. 9 <www.bis.org/publ/bisbull09.pdf>.

support from EBA's Statement of 31 March 2020.[16] Yet, in this context, it is the ECB's Recommendation issued on 27 March 2020,[17] by moving from a request of the banking industry itself, [18] that plays a pivotal role. Indeed, the ECB has recommended that every bank under its direct supervision within the SSM shall suspend any dividends distribution and shares buyback at least until October 2020, simultaneously requesting the NCAs to adopt similar measures concerning less significant banks.[19] An analogous decision has been made by the UK Prudential

[16] See European Banking Authority, *Statement on dividends distribution, share buybacks and variable remuneration*, Press release (31 March 2020) <eba.europa.eu/sites/default/documents/files/document_library/News%20and%20Press/Press%20Room/Press%20Releases/2020/EBA%20provides%20additional%20clarity%20on%20measures%20to%20mitigate%20the%20impact%20of%20COVID-19%20on%20the%20EU%20banking%20sector/Statement%20on%20dividends%20distribution%2C%20share%20buybacks%20and%20variable%20remuneration.pdf>.

[17] See European Central Bank, '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 <www.bankingsupervision.europa.eu/ecb/legal/pdf/oj_c_2020_102i_full_en_txt.pdf>.

[18] See European Banking Federation, 'EBF letter to ECB/SSM in context of actions to fight Covid-19 pandemic' EBF Holding Statement (27 March 2020) <www.ebf.eu/ebf-media-centre/ebf-letter-to-ecb-ssm-in-context-of-actions-to-fight-covid-19-pandemic/>.

[19] See for instance, in Italy, Banca d'Italia, *Raccomandazione della Banca d'Italia sulla distribuzione di dividendi da parte delle banche italiane meno significative durante la pandemia da COVID-19*, Press release (27 March 2020) <www.bancaditalia.it/media/notizia/raccomandazione-della-banca-d-italia-sulla-distribuzione-di-dividendi-da-parte-delle-banche-italiane-meno-significative-durante-la-pandemia>; in France, L'Autoritè de contrôle prudential et de resolution, *L'ACPR appelle les établissements de crédit sous sa supervision directe et les sociétés de financement à s'abstenir de distribuer un dividende*, Press release (30 March 2020) <acpr.banque-france.fr/sites/default/files/medias/documents/20200330_communique_presse_recommandation_lsi_et_sf.pdf>; in the Netherlands, the DNB recommendation issued on 27 March, <www.toezicht.dnb.nl/7/50-238213.jsp>.

Regulation Authority, that, having urged the largest UK banks not to distribute dividends,[20] has subsequently published a statement where it publicly welcomed the choice of the latter to suspend dividends distribution and shares buyback until the end of 2020.[21]

The situation arising from the above-described framework, although the result of an exceptional emergency, poses a number of questions and requires some further reflections. Dividends distribution and shares buyback are the means through which the shareholders' interest to get their investment remunerated is satisfied. Restrictions on shareholders' distributions that are emerging – in the form of legislative bans, market pressure or supervisory measures – in the context of the COVID-19 crisis, therefore, deserve a specific analysis, particularly in light of the current debate on corporate purpose and the conflicting views as to how to balance shareholders' interest and other stakeholders' interest in managing the companies. It also has to be ascertained, in order to fully grasp the way the corporate purpose may be affected, whether and to what extent such restrictions are the outcome of a unique *ratio*, or rather they arise from logics which, although similar, are not identical.

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[20] See UK Prudential Regulation Authority, *Letters from Sam Woods to UK deposit takers on dividend payments, share buybacks and cash bonuses* (31 March 2020) <www.bankofengland.co.uk/prudential-regulation/letter/2020/letter-from-sam-woods-to-uk-deposit-takers-on-dividend-payments-share-buybacks-and-cash-bonuses>. Letters to the seven largest systemically important UK deposit-takers (HSBC, Nationwide, Santander, Standard Chartered Bank, Barclays, RBS, Lloyds Banking Group).

[21] See 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) <www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-statement-on-deposit-takers-approach-to-dividend-payments-share-buybacks-and-cash-bonuses>.

2. Public financial support to companies and temporary bans on shareholders' distributions

Restrictions on shareholders' distributions applying to companies that ask for public help are a common feature of all the provisions adopted so far in several countries.

Prima facie, such restrictions appear to have an intuitive rationale linked to the need to ensure that the public support, to be given to companies that find themselves in really serious difficulties, will not be used for abusive or illegitimate purposes.

A more accurate reflection, however, suggests some different considerations.

The legislative acts in question, indeed, do not just limit the ways of using the provided public resources with a view to excluding that they can be employed for purposes which are deemed to be inconsistent with the objectives of the public intervention (such as remunerating shareholders). In fact, they introduce a general rule that significantly amends the legislation on capital distribution, thereby impacting an aspect of company law which contributes to define and strike a balance between shareholders' interest and other stakeholders' interests.

Yet, before proceeding further in the analysis, a closer look needs to be taken at the provisions barring companies that have received public support from distributing dividends and purchasing their own shares.

These legislative restrictions are connected either with the extension of favourable credit facilities by the state or other public entities or with the possibility to benefit from public guarantees attached to loans given by banks and other private financial intermediaries. Such constraints on the company's

capital are, therefore, not just aimed at preventing the company from using the liquidity received through facilities resulting from the public support to remunerate shareholders. In fact, they also aim at making sure that all present and future earnings are and will be fully retained within the company in order to increase its ability to absorb losses as well as to repay its debts, particularly the ones to the state and the ones guaranteed by the state.

In other words, the company's access to public financing or to credit lines with public guarantees causes the substantial curtailment of shareholders' interests. As a consequence, the latter cannot get any payout from the company even when, according to the general company law rules, this would be allowed.

This is a relevant shift in the overall balance set out by company law rules between the conflicting interests of shareholders and other stakeholders. Additionally, whereas in some jurisdictions the restraints to capital distributions are temporally limited [22], in others, they are meant to last until when the state (or the other public entities) will remain exposed to the risk of losses (and, therefore, will cease only after the repayment of the debt) [23].

The rationale behind the choice of setting a timeframe for the application of such restraints on the company's capital and the ensuing consequences still need to be further analysed.

To this end, it shall be stressed that legislative restraints on capital distributions also impact the corporate purpose, since

[22] See art. 2, co. 1, lett. i) of the Italian *Decreto Legge* 8 April 2020 no. 23 (n 2), which requires restriction up to the end of 2020.

[23] See Title IV, Subtitle A, sec. (4003) of the US CARES Act (n 5), which states 'A loan or guarantee recipient is prohibited from paying dividends or repurchasing stock while the loan or guarantee is outstanding or for 12 months following repayment.'

until when they are in force, it is not permitted to remunerate shareholders. It follows that the corporate purpose is, in this way, modified as, due to a legislative duty to retain earnings with a view to enhancing the net equity, the company's activity ends up aiming at primarily safeguarding the interests of public creditors and creditors benefiting from a public guarantee and, only secondly, the interests of other creditors, employees and customers whose prerogatives against the company's assets remain intact. In essence, those companies which have been hit by the health emergency and have accessed public support are made subject to a special regime that may imply, more or less temporarily, a substantial change in the company's purpose. Accordingly, shareholders' interests, which are no longer considered exclusive or prevailing, end up being subordinated to other interests, if not even temporarily cancelled.

Reversing the perspective, particularly when the ban on shareholders' distribution is meant to last until the expiration of the loan received thanks to the state intervention, it can be argued that the public support finds its main rationale in the safeguard of the interests of creditors, employees and customers who are involved in the business activity.

Still, particularly with regard to small and medium enterprises, it is relevant to focus on whether the company's activity performed without any prospect of remuneration for the shareholders, who in these companies often also act as directors, can discourage the continuation of the company and induce them to stop the activity. Against this background, it is not just a coincidence, perhaps, that most jurisdictions have introduced a ban on dividends distribution and shares buyback which only applies to companies that overcome some size thresholds. Nonetheless, even in these cases, an absolute preclusion of any equity remuneration that completely disregards the

shareholders' interest, particularly if it is meant to last for years, might end up negatively affecting the company's ability to raise capital, at least from private investors, thereby endangering its survival.

3. Market pressure on companies to refrain from shareholders' distributions

Whether (large) companies that benefit from public aid are subject to strict legal limitations concerning capital distribution, other (large) companies that do not request these forms of support, particularly if they are listed on stock exchanges, face pressure to abstain, in the current period of crisis, from paying out shareholders through dividends distribution and shares buyback.

The reasons for this, in essence, may be based on two different lines of reasoning which, although converging, move from distinct points of view.

According to the first perspective, the choice of not distributing capital to shareholders is grounded in need for maintaining the ability to cope with the negative repercussions that likely companies will have to face. This is further exacerbated by the uncertainties affecting both the developments of the health crisis and the seriousness of the resulting economic effects. Thus, the approach in question, which could be defined as the 'traditional approach', underscores the need to favour the company's capital reinforcement, thereby enhancing its ability to bear losses.

By contrast, the frequent observation under which, in a situation of a prolonged economic crisis that will negatively affect the social dimension as well, companies shall take into account the increasing difficulties of employees and customers, is based on

a different approach. From this perspective, that could be defined as the 'innovative approach', the retained resources should be employed in two directions with a view to reducing the impact of the crisis both on the company's employees (for example, by providing the latter with additional social care services) [24] and on the company's customers (by seeking to minimise the impact of the foreseeable increase in costs and, possibly, to reduce the inherent prices of goods or services).

The 'traditional approach' is linked to the need to prudently use the company's resources, particularly in light of a crisis that will likely be one of the most severe in history. Such a formulation is, therefore, instrumental in ensuring the survival of the company and its capability to make profits[25]. Accordingly, it is consistent with the idea of the corporate purpose giving primacy to the safeguard of the long-term shareholders' interests and in doing so, indirectly, protecting the interests of creditors and other stakeholders as well.

The 'innovative approach', differently, moves from a broadening of the corporate purpose, according to which the protection of the shareholders' interests is not the primary goal in running the business activity. The latter, indeed, is to be performed by taking into account a plurality of diverse interests of equal rank. And within an extremely serious scenario like the one caused by the current pandemic, in using the company's

[24] In this direction, see the explanation given by EssilorLuxottica for the decision to suspend dividend payments and the share buyback programme previously launched, EssilorLuxottica to Prepare for Recovery by Preserving Cash and Supporting Employees <www.essilorluxottica.com/sites/default/files/documents/2020-04/PR%20DIV-Covid%2019-%2020%2004%202020%20UK%20version.pdf>.

[25] For such a stance, see Financial Times, 'Wave of corporate defaults owes much to foolhardy share buybacks' *Financial Times* (29 April 2020) <www.ft.com/content/b3817772-ff39-42f5-af0e-4744fa07389b>.

resources and running the business activity, it can be justifiable to make choices that favour the interests of employees and customers over the shareholders' ones. It is worth highlighting, from this point of view, that the positions against dividends distribution by some institutional investors have expressly referred to their consistency with the ESG logics that are pivotal in their investment choices. Particularly, it has been underscored that the pandemic has prompted the investors[26] – and, more generally, the public opinion[27] – to focus on the effective level of attention that listed companies pay to social matters and to give priority to the compliance with the undertaken commitments in this area.

The adoption of one approach over the other is not just a matter of nuances, and it seems to be capable of affecting the choices concerning dividends distribution and, more in general, the strategic decisions on how to run the business activity.

With regard to companies operating in those economic sectors which are particularly exposed to the pandemic (oil and gas, tourism and transports), on the basis of the general principle of directors' diligence and irrespective of the adopted notion of company's objective, it seems possible to identify a directors' duty to refrain from putting forward dividends distribution and shares buyback proposals. On the contrary, this is not the case

[26] Larry Fink, the Chairman of BlackRock, in his Letter to Shareholders, exhorted them to be aware of the profound and lasting implications of the coronavirus outbreak for every nation and for clients and employees. See Larry Fink, *Larry Fink's Chairman's Letter to Shareholders Chairman* (29 March 2020) <www.blackrock.com/corporate/investor-relations/larry-fink-chairmans-letter>.

[27] See, among others, 'Coronavirus as the ESG acid test' *Financial Times* (2 April 2020) <ftalphaville.ft.com/2020/04/02/1585807115000/Coronavirus-as-the-ESG-acid-test>; 'Coronavirus forces investor rethink on social issues' *Financial Times* (30 April 2020) <www.ft.com/content/bc988e0e-687c-4c72-98eb-ae2595e29bee>.

for companies operating in economic sectors which have benefited from the current situation (e-commerce, internet and, more in general, online services). Companies operating in those sectors, indeed, have performed better than expected and do not need to get prepared to face losses in the near future.

Against this background, under the 'traditional approach', after ascertaining that there is no need to enhance the net equity position of the company, there would be no reason to restrictively amend the dividends distribution policies and the opportunity to increase shareholders' remuneration further, although carefully, should also be explored. By contrast, under the 'innovative approach', the appropriateness to constrict shareholders' interests in order to meet the other stakeholders' needs could not be ruled out even in case of outperformance, particularly in the face of an extremely serious economic crisis that will severely affect employees and customers.

Yet, it is worth underscoring that even in the context of the 'innovative approach', the subordination of shareholders' interests vis-à-vis the employees' and customers' interests can be only temporarily justified. In the medium term, it will still be necessary to strike a balance between all stakeholders interests, taking into account the need to remunerate the equity capital provided by shareholders in order to run the business. Otherwise, indeed, the capitalistic economic model would be dismissed.

The comparison between these two approaches can be even better understood if it is contextualised within the recent and ongoing debate on corporate purpose[28]. The latter, after having

[28] Corporate purpose is nowadays the focus of a fundamental and heated debate, with rapidly growing support for the proposition that corporations should move from shareholder value maximization to 'stakeholder governance' and 'stakeholder capitalism'. Prominent financial economists

crossed the borders of academia, has become a subject frequently discussed in entrepreneurial and financial *fora* as well,[29] where it has been progressively recognised the need to take into consideration a plurality of interests which are involved in running the business activity. Accordingly, shareholders' interests rank equally to employees', customers' and creditors' interests.

The economic crisis that will hit companies, therefore, offers the first and decisive test to verify whether, effectively, a different notion of corporate purpose will lead to management choices capable of providing more efficient – and possibly more equitable – solutions to the severe difficulties that the world will face[30].

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have recently devoted their attention to this topic: among others, see Colin Mayer, *Prosperity: Better Business Makes the Greater Good* (Oxford University Press, Oxford, 2018) (stating that the purpose of business should be to '*produc[e] profitable solutions to problems of people and planet*'). Mayer's approach has recently gain support by Alex Edmans, *Grow the pie: creating profit for investors and value for society* (Cambridge University Press 2020).

[29] In this perspective, in the summer of 2019, the Business Roundtable (BRT)—the influential association of corporate chief executive officers (CEOs)—announced a revision of its conception of corporate purpose. See Business Roundtable, *Statement on the Purpose of a Corporation* (19 August 2019), <opportunity.businessroundtable.org/wp-content/uploads/2019/12/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf>). Following the publication of the BRT statement, in December 2019 the World Economic Forum unexpectedly published a manifesto that urged companies to move from the traditional model of 'shareholder capitalism' to the model of 'stakeholder capitalism'. See Klaus Schwab, 'Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution' (Word Economic Forum, 2 December 2019) <www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution>.

[30] See Marco Ventoruzzo, 'Beware of the Panacea of Stakeholder-friendly Corporate Purposes' (Oxford Business Law Blog, 13 Apr 2020) <www.law.ox.ac.uk/business-law-blog/blog/2020/04/beware-panacea-

4. Supervisory measures restricting shareholders' distributions for banks and insurance companies

Banks and insurance companies have explicitly been urged to avoid distributions to shareholders in light of the situation caused by the spread at the global level of COVID-19. As mentioned, prudential supervisors, mostly in Europe, have adopted a number of measures recommending to suspend both dividends distribution and shares buyback[31].

Such supervisory measures are justified by the peculiar relevance that insurance regulation and, even more so, banking regulation give to the capital adequacy of institutions operating in those sectors. After the global financial crisis, this aspect has acquired a paramount importance and, in fact, in the context of the EU, the special provisions of CRR-CRD IV, on one side, request the supervisor's authorisation to purchase own shares and, on the other, limit the possibility to distribute dividends when capital falls below a given threshold (so-called MDA). The importance of capital adequacy is further reiterated by the role of supervisory authorities that are meant not only to verify the compliance of institutions with regulatory requirements, but they may also set additional capital requirements under the

stakeholder-friendly-corporate-purposes>, which highlights that now is the time to verify the role of corporate actors with respect to environmental issues and protection of employees, customers and suppliers.

[31] The European Commission has also recently 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), 28 April 2020. The Communication confirms several recent statements in the banking field made by the Basel Committee of Banking Supervision, the European Banking Authority (EBA) and the European Central Bank, also highlighting areas where banks are invited to act responsibly (including by refraining from making dividend distributions to shareholders or adopting a conservative approach to the payment of variable remuneration).

supervisory review process (SREP), as a result of an assessment of the effective adequacy conducted on a case-by-case basis, against the actual exposure to risks not captured by the regulatory capital requirements[32].

It is therefore not surprising that European regulators and supervisors have foremost highlighted the necessity that, in making their own decisions, banks and insurance companies pay careful attention to the need to strengthen their capital position. Accordingly, in view of the current exceptional situation and the uncertainties concerning the seriousness of its impact on the economy, generally, these institutions are expected to refrain from remunerating shareholders through capital distributions.

Yet, the measures adopted in Europe by the authorities in the banking and insurance sectors to face COVID-19 do not just recall the need to ensure the institutions' stability to justify their recommendations to suspend dividends distribution and shares buyback. They indeed refer such recommendations to a broader understanding of the role that banks and insurance companies should play in the economy and, more generally, inside the society. [33]

Such a novel approach emerges very clearly from the ECB's Recommendation of 27 March 2020, particularly if the latter is compared with the previous ECB's Recommendation issued in

[32] For a recent overview of the CRD IV framework see Peter O. Mülbert and Alexander Wilhelm, 'CRD IV Framework for Banks Corporate Governance' in: Danny Busch and Guido Ferrarini (eds.), *European Banking Union* (2nd edn, OUP 2020).

[33] Since they are not directly aimed at preserving the stability, may be open to question whether such measures properly fall within the notion of prudential supervision, as commonly understood.

January 2020 (which substantially replicated the one adopted in January 2019).[34]

In its previous Recommendation, the ECB urged every bank to assess very prudently their appropriateness to pay out shareholders and, after grouping banks in different categories on the basis of the outcome of the capital adequacy assessment, intensified its recommendations by inviting the most exposed banks to fully retain earnings with a view to increasing their ability to absorb losses. In the last Recommendation, the request to refrain from capital distributions until October 2020, addressed to every bank, does not mention the need to enhance capital requirements further to face the significant losses resulting from the COVID-19 emergency. By contrast, it refers to the ability of banks to lend to the real economy and the need that banks will be in the position to finance both households and businesses in the period of economic crisis that will inevitably follow the pandemic. In other words, the authorities' pressure to suspend any shareholders distribution is not primarily instrumental in enhancing banks' resilience, but rather in inducing banks to allocate as many resources as possible to their lending activities, in order to ensure they continue performing during the economic crisis their characteristic intermediation function.[35]

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[34] European Central Bank, 'Recommendation of the European Central Bank of 17 January 2020 on dividend distribution policies', ECB/2020/1 <www.ecb.europa.eu/ecb/legal/pdf/en_ecb_2020_1_f_sign.pdf>.

[35] This approach was explicitly clarified by Andrea Enria, Chair of the Supervisory Board of the ECB, which said that it is vital at this stage to keep as much capital within the banking sector as possible to support the real economy. See Andrea Enria, 'Public hearing at the European Parliament's Economic and Monetary Affairs Committee', Introductory statement by Andera Enria, Chair of the Supervisory Board of the ECB on 5 May 2020 <www.bankingsupervision.europa.eu/press/speeches/date/2020/html/ssm.sp200505~9decf20a47.en.html>.

From this perspective, the reason why the last ECB's Recommendation does not distinguish among different banks and accordingly requires all of them to suspend, at least for the time being, any distribution of net equity to shareholders is clear. In fact, considering that the less solid banks had already been requested to refrain from distributing dividends, the recommendation to retain resources to be then employed to support the economy and the society in times of crisis is actually addressed to the most solid institutions.

A reference to the peculiar function that, particularly during a crisis, banks are expected to play in order to support the economy and society is also made both in the measures adopted by the national competent authorities operating within the SSM and in the Statement addressed by the UK PRA to the largest UK banks. Analogous considerations concerning the need that also insurance companies have to keep on performing their characteristic intermediation function in transferring risks are made both in the last EIOPA's Recommendation and in the Statement addressed by the UK PRA to UK insurance institutions in order to explain the request to refrain from distributing net equity to shareholders.

It is clear that such measures impact extensively the way banks and insurance companies are managed and play a significant role in shaping the corporate purpose of such institutions. If we were to recall the distinction between the 'innovative approach' and the 'traditional approach' previously advanced, it would seem fair to argue that supervisors' recommendations are to be considered more in line with the former approach rather than with the latter.

Actually, the supervisory measures adopted by the European authorities are to be considered in the light of the results of the debate on the corporate purpose of financial institutions –

particularly with regard to banks – that started after the global financial crisis and which have already led to progressively rethink, in this context, the shareholders' interest primacy [36]. Once the collective interest to the stability of the financial system has emerged as crucial, the need to ensure that banks conduct their business with an adequate level of capital has become the primary objective of the regulation, and it has fostered a progressive shift in the corporate purpose of banks. On the basis of these assumptions, the shareholders' interest was firstly placed at the same level as the other stakeholders' interests and then expressly subordinated to the depositors' interest, since the latter have been identified as the ones more interested to the bank's solidity.[37]

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[36] The literature on this topic is extensive, among the most recent contributions, see Klaus J. Hopt, 'Corporate Governance of Banks and Financial Institutions: Economic Theory, Supervisory Practice, Evidence and Policy' (2020) ECGI Law Working Paper No 507/2020 <papers.ssrn.com/sol3/papers.cfm?abstract_id=3553780>; Tom Vos, Katrien Morbée, Sofie Cools, and Maria Wyckaert, 'A Cross-Sectorial Analysis of Corporate Governance Provisions: About Forest and Trees' in: Veerle Colaert, Danny Busch and Thomas Incalza (eds), *European Financial Regulation. Levelling the Cross-Sectoral Playing Field* (Hart Publishing 2020); Danny Busch, Guido Ferrarini, Gerard van Solinge, 'Governing Financial Institutions: Law and Regulation, Conduct, and Culture' in: Danny Busch, Guido Ferrarini, Gerard van Solinge (eds.), *Governance of Financial Institutions* (Oxford University Press 2019); Guido Ferrarini, 'Understanding the Role of Corporate Governance in Financial Institutions: A Research Agenda' (2017) ECGI Law Working Paper No 347/2017 <papers.ssrn.com/sol3/papers.cfm?abstract_id=2925721>.

[37] Such evolution can be appreciated thoroughly by comparing the objective of corporate governance of banks in the different versions of Basel Commitee corporate governance principles for banks: 'Enhancing Corporate Governance for Banking Organisations' (16 September 1999) <www.bis.org/publ/bcbs56.pdf>; 'Enhancing Corporate Governance for Banking Organisations' (13 February 2006) <www.bis.org/publ/bcbs122.pdf>; 'Principles for Enhancing Corporate governance' (4 October 2010) <www.bis.org/publ/bcbs176.pdf>; 'Corporate

The recent measures adopted by the supervisory authorities, from this viewpoint, seem to go even further, since they emphasise – more markedly than it used to be in the past – the need that banks and insurance companies must perform their activity by pursuing, as their main objective, the goal that both banking intermediation and insurance intermediation can effectively continue. And this is even more so in light of the exceptional crisis that is coming, where the ability of banks to lend to the real economy as well as the ability of insurance companies to offer risks protection will be crucial for the survival of both the economic and social system.

5. Conclusion

Emerging restrictions on shareholders' distributions – in the form of legislative bans, market pressure or supervisory measures – in the context of the Covid-19 crisis deserve a specific analysis, particularly in light of the current debate on corporate purpose and the conflicting views as to how to balance shareholders' interest and other stakeholders' interest in managing the companies.

Companies which have been hit by the health emergency and have accessed public support are made subject to a special regime characterised by a legislative restriction on shareholders' distributions that may imply, more or less temporarily, a substantial change in the company's purpose. Accordingly, shareholders' interests, which are no longer considered exclusive or prevailing, end up being subordinated to other interests, if not even temporarily cancelled.

governance principles for banks' (8 July 2015) <www.bis.org/bcbs/publ/d328.pdf>.

Whether (large) companies that benefit from public aid are subject to strict legal limitations concerning capital distribution, other (large) companies that do not request these forms of support, particularly if they are listed on stock exchanges, face pressure, from public opinion and institutional investors, to abstain from paying out shareholders through dividends distribution and shares buyback.

Such pressures seem to underpin an 'innovative' approach aligned to a broader notion of corporate purpose. The crisis will offer the chance to verify if this is the case and whether effectively such different notion of corporate purpose will lead to management choices capable of providing more efficient – and possibly more equitable – solutions to the severe difficulties that the world will face.

As for banks and insurance companies, recent measures adopted by the supervisory authorities, from this viewpoint, seem to go even further, since they emphasise – more markedly than it used to be in the past – the need that banks and insurance companies must ensure, as their main corpore purpose, that both banking intermediation and insurance intermediation can effectively continue. And this is even more so in light of the exceptional crisis that is coming, where the ability of banks to lend to the real economy as well as the ability of insurance companies to offer risks protection will be crucial for the survival of both the economic and social system.

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