Repair and Prepare
Strengthening Europe

The Corona crisis and the stability of the European banking sector

A repeat of the Great Financial Crisis?

Hertie School
Jacques Delors Centre

BertelsmannStiftung

The Corona crisis and the stability of the European banking sector

A repeat of the Great Financial Crisis?

Frank Eich, Theresa Küspert, Philipp Schulz

Content

6 Introduction

7 The Corona crisis
7 A dramatic economic outlook worse than the Great Financial Crisis
8 The Corona pandemic: another type of shock

9 Could the Corona crisis undermine the financial stability of the European banking sector?
9 Possible contagion from the real economy to the banking sector
9 The 2018 EBA stress test scenario
13 What might happen next?

15 Concluding Comments

16 Annex
16 Annex 1: Lessons from the Great Financial Crisis
17 Annex 2: Policy responses to the Corona crisis

19 Literature

23 Imprint

Introduction

The Corona crisis[1] has had a devastating effect on the global economy and could end up being worse than the Great Financial Crisis (GFC). Some commentators have already suggested that the decline in economic activity could be the most marked for several centuries. Unlike the GFC, the Corona crisis was triggered by an external shock. Governments responded to this shock by offering liquidity to the real economy, either directly or indirectly by guaranteeing new bank lending.

So far European banks have weathered the storm but will they be able to withstand a prolonged economic downturn? This paper suggests that the fortunes of European banking systems will depend on the economic recovery we experience. If we witness a "V-shaped" recovery as currently forecast by the European Commission, for example, then banks in the majority of EU member states might be able to survive unscathed. The picture could look very different if the recovery turns out to be more sluggish though. The paper suggests that capital ratios – one of the key benchmarks used to assess the stability of banking systems – could drop dramatically in a number of member states such as France and Spain to well below what supervisors generally consider to be "sound" even under stress conditions. With the situation looking less severe in other member states such as Germany or the Netherlands, this could renew political tensions seen last during the euro area sovereign debt crisis.

The paper is structured as follows. Section "The Corona crisis" presents the latest economic forecasts and contrasts the current crisis with the GFC. In Section "Could the Corona crisis undermine the financial stability of the European banking sector?" the paper draws on the results of the 2018 EBA adverse stress test. Comparing the 2018 EBA adverse scenario with a plausible "ticked-shaped" recovery post-Corona, the paper presents illustrative impacts on capital ratios in a selected number of EU member states. Section "Concluding Comments" looks at the role of European-wide policy responses to deal with the crisis and what the Corona crisis might mean for the future of the EU's Banking Union and Capital Markets Union.

1 We use "Corona crisis" to describe the pandemic caused by COVID-19, the most recently discovered coronavirus.

The Corona crisis

A dramatic economic outlook worse than the Great Financial Crisis

In the first quarter of this year, euro area GDP fell by 3.8 percent quarter on quarter and by 3.3 percent on a year-on-year basis (Eurostat, 2020). This is the sharpest contraction in GDP since comparable records began in 1995 despite only covering the first few weeks of the economic and social lockdown imposed by governments around the world.

The International Monetary Fund (IMF) forecasts euro area GDP to fall by 7.5 percent this year before rebounding by just under 5 percent in 2021 (IMF, 2020b). The current forecast for 2020 is thus significantly worse than the recession during the GFC in 2009 when euro area GDP dropped by a shade over 4 percent. If confirmed, this would be the worst peacetime economic deterioration since the Great Depression of the 1930s (IMF, 2020c).[2] The European Commission's Spring 2020 forecast paints a similar picture for 2020 (though there are country variations) but is generally more optimistic for 2021, predicting a much stronger ("V-shaped") recovery in most EU member states than the IMF (EU Commission, 2020a) (Table 1).

Some policy makers have already warned that the Corona pandemic could possibly turn out to be the worst economic crisis in several centuries (Vlieghe, 2020).

The high degree of uncertainty around these forecasts is illustrated by the case of Germany: the ifo Institut forecasts a much sharper recovery (+8.5%) in 2021 than both the IMF and European Commission. As a result, according to it, the level of GDP at the end of 2021 would be similar to that at the beginning of 2020 (ifo Institut, 2020). The European Central Bank (ECB) forecast for the euro area captures the uncertainty by looking at three different scenarios, which differ in the severity and length of the lockdown measures. They predict that real GDP will fall by 5 percent, 8 percent and 12 percent in the mild, medium and severe versions respectively (Chart 1).

GDP growth forecasts

(selected EU member states, year-on-year %, real GDP)

	IMF April 2020 WEO		EU Spring 2020	
	2020	2021	2020	2021
Germany	– 7.0	5.2	– 6.5	5.9
Finland	– 6.0	3.1	– 6.3	3.7
France	– 7.2	4.5	– 8.2	7.4
Greece	– 10.0	5.1	– 9.7	7.9
Italy	– 9.1	4.8	– 7.7	6.3
Netherlands	– 7.5	3.0	– 6.8	5.0
Poland	– 4.6	4.2	– 4.3	4.1
Spain	– 8.0	4.3	– 9.4	7.0
euro area	– 7.5	4.7	– 7.7	6.3

Table 1 | Sources: International Monetary Fund (2020a) and EU Commission (2020a).

Hertie School Jacques Delors Centre | BertelsmannStiftung

2 On 8th May IMF Managing Director Kristalina Georgieva raised the prospect that the IMF's April 2020 WEO forecast might have to be revised downwards, see: https://www.theguardian.com/world/2020/may/09/imf-warns-of-further-drop-in-global-growth-due-to-covid-19

ECB Alternative Corona scenarios

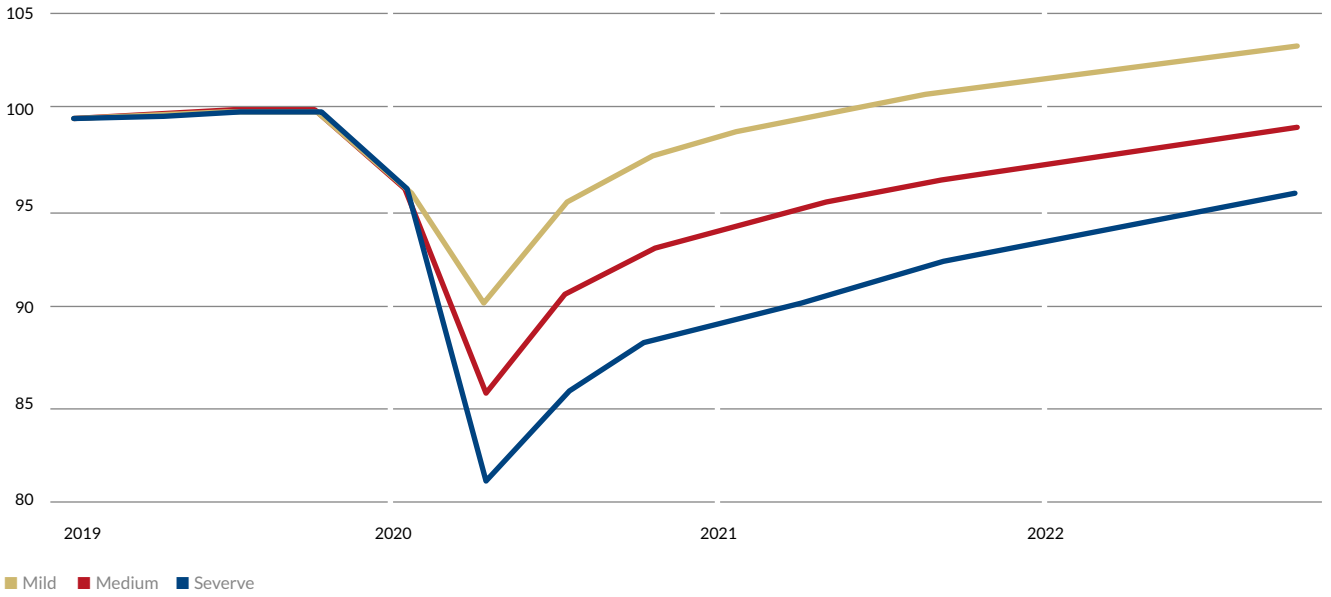

Chart 1
Source: European Central Bank (2020a).

The Corona pandemic: another type of shock

Many commentators have compared the current crisis with the GFC. One of its key characteristics was contagion from the financial system seeping into the real economy. Faced with too little capital, banks cut lending to the real economy, leading to a credit crunch, which in turn led to a deep recession and subsequently a sharp rise in non-performing loans (NPLs). A related issue was the liquidity mismatch between assets and liabilities held by banks. Annex 1 discusses the main policy lessons from the GFC.

In contrast to the GFC, the causes of the current crisis are not to be found in the financial system or (lack of) access to bank credit or funding more generally. Instead, the real economy has suffered a major collapse in demand and supply from the global lockdown, with businesses no longer generating the revenue to meet their costs – a liquidity issue. The crisis has hit all types of businesses – large and small, market leaders and laggards – and has had a devastating effect on labour markets. As such, this crisis not only threatens inefficient firms, but also solvent and efficient ones, which simply may not be able to survive the prolonged lockdown phase. The crisis has, however, been asymmetric in the sense that some sectors and countries have been harder hit than others.

Worse still, there is the possibility of a second wave of coronavirus infections so that the crisis may well not be over once the first lockdown measures have been lifted. The crisis thus risks destroying productive capacity in the economy permanently, affecting its long-term growth potential.

Could the Corona crisis undermine the financial stability of the European banking sector?

European policy makers reacted swiftly to the crisis and implemented some of the key policy lessons learnt from the GFC (see Annex 1). Their interventions were mainly aimed at providing liquidity to the real economy, hoping that this would stop a temporary shock translating into long-lasting damage to economic activity. Given the lack of time, policy interventions had to be broad brushed and generally untargeted.

As a result, governments intervened heavily in the real economy (e.g. through wage subsidies) and also in the financial and credit markets, e.g. Germany's up to 100 percent credit guarantee scheme of potentially unlimited size to private-sector banks or EIB guarantees of €25 bn to deliver up to €200 bn of private-sector capital.[3] These schemes are meant to offer liquidity support not only to small and medium sized enterprises (SMEs) but also larger businesses during the steep recession. Annex 2 provides more information on the policy measures taken.

Possible contagion from the real economy to the banking sector

Despite the swift policy responses, the impact of the crisis on the real economy is becoming increasingly obvious but what about the stability of the financial system and the banking system in particular? As it did not originate in financial markets, it is unclear how this shock might spread there over time. Mack (2020) assesses how the crisis could hit banking systems based on the four main vulnerabilities arising from market, funding liquidity and concentration risks, and weak levels of profitability.

The 2018 EBA stress test scenario

Can European banks withstand the Corona shock? To answer this question, it is useful to start with the most recent European-wide bank stress tests.[4] One lesson from the GFC (Annex 1) is that banking supervisors nowadays conduct regular stress tests to assess the financial soundness of individual banks or groups of banks under adverse economic circumstances. These tests generally try to capture some stylised macroeconomic shock resulting in a recession in the banks' key markets, which in turn leads to an increase in household and corporate default rates, in turn leading to non-performing loans.[5] The severity of the stress tests generally reflects the "risk appetite" of the supervisors, which use the insights gained to request the supervised banks to make changes to their business models or the amounts of capital they hold.[6] For comparative purposes supervisors also ask banks to run their internal models on "baseline" assumptions based on the latest economic forecasts.

3 For a detailed summary of European policy actions – which vary markedly across countries – see Redeker and Hainbach (2020).

4 In March 2020 the EBA announced to postpone the 2020 stress test as a result of the crisis. However, the EBA published the stress test in January. In the "adverse" scenario, which was meant to capture a "low for long" environment, EU real GDP was modelled to fall by 4.3% by 2022, according to the EBA the most severe scenario to date (EBA, 2020).

5 There are other channels through which banks' balance sheets can be adversely affected in a stress, including market risk.

6 The European Court of Auditors (2019) has suggested that the 2018 EBA adverse stress test would have benefited from a greater focus on risks.

Corona versus stress test scenario

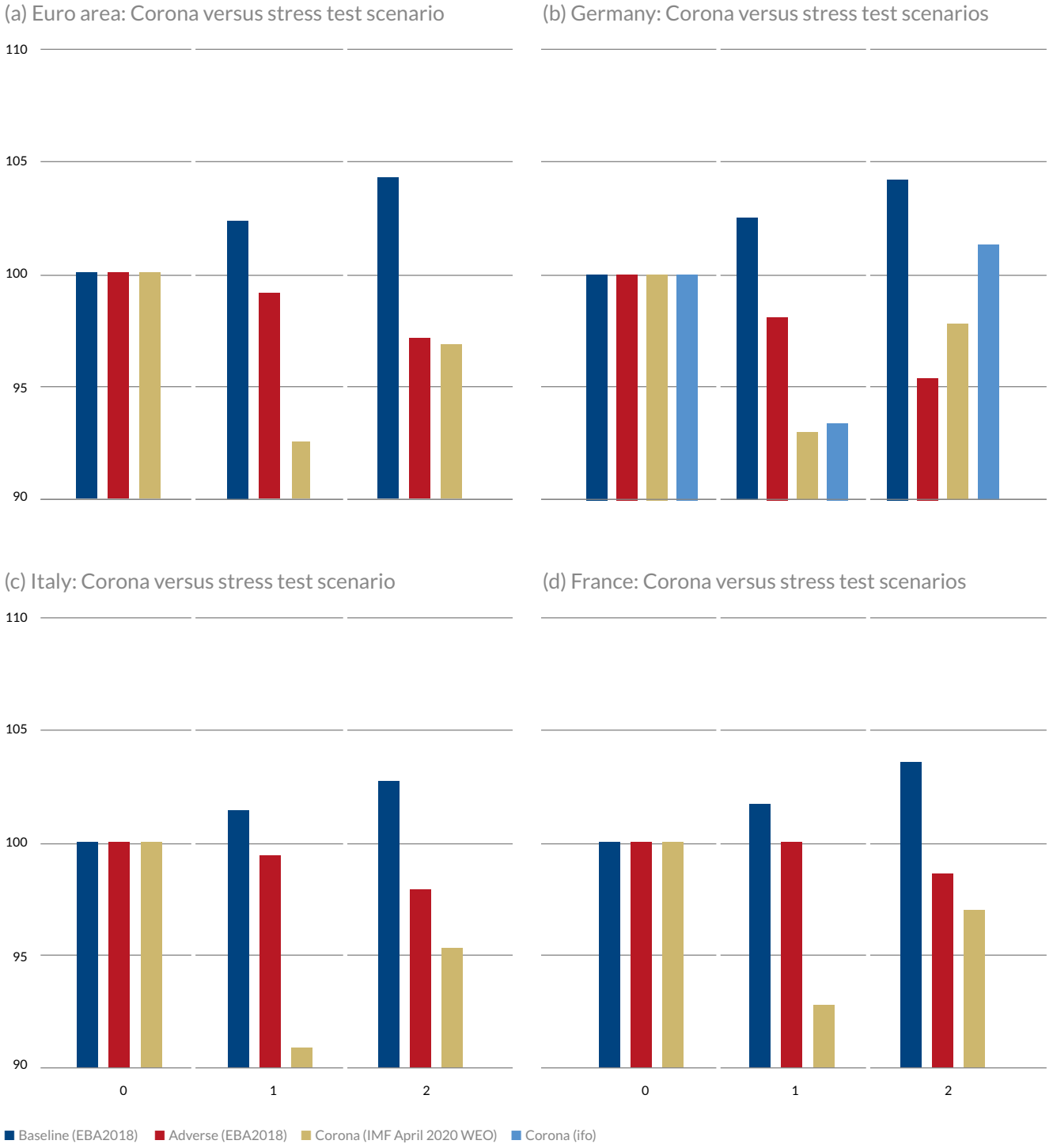

Chart 2
Source: European Central Bank (2020a).

Chart 2a shows the evolution of the 2018 European Banking Authority (EBA) baseline and adverse stress test scenario for euro area GDP relative to the IMF's April 2020 World Economic Outlook (where year 0 is the pre-crisis year, i.e. in the 2018 EBA scenario 2017 and in the IMF 2020 WEO 2019). The chart shows that the level of euro area real GDP is forecast to be much lower in the first year of the Corona crisis than in the EBA 2018 adverse scenario but by year 2 real GDP levels are very similar in both cases (ESRB, 2018). The cumulative output loss in both cases is around 4 percent.

The picture is different for Germany (Chart 2b), where the IMF forecasts real GDP to contract less in year 1 and bounce back more strongly in year 2 than the euro area average. As a result, the level of real GDP is forecast to be higher in year 2 in the Corona crisis than in year 2 of the EBA 2018 adverse scenario. The more optimistic ifo Institut forecasts that the level of GDP will be similar in 2021 to that in 2019.

The situation is much worse in Italy (Chart 2c), where the IMF forecasts a 9.1 percent GDP contraction this year, followed by a 4.8 percent expansion in 2021. If true, this would leave Italy's real GDP about 5 percent lower than the pre-Corona level and much lower than under the 2018 EBA adverse stress test scenario. France would also do worse (Chart 2d).

Unlike earlier European stress tests, the 2018 EBA stress test did not set a required "hurdle rate" for capital ratios so banks could not officially pass or fail the test. Table 2 shows the changes in Common Equity Tier 1 (CET1) capital – the highest quality of regulatory capital, as it absorbs losses as soon as they occur – in the EU member states in the 2018 EBA stress (EBA, 2018a).

CET1 in EBA 2018 adverse stress test

	Act. Dec 2017	Adv. Dec 2020	Change 2020/2017 (in bps)
European Union	14.51%	10.32%	–419
Austria	13.18%	9.04%	–414
Belgium	16.32%	13.47%	–286
Denmark	18.24%	13.39%	–485
Finland	20.10%	15.28%	–481
France	13.75%	9.71%	–404
Germany	16.00%	10.23%	–577
Hungary	15.21%	13.03%	–218
Ireland	18.49%	13.10%	–539
Italy	13.24%	9.57%	–367
Netherlands	15.84%	11.85%	–400
Norway	16.21%	15.03%	–118
Poland	16.47%	15.76%	–71
Spain	12.22%	9.41%	–280
Sweden	20.81%	17.94%	–287
United Kingdom	14.36%	8.87%	–549

Table 2 | Source: European Banking Authority (2020).

Illustrative GDP paths under Corona

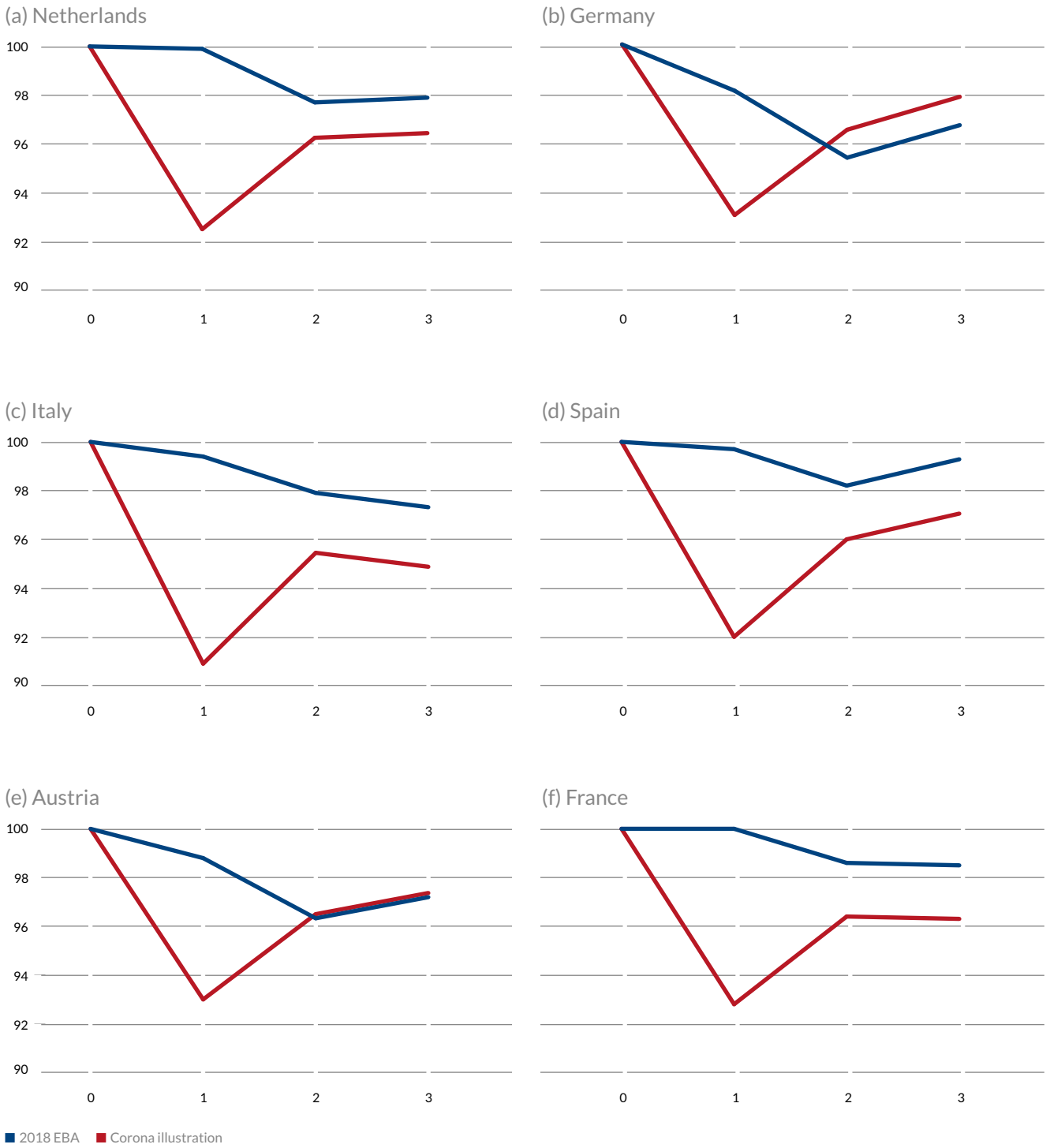

Chart 3
Source: EBA (2018), IMF (2020a) and authors' own calculations.

What might happen next?

The starting position for euro area banks at the outset of the Corona crisis in terms of their aggregate capital and leverage ratios was very similar to that at the end of 2017 when the 2018 EBA stress test was conducted.[7] The insights gained from the 2018 EBA stress test thus remain relevant.

Capital ratios might deteriorate sharply in a number of euro area countries

If we experience a much weaker recovery than currently forecast by, inter alia, the IMF or European Commission, then it is likely that NPLs will increase sharply and at different rates across countries.

We use the following scenario: let's assume that economies only recover half of their 2020 losses in 2021. This is more or less the IMF forecast for Italy and Spain for example and in between the ECB's mild and medium scenarios (see Chart 1). To facilitate comparison with the 2018 EBA results, we also assume that growth is the same in the third year of our illustration as in the third year of the 2018 EBA scenario. Charts 3a-3f above illustrate the GDP paths in this illustrative scenario vis-a-vis the 2018 EBA adverse scenario for a selected number of countries.

Our scenario – capturing a "tick-shaped" recovery – leads to smaller cumulative output losses after three years than the 2018 EBA adverse scenario in Germany and Austria and steeper losses in France, Italy, the Netherlands and Spain.

Without up-to-date bank-specific data, it is not possible to translate this illustrative macroeconomic scenario into firm-specific capital losses. For simplicity's sake, we therefore scale up the declines in Common Equity Tier1 (CET1) capital calculated in the 2018 EBA scenario (EBA, 2018b) with the ratio of output losses in our Corona scenario to output losses in the 2018 EBA adverse scenario.[8] For example, if CET1 drops by 10 percent as a result of a 1 percent loss in output in the 2018 EBA stress test, and the output loss is 2 percent in our scenario, then CET1 would drop by 20 percent in our case.[9] Note that the starting position at the end of 2019 was slightly different to that at the end of 2017. Table 3 shows the impact on Tier 1 capital across countries then.[10]

Reflecting the better macroeconomic performance in Germany and Austria in our Corona scenario than in the EBA adverse scenario and the modelling assumptions made, CET1 capital would be higher in those two countries at the end of 2022 than it was at the end of 2020 in the EBA scenario. Not surprisingly, the more pronounced the drop in CET1 capital, the bigger the output loss relative to the EBA scenario. This is particularly marked in Spain where our output loss is -2.9 percent compared to the -0.8 percent in the EBA scenario – nearly four times as much. Using our assumptions and methodology, the CET1 ratio drops to 2 percent as a result. This is probably an overestimate. The

7 On a transitional definition, the CET1 ratio stood at 14.58 % in Q4 2017 and 14.78 % in Q4 2019, while the leverage ratio stood at 5.57 % in Q4 2017 and 5.68 % in Q4 2019. See https://www.bankingsupervision.europa.eu/banking/statistics/html/index.en.html

8 See European Banking Authority (2018b) for summary charts with country data.

9 Another way to describe our methodology is that we calculate the elasticity of the capital ratio with respect to a change in GDP.

10 For simplicity, we ignore the implications of the introduction of IFRS9 on banks' balance sheets. See European Central Bank (2020e). By scaling the impact on the capital ratio based on domestic GDP in our illustrative and the EBA adverse scenarios, we also ignore banks' international exposures.

Illustrative capital impact of Corona crisis

	EBA 2018 adverse stress test			Illustrative Corona scenario		
	Cumulative output loss after 3 years	CET 1 capital Start	CET 1 capital End	Cumulative output loss after 3 years	CET 1 capital Start	CET 1 capital End
Netherlands	– 2.1	15.84	11.85	– 3.6	16.5	9.4
Germany	– 3.3	16.00	10.23	– 2.1	15.0	11.6
France	– 1.5	13.75	9.71	– 3.7	15.0	4.1
Italy	– 2.7	13.24	9.57	– 5.1	14.0	6.7
Spain	– 0.8	12.22	9.41	– 2.9	12.2	2.0
Austria	– 2.8	13.02	9.04	– 2.6	13.8	9.9

Table 3 | Note: For example, the ratio of GDP decline in the Netherlands in our illustration and in the EBA scenario is 3.6 / 2.1 = 1.71. In the EBA stress the Dutch capital ratio drops by around 25 % (= 11.85 / 15.84). We then scale up the decline with our ratio: 25 %*1.71 = 43 %. Imposing this decline on the new starting point of 16.5 yields 9.4 as the new end point. Sources: European Banking Authority (2018b) and authors' own calculations.

French and Italian banking systems would also suffer – on aggregate – substantial drops.

Banking systems might fall below Basel III capital requirements

Our illustrative scenario – which excludes any policy interventions – suggests that banking systems in a number of European countries would likely come under extreme stress and would probably fail a rigorous stress test.

On a national aggregate, banking systems in France and Spain would, for example, fail to meet the Basel III capital requirement of 4.5 percent for CET1 (Bank for International Settlement). In Italy the ratio would be below that in 2008 before the GFC (IMF, 2020a). To provide a benchmark: the 2014 EBA stress test set a hurdle rate at 5.5 percent (Bruno and Carletti, 2018),[11] while the Bank of England (BoE) set an aggregate hurdle rate of 7.5 percent for UK banks in its 2019 annual stress test (Bank of England, 2019). Half of the countries considered in our sample would thus have failed the hurdle rate set by the BoE.

11 Since then, EBA stress tests have no longer set an explicit hurdle rate.

Concluding Comments

Europe faces unprecedented challenges, with some forecasters worrying that the Corona crisis could lead to the deepest recession in several centuries.

Unlike the Great Financial Crisis, the Corona crisis is the result of an exogenous shock. Like the GFC, its severity is likely to differ across European countries. This paper shows that in the absence of unprecedented fiscal responses to support the economic recovery, the Corona crisis could have devastating effects on banking systems in some EU member states but not necessarily in others.

The nature of the crisis suggests that supporting the economic recovery must be the best policy now available to protect banking systems from rapidly rising defaults. That said, fiscal room for manoeuvre in the countries most affected by the Corona crisis is limited, suggesting that a European response involving an element of redistribution might be required (Odendahl et al, 2020). The European Commission's proposed Next Generation EU rescue plan – going beyond previously agreed EU-wide credit facilities – to support the most affected regions and countries could be a step in the right direction (European Commission, 2020c).

European solidarity might be tested in other areas too.

If our illustrative calculations are at all indicative of what might happen to banking systems in EU member states over the coming years, then the Corona crisis can also be expected to have far-reaching implications for the future of European financial markets initiatives, in particular Banking Union and Capital Markets Union.

One lesson of the GFC for European policy makers was to make banks stronger and better supervised. The EU set up a banking union comprising single supervisory and resolution mechanisms to achieve that. A third element, considered by many as necessary to complete the union (Carmassi et al, 2018), would be a European deposit insurance scheme. Significant resistance from a number of EU member states has meant that such a scheme has been put on hold so far.

Given the likely divergence in fortunes across countries post-Corona, we should not be surprised if resistance to a European deposit insurance scheme (and other policies perceived to involve "risk sharing" between EU member states) become even stronger.

What the Corona crisis means for the EU's Capital Markets Union (CMU) initiative is less clear. On the one hand, the rationale for CMU is probably stronger than ever, especially if European banking systems struggle to cope with the Corona fallout: Europe needs strong capital markets to support a recovery. On the other hand, the Corona crisis has already bolstered the role of the public sector – as exemplified by the European Investment Bank – in providing funding across EU member states. What then is the role of the private sector going forward? Can we expect closer collaboration between the public sector and markets in future or have the latter been crowded out? Will policy makers, faced with the crisis aftermath, potentially including future banking crises, have the capacity to progress this project?

Annex

Annex 1: Lessons from the Great Financial Crisis

Lesson 1 (global): Banks need to hold more and higher quality capital to ensure solvency and serve the real economy even in stressful times

A key lesson of the GFC was to make sure that going forward banks would have enough **capital** to stay solvent in order to keep on lending even during a deep recession. Therefore, regulators tightened capital requirements to ensure that banks can provide credit in any future crisis. Member states of the Financial Stability Board, a post-GFC innovation, also agreed to introduce countercyclical capital buffers (CCyB), which could be released in times of crisis to ensure the supply of credit (BIS, 2020).

Lesson 2 (global): Banks need to ensure liquidity to ensure cash flows even during a recession

Just like capital, **liquidity** is important for a well-functioning financial system. During the GFC, many banks faced liquidity risks from bank runs. Therefore, they today face more liquidity regulations as a whole than previously. One of these is the *liquidity coverage ratio (LCR)* that states that a bank needs to cover a fraction of deposits with high-liquid-assets to ensure short-term liquidity. Another is the net stable funding ratio (NSFR) to avoid future liquidity mismatch and to establish a sustainable funding structure (BIS). To ensure an appropriate analysis of a bank's liquidity and refinancing risk by the supervisory authorities, additional monitoring metrics (AMM) for supplementary observation have been established (Deutsche Bundesbank, 2019).

Lesson 3 (global): More effective supervision, including stress testing

To reduce the risk of contagion from one run on a bank leading to many bank failures, global awareness of the need for more effective supervision has increased post-GFC. EU member states, for example, agreed on improved supervision of banks under the Banking Union by the single supervisory mechanism (SSM) (European Commission). Under the SSM, banks – so far in the euro area only – are supervised in such a way that they act in accordance with EU banking rules and tackle problems early (Banking Union also covers a Single Resolution Mechanism). The expanded control also includes supervisory and bank stress testing (BIS, 2017). Both stress testing frameworks assess banks' capital and liquidity adequacies. Bank stress testing goes even further and includes various other objectives, aiming to improve the understanding of risk and adjust business practices.

Lesson 4 (specific to Europe): Develop capital markets across the EU to complement the banking system

For European policymakers another lesson from the GFC was to reduce the real economy's reliance on banks as a source of credit in future. This reliance varies across EU member states but is generally much higher than in the United States for example, which has a deeper and broader capital market. The Capital Markets Union (CMU) is meant to address this by developing other ("non-bank") sources of financing such as equity investments and risk capital.

A related objective is to establish a pan-EU capital market so that capital can be allocated more efficiently (i.e. optimal matching of investments and financing needs) and thus

raise productivity across the EU. The above-mentioned US model is often cited as a reason why its economy is more productive than the EU's. The reasoning behind the objective is that this would address the investment home bias and would enable investors to invest their funds across borders without any impediment. Similarly, a single capital market across the EU would ensure a greater choice of funding for businesses. By preventing any future fragmentation of European capital markets, the CMU would also forestall a situation arising as during the GFC, when cross-border capital flows dried up, leaving businesses in "periphery" countries without access to credit from banks in the European core.

Progress on CMU has been slow, with the European Council and European Commission keen to revive the initiative (European Council, 2019).

Annex 2: Policy responses to the Corona crisis

Governments

Governments provide **grants** to businesses directly (e.g. Germany's so-called *Soforthilfen/Kleinbeihilfen,* direct grants in Romania or compensations in Denmark), thus bypassing the banking sector.

On the upside, this can be quick and doesn't involve banks as an intermediary; on the downside, there are few checks and it is open to fraud. In terms of public finances, these measures will have an immediate budgetary impact.

Government **credit guarantee schemes** to support new bank lending. If firms default on these loans, banks will be able to recover their losses (partially or fully, depending on the guarantee) from the government and thus taxpayer. Examples include the German guarantees given by the Kreditanstalt für Wiederaufbau (KfW) and Italian guarantees granted by state-owned SACE. They are not meant to cover or be used to refinance existing loans. This implies that banks gain no benefit from the guarantees for the majority of their loan book.

On the upside, these measures are a contingent liability for the government and will not affect the deficit or debt – unless called on. They also involve in principle banks' usual credit assessments. On the downside, they may incentivise banks to provide more credit than they would normally give, lowering credit quality and potentially leading to an increase in non-performing loans in future (Schich, 2009).

In the EU, these schemes have to be approved under the State aid Temporary Framework adopted by the European Commission.[12]

Monetary authorities and financial regulators

In terms of (unconventional) **monetary policy,** on March 18th 2020, the ECB announced its Pandemic Emergency Purchase Programme (PEPP) to counter the impact of the Corona crisis on the economy. The central bank's govern-

12 For a detailed list of measures taken, see European Commission (2020b). The State aid Temporary Framework enables *"Member States to accelerate the research, testing and production of coronavirus relevant products, to protect jobs and to further support the economy in the context of the coronavirus outbreak. The amended Temporary Framework complements the many other possibilities already available to Member States to mitigate the socio-economic impact of the coronavirus outbreak, in line with EU State aid rules."*

ing council decided to implement a €750 billion temporary asset purchasing programme to stimulate euro area economies (ECB, 2020b). Moreover, banks are now allowed to post junk-rated bonds (lower than BBB-) as collateral at the ECB. This should help banks maintain their financing ability in the event that more and more loans lose their investment grade credit rating (Reuters, 2020). In terms of conventional monetary policy, the ECB kept its three main interest rates at their historic lows, where they have been since September 2019 (ECB, 2020g).

With respect to **prudential measures,** the ECB relaxed capital and liquidity requirements for the euro area's "significant" (i.e. systemically most important) banks directly supervised by it (Mack, 2020). During times of economic crisis banks might get into liquidity and solvency problems. Liquidity stress might come from increased withdrawals by banks' clients and, as experienced in the past, volatility in wholesale funding.[13] Furthermore, the ECB strengthened its position as the lender of last resort in the euro area, as the governing council decided to offer more immediate borrowing options for illiquid but solvent banks with the help of an increase in the longer-term refinancing operations (LTROs). These options should come with favourable conditions (ECB, 2020g). These measures were complemented by specific guidance on how to use capital. For example, the SSM recommended banks not to pay out dividends or engage in share buybacks (ECB, 2020c).

At the same time, national macroprudential authorities extended these measures to cover "less significant banks" supervised nationally (e.g. Banca d'Italia, 2020). Moreover, where possible, macroprudential authorities also lowered their country-specific countercyclical capital buffer (CCyB) (in most cases to 0%), the Systemic risk buffer (SyRB) and the Other Systemically Important Institution (O-SII) buffer (ECB, 2020f).[14,15]

These macroprudential measures involve short- versus longer-term trade-offs. On the one hand, they free up capital so that banks can keep on lending to the real economy during the crisis. On the other hand, these measures could potentially undermine financial stability – for example by encouraging banks to offer loans to more fragile businesses or by creating contagion risk within the banking system overall – and reverse years of macroprudential regulation (Borio and Restoy, 2020).

13 When the economic uncertainty is high, depositors for example might choose to hold an increased amount of cash – in the extreme this might lead to "bank runs". As a result, banks might be forced to fire-sell many assets at below market prices to raise enough liquidity to cover the withdrawals (and is also a reason why governments provide deposit insurance). This is a bleak but not unprecedented scenario – there were a number of bank runs during the GFC for example.

14 For an up-to-date list, see ESRB (2020b).

15 In most countries, the scope to lower the CCyB was limited by the fact that it had not been raised significantly above 0 prior to the Corona crisis.

Literature

Banca d'Italia (2020): *Recommendation of the Bank of Italy on the dividend distribution policies of less significant Italian banks during the Covid-19 pandemic* (Communicato Stampa 27 March 2020), at: https://www.bancaditalia.it/media/comunicati/documenti/2020-01/cs-dividend-policy-reccomendation.pdf?language_id=1

Bank for International Settlement: *Basel III: international regulatory framework for banks* (Updated regularly; last accessed on 13 May 2020), at: https://www.bis.org/bcbs/basel3.htm

Bank for International Settlement (2017): *Supervisory and bank stress testing: range of practices* (Basel Committee on Banking Supervision December 2017), at: https://www.bis.org/bcbs/publ/d427.htm

Bank for International Settlement (2020): *Counter-cyclical capital buffer (CCyB)* (Updated 15 April 2020), at: https://www.bis.org/bcbs/ccyb/

Bank of England (2019): *The results of the 2019 stress test of UK banks* (in Financial Stability Report December 2019), at: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf?la=en&hash=99431A541357AC6D601A99B950455E2344C-12901#page=12

Boot, Arnoud; Elena Carletti; Rainer Haselmann; Hans-Helmut Kotz; Jan Pieter Krahnen; Loriana Pelizzon; Stephen Schaefer and Marti Subrahmanyam: *The coronavirus and financial stability* (Vox CEPR Policy Portal 24 March 2020; last accessed on 15 May 2020), at: https://voxeu.org/content/coronavirus-and-financial-stability

Borio, Claudio and Fernando Restoy (2020): *Reflections on regulatory responses to the Covid-19 pandemic* (by Claudio Borio and Fernando Restoy (Bank for International Settlement Financial Stability Institute FSI Briefs No. 1 April 2020), at: https://www.bis.org/fsi/fsibriefs1.pdf

Bruno, Bunella and Elena Carletti (2018): *How demanding and consistent is the 2018 stress test design in comparison to previous exercises?* (In-depth analysis requested by the ECON committee of the European Parliament, June 2018), at: https://www.europarl.europa.eu/RegData/etudes/IDAN/2018/614520/IPOL_IDA(2018)614520_EN.pdf

Carmassi, Jacopo; Sonja Dobkowitz, Johanne Evrard, Laura Parisi, André Silva, Michael Wedow (2018): *Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?* (European Central Bank Occasional Paper 208, April 2018), at: https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op208.en.pdf

Deutsche Bundesbank (2019): *Liquidity regulation,* at: https://www.bundesbank.de/en/tasks/banking-supervision/individual-aspects/liquidity/liquidity-regulation-622878

European Banking Authority (2018a): *2018 EU-wide Stress Test Results* (European Banking Authority 2 November 2018), at: https://eba.europa.eu/sites/default/documents/files/documents/10180/2419200/126521e6-613f-45e4-af84-cbd3b854afc5/2018-EU-wide-stress-test-Results.pdf

European Banking Authority (2018b): *EU-wide stress testing 2018,* at: https://eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing/2018

European Banking Authority (2020): *EBA launches 2020 EU-wide stress test exercise* (EBA Press Release 31 January 2020), at: https://eba.europa.eu/eba-launches-2020-eu-wide-stress-test-exercise

European Central Bank (2020a): *Alternative scenarios for the impact of the COVID-19 pandemic on economic activity in the euro area* (Economic Bulletin 1 May 2020), at: https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202003_01~767f86ae95.en.html

European Central Bank (2020b): *ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)* (European Central Bank Press Release 18 March 2020), at: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html

European Central Bank (2020c): *ECB asks banks not to pay dividends until at least October 2020* (European Central Bank Press Release 27 March 2020), at: https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200327~d4d8f81a53.en.html

European Central Bank (2020d): *ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus* (European Central Bank Press Release 12 March 2020), at: https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html

European Central Bank (2020e): *IFRS 9 in the context of the coronavirus (COVID-19) pandemic* (European Central Bank 1 April 2020), at: https://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

European Central Bank (2020f): *Macroprudential measures taken by national authorities since the outbreak of the coronavirus pandemic* (European Central Bank, 14 April 2020), at https://www.ecb.europa.eu/pub/financial-stability/macroprudential-measures/html/index.en.html

European Central Bank (2020g): *Our response to the coronavirus pandemic* (European Central Bank, constantly updated), at https://www.ecb.europa.eu/home/search/coronavirus/html/index.en.html

European Central Bank (2020h): *Consolidated financial statement of the Eurosystem* (European Central Bank, 10 April 2020), at https://www.ecb.europa.eu/press/pr/wfs/2020/html/ecb.fst200415.en.html

European Commission: *Single supervisory mechanism* (Updated regularly; last accessed on 13 May 2020), at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/single-supervisory-mechanism_en

European Commission: *Capital Markets Union – A plan to unlock funding for Europe's growth* (Updated regularly; last accessed on 13 May 2020), at: https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union_en

European Commission (2020a): *Spring 2020 Economic Forecast: A deep and uneven recession, an uncertain recovery* (European Commission Press Release 6 May 2020), at: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_799

European Commission (2020b): *State aid rules and coronavirus*, at: https://ec.europa.eu/competition/state_aid/what_is_new/covid_19.html

European Council (2019): *Capital markets union: Council sets objectives for the deepening of the project* (Press Release), at: https://www.consilium.europa.eu/en/press/press-releases/2019/12/05/capital-markets-union-council-sets-objectives-for-the-deepening-of-the-project/

European Commission (2020c): *Europe's moment: Repair and prepare for the next generation*, at: https://ec.europa.eu/commission/presscorner/detail/ip_20_940

European Court of Auditors (2019): *EU-wide stress tests for banks: unparalleled amount of information on banks provided but greater coordination and focus on risks needed* (Special Report 10/2019), at: https://op.europa.eu/webpub/eca/special-reports/eba-stress-test-10-2019/en/

European Systemic Risk Board (2018): *Adverse macro-financial scenario for the 2018 EU-wide banking sector stress test*, at: https://eba.europa.eu/sites/default/documents/files/documents/10180/2106649/56989522-f7e5-413e-accc-5c39d23fdffa/Adverse%20macroeconomic%20scenario%20for%20the%20EBA%202018%20Stress%20Test.pdf

European Systemic Risk Board (2020a): *Countercyclical capital buffer*, at: https://www.esrb.europa.eu/national_policy/ccb/html/index.en.html

European Systemic Risk Board (2020b): *Measures taken in response to coronavirus (COVID-19) pandemic*, at: https://www.esrb.europa.eu/home/coronavirus/shared/data/esrb.covidpm.xlsx

Eurostat (2020): *GDP down by 3.8% in the euro area and by 3.5% in the EU*, at: https://ec.europa.eu/eurostat/documents/2995521/10294708/2-30042020-BP-EN.pdf/526405c5-289c-30f5-068a-d907b7d663e6

Ifo Institut (2020): *Wirtschaftsleistung bricht während der Corona-Schließungen um 16 Prozent ein*, at: https://www.ifo.de/node/54936

International Monetary Fund (2020a): *Italy Financial System Stability Assessment* (IMF Country Report No. 20/81), at: https://www.imf.org/~/media/Files/Publications/CR/2020/English/1ITAEA2020002.ashx

International Monetary Fund (2020ba): *April 2020 World Economic Outlook*, at: https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020

International Monetary Fund (2020c): *The Great Lock-down: Worst Economic Downturn Since the Great Depression*, at: https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression/

Mack (2020): *EU banks' vulnerabilities: Capital conservation key to withstanding Corona crisis* (Hertie School Jacques Delors Centre Policy Brief), at: https://www.delorscentre.eu/en/publications/detail/publication/eu-banks-vulnerabilities-capital-conservation-key-to-withstanding-corona-crisis

Odendahl, Christian; Sebastian Grund and Lucas Guttenberg (2020): *A proposal for a coronabond: The Pandemic Solidarity Instrument* (Centre for European Reform), at: https://www.cer.eu/sites/default/files/insight_CO_6.4.20.pdf

Redeker, Nils and Hainbach, Natascha (2020): *Flattening the Recession Curve Comparing Initial Fiscal Responses to the Corona Crisis Across the EU* (Hertie School/Bertelsmann Stiftung Policy Paper 1st edition 2020 April 2020) at: https://www.bertelsmann-stiftung.de/fileadmin/files/BSt/Publikationen/GrauePublikationen/20200409_Flattening_the_Curve_Redeker_Hainbach.pdf

Reuters (2020): *UPDATE 1-ECB accepts junk bonds as c ollateral to help virus-hit banks* (Reuters 22 April 2020), at: https://www.reuters.com/article/ecb-policy/update-1-ecb-accepts-junk-bonds-as-collateral-to-help-virus-hit-banks-idUSL5N2CA7CV

Roubini, Nouriel (2020): *Ten reasons why a 'Greater Depression' for the 2020s is inevitable* (The Guardian 29 April 2020), at https://www.theguardian.com/business/2020/apr/29/ten-reasons-why-greater-depression-for-the-2020s-is-inevitable-covid

Schich, Sebastian (2009): *Expanded Government Guarantees for Bank Liabilities* (OECD: Selected Issues), at: https://www.oecd.org/daf/fin/financial-markets/42779438.pdf

Vlieghe, Gertjan (2020): *Monetary policy and the Bank of England's balance sheet* (Speech given by Gertjan Vlieghe, External Member of the Bank of England's Monetary Policy Committee, Bank of England, 23 April 2020), at: https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/monetary-policy-and-the-boes-balance-sheet-speech-by-gertjan-vlieghe.pdf?la=en&hash=D76269239470F000514B5F6AA76500590254DBDC

Imprint

© 2020 Bertelsmann Stiftung and Jacques Delors Institut – Berlin, gemeinnützige GmbH

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
33311 Gütersloh
Germany
www.bertelsmann-stiftung.de

Jacques Delors Institut – Berlin,
gemeinnützige GmbH
Friedrichstraße 194
10117 Berlin
Germany
www.delorsinstitut.de

The Jacques Delors Institute Berlin is a joint project of

Hertie School of Governance

NOTRE EUROPE JACQUES DELORS INSTITUTE

Authors
Frank Eich, External Advisor
Theresa Küspert, Intern
Philipp Schulz, Junior Project Manager

Project lead
Katharina Gnath, Senior Project Manager, Programme Europe's Future, Bertelsmann Stiftung

Project support
Christina Claus, Project Assistant, Programme Europe's Future, Bertelsmann Stiftung

Editing
David Gow, Edinburgh

Layout and Graphs
Dietlind Ehlers, Bielefeld

Titelbild
Hans Braxmeier, Pixabay, https://pixabay.com/de/photos/euro-skulptur-eurozeichen-kunstwerk-2867925/
Pixabay License (https://pixabay.com/de/service/license/)

This publication is part of the joint research project Repair & Prepare: Strengthening Europe. To learn more, please visit our website: www.strengtheningeurope.eu

Hertie School
Jacques Delors Centre

BertelsmannStiftung