

ASSESSING EUROPEAN AND GLOBAL FINANCIAL SYSTEMS

The banking system has entered the crisis in good shape – unlike during the Great Financial Crisis (GFC), banks largely have sufficient capital buffers to absorb the shock. They have helped mitigate the situation, providing credit to the real economy. Core tier 1 capital ratios have either remained constant or increased, as banks set aside provisions for the progression of the crisis. There has also been no big corporate default. However, a large share of outstanding bank loans is to non-financial corporates, many of which are in affected sectors (the credit risk thus remains).

At the same time, this crisis is far from over. S&P Global expects credit losses to increase to over 200 billion for Western European banks in 2020-21 (compared to 59 billion in 2019-20). Furthermore, while there have been few credit rating downgrades, many European banks are assigned a negative outlook (especially in the UK, but across the board). Two main concerns are low profitability in the banking sectors (banks are unable to generate capital internally) and the bail-in preference that we have adopted, which may work in individual cases but not systemic crises.

Overall, the short-term policy response to the crisis has been positive, banking union (BU) works in conjunction to other policies at EU and national levels (including national guarantee programmes). Longer-term, deficits may become unsustainable and monetary policy support cannot continue indefinitely. A recovery strategy is needed.

This crisis is the first big test for BU. The Commission adapted the regulatory framework when the crisis began to aid the financial sector with amendments to capital requirements' regulation. Other proposals include a capital markets package and amending the securitisation framework, both under discussion at the legislative level. Beyond the quick fix, priorities include banking sector consolidation, progress on Capital Markets Union (CMU), sustainable finance and digitalisation (a Commission action plan is on the way).

This crisis provides an opportunity to further consolidate our banking sector. Mergers are likely to take place not only because of policy-maker incentives but also investor interest. The issue is investors largely prefer domestic consolidation (larger, short-term, economies of scale), these are thus more likely to happen in the short-term. The Commission (and other EU policymakers) would prefer large cross-country mergers, to improve capital and liquidity management at the cross-border level. Discussions between the Commission and member states are ongoing to smooth out preference differences. Policymakers should set direction, with the clear message that consolidation is welcome and a regulatory environment conducive to it.

A determining factor for the banking sector relates to how the extraordinary support measures, now in place, are withdrawn. There is both a risk of a premature or uncoordinated exit and of them being left too long (introducing moral hazard concerns). At the academic level, there should be relative agreement, but at a political level pre-crisis division could be enhanced.

The Basel committee postponed the final implementation round of the remaining Basel III framework. The Commission will have a legislative proposal on this in Q2 2021. However, the architecture of Basel III has sound fundamentals, it shouldn't be thrown-out. Progress is also on the way on anti-money laundering, this issue retains momentum despite the crisis.

Since we now have to rebuild part of our economies, we should do it in our sustainable manner, we have an opportunity to accelerate this transformation in a way that is economically beneficial. The green deal is ultimately a growth strategy, which allows Europe to become a world leader in a crucial and very relevant area with long-term potential. However, that does not mean that green goals are the sole priority. The case for digitalisation is similar and it is a process accelerated by the crisis. Technology is a winner take all game and may result in a deep divergence in the future. The same can be said for green growth, Europe should rise to opportunity.

International cooperation is essential both at a micro and macro level. Central Banks have given the system a temporary lifeline, but it is not time to dial-back on post-2008 improvements (eg. by allowing capital buffers to remain depleted). Regulatory progress on market financing is also key (central banks shouldn't in future be on the hook for non-bank financial entities too). At the macro level, we may no longer be facing a symmetric shock – divergence in outcomes appears likely. Sadly, the current global governance infrastructure is thinly stretched and likely insufficient.

Marta Domínguez-Jiménez