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# European Banks and the Covid-19 Crash Test

*Jézabel Couppey-Soubeyran (EconPol Europe, University Paris 1 Panthéon-Sorbonne, CEPII), Erica Perego (EconPol Europe, CEPII), Fabien Tripier (EconPol Europe, Université Paris-Saclay (Univ. Evry), CEPII)*

## Key Messages

- The Covid-19 crisis is not a financial crisis but it can become a serious test for European banks' strength and resilience
- European banks are stronger today than they were on the eve of the 2007-2008 financial crisis, however the Covid-19 shock more closely resembles the Great Depression of the 1930s
- This policy brief presents the problems that the Covid-19 crisis poses to banks, the proposals currently under discussion and the decisions taken to date by the monetary and prudential authorities.
- It highlights the fragility of the current prudential framework and the inadequacy of the resolution mechanism, which will require additional resources if the banking crisis cannot be avoided

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Telephone +49 89 9224-0, Telefax +49 89 9224-1462, Email Dolls@ifo.de
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# European banks and the Covid-19 crash test

Jézabel Couppey-Soubeyran, Erica Perego, Fabien Tripier

**Abstract**

European banks are stronger today than they were on the eve of the 2007-2008 financial crisis, thanks to the reforms that have taken place since then. But will they be strong enough in the face of a health crisis closer to the Great Depression of the 1930s than the stress scenarios envisaged by the European banking Authority for 2020? Access to central bank liquidity probably eliminates the risk of bank illiquidity, but it is not unthinkable that a bank insolvency crisis would have to be managed. The non-repayment of one in five loans would be enough to exhaust the current level of capital. The resolution mechanism would then have to be mobilised, which is unlikely to be sufficient in a context where, according to the European Systemic Risk Board, the risk of simultaneous defaults is increasing sharply. This would leave the possible mobilisation of the European Stability Mechanism. If this complement proves insufficient, a sovereign debt crisis in the euro area could re-emerge.

**Keywords**: Money&Finance; Europe

**JEL** : G21; G28; E58

*Jézabel Couppey-Soubeyran, Professor of Economics, University Paris 1 Panthéon-Sorbonne; Advisor, CEPII*
*Erica Perego, Economist, CEPII*
*Fabien Tripier, Professor of Economics, Université Paris-Saclay (Univ. Evry); Scientific Advisor, CEPII.*

**Introduction**

The Covid-19 crisis is not a financial crisis. But because it paralyzes the economy and profoundly disrupts financial markets, it poses the risk of a banking crisis. This would redouble the economic crisis and deepen the expected recession.

Banks' resilience in this unprecedented economic environment depends first and foremost on their access to central bank liquidity. The ECB has responded in line with other central banks and, for the time being, has avoided the risk that the banks would run out of liquidity. But the resilience of the latter also depends very much on their capacity to absorb losses and therefore on the level of their capital.

The requirements of Basel 3 have undoubtedly increased the proportion of liabilities on banks' balance sheet. But will the available capital buffers be sufficient? The ECB has taken the decision to allow banks to make full use of them, which means that capital ratios could fall below the regulatory minimum during the crisis. Will this relaxation allow banks to better support the economy or will it make them less resilient?

Banks, and not only public banks, are called upon to play a key role in supporting the economy. Through loan rescheduling, repayment moratoria, liquidity facilities, zero or negative interest rate loans, they will prevent the economy from sinking and thus also reduce their own losses. In other words, the resilience of banks will largely depend on the support they are able to provide to suffering businesses and households. Public loan guarantee schemes help banks too (such as the 'State-guaranteed loan' - PGE -in France). But, given the scale of the looming recession, if this support were to last for long periods of time, and if losses accumulate on bank balance sheets as a result, gradually depleting the absorption capacity constituted by equity capital, then inevitably difficulties will arise and bank failures will threaten. Would it then be possible to manage the situation using the Banking Union resolution mechanism agreed in 2012? The Covid-19 crisis is a serious test of the reforms undertaken in the wake of the 2007-2008 financial crisis.

This *Policy Brief* presents the problems that the Covid-19 crisis poses to banks, the proposals currently under discussion to raise the resilience of the European banking sector and the decisions taken to date by the monetary and prudential authorities. It highlights the fragility of the current prudential framework, which was not designed to deal with a crisis of this nature, and the inadequacy of the resolution mechanism, which will require additional resources if the banking crisis cannot be avoided.

## 1. Safer banks since the 2007-2008 financial crisis...

The current regulatory framework for European banks is the one inherited from the reforms carried out after the financial crisis of 2007-2008 (Table 1).

Following the recommendations of the Basel 3 agreement signed in 2010 and finalised in 2017, capital requirements have been strengthened, liquidity requirements introduced and a new, simpler capital ratio, not dependent on risk-weighted assets, added. Two new instruments, one adjusting the capital requirement to the financial cycle (counter-cyclical cushion) and the other to the systemicity of institutions (systemic overload), have also added a macro-prudential touch to the previously exclusively micro-prudential framework, i.e. dedicated to the prevention of individual bank's risks (credit, market and operational risks) rather than systemic risk.

The reforms have not only concerned prudential instruments, but also the organisation of the supervisory mechanisms. For euro area countries, the national systems have come to merge within the Banking

Union. More precisely, the ECB has become the supervisor of the so-called important banks (single supervisory mechanism, SSM, pillar 1 of the Banking Union), while smaller banks have remained under the supervision of national supervisors.

In addition to prudential measures, resolution mechanisms have also been put in place. The single resolution mechanism (SRM, pillar 2 of the Banking Union) is designed to make banks' senior creditors (holders of market debt included in the MREL[1]) accountable and to enable the orderly resolution of defaulting institutions. When capital is no longer sufficient to absorb losses, the bailout must first come from the senior creditors (internal bailout or "bail-in"). The latter must have taken at least 8% of the losses of the defaulting institution before the Single Resolution Fund (SRF) can be called upon to complete the bailout. This fund, which is made up of contributions from banks in proportion to their liabilities (excluding own funds and covered deposits), is not yet fully replenished. It will not be fully replenished until 2024, when it will have €55 billion at its disposal. Its current mobilizable endowment is about 80% of this amount. Bailout decisions are made by a resolution board.

In the event of a banking crisis, and after having made full use of the resolution mechanism, euro area Member States can also, *a priori*, count on the European Stability Mechanism (ESM), which is designed to help States in difficulty and also includes, in this framework, possibilities for direct and indirect bank recapitalisation, as well as indirect aid to States. The total lending capacity of the ESM amounts to €500 billion, of which the lending capacity for the banking sector is not specified, but it is one of the reasons why states can call on the ESM.

The gradual implementation of these reforms has led to a very significant increase in capital ratios on average in the euro area (Figure 1) and on a country-by-country basis (Figures 2 and 3). The risk-weighted capital ratio (ratio of Tier 1[2] capital to risk-weighted assets) for the euro area increased from 8.8% in 2008 to 14.7% in 2016, with the lowest values around 12% in Southern European countries and much higher values in Northern European countries (around 16-17% in Belgium, Germany and the Netherlands and a maximum ratio of more than 24% in Luxembourg). However, the differences between countries are much less pronounced in terms of unweighted ratios (i.e. the ratio of equity capital to total assets without risk weightings): all countries are around the euro area average of 5.8%. By construction, the unweighted ratio provides a lower assessment of the loss absorption capacity of banks' assets.

All these provisions have undoubtedly made European banks stronger than they were on the eve of the 2007-2008 financial crisis. But will they be strong enough in the face of a crisis as deep as the Great Depression of the 1930s? If the European Banking Authority seems optimistic[3], stock market investors are apparently less so: the stock market index of the European banking sector (Euro Stoxx bank), which never really recovered from the financial crisis of 2008, fell by more than 45% between December 2019 and March 2020 (Figure 4).

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1 The "Minimum requirement for own funds and eligible liabilities" is an expanded loss-absorbing cushion that includes debts that can be mobilised as part of the creditor bail-out (bail-in), adopted in 2016 and transposing the TLAC "Total Loss Absorbing Capacity" recommended in 2015 by the FSB, with the specific aim of making the resolution mechanisms operational.

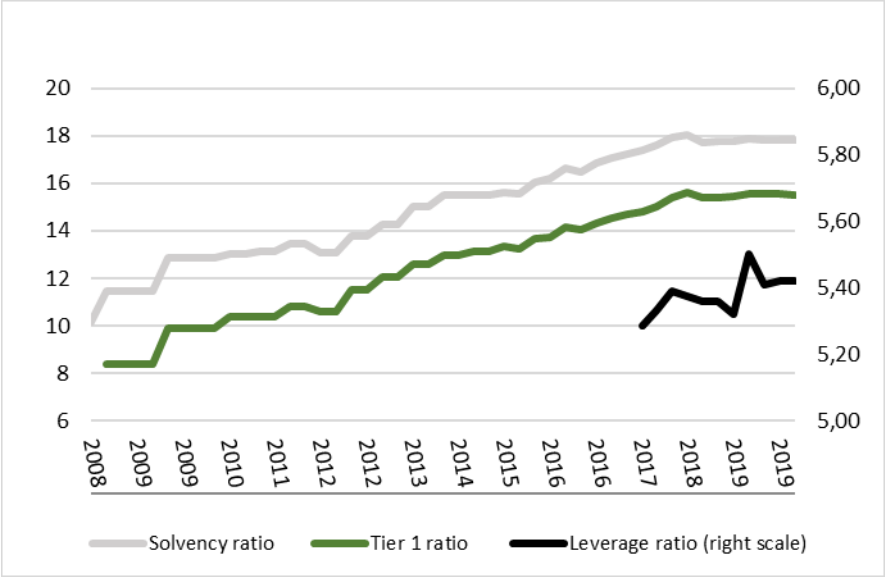
2 Tier 1 refers to Tier 1 capital, consisting of common shares and retained earnings.

3 The EBA published on April 14th 2020 an optimistic statement entitled "EU banks sail through the Corona crisis with sound capital ratios" https://eba.europa.eu/eu-banks-sail-through-corona-crisis-sound-capital-ratios.

**Table 1 - Bank reforms**

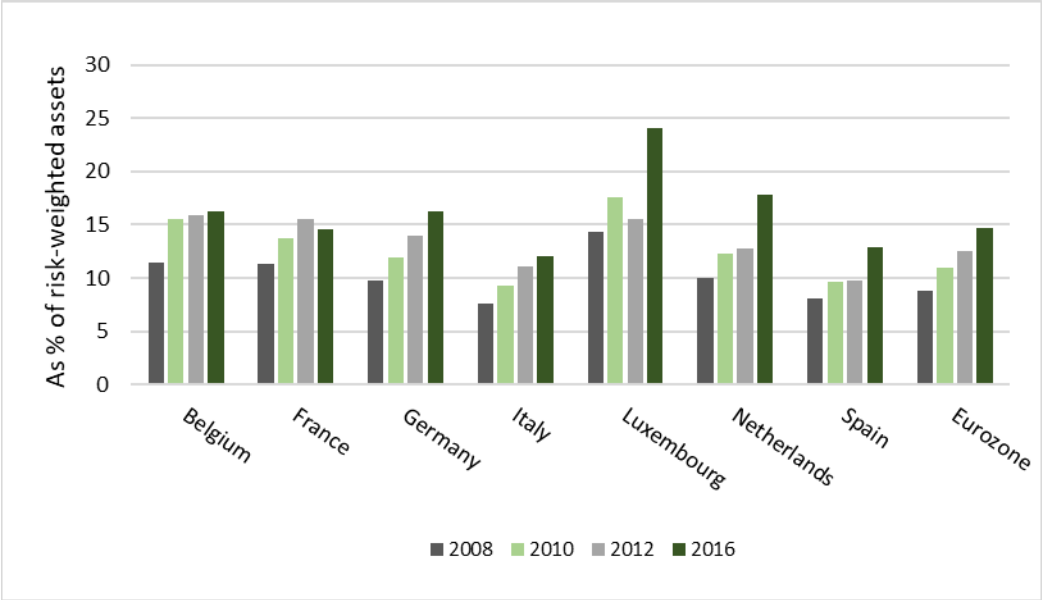
| Reforms | Provisions | Entry into force (Basel calendar) |
|---|---|---|
| **Basel 3 (2010)** | **Capital requirements :**<br>- solvency ratio: capital / risk-weighted assets> 10.5% (including 2.5 percentage points of conservation buffer)<br>- risk weighted assets are measured using two approaches: a standard measure provided by the supervisor; an internal measure based on a validated internal model<br>- *Output floor* (2017) for risk-weighted assets: internal measure / standard measure > 72.5%.<br>- Leverage ratio: equity / total exposures > 3%. | - Capital : 2019<br>- *Output floor* : 50% in 2022, 70% in 2026, 72.5% in 2027 (application postponed by one year due to the health crisis)<br>- Leverage ratio: 2018, revised definition of exposures (2023) |
| | **Liquidity conditions**<br>• LCR : high quality liquid assets / monthly net cash outflow > 100%.<br>*aims to ensure that banks are able to withstand a severe liquidity crisis over a period of about 30 days*<br>• NSFR : Stable financing available / stable financing required > 100%.<br>*aims to reduce maturity mismatches between assets and liabilities and increase the stability of ressources* | - Liquidity : 2019 |
| | **Macroprudential instruments:**<br>• countercyclical cushion : [from 0 to +2,5%]<br>• systemic overloads: [from +1 to +3,5%] | - Macroprudentiel (national policies)<br>*Rules transposed in Europe by the CRD4 Directive and the CRR Regulation adopted by the European Parliament in April 2013. Entry into force since 2014 (except output floor not yet transposed)*. |
| **Banking Union (2010)** | - Single Supervisory Mechanism (SSM): the ECB supervises major euro area banks<br>- single resolution mechanism (SRM): lease-in, single resolution fund (SRF), resolution plan, single resolution board (SRB).<br>- single deposit guarantee (unrealized) | - SSM: agreement signed in March 2013, operational since November 2014<br>- SRM : agreement signed in March 2014<br>- SRB operational since 2016<br>- Contributions to the SRF spread over 8 years from 2016 to reach 55 billion euros in 2024. |
| **European Stability Mechanism (2012)** | - Indirect bank recapitalisation via loans to Member States.<br>- direct recapitalisation of institutions<br>- Indirect aid to the banking sector through loans to States. | |

**Figure 1 - An improvement in the capital ratios of euro-area banks**



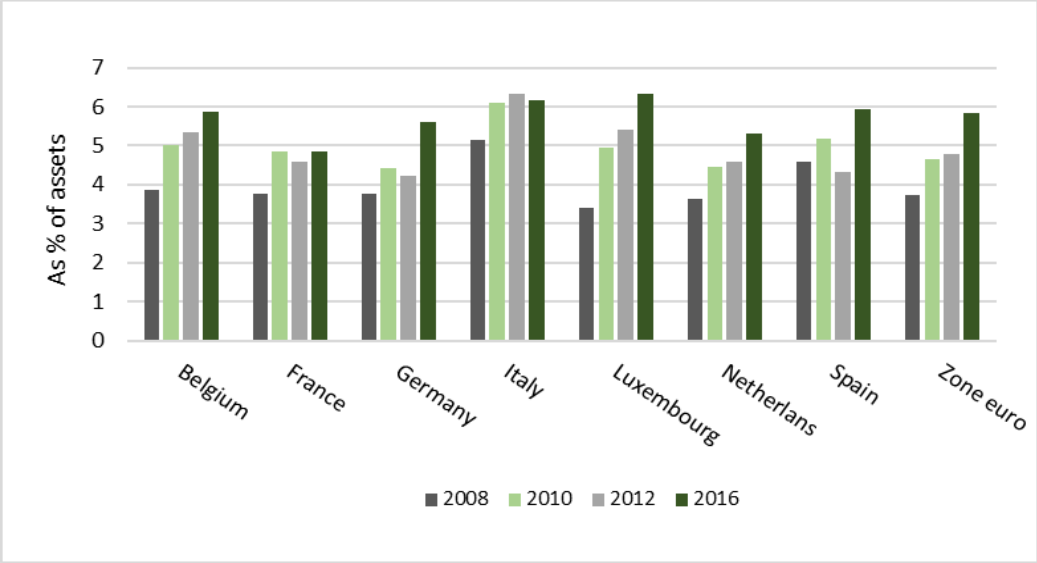

Source: ECB

**Figure 2 - An upward trend in the weighted capital ratio of euro area banks, differentiated by country**




Source: Bank for International Settlements (Table 1.20)

**Figure 3 - Another perception of the solvency of euro area banks based on the leverage ratio**




Source: Bank for International Settlements (Table 1.23)

**Figure 4 - Fall of the European banking sector stock market index (Euro Stoxx bank)**


Source : Euro Stoxx bank Index

## 2. … but not to the point of facing the risk of an economic disaster

The framework just described was designed, at best, to ensure that banks could withstand a repeat of the 2008 financial crisis. This resilience is periodically assessed in the context of the work on stress tests conducted jointly by the European Banking Authority (EBA) and the ECB in cooperation with the European Systemic Risk Board (ESRB), which is involved in the assessment and prevention of systemic risk in the EU financial system.

The EBA's worst-case scenario for economic growth in the year 2020 is far from the impact of the health crisis, which for the moment lies between the Great Depression of the 1930s and the Great Recession of 2008 (Table 2). The drop in stock prices has so far fallen short of these two major historical episodes, which were at the start of financial crises. If the crisis were to last, stock prices could fall further, beyond the 50% drop observed during the Great Depression. The IMF expects economic growth to be even weaker in 2020 than during the Great Recession, without reaching the double-digit negative growth rates observed during the Great Depression. The year 2021 will be critical. The IMF remains optimistic, forecasting a V-shaped recession with a strong rebound in economies by then, but uncertainty remains high.

The intention of the European supervisor, in its stressed growth scenario, was to ensure that the banking sector could withstand a repeat of a Great Recession, certainly not to prepare for an economic catastrophe like the Great Depression, with double-digit negative growth rates and a loss of more than half of the value of shares. In the face of such stress, considered hitherto unthinkable, the question of the resilience of the European banking sector arises.

**Table 2 - EBA stress test hypotheses compared to the past crises and to Covid-19**

| | | EBA Scenario | | | Great Depression | | | | Great Recession | | Covid-19 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Indicator | | 2020 | 2021 | 2022 | 1929 | 1930 | 1931 | 1932 | 2008 | 2009 | 2020- |
| Economic growth in % | United States | -2.1 | -2.7 | -0.1 | 5.2 | -10.2 | -7.4 | -14.6 | -1.2 | -0.3 | -5.9 |
| | Europe | -1.2 | -2.2 | -0.9 | 3.8 | -5.7 | -5.3 | -3.2 | -3.6 | -4.8 | -7.5 |
| Equity markets, % change compared to the year before the crisis | United States | -25 | -20 | -4 | -7.5 | -33.0 | -63.5 | -70.5 | -40.6 | -24.9 | -30,7 |
| | Europe | -25 | -20 | -4 | -11.2 | -28.9 | -51.8 | -52.3 | -44.4 | -32.0 | -34 |

*Note : for the Great Depression, the value for "Europe" is a non-weighted average of the values observed for France, Germany, Italy and Spain. For the Covid-19 period, the IMF's economic growth forecasts for 2020 (World Economic Outlook, April 2020) and the equity market fall observed on 23 March 2020 compared to 31 December 2019 for the Euro Stoxx 50 and the SP&500, are shown.*

*Sources : EBA, Jordà-Schularick-Taylor Macrohistory Database, Datastream and Fred Data.*

While rather optimistic and not taking fully into account the economic and financial impact of the health shock, the Covid-19 data in Table 2 would already lead to a large increase in borrowers' default. And this could have a rapidly negative impact on bank balance sheets. A simple calculation gives a minimal idea of this.

Aggregated assets of euro area banks (Table 3) amount to 34 trillion euros, of which 11.7 trillion are loans to the economy and 5 trillion are securities. Since own funds (capital and reserves) amount to 2,500 billion, it would only take 21% (11.7*21% = 2.5) of the loans not being repaid to exhaust them completely, without even mentioning the price drop in securities markets which mechanically degrade bank balance sheets due to accounting standards[4] which record trading securities at market value (trading book).

4 Accounting standards are the responsibility of accounting authorities (the International Accounting Standards Board (IASB) and national authorities such as, for example, the Accounting Standards Authority in France) and not of supervisors, even if they work together. Despite the problem of procyclicality that mark-to-market accounting can pose, it was not decided to suspend these standards during the crisis. However, the IASB recalled in its press release of 27 March 2020 that IFRS 9, which applies to banks, "requires judgment in its implementation". This can be interpreted, to some extent, as a relaxation of the principles for applying the standard.

**Table 3 - European banking sector aggregated balance sheet, end of February 2020**

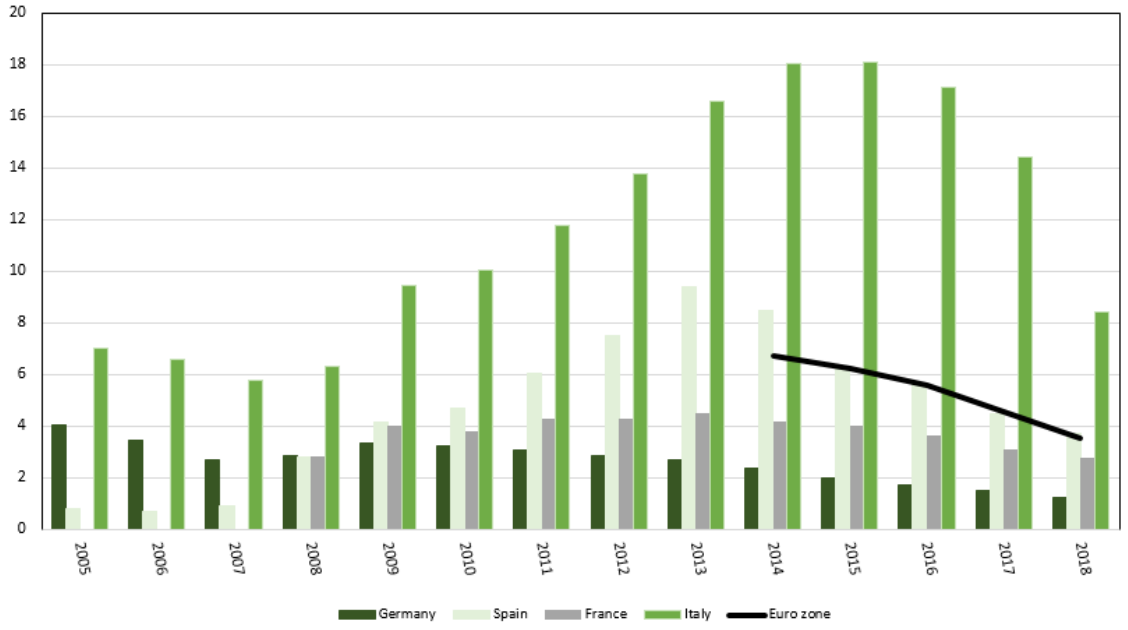
| | Capital and reserves | Total assets | Loans (private non-financial sector) | Debt securities (non-financial sector) | Shares and holdings |
|---|---|---|---|---|---|
| Thousands of billions of euros | 2,5 | 34 | 11,7 | 3,8 | 1,2 |
| Share, in % | 7,4 | 100 | 34,5 | 11,1 | 3,5 |

*Note : Are not included in this table interbank transactions, fixed assets and external assets, which account for around half of the aggregated balance sheet of the European banking sector as presented by the ECB in its Statistical Bulletin.*

*Source : ECB*

Is this rate of 21% implausible? Data on non-performing loans[5] provide an interesting order of magnitude, even if not all of them result in defaults. The rate of non-performing loans had fallen significantly in recent years, from an average in the euro area of 7% at the end of 2014 to 3% at the end of 2019 (Figure 5). But the disparities between countries are great. Italy, for example, had a non-performing loan rate of 18% in 2015, close to the figure mentioned above, and was still well above the European average in 2018 at 8%. Let's add that our figure of 21% is the result of a static reasoning that does not take into account the contagion and amplification effects that could accelerate the increase in default rates. Moreover, the aggregate data we are starting from conceals individual situations per country and per institution, which are necessarily contrasted.

**Figure 5 - Non-performing loans (as a % of total assets)**




Sources: World Bank and ECB for the Euro area.

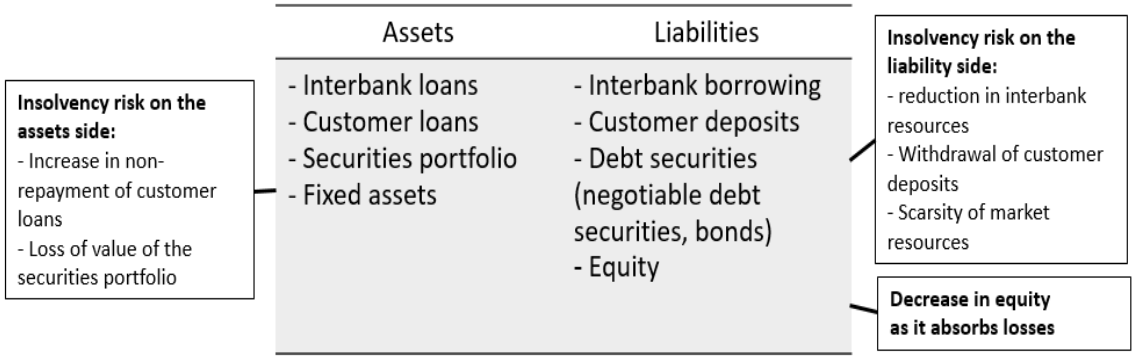
5 "A non-performing exposure is any credit risk exposure that is more than 90 days past due or unlikely to be recovered without recourse to the realization of collateral, whether or not it is past due" (ACPR, EBA).

In addition, the aggregated data from which we hide mask individual situations by country and by establishment necessarily in contrast. It is therefore not unthinkable that the capital of a number of European banks should be exhausted by the consequences of the health crisis and that an insolvency crisis should be managed. It is therefore not unthinkable that the capital of a number of European banks will be exhausted by the consequences of the health crisis and that an insolvency crisis will have to be managed. It is therefore not unthinkable that the capital of a number of European banks will be exhausted by the consequences of the health crisis and that an insolvency crisis will have to be managed.

## 3. A banking crisis difficult to prevent …

A banking crisis occurs when several banks are threatened with failure at the same time, as a result of insolvency problems (losses on assets) or illiquidity (inability to obtain sufficient funds to meet net cash outflows), which are propagated and amplified by precipitous asset sales and mass withdrawals by bank customers or creditors (diagram 1).

**Diagram 1: Liquidity and insolvency risk on banks' balance sheets**




*Source: Authors*

The long-term bank refinancing programmes announced by the ECB on March 12th and April 30th 2020 (LTRO, TLTRO[6], PELTRO[7]) should *a priori* limit the liquidity risk of euro area banks. The LTROs will be at negative rates and with no limit on amounts, since bids will be fully allotted until June 2020. Targeted longer-term refinancing operations (TLTROs) will follow from June 2020 until June 2021, which will allow banks maintaining their credit lines to refinance themselves at negative rates (25 basis points below the current deposit facility rate of -0.5%).

On the other hand, it is more difficult to predict the risk of bank insolvency, because this will depend both on the level of losses recorded by banks on their assets and on their capacity to absorb them, and therefore on the level of their capital.

6 "Targeted longer-term refinancing operations" (3rd series of operations of this type announced on March 12th 2020 at the same time of a further relaxation of "Longer-term refinancing operations": https://www.ecb.europa.eu /press/pr/date/2020/html/ecb.pr200312_1~39db50b717.en.html)

7 "Pandemic emergency longer-term refinancing operations" (program announced on April 30th: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200430_1~477f400e39.en.html)

The monetary, fiscal and prudential authorities, in seeking to limit the recessive consequences of the health crisis, are instead, for the time being, seeking to limit losses and provide additional sources of financing through guarantees and credit lines. Banks are encouraged to support the economy through credit, liquidity facilities, etc., and additional channels complement their support to the real economy through state-guaranteed loans[8] or additional liquidity facilities through deferrals of social security charges or tax maturities.

Of course, the additional financing provided could also end up in losses, but this support for the economy is rather expected to limit defaults on past claims by avoiding chain bankruptcies. It was also to facilitate their support for the economy that the ECB decided on March 12th to allow banks to fully use their capital and liquidity buffers. The EBA's decision to use, during the health crisis, the flexibility provided for in the supervisory framework as well as the banking package adopted by the European Commission on April 28th 2020 go in the same direction. The aim is to make it easier for banks to respond to their customers' liquidity needs. The Eurogroup agreement of April 9th mobilising the ESM, the European Investment Bank[9] (EIB) and the European Commission's SURE plan (credit lines to States to help finance short-time working and the health sector) also goes in this direction. By increasing the EIB's credit capacity by 200 billion, it relieves the banks and indirectly helps them to limit their losses. The mobilization of the EIB is in line with the proposal of Brunnermeier et al. (2020) who saw it as the right way to help banks meet the urgent liquidity needs of businesses across Europe. The mobilization of the ESM is similar to that of Bénassy-Quéré et al (2020) to create a special Covid-19 line of credit, including long-term financing, allocated proportionally to the health difficulties of each Member State.

It is therefore understandable, on the one hand, the interest of relaxing prudential constraints to allow banks to deploy their response capacity to the best of their ability. But, on the other hand, these relaxations will result in a deflation of capital buffers, which will ultimately reduce the banks' ability to absorb losses. Prudential authorities are thus facing a dilemma, since they have to reduce the procyclical, depressing impact of prudential constraints in the current situation, without excessively reducing banks' loss absorption capacity when they allow the reduction of capital cushions.

The conservation and counter-cyclical cushions resulting from the Basel 3 agreement (see Table 1) are supposed to mitigate this dilemma, as they can be deflated when the economic and financial situation justifies it -which is of course the case- by preserving the base cushion. The conservation cushion (2.5% of the 10.5% of the regulatory capital ratio) applies to all banks, since it is part of the capital standard which has been imposed since Basel 3. It should be noted, however, that if it were to deflate, as allowed by the prudential authorities at the time of the crisis, capital ratios (risk-weighted) would fall back to levels close to or below pre-2008 levels, around 8%, and those not weighted (leverage ratio) potentially below 3%.

As for the counter-cyclical cushion, it does not concern all banks, since its activation, which is the responsibility of the national authorities, had not been decided everywhere[10]. Faced with the Covid-19 pandemic and the need to counter a depressed phase for banking activity, most of the competent authorities have already announced, as did the High Council for Financial Stability (HCSF) in France on

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8 In this way, part of the credit risk is transferred to the government guaranteeing the loans in most euro area countries.

9 The European Investment Bank is the financing institution of the European Union. It claims to be "the first multilateral lender and the main funder of climate action in the world". The EIB group consists of two entities: the European Investment Bank and the European Investment Fund, which specializes in financing SMEs and mid-cap companies. As part of the Eurogroup support plan approved on April 9th 2020, the EIB has created a Covid-19 European guarantee fund, which will be endowed with 25 billion euros (provided by the 27 member states and the budget of the European Union) and will enable it to increase its support for European businesses by up to an additional 200 billion euros, in particular in favour of SMEs.

10 Of all the countries of the European Union (including the United Kingdom), before the health crisis, only 11 had activated the countercyclical capital buffer (and Italy was not one of them), for the most fairly weakly (below 1% in 8 of the 11 countries), with the exception of Ireland (2%).

April 1st, that they were lowering the countercyclical cushion rate to 0%. However, given that the cushions were weakly activated and that, even if they had been fully activated, their rate would not have exceeded 2.5%, the margin obtained by lowering them will be very limited to counter the downward phase of the cycle. Hence the reduction, tolerated during the crisis, of capital buffers below the macroprudential over-cushion, and potentially below the regulatory minimum of 10.5%. On April 16th 2020, the ECB clearly announced a reduction in capital requirements for market risks[11].

Another important aspect in the prevention of bank failures concerns the communication strategy to be followed. Should supervisors be transparent and regularly communicate on the state of bank balance sheets as the health crisis unfolds, at the risk of panicking bank customers and investors? Or, on the contrary, should they opt for opacity, during the crisis, to reduce the risk of panic, even if this means increasing uncertainty and paralyzing the economic decisions of bank customers?

Researchers are divided on the strategy to be followed in this area. Adrian and Narain (2020) argue for transparency on losses, which, according to them, allows all stakeholders to be prepared, and strengthening communication between banks and their supervisors. Beck (2020) also defends transparency, like Cecchetti and Schoenholtz (2020), the latter even advocating an extraordinary mechanism for communicating information to supervisors ("extraordinary disclosure mechanism"). On the contrary, Anderson and Copeland (2020) put forward that the communication of precise information can prove to be counterproductive and lead to phenomena of creditors' flight, which leads them to recommend not producing information on bank balance sheets. The tension between the risk of panic associated with transparency on the one hand and the risk of uncertainty and surprise associated with opacity on the other makes it very difficult to reach a clear-cut opinion on the matter. Admittedly, one can bear in mind the transparency of the US stress tests as early as 2009 and the debates sparked by those conducted in Europe by the EBA (in July 2010 and July 2011) at the start of the sovereign debt crisis, which were criticized for a major lack of credibility. This may have made the management of the banking crisis easier in the United States, but the ordeal of the sovereign debt crisis, as such, is perhaps a greater reason why the banking crisis was more difficult in Europe. As for confidence, a key factor in the functioning of the banking sector, is it better preserved when difficulties are ignored (opacity) or when they are revealed (transparency)? Both options are defensible.

Instead, the prudential authorities have opted for opacity. The EBA postpones the stress test work until 2021. The state of resilience of bank balance sheets will therefore not be known at the time of the crisis. However, the authority does plan a transparency exercise in 2020 to provide market participants with up-to-date information on banks' exposures and asset quality. The relaxation, during the health crisis, of the reporting requirements for supervisors, which is one of EBA's recommendations[12], may not facilitate this exercise.

Taken as a whole, will these preventive measures prevent a new banking crisis? And if, in the end, a banking crisis should occur, will the measures in place (SRM, ESM) be sufficient to manage it?

**4. … and even more difficult to manage in case it occurs**

If losses accumulate in the economy and financial markets, the erosion of banks' capital will increase their insolvency risk. It will then be necessary to activate the resolution mechanism (SRM). After mobilization of the creditors of the banking groups concerned for at least 8% of the losses, the SRF could then be mobilized for approximately 40 billion (its current allocation equal to 80% of 55 billion), which however

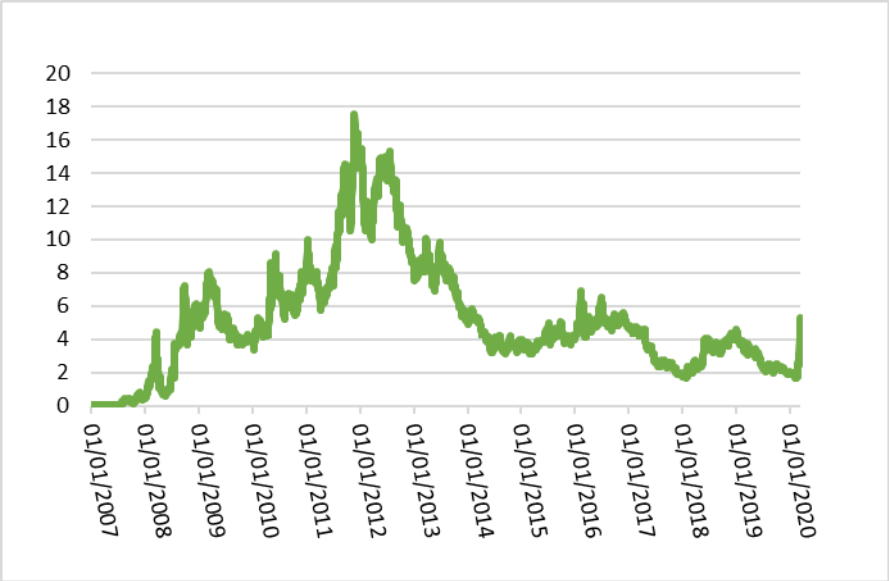
11 On April 1st 2020, the Fed also announced a temporary change, aimed at easing the leverage ratio of U.S. banks. See Nicolas Véron (2020).

12 https://eba.europa.eu/eba-provides-additional-clarity-on-measures-mitigate-impact-Covid-19-eu-banking-sector.

represents barely 2% of the capital of euro area banks. This amount would not be sufficient if several banking groups had to be recapitalized at the same time.

However, according to the European Systemic Risk Board (ESRB), the risk of bank failure has increased sharply since the start of the Covid-19 crisis. The probability of at least two major European banks defaulting exceeded the 5% mark in March 2020 (Figure 6). While we are still a long way from the record levels of over 15% observed during the sovereign debt crisis, the speed at which this indicator is rising and the gloomy economic outlook for the coming year suggest a substantial risk of contagion from the current crisis to the banking sector.

**Figure 6 - Probability of simultaneous default of at least two large banks**




*Source: European Systemic Risk Board (ESRB)*

In a banking crisis, it would become even more difficult to ask banks to increase their financing to the economy, especially as there are no procedures to force them to do so. Brunnermeier and Krishnamurthy (2020) recommend that monetary authorities use their system of incentives (by lowering the cost of refinancing for those who maintain their credit activity) and sanctions (by classifying non-performing loans more strictly in order to induce banks to renew loans before their customers are unable to pay interest). In the case of the euro area, incentives are in place with refinancing at negative rates for banks that maintain credit (TLTRO), but conditionality and sanctions are weak: in particular in the case of non-performing loans, the ECB and the EBA have relaxed their prudential treatment (more flexible classification, lower provisioning) to allow banks to benefit fully from government loan guarantees.

Should the resolution mechanism not be sufficient, the ESM could contribute to bank rescue via direct and indirect recapitalisation (Table 1). But could it be sufficient and what would be the counterpart of its mobilisation? According to Schularick and Steffen (2020), the ESM recapitalisation instrument is limited to 60 billion euros. The latter propose to extend it to 200 billion euros, which would correspond respectively to about 10% of banks' current capital level (Table 3) and about 50% of the current banks' market capitalisation in the euro area. In addition, ESM aid to states in difficulty is generally subject to counterpart measures, which were at the heart of the Eurogroup's discussions in reaching the April 9th agreement that ESM credit lines (ECCL precautionary lines), which can be used up to a maximum of 2% of

each member's GDP, should be exempt from conditionality for direct expenditure related to the health crisis. What would then be the counterparties vis-à-vis the banks, would they also be exempt?

In general, the counterparties required from banks in exchange for the support they receive from the ECB and the supervisory authorities are weak or even non-existent. For the time being, the ECB and the EBA have only "enjoined" and "urged" the banks to suspend the distribution of dividends to their shareholders, so that the retention of the corresponding profits would increase shareholders' equity rather than shareholders' remuneration.

If the combination of the SRM and the ESM proved insufficient, then the vicious circle between banking risk and sovereign risk, which the Banking Union intended to break, could reappear as the burden would fall on each state. It should be remembered that two years after the financial crisis of 2007-2008, when the Banking Union did not exist yet, the deterioration of public finances resulting from the rescue of the banking and financial sector had contributed to the sovereign debt crisis in the euro area, particularly affecting Spain and Ireland. The current situation is admittedly somewhat more favourable. Compared to 2010, a part of sovereign securities are held by euro area central banks, which *a priori* reduces the transmission of sovereign risk to banks. Moreover, when the Pandemic Emergency Purchase Programme (PEPP) was announced on March 18th, Christine Lagarde's ECB returned to her predecessor's famous phrase ("Whatever it takes") by declaring "The Governing Council will do everything necessary within its mandate", and added that the purchases under this programme would be made "in a flexible manner", meaning that the ECB would be able to deviate temporarily from the distribution key (based on each country's share in the ECB's capital) normally prevailing for its purchases of government debt, which it was already doing in April 2020. However, the ECB will have to demonstrate the necessity and the proportionality of its action, so as not to run up against adverse court decisions like that of the German constitutional court in Karlsruhe on May 5th 2020.

But, again, will that be enough? Will it be possible to avoid not only the banking crisis but also the reactivation of the vicious circle between banking risk and sovereign risk? No one can say for sure, as there is so much uncertainty about the outcome of the health crisis itself and, *a fortiori*, about its economic consequences. On the other hand, a new banking crisis would certainly lead to a re-examination of the current regulation. The 2008 crisis led to reforms that were intended to prevent a systemic financial crisis or, failing that, to mitigate its consequences. The reality of systemic risk was one of the major lessons of the financial crisis. We are now faced with the reality of health risk, hitherto underestimated. In addition to the fact that the post-2008 reforms might not even have been enough to deal with a simple repetition of a systemic financial crisis, they were certainly not designed to confront an economic disaster such as the one hinted at by the current health crisis. On the scale of disasters, this health crisis is even more serious than a systemic financial crisis because of the way in which it simultaneously affects all economic activities at the global level.

In April 2020, the IMF, perhaps being over-optimistic as it did during the 2007-2008 financial crisis, predicted a V-shaped crisis for Europe with negative growth of 7.5% in 2020 followed by a rebound in 2021, with growth of 4.7% (WEO, April 2020). The financial difficulties currently mainly concern non-financial companies, for which public recapitalisation programmes are underway as for Air France KLM, and not yet banks. The evidence presented in this Policy Brief suggests that European banks could hold in this scenario very (too) optimistic, as the banking reforms implemented after the crisis have increased their resilience. But if the crisis were to continue beyond 2020, it is highly likely that major European banks would be hit by the crisis and that the current framework for bank resolution would then prove insufficient.

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