FINANCE IN THE TIME OF COVID-19

THORSTEN BECK
GREAT FINANCIAL CRISIS VS. GREAT LOCKDOWN

- This crisis did NOT start in the financial sector, but financial sector will be affected negatively as many/most other sectors
- Financial sector can be catalyst for recovery or for prolonged crisis
- Quick monetary and prudential policy reaction reflects better preparation
  - Regulatory reforms have strengthened capital buffers in banking system (but maybe not sufficiently)
  - More data available to monitor situation
  - Experience with crisis management enabled quick policy reaction
  - Framework for international cooperation as good if not better (but is it being used?)
- Biggest risk: economic crisis turns into a financial (e.g., banking or sovereign debt) crisis
THE ROLE OF BANKING IN HELPING THE REAL ECONOMY

• Heavy draw-down of credit lines and increased credit demand
• Relationship lenders can be useful in current situation
• Banks have critical role in transmission of monetary policy and fiscal support measures
• Credit guarantee schemes:
  • Are loans what is needed? Or rather grants? Liquidity vs. solvency
  • Existing loans, new loans or both?
  • Coverage ratio: skin in the game vs. getting cash out quickly
  • How long will guarantees last? How to get private sector off the guarantees?
  • Quick recovery vs. capital reallocation
  • Banks as utility (passing on government support payments) vs. banks as screeners/monitors
  • There will be losses and government will have to bear them?
• Cross-border externalities (e.g., within Single Market)
• How to deal with widespread corporate failure post-lockdown
EUROPEAN BANK REGULATORS IN THE TIME OF COVID-19

• Immediate response of prudential authorities to looming pressures (and losses) in banking during and after the Great Lockdown
  • Release capital conservation buffer
  • Reduce counter-cyclical capital buffer to zero (where positive)
  • Allow banks to reduce capital below pillar 2 guidance
  • Request suspension of payouts (dividends, share buy-backs and, possibly, bonuses)
  • Easing on provisioning rules to mitigate their procyclical effect
  • Moratorium on further regulatory reforms

• Actions aimed at mitigating pro-cyclicality of bank lending
  • Central banks have intervened in financial markets, both to maintain liquidity, and to maintain bank lending (asset purchase programs, ease of collateral requirements)
  • Less emphasis on interest rate reductions (cost might not be the most important constraint)
LOOKING FORWARD TO THE AFTERMATH

• Losses will incur
  • Recovery will be uneven across sectors and countries (e.g., varying with containment policies)
  • Losses will thus vary across banks and countries

• Capital relief and changes in provisioning standards cannot prevent losses!

• Further sources of bank losses:
  • Low for longer
  • Stronger competition from BigTech companies, which will come out well from crisis with big cash piles

• How to deal with losses
  • Bank resolution frameworks post-2008 (BRRD) can deal with idiosyncratic risks
  • Unlikely that they are able to deal with systemic crises
  • Incomplete banking union
  • Possibly need for bad bank/recapitalization, but on EU/euro area level
CROSS-BORDER BANKING AND CHALLENGES FOR SINGLE MARKET

• Single Market includes principle of free capital movement
  • There should be no profit distribution restrictions within banking groups
  • Banks should have right to allocate resources where needed most and where highest return

• Fear of capital outflows, especially in countries heavily reliant on cross-border banks, negatively affecting financial stability and real sector lending

• Risk of broader regulatory ringfencing actions; flashback to post-2008

• Need for Vienna Initiative 3.0 or a similar framework

• Broader implications for developing/emerging world
FINANCE IN DEVELOPING COUNTRIES IN TIME OF COVID-19

- Often better capitalized than in advanced countries, but: less diversified asset portfolios
  - Focus on natural resource economies
  - For better or worse, financial system less relevant in less developed economies (higher reliance on internal finance) – can be an advantage in current circumstances
- Countries with increasing trend towards consumer credit might be in for shock
- Sovereign default risk has increased substantially – increasing sovereign indebtedness in recent years (with increasing role for Chinese debt)
- On the upside: mobile phone/banking networks allow for:
  - Better risk sharing within families/networks
  - Easier, speedier and more effective push-out of government support programs
IN SUMMARY

• Crisis did NOT start in the financial sector, but financial sector will be critical in determining how this crisis will play out

• Initial policy reaction by monetary, fiscal and prudential authorities very welcome

• Hard work still ahead: how to allocate losses; how to restart economy

• There will be hard political choices coming up:
  • Bail-outs (didn’t we say: never again?)
  • State aid for firms headquartered in tax havens?
  • (Indirect) transfer payments across countries?
  • Higher income/wealth taxation?

• Important: decisions to be taken by politicians, as accountable directly to people
THANK YOU

THORSTEN BECK

WWW.THORSTENBECK.COM

@TL_Beck_London