A PROPOSAL FOR A TEMPORARILY AMENDED VERSION OF PRECAUTIONARY RECAPITALISATION UNDER THE SINGLE RESOLUTION MECHANISM REGULATION INVOLVING THE EUROPEAN STABILITY MECHANISM

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THE COVID-19 CRISIS

- The **current Covid-19 (pandemic) crisis significantly differs** from the global financial crisis **(GFC) of 2007-2009, which was centered on the financial system**.

- It is a **crisis predominantly in the real sector of the economy**, mainly caused by the pandemic and the **lock-down and measures on containment and social distancing** implemented around the world.

- It has **affected both demand and supply of goods and services** and is expected to **hit the banking sector** as well.

- **Enterprises have been struggling due to the impossibility to operate** and the drop in the demand and have already started **defaulting on their loans**. **Households** may as well become **unable to repay their mortgages**, once again **passing their (in)solvency issues onto the banking sector.**

- This situation, replicated on a large scale, may have a significant negative effect on the **banking sector and affect its stability**.

THE DIFFICULTIES FACED BY BANKS

- **Banks** will find increasing **difficulties in lending money** due to the sharp **deterioration of the risk profile** of many of their borrowers.

- This might **exacerbate the current economic crisis**, probably **prolonging its duration**.

- Equally sifnificant, banks are expected, on average, to end up with **plenty of non-performing loans in their balance sheets**.

- All these criticalities are further exacerbated by the **low profitability characterising the commercial banking business model** over the last years, particularly in Europe.

- On the other hand, **banks** are, on average, **better capitalised than they used to be** before and during the global financial crisis of 2007-2009, and with solid **liquidity ratios** (the **“Basel III effect”**).

THE NEXT STEPS

- The very question is then **whether this higher level of capital will prove sufficient to absorb the losses** that banks will soon experience.
- **Too early to answer** but there are already two opposite schools of thought.
- If the banking system were to succeed in absorbing future losses, it would also manage to avoid negative spillover effects, **but - if this were not to be the case - recapitalisations will be necessary**.
- Still, in a context where many **private investors might be unwilling and/or unable to subscribe** to banks' increased demand for capital, having **effective regimes** in place, *possibly* also **relying on targeted public intervention, will be key** to limiting spillover effects.
- This also rests on the premise that the **banking system is meant to play a pivotal role in granting credit**, which will be particularly **important to keep the economy alive** and make it restart working when the pandemic will end.

A TEMPORARY, REVISED AND STANDARDISED PRIVATE-PUBLIC PRECAUTIONARY RECAPITALISATION

The **essence** of the **proposal** is to ***temporarily*** (i.e. for the duration of the crisis) **amend** specific **rules of the SRMR** on precautionary recapitalisation to make this **tool available on a larger scale and on a *quasi*-automatic basis to BU banks whose resolution plan already provides for resolution (and not liquidation)** in the event of a FOLF determination.

Additionally, we envisage the **recapitalisation** to be **conducted also by the ESM**.

The main assumptions are:

1) the **resolution framework** in place will, in essence, **not be compromised** and resolution planning should continue to develop;
2) since the **bar for resolution** set by the SRB is very **high according to its "public interest assessment"**, most significant **credit institutions, determined as FOLF** as a consequence of the crisis, will be **liquidated**, possibly with the use of public money, as in the past;
3) even though the ESM has a significant amount of resources quickly available, **no Member State has so far requested ESM credit lines** due to concerns of negative signalling in the market.

THE 7 CONDITIONS

1. There is a need to **(avoid or) remedy a serious disturbance of the economy and preserve financial stability**: NO CHANGE
2. This measure is only available for **solvent institutions that are not FOLF**: TO BE AMENDED
3. The measure must be of a **precautionary and temporary nature**: NO CHANGE
4. The intervention must be **approved by the Commission**: NO CHANGE
5. The measure should be **proportionate to remedy the consequences of the serious disturbance**: NO CHANGE
6. The measure should **not** be **used to offset losses that the institution has incurred or is likely to incur**: TO BE AMENDED
7. The capital **increase** should be **limited to injections needed to address a shortfall resulting from stress tests**: TO BE AMENDED

SOLVENT AND NOT FOLF INSTITUTIONS

- Depending on the amount of **NPLs** accumulated, some credit **institutions** will likely end up being **insolvent and determined as FOLF**.

- To face this obstacle, a **narrower application of the concepts of insolvency and FOLF** could be advanced.

- A **timeline** (*i.e.* the World Health Organiszation pandemic declaration on 11 March 2020, or sometime afterward) could **be introduced**.

- Accordingly, only **credit institutions whose liabilities have exceeded the assets as a consequence of their requalification as NPLs due to defaults occurred after the WHO declaration** (or sometime afterward) and **due to the pandemic will keep on being considered solvent and not-FOLF** for the purposes of the proposed temporarily amended precautionary recapitalization.

INCURRED OR LIKELY FUTURE LOSSES

- The **tool** is **meant to prevent banks from becoming FOLF and insolvent** as a consequence of the Covid-19 provoked crisis.
- The crisis will cause a **significant increase of NPLs** that, at some point, will have **to be accounted and subsequently written off**, thereby leading the **institutions to record losses**.
- Whether it can be argued that these losses are not previous losses already incurred by the institutions, it seems more **difficult to claim that they are not to be considered as losses that the institution 'is likely to incur in the near future',** (Article 18(4) SRMR).
- This **requirement** should be **either temporarily removed or reformulated** with a view to **excluding from its scope losses resulting from the Covid-19 provoked crisis.**
- A possible reformulation of this requirement could be based on the **same time-line** previously discussed.
- **Losses arising from loans which have become NPLs due to repayment defaults occurred after the WHO declaration** on 11 March 2020 (or sometime afterward) **and due to the pandemic would not be considered likely future losses**.

STRESS TESTING

- The **capital increase** should be **limited to injections needed to address capital shortfall resulting from stress tests** and asset quality reviews.

- Even though the EBA has decided that **stress tests will be suspended until 2021**, credit **institutions should be encouraged to undergo a recapitalization** to promptly react to their borrowers' inability to pay back their outstanding loans and credit lines.

- Therefore, **a standardized, yet case-by-case, assessment of capital shortfall could be performed by supervisory authorities**, as an alternative to system-wide stress tests, with a view to determining the amount of losses to cover.

THE ROLE OF THE ESM

- The **ESM** could be the **supranational player providing resources to precautionary recapitalize** credit institutions within the BU that need an increase of capital.
- The **ESM** could **raise resources by issuing senior bonds** on the market to be then **used to buy CoCos issued by credit institutions** in need.
- Such **CoCos** should have a **set of contractual clauses allowing them to be included within the CET1** of the institutions concerned.
- To face the **potential financing mismatch**, the ESM could issue **bonds *cum* warrants**, *i.e.* **senior bonds providing their holders with the call option to buy**, at pre-determined conditions, **the CoCos** previously purchased by the ESM.
- A further **alternative** could be to **enable ESM bondholders to convert CoCos in ordinary shares of the credit institution** after a given timeframe.
- **If bondholders were not to have the risk appetite** to buy CoCos or convert their senior bonds into shares, the **ESM should still be able to refinance its investments by issuing new bonds.**

FINAL CONSIDERATIONS

- The spirit of this **proposal** is **consistent with the position taken by the Commission** to tackle the Covid-19 crisis.

- The Commission has already adopted **measures aimed at facilitating public intervention** with a view to supporting private businesses struggling because of the crisis caused by the pandemic.

- Accordingly, it has **allowed Member States to deviate from the State aid general prohibition** and, accordingly, permitted them **to rescue failing firms, including banks, possibly without requesting burden sharing measures if problems are due to the pandemic (Temporary Framework).**

- The **amount of available bail-inable instruments** may still be **sub-optimal** for many credit institutions. Bail-in, therefore, **could turn out to trigger widespread failures**; this would happen if enterprises' bank deposits with a balance exceeding EUR 100,000 were to be bailed-in. Clearly, a similar resolution strategy would have **severe pro-cyclical effects potentially able to endanger both economic and financial stability.**