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EU Banking in the COVID-19 Crisis: Time for a "New Deal"

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The current COVID-19 sanitary and economic crisis requires a "New Deal" between EU governments and EU banks: EU banks agree to partner with governments in enabling the effective transmission of the government's vital financial support to the real economy in exchange for a transformation of the EU banking sector. This deal consists of a quid pro quo: governments condition the transmission via the banking sector of considerable monies to the real economy on a rationalization of the EU banking sector, which thus would become part of the post-COVID-19 "new normal."To be successful, this unparalleled support of the EU economy will come with governmental guarantees and fees for banking services. Banks partnering in the salvage operation would be required to review and render their business models "fit for purpose." A three-layered banking ecosystem in the EU should thus emerge one serving large corporates across the EU and also abroad, a second serving particular geographies and industries, and a third one more focused on retail clients and communities. Given the EU's openness and size, the region should host several banks of global standing and reach. The COVID-19 crisis is also an opportune time to enhance EU capital markets as a complement to the banking sector, especially with London's departure as a European financial center. The necessity of this project has been stated by many; COVID-19 has made it imperative to act. If this "New EU Banking Deal" deal does not materialize, the EU saga will include one more lost opportunity. More importantly, the consequences for both the banking sector and the entire EU financial and economic systems risk being dire. EU and banking authorities will have added to the costs of the economic and health catastrophes unfolding in front of us. Effective EU governance has never been more necessary in the face of major global issues such as COVID-19, climate change, and North-South migration. Now is the time for EU nations and their leaders in the public and private sectors to agree to a more robust financial union serving the EU population and its corporations. In doing so, the EU leadership will have met the growing concerns of an impatient EU public querying the purpose and value of the EU project.

EU Banking in the COVID-19 Crisis: Time for a "New Deal"

by

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Executive Summary

- The current COVID-19 sanitary and economic crisis requires a "New Deal" between EU governments and EU banks: EU banks agree to partner with governments in enabling the effective transmission of the government's vital financial support to the real economy in exchange for a transformation of the EU banking sector.

- This deal consists of a quid pro quo: governments condition the transmission via the banking sector of considerable monies to the real economy on a rationalization of the EU banking sector, which thus would become part of the post-COVID-19 "new normal."

- To be successful, this unparalleled support of the EU economy will come with governmental guarantees and fees for banking services. Banks partnering in the salvage operation would be required to review and render their business models "fit for purpose." A three-layered banking ecosystem in the EU should thus emerge one serving large corporates across the EU and also abroad, a second serving particular geographies and industries, and a third one more focused on retail clients and communities. Given the EU's openness and size, the region should host several banks of global standing and reach.

- The COVID-19 crisis is also an opportune time to enhance EU capital markets as a complement to the banking sector, especially with London's departure as a European financial center. The necessity of this project has been stated by many; COVID-19 has made it imperative to act.

- If this "New EU Banking Deal" deal does not materialize, the EU saga will include one more lost opportunity. More importantly, the consequences for both the banking sector and the entire EU financial and economic systems risk being dire. EU and banking authorities will have added to the costs of the economic and health catastrophes unfolding in front of us.

- Effective EU governance has never been more necessary in the face of major global issues such as COVID-19, climate change, and North-South migration. Now is the time for EU nations and their leaders in the public and private sectors to agree to a more robust financial union serving the EU population and its corporations. In doing so, the EU leadership will have met the growing concerns of an impatient EU public querying the purpose and value of the EU project.

EU Banking in the COVID-19 Crisis: Time for a "New Deal"

What difference between the financial bailout and the COVID-19 support?

For the past twelve or thirteen years, the term crisis has become an integral part of the vocabulary of financial markets and the banking sector in particular. The crisis has essentially become an abbreviation for the financial crisis. The reasons are clear: after an extended period of economic growth, the banking sector essentially blew itself up in 2007. Regarding the banks as vital for the economy, governments and central banks had to rescue the industry through forceful and combined actions.

One of the many remarkable aspects of the COVID-19 crisis is that the situation has now completely reversed itself: banks, on both sides of the Atlantic, are being asked by governments to help them save their economies.

As always, in crisis, challenges abound and are numerous. But so do opportunities. In this paper, we wish to point out that the situation presents both EU governments and their banking sectors with a historical opportunity for needed transformation and rationalization. The call for EU action in the face of the catastrophe has been thoroughly addressed[1].
The banking aspect has not. On the contrary, the common assumption in these calls is that the EU banking sector being well-capitalized, the industry should readily respond to the request. We address and dispute this claim here.

In both the EU and the US, the call on the banking sector is the same. However, the current state of these two differs substantially. From an economic perspective, US banks came out of the financial crisis much better than their EU cousins. Before COVID-19, US Money Center banks were valued at around 1.24 times book value and US regional banks at 1.5x. The average price to book value for European banks was just over 0.5x, a ratio similar to that of the largest Chinese banks. The return on equity (ROE) of the US banking system at the end of 2019 was 11.8 %[2] as compared with 5.8 %[3] for the EU banking system, whose profitability deteriorated in Q4.

These comparative valuations and profitability measures suggest that the EU banking sector hasn't fully recovered from the crises that enveloped the Eurozone following the 2007-08 financial crisis. That is not solely the responsibility of banks, confronted in the Eurozone with near zero and even negative interest rates. The starting point for any improvement in the current state of affairs of the EU banking sector is a responsibility shared with governments that bailed them out, and with regulators. At this point, there is no need to point fingers. Matters need to improve. And so does collaboration.

The COVID-19 crisis is fueling several tensions, including on the role the European banking sector will be asked to play by national and EU governments. The Head of the ECB, Christine Lagarde, initially stated that banks and nations should no longer rely to the same extent on the ECB as they had done with her predecessor and that she was not "Mario Draghi No.2." Draghi is generally credited with salvaging,

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[1]. See, e.g., COVID-19: Europe needs a catastrophe relief plan, by Agnès Benassy-Quéré, Ramon Marimon, Jean Pisani-Ferry, Lucrezia Reichlin, Dirk Schoemaker, Beatrice Weder di Mauro, *VOX CEPR Policy Portal* (March 11, 2020) / https://voxeu.org/article/covid-19-europe-needs-catastrophe-relief-plan
[2] Federal Financial Institutions Examination Council (US), Return on Average Equity for all U.S. Banks, retrieved from *Federal Reserve Bank of St. Louis* (April 30, 2020) / https://fred.stlouisfed.org/series/USROE
[3] EU banks sail through the Corona crisis with sound capital ratios, *European Banking Authority* (April 14, 2020) / https://eba.europa.eu/eu-banks-sail-through-corona-crisis-sound-capital-ratios

nearly single-handedly, the EU banking sector from a crisis that had originated in the US.[4] Massive purchases by banks of risky US financial instruments that later proved to be toxic brought the crisis to Europe. It then was compounded by individual EU governments exceeding previously agreed debt ceiling targets.

Lagarde was not shy to remind everyone that the current European financial situation is not healthy, and rapidly deteriorating due to the COVID-19 crisis. Yet, she first stated that the ECB was not there to take care of interest rates on bonds issued by various EU countries.[5] Lagarde's pronouncement was a direct admonishment to national governments and finance ministers to get their houses in order first by reducing national debts and, also, reducing banks' dependence on finance ministries and national or EU handouts. This dependence was immediately illustrated, following her statement, by rapidly growing spreads amongst national debts (pressuring Italian bonds first). Lagarde was not wrong but immediately faced hostile comments from indebted countries. She quickly had to backtrack. The ECB had to promptly announce a 750 billion Euro bond buy-out program to defend the Euro economies from collapsing in debt following COVID-19 governmental actions.[6] Referring to the way WWI shaped Italy, Chicago Professor Zingales has framed the current crisis as a "live or die" moment for the EU.[7] Lagarde had become Mario Draghi No.2, against her own will. The passivity of European governments left her no choice.

Why US banks emerged better and faster from the global financial crisis

Differences between the banking sectors are not the only characteristic that sets the US apart from the EU. The breadth, depth, functioning, and dynamism of capital markets differ vastly between these two regions. These factors profoundly affect the effectiveness of the public sector's response to a financial crisis. Easy US monetary policy (or quantitative easing, QE in short) can effectively transmit real stimulus into the real economy through a vibrant capital market that allows the efficient repricing of financial assets.[8] The US economic rebound and response to the stimulus was swift and protracted. As a separate matter, there are associated questions regarding the distribution of this wealth creation, which still linger.

Stimulation of the economy appears harder to achieve in Europe. Governments typically issue bonds in their efforts to stimulate the economy. Banks then buy these bonds and hold them for substantial periods. Little new investment results, leaving industrial activity unchanged. The US produces more asset bubbles in a shorter period; it also seems to recover more quickly after a systemic collapse or business-cycle downturn. While the size of non-bank capital markets has increased in the EU relative to the entire economy, there is still much more to be done for Europe to dispose of, and benefit from, a

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[4] Draghi leaves Lagarde to heal rift at European Central Bank, by Balazs Koranyi, Francesco Canepa, *Reuters* (October 29, 2019) / https://www.reuters.com/article/us-ecb-draghi-insight/draghi-leaves-lagarde-to-heal-rift-at-european-central-bank-idUSKBN1X80HC

[5] Italy furious at ECB's Lagarde 'not here to close spreads' comment, by Giuseppe Fonte et al., *Reuters* (March 13, 2020) / https://www.reuters.com/article/us-ecb-policy-italy-minister/italy-furious-at-ecbs-lagarde-not-here-to-close-spreads-comment-idUSKBN20Z3DW

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

[7] The EU must be forged in this crisis or it will die, by Luigi Zingales, *Financial Times* (April 5, 2020) / https://www.ft.com/content/8f554b7a-74d1-11ea-90ce-5fb6c07a27f2.

[8] Has quantitative easing worked in the US?, by Andrew Walker, *BBC* (October 30, 2014) / https://www.bbc.com/news/business-29778331

sizeable capital market.[9] This shortcoming severely limits the power of monetary stimuli from the center.

In sum, the situations of US and EU banks today still differ significantly.[10] This difference impacts the capabilities of the respective banking sectors to successfully answer today's call from governments in rescuing the economies from their COVID-19-induced halt. On the EU side – and it is the main point of our article - the current state also presents an opportunity for an innovative public-private partnership directed at banking reform and bridging the gap. Daunting challenges face the EU economies in the months and years to come. It is our view that this partnership is a vital element in steering the EU economies through them.

One factor to consider when looking at the US recovery from the financial crisis has been the clarity and swiftness with which US regulatory and government authorities have acted. The US is more vigorous in its responses and actions during an emergency. This greater vigor stems from several factors: the versatility and strength of its capital markets, American resolve by public and private sector authorities alike to "get on with it," and lesser concern for the social impacts of individual policies are often-cited factors.

In contrast, Europe's measures often are difficult to come about and piecemeal, mostly because of a lack of agreement across EU countries on the role of central banks and the role and size of fiscal policies. What the EU is sorely missing is a European-level finance ministry overseeing national budgets and implementing EU fiscal priorities in a consistent and timely manner. The lack of agreed answers on these questions invariably evokes loud public national debates, as does the distributional impacts of such interventions. A consensus around the size, form, and speed of government intervention is then tricky to obtain. In contrast, US monetary and fiscal policies are much easier to coordinate. Hence, the prevailing view that US banking is in better shape mainly due to market forces and laissez-faire by the government is only half of the story.

The other half of this story is greater ease in securing the needed alignment amongst political and economic forces. During the financial crisis, the US government intervened to recapitalize its banks in the "public interest." But, injections of capital did come with requests for business model changes by recipient banks. There were real quid pro quos, orchestrated if not mandated by the US Treasury and the Federal Reserve. For example, in exchange for additional liquidity, Goldman Sachs and Morgan Stanley were required to become Bank Holding Companies regulated by the Federal Reserve.[11] That gave them additional funding sources, amongst other things. The alignment and swiftness of the actions by the US Government and the Federal Reserve, not to mention some national discretion in the adoption of new post-crisis BIS guidelines, have substantially contributed to US banks being fitter today. It endowed them with the economic energy and muscle expected in the US from private companies. Their market valuations before the COVID-19 crisis attest to this.

[9] ECB pushes for EU capital markets integration and development, *European Central Bank* (March 3, 2020) / https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200303~5eaf4c119d.en.html

[10] Share of non-performing loans held by banks in the U.S. 1995-2019, by M. Szmigiera, *Statista* (February 20, 2020) / https://www.statista.com/statistics/211047/percentage-of-non-performing-loans-held-by-us-banks

[11] The Federal Reserve Board of Governors Provides Ongoing and Expanded Access to Federal Reserve Window and Other New Funding Opportunities, *Morgan Stanley* (September 21, 2008) / https://www.morganstanley.com/press-releases/morgan-stanley-granted-federal-bank-holding-company-status-by-us-federal-reserve-board-of-governors_6933.

Coupled with well-functioning capital markets, the unprecedented quantitative easing (QE) measures initiated by the Federal Reserve allowed the monies printed by the Fed to enter the real economy in substantial quantities and through various channels, leading to a renewed vitality of the US economy. These channels affect the multiple segments of the US capital markets in real yet differential ways.[12] Such effects are much less present in Europe due to underdeveloped capital markets.

We have all witnessed the tremendous energy of the US economy over the last years. It has been the envy of the world's economies, many of whom benefited from it through trade and investment. The valuations of US banks, which also are the envy of many, reflect this strength.

How EU banks came out of the financial crisis

In contrast, Europe has not seen a reduction in the number of banks, and little restructuring or downsizing has occurred so far.[13] Frieden and Walter point to the unmet need for European countries to agree on the management and governance of their common currency. One consequence of this indecision is that high levels of non-performing loans (NPL's), or non-performing exposures (NPE's), are weighing on EU banks that are struggling to do their share in sustaining profitable businesses.[14] "Too big to fail" is still alive and kicking across EU countries. Banks continue to have close ties to their national governments and regulators. These relations create distortions amongst banks throughout the EU. Size and importance to the domestic market - and not the EU - is their driving force and their main "raison d'être." EU banks have been allowed to maintain national monopolies or oligopolies for too long. As a consequence, QE measures initiated by the ECB have resulted in banks' balance sheets swelling with excessive amounts of the national debt, insufficient monies entering the private sector. Zero-to-negative interest rates have further soured the banking climate and killed any economic vibrancy that may have remained in challenging banking contexts. As a result, EU banks are relatively weak as vital private commercial entities providing credit to the economies and the customers they are meant to serve. The COVID-19 crisis offers the opportunity to change all that.

Governments, regulators, and bankers are quick to point out that banks in Europe are now well-capitalized. However, there have been regulatory disincentives for banks to make new loans through the use and modification of risk weightings. If banks truly were overcapitalized, one would expect them to clear out their existing and stale NPL balances into the market. The ECB would like to see more improvement on this front,[15] notwithstanding some progress reducing the NPL loan books across Europe

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[12] The Effects of Quantitative Easing on Interest Rates: Channels and Implications for Policy, by Arvind Krishnamurthy and Annette Vissing-Jorgensen, *NBER Working Paper Series No. 17555* (October 2011) / https://www.nber.org/papers/w17555

[13] Understanding the Political Economy of the Eurozone Crisis, by Jeffry Frieden and Stefanie Walter, *Annual Review of Political Science*, Vol. 20:371-390 (May 2017) / https://www.annualreviews.org/doi/10.1146/annurev-polisci-051215-023101.

[14] Non-performing loans, *European Central Bank (*Letter from Danièle Nouy, ECB Supervisory Board Chair, to MEP Marco Zanias / https://www.bankingsupervision.europa.eu/banking/priorities/npl/html/index.en.html

[15] Non-performing loans in the euro area – where do we stand?, *European Central Bank* (Speech by Andrea Enria, ECB Supervisory Board, at the Conference "EDIS, NPLs, Sovereign Debt, and Safe Assets," Institute for Law and Finance, Frankfurt, June 14, 2019) /
https://www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp190614~bee1d0f29c.en.html

(Greece and Cyprus remaining particularly problematic).[16] A more significant action in reducing "bad loan books" would reduce the drag on the banks' balance sheets and allow them to focus more on funding new economic activities and also on transforming their business models. Both thrusts would increase bank profitability and sustainability. Low bank share prices reflect this sorry state of affairs. In this environment, a final puzzle is why bank shareholders have not led a higher charge to more substantial and faster transformation in the banking sector.

Thus, the European banking sector faces the COVID-19 health and economic crisis - unfolding in front of our eyes - in a very different shape than the US banking sector. New investment commitments by existing and original private equity holders are quite challenging and difficult to envisage in this environment. Investors and equity holders, acknowledging their failure to see changes they requested materialize, look like they have stopped pushing for significant changes. Even worse, they are devoting their energies to explain the current state of affairs and the difficulty of meaningful change or progress, when they could apply higher pressure on boards and executives to demand significant changes.[17]

The dilemmas facing EU banking boards in the current crisis

Today, our economic infrastructure in the EU, as in the US, needs to be kept on life support. Banks everywhere are called by their governments to play an essential role in the rescue of businesses and economies. In what are indeed war-like efforts, governments are calling on banks to play a critical role as the transmission and disbursement mechanism for their fiscal and credit stimuli. Loans need to be underwritten, disbursed, and monitored.[18]

Banks exist to perform detailed and complex disbursement, monitoring, and reimbursement tasks, and to do so both effectively and efficiently. Governments cannot assume this. The path for a financial, economic, social, and political partnership between banks and their governments – and the citizens that elect them - is thus unprecedented. It also is needed as this is not a time to be wasting precious resources, and the outcomes of failure will be severe in terms of economic recovery.

Embracing this call will have profound consequences for EU banks, especially in their relations with stakeholders, and ultimately their governance. One is the discussion surrounding the provision of the additional capital necessary to expand the desired lending to the economy. Not all companies will be saved or should be protected. Nor will all existing and new loans be repaid as scheduled, adding to the non-performing loan issue many institutions are already suffering from, and which others will now share. If one adds to these concerns, share buy-back limitations, and new minimum capital requirements, it is clear that today's banking boards face profound and challenging issues. They need to find the appropriate balance in responding to their new government mandates on the one hand and the expectations of shareholders on the other.

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[16] Three authorities, five sets of NPL rules: Banks face a raft of supervisory initiatives over non-performing loans, by Alessio Venturino *KPMG* (2020); https://home.kpmg/xx/en/home/insights/2019/04/three-authorities-five-sets-of-npl-rules-fs.html

[17] Why big UK and European banks are struggling to grow returns, by Ian King, *Sky News* (February 24, 2020) / https://news.sky.com/story/why-big-uk-and-european-banks-are-struggling-to-grow-returns-11938574

[18] Quantitative Easing in the Euro Area: Transmission Channels and Risks, by Klaus-Jürgen Gern, Nils Jannsen, Stefan Kooths, Maik Wolters; *Intereconomics* Vol. 50, 4: 206-212 (2015) / https://www.intereconomics.eu/contents/year/2015/number/4/article/quantitative-easing-in-the-euro-area-transmission-channels-and-risks.html

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The relative weights of stakeholders and the strengths of their voices have changed since the financial crisis. Banks have undoubtedly become more complex to govern. Their boards must navigate the regularly conflicting demands of key stakeholders. Even in the US, a context of growing income and wealth gaps has challenged the dominating paradigm of shareholder primacy and fueled in calls for greater social responsibility. Shareholder supremacists everywhere had to accept the legal requirement that the fiduciary duties of board members are first to the organization and that shareholders are privileged stakeholders for sure, but also governments and lenders have their rights. And that in the end, customers pay for everything, not shareholders.

The governance issue for EU banking boards

The question facing EU banking boards is clear: how will they replay to the urgent call from their governments to help them restart their economies? Will they voluntarily and firmly embrace the call, making serving their customers and communities their number one priority? Their reportedly high capitalization suggests they could do so. Their low earnings and valuations make them more vulnerable, yet simultaneously make them more eager to accept the additional business handed to them by their finance ministries.

Alternatively, EU banks, now used to substantial interference by public regulators and governments, may embrace the call reluctantly and mostly because they feel forced by political leaders to be an extension of public policy. These political leaders indeed are elected by the same citizens that banks serve, creating pressures on the banks from both sides.

Banking boards will need to review whether this latest "invitation from their government" is good business and suitable for value creation, given the enormous pressures from governments and the public not to profit, and to accept this invite "with great benevolence and a sense of sacrifice." Fiduciary duties of board members will lead these members to answer the call differently. Community savings banks, as well as mutual and cooperative banks, are likely to take the moral stance and commit to being socially responsible regional actors first and put short and more long-term implications second.

It is paradoxical that EU banks, which have been, and for some still are, in critical condition, are suddenly being called upon to be stable pillars in a changing and volatile world and form a line of defense in a world at war against COVID-19. They are requested to become key "revitalizing" agents – providing corporations and economic entities with the (financial) oxygen needed to survive the economic crisis generated by the health crisis. The pandemic has provided banks with a unique and unexpected opportunity to redeem themselves in the eyes of the public and even reach a ground few expected possible even a few weeks and months ago. The moment is unique, and stakes could not be more substantial.

So far, the move initiated by governments seems to be working. Deposits in banks appear stable, even when valued at less than 0.2x book value, which would have rendered a regulated banking entity out of business at other times. Shareholders have been called to see their banks through the past ten years and have a sense of déjà vu. They appear to again be in the back seat. Remarkably, they don't seem to be objecting to the rescue operation, even when, or more likely because of their low valuations, struggling business models, and a "low-for-longer" interest rate environment leave them little choice but to accept restrictions on, or elimination of, dividends. Though governments keep saying, "We're all in this together …" EU bank shareholders will have to wait a lot longer to see any recovery. The quid-pro-quo value finally brings much-delayed change nearer and, as usual, offers positive prospects for those that will be able to navigate the transition successfully.

The likely squeeze on shareholders of EU banks risks leaving them less fit

Over the past decade, finance ministries around Europe have used the banks as proxies. The banks' task consisted of transmitting expansive monetary policy to the real economy while also funding government deficits through bond purchasing. The efficacy of such government initiatives has not met the results experienced in the US. There are still unresolved structural issues in the EU[19] and in the banking sector that has impacted the effectiveness of capital markets, and therefore of the transmission of financial stimuli into the real economy[20]. These include continued harmonization of regulatory architecture, including cross border resolution, sustained improvements in cross border funding flows, more effective and more consistent bankruptcy and insolvency laws, to name a few. Broad and deep capital markets would require many of these to be improved. Too often, unfortunately, the primary beneficiaries of these policies have been government treasuries looking to issue more debt at low-interest rates, which is then carried by the banks.

A European Commission's working paper[21] attests on the needed progress towards an EU Capital Markets Union, and reviews 71 legislative and non-legislative measures that have been formulated and form a comprehensive plan for reaching this goal. The paper also recalls the principal reasons for these changes, namely: financing innovation, start-ups, and non-listed companies; making it easier for companies to enter and raise capital on public markets; investing for the long term, investing in infrastructure and sustainable investment; fostering retail and institutional investment; facilitating cross-border investing; and leveraging banking capacity to support the wider economy.

As the major actor of the current EU financial system, the banking sector – and their shareholders - must not continue to accept the current status-quo of a cozy – and occasionally also conflicting – relationship with the national government. Banks ought to have the ambition to be the vital players in their economies they can be, and also contributing to the emergence of a strong EU capital market. They should be looking to turn their institutions into viable financing entities that do more than provide employment and finance government debts. After breaking cozy oligopolies, reviewing their business models, and committing to risk-based pricing, the banking sector will be in a better position to play its role in recycling capital on the broader economy. In conjunction with developments in non-bank capital sourcing, it will then be more likely to help meet the EU's stated goals for its citizens, businesses, and investors.[22] By the integration of national economies, European banks have more experience operating outside of their home market. They also are substantially more exposed to the rest of the world compared to US banks. This fact, combined with the global vacuum that has been created by isolationist

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[19] ECB pushes for EU capital markets integration and development, *European Central Bank* (March 3, 2020) / https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200303~5eaf4c119d.en.html

[20] Monetary policy transmission in the euro area*,* *European Central Bank* (Policy address by Peter Praet, Member of the Executive Board of the ECB, at the SUERF Conference "Global Implications of Europe's Redesign," New York, October 6, 2016) / https://www.ecb.europa.eu/press/key/date/2016/html/sp161006.en.html

[21] Capital Markets Union: progress on building a single market for capital for a strong Economic and Monetary Union, *European Commission* (March 15, 2019) / https://ec.europa.eu/finance/docs/policy/190315-cmu-staff-working-document_en.pdf

[22] Capital Markets Union: progress on building a single market for capital for a strong Economic and Monetary Union, *European Commission* (March 15, 2019) / https://ec.europa.eu/finance/docs/policy/190315-cmu-factsheet_en.pdf

political policies following the global financial crisis from many countries, has resulted in a natural opportunity for the larger international European banks to fill. In sum, there is no reason that the EU should not have several leading global banks.

Governments have asked banks for help in rescuing the private sector from economic collapse. At the same time, banks will come under pressure from their employees and from governments to not drastically rationalize staffing costs and not add to the overall economic burden. The policies envisaged today risk being directly at odds with rational shareholder expectations of improved profitability and business model transformation when profitability is already barely achievable.

COVID-19 and the opportunity for a "New Deal"

COVID-19 is providing banks with two unexpected "windfall" benefits: the opportunity to regain the trust of the communities they serve and their elected governments, as well as restarting credit operations that have suffered since the financial crisis.

Embracing this new mission and forcefully playing a critical role in the distribution and servicing of government rescue programs, while also supporting existing clients through an unmatched period of uncertainty, is a feasible outcome. One significant condition is that shareholders will have to tolerate that their boards will go against their short and likely medium-term interests in a bet on more favorable long term outcomes.

Collaboration across the banks on a sectoral basis may make sense here, particularly when it comes to the dialogue with the government and the public. It would indeed appear wise to avoid excessively individual negotiations with the government and also to limit negative competitive behaviors. Anti-trust and competition rules will have to be handled carefully, as will rules on minimum capital requirements. Ours are unprecedented times, and authorities should be allowed appropriate leeway.

Should banks, on the other hand, not embrace this new government mandate with some enthusiasm, governments will have to turn to other transmission mechanisms to deploy their envisaged COVID-19 rescue package might. These could involve the shadow banking sector, including the new digital challenger banks, or lead governments to set up the needed infrastructure without the banks. Neither offers the immediate assurances and capabilities that banks provide.

The risk for our economies – and hence for banks - is unparalleled. Should large segments of the economy collapse, banks will be in an even worse position to deal with horrific and more significant problems, at a time when they will still be digesting their past high NPL and NPE balances. This risk is particularly relevant for banks in countries that are more adversely impacted by the financial crisis and are now facing uncertain summer tourism forecasts. Portugal, Spain, Italy, Greece, and Cyprus come to mind, even though they are not the only ones among EU countries facing these issues.

Lessons for EU banking governance

Existing bank shareholders are, in our view, well advised to agree with their governments and their boards to commit to this vital new role and be open to what is next. Indeed, the risk of significant economic collapse is real, and banks may require more capital down the road. A good partnership with the public sector seems an asset in our dangerous times, and one worth cultivating.

Thus, there has never been a more forceful call for more excellent stakeholder governance in banking, and for greater alignment between government, bankers and their shareholders in rescuing EU economies from adverse COVID-19 impact through the rescue of their corporate clients and the provision of economic life support. Bank shareholders may look at this operation as purgatory. More simply, they may consider it the right thing to do in war-like conditions. Visionary optimists may see this as the pain to endure before the road to heaven opens again.

Regretfully, due to the public and regulatory complexities prevailing in Europe, and due to their failure to change themselves, EU banks are not in ideal shape to positively answer the critical call that is put to them by their governments. Their limited equity value indicates financial frailty and the absence of some cushion available to the US banks. Raising capital becomes a daunting challenge as a result. The lack of deep EU-wide capital markets limits the abilities of banks to source new money for themselves, or to place new bailout instruments and programs with third-party investors. The departure of the UK from the EU has also impacted the EU, losing the role that London played as the European and global capital market center.

EU funding has no choice but to come forward and ensure that the risks EU banks cannot cover through the private sector alone become de facto covered at EU or national levels. **If** this becomes a reality, the banking sector will be able to meet its mandate within the EU. With proper quid pro quos on business transformation, EU banks may even gain strength and become more profitable and sustainable, thus preparing for better times.

This quid pro quo between banks and governments could also achieve the segmentation of the industry into broadly three types of business models. One would consist of several European champions serving international businesses. A second segment would comprise a significant number of smaller and more focused commercial banks, providing high-value services on a more specialized basis to particular geographies or industries. Finally, a third group would be networks of local saving banks, efficiently serving retail clients and communities. This structure would mimic the US, with its national, regional, and community banks.

The additional transformation could result from the rationalization of cost structures, the offering of more attractive products and services, and by effective utilization of technology. Outside fintech partnerships, an element of open-banking and greater reliance on banking as a service model would be further elements that are already present, but that must become much more prevalent across the EU banking sector.

Unfortunately, because the necessary rationalization in the EU banking sector has not previously taken place, much of the EU funding risks going to less viable entities. This support extends their life in the short run but is insufficient by itself to ensure sustainability. It also renders the economic rescue operation more costly than it could have been with a more efficient banking sector. The challenge for the banks is that their participation in the rescue operation will indeed provide them with much-needed revenues, particularly in the short run. Still, it will also increase their risk exposure in the longer term while simultaneously diverting them from addressing their structural inefficiency problems. The lack of fitness of the EU banking sector will result in additional strains on EU and national budgets, or in less decisive interventions in the EU economies, at a time when EU and the national governments precisely can afford neither ineffectiveness nor inefficiencies in the rescue operation.

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For all these reasons, the EU banking sector and EU governments are well-advised to, paradoxically, use the COVID-19 crisis to quickly rationalize and make changes to the European banking sector and EU capital markets. The delay in implementing these changes has been far too long. Authorities have been incredibly supportive of the economy in this crisis, including regulators who have been unusually flexible in navigating banks through these difficult times. Our point nevertheless is that they might be more demanding in their partnership with financial institutions to also insist and facilitate business model change and rationalization of EU banks into profitable institutions that are fit for purpose. The massive support of governments and central banks should not go without a grander plan that focuses on better functioning capital markets across Europe, on the needed reforms to the EU banking system, and on rationalizing EU banks into profitable institutions fit-for-purpose.

This program should become an essential priority for European states, which is not currently the case. National governments are most likely concerned with banks slimming down their often abundant workforce too quickly, and the social problems this may create. Governments also wish to keep their banking system as "close and privileged" partners. Seeing them become more independent private actors is a novel and not necessarily an attractive scenario for them.

It is our conviction that the COVID-19 crisis, precisely because it has generated an economic crisis of European and global dimensions, again points to the need to have EU-wide solutions and approaches. This goal requires banks that can operate at the EU level, as well as more national levels. The crisis, in our view, points both to the need and to the opportunity to enable and allow such a move. If successful, the result would be a much improved and more sustainable EU financial infrastructure and governance to the benefit of the EU population and EU corporations.

That would be a remarkable achievement, aligned with the mandate to see banks not only help their economies navigate our unusual crisis times, but that also impose significantly delayed beneficial changes on themselves. The outcome will provide Europeans with fitter banks providing more excellent financial capability and resilience, as well as with better crisis-fighting tools for when the next one arises. It would validate Churchill's warning never to let a good crisis go to waste. In the words of Professor Zingales, this is nothing less than Europe's unification moment. More pragmatically, it is a formidable task vital to the EU project as conquering the COVID-19 health crisis.

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