

Covid-19: are challenges for the EU financial sector all new?



This Eurofi Magazine is published at a particularly challenging moment for the EU and its financial sector.

Many initiatives that have the potential to significantly change the EU economy are underway and still need achieving: the Banking Union, the CMU and the EMU, which all aim to strengthen and further integrate the EU and its financial system; the Green Deal and the sustainability agenda designed to respond to climate change and encourage greener investment.

Major changes are happening in the financial market in parallel, triggering business model and market structure transformations. Brexit will be a reality in 8 months' time potentially modifying the current dynamics in a number of EU wholesale markets. New technologies are developing, progressively changing many financial value chains and creating new opportunities and challenges for the financial sector.



The Covid-19 pandemic, unprecedented in its reach and impact in recent decades, may upset to a large extent this unfinished agenda, opening new questions, creating additional challenges or possibly a new agenda altogether, depending on the severity and length of the crisis. Why? Previously expected to grow by 3%, the global economy is anticipated to decline by 4 to 5% in 2020 if not more, due to the forced lock-downs. And figures look worse for the EU. Moreover a V-shaped scenario or even a narrow U seem increasingly unlikely, with much uncertainty about treatments, how and when businesses and travelling will go back to normal and whether a second wave of the pandemic is possible. A severe economic crisis seems therefore inevitable, despite the exceptional measures taken by the ECB and Member States, and is already materializing in several business sectors and impacting many EU citizens. The current market volatility is an illustration of this.



In terms of financial stability and capacity for the financial sector to support the economy, this crisis is happening in an environment that is quite different from 2008. Banks and insurance companies are strongly capitalized, much has been

done to increase transparency and reduce interconnectedness in the financial system, liquidity and leverage risks are better controlled in the EU non-banking sector... However, the Covid-19 and the 2008 financial crises have one main commonality: they are occurring in a financial context already weakened by lasting zero – and even negative – interest rates and an excessive level of indebtedness that the responses to the crisis may further deteriorate: indeed : (i) corporates and sovereigns that are already highly indebted and also investors are vulnerable to deteriorating economic and market conditions, eventually threatening the Euro and the unity of the EU if this situation is perpetuated; (ii) very low interest rates also undermine financial intermediaries and savers and foster bubbles.

This may create vulnerabilities for the financial sector that will need tackling (e.g. if corporate or consumer defaults increase significantly or if the contribution of banks and insurance companies to supporting the economy exceeds reasonable capacities...) and could potentially lead to a new financial crisis if the debt situation gets out of control or if there is an outburst of defaults.

As for the impacts of this crisis on the financial policy agenda, these are still difficult to measure and anticipate at this stage, but many questions will need assessing in the coming weeks and months: Will the Covid-19 crisis reduce the dynamics of sustainable finance because other priorities have emerged or on the contrary will green finance continue to be a major priority for kick-starting growth in the EU? Will CMU become secondary because bank financing is more readily accessible or on the contrary will capital markets be needed more than ever to develop equity and to fund innovation and growth? Will financial institutions be able to continue investing in their digital transformation in the coming months or is the lock-down making technology even more essential? Will global cooperation stall or will it thrive with all countries sharing a common goal to restore growth? Will Basel III final evolutions be eventually postponed sine die in the EU to facilitate bank financing, or will strict and harmonized prudential requirements remain the cornerstone of bank regulation? Etc...

Many of the articles of this Magazine address the new challenges created by the Covid-19 crisis. It is however still early days and many questions remain open at this stage, on which Eurofi will be working in the coming months with the public authorities and our member community.

We warmly thank the 160+ contributors who have taken the time in these turbulent times to provide us with their views and thoughts and are sure that you will read their contributions on these challenging questions with great interest. ●

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