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A sound framework to safeguard financial stability

The COVID-19 pandemic constitutes an unprecedented global shock. The latest economic forecasts point at the deepest recession since World War II and, at this stage, we do not yet know its full and final impact on the economy: it remains a very large 'known-unknown'.

In mid-March, stress metrics reached historical high levels, and strong market reactions led to major re-pricing in the financial markets, including sharp declines in bank equity prices. The large uncertainty surrounding the scale and duration of the pandemic's economic impact provoked acute stress in key funding markets (including US dollar liquidity markets), unleashing concerning destabilising dynamics and jeopardising financial stability.

Fortunately, during the last few months we have seen some easing of financial conditions and a substantial (although asymmetric) asset price recovery. This is the result of two main factors. First, we have much firmer foundations in place across Europe today than a decade ago. It is often said that one should never let a crisis go to waste. In Europe, we acted on the lessons of the financial crisis, and are now harvesting the benefits of that work.

The banking system is today more resilient as a result of the regulatory reforms adopted in the aftermath of the previous crisis. Banks have higher capital and liquidity buffers and lower NPL ratios, proving that the system on average is fit for purpose and can absorb shocks. Without the existing institutional and regulatory framework, a recession of this magnitude would have had immediate devastating effects on our banks and therefore on financial stability.

The ECB's most recent vulnerability assessment by contrast showed that, overall, banks in principle can withstand pandemic-induced stress, although there is still large uncertainty regarding the final magnitude of the crisis.

Second, swift and bold policy actions adopted by the authorities have substantially contributed to cushioning the global hit and thus safeguarding financial stability, including unprecedented ambitious monetary and fiscal measures.

At the SRB, in line with other European authorities, we have focused on giving banks operational relief but simultaneously moving forward with our resolution planning. Coordinated policy action by public authorities is supporting the banks' capacity to absorb losses and to channel funds to the real economy, which is especially relevant in times of large revenue shortfalls.

We have adopted a transparent and pragmatic approach, using the existing flexibility in our legal framework while ensuring that we do not undermine its credibility. Disorderly bank failures have proven their devastating effects in the past. Avoiding them is precisely our *raison d'être*. We cannot roll back recent reforms that have made our banking system more robust. Focus on making banks resolvable is key to protecting financial stability.

To conclude, the financial and economic outlook is still largely uncertain. The second quarter data point to an unprecedented and severe recession and an uneven recovery, as the economic toll of the lockdown is proving more severe than initially expected. Second-round effects like increased unemployment or precautionary savings could put further strain on the economy. High levels of debt may prove challenging for some borrowers, especially in case of a second wave of infections or hysteresis. Until now, banks have proven their resilience. Recent regulatory reforms have put our banks in a better shape to cope with the crisis, but they are not bulletproof. Banks are under severe profitability pressure, and asset quality deterioration would imply an additional burden at least for those institutions that are still recovering from the financial crisis. If the situation worsens, depletion of bank capital would be material.

Looking forward, we must continue our work on the completion of the Banking Union, building on the progress achieved thus far. We will continue to support the recovery and strive to ensure that banks keep on acting as a countercyclical force, and not as an amplifier of financial instability.

If, and when needed, we have the appropriate tools to manage bank failures effectively and avoid financial instability. We also firmly believe they will be up to the task. Solid resolution planning and resolvable banks are the best safeguard of financial stability. ●