

MAJOR FINANCIAL RISKS IN THE CURRENT MONETARY AND MACRO-ECONOMIC CONTEXT

Major financial risks include public and private levels of indebtedness, financial system profitability, credit risks leading to non-performing loans (NPLs), and overstretched asset prices. The Chair reminded the audience that this goes back to the financial crisis of 2008-2009, when financial sector excesses could have led to a great depression, which was avoided by monetary and fiscal policy. Fiscal policy withdrew in 2010, when monetary policy faced a phase of circular stagnation in advanced economies, with low growth, inflation, and real equilibrium interest rates.

Monetary policy tried to lower market rates across the spectrum of the yield curve using different instruments but was not enough to spur private expenditures sufficiently to normalise robust growth and inflation, which are low everywhere. The Covid crisis has implicated the support of households' and firm's incomes, leading to the reactivation of fiscal policy and a new consensus on policy mix. All policies have trade-offs and challenging spill-overs that have to be analysed, faced, then mitigated or overcome.

This session discussed to what degree corporate indebtedness can lead to increasing default rates and pose financial stability issues or if the post-pandemic recovery will offset those effects. Speakers also examined the policy challenges raised by the current monetary and macroeconomic context and expressed their views on the appropriate regulatory, monetary and fiscal policies for addressing the EU's major financial risks.

1. The risks raised by the corporate-sovereign-bank nexus

While strong national and European policy responses have contained the economic impact of the pandemic, there are spill-over risks from corporates to banks and sovereigns. This nexus is vital at the moment for supporting the economy. But it also means sovereigns are increasingly exposed to corporate risk, and vice-versa. This might be a financial stability issue if many businesses suddenly were to go bankrupt. Rising credit losses for banks may require governments to provide more support and pay out on guarantees. This would further increase pressure on public finances. Conversely, rising risk premia could also affect banks through their domestic bond holdings.

The present situation entails the risk of NPLs increasing after the temporary measures of public guarantees to loans and moratoria end when the pandemic is under control. The scale of the impact of the pandemic on NPLs is difficult to predict.

1.1 Strong EU and national policy responses have contained the impact of the pandemic

An official considered the nexus between the corporate, the bank and the sovereign balance sheet. The pandemic and lockdowns caused a revenue collapse for the corporate sector, which implied a liquidity crunch. In

the first wave it was general; in the second and third, it is now impacting specific sectors. A liquidity crisis was avoided by substantive support from central banks, regulators and governments at national and European level, which successfully provided the corporate sector with means.

1.2 Policy responses resulted in a growing dependence on public policy support

An official noted the strong reliance by companies and banks on public support, as much European bank lending was done against a backdrop of significant government guarantees. This interconnectedness carries risks when the temporary policy support is phased out. On the corporate side, a wave of bankruptcies was largely avoided due to those measures and the moratoria that are in place. As these are phased out, this will change. In the corporate sector, what was initially a liquidity issue will increasingly become a solvency issue. Even viable companies that can sustain business face the challenge of the leverage they received during the crisis. This may lead to underinvestment during the recovery.

The bank side provided credit and is well-endowed with capital. The European Banking Authority (EBA) and the European Central Bank (ECB) stated that the banking sector should be in a good position to weather an increase in NPLs, even under a relatively severe scenario, with two provisos: first, what is true for the sector overall may not hold for each bank, so problems may still arise; and an increase in NPLs also implies a drag on profitability, having implications for the ability and willingness of banks to lend and finance the recovery.

Governments face the challenge of phasing out and withdrawing public sector support measures to support viable and new companies. This is a challenge as it is not the predominant task of governments and so a suitable instrument must be considered. Comprehensive, gradual and well-sequenced promotion of post-pandemic bank and capital market financing is critical for a strong and sustained recovery. This includes narrowing support schemes to viable firms, restoring transparency, removing forbearance in bank operations and accounting, and remedying capital shortfalls.

Debt levels also increased due to the broader fiscal support given to the economy. Further government aid during the recovery may increase the contingent liabilities of that. It looks manageable but must be considered in the future. The task is to make the best use of the European measures – and particularly Next Generation EU (NGEU) – to make that work.

1.3 The banks have not been tested hard by Covid so far

A Central Bank official stated that exiting the EU during a pandemic has not been completely straightforward. However, the broad lessons and the approach being taken on financial services Covid measures are similar to the EU. The UK is determined to maintain standards of resilience at least as high as those existing before Brexit

and Covid. Banks have not been tested by Covid, due to the fiscal and monetary support provided. Nonetheless, if they had gone into Covid with bank balance sheets as in 2007, there would now be a financial crisis as well as a health and economic crisis, and there is a lesson to draw from that.

An industry representative agreed that banks have not been tested. The sector gets credit for having been part of the solution, but it is really due to fiscal and monetary policy. The guarantees were there, and banks went to central banks for liquidity, as they are still, unfortunately, not profitable enough to raise money competitively in the market. Fiscal and monetary policy is crucial, and the key risk is withdrawing too early.

1.4 The scale of the impact of the pandemic on NPLs is difficult to predict

An official noted that there will be an increase in insolvencies and NPLs when budgetary and regulatory support is phased out. The question is how big the impact will be. That is hard to assess at this stage and many measures have been put in place to address it. It will not be such an 'easy ride' as it has been so far, and more will be seen, but there is no reason to be excessively alarmed about that perspective.

A regulator stated that government support will have to become more targeted so it might be a step-by-step finish. The focus must be on supporting viable corporations, particularly those at risk or unable to invest. Selection is difficult for public authorities. Dialogue is needed between governments and banks as the banks know their clients, such as considering situations where, for stronger corporates, governments could finance partial debt relief with the condition that banks would refinance the loans on better terms, so as to have a partnership between the state and banks. Repayable instruments could be converted into grants, up to a ceiling, to support corporates. The banking sector has the task of identifying them. That implies additional spending but would defend the economy and reduce long-term indebtedness problems.

The Chair noted that supporting the banking sector and financial institutions requires an awareness of the Solvency II review for the insurance sector and the long-term financing perspective that the sector can provide. A different public sector may be needed when the pandemic is over as temporary measures' consequences come to the fore. A degree of different types of public support will be necessary.

An industry representative noted that a surprise silver lining is the success of the crisis response from monetary, regulatory and fiscal policymakers in muting the expected impact on the corporate sector. The confidence that policymakers will be as successful when withdrawing the stimulus is an article of faith, as these are uncharted waters, and so future uncertainty is the greatest theme.

2. Policy challenges: exit strategies to consider corporate revenues and debt dynamics

The scale of potential solvency problems depends on the evolution of the pandemic the performance of sectors and appropriate policy responses. The temporary regulatory relief given to industries should be phased

out firmly as economies recover. Policy challenges are significant but there are reasons to be positive.

2.1 Authorities must manage trade-offs related to the duration of support measures

A regulator stated that Europe is ahead in some respects. Insolvencies have not materialised. There is an opportunity for states, banks and corporates to take combined action to reduce or prevent this wave. Negotiations between the Dutch government and banks on supporting corporates are ongoing. Parties must consider existing options to facilitate debt restructuring.

Potential solvency problems depend on the evolution of the pandemic, the performance of sectors and appropriate policy responses. Withdrawing fiscal support too soon could exacerbate the effects of the economic crisis and risk instability. Maintaining it for too long increases budgetary pressures and delays structural change and recovery. Managing this requires access to timely, reliable economic information.

Timing is key, and a European Systemic Risk Board (ESRB) report will be published soon. Action is needed before resigning to the fact of a large set of NPLs, and there is time to identify schemes where governments, banks and corporates might help to reduce the problem. There are concrete possibilities that are feasible and await implementation.

2.2 Temporary relief given to industries should be phased out as economies recover

A Central Bank official agreed that temporary regulatory relief for industries should be phased out as economies recover. The Fed's decision to put Treasuries back into the denominator or the leverage ratio is important. Although the rationale for it was understandable, if left in place it could have set a concerning precedent as it could be a path back to the banks' sovereign doom loop which has caused trouble before. It is right to reverse that, and that is the right spirit for the transition out of Covid.

That does not mean that there are no lessons from Covid. While short-term pressures to weaken regulation with the supposed aim of boosting the recovery should be resisted, it is important to learn from the crisis. Buffer usability is key. Although buffers were not tested, regulators and investors have created a system where, if possible, banks will avoid using buffers to support the economy. That must be looked at.

The Chair underlined the importance of the Fed's decision on Treasuries. The measure was temporary but was against the Basel III agreement. Other regulatory relief measures during this period will have to end.

2.3 Four reasons to be positive

An industry representative noted four reasons to be positive concerning the global financial crisis (GFC). First, this was not a cyclical event. It did not result from unsustainable imbalances, particularly in property. While some imbalances present in the GFC still exist, corporate debt has not risen by as much as it did then. This crisis is expected to unwind more quickly than the GFC. Second, it was not accompanied by a credit and a real estate boom, which would magnify the downturn impact on the banks.

Third, the European banking sector is better able to weather a shock now, with higher capital levels, more forward-looking provisioning policies and strong liquidity, partly due to the actions of regulators and the ECB. Fourth, government support has been rapid and strong, aiming to cushion the impact while addressing its cause through the development of vaccines, allowing the crisis to unwind. That is what is broadly expected to happen. Support has been effective in limiting defaults and NPLs. While these are expected to increase in the coming years, particularly in economies where the small and medium-sized enterprise (SME) sector plays a significant role, the level of defaults will not be anywhere near those of the GFC.

These are uncharted waters and there is uncertainty and risk. Much rests on policymakers' ability to find and afford withdrawal mechanisms to avoid the cliff risk. There are concerns given the straitened circumstances of many sovereigns in Europe. In Europe, the nexus between weaker banking systems and sovereigns means that much rests on the willingness and ability of the euro area to stand collectively in support. There has been a willingness to do that with Support to mitigate Unemployment Risks in an Emergency (SURE) and NGEU, and the ECB stepping up again. It is assumed that that will continue, but the confidence of investors, banks and others that that will continue will be crucial in how the crisis unfolds.

An industry representative considered this is a peculiar recession from the banking industry's point of view, affecting a subset of industries. When the economy rebounds, the expectation is that NPLs will be under control. They have been so far, thanks to the support measures implemented. If measures contain equity components for the affected sectors, a huge increase in NPLs is not anticipated.

3. Cautiously normalising monetary policy

The low-rate environment exacerbates the structurally weak profitability of the EU banking and insurance sectors. Lasting ultra-low interest rates also encourage the growth of public and private indebtedness and holding cash without promoting productive investment. Low interest rates risk may increase with the 2020 review of Solvency II. It is time to exit, cautiously and gradually, from accommodative monetary policy.

3.1 Normalising monetary policy is challenging

A Central Bank official stated that it is awkward to talk about normalisation when it seems that things are not getting better. The vaccine brings hope that Covid will be under control soon. A year ago, the discussion was on how to get out of unconventional monetary policies, before Covid came, and it all changed. It was not an easy discussion, and it has become more difficult as monetary policy has become expansionary and balance sheets and debt have grown. Exiting these policies is uncharted territory.

Quantitative easing (QE) was always said to be easier to get into than to get out of. Central bankers and markets saw the consequences of the taper tantrum in 2013 and will carefully judge how to normalise monetary policy. That means getting out of the zero lower bound and back to normal monetary policy, which might be far from the position now, so unconventional QE-

type policies must be considered first. That requires assessment of the trade-offs involved and the changing conditions. There are risks if monetary stimulus is removed prematurely or abruptly or if this policy goes on too long, creating excessive reliance on monetary policy and potentially working in the opposite direction on the necessary economic policies. Governments could be disincentivised to make the necessary structural reforms, or the corporate sector to restructure, thereby creating zombie firms. Risks must be balanced as monetary policy begins to normalise.

There are two questions: one that is key for central banks is the reason for the disconnection between monetary policies and inflation. If monetary policy wants to stay goal-oriented – and colleagues will agree that it should – then the goal is inflation. If the mechanism between monetary policy and reaching the goal is not understood, it will be difficult to assess if the right thing is being done. Central banks must understand the reasons for the disconnect between monetary policy and inflation. The interest rate level is less important than understanding the mechanics of what is being done and how it translates into the stated main goal.

The Chair noted that there is great awareness of the pressure that monetary policy has been subject to. Monetary policy is asymmetric in its effects; it is more effective to counter high inflation than to push inflation up in periods of low growth in advanced economies due to circular stagnation. It needs the help of other policies to reach its objectives. It cannot do it alone.

3.2 The risk of low interest rates could increase with the 2020 review of Solvency II

3.2.1 Ultra-low or even negative interest rates weaken insurers

An industry representative noted that the impact of the policy dilemma on insurers is different to other sectors. Balance sheets must be managed over the very long term, all the more so as the population's needs, linked to ageing and pensions, increase. Insurers are used to tackling events like the pandemic, even with the death toll, whereas the pressure on balance sheets from the persistent very low or negative interest rates is a shaping component of medium-to-long-term management.

This is not apparent in terms of profitability, even if it is not as high as it should be but is visible on solvency positions. The sector is solid, but the very long-term effects must be foreseen, and the pressure from very low rates is diminishing solvency. It also impedes offering clients long-term products combining yield, security and liquidity; and investing as freely as possible, as the regulatory environment requires caution.

3.2.2 The EU economy needs a balanced Solvency II review

An industry representative noted that the conjuncture of this very-low-rate situation and stringent regulation may be greater when the Solvency II Directive reform considers the situation. This limits the capacity to take more risks on the asset side and investing, or to pay back to clients a good yield or warranty for their investments. An appropriate solution for the sector would be a slight rise in interest rates, getting them back into positive territory, without harsh movements.

3.3 If the US overheats, global and European financial conditions could worsen

An industry representative stated that the US position is worrying. It implemented an aggressive stimulus package at the end of 2020 and in March 2021, which is already leading to an increase in long-term interest rates, due to the expectation of increased activity and increased inflation in the US. Europe is behind that trend. The brisk recovery in the US implies for Europe – and Europe is behind in terms of monetary policy reaction – a weaker euro and comparatively lower rates and better financial conditions. At some point, European monetary policy should change and tighten as the eurozone's recovery progresses.

The challenge for the ECB will be to administer an increase in long-term rates while considering the differential effect on member states, which are suffering to different degrees from the pandemic and the deterioration of their fiscal positions. The US is likely to change monetary policy earlier than Europe, but, since monetary union has not been completed, the ECB's challenge will be in accommodating rate increases and ensuring that a fully integrated European market is maintained.

3.4 Time to start gradually exiting very accommodative monetary policy

The Chair noted that it should not be problematic to normalise monetary policy. The increase in 10-year Treasuries yields was mild and is still at 1.67%. By the end of 2019, it was at risk of going above 3%.

An industry representative hoped that a policy normalisation phase would follow. It must be cautious, but he sympathises with Jacques de Larosière's view that the market should be allowed to work. If markets anticipate higher rates, it is counterproductive to go against that trend. The ECB is forced to do that to maintain an integrated eurozone. Interest rates should be allowed to rise as the recovery takes hold.

The Chair stressed that a distinction should be made between developments in nominal terms and in real terms of market yields. One is nominal accompanying developments and the other is real rates, in a situation which needs a robust post-pandemic recovery. That is partly why ECB policy has differed from the Fed.

An industry representative advised that there is room to go into more positive ground for interest rates, be they nominal or real. Long-term market rates used to be higher. Throughout the crisis, other than at the beginning, there was not a huge widening of spreads within the eurozone, which is a sensitive indicator. There is room for an orderly and moderate return to a more normal level of interest rates. This would be appropriate for private investment and savings and would alleviate the public finance burden. This is not pleading for a burst in the level of interest rates; on the contrary, that would be a tremendous risk.

4. More fiscal stimulus would be welcome but is not realistic

The Chair stated that in 2021, the US will attain a gross domestic product (GDP) level that returns to the growth trend before Covid. Europe will reach the

2019 level by the end of 2022, and several European countries will reach it in 2023.

An industry representative noted that there is confusion between gap fillers and investment. This is an unusual recession, and it is seen as natural, economically and morally, for fiscal policy to step in after the private sector raised savings ratios, trying to find and fill this gap to reduce scarring. Talk of zombie firms theoretically makes sense, but creative destruction is done by market forces, not the pandemic, so it is difficult to identify now. The argument is around filling the gap in the short term, until the economy is on its feet again. Europe is conservative on this. Europe seems to be focusing on returning GDP to 2019 levels, whereas other countries – the US in particular – are trying to reach the trendline. That is appropriate. On monetary policy, the paper only runs to March before GDP is predicted to get to even the end-2019 level.

The other important part is investment, but there is no realistic way for fiscal policy to fill a hole within a year through investment, because of appropriate procurement rules. It is crucial to separate gap fillers supporting firms and people who have been hit by the lockdowns, but also to use the opportunity to put in place longer-term investment, which is where NGEU is important. In Europe, there is no question that gap fillers can be done only by national budgets. Longer-term things can be done by the budget and by Europe. NGEU is key. It is hoped that it will happen, but the US investment programme as a share of GDP is three times the size of NGEU. NGEU is good, but interest rates are low, and it is easy to get a return from the public sector to make it profitable. More would be welcome. It is not realistic, but Europe is on the stingy side, and that is a risk.

The Chair stated that the US infrastructure programme presented recently is to be implemented over 10 years. When discussed and analysed, this aspect is not underlined: it is not comparable with previous fiscal stimuli that the US ran in order to direct immediate support to households, firms and the economy.