Luis de Guindos: Financial stability and the pandemic crisis

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the Frankfurt Finance Summit, Frankfurt am Main, 22 June 2020.

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As the last speaker of the day, after providing you with a brief overview of the economic outlook for the euro area, I will focus my remarks on the financial sector, the stability of the financial system as a necessary condition for the recovery from the pandemic crisis and related policy issues.

The euro area is experiencing an unprecedented contraction. Following a sharp drop in real GDP of 3.6% in the first quarter of the year, a much larger contraction is expected in the second quarter, with Eurosystem staff projections seeing a fall of 13%.

After this unprecedented downturn, a rebound in activity is expected in the second half of the year, supported by very accommodative monetary and fiscal policies, along with an expected gradual resumption in global activity. However, the speed and scale of this recovery are extremely uncertain. Eurosystem staff macroeconomic projections for the euro area foresee real GDP falling by 8.7% in 2020 and rebounding to growth rates of 5.2% in 2021 and 3.3% in 2022, which means that GDP at the end of 2022 will still be 4% lower than projected in our March 2020 staff projections.

Turning to inflation, euro area headline inflation is declining sharply and is expected to remain subdued this year. Euro area annual HICP inflation decreased to 0.1% in May, down from 0.3% in April, mainly on account of lower energy price inflation. Over the medium term, weaker demand is expected to put downward pressure on inflation, which will be only partially offset by upward pressures related to supply constraints. Annual HICP inflation is projected to be 0.3% in 2020, 0.8% in 2021 and 1.3% in 2022 in the June 2020 Eurosystem staff projections.

The monetary policy measures taken by the ECB in March were critical in removing the tail risk of the pandemic, with the drop in economic activity and rising financial market turmoil morphing into a financial crisis. That risk has receded materially since March.

However, in our reassessment of the situation in June, two main factors called for additional monetary policy easing: the deteriorating inflation outlook threatening our medium-term price stability objective and the tightening of financial conditions.

On 4 June, we decided on a set of monetary policy measures to support the economy during its gradual reopening and to safeguard medium-term price stability. The envelope for the pandemic emergency purchase programme (PEPP) was increased by €600 billion, to a total of €1,350 billion. The horizon for net purchases under the PEPP was extended to at least the end of June 2021, and we also decided to reinvest maturing principal payments from securities purchased under the PEPP until at least the end of 2022. Looking ahead, the Governing Council will continually evaluate whether the size, duration and composition of the PEPP remain appropriate as the economic consequences of the pandemic unfold.

The role of the financial sector in the recovery

The recovery is surrounded by extreme uncertainty. But we are certain that the financial sector – and notably the banking sector – has a very important role to play. It is of utmost importance that the system remains resilient to ensure that financial markets continue to function well and lending to firms and households is safeguarded.

The impact of the coronavirus shock was amplified by a range of existing vulnerabilities in the

euro area. Bank losses and funding strains in the aftermath of the great financial crisis gradually morphed into low bank profitability, with structural and cyclical dimensions that we have been highlighting as key risks to euro area financial stability for almost a decade. At the same time, non-bank financial intermediaries have grown in size, taking on more credit, liquidity and duration risk. The pandemic crisis comes on top of these existing vulnerabilities and risks in the financial sector.

Euro area banks entered this crisis with stronger capital and liquidity positions than they had at the start of the global financial crisis. This enhanced resilience has allowed them to weather the initial strain of the pandemic shock and enabled them to keep lending to the economy.

But while banks in the euro area are not at the epicentre of the current crisis, their market valuations were hit hard amid concerns over a further weakening in their profitability prospects. This mainly reflects expectations that banks are likely to see a rise in credit losses as they are confronted with credit impairments and a growing number of corporate defaults over the coming quarters. Banks' first quarter results already show a considerable negative impact from the crisis in the form of a sharp deterioration in profitability, driven by large increases in loan loss provisions. Beyond cyclical challenges, euro area banks' profitability prospects are further hindered by ongoing structural problems, such as low cost-efficiency and overcapacity.

Fiscal and monetary policy measures are significantly helping to support financial stability by reducing or delaying banks' credit losses and enhancing market liquidity. Micro- and macroprudential authorities have acted swiftly and introduced a range of capital relief measures to help the banking system maintain the flow of credit. ECB Banking Supervision has allowed banks to temporarily operate below the level of capital defined by Pillar 2 guidance and the combined buffer requirement. Banks are now also allowed to meet Pillar 2 requirements with lower quality capital. It has increased the flexibility in accounting rules and the recognition of non-performing loans. Furthermore, ECB Banking Supervision recommended that banks limit capital distribution by refraining from paying dividends or buying back shares.

On the macroprudential side, national authorities have either announced a full release of countercyclical capital buffers or revoked previously announced increases to these buffers. They have also released or reduced buffer requirements for structural risks and delayed the implementation of new requirements.

These swift micro- and macroprudential policy actions sent a clear signal that banks are encouraged to make use of their existing capital buffers so they can continue to provide key financial services and absorb losses while avoiding abrupt and excessive deleveraging that would be harmful for the economy. Indeed, prudential buffers are designed to be used, or drawn down, in periods of stress. ECB analysis shows that economic outcomes can be considerably better when banks use their buffers while maintaining lending to the real economy, rather than deleveraging in order to preserve them. While using the buffers can have initial negative effects on bank solvency ratios, it ultimately reduces bank losses as the economy can remain healthier due to the easing of credit constraints. These results suggest that there is currently no trade-off between using buffers for lending now and using them to absorb losses later, as using buffers now will help to reduce losses in the future.

Taken together, these measures should help the euro area banking system to sustain lending to households and companies while weathering losses.

I will now turn to the non-bank financial sector and to investment funds in particular.

As the market sell-off intensified in late February and early March 2020, investment funds experienced exceptionally large outflows similar in magnitude to those seen during the global financial crisis. Initially, redemptions largely centred on corporate bond funds and equity funds, while flows into safe haven assets surged. However, market strains eventually also spread to

safe and liquid assets, such as money market and sovereign bond funds. The combination of high redemptions and low liquidity buffers prompted funds to sell both risky and less-risky assets. This amplified liquidity stress in an environment of rapidly increasing demand for cash and high market volatility.

Liquidity stress was also exacerbated by a sudden increase in margin requirements. As volatility in financial markets surged, investment funds were required to post higher margins on their derivatives positions. This added to the demand for cash, which investment funds and other intermediaries had to raise at very short notice.

Decisive policy action by central banks has helped stabilise financial markets and improve liquidity conditions across a broad range of assets. This has alleviated liquidity stress, including in the investment fund sector. Margin calls declined and we saw renewed inflows across all asset classes.

The ECB and other public institutions have for some time been warning of growing systemic risks in the investment fund sector and insufficient policy tools to tackle them. The sector has become too important for financial stability to be left out of broader policy considerations. Total assets held by investment funds in the euro area more than doubled over the last ten years, reaching €15.4 trillion by the end of 2019. This has been accompanied by increasing interlinkages between investment funds and the broader financial sector – including banks, insurance companies, pension funds and money market funds. In this context, non-banks are playing an increasing role in financing the real economy.

The rising levels of liquidity stress at the height of the crisis highlighted important weaknesses in the policy framework for non-banks. To date, the prudential policy framework for investment funds relies, to a large extent, on ex post liquidity management tools in the hands of asset managers (redemption fees or the suspension of redemptions). But these tools are of limited use to prevent liquidity stress at the system level. If applied in a period of widespread market stress, they could limit the ability of firms and other financial institutions to raise cash, undermining market confidence more broadly.

To reduce systemic risk in the investment fund sector, we need to ensure that asset liquidity is closely aligned with fund redemption terms. Additional macroprudential policy tools should be made available to authorities to mitigate the build-up of systemic risk during times of financial exuberance. They should also support the sector’s ability to meet potential funding needs under stress, including from margin calls. Strengthened supervisory powers at EU level could further contribute to a timely and consistent use of liquidity management tools. Moreover, the regulatory framework for money market funds should be re-assessed in the light of specific vulnerabilities in the sector.

Beyond a strong macroprudential mandate and an adequate toolkit for the non-bank financial sector, accelerating progress towards completing the capital markets union remains a key priority. This is particularly important in the current situation, as integrated and resilient European financial markets could help support the economic recovery. First, deep and integrated capital markets can complement bank lending, thus ensuring access to funding for a wide range of businesses. This would contribute to a swift recovery of economic activity. And second, the risks that materialised during the pandemic have highlighted the need to increase the resilience of the financial sector to large exogenous shocks. This underscores the importance of the Europe-wide supervision of capital markets, which would enhance cross-border risk monitoring and coordinated action across Europe.

Conclusion

Let me conclude. In the wake of the coronavirus pandemic, the euro area financial system has faced an economic shock of global breadth and of enormous scale and speed. Policy measures

have so far helped prevent a health crisis turning into a systemic financial crisis, but medium-term risks to financial stability have increased markedly.

Despite pre-existing vulnerabilities, the euro area financial system has weathered the immediate stress relatively well, thanks to the regulatory reforms of the past decade and bold policy responses by monetary, fiscal and prudential authorities.

The forceful fiscal policy response to the pandemic by euro area governments acted as a first line of defence: introducing discretionary support measures and letting automatic stabilisers act as intended was absolutely necessary.

However, this response raises fragmentation issues and will significantly increase public debt. The size of national responses and the design of guarantees differ across countries. Large differences in loan guarantee packages can distort the level playing field for corporates and banks in the euro area and contribute to financial fragmentation. Very large guarantee envelopes may, for example, allow companies operating in the country in which these envelopes are granted to access credit on a much larger scale, which could lead to a competitive advantage in the Internal Market. Equally, banks in these countries have a greater potential to increase their profitability. To avoid such national fragmentation, EU-level initiatives that support the recovery play a very important role.

At the same time, deteriorating economic conditions may give rise to debt sustainability concerns in the medium term, notably in countries with already limited fiscal space. The increase in public debt levels, while necessary today, needs to be managed in the medium term.

The shape and strength of the recovery are uncertain and this uncertainty will persist for some time. There are substantial downside risks, in particular if the easing of containment measures turns out to be premature or their impact on productive capacity is more persistent.

Macroprudential policy can play an important role in safeguarding the resilience of the system and supporting the recovery. Regulatory capital buffers were designed to be used, or drawn down, in periods of stress. Banks that use their buffers are acting in line with the intended functioning of the framework and in accordance with authorities' expectations. By using buffers now and avoiding excessive deleveraging that would be harmful for the economy, banks help reduce losses later.

Turning to non-banks, European-wide supervision of capital markets and a macroprudential framework for the sector is needed. This would help mitigate system-wide liquidity risks, reduce the sector's vulnerability to turbulence in financial markets, and thereby reduce the need for ex post policy interventions.

A resilient financial system is essential to support the recovery, address inevitable pressure on bank profitability and reduce overall vulnerability to market volatility. Accelerating progress towards the capital markets union remains a priority, as does completing the banking union. This would help ensure access to funding for a wide range of firms, support a level playing field and counter fragmentation along the path to recovery.