MIND THE GAP WHEN AND HOW TO UNWIND COVID-SUPPORT MEASURES TO THE BANKING SYSTEM?

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MARCH/APRIL 2020

- Emergency measures: swift and big care about costs and proper targeting later
- Fiscal policy: furlough, Kurzarbeit, direct support payments, tax payment holidays, loan payment holidays, loan guarantees, direct lending
- Monetary policy: flood markets with liquidity, market maker of first resort, direct firm support
- Regulatory policies: capital and loan provisioning relief, delay in Basel III implementation, delay in stress tests, but also pay-out restrictions
- Result: delay in corporate and household insolvencies, avoid hysteresis, limited rise in unemployment (in Europe) it is all about social and economic survival

THE ROLE OF BANKS IN HELPING THE REAL ECONOMY DURING COVID-19

- Heavy draw-down of credit lines and increased credit demand as firms want to hold on to cash
- Relationship lenders can be useful in current situation as they know their clients
- Banks have critical role in transmission of monetary policy and fiscal support measures
- Challenge: procyclicality of bank lending calls for capital relief and payout restrictions
- Challenge for financial institutions access to liquidity and solvency concerns
 - Credit lines by central banks to banks and MFIs or purchase of loan packages (e.g., through SPV or DFI)
 - Adjustment of loan provisioning requirements?
- Different policy tools: grants for firms/households, tax and credit holidays
- The role of credit guarantees?



Banks' credit exposure

Covered by public guarantees

- Limits on loan size and/or coverage ratios up to 100%*
- Loan forgiveness under certain conditions
- Cost of loan and guarantee is typically subsidised
- Limited lifespan (often end-2020) or until funds run out
- Limits on the original maturity of the guaranteed loans



Covered by payment holidays

- Legislative and non-legislative programmes
- Suspension of principal or interest and principal
- Duration often up to 3 or 6 months
- Change in repayment schedule through extension of loan maturities in many cases



Covered by both relief measures

 If conditions of both public guarantees and payment holidays are met



Not covered by relief measures

Small and medium-sized entities (SMEs)

Larger entities

Affected borrowers

Common eligibility conditions for guarantees or payment holidays

- Good credit standing prior to outbreak
- Borrower to be classified as performing as of a cut-off date

Any debtor

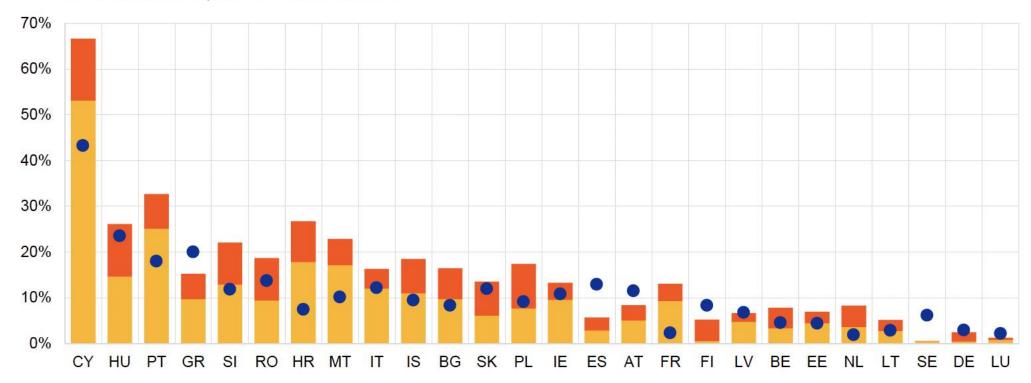
Not eligible for relief measure or has not applied Source:

Ehrentraud and Zamil (2020)

Loans and advances under moratoria by sector (June 2020)

(percentages of total loans and advances to the household, SME and NFC sectors)

- Households
- Non-financial corporations SMEs
- Non-financial corporations other than SMEs

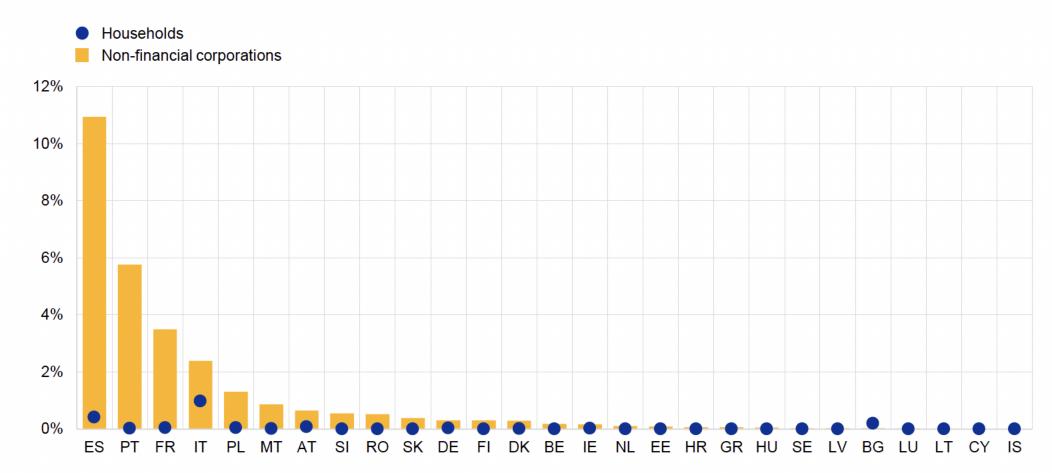


Sources: EBA, ESRB calculations.

Notes: Countries are ranked by loans under moratoria as a percentage of total loans and advances to households, SMEs and NFCs. The values are the mean value for banks in a given country.

New loans subject to public guarantees by sector (June 2020)

(percentages of total loans and advances to the household and the NFC sector)



Sources: EBA, ESRB calculations.

Notes: Countries are ranked by loans with public guarantees as a percentage of total loans and advances to households and NFCs. The values are the mean value for banks in a given country.

2022 ONWARDS

- Some/many corporates will be overleveraged; some will be no longer viable
 - How to deal with a wave of corporate insolvencies? Restructuring vs. liquidation
 - Bank-led restructuring process?
- Some/many banks will face loan losses
 - But might have to be forced to recognize them (incentives for evergreening?)
 - How to deal with these non-performing assets? Market in NPAs, AMCs?
 - How to deal with failing banks?
- Some governments will face high deficits and debt burdens?
 - How to deal with this?
 - Monetary policy (fiscal dominance?)
 - Another taper tantrum as Federal Reserve 'normalizes' monetary policy?
- Ukraine shock on top of the unwinding from Covid shock

EXIT STRATEGIES WILL DETERMINE FUTURE PATH

- Keynes vs. Schumpeter/Hayek avoiding hysteresis vs. allowing for necessary resource allocation
- Remove fiscal support for corporations and households? This has implications for banks who
 might face non-performing borrowers
- Force banks to recognize losses, reverse capital relief etc.? This has implications for corporate borrowers who might be cut off from lending
- How to manage non-performing assets fire sales vs. 'storage' in AMCs with liquidity support
- Broader question: How to recognize and distribute losses?
 - Create transparency to avoid zombie lending

MIND THE GAP..... WHEN EXITING

Exiting from different support policies requires coordinate approach as the following examples illustrate:

- Returning to standard loan classification rules requires remodulation of moratoria
- Exit from guarantees requires being ready to address possible rise in corporate insolvency
- Return to 'standard' regulatory requirements requires being prepared for resolving fragile banks

In sum:

- Need for coordinated approach across different policy areas and authorities
- Avoid cliff effects

THANK YOU

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