2020

Europe - U.S. Symposium on Building the Financial System of the 21st Century
2020 SYMPOSIUM ON BUILDING
THE FINANCIAL SYSTEM OF THE 21st CENTURY:
AN AGENDA FOR EUROPE AND THE UNITED STATES

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Discussion Topic:
The Role of the Government and Financial Sector in Supporting the Real Economy During the Crisis
The pandemic and the real economy

• Historic declines in GDP, employment, trade
• Shape of recovery is highly uncertain
  – Some official forecasts of V-shaped recovery in US and Europe in second half of 2020 (not by Federal Reserve or IMF)
  – Are these realistic? Unless the pandemic is controlled, sustainable growth appears impossible
• Containing the pandemic
  – Failures of containment in US
  – Europe mostly more successful (except UK), but hot spots can reemerge
  – To fully restore economic growth, will need effective treatment, vaccine – how likely, and when?
• What will “recovery” look like?
  – Sectoral devastation in travel, hospitality, events
  – Widespread business failures likely, especially among SMEs
  – If many firms go out of business, where will employment gains come from?
Financial sector – performance so far

• Financial stability so far, despite unprecedented economic shock
  – Governments and central banks have been proactive
  – Post-crisis reforms have largely worked as intended
    • Bank capital and liquidity buffers have prevented failures so far
    • Clearing and exchanges functioning effectively
  – But some markets have required direct or regulatory interventions – CP, MMF, etc.
  – Most important: how long can financial stability hold if economic growth does not resume?

• How to ensure success of financial markets and regulation?
  – Key short-term indicators are credit provision, market liquidity
    • Banks have been central to success of policy support of SMEs
    • Financial markets have supported larger firms’ liquidity and capital needs, facilitated government debt issuance, but only after central banks intervened to support market liquidity
  – Challenges remain
    • Short-term: disparities in uptake of credit based on ethnicity, sector, size of firm
    • What if we don’t see V-shaped recoveries in US and Europe?
    • Long-term: debt build-up may be unsustainable for many firms, leading to future bankruptcies and/or zombie firms
Financial markets and credit to real economy

• Banks have helped to mitigate disaster so far, by providing needed credit
  – High levels of capitalization and liquidity put them in a position to continue lending
  – Only banks are in a position to act as credit pipelines to SMEs
    • But some concerns that banks’ fears of NPLs, as well as CECL accounting for expected credit loss, may restrict new lending
  – Government action, including regulatory guidance and loan guarantees, have been essential to banks’ lending and forbearance

• Financial markets
  – Much of non-bank sector has functioned as intended (albeit with government and central bank support)
    • Few liquidity-driven sell-offs - central clearing has prevented cascading defaults, equity and bond trading platforms have worked well
    • Massive issuance of government and corporate debt have been absorbed by investors
    • Long-term investors such as pensions, insurers, SWF have prevented asset fire-sales despite price volatility
    • However, asset prices have diverged from performance of real economy – will there be a reckoning?
  – Concerns expressed over CP, MMF
    • Significant outflows from institutional MMFs required asset sales and collateral calls, contributing to March/April liquidity freezes that only ended with Federal Reserve support
    • CP markets hit worst – liquidity only restored with support of liquidity injections and regulatory reassurance to banks

• Additional government intervention may be needed if/when debt sours
Judging policy responses – short term

- Financial, fiscal and monetary policy have had positive effects in US and Europe
  - Lessons of global financial crisis being applied proactively – stimulus, liquidity
  - Contrast to considerable variability in public health responses
  - Long-term financial sustainability is a serious concern – will be determined by conditions in real economy, duration of pandemic

- Europe has been nimble and proactive, in contrast to 2008-10
  - ECB support has been large, swift, relatively flexible
  - Member-state fiscal actions
  - Joint EU bond issue (is this a “Hamilton moment”?)
  - Regulatory/supervisory focus primarily on banks

- US has also been effective and proactive
  - “Shock and awe” in monetary policy
  - Unprecedented fiscal effort, including PPP, extended unemployment, sectoral support
  - But Main Street Lending Program has been a failure – is there a role for Fed in supporting real economy? What kind of fiscal support is needed?
  - Cooperation across regulatory agencies to ensure comprehensive response (avoiding “regulatory whack-a-mole”)
  - Helped by existence of extensive crisis toolkit, bipartisan consensus for action
Cooperation within and across jurisdictions

- Among US public authorities
  - Fed and Treasury
    - Fiscal/monetary coordination
    - Fed has been subject to Treasury controls due to Dodd-Frank over lending to non-banks, both financial and non-financial (makes responsibility for terms of programs, as between the Treasury and Fed, unclear)
  - Cooperation across FDIC, Fed, OCC has made for consistent bank regulatory and supervisory response

- EU has also seen extensive coordination
  - Across regulatory and supervisory bodies, ECB, member governments
  - Joint bond issuance seen as historic

- High levels of technical cooperation across Atlantic, G7
  - Builds on trust and shared frameworks of action developed over many years
  - In contrast, low levels of cooperation among top political leaders
    - Political tensions have not interfered with technical cooperation
    - But will lack of political cooperation hamper crisis management and recovery down the road?
Banking sector – lessons learned

• Post-crisis reforms appear to have kept banks healthy in face of crisis
  – However, banks’ unwillingness to dip into regulatory capital buffers may limit future lending
  – Strong averages conceal considerable variation in bank health, especially in Europe
    • Variation will likely increase depending on geographic and sectoral lending profiles
  – Long term health is more questionable

• Bank health has enabled governments’ directed lending programs to work
  – True not only in Europe, where banks dominate credit provision, but also in US
  – Only banks have expertise and resources to quickly provide and service thousands of new SME loans
  – But what will be needed to significantly expand use of the Main Street Lending Program?

• Crisis tools require official backstopping and clear regulatory guidance
  – Banks do not want to get stuck with NPLs as result of lending into crisis
  – Most successful government lending programs are unconditional – 100% guarantee, clear criteria for eligible borrowers (contrast to Main Street)
  – Regulatory guidance gives important reassurance to banks
    • Removing risk-free assets from leverage ratio denominator
    • Clarifying accounting for pandemic-driven restructurings
    • But does regulatory forbearance raise the longer-term threat of NPLs and other credit events

• Stress testing and COVID sensitivity analyses have given supervisors essential visibility into macroprudential risks but unclear how this analysis should effect capital ratios and dividends and share buybacks
Future concerns – financial sector

• Likely rise in NPLs will challenge banks and regulators
  – Looming solvency crisis for non-investment-grade mid-sized and small firms?
  – How to understand balance between resilience, flexibility, and profitability?

• Disputes over regulation of non-banks
  – Some calls, especially in EU, for greater regulation of funds industry
  – Significant pushback against this point of view
    • CP market freeze largely due to non-participation by banks; US CP market comeback due to new guidance on risk weighting as well as Fed liquidity provision
    • Treasuries seized up, whereas derivatives did not – central clearing more important in crisis rather than types of investors
    • Macroprudential measures inspired by banking regulation would kill funds industry and exacerbate market liquidity issues
    • Inflexibility of US weekly liquidity minimum may contribute to illiquidity in time of crisis

• Financial infrastructures have worked as intended
  – CCPs, exchanges, trading platforms have avoided liquidity problems of uncleared OTC
Future concerns – real economy & policy

• Pandemic and the real economy
  – No one knows how long it will last or how it will change long-term economic behavior
  – Are massive fiscal efforts in US and Europe economically and politically sustainable?
  – Potential for widespread business failures due to continued or renewed demand shock
  – Long-term effects of overleverage for those companies that survive will include slow growth, low interest rates

• Government intervention is pervasive – will this continue, and with what effects?
  – Are there contradictions between long-term policy goals and growth imperatives? (e.g., EU inclusion of ESG in financial regulation)
  – What will policy exit look like, and who will take responsibility for business failures as crisis credit provision is withdrawn?
  – EU & US have differing philosophical views on when govt should step in, role of market discipline, dangers of moral hazard
  – Inequality driven by pandemic and govt responses will raise social tensions and economic nationalism – how can this be managed?
UPCOMING EVENTS

The Rise of Private Equity: Implications for Public Markets and Investor Access
Virtual Roundtable, August 20, 2020

China – US 2020
Virtual Symposia, September 10-11, 2020

The Role of Asset Management in ESG Investing
Virtual Roundtable, September 17, 2020

Japan – US 2020
Virtual Symposia, November 5-7, 2020

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