Will the Covid Crisis Force us to Reevaluate the Architecture of Banking Law (or Just Expose an Already Occurred Transformation)?

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Opinion

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From 'direct controls' on banks to 'prudential' supervision

In other times, the decision of a supervisory authority to prohibit dividend distributions to banks' shareholders would not have made the news. For decades after the 1929 crash, supervisory authorities had powerful discretionary tools that enabled them to shape the structure of banking markets. The approach aimed at avoiding bank insolvencies by reducing market tensions, and thus competition, to a minimum.

In such a system, depicted as 'financial repression' (Masciandaro and Quintyn 2013) or, more diplomatically, 'direct controls' (Padoa Schioppa 1975), authorities also had the power to direct and control lending in order to channel it towards the real economy, supported by expansionary monetary policies combined with tight capital and exchange controls.

The model was abandoned as a consequence of the North-American liberalizations of the seventies, followed in Europe in the eighties and nineties. Direct controls were replaced by the so-called 'prudential' regulation and supervision, whose goal was controlling the free market rather than a priori suppressing it, essentially by regulating the risks posed by banking activities (hence, with the introduction of capital and liquidity requirements).

The Banking Recovery and Resolution Directive

The 2007–08 global financial crisis exposed the shortcomings of this approach, or at least of its enforcement. When confronted with the burst of the bubble, banks turned out to be insufficiently capitalized to face a systemic crisis. This resulted in a wave of bailouts by States, in order to prevent the collapse of the system. The European regulatory response was two-fold.

On the one hand, prudential supervision was reinforced, both by enhancing the capital/liquidity requirements and the internal governance rules, including bankers' remuneration (see Basel III and the package Capital Requirements Directive-Capital Requirements Regulation), and by adopting a macro-prudential perspective, which led to the creation of the Single Supervisory Mechanism ('SSM'). On the other hand, a whole new set of rules and supranational authorities were introduced, with the specific task of dealing with bank insolvency: the 'resolution' (Banking Recovery and Resolution Directive, 'BRRD').

The 'resolution' is driven by the idea that the consequences of insolvency should fall on the investors of the insolvent bank. Thus, both shareholders and creditors may, and likely will, incur in write down, conversion into equity or outright annulment (bail-in). Creditors do not have any voice in the procedure and their protection is limited to ex post (judicial) remedies. Bailouts with public money should be avoided and, if unavoidable for macro-stability purposes, may occur only after substantial burden sharing by private investors.

Regulatory interventions after the Covid-19 pandemic

Nobody knows exactly the depth of the economic slowdown caused by the Covid-19 pandemic. Still, one can imagine that the operativity of banks will be affected, since probably more debtors will fail to repay their outstanding debts while others will face the need of further financing.

Although it is generally deemed that banks are in a better shape to cope with the crisis (thanks to the capital and liquidity ratios and buffers built up in the aftermath of the previous crisis), regulators have already intervened, aiming at safeguarding the capacity of banks to provide lending and to support the real economy.

It is easy to hear the echo of approaches characteristic of the financial repression era in such regulatory stances, especially if one looks at their rationale.

Take, for example, the prohibition of dividend distributions (and of share buybacks) which has been enacted by the ECB, alongside with limitations to executive remuneration. The ground for their introduction is that the ECB 'considers it crucial that credit institutions can continue to fulfil their role to fund households, small and medium businesses and corporations amid the coronavirus disease 2019 (COVID 19)-related economic shock. For this purpose, it is therefore essential that credit institutions conserve capital to retain their capacity to support the economy […]' (ECB Recommendation, 27 March 2020). Not by chance, the wording frequently recalls the dynamics of direct control on bank lending (note the focus on the 'role' of banks to 'support the economy', and the like). In this case, these goals justify a (reasonable) measure which has a significant impact on the position of banks' shareholders (incidentally, it is interesting to wonder how it might affect institutional investors, such as mutual and pension funds, holding relevant shareholdings in banks).

A similar logic is behind the ECB decision to authorize banks to use the capital and liquidity buffers and to relax the quality requirements for the composition of Pillar 2. [1] The same can be said with regard to the 'adaptation' of accounting and/or regulatory reporting duties to contingent needs (see also ECB, FAQs on ECB supervisory measures in reaction to the coronavirus). According to one estimate by The Economist, 'regulatory forbearance has created $5 trn of lending capacity'.

Likewise, on 12 March 2020, the EBA called on national regulators to 'make use of the flexibility already embedded in existing regulation', since 'EU banks have implemented measures to ensure business continuity and adequate service to their customers, but they are facing operational challenges, hence the need to focus on their core operations and critical functions. Supervisors are working with banks as they maintain their support to household and corporate sectors […]'.

All in all, taking into account also the proposals of using banks as conduit for the financial support that States will pump into the economy (Draghi 2020; Quadrio Curzio 2020), one might have the perception that the system is drifting backwards to a more market-controlling structure of banking supervision. This raises an important question: is it better for the functioning of the banking market a tight ex ante regulation (direct controls) or the current status quo?
Putting perceptions aside, such concern appears naïve, since it overlooks the robust market-controlling elements that are already embedded in the current architecture of European banking regulation.

The resolution ideally mimics the features of corporate reorganizations in insolvency proceedings: shares are cancelled and credits are converted into shares (or cancelled) insofar as it is necessary to reestablish a certain equilibrium in the financial structure of the firm. However, while in reorganization proceedings the 'insofar as it is necessary' standard is established on the market, by an actual sale (or similar transaction) of the firm, which 'objectively' appraises the firm intrinsic value, in the resolution under the BRRD, bail-ins, write-downs and burden-sharing are decided by the resolution authorities on the basis of a purely abstract appraisal of the value of the firm (Avgouleas and Goodhart 2019; Presti 2015 [2]). The potential values underlying the reorganization are established by an independent expert appointed by the resolution authority itself.

Of course, direct controls on banking markets had their flaws (in terms of development of the market, costs of credit, influence of politics on lending, etc.). However, to consider as market friendly the current overall structure of banking law (deriving from the combination of prudential supervision and resolution) seems a misunderstanding.

In fact, the BRRD allows for an ex post intervention on proprietary rights of market participants that is unilaterally decided by an administrative authority (rather than a

judicial one: Cassese 2017). Creditors may be stripped of their rights without a market oversight on the proceeding and without having had the opportunity of assessing such risk at the time they granted credit. Therefore, the current system is market friendly only as long as things are going well, but such friendliness is replaced by an authoritative approach when things go south. (One might note that, since the viability of market alternatives excludes the opening of the resolution, the latter is adopted only after a market failure. However, it is the resolution authority that establishes the absence of market solutions). This is even more puzzling if one looks at the uncertainties created by the vagueness and discretion of the decisions of resolution authorities and by the complexity of the process. (Binder 2017; Ventoruzzo and Sandrelli 2019, also highlighting the hesitations by authorities in fully implementing the BRRD principles.) Especially if there will be more resolution cases in the future (a likely possibility, depending on the severity and the duration of the upcoming economic distress), the uncertainties could outweigh the benefits.

Against this backdrop, the recent regulatory interventions, by recalling values and dynamics that are not explicit in the current legislation, represent an opportunity to reflect on its foundations. Namely, to wonder on what the best regulatory approach to deal with a sensitive sector such as the banking market might be: a less market friendly *ex ante* regulation or an *ex post* discretionary sacrifice of market rules (resolution). The doubt is timely, given that the rules of the market will have to coexist with massive public intervention for years to come.

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[1] See also EBA Statement on supervisory reporting and Pillar 3 disclosures in light of COVID-19, 31 March 2020; Basel Committee sets out additional measures to alleviate the impact of Covid-19, 3 April 2020; and Maintaining Banking System Safety amid the COVID-19 Crisis, 31 March 2020, IMFblog, by Tobias Adrian and Aditya Narain.

[2] Gaetano Presti, 'Il Bail-in' [2015] Banca impresa società 339.

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