Banking and Finance after COVID-19

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I. INTRODUCTION—FROM VILLAIN TO SAVIOUR

The COVID-19 crisis has had a major impact across all sectors of the economy. For the most part, businesses and households have been affected negatively; although some, notably online retailers and streaming platforms, have significantly increased their profits. Alongside health care and the pharmaceutical industry, banking and finance will be essential for helping the real economy to get through the crisis, and for paving the way to economic recovery and a return to a more normal life.

The liquidity generated by the vast stimulus and rescue programmes launched by governments and central banks around the world has to be channelled to businesses and households. To have any chance of financial survival, businesses and households in lockdown need leniency with their existing credit arrangements; new credit should flow freely. When the pressures of the pandemic eventually subside, the ensuing recovery will have to be funded largely through the money supply provided by commercial banks.¹ To accommodate these needs, banking and finance law had to be adjusted, affecting both minute regulatory detail and broader private law principles.

Overall, this process is part of a remarkable transformation: the villain of the Global Financial Crisis (GFC) has become one of the saviours during COVID-19. Caused by the excesses of the banking and finance sector, the GFC triggered regulatory intervention on an unprecedented scale. A key element has been enhancing institutions’ resilience and ensuring that any losses are predominantly borne by the institutions themselves, their investors and management (Part II below). During COVID-19, banks are no longer the problem, but an essential part of the solution²: regulatory measures brought in only recently have to be relaxed and loan losses may have to be socialised again (Part III below). However, in the long term this will not be sustainable.

In the aftermath of COVID-19, a new equilibrium will have to emerge where non-viable businesses can go insolvent and distressed banks can fail with as little public

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¹ European Parliament, Briefing: Exchange of views with Andrea Enria, Chair of the Supervisory Board of the ECB (May 2020) 1–2.

² Ibid, 1.
financial support as possible (IV). Reaching this new equilibrium sooner rather than later will be essential for shoring up public finances with a view to preparing for the next crisis.

II. CRIME AND PUNISHMENT—REGULATORY REFORMS AFTER THE GFC

The GFC of 2007/08 was rooted in the design and operation of the financial system itself: During the years leading up to the crisis, the financial system was awash with cheap and easy cash, a result of trade imbalances and low interest rates.³ In search of ever higher returns, banks redirected their activities away from traditional deposit taking and lending to the more profitable ‘originate-to-distribute’ (securitisation) business model and the trading in securities and derivatives markets.⁴ The interconnectedness of the financial system accelerated on a global scale and new and opaque channels for the transmission of risks opened up. At the same time, banks and the shadow banking system massively increased their leverage by borrowing short term in wholesale markets, rendering them much more exposed to a decline in asset prices.⁵

When foreclosures on US subprime mortgages increased, the asset base of financial institutions holding these instruments deteriorated rapidly, triggering a widespread lack of confidence within the system. With the fall of Lehman Brothers, short-term wholesale credit markets seized up and, in order to fund themselves, banks had to liquidate their assets, forcing asset prices down even further.⁶ This downward spiral was stopped by massive injections of taxpayers’ money, through central bank liquidity assistance, state guarantees of deposits, purchase of illiquid ‘troubled’ assets, or outright public recapitalisation or temporary nationalisation.⁷ For a number of countries in the euro area periphery the financial crisis subsequently developed into a sovereign debt crisis. This was largely due to a negative feedback loop between the banking sector, sovereign debt and the wider economy.⁸

These various contributing factors were linked and exacerbated by the so-called ‘too-big-to-fail’ problem, as a convenient shorthand for those circumstances in which public authorities will do whatever it takes to ensure the survival of a financial institution. Banks benefitting from this implicit state guarantee enjoy a public subsidy of their funding costs; they were the drivers of financial innovation and its excessive use for speculative purposes, in particular through securitisation and derivatives. Moral hazard encouraged a culture of short-termism and rampant speculation in order to achieve ever-higher returns for investors and compensation for traders and bank executives⁹; with any potential losses being shifted to the taxpayer.

³ J Taylor, Getting Off Track (Hoover Institution Press 2009) 1–11.
⁴ Financial Services Authority, The Turner Review, A Regulatory Response to the Global Banking Crisis, 74 (Mar. 2009) 16–25.
⁵ Ibid, 19–20; E Avgouleas, Governance of Global Financial Markets (CUP 2012) 96–104, 113–16.
⁶ Financial Services Authority (n 4) 27.
⁷ For an overview of the different measures: European Union Committee of the House of Lords, ‘The Future of EU Financial Regulation’ HL Paper 106–1 (June 2009) para 216–22; Taylor (n 3) 15–24.
⁸ European Commission, Commission Staff Working Document – Economic Review of the Financial Regulation Agenda, SWD (2014) 158 final, 35–36.
⁹ E Avgouleas, Governance of Global Financial Markets (CUP 2012) 113–15.
Accordingly, enhancing the resilience of individual financial institution and tackling ‘too-big-to-fail’ by putting in place effective resolution regimes emerged as key elements of the post-crisis reform agenda pushed by the G20 leaders and international standard setters.\(^\text{10}\) The Basel III capital requirements\(^\text{11}\) strengthen institutions’ capital base by increasing the amount of, and by restricting what counts as, capital of the highest quality\(^\text{12}\) that institutions need to hold. Basel III further introduced minimum liquidity standards, requiring banks to have sufficient high-quality assets to fund projected cash outflows over a 30-day period, as well as a leverage ratio as a non-risk-based backstop measure. According to the Financial Stability Board (FSB),\(^\text{13}\) effective resolution regime seek to make feasible the resolution of financial institutions ‘without exposing taxpayers to loss.’\(^\text{14}\) Complex new resolution frameworks have been introduced in all major financial jurisdictions,\(^\text{15}\) as in the European Union through the Bank Recovery and Resolution Directive (BRRD),\(^\text{16}\) with more centralised decision making for the Euro-zone.\(^\text{17}\) Despite differences in detail, these resolution frameworks have a common goal: to simulate the loss allocation principles of general insolvency/bankruptcy law with a view to limiting market distortions, whilst at the same time preventing contagious knock-on effects.\(^\text{18}\)

\(^\text{10}\) G20, Declaration: Summit on Financial Markets and the World Economy, Washington, 15 November 2008; G20, London Summit – Leaders’ Statement, 2 April 2009; G20, Leaders’ Statement – The Pittsburgh Summit, 24–25 September 2009; FSB, Intensity and Effectiveness of SIFI Supervision – Recommendations for enhanced supervision, 2 November 2010; BCBS, Basel III: A global regulatory framework for more resilient banks and banking systems (BIS, 2011); BCBS, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (BIS, 2013); FSB, Report on Reducing Moral Hazard Posed by Systemically Important Financial Institutions (11 November 2010); FSB report with recommendations to strengthen oversight and regulation of shadow banking (27 October 2011); FSF, Principles for Sound Compensation Practices (2 April 2009); FSF, Principles for Reducing Reliance on CRA Ratings (27 October 2010); FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions (4 November 2011); and various follow up reports.

\(^\text{11}\) BCBS, Basel III: A global regulatory framework for more resilient banks and banking systems (BIS, 2011); BCBS, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (BIS, 2013).

\(^\text{12}\) Common Equity Tier 1 (CET1) essentially consists of common shares issued by the institution and the related share premium accounts, as well as retained earnings.

\(^\text{13}\) Financial Stability Board (n 10).

\(^\text{14}\) Ibid, 3 (Preamble).

\(^\text{15}\) In the US, the Dodd-Frank Act was enacted to end ‘too big to fail’ and ‘to protect the American taxpayers by ending bailouts’. Dodd-Frank Wall Street Reform and Consumer Protection Act, Publ. L. No. 111–203, 124 Stat. 1376 (2010), Preamble.

\(^\text{16}\) Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU/2012/30/EU and 2013/36/EU, and Regulations (EU No 1093/2010) and (EU) No 648/2012, of the European Parliament and of the Council, OJ EU L173/190 12.6.2014.

\(^\text{17}\) Regulation (EU) No 806/2014 of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council, OJ EU L 225/1 30.7.2014 (SRMR).

\(^\text{18}\) J-H Binder, ‘Systemkrisenbewältigung durch Bankenabwicklung? Aktuelle Bemerkungen zu unrealistischen Erwartungen’ 2017 Zeitschrift für Bankrecht und Bankwirtschaft 57, 60.
Reserved for exceptional circumstances, administrative resolution tools and powers enable a transfer free and clear of the viable parts of a failing institution’s business—assets and liabilities—to a private sector purchaser or to a newly incorporated bridge bank as a temporary holding mechanism, combined with the liquidation of the residual entity. The transfer powers may further be used to separate performing from non-performing assets and insulate the latter in an asset management company (AMC) for eventual wind down. Formal bail-in tools may be available for a write down or conversion of an institution’s equity and debt instruments with a view to its recapitalisation as a going concern or for a reduction of its debt load in a gone concern scenario. The same result may be achieved ‘informally’ through a securities-for-claims exchange. Resolution may be financed through standing resolution funds or a direct line of credit to the Treasury or central bank. The key underlying rationale is to ensure that private investors bear an adequate amount of the losses incurred by a failing institution (private sector involvement) with a view to tackling moral hazard and reducing the burden on the taxpayer. As a consequence, the BRRD contains a minimum loss contribution requirement for the shareholders and creditors of a failing institution of 8 per cent of total liabilities before any public funds can be advanced during the resolution process.

In the immediate aftermath of the GFC this anti-bailout philosophy was strong. However, in the EU over the last decade the exploitation of loopholes seems to have become more important than the resolution tools and powers themselves. For example, the Commission-approved bailout of Italian bank Monte dei Paschi di Siena, based on an extensive interpretation of the ‘precautionary recapitalisation’ exception, created an important precedent and other bailouts have followed since. The COVID-19 crisis seems to have reinforced and accelerated this trajectory towards a more bailout-friendly approach.

19 M Schillig, Resolution and Insolvency of Banks and Financial Institutions (OUP 2016) Chapter 10.
20 Ibid, para 11.10–11.31.
21 Ibid, para 11.49–11.51.
22 For EU and Euro-zone Ibid, 12.28–12.35.
23 Ibid, para 12.36–12.39 for the UK, and para 12.50–12.53 for the Orderly Liquidation Fund under Dodd-Franck.
24 BRRD, Art 44(5), 101(2); SRMR, Arts 27(7), 76(3).
25 European Commission – Statement, Statement on Agreement in principle between Commissioner Vestager and Italian authorities on Monte dei Paschi di Siena (MPS) (June 1, 2017); <https://europa.eu/rapid/press-release_STATEMENT-17-1502_en.htm>; European Commission – Press Release, State aid: Commission authorizes precautionary recapitalization of Italian bank Monte dei Paschi di Siena (July 4, 2017); <https://europa.eu/rapid/press-release_IP-17-1905_en.htm>.
26 Banca D’Italia, The ‘Precautionary Recapitalization’ of Banca Monte dei Paschi di Siena (Dec. 29, 2016); <https://www.bancaditalia.it/media/approfondimenti/2016/ricapitalizzazione-mps/precautionary-recapitalization-mps.pdf?language_id=1>.
27 Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A. (the ‘Institution’) with a Legal Entity Identifier 549300W9STRUCJ2DLU64, addressed to Banca d’Italia in its capacity as National Resolution Authority (SRB/EES/2017/11); Decision of the Single Resolution Board in its Executive Session of
The IMF has projected that the COVID-19 crisis is likely to result in the worst recession since the Great Depression, surpassing the Global Financial Crisis in severity.\(^\text{28}\) According to the Bank of England, the UK economy is likely to experience its deepest recession in 300 years.\(^\text{29}\) Following the mass rollout of effective vaccines, some form of recovery is likely to occur later in 2021. However, it remains unclear whether this recovery will be ‘V-, U- or L-shaped’ and in any case GDP levels are likely to remain below previous trends.\(^\text{30}\)

Given the severity of the health crisis, the governments and central banks of the most affected countries have acted swiftly and introduced vast fiscal and monetary stimulus and rescue packages. In the US, the Federal Reserve and the Treasury have more or less backstopped the entire private and public debt in the economy.\(^\text{31}\) The ECB has stepped up liquidity provision to the financial sector and vastly increased its sovereign bond purchasing programmes. In addition to various measures at national level, the EU has agreed on a EUR1.8 trillion stimulus package, including a EUR 750 billion temporary recovery instrument for helping to relieve the immediate economic and social damage caused by the pandemic.\(^\text{32}\) Similarly, the UK government has made available more than £330 billion in loans and guarantees to support businesses and their employees during the crisis,\(^\text{33}\) and the Bank of England has also increased its government bond buying programme.\(^\text{34}\)

Unlike the largely self-inflicted Global Financial Crisis, the coronavirus pandemic is, from the perspective of banking and finance, an exogenous event. Banks and other financial institutions are no longer seen as (part of) the problem. On the contrary, their contribution is deemed to be essential for providing much needed relief to ailing businesses and suffering households.\(^\text{35}\) Banks are the main channels through which, in particular, small and medium sized businesses can gain access to the government and/or central bank-provided liquidity. More generally, by expanding their

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23 June 2017 concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza S.p.A. (the ‘Institution’) with a Legal Entity Identifier V3AFM0G2D3A6E0QWDG59, addressed to Banca d’Italia in its capacity as National Resolution Authority (SRB/EES/2017/12); European Parliament Briefing, Recent Measures for Banca Carige from a BRRD and State Aid perspective (February 2019), <https://www.europarl.europa.eu/RegData/etudes/BRIE/2019/624413/IPOL_BRI(2019)624413_EN.pdf>.

28 IMF World Economic Outlook Update, June 2020: A Crisis Like No Other, An Uncertain Recovery; <https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020>.

29 Bank of England, Monetary Policy Report (May 2020); <https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2020/may/monetary-policy-report-may-2020>.

30 IMF (n 28).

31 <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm>.

32 <https://ec.europa.eu/info/strategy/recovery-plan-europe_en>.

33 <https://www.gov.uk/government/news/coronavirus-business-support-to-launch-from-today>.

34 <https://www.bankofengland.co.uk/markets/market-notices/2020/asset-purchase-facility-gilt-purchases-june-2020>.

35 European Parliament (n 1).
lending to businesses and households in need, banks can help firms and individuals to weather any short- or medium-term liquidity shortages and eventually lay the foundation for the subsequent recovery. This requires, first, that banks, as the main lenders to businesses and households, should be allowed to treat their borrowers more leniently than would normally be the case, with a view to ensuring that borrowers can survive the financial challenges of the pandemic. Secondly, banks should be incentivised to expand their lending business throughout the pandemic, providing credit to businesses and households on a continuous basis, thereby protecting jobs and livelihoods.\(^{36}\)

A range of supervisory and regulatory measures have been put in place to support these goals.\(^{37}\) In order to relieve the financial pressures on businesses and households caused by closures and lockdowns, various jurisdictions have introduced repayment holidays and moratoria. Whilst interest continuous to accrue, a borrower may opt to pause repayment of loan instalments for a certain period of time; conversely, lenders may be prevented from initiating or continuing enforcement action. As a regulatory corollary, banks may refrain from treating loans subject to general moratoria or repayment holidays as ‘in default’ or ‘non-performing,’ which otherwise would require them to provision for potential ‘loan losses,’ thereby reducing the CET1 capital available for lending purposes.

On the contrary, banks are encouraged to fully utilise the flexibility inherent in the IFRS 9 accounting framework, to take a long-term view given the temporary nature of the pandemic, and to avoid excessive loan-loss provisioning. Moreover, depending on the jurisdiction, banks may be allowed to temporarily operate below the level of capital buffer requirements. Liquidity and, where applicable, leverage thresholds have also been relaxed. In addition, banks have been encouraged, and a number of banks have agreed, to cancel or restrict the payment of dividends, bonuses or share buy-backs in 2020. Both, the Bank of England and ECB have further reduced the interest rate on longer-term funding schemes; the ECB has temporarily eased eligibility criteria for collateral; and the Bank of England supports large businesses by offering cash for their corporate debt.\(^{38}\)

Obviously, these measures are part of a difficult balancing act: providing the necessary flexibility to preserve businesses, jobs and livelihoods during a severe, but temporary health crisis; whilst seeking to maintain an adequate threshold of prudence and of loan underwriting standards.\(^{39}\) However, further down the line some banks and financial institutions will almost inevitably be confronted with increased

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36 I Chiu, A Kokkinis and A Miglionico, ‘Regulatory Suspensions in Times of Crisis: The Challenges of Covid-10 and Thoughts for the Future’ ECGI Law Working Paper No 517/2020 6 (<https://srn.com/abstract_id=3605423>).
37 Ibid, 7–13.
38 <https://www.bankofengland.co.uk/coronavirus; https://www.bankingsupervision.europa.eu/home/search/coronavirus/html/index.en.html#item2>.
39 Chiu, Kokkinis and Miglionico (n 36) 7, 10.
loan losses potentially putting them at risk of distress. In a recent Communication, the EU Commission has outlined its proposals for addressing this issue when it arises in the future. The ‘upcoming flows of NPLs’ (non-performing loans) should be addressed primarily by strengthening the secondary market for distressed assets, allowing NPLs to be removed from banks’ balance sheets, and by a further harmonisation and improvement of insolvency and debt recovery regimes. Interestingly, in order to deal with any potential difficulties of individual banks, the Commission does not envisage the application of the EU bank resolution framework at all. Rather, presumably because of the mandatory private sector loss contribution under the BRRD, the idea seems to be to circumvent resolution where possible in favour of public bailouts.

The Commission’s preferred policy instrument appears to be the setting up of asset management companies (AMCs). These are the so-called bad banks in common parlance: impaired assets and NPLs that a bank carries on its balance sheet are sold to an AMC. As a consequence, the bank’s balance sheet is cleansed of a risky asset which is replaced with a certain amount of cash. The AMC is tasked with realising the maximum value of the impaired asset, by participating in workouts and debt restructurings or simply by benefitting from a recovery of asset prices over time. According to the Commission, AMCs are particularly suitable when impaired assets affect large parts of the domestic banking system and mainly cover loans secured by commercial real estate and large corporate exposures. In the past, AMCs have been used successfully in Italy and Greece.

There is a wide range of design alternatives: centralised AMCs can be set up at national level, pooling expertise and resources and benefitting from economies of scale; decentralised AMCs can be bank-specific and targeted to the needs of an individual institution or class of institutions. AMCs can be privately funded, for example by the banking sector, or publicly funded by the government, or by a combination of both. Given the funding needs for impaired asset measures, substantial amounts of public money in the form of equity injections possibly combined with guarantees of the AMC’s future funding needs will usually be required. As a consequence, the setting up of the AMC will be subject to assessment under the EU State Aid framework, which will not pose a major obstacle where the NPL exposure of the national banking system has reached systemic proportions. The Commission does not envisage

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40 T Beck, ‘Finance in the times of coronavirus’ in R Baldwin and B Weder di Mauro (eds), Economics in the Time of COVID-19 (VOXEU.org/CEPR Press 2020) 73–74.
41 European Commission, Communication from the Commission to the European Parliament, the Council and the European Central Bank: Tackling non-performing loans in the aftermath of the COVID-19 pandemic, COM(2020) 822 final.
42 Ibid, 2.
43 Ibid, 11–13.
44 Ibid, 11.
45 Ibid.
an EU- or Eurozone-wide AMC, an idea floated a view years ago, but a cross-border network of national AMCs to boost cooperation and create valuable synergies.

Where an AMC is (part) publicly funded or backstopped by the government, its involvement in an impaired asset measure may constitute ‘extraordinary public financial support’ in form of the compensation paid in exchange for an institution’s impaired assets and NPLs. As a consequence, the institution would be considered to be failing or likely to fail, and subject to the EU resolution framework, provided there is no equally suitable alternative measure and firm failure is deemed to be systemically important.

Within resolution, an ACM on the basis of the asset separation tool may be used only in combination with one of the other resolution tools: sale of business, bridge bank or bail-in, so as to keep moral hazard in check. In any case, the mobilisation of public funds would be subject to the 8 per cent minimum private sector contribution to loss absorption.

One way out of this predicament would be to structure the impaired asset measure so that it does not constitute State Aid at all, and therefore does not amount to ‘extraordinary public financial support.’ This can be achieved through the purchase by a publicly funded AMC of the impaired assets at market price, that is, the price which a private investor would pay at the same moment for the same asset. More often than not, the actual market price will not be directly observable because the market has seized up or there is no market. In these cases, what matters is the Estimated Market Value, on the basis of observable transactions for similar types of assets. This endows the relevant authorities with significant leeway: in the absence of any private investors even remotely interested in the impaired asset it is difficult to convincingly argue that a fictitious private investor would have paid less for the asset.

Still, occasionally even a generously Estimated Market Value may be insufficient to shield an institution from significant loan losses that jeopardise its viability. For these scenarios the Commission envisages the activation of the ‘precautionary recapitalisation’ loophole with a view to enabling continued lending to the real economy, supporting the recovery and cushioning the social impacts of the crisis. In the Commission’s Communication, this almost comes across as a reward for banks’ key role in ‘dealing with the effects of the COVID-19 crisis by maintaining the flow of credit to the economy.’ Consequently, support ‘to the banking sector is meant to incentivise the continued funding of economic activity in the EU.’

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46 European Parliament (n 1) 6.
47 European Commission (n 41) 12.
48 BRRD, Art 32(4)(d); SRMR, Art 18(4)(d).
49 BRRD, Art 32(1); SRMR, Art 18(1).
50 BRRD, Art 37(5).
51 BRRD, 2(1)(28); SRMR, Art 3(1)(29.).
52 European Commission, Commission Staff Working Document: AMC Blueprint SWD(2018) 72 final, 28.
53 Ibid.
54 European Commission (n 41) 15.
55 Ibid.
A precautionary recapitalisation is extraordinary public financial support normally in the form of an injection of own funds or the purchase of capital instruments, but may also be used to transfer impaired assets to a publicly funded AMC. This will not trigger the resolution framework provided support is being granted in order to remedy a serious disturbance in the economy of a Member State and to preserve financial stability, the beneficiary is solvent, and the measure is of a precautionary and temporary nature and proportionate for remedying the consequences of the disturbance. Precautionary recapitalisation is conceptualised as an exception to the resolution framework, reserved for unique situations and subject to, at face value, strict conditions. However, if past experience is anything to go by, these conditions are unsuitable for effectively preventing the bailouts of banks that were already experiencing viability problems before the COVID-19 crisis.

IV. TOWARDS A NEW EQUILIBRIUM IN A POST-COVID-19 WORLD

When COVID struck, banks and financial institutions were in much better shape than a decade ago. Regardless, many institutions are likely to experience significant levels of loan losses and may potentially face precarious liquidity and solvency shortfalls, resulting in renewed fragility within the financial sector. Beck has argued that in the event of widespread stress in the financial system the government should stand in as the ultimate loss absorber, right behind the central bank as lender and market maker of last resort. The resolution regimes were not conceptualised for a systemic crisis; a widespread undercapitalisation in the banking sector should be addressed with taxpayer funded recapitalizations or impaired asset measures, along the lines envisaged by the EU Commission.

According to Cochrane, it has been essential to prevent a disorderly collapse of the real economy and of the financial system in the short term. Without government intervention on a massive scale there would have been a wave of insolvencies and many people would simply have been unable to pay their bills. Lender of last resort support and capital injections into ailing banks may become necessary should the recession turn out to be deeper and the recovery slower than expected. Thus, given banks’

56 BRRD, Art 32(4)(d)(III); SRMR, Art 18(4)(d)(III).
57 European Commission (n 52) 34.
58 see European Commission (n 41) 15.
59 Beck (n 40) 73–75.
60 T Beck, ‘Finance in the Times of COVID-19: What Next?’ in R Baldwin and B Weder di Mauro (eds), Mitigating the COVID Economic Crisis: Act Fast and Do Whatever It Takes (VOXEU.org/CEPR Press 2020) 181.
61 European Commission (n 41).
62 J Cochrane, ‘Coronavirus monetary policy’ in R Baldwin and B Weder di Mauro (eds), Economics in the Time of COVID-19 (VOXEU.org/CEPR Press 2020) 105, 106.
63 Beck (n 40) 182.
vital contribution to alleviating the economic fallout of the pandemic, perhaps they should benefit from an implicit or explicit government guarantee that ensures their capacity to provide liquidity to the real economy on a continuous basis.

After all, commercial banks and other financial institutions provide a public good in form of the issuance and allocation of the money supply.64 Through lending, commercial banks create credit money in the form of deposits as the prevalent medium of exchange.65 The depositors—which are mainly the bank’s borrowers—hold claims for which the credit nature (right to a future cash flow) is merely incidental to the monetary or ‘liquidity’ function of the claim. Liquidity adds value to such a claim beyond the net present value of the future cash flow; value that will be lost—the claim’s moneyness forgone—if the bank fails and the holder of the claim is prevented from immediately accessing what is owed to them.66 A failing bank in resolution or liquidation may be prevented from providing these critical liquidity services to its customers. This could result in monetary contraction, reducing output and activity across the economy.67 In a pandemic and its aftermath, this could slow down any economic recovery.

On that basis, it could be argued that the banking sector’s reliance on public financial support—bailouts—is simply an inherent feature of the current financial system. Society overall benefits and the taxpayer represented by the government may be the superior risk bearer of financial firm failure. However, it is worth considering why the government or central bank does not provide liquidity directly to businesses and households but enlists the assistance of private financial institutions in the process. By relying on commercial banks for the issuance and allocation of the money supply, investment decisions are placed in the hands of local investment specialists with a view to improving asset allocations and insulating the process from political interference.68

This requires appropriate incentives: financial institutions and their stakeholders must be able to benefit from good portfolio performance; whereas any portfolio losses must first and foremost be absorbed by them.69 It seems appropriate that the state absorbs the costs of exogenous risk that are out of anybody’s control. The costs of endogenous risks, however, those resulting from investment in non-viable businesses or impaired assets, should, even during a global pandemic, in principle still be borne by the respective financial institution and its equity and debt investors.

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64 R Hockett and S Omarova, ‘The Finance Franchise’ (2017) 102 Cornell Law Review 1143, 1158–64.
65 M McLeay, A Radia and R Thomas, ‘Money in the Modern Economy: An Introduction’ (2014) Bank of England Quarterly Bulletin Q1; ‘Money Creation in the Modern Economy’ (2014) Bank of England Quarterly Bulletin Q1.
66 J. Sommer, ‘Why Bail-In? And How?’ (2014) 20 Economic Policy Review, Special Issue: Large and Complex Banks 1, 5–11.
67 M Friedman and A Schwartz, A Monetary History of the United States, 1867–1960 (Princeton University Press 1963) 351.
68 M Ricks, The Money Problem (University of Chicago Press 2016) 15–16.
69 Ibid, 16.
When much of the economy is in lockdown, it can be difficult to assess the viability of businesses and the creditworthiness of households. Therefore, temporary leniency and flexibility are justified. However, in the medium term, firms and households that are settled with too much debt will be unable to invest, spend and consume, and potentially slow down a budding recovery.\textsuperscript{70} Banks with fragile balance sheets will be prevented from lending and expanding the money supply, unless they are relieved of the impaired assets they carry. The permanent socialisation of losses through government bailouts cannot be the solution. Currently, governments can borrow at interest rates close to 0 per cent. But there is no such thing as a ‘free lunch:’ the increasing costs of sovereign debt will merely be shifted towards off-balance sheet obligations—for pensions, health care and social welfare programmes. Costs will remain hidden until they come to the fore in the form of lower welfare payments, worsening health care provision and/or higher taxes.\textsuperscript{71}

Bailouts only move the problem from one part of the economy to another. Thus, after COVID-19, insolvent companies must be allowed to exit the market and households to go bankrupt. Similarly, failing banks need to be resolvable and resolved with as little taxpayer involvement as possible.\textsuperscript{72} The government’s spending power should be reserved for cushioning the impact of exogenous risks, like the pandemic that has been unfolding. Should a similar occurrence materialise in the future, states’ capacity to adequately and speedily respond should not be impaired by the need to intervene in idiosyncratic firm failures in which losses should be privatised as much as possible.

\textsuperscript{70} N Roubini and S Mihm, \textit{Crisis Economics} (Penguin Books 2011) 58.
\textsuperscript{71} K Rogoff, ‘Falling Real Interest Rates, Rising Debt: A Free Lunch?’ (February 2020); see also F Hayek, \textit{Denationalisation of Money} (Institute of Economic Affairs, 3rd edn 1990) 104–105.
\textsuperscript{72} Roubini and Mihm (n 70) 58.