Early takeaways on virus-triggered bank stress

The coronavirus panic continues to shake the market. While opportunistic players (self-serving oil-producing states) add fuel to the fire, it is possible to sketch out some early lessons from the current turmoil.

- This time around, central banks cannot be expected to act as "white knights" the way they did – in most cases successfully – during the last financial crisis. First, because the current panic was not triggered by the bursting of financial excesses leading to a bubble. The agent is a deadly viral pathogen and no central bank, or any financial actor for that matter, is either able or should be expected to fix it.

  Second, because, unlike last time, central banks – especially those sitting on negative rates like the ECB and Bank of Japan – have very limited room for manoeuvre. A bold "whatever it takes" statement today would no longer sound like the lion's roar of eight years ago. Certainly, new business loan purchase programmes can be initiated, or the existing schemes for corporate debt can be extended. But, with over-stretched central-bank balance sheets and a more sceptical market, the save-the-day impact will not be the same as last time around.

  The market will have no choice but to revisit its belief that the ultimate solution to a financial crisis – wherever it originates– lies in decisive central bank action.

- If a full financial crisis takes hold (not a central scenario: the scary global market dip is not yet a crisis), the banks will not be to blame this time around. On balance, weak profitability notwithstanding, European banks' prudential metrics are reassuring, including capital and liquidity. Banks have taken no glaring excessive risks in during the last decade that are now bursting out with a vengeance.

  That said, the broader financial system outside the highly regulated banking sector – market finance, non-bank lending -- has dangerously re-leveraged in the post-crisis decade, which certainly heightens systemic vulnerability.

- In the years since the crisis, the market has ranked regulatory risk as one of the main risks for the banking sector. Specifically, the risk that a bank will run afoul of its supervisors' tougher requirements and be penalised in some form. But this time around, it would be helpful, and certainly be viewed as positive, if supervisors avoided unnecessary toughness when dealing with banks experiencing problems related to coronavirus.

  It is one thing to mete out harsh supervisory treatment or send banks that run into trouble of their own making into resolution or liquidation. It is quite another thing to adopt the same approach and with the same timing for a bank that finds itself in difficulty because of coronavirus effects. For example, a bank experiencing material credit losses on large exposures to airlines, hospitality and tourism, or other sectors badly hurt by the virus panic.

  In the euro area, it is quite possible that, in the unlikely case the SSM pushes for harsh resolution for the latter case, national governments may step in and try to help their ailing bank(s) in their own ways. Again, assuming the problems are not self-generated by the respective bank(s); public opinion will not otherwise react positively to a bailout.

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- At the same time, this is not the right time for new adventures e.g. for banks to contemplate transactions or actions which could lead to additional risks, or at least give the market that impression. Daring acquisitions or other transformational moves should be left for another day. Certainly, if a bank experiences serious problems and the supervisor encourages a merger with a financially stronger domestic (or in rare cases, a foreign) competitor, and if it is in the latter's interest to engage in such a transaction, M&A can be envisaged even at a time of stress (as BNP Paribas successfully did with Fortis at the height of last crisis. Or not so successfully Commerzbank with Dresdner or Lloyds with HBOS).

  The less banks are seen trying to capitalise on a situation that is intensely stressful for everybody – including their own customers -- to opportunistically boost some earnings, the less their public image will suffer.

  Needless to say, this is equally not the time to put on the back burner any initiatives to address sustainable-finance goals (including on climate change) or any steps to strengthen anti-money laundering policies and practices. Not to mention intense efforts to boost investments and expertise in cyber security.

- Unlike central banks, governments can and should be expected to play a bigger role in addressing the current stress, in the form of fiscal stimulus or aiding the financing of sectors in distress (e.g. airlines, tourism, SME segments, etc). This is likely to happen when there is no other way out – meaning too late in some cases. Addressing these challenges earlier, and doing it in an emphatic and transparent manner, would help a lot. So far, however, there are only few walk-the-talk steps in Europe.

  Co-operation between governments would clearly also help to address a global virus panic, but this would mean going against the national populist 'circle-the-wagons' trend prevailing today, with trade wars, oil-price wars, and anti-globalisation and me-first approaches.

  In the EU there is inherently a much higher likelihood for co-operation among member states. Thus far, the German government – one of the few large EU states with a favourable fiscal condition – has been less eager to extend meaningful help cross-border. Helping the quarantined Italian economy could definitely be such a meaningful step.

- Ultimately, the light at the end of this tunnel will be when an anti-coronavirus vaccine and its mass commercialisation is successful. This is not yet around the corner. In the meantime, successfully containing and reversing the current epidemic through decisive steps – virus mass testing, travel and assembly restrictions, and quarantines – will help bring back public confidence, and with it potentially a better market.

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