Op-Ed

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Preparing for Safe and Sensible Economic Recovery! One Daunting Thought and Three 'Simple' Strategies to Bridge European and Italian Action?

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Suggested citation: Marco Lamandini, Guido Ottolenghi, David Ramos Muñoz, "Preparing for Safe and Sensible Economic Recovery! One Daunting Thought and Three 'Simple' Strategies to Bridge European and Italian Action?", EU Law Live, 2 April 2020

Preparing for Safe and Sensible Economic Recovery! One Daunting Thought and Three 'Simple' Strategies to Bridge European and Italian Action?

Marco Lamandini, Guido Ottolenghi, David Ramos Muñoz

1.- These are daunting times. The current pandemic is causing unprecedented economic and social challenges due to the protracted (quasi-) suspension of economic life imposed by most governments worldwide. No one can claim any superior knowledge or previous experience of how to handle the crisis. No one can conjure an economic spell that lifts the fog of uncertainty and guarantees the overcoming of these challenges. We are no exception. Our thoughts intend to trigger a discussion and invite further analysis of the situation, not to offer infallible solutions. And yet, history (and economic history in particular) teaches us lessons which would be irresponsible to ignore insofar as they could help with advance preparation of a backstop response, should the worst case scenario materialise, and our economies experience a Great Depression-like deep recession. However, since those lessons, in the present circumstances, can only fit 'to some extent', a bit of creativity may be necessary to adapt them.

2.- Luigi Einaudi, an Italian economist and first president of the Republic, gifted with the ability to explain complex matters with simple words, endlessly repeated the motto: 'knowledge must come before deliberation'. The sudden coronavirus pandemic has turned the tables on us, and deliberation has, by necessity, often come before full knowledge, determining the largest worldwide political intervention in our economic and personal freedoms after the Second World War and possibly setting the scene for the largest experiment in planned economy in history. Did the bubonic plague strike? Have the economies stopped performing, and have people become unwilling to work for a living? None of the above: a new virus, to which humans are highly and deeply exposed because we lack the proper immune system responses, has spread around the globe in a matter of days, showing not only how our economies are connected and global, but also that every aspect of our life (social, cultural, emotional) is also continuously connected to distant places. Even the most advanced health systems turned out to be unprepared, not only in terms of response to the spread of respiratory diseases (which was unpredictable), but also in terms of the most basic supplies to face any form of pandemic. Since the oil crisis of 1973 countries carry safety stocks of energy products, but we discovered to our dismay that we do not have safety stocks of basic medical supplies or protective equipment, we do not have testing resources, nor plans capable of protecting the ability of doctors and nurses to cure us. The spread of the disease clogged the hospitals, sometimes the hospitals became a fertile vehicle for the virus, the sanitary authorities warned of the imminent inability to deal with contagion, governments, called by necessity to respond with urgency, adopted social distancing measures, limited freedoms, and imposed an economic lockdown as an emergency response to stop or slow down the spread of the illness. Could they have acted differently? Probably not, but it is important to remember that the consequences on the daily toils and joy of our life are largely the result of these decisions. Airlines are grounded, cruise ships docked, cargo ships have an ever-harder time finding crews, some sectors of production are closed down, most likely preparing shortages and disruptions for all other sectors in a short while. Hotels, B&Bs, restaurants, and shops are mostly barred from operating and may stop paying rent and lay off their workers. Small and large owners of houses, commercial spaces, and offices may run into trouble and eventually default on their loans. People locked up in small apartments are burning through their savings and their psychological well-being is being tested.

The emergency decisions to face the contagion have been taken, but now knowledge must regain its role before further deliberation, because lockdowns are justified and proportionate only for the time necessary to set up the ability to cure people, because we cannot survive in a generational lockdown. At the same time, Europe should speedily set up a plan to test a large and representative sample of the population to estimate more accurately if the contagion is limited to the numbers each country announces daily, or if most cases remain undetected.

There should be a spiked and EU coordinated (and financed) effort to quickly set up more ICU beds and dedicated hospitals. The EU could find innovative ways to speedily sustain research, not only through funding, but coordinating the efforts of different laboratories, making available free loan instruments and helping to allocate substances that are in low supply and needed for production tests. In other words we wish to draw further attention to the need to acquire and share with the population a more structured amount of knowledge, in order to direct the future efforts: if lockdowns can be rapidly reduced through better understanding of the data and by investing speedily in hospital facilities, and medical research, most EU resources should be directed to that end, to avoid the risk that of a self-induced economic crisis turning into a more dramatic outcome than the pandemic itself. If on the other hand the current approach is inevitable and should be prolonged, then measures to address the huge economic and social distress that will ensue must be thought up at once.

3.- As noted by Mario Draghi in his article in the Financial Times of 25 March 2020, 'the challenge we face is how to act with sufficient strength and speed to prevent the recession from morphing into a prolonged depression, made deeper by a plethora of defaults leaving irreversible damage'. The solution would be found through a significant increase in public debt. This may not be a 'war' in the full sense of the word, but, in the worst case scenario, we may indeed face a 'post-war-like' reconstruction effort and perhaps even a Great Depression-like deep depression. In such a (overly pessimistic, but we hope, not impossible) scenario, no private actor can act as a backstop to the system, only the states can. Under that assumption, a belated strategy could turn a severe downturn into a human tragedy, with unpredictable consequences for our democracies. It is therefore necessary to devise, in a timely way, several complementary strategies to make the most efficient use of the government's balance sheet. We think that a savvy use of established legal and financial schemes may also help in preparing a backstop to face the worse, should it materialise (we hope not). The legal framework encompasses the EU level, and the domestic level too. From the perspective of the latter, we will use Italy as an example. As the first European 'mover' in the face of the coronavirus, Italy is also called to act in the forefront of the recovery, hopefully as a committed striker of the European team. Yet, many of the lessons could be extrapolated to other EU Member States. The goal is to suggest policies that, in a worst case scenario, can turn into viable backstop actions with as little execution, risk and legal complexity as possible, and with the least 'moral hazard content' conceivable.

4.- The list of necessary actions is long and open-ended. The current Eurogroup political negotiations on ESM and/or (appallingly named) Coronabonds as well as on the possible EIB-ESM Enhanced Conditions Credit Line cover uncertain terrain. Thus, to avoid making assumptions that circumstances may render obsolete in a matter of days, or hours, we will look past them. We will also look past the most urgent task of providing a short-term liquidity bridge, as in that case the measure is clear, and hardly controversial (if mere liquidity support were controversial, the malaise would be beyond help). We will thus focus only on three, 'simple', but significant schemes, or initiatives, which could be set up, within the existing European institutional framework, and which meet three separate needs:

(a) to support the equity of businesses that are credibly sound and solvent (or were at least at the time the pandemic broke out, based upon a careful assessment of their balance sheets as of 31 December 2019), which may become unviable due to the losses associated with the protracted inactivity (and loss of turnover) caused by the restrictions imposed for the containment of the pandemic;

(b) to provide a last instance market maker (and emergency liquidity window) for households, capable of transforming their potentially highly illiquid real estates into fair money;

(c) to support the process of rapid consolidation of national banking systems to better withstand the shocks that may materialise in the banks' balance sheets.

At the same time, the proposed measures embrace three ideas that, in our view, have not been sufficiently present in the European policy landscape. These are:

(a) rebalancing of the financial system structure away from debt and towards equity;

(b) extrapolating the logic of the collateral-liquidity link from the wholesale to the retail level, but seeking positive outcomes from both a macroeconomic and social level; and

(c) putting the 'macro' structure of the financial system at the service of the needs of the individual citizens.

5.- The first initiative should support businesses with fair equity, to help them absorb losses they are going to face, without managerial responsibility, due to the coronavirus lockdown, and to do so via sound fiscal policy. This entails: (i) the pooling of resources through a coordinated EU-wide strategy; (ii) a legal structure that implements that strategy, and reconciles it with other competing needs, with an innovative and credible governance to some extent mirroring that of central banks, capable of ensuring independence from any undue political influence and in this way warranting sound and sustainable policies vis-à-vis competing economic interests which would pose a time-inconsistency problem similar to that faced by central bankers; and that signals (iii) a clear roadmap with an 'exit' strategy.

First, (i) for the pooling of resources national states (Italy, in our example) could join the European Investment Bank and its funds, the European Recovery and Development Fund, the European Social Fund, or the Cohesion Fund, which have already mobilised through the Coronavirus Response Investment Initiative in force from 1 April 2020 and/or any other available European funds with those of national Development banks (Cassa Depositi e Prestiti, in Italy). This would vest an infrastructure with good expertise and track-record and good track-record on returns (financial and social) with sufficiently large financial firepower to make a difference.

Second, (ii) such pooling of resources could crystallise in a dedicated special purpose vehicle (SPV) or closed-end, umbrella fund, initially funded by these public funds, but eventually open to international investors. This vehicle could provide 'Emergency Response to Business' (quasi) equity to businesses based on their balance sheet as of 31 December 2019. This would mean a specially issued tranche of hybrid securities of quasi capital (equity-like 'strumenti finanziari partecipativi' or SFP under Italian law). In our view, these securities (unlike in other meritorious proposals voiced these days in the debate, where SFP would be rather used in connection with banks' loans and would be backed by state guarantees) should be subscribed to the publicly funded SPV or umbrella fund, should be perpetual, should provide an initial return based on the profits of the business, and have priority over shares. The returns should also be cumulative (to the extent permitted by IAS32), and calculated in a way to ensure, if the business is profitable in the next 10-15 years, for fully amortising, economically, the original contribution and pay a fair market rate. This would also reconcile the need to support businesses with the need to align such support with applicable State aid provisions through the paid-out returns, and after such a 10-15 year period, a floating rate at fair market conditions with a right of the borrower to repay and 'be free'. The hybrid instruments should be transferable, to facilitate the entry of private or other actors, and should also be convertible into common shares upon request of the holder if at the end of the 10-15 year period if it is not fully amortised, and the conversion rate should be calculated by actualising the original (quasi-) equity investment and the expected interest rate flows less its paid-out returns and appraising the company at its book value at the time of conversion. The programme should also allow the early redemption or buy-back by the company of the hybrid at any time, to prevent risks of dilution for existing and committed shareholders, at the conversion value plus a fair premium.

Specificities aside, the conclusion is simple: we see a role, with the Emergency Response to Business, for governmental action to stabilise and normalise the situation, but under fair market conditions and with a clear market exit. Financial ingenuity would immensely help, in our view, all along the road. Currently, a growing number of entrepreneurs are given a morally hazardous message that if they struggle to keep doing business, they are exposed to losses, legal risks, credit risks and union hostility, whereas if they close down the state will give them a free hand when 'reopening time' comes. Our proposal introduces a cost for the entrepreneur to access this form of assistance and induces, in our view, a more balanced way of thinking. On the other hand it is not devoid of problems, as a large EU or state vehicle might prove slow and exceedingly bureaucratic in responding to the applications of millions of small and medium-sized enterprise, and also because, once active, the leadership position of such funds will carry huge political power and may excite the appetites of those less apt to manage them wisely. For this reason, we also suggest an innovative and credible governance to some extent mirroring that of central banks, capable of ensuring independence from any undue political influence.

6.- The second initiative tackles the problem of housing and real estate. Many families will sadly add, to the tragedy of the fatalities, the sudden loss of their livelihood. Social money will hopefully deal with those most in need, and we can only hope that social programs will deliver on this appropriately. Yet, the problem of a vast swathe of the population in Europe is that it has net worth but lacks liquidity, and mortgages extended by the banking system to provide liquidity against the real estate collateral may prove insufficient to cope with such needs, if we truly entered into a deep, Great Depression-like depression. Working class wealth is concentrated mostly in real estate, and families – if redundancy numbers skyrocketed due to a plethora of defaults or business downsizing, also due to the persistence of an unprecedented shrinking of global commerce – may urgently need to mobilise, or 'monetise' them to face their most urgent needs in bad times. In a deep recession, however, real estate markets (or, indirectly, the banking system) cannot absorb the increased supply, resulting in a downward price spiral, which can in turn exacerbate the economic crisis with a real estate crisis, and, as under-water owners default, a(nother) banking crisis, as memories of the 2008-2013 crisis (still fresh) in Italy, Spain, Ireland, or Portugal duly attest.

Such citizens' liquidity crisis can be stopped if we extrapolate to the retail, real estate market, the logic collateral-liquidity, and 'dealer of last resort', where, for example central banks or treasuries intervene as market makers where certain assets have become illiquid. If the State acts as a market maker, or dealer, of last resort for households, it can transform their illiquid real estates into fair money. Singapore has a long and successful experience in using the state managed real estate market as a tool to address social problems in life and social crises.

In our view, in a worst case scenario of deep depression, this can be done without renouncing sound fiscal policy: using the same pooling of resources illustrated above (where European funds and domestic funds coalesce around the Coronavirus Response Investment Initiative, eventually opening to private investors) a second special purpose vehicle (SPV), or closed-end real estate, residential fund could be set up to provide the 'Emergency Response to Households' by offering to buy at a fair and not overly generous discount over market price the bare ownership of the real estate assets. In doing so, households in need would find a backstop to monetise their real estate assets, while at the same time keeping the usufruct, and thus the availability of the estate for their living needs or, if so requested by the seller, the full ownership of residential and/or tourists homes. With a large enough size of real assets under management, this financial vehicle would become a major real estate player in the country with a viable business and a good entry point for international investors, which provides a clear exit strategy.

This could bring other positive side effects too. Households could be given incentives to repay and recover the unencumbered property; and the creditor-debtor relationship could be more trust-based, as it would take place at the initiative of a debtor seeking temporary relief, and with a fund that would provide a visible contact point, thus avoiding the friction and 'social distancing' resulting in securitisation or other instances where the creditor that changes on its own initiative without consulting the debtor. Even in this case we do not underestimate the risk of the complexity to rapidly set up a programme for millions of households, the difficulty of providing a fair evaluation (and to that end similar privately run programmes should be encouraged to operate in competition to the publicly sponsored fund), and of the danger of transferring a large part of the personal real estate of EU citizens to bodies that are influenced by politics. Again, as a counterbalance, we suggest innovative and credible governance for this vehicle too, to some extent mirroring that of central banks, capable of ensuring independence from any undue political influence.

7.- The third initiative acknowledges an inescapable reality: EU-level policy, and its linchpin, the Banking Union, has not produced EU-level banks, and domestic policies have not filled the gap. The convoluted strategy followed by the Italian government in the wake of the 2008-2013 financial and economic crisis to deal with diffuse weaknesses, insufficient scale, an outdated (and costly) business model of small-to-mid size banks, and an excess in overall supply capacity in commercial banking is internationally well-known, and yet, looking around, one finds that it is hardly alone in its lack of definition, and success stories are rare. Efforts to push forward more consolidation through supervisory moral persuasion have been equally unsuccessful. Domestically: due to entrenched local vested interests. At a European level: due to regulatory obstacles to cross-border mergers and acquisitions. The current EU landscape is full of banks that are too-big-for-a-state, and too-small-for-the-EU, and it is not because the obstacles are not known. A recent EBA paper (EBA Staff Paper Series – No. 7, February 2020) reflects on many of these regulatory and institutional factors in prudential regulation and supervision and identifies a list of urgent reforms. This is, most likely, not yet the right time to expect a significant inversion of the trend and more European consolidation, also in the face of the 'beggar-thy-neighbour' reactions unfortunately exposed in the first stage of the European coronavirus pandemic (with a related resurgence of nationalist responses in the political narrative). Yet, the 'Emergency Response to Banks' – which will undoubtedly be made of several complex chapters – should in our view also support the rapid consolidation of national banking systems to withstand the shock of a deep recession. This could be done by simultaneously tackling the infrastructure side, and the customer side.

From an infrastructure side, whilst Europe sets to work to remove all identified obstacles to European consolidation, Member States (with Italy at the forefront) should improve the resilience of the weakest links. Banks (typically small-to-mid size) showing serious weaknesses in their supervisory review, should be demanded, as a requisite to do business, to go through a two-stage process of:

(a) recapitalisation, through a public Emergency Recapitalisation Fund if (always preferable) market solutions are not available to them, with severe dilution of the existing shareholders, in line with applicable State aid rules (including, now, the temporary framework in force since 20 March 2020) and;

(b) mandatory merger or consolidation with top-tier credit institutions or participation in a cross-guarantee scheme, for example affiliation with an institutional protection scheme or into a cooperative banking group (which, to this effect, could be open to the affiliation also of non-cooperative banks).

Once market conditions are back to normal, the Emergency Recapitalisation Fund would sell its holdings, thus combining a timely stabilising governmental action, and fair conditions and a clear market exit. From a customer side, regulators should deepen into the PSD2 scheme, whereby a customer should enjoy the benefits of open banking, and of using a single interface to interact with different bank accounts. As the 'visible' features such as the apps, become more dominant, and the infrastructure elements such as bank accounts (and their deposit guarantee) less so, there will be an incentive to consolidate, nationally and across borders, if only for the critical mass to compete with Big-Tech companies. If banks have not merged in response to regulatory incentives, they may do so in response to competitive pressures, as it is desirable.

8.- While, unfortunately, we still do not know much about the virus and the real economic consequences of our response to it, we must take this emergency to learn lessons of future preparedness, to quickly develop enough knowledge for better deliberations, and to prepare for the worst, economically, in a savvy way. We can also do some of the above regardless of the virus, because crises should always bear better ideas for the future. Most of all, we must maintain rationality and humanity and think of solutions that arise from this forced withdrawing from normal daily life and that direct us to newly and vigorously embrace life with safety, compassion and a vigorous sense of collective resilience.

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