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ISSUES ON FINANCIAL MARKET REGULATION, BUSINESS DEVELOPMENT AND GOVERNMENT'S POLICIES ON GLOBALIZATION

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The "Law and Economics Yearly Review" is an academic journal to promote a legal and economic debate. It is published twice annually (Part I and Part II), by the Fondazione Gerardo Capriglione Onlus (an organization aimed to promote and develop the research activity on financial regulation) in association with Queen Mary University of London. The journal faces questions about development issues and other several matters related to the international context, originated by globalization. Delays in political actions, limits of certain Government's policies, business development constraints and the "sovereign debt crisis" are some aims of our studies. The global financial and economic crisis is analysed in its controversial perspectives; the same approach qualifies the research of possible remedies to override this period of progressive capitalism's turbulences and to promote a sustainable retrieval.

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CONTENTS

Presentation..1

Francesco Capriglione

Covid-19. What solidarity, what cohesion in the EU? Uncertainties and fears.........4

Francesco Capriglione

For a resilient, sustainable, and inclusive recovery in Europe: challenges and proposals in response to the pandemic crisis 61

Rainer Masera

Implications of Covid-19 crisis for regulatory regime in Russia..............................81

Ilya A. Goncharenko - Gennadi P. Tolstopyatenko

The great lockdown: the UK regulatory responses to the pandemic crisis...........94

Andrea Miglionico

Reflections on the Italian emergency regulation in support of businesses...........112

Diego Rossano

The Italian foreign direct investments screening in times of Covid-19: trends and perspectives... 122

Andrea Sacco Ginevri

Banks' balance sheet in the time of Covid-19... 133

Valerio Lemma

Legitimacy deficits of Austrian legal Covid-19 measures...................................147

Konrad Lachmayer

The certificate of good health of the Austrian consociational democracy during the Covid-19 and the new paradigms for the protection of fundamental freedoms... 162

Ulrike Haider-Quercia

The impact of the Covid-19 pandemic on credit institutions and the importance of effective bank crisis management regimes... 182

Marco Bodellini - Pamela Lintner

Reimagining and re-designing the post-Covid-19 higher education organizations to address new challenges and responses for safe and effective teaching activities... 219

Mirella Pellegrini - Vladimir Uskov - Nunzio Casalino

THE GREAT LOCKDOWN: THE UK REGULATORY RESPONSES TO THE PANDEMIC CRISIS

Andrea Miglionico *

ABSTRACT: *The unprecedented spread of pandemic crisis has changed the paradigm of banking and financial regulation worldwide. Specifically, the Covid-19 has imposed emergency regulatory measures to contain the risk of default for businesses and households. Liquidity support and loans guarantees have been adopted by public authorities to mitigate the deterioration of debt market and commercial paper. However the policy makers and regulators have concentrated their attention on temporary and short-term ad hoc interventions that leave discretion in decision-making process. This article examines the UK regulatory responses to the pandemic outbreak addressing the challenges of "monetary financing" and the impact of exceptional lending schemes for consumers borrowers. It also discusses the regulatory toolkit adopted by the Financial Conduct Authority and Prudential Regulation Authority for keeping credit lines flowing and funding the marketplace (e.g. mortgages and payment holidays). The Bank of England has launched operations intended to release the banking sector of pressures in the time of coronavirus and reduce the economic contraction although this regulatory package seems a frenetic reaction to the unexpected risk of systemic collapses.*

SUMMARY: 1. Introduction: the global response to the threat of Covid-19. – 2. The UK strategy for dealing with the pandemic crisis. – 3. The "monetary financing" of Bank of England. – 4. The prudential regulatory policies to support loan market and lending schemes. – 5. Conclusive remarks.

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1. In the midst of unprecedented Covid-19 pandemic crisis, regulatory authorities and policy makers have adopted emergency measures to contain the economic shock and address the liquidity risk of financial firms.[1] The global regulators introduced various toolkit directed to ensure the stability of markets, at the macro level, and the confidence of investors, at the micro level. The G20 has suspended the debt payments and interest for the world's poorest countries in order to bolster health services to confront the coronavirus.[2] The aim is to create a process that involves private creditors, banks and other commercial creditors to offer debt relief. The International Monetary Fund (IMF) forecasted a huge economic depression and reinforced the intervention through special concessional lending.[3] The IMF provided loan resources for the Poverty Reduction and Growth Trust and concentrated both lending and policy support to reduce the scarring of the economy caused by bankruptcies and unemployment in order to support a speedy recovery.[4] In parallel, the Basel Committee on Banking Supervision has deferred the implementation of the Basel III standards by one year to 1 January 2023 and the implementation date of the revised Pillar 3 disclosure requirements to 1 January 2023.[5] Same prudential actions have been taken by IOSCO that granted regulatory flexibility to support market participants addressing the

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[1]Tobias Buck and Guy Chazan, 'Coronavirus declared a pandemic as fears of economic crisis mount', *Financial Times*, 11 March 2020, available at https://www.ft.com/content/d72f1e54-6396-11ea-b3f3-fe4680ea68b5.

[2]See 'G20 Suspends Debt Payments for Poor Countries As the Coronavirus Spreads', 15 April 2020, available at https://www.jubileeusa.org/pr_imf_g20_debt_relief_stmnt.

[3]See IMF Executive Board Approves a US$109.4 Million Disbursement to Rwanda to address the COVID-19 Pandemic, 2 April 2020, available at https://www.imf.org/en/News/Articles/2020/04/02/pr-20130-rwanda-imf-executive-board-approves-disbursement-to-address-covid19.

[4]See the remarks of Kristalina Georgieva during the G20 Finance Ministers and Central Bank Governors Meeting, 15 April 2020, available at https://www.imf.org/en/News/Articles/2020/04/15/pr20160-remarks-managing-director-kristalina-georgieva-g20-fin-min-cen-bank-gov-meeting.

[5] Basel Committee on Banking Supervision, 'Measures to reflect the impact of Covid-19', April 2020, available at https://www.bis.org/bcbs/publ/d498.pdf. See also Jean-Philippe Svoronos and Rastko Vrbaski, 'Banks' dividends in Covid-19 times' (May 2020), BSI FSI Briefs No 6, available at https://www.bis.org/fsi/fsibriefs6.pdf.

challenges posed by COVID-19 while ensuring that market integrity and investor protection principles are maintained.[6]

Domestic interventions have been characterised by temporary suspensions of regulatory structures (e.g. capital buffers, payment holidays, mortgage and loans relief) that supported in the short time businesses and households. However, the responses of national regulators showed a frenetic reaction to the negative consequences of coronavirus, in particular discretionary decisions have been adopted outside the institutional framework leaving room for different interpretation of guidance and policies.[7] In this context, the US Congress approved 'The Coronavirus Aid, Relief, and Economic Security (CARES) Act'[8], which is the largest economic stimulus with over $2 trillion economic relief package providing economic assistance for workers, families and small businesses. Under the CARES Act, the Federal Reserve performs as a state bank engaging in the sensitive allocation of credit to nonfinancial firms, as well as to state and local governments, although this raises some concerns on the legitimacy and lack of transparency of its regulatory actions.[9] The Fed's new facilities lend directly to private and public bond issuers, including state and local governments as well as provide loans to medium and large firms. It is observed that the CARES Act has delegated the Fed the role to allocate credit to the nonfinancial sectors of the economy which means deciding who should receive subsidised credit and who should not.[10] The US central bank announced confidence-restoring measures to

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[6]IOSCO, 'Securities regulators coordinate responses to COVID-19 through IOSCO', 25 March 2020, available at IOSCO/MR/06/2020, https://www.iosco.org/news/pdf/IOSCONEWS559.pdf.

[7]Alistair Milne, 'A Critical COVID-19 Economic Policy Tool: Retrospective Insurance' (March 2020), available at https://ssrn.com/abstract=3558667.

[8]See https://home.treasury.gov/policy-issues/cares.

[9]John C. Coffee, 'Wall Street CARES!: Who Gets the Hidden Subsidies Under the CARES Act?', Oxford Business Law Blog, 8 May 2020, available at https://www.law.ox.ac.uk/business-law-blog/blog/2020/05/wall-street-cares-who-gets-hidden-subsidies-under-cares-act.

[10]Steve Cecchetti and Kim Schoenholtz, 'The Fed Goes to War: Part 3', 12 April 2020, available at https://www.moneyandbanking.com/commentary/2020/4/12/the-fed-goes-to-war-part-3. The authors argue that the Fed should limit its involvement in the allocation of credit to the private nonfinancial sector.

relieve strain in the trading of US Treasuries, agency mortgage-backed securities and commercial paper, as well as municipal and corporate bonds.[11] Further, the Federal Reserve has taken a step to meet the global demand for dollars, setting up a facility that would allow central banks and international monetary authorities to enter into repurchase agreements with the US central bank.[12] The temporary facility for foreign and international monetary authorities (FIMA) allows central banks and international organisations with accounts at the New York Fed to temporarily exchange their US Treasury securities held with the Federal Reserve for dollars, which can then be made available to institutions in their jurisdictions. On this point, it can be argued that financing corporate credit and commercial paper already moved the Fed into uncharted territory.[13]

At the EU level, regulators have lowered banks' capital requirements and urged them to freeze dividends and rein in bonuses to give them more headroom to absorb the losses, as part of a global move to free up almost $500bn of capital on bank balance sheets. It has been reported that the Governing Council of the ECB is committed to playing its role in supporting households the euro area through this extremely challenging time and the European Central Bank (ECB) will ensure that all sectors of the economy can benefit from supportive financing conditions that enable them to absorb this shock.[14] The ECB policy response aims to allow banks to use capital buffers and to get relief in the composition of capital for Pillar 2 Requirements (the additional capital a bank needs to hold over the

[11]Kathryn Judge, 'Congress Should Endorse the Federal Reserve's Extraordinary Measures' (24 March 2020), Columbia Law School's Blog on Corporations and the Capital Markets, available at https://clsbluesky.law.columbia.edu/2020/03/24/congress-should-endorse-the-federal-reserves-extraordinary-measures/.

[12]The Federal Reserve introduced facilities to support the flow of credit as follows: (i) Commercial Paper Funding Facility; (ii) Primary Dealer Credit Facility; (iii) Money Market Mutual Fund Liquidity Facility; (iv) Primary Market Corporate Credit Facility; (v) Secondary Market Corporate Credit Facility; (vi) Term Asset-Backed Securities Loan Facility; (vii) Paycheck Protection Program Liquidity Facility.

[13]Financial Times, 'The Fed's radical policies are uncharted territory', 9 April 2020, available at https://www.ft.com/content/70a0d2ca-7987-11ea-af44-daa3def9ae03.

[14]See https://eulawlive.com/op-ed-the-european-central-banks-pandemic-bazooka-mandate-fulfilment-in-extraordinary-times-by-rene-smits/.

statutory capital under the Capital Requirements Regulation as a result of the Supervisory Review and Evaluation Process). Specifically, the ECB would ‘consider operational flexibility in the implementation of bank-specific supervisory measures’ to permit ‘flexibility in prudential treatment of loans backed by public support measures’ and by ‘introducing supervisory flexibility regarding the treatment of non-performing loans (NPLs)’.[15] The ECB prudential measures are intended to support banks avoiding the procyclical effects of capital requirements and financial reporting. More importantly, the ECB has postponed the enforcement of major supervisory decisions, such as deadlines for remedial actions imposed as a result of on-site inspections, in the context of the review of internal models to calculate banks’ risk-weighted assets.

In terms of monetary actions, the ECB adopted a Pandemic Emergency Purchase Programme (PEPP)[16] to expand the range of eligible assets under the corporate sector purchase programme (CSPP) and to ease the collateral standards.[17] According to this PEPP, the ESCB will purchase ‘private and public sector securities’ in amounts of up to 750 billion euros: eligible securities are the marketable instruments that can be purchased under the current Asset Purchasing Programmes (APP). The PEPP would generate a bigger impact on investment-grade corporate bond spreads within the eurozone, as it would help to close the ETF discount and reduce the selling pressure ETFs are exerting on bond markets.[18] This would improve corporate funding rates and preserve the integrity of ETFs to

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[15]See ‘ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus’, 12 March 2020, available at https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html.

[16]See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2020:091:TOC.

[17]See Sebastian Grund at https://www.delorscentre.eu/en/publications/detail/publication/legal-compliant-and-suitable-the-ecbs-pandemic-emergency-purchase-programme-pepp/> and the speech by President Lagarde on 19 March 2019 available at https://www.ecb. europa.eu/ press/ blog/date/2020/html/ecb.blog200319~11f421e25e.en.html.

[18]Agnès Bénassy-Quéré et al., ‘A proposal for a Covid Credit Line’, 21 March 2020, available at https://voxeu.org/article/proposal-covid-credit-line.

the end-investor, breaking the doom loop.[19] However, criticisms have been expressed by some European members about the necessity of launching a new dedicated asset categories eligible under the APP[20], and a clear preference for employing the existing toolkit of the governing council, such as scaling up the current APP or considering Outright Monetary Transactions[21] (a controversial measure that permits to buy an unlimited quantity of a country's bonds as part of an official EU bailout). The EU crisis regulatory responses[22] also include: (1) the Emergency Support Instrument; (2) the pan-European guarantee fund of EUR 25 billion; (3) the Pandemic Crisis Support, based on the existing Enhanced Conditions Credit Line and adjusted in light of this specific challenge; (4) the temporary loan-based instrument for financial assistance under Article 122 of the Treaty on the Functioning of the European Union; (5) the Recovery Fund[23]. A controversial debate around EU countries raised on the use of Eurobonds: despite they are not the only instrument of sharing the financial burden of the coronavirus pandemic, they have been advocated as the best way to express solidarity (the ill-named corona-bonds).[24] Some in Germany after opposing the issuance of common bonds as a way of condoning some European countries' lack of budgetary discipline, with the onset of the Covid-19 pandemic, have started to support such joint 'European

[19]See 'The liquidity 'doom loop' in bond funds is a threat to the system', *Financial Times*, 25 March 2020, available at https://www.ft.com/content/b7c15426-6e1b-11ea-89df-41bea055720b.
[20]See https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html.
[21]Jana Randow and Piotr Skolimowski, 'ECB's Pandemic Program Means Most Powerful Tool Stays in Reserve' (26 March 2020), available at https://www.bloomberg.com/news/articles/2020-03-26/how-italy-and-others-can-use-the-ecb-s-most-powerful-tool.
[22]European Council, 'A Roadmap for Recovery. Towards a more resilient, sustainable and fair Europe', 21 April 2020, available at https://www.consilium.europa.eu/media/43384/roadmap-for-recovery-final-21-04-2020.pdf.
[23]Kajus Hagelstam, Alice Zoppè and Cristina Sofia Dias, 'An EU Recovery Fund: How to square the circle?', SUERF Policy Brief, No 5, May 2020, available at https://www.suerf.org/docx/f_f2d34fcd37e85f9867708bf71782cda6_12945_suerf.pdf.
[24]Guy Chazan, Sam Fleming, Victor Mallet and Jim Brunsden, 'Coronavirus crisis revives Franco-German relations', *Financial Times*, 13 April 2020, available at https://www.ft.com/content/69207155-6ca8-43b1-bb08-1385d3656090.

Crisis bonds' to help the countries worst affected by coronavirus.[25] Some others consider resorting to the European Stability Mechanism, point that since this is a natural disaster, this could attach very light conditions to the loans, e.g. to some IMF facilities designed for this type of events. Others have suggested the European Investment Bank or disaster aid – grants not loans – to deal with consequences of pandemic.[26] Recently, the German Constitutional Court held that the European Court of Justice (ECJ) has no jurisdiction on the ECB's Public Sector Asset Purchase Programme (PSPP) raising concerns on the limits of ECJ power.[27] The German court ruled that the ECJ had only conducted a limited review of the effects of the PSPP programme and could not assess if the ECB had breached the principle of proportionality, under which the content and form of any EU action must be limited to what is necessary to achieve the pursued aim.[28] The German judges' decision poses the problem whether the hierarchy of EU law is clearly demarcated as it seems the ECJ judgment being ultra vires in Germany.[29]

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[25]Guy Chazan, 'Coronavirus crisis prompts German rethink on eurobonds', *Financial Times*, 6 April 2020, available at https://www.ft.com/content/8da39299-b257-4e8f-9b83-a84a8930f1c1. See also Ingobert Waltenberger, 'The range of different opinions and moods in Germany on collective 'corona bonds', SUERF Policy Note Issue No 155, April 2020, 3-4, available at https://www.suerf.org/policynotes/11983/the-range-of-different-opinions-and-moods-in-germany-on-collective-corona-bonds.

[26]Gideon Rachman, 'Eurobonds are not the answer', *Financial Times*, 6 April 2020, available at https://www.ft.com/content/b809685c-77de-11ea-af44-daa3def9ae03. Rachman suggests that if Eurobonds are adopted, "they should be backed by giving the European Commission a larger budget, underpinned by a dedicated EU tax. Armed with more capital and its own resources, the commission could then borrow from the markets".

[27]Martin Arnold and Tommy Stubbington, 'German court calls on ECB to justify bond-buying programme', *Financial Times*, 5 May 2020, available at https://www.ft.com/content/a1beda5e-5c2d-429e-a095-27728ed2d72b.

[28]Jorge Valero, 'German court gives ultimatum to ECB on bond-buying programme', 5 May 2020, available at https://www.euractiv.com/section/economy-jobs/news/german-court-gives-ultimatum-to-ecb-on-bond-buying-programme/. See also Matthias Lehmann, 'The End of 'Whatever it takes'? – The German Constitutional Court's Ruling on the ECB Sovereign Bond Programme', Oxford Business Law Blog, 6 May 2020, available at https://www.law.ox.ac.uk/business-law-blog/blog/2020/05/end-whatever-it-takes-german-constitutional-courts-ruling-ecb.

[29]Dimitrios Kyriazis, 'The PSPP judgment of the German Constitutional Court: An Abrupt Pause to an Intricate Judicial Tango', European Law Blog, 6 May 2020, available at https://

However, the emergency time of pandemic requires exceptional measures in public finance, monetary and fiscal policy although the various regulatory responses of "whatever it takes" should follow a consultation process within a justified institutional framework.

2. The UK strategy for dealing with Covid-19 crisis has been characterised by a vast package of monetary measures that modified existing legal obligations for banks and financial institutions.[30] The great lockdown imposed by the coronavirus has affected the prudential policies of regulators and central bank with the result of unprecedented interventions in key areas of capital markets (dividends, capital buffers, payment holidays and company audit reporting). The UK government has adopted a number of schemes to support the domestic economy: (a) the Coronavirus Job Retention Scheme under which employers can claim a grant covering 80% of the wages for a furloughed employee, subject to a cap of £2,500 a month[31]; (b) the Self-Employed Income Support Scheme under which self-employed people, who have been adversely affected by the coronavirus, will receive a taxable grant worth 80% of their average monthly profits over the last three years, up to £2,500 a month.[32] The UK central bank has committed with Treasury to "monetary financing" policy which enables the government to borrow in the short-term as much as it needs to meet its commitments.[33] Despite the laudable initiative, this macro-economic response to Covid-19 can translate in the long-term in high inflation and resurgence of non-

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europeanlawblog.eu/2020/05/06/the-pspp-judgment-of-the-german-constitutional-court-an-abrupt-pause-to-an-intricate-judicial-tango/.

[30]Bank of England, 'Our response to Coronavirus (Covid-19)', available at https://www.bankofengland.co.uk/coronavirus.

[31]See https://www.gov.uk/government/publications/coronavirus-job-retention-scheme-step-by-step-guide-for-employers.

[32]See https://www.gov.uk/guidance/claim-a-grant-through-the-coronavirus-covid-19-self-employment-income-support-scheme.

[33]Silvana Tenreyro, 'Monetary policy during pandemics: inflation before, during and after Covid-19', 16 April 2020, 5-6, available at https://www.bankofengland.co.uk/speech/2020/silvanatenreyro-speech-monetary-policy-during-pandemics.

performing exposures.[34] Even if this support will be temporary and transitional with balances repaid as soon as possible and before the end of the year, the uncertainty of pandemic raises concerns on increased moral hazard and insolvency scenario.

Generally, moral hazard prompts governments to introduce rules that constrain risk taking by financial institutions, such as rules on minimum capital ratios, rules on liquidity, structural rules separating retail from investment banking activities and rules relating to their corporate governance and senior management accountability. To mitigate the risk that public funds will be required if major banks fail, governments introduce rules that require banks to plan their own resolution and structure their liabilities in a way that there have sufficient loss-absorbing liabilities that can be written-down or converted to equity if a bank faces difficulties. The immediate response of UK government to pandemic crisis was the provision of liquidity support through the central bank[35] and the setting up of deposit insurance schemes that guarantee bank deposits (up to a limit) to prevent creditors' runs on banks.[36] These tools of crisis management protect the financial system from immediate collapse, but come at the cost of exacerbating the problem in the long run, as explicit or implicit state support strengthens the incentives of financial institutions' managers and clients to take excessive risks.

The legislative emphasis on financial stability and market integrity in the UK is relatively recent and has clearly been a response to the 2007-09 global crisis.

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[34]Stephen Morris and David Crow, 'European bank investors brace for loan-loss provisions', *Financial Times*, 27 April 2020, available at https://www.ft.com/content/1d9d862a-df05-47c1-8245-cf798127165f.

[35]For an analysis of the lender of last resort function of the Bank of England, its history and its recent evolution, see Andrew Campbell and Rosa Lastra, 'Revisiting the Lender of Last Resort - The Role of the Bank of England' in Iain MacNeil and Justin O'Brien (eds), *The Future of Financial Regulation* (Oxford and Portland, OR, Hart Publishing 2010) 161-162.

[36]For a critical discussion of the relationship between deposit protection and moral hazard, see Jenny Hamilton, 'Depositor Protection and Co-insurance after Northern Rock: Less a Case of Moral Hazard and More a Case of Consumer Responsibility?', in Johanna Gray and Orkun Akseli (eds), *Financial Regulation in Crisis? The Role of Law and the Failure of Northern Rock* (Cheltenham, Edward Elgar 2011) 19-24.

The macro-prudential objective of liquidity support aims to limit the costs to the economy from financial distress, including those that arise from any moral hazard induced by the policies pursued, whereas the micro-prudential objective of loan assistance aims to limit the likelihood of failure of individual institutions. The Covid-19 pandemic can have detrimental effects on the real economy. In a typical crisis scenario, the bank lending is curtailed as ailing banks seek to reduce their loan portfolios. The resulting credit outbreak undermines the ability of firms to raise debt and expand, and can thus cause the economy as a whole to enter into a recession[37] and unemployment to rise.[38] It is likely that the UK government spending to prevent the failure of businesses and households (and thus the collapse of debt market) and to stimulate the economy leads to increasing public debt with serious long-term economic consequences.[39]

3. The Bank of England (BoE) has expanded the overdraft facility to aid the UK economy raising concerns about potential strains in the state debt market brought on by the Covid-19 emergency.[40] The current limit of the central bank's overdraft for the Treasury is £400m but it will effectively be able to borrow unlimited amounts, although this support will be transitional with balances repaid as soon as possible and before the end of the year.[41] The Monetary Policy Committee voted unanimously to increase the Bank of England's holdings of UK government bonds and non-financial investment-grade corporate bonds by £200 billion, financed by the issuance of central bank reserves; and to reduce Bank Rate

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[37]For instance, in 2009, UK GDP declined by 4% as a result of the 2008 financial crisis.

[38]For example, the UK unemployment rate increased dramatically from around 5.3% in 2007 to 8% in 2011. See European Economic Forecast Autumn 2013 (Commission, August 2013) 101, available at http://ec.europa.eu/economy_finance/eu/forecasts/2013_autumn_forecast_en.htm.

[39]The UK national debt to GDP ratio increased from 43.3% at end of the 2007-08 fiscal year to 88.1% at the end of 2012-13.

[40]Gertjan Vlieghe, 'Monetary policy and the Bank of England's balance sheet', Speech given at the Bank of England, London, 23 April 2020, 10, available at https://www.bankofengland.co.uk/speech/2020/gertjan-vlieghe-speech-monetary-policy-and-the-boes-balance-sheet.

[41]See https://www.independent.co.uk/news/business/news/coronavirus-bank-of-england-treasury-ways-means-overdraft-borrowing-a9457071.html.

by 15 basis points to 0.1%.[42] The Committee also agreed that the BoE should enlarge the Term Funding Scheme with additional incentives for SMEs (TFSME).[43]

The BoE adopted provision of liquidity to the banking sector and purchase of commercial paper in the new Covid Corporate Financing Facility, a new lending scheme designed to provide financial assistance among larger groups.[44] The BoE's Corporate Bond Purchase Scheme is designed to buy a balanced portfolio of bonds across eligible issuers and sectors without affecting the allocation of credit to particular companies.[45] The BoE also launched operations that are temporary but are intended to have an impact on monetary conditions in the medium term, i.e. Quantitative Easing (QE) where the BoE purchases bonds. QE increases bond prices and therefore reduces yields, which in turn lowers borrowing costs and support spending.[46] Most importantly, the BoE engaged with the "monetary financing" of government, which means that the bank would directly finance its ballooning operations although on a "temporary and short-term".[47] The BoE agreed to a Treasury demand to directly finance the state's spending needs on a temporary basis. The monetary financing allows the government to bypass the bond market until the Covid-19 pandemic subsides, financing unexpected costs such as the job retention scheme. The "monetary financing" is highly controversial because if a government keeps spending without limit and gets the central bank to pay for this assistance, more money will be spent than goods and services can be

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[42]See https://www.bankofengland.co.uk/markets/market-notices/2020/apf-asset-purchases-and-tfsme-march-2020.

[43]See 'The Bank of England's Term Funding Scheme with additional incentives for SMEs will open to drawings on 15 April 2020', available at https://www.bankofengland.co.uk/news/2020/april/the-tfsme-will-open-to-drawings-on-april-15-2020.

[44]See https://www.bankofengland.co.uk/news/2020/march/the-covid-corporate-financing-facility.

[45]Bank of England, 'Asset Purchase Facility (APF): Additional Corporate Bond Purchases', 1 May 2020, available at https://www.bankofengland.co.uk/markets/market-notices/2020/apf-additional-corporate-bond-purchases-may-2020#footnotes.

[46]Charles Goodhart and Manoj Pradhan, 'Future imperfect after coronavirus', 27 March 2020, available at https://voxeu.org/article/future-imperfect-after-coronavirus.

[47]Chris Giles and Philip Georgiadis, 'Bank of England to directly finance UK government's extra spending', *Financial Times*, 9 April 2020, available at https://www.ft.com/content/664c575b-0f54-44e5-ab78-2fd30ef213cb.

produced, generating impossible to resist pressure for higher prices.

The UK authorities extended the size of the government's bank account at the central bank, known as the "Ways and Means Facility".[48] It is a mechanism to account for more direct lending of electronically created money from the BoE to the Treasury.[49] This helps take the pressure off those processes at a time when large volume of liquidity in cash is being handed out to businesses and to workers, and at a time when tax revenues are likely to stall alongside an economic contraction.[50] The "Ways and Means Facility" had long been used as a financing means of government for day-to-day spending before the BoE would sell government bonds to the market. In terms of rescue plan, the BoE has approved a £330bn package of bailout loans alongside an extraordinary offer of wage subsidies. Within the rescue plan the regulatory authorities have introduced the Coronavirus Business Interruption Loan Scheme (CBILS)[51] that provides financial support for small businesses with loans of up to £5m. The government-backed guarantee for the loan repayments is designed to encourage more lending, rather than bail out the borrower, who remains fully liable for the debt.

4. The Prudential Regulation Authority (PRA) set out supervisory expectations that banks should not increase dividends or other distributions, such as bonuses, in response to policy actions.[52] This measure is directed to strengthen the core equity capital for banks and financial institutions although the decision to

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[48]See https://www.bankofengland.co.uk/news/2020/april/hmt-and-boe-announce-temporary-extension-to-ways-and-means-facility.

[49]See https://www.bankofengland.co.uk/-/media/boe/files/news/2020/april/hmt-and-boe-announce-temporary-extension-to-ways-and-means-facility.pdf?la=en&hash=974CAE1A89719CFB8CAAC7233C95842E2B763895>.

[50]The UK government has already tripled the amount of debt it wanted to raise in financial markets from £15bn to £45bn.

[51]See https://www.gov.uk/guidance/apply-for-the-coronavirus-business-interruption-loan-scheme.

[52]See 'Bank of England announces supervisory and prudential policy measures to address the challenges of Covid-19', 20 March 2020, available at https://www.bankofengland.co.uk/news/2020/march/boe-announces-supervisory-and-prudential-policy-measures-to-address-the-challenges-of-covid-19.

stop banks' dividends came late and only as a reaction of the pandemic crisis.[53] The PRA has also incentivised firms to absorb losses and provide an additional layer of capital above minimum requirements. The UK regulatory authorities have relaxed banks' constraints in the use of liquidity and capital buffers, e.g. the banks' countercyclical capital buffers allowing them to support bank lending capacity.[54] In this context, the PRA has modified the calculation of the total exposure measure of the leverage ratio: firms may calculate their exposure value of regular purchases and sales awaiting settlement according to Article 429g of the Capital Requirements Regulation (CRR II).[55] The release of capital requirements reflects the Commission's Proposal for amending the CRR and CRR II which aims to address the emergency situation triggered by the Covid-19 pandemic.[56] The Commission reinforced that these proposed changes will not fundamentally alter the prudential regulatory framework which would facilitate mitigating the impact of the crisis.[57] It is interesting to note that the EU legislator as well as the UK supervisory authorities emphasised the greater flexibility given to banks in the forward-looking approach to report loans that can deteriorate due to the economic shock.[58]

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[53]Jonathan Ford, 'Coronavirus exposes illusion of UK bank capital strength', *Financial Times*, 5 April 2020, available at https://www.ft.com/content/31e9e474-1398-430e-92fa-ef4e43c4e0ac.

[54]Countercyclical capital buffers aim to absorb losses in times of crisis: prudential authorities can determine the use of capital buffer during financial shocks.

[55]Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012.

[56]European Commission, 'Proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards adjustments in response to the COVID-19 pandemic' COM(2020) 310 final, 28 April 2020.

[57]See 'Commission Interpretative Communication on the application of the accounting and prudential frameworks to facilitate EU bank lending. Supporting businesses and households amid COVID-19' COM(2020) 169 final, 28 April 2020.

[58]Stephen Morris and Olaf Storbeck, 'Banks to book more than $50bn against bad loans', *Financial Times*, 3 May 2020, available at https://www.ft.com/content/c31db8ab-9a90-4680-bf13-b0a859e7e1b4.

In the same line of prudential actions, the Financial Conduct Authority (FCA) introduced temporary measures to support customers and firms affected by the coronavirus.[59] These measures introduced transitional arrangements to freeze payments for regulated firms within high-cost short-term credit loans.[60] Specifically, the Coronavirus Business Interruption Loan Scheme has approved loans to small firms with turnover of less than £45mn.[61] The scheme is administered by the government-owned British Business Bank and allows accredited lenders to provide loans and overdraft facilities of up to £5 million, to be repaid over up to six years. It is a requirement of the scheme that for loans above £250,000 lenders must take security over available assets with the government's 80 per cent guarantee covering those residual losses remaining after any recoveries. For loans up to £250,000 approved lenders and the scheme are required to apply their normal lending criteria. Lenders must judge that such government-guaranteed finance will help these businesses trade through the short- to medium-term revenue loss of the lockdowns and then be repaid. However, the loans on offer should have been based on revenue loss and focused on a reasonable estimate of essential costs.

The small and medium sized enterprises (SMEs) will also benefit from the Bounce Back Loan Scheme (BBLS) provided by the British Business Bank that grants loan facilities guaranteed at 100% by the government to be repaid over up to six years with no payments in the first twelve months.[62] The BBLS is a welcome measure providing breathing space for SMEs even if is a temporary intervention

[59]FCA, 'FCA information for firms on coronavirus (Covid-19) response', 24 April 2020, available at https://www.fca.org.uk/firms/information-firms-coronavirus-covid-19-response.

[60]FCA, 'High-cost short-term credit and coronavirus: temporary guidance for firms', 24 April 2020, available at https://www.fca.org.uk/publications/finalised-guidance/high-cost-short-term-credit-and-coronavirus-temporary-guidance-firms. See also FCA, 'Coronavirus: information for consumers on personal loans, credit cards, overdrafts, motor finance and other forms of credit', 24 March 2020, available at https://www.fca.org.uk/consumers/coronavirus-information-personal-loans-credit-cards-overdrafts#other-credit.

[61]See https://www.gov.uk/guidance/apply-for-the-coronavirus-business-interruption-loan-scheme.

[62]See https://www.gov.uk/guidance/apply-for-a-coronavirus-bounce-back-loan.

and loans have to be paid back.[63] By freezing loan repayment, the FCA has suspended the terms of agreement between banks and customers. This relaxation of contractual obligations can trigger requests by lenders to customers demanding repayment of their debts because they will have gone into arrears, even though the loan holidays will have been agreed in advance.[64] The loan market has benefited of the low rate designed primarily to give relief to businesses and help mortgage consumers borrowers with their monthly payments. However, banks and mortgage lenders are trying to discourage customers from taking advantage of a government offer of mortgage holidays, warning that unclear advice from the regulators risks pushing customers into more debt.[65] The borrower remains liable for the loan which has caused criticism from business owners who are reluctant to add to their long-term debt burden. The FCA did not provide clear guidance to lenders on how to deal with requests of payment holidays leaving to borrowers the option to renegotiate their payments affected by the crisis. In this context, non-bank specialist lenders play a key role in financing small businesses and providing consumer finance such as point of sale credit.[66] It can be observed that the marketplace has been excluded from state measures to support lending schemes and it seems that the warehouse sector (credit lines facilities and mortgages) has been ignored in the FCA prudential regulator's assessment.[67]

The UK government did not include non-bank lenders in the emergency

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[63]Alistair Milne, 'UK "bounce back loans" … a welcome short term measure', 7 May 2020, available at https://alistairklmilne.com/uk-bounce-back-loans-a-welcome-short-term-measure/.

[64]Nicholas Megaw and Matthew Vincent, 'UK loan freeze plan leaves customers still open to arrears letters', *Financial Times*, 5 April 2020, available at https://www.ft.com/content/7a533dc5-8cd8-4ef3-9963-d1f43e76ff47.

[65]Nicholas Megaw and Matthew Vincent, 'Lenders sound warning on mortgage holidays', *Financial Times*, 25 March 2020, available at https://www.ft.com/content/3a6b82b0-6e77-11ea-89df-41bea055720b.

[66]Non-bank mortgage lenders tend to cater to customers who are turned down by mainstream banks, such as buy-to-let landlords, customers with impaired credit histories, and self-employed and contract workers with unpredictable or irregular income streams.

[67]Peter Lee, 'CBILS faulty: Sunak's flagship UK lending scheme looks unfit for purpose', *Euromoney*, 24 April 2020, available at https://www.euromoney.com/article/b1lbgfwrx 72nn3/ cbils-faulty-sunaks-flagship-uk-lending-scheme-looks-unfit-for-purpose.

measures. It has been noted that 'specialist lenders stop offering new loans, customers may find themselves unable to switch to new deals at the end of their fixed terms, even if they have kept up with repayments'.[68] The wholesale and capital markets were effectively closed to non-bank lenders limiting the ability of them to continue lending. To address the problem the BoE strengthened the "Term Funding Scheme"[69], which provides cheap funding to help maintain credit volumes if wholesale funding markets dry up, but it is only open to banks and building societies. In addition, the FCA has provided temporary relief for listed companies to publish their audited annual financial reports.[70] The FCA approach includes: (1) delaying the filing of accounts by companies; (2) postponement of auditor tenders and audit partner rotation; (3) reduction of FRC demands on companies and audit firms; and (5) extension of reporting deadlines for public sector bodies.[71] Following the EBA's recommendations to delay the submission of regulatory reporting, the FCA requested banks to observe a two-week moratorium on issuing preliminary results.[72] These regulatory responses raise concerns for the degree of flexibility in taking prudential actions given the risk that existing legal structures will be relaxed or suspended in the future. On this view, the PRA and FCA have modified certain regulatory obligations which can create distortions in

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[68]Stephen Morris, Nicholas Megaw and Daniel Thomas, 'Non-bank lenders push for access to emergency state funding', *Financial Times*, 24 March 2020, available at https://www.ft.com/content/51340b70-6d28-11ea-89df-41bea055720b.

[69]Bank of England, 'Updating the TFSME to reflect HMT's new Bounce Back Loans Scheme', 2 May 2020, available at https://www.bankofengland.co.uk/news/2020/may/updating-the-tfsme-to-reflect-hmt-new-bounce-back-loans-scheme.

[70]FCA, 'Delaying annual company accounts during the coronavirus crisis', Statement of Policy, 26 March 2020, available at https://www.fca.org.uk/news/statements/delaying-annual-company-accounts-coronavirus.

[71]See 'FCA requests a delay to the forthcoming announcement of preliminary financial accounts', 22 March 2020, available at https://www.fca.org.uk/news/statements/fca-requests-delay-forth coming-announcement-preliminary-financial-accounts.

[72]EBA, 'Statement on supervisory reporting and Pillar 3 disclosures in light of COVID-19', 31 March 2020, available at https://eba.europa.eu/eba-provides-additional-clarity-on-measures-mitigate-impact-covid-19-eu-banking-sector. See also Matthew Vincent, 'Regulators tackle concerns over companies' coronavirus reporting', *Financial Times*, 26 March 2020, available at https://www.ft.com/content/e8e7caa9-a48f-408e-b082-5bc276f4e061.

the financial markets due to negative externalities (e.g. overreliance to temporary measures) and asymmetric policies in the interpretation of new rules.

5. The Covid-19 pandemic has demonstrated the limited ability of regulators to forecast crises and the frenetic responses of governments of the most developed countries that were largely unprepared to face the spread of the contagion and the combined supply and demand shock.[73] This means the public authorities have not capitalised the experience of 2007-09 global financial crisis that involved systemic failures and massive state aid to support the banking and financial sector. The too-big-to fail policies created the premises for an improved supervisory system that imposed higher capital requirements, new resolution tools and macro-prudential interventions. On a different side, the inability of financial markets to distinguish between sound and unsound banks in times of crisis can paralyse the inter-bank lending market and make it more difficult for banks to raise equity capital. Similarly, the general inability of depositors to distinguish between good and bad banks affects confidence in case of systemic collapses.[74] To assess the magnitude of the threat that the coronavirus poses to financial stability it is relevant to note that the heavy reliance on debt financing of credit institutions can create perversive incentives to market participants in terms of speculative actions (undercapitalisation of banks and missing recognition of loan losses) when regulatory structures are temporary suspended.[75]

The regulatory package adopted by the UK government to mitigate the shrink of the lending system in this time of uncertainty and to stimulate the

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[73]David Simchi-Levi and Edith Simchi-Levi, 'We Need a Stress Test for Critical Supply Chains', *Harvard Business Review*, 28 April 2020, available at https://hbr-org.cdn.ampproject.org/c/s/hbr.org/amp/2020/04/we-need-a-stress-test-for-critical-supply-chains.

[74]Una Okonkwo Osili and Anna Paulson, 'Bank Crises and Investor Confidence: An Empirical Investigation' (2009) Federal Reserve Bank of Chicago Policy Discussion Paper PDP2009-9, available at http://www.chicagofed.org/webpages/ publications/policy_discussion_papers/ 2009/ pdp_9.cfm.

[75]See 'Pandemic is putting banks' resilience to the test', *Financial Times*, 3 May 2020, available at https://www.ft.com/content/c7beb584-8bae-11ea-a01c-a28a3e3fbd33.

economy can lead to increasing public debt with serious long-term economic consequences. Further, transitional deviations of certain regulatory obligations in the bank management can generate distortions and potential market failures such as the illusion of both strenghtening capital and containing liquidity risk. The consequences of Covid-19 can be severe and it is unlikely that any benefits accruing from profitable risk taking during the period leading up to a crisis outweigh the cost of a distress scenario. The UK regulatory responses to coronavirus have been concentrated in rescuing businesses and households, however the effects of these measures need to be tested in the long-term whether the adopted temporary arrangements will avoid bank bail-out plans and firms debt restructuring.