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Bank supervision between risk reduction and economic renewal

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ABSTRACT
This paper investigates specific challenges of Covid for balancing economic growth and financial stability as they apply to paradigms, programmes and policies of bank regulation and supervision at the European Commission and European Central Bank. It finds that dominant paradigms of risk reduction and control remained intact, despite a temporary programme of regulatory relaxation to spur credit growth. The ECB and the Commission were united on state aid, regulatory loosening and promoting credit creation. However, while the Commission sought credit for businesses, much of the credit went into the European housing sector, with ECB support.

KEYWORDS
Banking Union; bank supervision; economy; state aid; credit creation

1. Introduction

The COVID shock to the European economy challenged European and national authorities to prevent economic collapse and then promote economic recovery in the absence of a fiscal union to act as an automatic stabilizer. The methods employed were familiar from the 2008 global financial crisis and the eurozone crisis that followed. State aid was permitted for banks for a number of years, capital adequacy requirements were loosened and then tightened again, and interest rates remained low for the economy at large for an extended period of time (2012–2022). To these familiar support mechanisms, a temporary fiscal stimulus programme was established at the EU level in 2020 that added to the funds available for recovery and reconstruction – the Recovery and Resilience Facility – and new arrangements were made to supplement the meagre resources of the Single Resolution Fund supporting insolvent banks with credit lines to the European Stability Mechanism.

Much of the most recent research to date on the EU's response to the COVID shock has focused on the EU's stimulus response through the Recovery and Resilience Facility (Alcidi and Gros 2020; Hodson 2022). This special issue examines how Banking Union has evolved over the last decade, including how policy preferences regarding Banking Union, financial stability and macroeconomic institutions have evolved and diverged in light of the COVID shock (Authors 2 and 3, this volume) how specific aspects of bank supervision have responded to the desire to relieve the pressure on banks to hold on to capital during periods of economic turbulence that could otherwise be channelled to the economy

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(Authors 5 and 8, this volume); the increase of EU institutional powers and remaining gaps (Authors 6 and 9, this volume) and how national central banks still retain considerable discretion and responsibility in applying common policies (Author 10, this volume). Common to all of these insights is the incremental adjustments of European Banking Union institutions to a strong economic shock, with a focus on averting disaster.

These crisis-related adjustments occur in a highly politicized context where advocates of different visions of Banking Union and EMU (Donnelly 2018a) argue for different prescriptions for supplying financial stability and economic growth simultaneously. These tensions extend beyond supervision and the quality of deposit insurance and bank resolution to include issues of monetary policy transmission involving liquidity support mechanisms for banks for which the ECB is responsible, national state aid for banks in the context of the Union's macroeconomic policy goals, and even EU fiscal policy that affects the balance between stability and growth (Matthijs and McNamara 2015). Between 2012 and 2020, there was already considerable tension between supporters of the European Central Bank, which eased credit conditions for European banks (even as it exercised its responsibilities as head of the Single Supervisory Mechanism), and those who felt that quantitative easing and liquidity easing extended the artificial life of zombie banks and contributed to inflation.

This paper asks about (1) the relationship between the European Commission and the European Central Bank as they dealt with the consequences of COVID, and (2) how their responses impacted the economy. This paper conducts this analysis through the lens of paradigmatic, programme and policy ideas as macro-, meso- and micro-level ideas on how to understand a problem (paradigm), design an appropriate response strategy compatible with it (programme) and specific policy interventions designed to achieve that strategy. A key question is whether the Commission and ECB shared an ideational framework in terms of COVID-related adjustments providing short-term support for banks (policy), how long that support would last (embedded in a programme or not), and whether this reflected a shift from pursing economic growth through stability (the dominant pre-crisis paradigm) to pursuing stability through economic growth. The final question is what impact the adjustments of the Commission, the ECB and potentially of national bank supervisors have had on the real economy. One part of this question is whether there are discrepancies between stated and actual goals. To the extent that credit is intended to become more readily available, are EU institutions insisting that it moves to the same sectors of the economy, and if not, why? Finally, what is the real impact in terms of credit flow to the economy? Overall, this paper seeks to contribute to the literature on the nature and functioning of EU economic governance, of banking union and supervision more specifically, and to link this field of study more closely to the behaviour of banks, the impact of public institutions on them, and their ultimate effects on economy and society.

2. The European central bank as monetary and supervisory authority

The ECB remains the single supervisor for systemically important banks in the Eurozone (E-SIBs), and a co-creator with the European Banking Authority of the Single Rulebook on Banking Supervision (Lefterov 2015). Both are geared towards ensuring capital adequacy for all European banks in accordance with the EU's Capital Requirement Directives (currently CRD IV) and related Capital Requirement Regulations (CRR). This promotes caution on the part of banks in lending money. The ECB has the additional responsibility of imposing consequences on banks that are failing or likely to fail in the Single Resolution Mechanism, should they fail to remain sufficiently capitalized (Howarth and Quaglia 2014). This power acts as a distant but important incentive for banks to create credit prudently rather than liberally.

At the same time, the ECB has practical responsibilities to sustain and promote economic growth as an alternative to deflation and economic collapse, particularly following economic shocks, as confirmed by the CJEU in its *Pringle* and *Weiss* (C-493/17) rulings. The ECB extended its mandate in 2012 to prevent deflation and eurozone collapse with liquidity creation, a paradigmatic shift that created a potential tension with its responsibilities from 2014 onward as bank supervisor for ensuring risk reduction within banks (Author 3, this volume; Heldt and Mueller 2021; Chang 2020). While not unlimited, the Court's ruling in *Gauweiler* (C-62/14) permitted the ECB to intervene in ways unforeseen in its original mandate where such concerns were acute (Borger 2016). As a central monetary authority, it takes interest rate decisions that affect bank lending, undertakes quantitative easing operations during periods of economic disequilibrium to promote lending through better cash flow, and authorizes emergency liquidity assistance to banks that allow them to weather temporary adverse conditions (Dietz 2019). Finally, it has the discretion as a single supervisor to determine the legal use of state aid for precautionary recapitalizations of troubled banks. All of these tools have been used extensively since the financial crisis of 2008, given the EU's slow economic recovery and periodic financial and economic crises. They constitute a paradigmatic evolution from the bank's initial mandate to pursue price stability in the sense that they transform the ECB from a truncated institution to a fully fledged central bank with full powers to pursue financial stability (Author 3, this volume). This transformation, however, does not alter the bank's missions to pursue price-sensitive monetary policy and capital-sensitive bank supervision. A relevant question is whether the ECB compartmentalizes these missions under crisis circumstances as opponents feared (Author 2, this volume; Fiordelisi, Ricci, and Lopes 2017), or whether the ECB can balance them out.

Prior to either COVID or Russia's war on Ukraine, the ECB had addressed what it saw as a paradigmatic weakness baked into EMU institutions that generated poor coordination between its own responsibilities to balance stability with growth, and the EU's fiscal (European Semester), macroeconomic (Macroeconomic Imbalances Procedure) and microeconomic (Banking Union) policies. The problem was the underlying focus on stability through financial risk reduction at the expense of employment, production and credit creation, which generated its own increased financial risks and continued instability, particularly in the absence of any fiscal mechanism to steer against negative shocks. As an alternative, it advocated a resequencing of fiscal policy initiatives in the European Semester to prioritize growth first, and then tackle financial stability through risk reduction measures second once income levels had been restored (Ban and Patenaude 2018; Diessner and Lisi 2019; Donnelly 2018b). Only then could it draw down its extraordinary programmatic support for European banks and bank lending, which had become more normal as Europe's anemic recovery dragged on, without seriously damaging the European economy. Its self-empowerment would not only be 'whatever it takes' but, however, long it takes.

While the European Commission and Council ignored such advice to use fiscal policy to support economic recovery prior to 2020, COVID's impact on the European economy led to new political impetus for (temporarily) supporting growth within the Council and the Commission. One element of this response was a willingness to accept state aid for wide sectors of the economy, including banks, to compensate for economic dislocations. The EU's Recovery and Resilience Facility (RRF) embodies and reinforces this shift at the European level (Vanhercke and Verdun 2022). However, it falls short of a full paradigmatic shift, being limited in terms of size, its 4 time horizon, and conditions for accessing grants and loans that are grafted on to the European Semester.

In addition to the innovation of the RRF, the European Parliament's hearings with the ECB pushed for such a paradigmatic change, insisting on greater attention to reducing unemployment through central bank support for the banking sector (Ferrara et al. 2021). Generally, the Commission also received support from the Council in 2020 in advocating support for banks so that credit would be created, and not withdrawn, from small and medium-sized enterprises (SMEs) in particular, as the economy's primary provider of employment. Overall, this means that the Commission and ECB become involved together in the question of how to support credit creation and financial stability moving forward. This includes how long and how generously the European Commission should permit state aid to banks (under block exemptions, bespoke arrangements or channeling state aid to target specific kinds of lending), and what repayments should look like looking forward (Ferri 2021; European Commission 2020b). Of course, it also raises questions about the specific mechanisms used to alleviate bank obligations to hold onto capital rather than lend it (Authors 8, this volume).

These observations bring us back to the research questions mentioned earlier: how much of a shift in thinking has taken place in both the Commission and the ECB? Are adjustments temporary, only to return to pre-COVID norms after the effects of the pandemic subside? Are there gaps between the intended goals of the Commission and the practical implications of carrying out support for credit creation? Finally, is there any noticeable variation with location based on the approach of national bank supervisors?

To seek answers to these questions, this paper starts with a study of statements of support for credit support in eurozone bank supervision and state aid policy from both the Commission and the European Central Bank for the period since 2020, as they apply to the balance between focus on credit creation and risk mitigation (in the form of enforcing capital adequacy requirements). The main focus of the paper is on how credit creation unfolded, what this says about the attitudes of the Commission and ECB moving forward, and what impact it has had on the European economy. This latter analysis is key to judging how EU institutions, policy paradigms and policy actions have a real effect at a critical moment for EMU and the EU. For this, the paper examines data on bank credit creation for households and for businesses in the EU. Granular data are fully available for Eurozone countries, so that these receive the most attention.[1]

3. Framework

Research on ideas, public policy and change makes frequent reference to the distinction between policy ideas, policy programmes and policy paradigms (Hall 1993). Policy ideas are the most adaptable to specific circumstances and while normally expected to be informed by broader policy programmes and paradigms that signify appropriateness, can deviate where required in an ad hoc way that is consistent with experimental governance. Policy programmes strive to articulate a coherent logic of action directed at a specific purpose, and plan individual public policies into performing specific roles within a broader strategy. Paradigms encompass an underlying set of preferences and expectations about how the world works and should work (norms), which inform policy programmes. They are generally considered to be the most durable and resistant to change. Paradigm change can be punctuated and radical when crisis undermines both institutions and the assumptions underpinning them (Baumgartner et al. 2009), or incremental as new understandings and institutions to give them life to displace, redefine and sideline older ones over time (Thelen 2009).

The ECB's history of policy development and initiative demonstrates the evolution of its institutional mission and behaviour to reflect a paradigm shift to a more growth-oriented policy outlook since 2012. The literature on ECB adaptation beyond its original institutional mission includes studies of ECB internal politicisation over monetary policy (Moschella and Diodati 2020); and willingness to engage in external politicisation towards EU institutions regarding fiscal and macroeconomic policy (Moschella, Pinto, and Martocchia Diodati 2020; Donnelly 2018b). However, research on the ECB's role as single supervisor is focused primarily on its 2014 mission to do a more thorough job than the European Banking Authority, and building a reputation for strength in that regard, even under conditions of strong contestation over whether it should focus solely on de-risking bank balance sheets (Howarth and Quaglia 2016; Lombardi and Moschella 2016; Chang 2015; Kern 2015).

This paper first tests the argument that policy paradigms on macroeconomic policy and microprudential regulation at the European Commission and ECB have remained relatively stable in the context of the COVID pandemic, while remaining different from one another. Adjustments from 2020 onward are seen as temporary, and pre-existing tensions between the ECB and Commission over the relative balance between growth and stability remain. COVID has mainly led the Commission to move closer to the ECB's position on a programmatic and policy level, allowing more flexibility to pursue financial stability without stifling economic growth, but intergovernmental politics within the Council serve as a brake on further movement toward a new growth-oriented paradigm.

The second argument is that while there is unity between the European institutions about the need for adjustments in discretionary support for banks, there is a gap between the political selling of policy adjustments at the Commission and the Council, which stress loans to small and medium-sized enterprises (SMEs), and the application within banks themselves and supervised by the ECB, which directs credit to less risky investments, particularly collateralized real estate. This demonstrates a continuing ECB (and banking sector) paradigmatic and policy commitment to traditional prudent lending practices.

The paper's third argument, following Fiordelisi, Ricci, and Lopes (2017) and (Author, this volume) is that national bank supervisors have considerable policy implementation discretion. Banks under national rather than ECB direct supervision can pay less attention to ensuring strong capital buffers and reserves against losses if national authorities interpret requirements accordingly. This should allow some of them to be more liberal in their credit creation than banks under direct ECB supervision. Notable is that Fiordelisi, Ricci, and Lopes (2017) find no evidence that this effect varies by country – it is specifically linked to whether the supervisor is the ECB or a national authority. This paper tests this hypothesis indirectly by looking at national differences in credit terms and creation.

This paper tests these arguments by outlining paradigmatic, programmatic and legislative priorities pre- and post-COVID regarding the need or rejection of common fiscal resources during bank crises, and regarding the need for risk reduction measures that restrict credit to the economy or measures that expand it.

The rest of the paper is structured as follows. The next section briefly outlines the broad economic challenges and political responses of the EU and Council authorities to set the stage for the challenges facing EU banking supervisors. The sections following examine credit creation within the eurozone and demonstrate the degree to which the overall development of loans and their direction was intended and acceptable for the Commission and ECB. It will also look for outliers across countries that point to potential points of concern.

4. Broad economic changes and policy response under covid

COVID imposed strong external economic shocks on the European economy, beyond their more obvious impacts on societal health, social and defence goals. This led not only to the use of fiscal stimulus through transfers and public investment at the national and EU levels but also to functional demand for strong credit generation from banks.

4.1. Pre-COVID economic governance and paradigms

Pre-COVID economic policy and institutions reflected the politically determined outcome of the 2010–2015 Eurozone crisis. Institutions and policies focused on risk reduction in the private sector (Banking Union) and public sector (European Semester), which advocated reductions in credit creation and public sector borrowing, respectively. A fiscal union, which would entail collective tax revenue, expenditures and borrowing was explicitly ruled out at the behest of Germany and the Netherlands. These risk reduction initiatives demanded a decline in economic demand, and came at the cost of lower economic growth, job growth and social policy goals, particularly in Southern Europe. Internal devaluation, a shift from demand-led to export-led growth, again for Southern Europe in particular, was central to this strategy (Donnelly 2021). Countervailing measures, such as the much-prized mainstreaming of progressive social goals in the European Semester (Zeitlin and Vanhercke 2018) remained largely confined to the realm of rhetoric, but not so much in reality (Veen and van der 2014), as evidenced by a 2019 proposal for Social Imbalances Procedure and further pressure post-COVID (Sabato, Vanhercke, and Guio 2022). Macroeconomic adjustment led countries dependent on demand-led growth to rely heavily on exports like Germany, which shows up as a current account surplus (Baccaro and Pontusson 2018). This overall shift has declined since COVID, but retains its overall importance (European Central Bank 2022a). While this set of policies and the paradigm underpinning it were not universally supported, they were accepted as the price of Germany and the Netherlands agreeing to any mechanism to hold the EU economy together, which was the loan programmes of the European Stability Mechanism (Hodson 2022).

4.1.1. Legislator-supervisor pre-COVID unity

EU legislators and the bank supervisor (ECB as SSM) showed strong unity of purpose in monitoring and policing capital adequacy and financial stability, with only minor deviations prior to the pandemic. The ECB's approach to supervision has its basis in the construction of the Single Supervisory Mechanism, as well as the EU's Capital Requirements Directives and associated regulations for ensuring capital adequacy. Vigorous supervision and attention to supervisory reputation dates back to the launch of the SSM in 2014, with the application of the Asset Quality Review (De Rynck 2016), and afterward, two initiatives to enlist and harness the cooperation of national counterparts: cooperation with the EBA on the development of a Single Rulebook; and the formation and deployment of Joint Supervisory Teams (Authors 5 and 8, this volume).

From the outset of the Banking Union, EU legislators laid the stress in supervision on risk reduction, reflected in improved risk management, reduced incentives to take 'excessive risks', disposal of non-performing loans, and increased capital holdings (European Commission 2016). While the 2016 and 2019 Banking Packages drew on Basel III standards, their details were driven by political bargaining over how to reduce the overall fragility of national banking systems within the Eurozone. In aggregate, the failure to agree on a European Deposit Insurance Scheme not only rendered the Eurozone economy more prone to financial contagion in the event of an E-SIB failure; this heightened financial stability risk necessitated supervisory stress tests that priced this contingency into banks' capital adequacy requirements (Howarth and Quaglia 2018). Within the Banking Packages, this was reflected in 2016 rules covering the Net Stable Funding Ratio (NSFR), Minimum Requirement own funds and Eligible Liabilities (MREL) and a new EU Liquidity Coverage Ratio (LCR) for good capitalisation that would also allow resolution authorities to quickly identify and apply bail-ins in the event of insolvency. Legislation also introduced new rules for increasing the use of market values for troubled assets rather than internal modelling (Regulation 2016/2067 on IFRS 9). This again would pressure banks with NPL problems to recognize them, write down part of their value and recapitalize accordingly.

At the same time, the legislation made exemptions or lower requirements for less-systemic institutions. The 2016 Package raised the threshold for exemption on capital requirements, with the intent of creating more room for banks to extend loans to SMEs and to government for infrastructure investments. It also introduced the supervisor's ability to set the level of a Systemic Risk Buffer, to be applied to any institution as required for macroprudential purposes, which forms a small portion of the overall capital requirement, and is set by the national supervisor (ESRB 2022).

The 2019 Banking Package (applicable June 2021) continued this formula as it updated the CRD/CRR, the Bank Recovery and Resolution Directive (BRRD) & Single Resolution Mechanism Regulation (SRMR) to incorporate the 2017 Basel leverage ratio framework requirements (3% own funds requirement). CRD IV adjusted capital requirement add-ons, including the NSFR and the Systemic Risk Buffer. The Package's main innovation, however, was a new Regulation for the Massive Disposal of NPLs. This allowed banks to offload non-performing loans, based on (higher) hypothetical values rather than current market prices under certain conditions. The scheme would work to incorporate NPLs with other assets to ensure derivative safety and provide capital to banks burdened with bad loans as investors purchased them (European Commission 2018). However, Gual (2021) notes that

SME loans constituting the bulk of such NPLs typically lack collateral underpinning their value, which impedes the viability of the plan.

At the same time, the 2019 Package repeated and extended the practice of lowering the bar for banks lending money to SMEs and to public authorities for infrastructure. Both of these kinds of loans could be assigned lower risk weights, which would allow banks to retain less capital, increasing aggregate loans. The other requirements would also be simplified for simpler institutions, particularly alternative banks with social, public and market-correcting missions.

The risk reduction paradigm therefore remains intact. Overall, the period between 2015 and 2019 demonstrates concern from both legislator and ECB to prioritise financial stability through improved capital adequacy. This stems from Banking Union's politics, including the NPL Disposal Regulation. At the same time, the legislative room was provided supervisors to permit banks to lend to politically supported priority groups and infrastructure projects.

4.2. The COVID shock

The COVID shock is visible in eurozone GDP growth, current account balance and general government deficit levels. COVID led to a sharp (15%) drop in economic activity and a rise in unemployment everywhere in Europe, with a brief but strong recovery between mid-2020 (Quartile 2) and mid-2021 (Quartile 2). National governments compensated part of the drop in national income with subsidies, permitted temporarily during a state of general economic disequilibrium. Average eurozone government deficit spending rose from one to more than 8% of GDP in 2020 (ECB 2022a). In this context, fiscal counter-measures were required to prevent economic freefall, though there was disagreement between the Council and other institutions over how much should be provided collectively, while the Commission and ECB focused on bank credit creation to support the economy.

4.2.1. COVID-induced changes: how much programme and how much paradigm?

The EU's initial response to the COVID pandemic shock reflected intergovernmental and inter-institutional divisions over appropriate responses. The Commission and ECB favoured completing EMU, which meant better-resourced Banking Union institutions, a deeper Capital Markets Union, and above all, a fiscal union to cushion economic downturns and prevent economic fragmentation (European Commission 2020c). Though they had support from most EU governments for a crisis-specific borrowing programme, this proved a bridge too far for the Council to agree on. The Netherlands stood out for not only rejecting changes to EMU's institutionalized rules and norms but also rejecting a temporary fiscal measure until the fifth day of a two-day July 2020 Council Summit. Countries that had been devastated deserved no assistance, much less new European programmes to borrow and redistribute, because they were poorly governed and prepared (Matthijs and Merler 2020). The Netherlands' eventual agreement with the Recovery and Resilience Facility (RRF) insisted that borrowing be temporary, means-tested, subject to conditionality, enforced by the Commission and weighted towards loans rather than grants. National responsibility for economic management as a paradigmatic norm remained baked into the RRF, even as it borrowed and spent for a particular event (Vanhercke and Verdun 2022). This speaks more to a policy programme than a paradigm shift.

As a temporary programme, the RRF demonstrated legislative unity on the imperative of collective borrowing to support economic recovery for a period of 4 years. However, the need for national governments to repay some of this money, plus conditionality, reflected Dutch and German concerns about ensuring economic transformation and repayment (Bekker 2021). Loans and grants would be required to fund investments in health, green and digital economic developments. Governments would have to submit detailed national action plans for meeting these criteria before Commission approval. The Commission subsequently internalized the view that investment in industrial, digital and green development was the most promising path to rejuvenating productivity and generating new income to repay loans (European Commission 2020a). Applying conditionality to national plans also ensured that the EU COVID response was hesitant, difficult to unlock, and still being rolled out in 2022. Rather than being a direct fiscal instrument, it effectively backstopped national initiatives. These outcomes show that the RRF and the policy drive behind it reflected at most a battle of paradigms that the Council won rather than a paradigm shift.

In the absence of greater fiscal stimulus, banks were left to do the heavy lifting of restoring confidence to the economy and providing credit for investment. However, they also had to balance credit creation against assessing the creditworthiness of potential borrowers, and meeting capital requirements under EU law. With this in mind, the European Commission's communication of April/May (2020b) permitted national governments to aid banks, typically with loan guarantees, as a result of COVID if those funds flowed through to small and medium-sized enterprises (SMEs). Under these conditions, funds would not be regarded as traditional state aid, and bail-ins for private investors would be waived as a condition of assistance. The Communication underlined precedent from the 2013 Banking Communication permitting direct aid to banks under pressure from a general disequilibrium. These measures helped banks indirectly by supporting the repayment capacity of their borrowers and halting growth of non-performing loans. In addition, the ECB provided favourable interest rates for banks lending to the real economy that wanted to make use of targeted long-term refinancing operations (TLTRO) that it extended from December 2020 to June 2022 (European Central Bank 2020).

The consequence of banks being on the front lines of economic recovery in the absence of a stronger fiscal capacity is also true for the ECB (and the Commission) doing the heavy lifting of creating regulatory room for banks to lend more. They did this by temporarily allowing banks to hold less capital on hand as they lent to the economy and by allowing them to ignore the impact of the pandemic on their loan portfolios. The ECB, Parliament and the Commission agreed in June 2020 on temporary adjustments to the Capital Requirements Regulation (CRR), which reduced how much money banks had to set aside, given their assets and liabilities when making loans (European Banking Authority 2020). Additionally, the ECB announced in April 2020 that banks would not have to downgrade their assets along with declining market values for existing loans,[2] but use a model generated by the ECB instead that turned a blind eye to the effects of the pandemic. Where banks would normally have to set aside cash (raise capital) rather than lend it as asset values dropped, they would no longer need to do so. By shielding banks from reporting expected declines in assets values, the ECB prevented a fire sale of SME loans in particular. For this relief to lead to positive gains in lending, it could not be used to increase dividends or be used to increase capital buffers (hoard cash). Both of these were potential outcomes as banks sought to boost market confidence in a competitive environment (ECB Banking Supervision 2020, European Securities and Markets Authority 2020).

However, the ECB's supervisory mission and philosophy ensured this discretion was short-lived, and banks would have to shift attention back to creditworthiness within a year of the pandemic's start. In 2021, the ECB outlined four supervisory priorities affected by Covid. The first was *credit risk management*. While public subsidies had avoided the problem of mounting NPLs, the ECB wanted banks to assess possible payment problems when support ended. In addition, to ensure *capital strength*, it now wanted them to set aside capital buffers to compensate for the losses while continuing to restrain discretionary payments and purchases. It further intended to use joint supervisory teams to review *business model sustainability* (lending in sufficiently safe areas while making a profit) and resilience-related governance structures (non-financial infrastructures like crisis teams, cybersecurity and standard operating procedures) (ECB 2021b). By 2022, as head of the Single Supervisory Mechanism, the ECB announced three priorities: emerging from the covid crisis (dealing with increased leverage in the economy and increased turbulence in interest rates); addressing bank model and governance weaknesses (boards not taking risk management seriously); central counterparty risks (especially to non-bank entities like hedge funds); and adjusting to politically desirable changes to lending activity as set out in the RRF (greening and digital finance; ECB 2022b). This signaled a return to risk reduction as a core paradigmatic and programmatic necessity for banks to contend with.

The ECB at the start of 2022 was satisfied with the state of bank capital and the ability of banks to extend credit to the economy in the short term. It noted that extraordinary economic support (national financial transfers and loans to the economy as a whole) had kept NPLs levels low, but that they would rise again when support ended. There were concerns that banks should have to devote more attention to risk management in preparation for the end of financial subsidies to households and companies. The ECB noted a particular, lasting weakness in *commercial* real estate posing risks to banks, as opposed to the rising price of housing and credit provision to households, which might generate NPL risks in the future that banks would have to set money aside to compensate for (European Central Bank 2022b). While the ECB's statement of December 2020 stresses that TLTRO subsidies are intended to support lending to both businesses and households (ECB 2020), this later statement indicates a shift in what the supervisor expects in terms of loan creation, which is visible later in bank lending (below).

Still, there are some indications that banks extended credit in meaningful ways early on in the pandemic that did not interfere with financial stability concerns. Jordi Gual from CaixaBank estimated that banks in Italy and Spain, for example, had increased (pre-approved) loans in the first 6 months of the pandemic by 7% year-on-year and granted or extended debt moratoria as a result (Gual 2021) of the Commission's relaxing terms of the Capital Requirements Regulation. Banks were also doing their part by introducing and extending debt moratoria, granting pre-approved loans (Gual 2021). The latter are most prevalent in mortgage lending, which has significant collateral and a deep market.

The analysis below, which is largely based on comparative data presented by the ECB in the European Systemic Risk Board's *Systemic Risk Dashboard*, is undertaken to piece together how much these insights are shared evenly across the EU's banking systems, and whether they are durable or fleeting. This is important for assessing the impact of policy adjustments on credit creation in the EU economy, and for showing the impact of temporary adjustments at the Council, the Commission and the ECB.

5. Credit creation: households or companies?

In aggregate, the data from the European Systemic Risk Board show that credit creation in the Eurozone increased as a result of COVID across three main sectors of government, households, and other banks. It also shows increased annual growth rates for loans to households throughout 2021. The largest loan category in 2021 was banks loaning to other banks as they struggled to stay afloat. Table 1 excludes these inter-bank loans to focus on growth rates for households, businesses and non-profits.

5.1. Credit creation growth rates by country: households and companies

One result for bank-based systems typical of Europe is that while credit was being created, there remain questions about whether it is equally available across the EU, and whether it is in the intended areas of the economy. While the Commission and Council underlined loans to businesses, including companies that want to re-enter manufacturing, credit could also flow to 'safer' real estate assets that are backed with collateral (property subject to repossession where loans are not being repaid) but are also prone to inflation and housing bubbles. In addition to not directly supporting businesses unrelated to the housing sector, this channel has other risks associated with it, particularly increasing private debt levels, and the dependence of mortgage repayment on the future course of pandemic and economic recovery. This section examines credit creation across the EU's banking systems to get a picture of what happened to these intentions and actions.

5.2. Households

Data from the European Systemic Risk Board's March 2022 Risk Dashboard shows that the growth of loans to households decreased across the EU in 2020 but still remained in positive territory everywhere except Ireland, the Netherlands, Spain and Greece. In 2021,

Table 1. Credit Creation in Non-Monetary Financial Institutions.

	Euro Area*	Households	Mortgages	Businesses	+ Non-Profit
2020	4.2				
2021 Q2	2.9	4.5	5.7	1.4	1.9
2021 Q3	2.7	4.3	5.5	1.6	2.1
2021 Q4	3.2	4.3	5.4	3.8	4.3
2022 Q1	4.0	4.5	5.5	3.8	4.4

Note: * Source: ECB Statistical Data Warehouse, Table 2.1: Euro Area Aggregate balance sheet of euro area credit institutions https://sdw.ecb.europa.eu/home.do.

Ireland remained the only country where credit for households was contracting (ESRB 2022: Table 3.1). For the other 23 EU countries, household credit grew in France at the EU average of 5.5%. Above France with stronger household credit growth, in ascending order, were Slovakia, Austria, Latvia, Sweden and Belgium (less than 8% growth), as well as Romania, Estonia, Slovakia, Malta, Czechia, Luxembourg, Lithuania, Bulgaria and Hungary (8–15% growth). The remaining countries had credit growth rates below the EU average. National differences in credit creation were therefore quite strong, but the flow of credit to households remained positive nearly everywhere. Newer member states were more strongly represented in high credit expansion category, though Luxembourg and Belgium stand out in this group. ESRB data also show that credit standards for loans to households tightened briefly in 2020 in an initial reaction to the pandemic but relaxed and returned to normal by 2021 (ESRB 2022: Table 3.7). After an initial panic, banks could be seen to be ready to make loans available again without state loan guarantees.

5.3. Corporations

In a mirror image of households, credit to (non-financial) corporations grew significantly in most EU countries through the first pandemic year ending January 2021. This suggests a direct impact of support for credit creation during this period. Four countries out of 27 witnessed a credit contraction: mild contractions in Czechia and Latvia (<2%) and strong contractions in Poland and Lithuania (6% and 18%, respectively). In the second pandemic year ending January 2022, however, the EU splits into different groups. Credit contracted in Malta, Latvia and Luxembourg (2–4%). It dwindled to less than 2% in Cyprus, Italy, Croatia and Spain and was average at around 4% in Belgium, Greece, Poland, France, Portugal and Finland. In the countries where credit to businesses grew weakly in 2021, it had fallen to roughly one-third of credit growth in the first year of the pandemic. Meanwhile, credit growth in the rest of the EU showed a reverse trend. It was more moderated in 2020 and then rebounded, sometimes doubling in 2021 (6–20%) (ESRB 2022: Table 3.2). ESRB data also show that while corporations benefitted briefly from a temporary loosening of bank credit risk assessments in loan decisions for companies for the first half of 2020, this was not the case afterward. Credit risk assessments by banks tightened (ESRB 2022: Table 3.8), which means that banks treated businesses less favourably than households when extending credit after mid-2020. This was also true for the group of countries where credit creation was strong in 2020. This effect was temporary, returning to 'normal' in 2021, which explains the drop in loans.

Overall, for countries in Southern Europe (France, Portugal, Greece, Italy, Spain and Croatia), there is a noticeable increase in loan growth to companies in the first year of the pandemic that is not found elsewhere in the EU. In the second year, growth rates elsewhere picked up, while Southern Europe moderated. Overall, this shows that credit creation to companies in Southern Europe reflected the Commission and Council's stated desire to support businesses in the first year of the pandemic when demand-led economic activity was weak. Credit creation in Northern Europe, in contrast, followed the arc of economic growth.

5.4. Different prices for business and household loans: lending margins

The ESRB data above show credit flowing much more strongly to households than to businesses. This is at odds with the stated intentions of the European Commission to shore up credit supply for businesses with any available state aid to banks. Additional ECB data on lending margins from March 2021 reinforces this picture. When looking at lending margins, the higher the level, the more interest banks demand from businesses or households above the rate the banks pay depositors, and the less credit is created. Generally, banks restricted loans to business by increasing the lending margins they charge after the initial loosening of interest rates in 2020 in some cases dramatically as a percentage of their pre-COVID margins (Malta, the Netherlands, Austria and Czechia), and in a few others noticeably (Estonia, Lithuania, Finland, Hungary, Austria, Germany, Denmark, Belgium). In only five other countries was there a significant reduction in the margin, pointing to easier terms for business (France, Greece, Slovakia, Poland and Sweden). In Italy, the margin rose, but was already the lowest in Europe, signifying the smallest premium for business loans (ESRB 2021, Table 3.6).

In contrast, banks lowered margins for households buying houses across the EU, with a few notable exceptions (Czechia, Romania, and to a lesser degree, the Netherlands) (ESRB 2021, Table 3.5). This shift into real estate lending rather than business loans likely reflects (1) the hot market in such transactions as households sought larger houses in a pandemic and (2) the ability of banks to repossess buildings in the event of default. A first take is that the pattern of credit creation does not reflect what the Commission and the Council stated they wanted to see.

5.5. Good, bad or equivocal? supervision and the corporate-household lending divide

From the perspective of a central bank looking at the monetary transmission mechanism and its impact on growth and financial stability, however, the gravitation of lending towards mortgage financing is not necessarily problematic, and somewhat beneficial in that it fits with established paradigms about minimizing the risk of future loan defaults. Indeed, the ECB's own statements indicate that financing to either households or businesses is positive (ECB 2020) and that they focus on the potential risk of non-repayment to banks and the financial system as a whole. Money to households for the building, purchase or renovation of real estate generates jobs and demand in the economy, while loans taken out against the collateral of appreciating house prices fuel demand in an otherwise fragile economy, while offering banks better security against failure than a startup business loan (ECB 2022c). In terms of bank supervision therefore, credit creation through mortgages is functionally equivalent to creation through business loans, but is also the safer choice of the two. It eventually creates more credit for the broader economy by channeling it into areas that require lower capital reserves for banks, given the recourse to repossession to recoup losses. Finally, there is the question of whether a viable alternative could perform just as well. Small business loans do not really provide an equally safe alternative, and the ECB and NCBs tend to accept this in the context of Banking Union's strong emphasis on risk control and reduction. In other words, the paradigm and the programme remain intact, with adjustments to capital requirements

(Authors 5 and 8, this volume) as temporary measures bound to go away as the COVID crisis dissipates.

Despite this sanguine view of where credit flows, there is an undeniable effect of strongly rising house prices, indeed housing bubbles, as a result of this pattern of credit creation, and a reliance on trickle down effects by which the affluent get richer through their housing assets and are expected to spend it on other things (by taking out additional mortgages to fuel consumption, particularly in an inflationary environment like the one that emerged in 2022), even if there is less evidence that other segments of society benefit as expected. This does not appear to have happened, however, as can be seen in the development of nominal labour costs, which reflect wages and payroll taxes. These declined in 2020 until mid-2021, reaching a rate of 4% by early 2022 (Eurostat 2022a), significantly below the inflation rate of 8.6% in May 2022 and 9.9% in September. Meanwhile, house prices in all countries except Cyprus and Romania grew significantly, with price increases exceeding 4% in 2021 after subtracting inflation (Eurostat 2022b), and hitting nominal rates of 9.8% for the euro area and 10.5% in the EU in the first quarter of 2022 (Eurostat 2022c).

However, research at the ECB immediately prior to the pandemic reflects a view that lending even in housing bubbles might be positive in the absence of alternatives to provide better-secured loans to the commercial sector. The argument goes that bubble lending supports continued credit flow into the economy that would otherwise dry up entirely (Martin, Moral-Benito, and Schmitz 2019). In other words, household borrowing had advantages for supporting economic demand while minimizing future risk of default. This made the mechanism compatible with existing risk reduction paradigms at the ECB. By November 2021, the ECB's Financial Stability Review built on this foundation, stating that while credit creation for housing was indeed very strong that bank attention to the risk of default was even stronger than it had been in the years preceding the 2008 great financial crisis (Lo Duca et al. 2021). This in turn reflected that banks were generally lending to safer borrowers who were older and had higher incomes as a result of general internalization of greater supervisory demands for lending safety during the development of banking unions (Kelly, Le Blanc, and Lydon 2019). This attachment to risk reduction remained intact as Russia's war against Ukraine raised the prospect of an EU economic downturn and increasing NPL levels. The ECB made it clear that banks would need to reduce risk once again (Di Casola et al. 2022). Ultimately, this points to the continuity of paradigms in banking within the banking sector, and central banks themselves, including the ECB. It also points to the continued need for alternative banking that serves an underbanked market for communities and businesses throughout Europe (Howarth and Quaglia 2016).

6. Conclusions and discussion

A core function of the SSM, combined with banking regulations adopted since 2016, is to deal with questions of risk reduction, capital adequacy and corporate governance. These are largely preventive measures that push banks to avoid problems before they become acute. In the absence of a general economic crisis, the ECB is able to prioritise financial stability through capital adequacy, as it did between 2014 and 2020. It can sustain pressure on individual banks to raise additional capital and to reduce credit creation where necessary to ensure their continued (or restored) financial solvency. Where banks are in actual trouble on a systemic level due to a symmetric economic shock (one extending throughout the EU), the pressure to balance capital adequacy against credit creation rises. This in turn leads to the question of what happens then. Evidence here and elsewhere suggests that both the legislator and the ECB provide extraordinary room for state aid for banks and softened capital adequacy standards, as long as they are means-tested and limited in duration. In other words, these are policy adjustments, not paradigmatic, or even programmatic in nature. This had a noticeable effect in 2020, particularly in Southern Europe, and a much weaker effect in 2021/2022, when bank lending followed the economy, rather than spurring it on. The exception remains lending for house purchases, which fit into the traditional risk-reduction paradigms of the previous decade.

This article adds to the literature on EMU and Banking Union by examining the attitudes of EU institutions towards risk control as it applies to bank supervision and the desirability of extra financial resources to deal with systemic shocks. It found that economic policy paradigms at the Commission and ECB have shifted marginally but retain much of their pre-COVID preoccupation with monitoring and enforcing reduction of risks in the European banking sector. While both institutions favour greater fiscal resources to provide macroeconomic buffers and a special fund for deposit insurance, the Council remains unconvinced, focusing heavily on domestic objections (Hodson 2019; Saurugger et al. 2021), which make a paradigm shift impossible at the moment. Funds are limited to emergency measures only. On the fiscal side then, new programmes neither lead to a fundamental rethinking of European economic governance nor constitute a Hamiltonian moment of an EU budgetary capacity, or even bank-specific funds. National fiscal intervention remains at the fore, even as the RRF facilitates this spending. This means that bank regulations and supervision are left to do the heavy lifting of economic support through traditional credit creation, potentially supplemented by national governments providing loan guarantees, and EU institutions providing temporary leniency at the level of capital buffers retained when making loans.

On the supervisory and capital adequacy side, therefore, there are adjustments to capital requirements that give banks more breathing room to lend more money during a period of emergency, and the European Commission remained ahead of the ECB in its decision to permit state aid for banks, and generally support credit creation for business through temporarily weaker capital rules. However, the quick return on the part of the ECB emphasizing future risk reduction reinforces the concern of banks to lend first where it is safest, and only carefully to riskier, more unknown borrowers, particularly those without collateral, who are the Commission and Council's intended beneficiaries of state guarantees and capital requirement reductions. While the decision-making chain of banks has not been directly investigated in this paper, it remains an important topic for future research.

The investigation above of credit creation in this environment demonstrates that banks, just like EU institutions, did not undergo a paradigmatic change, but at most reacted temporarily to public policy initiatives. They made credit available to companies and households in 2020 and afterwards, but in the mix of loans issued, we can see their continued preference for loans to households for purchasing houses, and their increased emphasis on loans in this category over businesses. This makes sense from the perspective of extremely high retail demand for larger houses with bigger gardens and home offices during a pandemic, but also through the perspective that mortgages, while not risk-free, provide a form of insurance against default via repossession and re-sale.

This outcome has implications supporting future negotiations over fiscal resources in the EMU. The emphasis on credit creation through the banking system and the use of tools to support banks in that endeavor cannot be readily directed where the Council and Commission want it to go. Banks and supervisors still have to think about credit risk, and remain unwilling to stick their necks out too far for too long. Their understandable concern with the legacy issues of non-performing loans in European banks leads to paradigmatic and programmatic stability, with only fleeting adjustments to daily policy on capital adequacy and credit creation. While this is good for the long-term viability of Banking Union and its approach to financial stability, the fiscal question remains alive.

Notes

1. For the approach taken in non-eurozone countries, see Authors, this volume.
2. As decided in the 2016,(REGULATION ON IFRS 9).

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