CHALLENGES FOR THE EU BANKING SECTOR IN THE COVID CONTEXT

According to the outcome of the discussion, the banking sector has not contributed to the economic crisis and is part of the solution. Due to the support provided by monetary and fiscal policies, loan moratoria and prudential flexibility granted to banks by supervisors, the pandemic has not translated into higher NPL ratio so far. But high uncertainty surrounds economic outlook. NPLs are expected to increase in the coming months as the impact of the COVID-19 crisis on the real economy intensifies and the current economic crisis exacerbates pre pandemic challenges and notably the low profitability of European banks. In such a context, preventing insolvencies of distressed but viable forms and achieving a genuine banking union are essential for preserving economic and financial stability.

1. This time is different, but we are in a situation of high uncertainty

The Covid crisis is very different from 2008, which was a financial crisis. European banks entered this pandemic with stronger capital positions, higher liquidity buffers and better asst quality. So, this time, they have helped to mitigate the impact on households and corporates. But the future is uncertain. We do not know the damage to the banks' balance sheets and the structural changes that will be caused by the present crisis.

1.1 A very different type of crisis

A Central Bank official highlighted three important differences of the current crisis with the 2008 crisis. The first is that the origin of the current crisis is not macroeconomic imbalances in economies; it is a health crisis. The second is that banks' balance sheets are in a better shape. Third, the overall regulatory framework is very different. Much was learned in this respect from previous crises.

1.1.1 The policy response

A Central Bank official stated that the policy response was different. It was much faster, better coordinated and broader. Monetary, fiscal, employment, social, regulatory and supervisory policies were used in hitherto unseen dimensions.

1.1.2 Banks are part of the solution thanks to exceptional support from public authorities

An industry representative noted that credit risk is one of the most important challenges of the crisis. Banks are part of the solution by channelling state-guaranteed loans. Banks need to make full use of their capital and liquidity. We are fortunate the banking system has entered this crisis with quite strong capital buffers. It is also a challenge because the current crisis compounds profitability challenges and increase the sovereign-related exposures.

However, all of the measures have proven to be very effective. Despite the significant drop in gross domestic product (GDP), there is not a surge in bankruptcies or defaults. To the contrary, in some cases there has been a record low number of bankruptcies. The question is whether they have been delayed or avoided. Banks are seeing that the crisis impacts different sectors differently. Companies are being more productive and adapting to digital, and the measures are increasingly targeted rather than being full lockdowns.

A Central Bank official added that the support measures have prevented insolvencies in companies affected by Covid, but also prevented insolvencies by some companies who would otherwise have failed in normal times of market dynamics. A Central Bank official summarised the impact of Covid on the banking system as so far so good. However, the major risk is still ahead with the materialisation of insolvency risk in the corporate sector. The extent of the impact will be a function of public support and the capacity to limit the risk.

1.2 We still do not know what is going to happen

1.2.1 The health crisis is not over yet

A public representative noted we are still in the second wave of the pandemic. The vaccination process is slow, there are some countries with lockdown measures on the table, there is no free movement around Europe and new variants are spreading around the world. Though the European and national answers from an economic policy perspective have been correct and timely, there are many doubts about the recovery.

1.2.2 The extent of economic recovery remains uncertain in Europe

A Central Bank official stated that a weak economy produces a weak banking sector, and vice versa. The dimension of the recovery over the coming two years is quite uncertain. In terms of economic policy, the current year will be more difficult than the previous.

A Central Bank official noted that there are some encouraging experiences. There was a great readiness by citizens and companies to return to a normal situation and to usual behavioural patterns as soon as the virus recedes. Also, when the health situation deteriorated again in Q4 2020 and Q1 2021, it was demonstrated that there is great resilience in the economy, as many companies and consumers have well adapted to the Covid- related constraints. The affected parts of the economy are much smaller compared to the first wave at the beginning of the prior year. Future macro-financial developments crucially hinge on future progress in vaccination, and whether the encouraging data from the past two weeks will continue. If these factors come together, the stress in banks will be relatively manageable.

1.2.3 It is not known what will happen if these massive support measures are phased out

A policymaker noted that the problem is that it is not known what will happen if the massive support measures are phased out. It is now said that the cliff

effect might not be that bad. However, the ratios should be considered. Insolvencies were up to 60% lower in 2020 than in 2019, which is not healthy. There is a risk of fragmentation after the crisis. There is a need to at least be prepared.

2. With extensive support measures, the effects of the crisis on banks' balance sheets, in particular on credit risk, have been limited but visible

While the pandemic economic impact has not resulted so far in an increase of non-performing loans, for SSM banks, an increase in corporate defaults is expected. Credit risk must be therefore proactively managed, and provisioning must remain prudent.

2.1 Banks will inevitably experience increasing non-performing loan (NPL) levels

A Central Bank official noted that a full reflection of the current crisis is not yet seen in banks' balance sheets. The most visible indicators, like NPLs, have not started to deteriorate yet. This is mainly because of the strong monetary, regulatory, and economic policy responses to the pandemic. On the regulatory side, there are capital requirement reliefs, and on the fiscal side there is strong support for citizens and companies. But the early signs of asset deterioration can be seen in the form of the migration of loans from stage one to stage two[1] and some to stage three. In addition, some countries have reported moderate increases in the non-performing exposures (NPE) ratio. Some further deterioration of the situation in the banking sector can be expected in the coming months. Countries that entered the crisis with a higher share of NPLs will probably have more difficulties coping, and this is also true for the mainly smaller banks which are more exposed to small and medium enterprises and sole proprietors.

A policy-maker agreed that a rise in NPLs should be expected. The new action plan tried to focus on the leftovers of the 2017 plan, focusing mainly on secondary markets and insolvency frameworks. An industry representative noted that for the time being there is confidence that companies have been able to adapt and that the measures have been quite effective and well-designed. A public representative emphasised that there must be willingness to review economic policies to solve the health crisis. The size of European help and current measures may be in place for longer than is currently thought. The European Commission's action plan on NPLs is very prudent, although less ambitious than desired. The European response to NPLs may need to be reviewed.

2.2 A cliff effect scenario is not anticipated

An industry representative stated that a cliff effect is not expected at the end of the moratoria. There is not a surge in defaults. NPLs will be around 2-3%. Although the banks have seen a significant increase in the cost of risk, it is not through stage three but mainly through building reserves in stages one and two and forward-looking provisioning. It will all depend on the pace of the unwinding of measures, but the recovery could be swift and strong. Much of the government loans or support measures sits in excess cash and has not been fully used.

2.3 Credit risk management at bank level is key

A Central Bank official noted that from a supervisory perspective credit risk management at bank level is key. The provisioning practices are also important. Nonetheless, the collective reaction to this crisis was good, swift and potent, and each party has to play its part in the next phase.

2.4 The banking sector should be able to adjust to the changing environment

2.4.1 The pandemic may lead to structural changes and a shift in consumer preferences

A Central Bank official noted that the relatively strong decline of insolvencies in many countries shows that, by doing as has been done, part of the normal market mechanism was prevented from functioning. When coming back to markets, which should happen, some pick-up in losses should be expected. Firms need to come back to market conditions for doing business when their activities are no longer restricted. That is not a monetary policy or financial-stability issue in the first place, but it is important for the dynamics of the economy. It is very challenging to assess what a viable non-financial company is. It depends tremendously on the demand, which is affected by the current situation, but there could also be some structural changes and the market should play its role in adjusting to that.

2.4.2 The banking sector should be able to adjust to these changing environments

A Central Bank official stated that there are differences across countries for banks, in terms of public and fiscal interventions and the degree to which banks have added forbearance and the like. Over the next 12 months, it will be seen what happens when returning to market dynamics. In some countries, there is a quite pronounced K-shaped recovery because consumers have been prevented from spending in the way that they normally would. Perhaps the most important issue for the financial system is the housing market, which has been boosted by spending constraints on many services as well as a growing need for quality space for offices, teaching, exercise etc. at home. Over a two-to-four-year period, what is going on in the housing market and what will happen on the other

1. Impairment of loans is recognised – on an individual or collective basis – in three stages under IFRS 9:
Stage 1 – When a loan is originated or purchased, expected credit losses (ECLs) resulting from default events that are possible within the next 12 months are recognised (12-month ECL) and a loss allowance is established.
Stage 2 – If a loan's credit risk has increased significantly since initial recognition and is not considered low, lifetime ECLs are recognised. The calculation of interest revenue is the same as for Stage 1.
Stage 3 – If the loan's credit risk increases to the point where it is considered credit-impaired, interest revenue is calculated based on the loan's amortised cost (that is, the gross carrying amount less the loss allowance). Lifetime ECLs are recognised, as in Stage 2.

side of a potential housing/construction boom should be closely observed.

3. The profitability of European banking institutions remains a source of concern

The pandemic has exacerbated the chronically low profitability of European banks, reflecting ultra-low interest rates and depressed margins, legacy assets from the previous crisis and competition from non-banks.

3.1 The profitability of the EU banking industry is particularly affected by lasting negative interest rates

An industry representative noted that for many banks the interest-rate level is the biggest profitability challenge in the near future, as interest rates were not going up. Indeed, the European Central Bank (ECB) will always err on the side of caution here, given the structural weaknesses in the eurozone economies that have been exacerbated by the Covid crisis.

3.2 Achieving return on equity (ROE) in double-digit figures in the current regulatory context is particularly challenging

An industry representative's firm needs to maintain the position on ROE. Some central bankers say that their ROE levels should come down, but the market still expects ROEs in double-digit figures. The question is how to do that if risk pressures arise, and capital buffers remain. There is an ever-expanding level of regulatory costs (contributions to Funds, costs associated with Know Your Customer requirements…). His firm spends about €1 billion a year on dealing with them, which is largely misspent according to a recent article of The Economist. Then there are taxes, and governments will have to find ways of getting out of their huge debt numbers. In certain countries governments seem to take the view that banks should contribute at potentially double the levels compared to other market players.

3.3 Cross-border mergers and the Banking Union (BU)

According to a leader of the industry, completing BU remains of paramount importance. Cross-border mergers are extremely difficult and largely ineffective as long as the BU is not completed (Home/host issues leading to ring fencing practices…). Covid-19 should serve as a catalyst to complete BU.

4. Supporting solvent firms is crucial

Corporates and SMEs all over the world have suffered from the lockdown and the drop in demand. Bold support measures have been adopted by governments, which postponed payment difficulties. It is crucial in this context to ensure the viability of solvent firms that face temporary problems and/or an increase in debt as a result of the pandemic.

4.1 Banks have a key role to play in distinguishing solvent from insolvent firms

An industry representative explained that there are three types of firms: solvent firms that do not need help, solvent firms that need help and insolvent firms. The second category should be concentrated on. The worst mistake to make is not helping solvent and viable firms. By providing support to firms that are not viable or that do not need help, public resources may be wasted, but not helping solvent and viable firms would provoke permanent and unfair damage to the healthy part of the economy.

Banks have a very important role to play, because they have skin in the game as a result of the lending relationship with the affected companies and therefore can help in distinguishing between solvent and insolvent firms. Tools must be designed that align the incentives of the government, banks and corporates to inject equity into firms that are solvent and inject public aid where it is needed. A last resort is debt-restructuring, with longer terms and conversion to equity loans or debt relief.

4.2 The eventual return to normality of financial regulation should be calibrated carefully

A Central Bank official noted that on the supervisory side the major stance was to provide flexibility to banks to use their buffers to absorb the shock. This capacity has not been used to a large extent and must remain in place. For macroprudential policies, the most important issue is that the risks moved from the banking system to the non-bank financial institutions, so it is important to not focus only on the banking system.

4.3 When returning to normality, the countercyclical capital buffer should fairly quickly be set up again.

A Central Bank official stated that when back to normality the countercyclical capital buffers should get back on track. This is not only due to the housing market but also there being an extraordinary fiscal and monetary situation, plus pent-up demand. In addition, there are underlying challenges in the banking system, including overcapacity legacies. The banking sector should continue to consolidate and there is a need to be able resolve failing banks in an orderly manner, which remains challenging.

4.4 Member States should improve their national insolvency framework to facilitate orderly winding-up of non-viable banks/firms

An industry representative noted that non-viable firms require an efficient and quick resolution framework that facilitates a fresh start. The latter requires making the insolvency framework swifter and more efficient. A policy-maker added that banks and fiscal authorities need to work together to identify debtor distress early and engage in timely and appropriate restructuring to prevent insolvencies of fundamentally viable firms. Without this, banks' asset quality could deteriorate sharply. The preventive restructuring framework would be very useful. Unfortunately, only a few member states have transposed this 2019 directive.

A Central Bank official stated that the issue is how long the support should be prolonged for. The quick answer is: long enough but not too long. There is a need now to move to a more targeted and equity-focused type of support. A Central Bank official noted that supervisors should have an active role in guaranteeing that banks reinforce their efforts in the timely identification of situations where borrowers are facing financial difficulties, and the setting up of sustainable solutions for viable customers that allow them to continue their activities while recovering their ability to repay debts.

5. The crisis highlights the need for completing the BU

The Banking Union (BU) remains fragmented and incomplete, which weakens the global competitiveness of European banks and raises the risk of dysfunction in the event of a future shock. The asymmetric impact of the Covid crisis makes it all the more urgent to achieve an EU agreement on a credible way forward to complete the Banking Union.

5.1 The crisis has increased fragmentation across the BU area

An industry representative indicated that the crisis has increased fragmentation, but this is masked by the massive support measures. The risk is that once all these measures start to be unwound the underlying fragmentation will appear. The fragmentation has been masked by the massive liquidity injection by the ECB and the coordinated regulatory response from the European authorities in terms of regulatory, supervisory, and accounting flexibility, as well as the fiscal support measures at the EU level. As a result of this, sovereign spreads remain low. Most of the funding of EU Treasuries has been provided, directly or indirectly, by the ECB, but there are some indicators that home bias has increased with an increasing concentration of sovereign debt in the hands of domestic banks. This implies a latent increase in the doom loop between banks and sovereigns that potentially works in both directions.

A Central Bank official noted that all EU countries promptly adopted measures to support firms and households. However, the design of these measures varied widely. In terms of fragmentation, the implications of the support measures depend on their impacts on banks and sovereigns, and, ultimately, on borrowers. The European banking sector is now in a much more favourable situation than before the previous crisis, with a significant improvement in banks' capacity to absorb the potential losses of the crisis. However, the risk of a less pronounced recovery until vaccination allows for more definitive withdrawal from lockdown measures, and may lead to more acute solvency issues that, if not addressed at the non-financial sector level, will lead to a significant increase in losses in the financial sector

5.2 The crisis highlights the need for a single banking market

An industry representative warned that the risk is that the underlying fragmentation is exacerbated when support measures are unwound, especially if countries exit the crisis at different speeds and with different measures, and there is divergence in the degree of Government support in the exit of the crisis. This is because there is an incomplete BU that is intrinsically unstable. There is no rationale for having an incomplete BU. The review of the crisis-management and deposit-insurance framework that has been put forward by the Commission is an excellent opportunity for completing the BU, and to address the weaknesses of the crisis-management framework seen in recent years.

A Central Bank official stated that regarding the fully mutualised European Deposit Insurance Scheme (EDIS), completing the third pillar of the BU is necessary but not sufficient. There should also be further improvements to the crisis-management framework. More work is now needed on the management of crises for small and medium-sized banks that will fall outside the resolution.

A public representative added that a proposal is expected from the Commission to review the crisis management framework. The dual system of EU resolution and national liquidation needs to be reviewed. There is a need to be better prepared to intervene in order to solve banking problems in the future if the health crisis lasts for longer than expected.

A policy-maker emphasised, regarding the EU crisis management framework, especially the Bank Recovery and Resolution Directive (BRRD), there is a need for a more general overhaul, but not now. Currently it is fit for purpose. Macroprudential policy has worked to some extent. The countercyclical buffers have been released and dividend restrictions imposed.

BU is key and this fragmentation has to be overcome. A single market for banks is needed. The key is to build sufficient trust among all member states for the remaining issues, in particular on EDIS and the crisis-management framework. The same holds for the macroprudential framework. There is no need to react immediately. But there is a question of whether things are good enough countercyclically and whether there is something that needs to be changed in the overall setting of macroprudential tools. The review of this framework is coming at the end of 2022. Next Generation EU is also important when coming out of the crisis.