EXIT FROM COVID MEASURES: IMPACTS ON THE EU BANKING SECTOR

Following the pandemic, EU Institutions, national governments, Central Banks, and supervisory and resolution authorities took unprecedented action to support the economy. At the same time, there are good reasons to unwind the support measures: the public support measures taken so far have prevented the expected disruption from the pandemic on the European economy from fully materialising, the economic recovery seems grounded on a sound path, and the 2021 stress test exercise has revealed the strong position of EU banking sector.

In such a context, a gradual withdrawal of support measures should in principle avoid cliff effects, but the exit from COVID-19 support measures poses several policy challenges.

1. A gradual withdrawal of support measures to avoid cliff effects

Businesses have been less impacted by the pandemic than anticipated. However, there is no room for complacency, even if the European banking system remains resilient enough to cope with exit from COVID-19 measures.

1.1 The mitigating effect of the support from public authorities

A Central Bank official noted that expectations in the early weeks of the pandemic were pessimistic and quite different from how things turned out. However, that result was because of the actions stakeholders took. The response of macroeconomic and monetary policies to this health and economic shock has been extensive and well-coordinated at EU level. Monetary policy, fiscal policy, microprudential supervision and macroprudential supervision all hang together. The Eurosystem acted early and decisively, and in the spring of 2020 EU member states took a wide range of support measures to dampen the impact of the COVID-19 pandemic on the economy. These mainly took the form of public loan guarantees, direct grants, tax reliefs and loan moratoria.

A Central Bank official stated that the number of bankruptcies has been relatively modest so far, and actually lower in the past year than in normal times. As the measures are withdrawn there will be an increase of non-performing loans (NPL). At the same time, it is very difficult to predict the exact level of the effect and which sectors will be more affected, because there has been a diverse set of government support measures, differing across member states.

An industry representative confirmed that counterparts have generally been less impacted than anticipated. Though there is a deterioration of clients' 2020 balance sheets it is not as severe as initially expected. In countries where measures have been lifted, or where measures were more limited, things continue to be under control. This is largely linked to the strong rebound observed in these countries, but generally there is no wave of defaults. The cash that has actually been dispersed in some cases has been used by companies for buffers and are still in clients' accounts. The supporting measures have been efficient not only in postponing the wave of defaults but also in reducing the number of those defaults with an increased level of gross debt.

With liquidity assured, firms found the financial space required not just to stay afloat but also to invest in adaptations. There is generally limited pickup on equity-based products because of the abundance of liquidity in the market and the debt products still available. Leaders emerging even stronger from the crisis are now engaging in a consolidation spread which will help alleviate the burden of viable but overly indebted firms. The market is regulating itself and new players emerging such as private equity firms.

1.2 There is no room for complacency

1.2.1 Addressing the increasing number of NPLs and loans subject to forbearance

A Central Bank official stated that banks need to take decisive action to address the increasing number of NPLs. When provisioning, banks should take into account the withdrawal of the government support measures. Banks need to recognise payment problems for customers at an early stage and find suitable solutions. Supervisors have seen some deficiencies in the credit risk management practices of eurozone banks. Early warning systems were not sufficiently granular, and some indicators of deteriorating credit quality are mainly backward looking.

A Central Bank official highlighted that there are differences among national financial systems. The initial positions of national banking systems were far from equal. Secondly, the use of pandemic support measures differed enormously from country to country. The deterioration in the asset quality of loans under support schemes is becoming increasingly evident. Loans that still have moratoria or public guarantee schemes are riskier. In the event of extended and repeated business restrictions in activities most affected by the pandemic, an increase in NPLs could still be expected. The recently published stress tests confirm that although there remains robustness in Europe there are differences between financial institutions.

A Central Bank official stated that the speed of exiting COVID measures would matter. The support measures, which are why the situation is better than expected, do not come for free. They have some structural repercussions which are not particularly healthy in the longer term. The historically low NPL recordings is an indication that some of the normal market dynamics have been blocked.

An industry representative highlighted that one area of concern might be the use of forborne loans. With the loan moratoria, many loans have been forborne for good reasons, but it was difficult to identify all of the loans forborne in the systems of the banks back when

the asset quality review (AQR) was being conducted. The systems are not very flexible, so it is not always easy to look at the loans forborne because there was a loan moratoria. There may be some loans which were not forborne for a good reason, which will be difficult to identify.

1.2.2 New waves of the pandemic may slow the economic recovery, and emerging financial risks must be addressed

A Central Bank official noted that a new pandemic wave is incoming and ever harsher variants of the virus are developing. The health risks are not yet abolished and nor are the financial and economic risks. A regulator emphasised that if corporate risk is more under control thanks to the policies it is also true that there are new vulnerabilities emerging. There is the risk of sharp asset price corrections, risks on long-term interest rates, inflation risk in the US and more. It is very important to keep an eye on this because, whilst it is good there was not a 'tsunami' of insolvencies, there are not yet completely 'calm waters'.

An industry representative noted that there are many new upcoming risks. Banks and supervisors need to work together to find a way to accelerate the integration of the banking sector, to make sure there are economies of scale. An industry representative stated that one area to specifically draw attention to is the guidance currently in place for leveraged finance. The primary focus of the European Central Bank (ECB) on leveraged transactions, and in particular on highly leveraged transactions, is valid and one area which banks are also very much concerned with. Liquidity is essential. Curtailing financing of highly affected but still viable companies could be very detrimental for them, even though they have high chances of survival.

A regulator remarked that moratoria are de facto at an end. The measures which concern exemptions on the obligation to register insolvencies with courts are also coming to an end. It is important that some public support continues to be there until it is clear that growth is firmly entrenched. There has to be very good use of the growth impact of the Recovery and Resilience Facility (RRF)[1].

An industry representative warned that the crisis has primarily been a sector crisis and measures will need to be retained, and possibly further adjusted, for some sectors. A regulator (Francesco Mazzaferro) added that there is now an opportunity to address the shortcomings in national insolvency frameworks, in order to facilitate the orderly winding-up of non-viable firms. Public support measures will have to change. There will have to be much less focus on liquidity, more selective support and more focus on solvency.

1.3 The European banking system remains resilient enough to cope with exit

The EU banking sector has shown remarkable resilience through the pandemic crisis and is in a strong position overall to absorb losses even in a deteriorated macroeconomic environment.

1.3.1 Banks are part of the solution

An industry representative noted that that there are fundamental differences between the current crisis and other crises faced in the past decades. Usually, the banks were part of the problem, but banks are part of the solution to the COVID crisis. Before the outbreak of the crisis, the banks' clients were globally good and had clean payment recalls. During the crisis, these clients were, and still are, facing a decrease in revenue incomes. The banks' problems are about how to deal with the unlikely to pay (UTP) cases that can cause problems for reimbursing the debt. The public and private sectors have worked together in an efficient manner and the spread of systemic risk was successfully avoided. The banks were able to continue to lend during this period because of the stability there was.

1.3.2 The EU banking sector can deal with the increase of NPLs

An industry representative stated that there was pessimistic forecasting in the summer of 2020 about the number of NPLs in the eurozone. This has not happened as predicted, and currently there is one of the lowest NPL ratios in history. The industry has observed an increase of clients in IFRS 9 stage two. The staging put credit facilities in a less comfortable zone where banks had to take more provisions. However, the banks are better prepared. Thanks to Basel and the last financial crisis, the banks are more capitalised and can better absorb the unexpected credit risk. The peak of the NPLs could occur in 2022, but the banks have more provisions to face this. If NPLs are spread over time, the banking sector will resist. If it is sudden and concentrated, then this could cause a problem to the stability of the sector.

A Central Bank official stated that there is confidence that the eurozone banks will be able to cope with the increase in NPLs. The stress test results confirm that the eurozone banking system is resilient and in an overall strong position to absorb losses in a deteriorated macroeconomic environment.

An industry representative added that the level of provisioning increased significantly in 2020, which means all NPLs have been better provisioned, but as a number of loans have been moved to stage two the level of provision has also increased. When considering where it has increased, generally it is not coming from the usual models because they use historical data and, as defaults were not there, they have less data. The adjustments post-models have been very important and show that the banks are prepared to take into account the increase in risks, which they have already done in 2020.

1.3.3 The EU banking sector has the capacity to lend but needs to improve its profitability

A Central Bank official noted that Danish banks have an incredible capacity to lend, not only given the solvency situation but because banks have introduced negative interest rates on deposits in order to scare away some of the excess liquidity which does not work particularly

1. The EU package has not only been designed to boost aggregate demand in the medium term but also addresses long-term challenges such as greening the economy, Europe's lag in digitalisation, country-specific structural challenges and economic resilience in general.

well. They are quite eager to lend and they can do it under normal conditions. Insolvencies will increase, but that is something which happens in a normal, functioning market economy.

An industry representative emphasised that the capital position of the banking sector has never been as high, thanks to all of the measures taken by all of the banking supervisors after the first crisis. The banking sector as a whole can withstand huge stress tests, albeit with some differences between countries and banks. If they can absorb potential additional losses, then that will also have an impact on the profitability of the banks. It is necessary to have new measures to accelerate the integration of the banking sector to improve the profitability of the banks.

2. The necessity of the withdrawal of support measures and the policy challenges

There are good reasons for exiting the support measures. The timing and sequence of withdrawal of support measures need to be well calibrated in order to avoid a cliff-edge effect that can jeopardise all the efforts accomplished. Exiting is happening now. Most moratoria are expiring and, in any case, will be expired by the end of the year. Public guarantees are also expiring. Some sectors or activities, such as hotels and restaurants, remain affected and could require further support or face widespread restructuring. Looking ahead, an optimal allocation of resources towards innovative and sustainable uses must be ensured and the heterogeneity of fiscal performance across Member states also needs to be addressed.

2.1 Good reasons for exiting the support measures

An industry representative stated that there are good reasons for exiting the measures. There has to be consideration of returning to economic fundamentals. The question is whether this current period of stability is artificial or strong stability. Everything is also based on gross domestic product (GDP) growth, natural growth and firm growth. There is also the trust and confidence of the population. These are the key fundamentals of the economies. The exiting is happening because the measures are expensive and because the indicators are brighter. The lifting of the measures should consider the industries that are still very fragile. There are industries that have been over-performing during the crisis which should be lifted from the measures. The US and China have already largely recovered from the crisis. There is optimism about the ECB response to the pandemic and the ambitious NextGenerationEU programme.

2.2 The sequence of withdrawal has to be well calibrated

A Central Bank official stated that there is additional risk from exiting support measures too soon or not doing so prudently. The support measures have been timely and well-coordinated, and that should also be the case for exiting them. They should be lifted gradually and in a balanced way. The immediate withdrawal of all support measures could lead to adverse pro-cyclical effects. However, being too slow to remove the measures could lead to additional financial stability risk. To avoid unwanted negative effects the exit measures should be communicated clearly and in a timely manner and supported by other measures such as the Capital Markets Union (CMU) and bankruptcy legislation.

An industry representative emphasised the extraordinary nature of the current crisis, with its unprecedented sector heterogeneity and likely permanent changes to consumer and business behaviours. Some of the particularly impacted sectors will need more measures to remain in place for a longer time.

The tools have already been well identified and have proved to be performing. Ultimately, it is about supporting the economy, ensuring the positive dynamics of the market and supporting banks. Looking at the monitoring tools, there is the targeted longer-term refinancing operations (TLTRO), the conducive rates at the moment, budgetary and investment stimulus, which is already on the cards in the EU, and also facilitation of the digital, green, new ways of living and working conditions, which have been accelerated by the crisis and are absolutely fundamental to continue to attract investors' interests.

For banks, the results of the stress testing again demonstrated the resilience of the industry and the provisioning steps that have been made in terms of stage two buffers.

2.3 Three issues to tackle

A Central Bank official highlighted first that government liquidity support measures could end by them expiring and possibly being replaced by bank lending, but some incentives to exit government liquidity support could be considered by introducing interest rates or making credit assessments to transfer some of these measures to the banking sector. Secondly, transparency has to be brought back to the accounting and reporting of bank exposures. Thirdly, there has to be preparation for the other side. That could be the other side of a housing boom, which is prevalent in quite a few countries, pressure in the goods and labour markets and maybe somewhat higher inflation and interest rates. It is not obvious that there is readiness for higher interest rates.

Denmark had an early and strong rebound, and widespread pressures in quite a few markets. In terms of government support, Denmark relied more on postponing tax deadlines and government lending. Without credit assistance and interest rates it is possible to lend compared to what is normally reported for tax revenues. There is now much better micro data compared to only a few months ago. Those companies that took up the measures are less liquid, more indebted and have a lower credit quality for their exposure to the banks.

2.4 Exiting is already happening

A regulator stated that most moratoria and public guarantees are expiring. Any deterioration of asset quality should be appropriately reflected in bank balance sheets. Banks have to be stronger for when the public support is withdrawn. There should be consideration of instruments like tax incentives and other possible public support measures through which banks could be encouraged to actively engage in the restructuring of viable debt. Restructuring will probably be the most important instrument of recapitalisation of the non-financial corporations. The Commission's NPL

action plan has to be implemented and Basel III must be fully implemented.

A Central Bank official suggested that in some cases the exit could be sped up, but if there is a credible strategy in place and it is well communicated then it should run its course. Many banks are eager to return to normality. They have the capacity to lend and have, to some extent, interpreted government support measures as a substitute for their own lending. There will be losses to bear, and not only in the banking sector. If the government has issued lending with no credit assessment and no interest payments then they will also bear losses. By waiting longer, these losses will rise and distortions of some market conditions grow.

Government support measures may ensure that labour continues to have an attachment to companies during a lockdown with a low level of activity. But this becomes structurally unhealthy during the recovery where labour shortages are becoming more and more prevalent in other parts of the economy. However, it might be relevant, for vulnerable sectors, to maintain the attachment of labour to these industries since it might become difficult to regain that labour afterwards.

2.5 Returning to market dynamics

A Central Bank official emphasised the importance of realising that the economy is moving in a structurally different way. The way people shop, spend their free time and work will be different from pre-COVID times. Moreover, the virus may be present for years still. Removal of government support measures should proceed, but there are also productivity impacts for the economies in Europe the longer that is delayed. Air travel will not get to pre-COVID levels for a long time and more people are needed in the health sector. The longer government support measures continue the longer these inefficiencies and lower productivity will exist within the economies.

It is important to return to market dynamics. To some extent this has already happened. The second and third waves have been coped with better than the first wave. However, there is a cost in prolonging the government support measures, so there should be a proper pace to moving ahead, because it is also hampering dynamics such that it is delaying the adjustments in economies. Policy support should not hamper structural adjustment as this could undermine productivity growth.

Regarding the specific measures for the banking sector and the relief measures, there is also a need to move ahead. By the end of this month there will be an end to the dividend restrictions. Single Supervisory Mechanism (SSM) guidance must be given on the ending of the relief measures related to leverage and Pillar 2 Guidance (P2G).

There have also been some stories about trying to connect the Basel reforms and their implementation to this recovery. There is no such connection. There will be a longer implementation, and the Basel reforms should be proceeded with while making sure that is done in a consistent, timely and full way in the EU.

2.6 The ongoing role of regulators and supervisors

An industry representative stated that many would agree that the sectors and assets most affected by the crisis differ from previous crises. In Spain, recent evidence suggests that the non-financial corporate sector is proceeding fairly well with the crisis. This is down to the public measures but also the better initial conditions of the sector in comparison to the last financial crisis. In 2020, the consolidated debt on non-financial corporates grew 12%, reaching 85% of GDP, which is far from the 120% peak that Spain reached in 2009/2010.

However, the full face of the crisis remains to be seen. There is a wide range of corporates to consider, and small and medium-sized enterprises (SMEs) could be particularly affected. Many SMEs were able to navigate the crisis, supported by fresh credit from banks, but their future may be compromised because of the level of debt they reached during the pandemic.

An industry representative noted that to help viable companies have access to the finance they need, or to even structure their financial obligations, three types of measures could be taken. The first is on the fiscal side. That was mentioned before with the opportunity for some public support. That will be necessary to accelerate some additional public supporting measures to viable but highly impacted SMEs. This could be in the form of direct fiscal stimulus.

The second type of policy is regulation. The regulatory rules should provide enough flexibility for banks to be able to differentiate between viable and non-viable companies, avoiding something like an 'automatism bias' in the regulation applicable to exposures classification, especially to SMEs. In particular, provisions should be allocated to exposure to non-viable companies, while re-financing of viable projects should be encouraged by avoiding undue costs for banks.

Finally, there is supervision, which should go hand in hand with regulation. The flow of finance to viable SMEs could also be supported by avoiding something like an 'inertia bias', where some supervisory approaches aimed to address legacy issues from previous crises, or which would be more suitable for normal times, are applied to times like the present. These three kinds of policies could help to sustain credit.

2.7 Addressing the heterogeneity of fiscal performance across member states

The Chair noted that there was a question from the audience on whether small and medium-sized banks, in this very low interest rate environment, will be able to lend, given the restrictions and constraints the low interest rate environment put on profitability.

An industry representative remarked that it is a difficult question. A gradual, balanced removal of any support measures should be welcomed, and this is happening right now, with measures being exited, but there has also been an extension of the measures. The stability of the measures is something that countries and authorities are well aware of. On monetary policy, economic and financial indications and the outlook should remain central for the final withdrawal of the stimulus.

An industry representative highlighted that, in Spain, economic indicators have improved markedly over the summer. Economic activity is expected to reach pre-COVID levels during 2022. Despite the impact of COVID

on tourism, employment in August reached the level of February 2020 and less than 2% of employees remain on furlough schemes.

Domestic tourism has performed extraordinarily well and has partly offset the continued weakness in international tourism. Some sectors may lag behind and it may take time for some companies to fully recover, so in this sense they will avoid ill effects and err on the side of caution when deciding on the final withdrawal of the stimulus measures.

Regarding monetary policy, there is stimulus on the monetary side in the context of a low interest rate environment, which puts pressure on banks, for example compressing their net interest margins. The monetary policy might be usefully complemented with fiscal policies. These fiscal policies could focus on supporting viable companies with good growth prospects. Also, structural reforms in countries should be supported.

An industry representative highlighted the heterogeneity of fiscal policies across member states. A significant part of the policy responses has pivoted on countries' own fiscal capacity, but this fiscal capacity is quite heterogeneous across the EU. This heterogeneity could be a source of fragmentation, and cross-border negatives could spill over to other countries. As a result, further efforts might be necessary to avoid differences in the levels of public support provided to the private sector and it turning into gain for some countries at the expense of others. That is something that should be addressed.

The Chair thanked the panellists for the discussion. Two good messages came from the discussion, which would be good starting points for the conference. There was confirmation about what was achieved with the measures in keeping the banking sector healthy, and there has been good news and a good message on the capability of lending. At the same time, there is a call for caution in removing the support measures. That concerns the current learning experience all are going through. The Chair noted that this is not a one-way street and thanked Eurofi in that regard. Public policymakers will have to move on this.