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Decisive action for a strong European banking sector

The COVID-19 pandemic is hitting the European economy and our financial sector at an already challenging time. Economic growth in many European markets has already been relatively subdued even before the pandemic, while sovereign debt levels in many countries are elevated, if not even at record levels, and monetary policy room to manoeuvre is limited due to low rates and quantitative easing. Authorities across the continent have nevertheless pulled off a remarkable set of economic stabilization measures to instill confidence to employees, corporations, financial markets and society at large. The current economic crisis is also an important test for the European banking sector. It's certainly too early to make a final call but there are some meaningful observations that can be made already today.

Strong and effective collaboration among regulators and authorities has been key to mitigate the effects the pandemic has on the economy to the extent possible. This includes temporary reliefs on capital and liquidity requirements to allow banks to serve the real economy. However, banks will need to demonstrate prudent lending practices and avoid adding on low credit quality. This is particularly important as many European banks are still struggling to adapt their business models and operate a sustainably profitable business, due also to structural issues as well as the expansive monetary policy, which has severely impacted a main income stream of the banking industry for a prolonged period of time.

In other words, the European banking industry enters the COVID-19 crisis period having not even fully digested the consequences of the financial crisis. The longer-term implications of the short-term stabilization measures need to be considered carefully. UBS research shows that only around 25% of the 40+ largest European banks would have earned their cost of capital if you were to adjust their 2019 return on tangible equity for the average loan-loss-provisioning rate of the years 2000-2005. And the 2019 ZEB European Banking Study forecast that, already in the baseline scenario which assumed that interest rates, profit margins and loan loss provisions would remain at 2018 levels, Europe's top 50 banks were expected to see their RoE halve over the next five years, mainly due to higher regulatory requirements.

Particular attention is therefore required in the following areas:

- Expansive monetary policy will add further pressure on the banking systems' Net Interest Income (NII) in an environment where Eurozone NII at the beginning of 2020 was already 45% lower than in 2007.
- Loan losses will be smoothed by public stabilization measures and some adjustments to accounting standards. However, banks, especially those banks with sizable non-performing loan portfolios, must avoid loading their balance sheets with low credit quality and associated future losses, which would further weaken their profile. There will need to be a fine balancing act between supporting the real economy and due risk management in such a highly uncertain environment.
- While central bank liquidity support is needed and welcomed, it should not be the main determinant of bank lending in the short- to medium-term. In an environment in which the ECB's term facilities have been funding around 15% of bank lending in some jurisdictions, this will require a significant broadening of funding sources for many European banks, potentially at a higher cost than that which is currently available.

In addition to these COVID-19-related factors which need to be addressed if and when the circumstances allow, a number of strategic measures by banks and policymakers can help enhance the resilience of the European banking sector in light of these threefold pressures.

On the one hand, banks will need to accelerate the adoption of new business models and, with the appropriate framework set by policymakers embrace the consolidation of the industry, focus on fostering critical size and enabling necessary investments in new technologies to support structural changes.

Decisive action both by authorities, including regulators and central banks, and the banking industry will help to translate the threats of the crisis into an opportunity of building a stronger banking industry in Europe which is crucial to foster a positive economic development in the post-COVID-19 period. ●