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The Corona crisis: a chance to build a stronger and more viable banking sector

The outbreak of the Coronavirus has brought huge social disruptions and unprecedented economic challenges. Banks have entered the crisis on a sound footing thanks to the post Great Financial Crisis' (GFC) reforms. Capital ratios are relatively high, with a CET1 ratio of 14.4% in Q1 2020, which compares with 9% in 2009. Management buffers of capital above supervisory requirements, and the release of macroprudential- and other supervisory buffers have provided room for banks. However, expectations for banks to manage this crisis well are high. Banks are also maintaining stable liquidity positions, with LCR at 148.9% in Q1 2020 (149.9% in Q4 2019). Banks' funding compositions are moreover healthier nowadays than at the outbreak of the GFC, not least thanks to higher shares of deposits from households and non-financial corporations in the overall funding mix. Banks are also making strong use of favourable conditions on wholesale funding markets, and quickly resumed issuance activity of debt instruments across the capital structure after funding markets were temporarily closed following the outbreak of the crisis.

While solvency and liquidity ratios are providing certain comfort, concerns are significant when it comes to the outlook for profitability and asset quality. Average return on equity (RoE) contracted to just 1.3% in Q1 2020, mostly driven by declining net interest and trading income as well as rising cost of risk. Persisting underlying weaknesses, such as low interest- and lending margins, are expected to exacerbate in the even longer for lower interest rate environment. The expected asset quality deterioration in the evolving economic downturn will likely result in markedly rising impairments. Cost of risk already sharply increased to 81bps in Q1 2020, after it had mostly been around 50bps in the past two years. Intense competition and overcapacities in many banking markets, coupled with sticky operating costs, pose further profitability challenges. Online banking and technological solutions are thriving in the crisis, and many banks will face additional needs to embark on ambitious but costly digitalisation strategies.

It is paramount that banks keep on supporting the economy. The EBA encouraged supervisors and banks to make use of the flexibility embedded in the regulatory framework. Several competent authorities released buffers accordingly and allowed flexibility for banks to operate below their Pillar 2 Guidance (P2G). The EBA has emphasised that capital relief should be used to finance the corporate and household sectors and urged banks to refrain from dividend distribution and share buybacks.

Banks legitimately request more clarity about the timing of reintroduction of buffers, as well as a potential lifting of the dividend restrictions. More certainty on these aspects is key but needs to go hand in hand with more certainty on the path of the crisis and its economic impact.

Notwithstanding unparalleled fiscal, monetary and supervisory measures deployed by EU and national authorities, the economic crisis will hit the sector hard, particularly in terms of deterioration of credit quality and profitability. Our analyses show that the sector is overall resilient, but banks that entered the crisis with lower capital levels, poor business models and riskier exposures may face challenges. In addition, second waves of contagion and a delayed economic recovery could further weaken the banking sector.

Pre-existing elements of weakness in the banking sector must not exacerbate the crisis. The need to address overcapacities and advance with banking sector consolidation will become ever more important and supervisors are supporting measures to facilitate such process. Addressing overcapacities includes mergers and enabling non-viable banks to exit the markets in a sound and orderly fashion. A coherent and consistent application of the European resolution framework will be important where banks may become non-viable in the crisis. Although the challenges ahead are huge, the crisis might as such offer the chance for the banking sector to leave it behind stronger and more advanced. ●