CHALLENGES FACED BY THE EU BANKING SECTOR

EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board, European Central Bank (ECB)

How healthy is the European banking sector in the pandemic?

On 11 March 2020, the World Health Organization declared Covid-19 a pandemic.[1] The very next day, ECB Banking Supervision announced its first supervisory relief measures with a view to giving banks the breathing space they needed to continue supporting viable households, small businesses and corporations. That policy, which was fully consistent with the decisive action taken by other public authorities in the EU, has been a success. At the end of 2020, the ECB was generally satisfied with the prudential situation in Europe's banking sector. Nevertheless, many uncertainties remain, with European banks facing four clearly identifiable challenges as regards their financial health.

The first issue relates to credit risk, which is one of the most immediate challenges facing the European banking sector. When loan moratoria and other policy measures (such as government guarantees) that have been used to support the real economy are phased out, solvency risk may rise at the most affected firms, potentially resulting in an increase in non-performing loans. Consequently, banks should proactively manage credit risk, reclassifying loans on a case-by-case basis and ensuring prudent provisioning.

While it is true that banks went into this crisis with improved asset quality, they may find, when support measures expire, that their asset quality and capital adequacy deteriorate again. Banks need, therefore, to have a comprehensive and forward-looking credit risk strategy that allows for adequate provisioning and efficient management of asset quality.

What challenges are European banks facing as regards their financial health and how can they be addressed?

Second, banks' interest income and profitability levels have fallen further in the course of the pandemic as a result of increased impairment, loan moratoria and declines in lending rates. At the same time, commission and fee income has also declined amid strong competition.

Third, pre-existing vulnerabilities (such as banking overcapacity, lingering cost inefficiencies and increased competition from non-banks, particularly fintech and big tech firms) are putting additional pressure on banks to adjust their business models and make them more sustainable. Banks should, for example, increase their use of digitalisation in response to the pandemic.

Fourth, the COVID-related protection schemes that have been established by European governments have resulted in surging public debt ratios. Consequently, a significant increase in banks' exposure to domestic government debt could potentially give rise to a sovereign-bank nexus, which could, in turn, trigger the return of adverse feedback loops between weak fiscal positions and weak banks in some countries if concerns regarding the sustainability of public debt were to re-emerge.

All of these challenges have been addressed in our supervisory priorities for 2021, with credit risk being our key area of focus this year. However, this is not something that we can deal with on our own. It is essential to have a harmonised European crisis management framework to make Europe's banking sector healthier and more resilient.

For example, it is important to avoid "limbo" situations after banks are declared failing or likely to fail (FOLTF), thus ensuring that a bank which is declared FOLTF and is not subject to resolution is wound up and exits the market within a reasonable time frame. It seems that national implementation of the revised version of the Bank Recovery and Resolution Directive (BRRD2) will not be sufficient to achieve this objective in all Member States, so further legislative amendments should be considered in order to harmonise the definition of "orderly winding-up".

Furthermore, in order to foster such orderly winding-up, it is important to expand the available toolbox across the EU with a view to properly managing exits from the banking system for all types of unsustainable bank (including those not eligible for resolution as defined by BRRD2) in full consistency with the aims and mechanisms provided for in that directive.

1. https://www.who.int/director-general/speeches/detail/who-director-general-s-opening-remarks-at-the-media-briefing-on-covid-19---11-march-2020

JEAN
LEMIERRE
Chairman, BNP Paribas

What are the priority measures that would enable the EU financial industry to contribute to a strong and rapid recovery in Europe?

Since the beginning of the Covid-19 crisis, banks have provided support to their clients, through moratoria, credit lines drawn, and loans, with or without public guarantees. The economy was also supported by massive measures at European and national levels, considerable fiscal support, prompt resumption of the ECB asset purchase programs and TLTROs, as well as targeted measures to operationalize the flexibility embedded in the accounting and regulatory framework.

From a policy standpoint, this response to the crisis has been a success, with corporate bankruptcies still at a low level, job losses contained, and financial stability maintained, despite the unprecedented drop in EU GDP.

While we can see positive signals of recovery in 2021, notably given progress in vaccination, uncertainty remains high, and the crisis will have profound impacts in some sectors, while others will show robust recovery potential. Banks will again be at the core of the new phase, unavoidably affected by some rise in NPLs, and at the same time actively involved in financing liquidity needs, consolidating debt, and providing equity or quasi-equity to enable viable corporates to absorb the shock and invest into the future recovery.

While regulatory and fiscal support is likely to be progressively phased-out, monetary policy is expected to remain accommodative to support the economy but will continue to weigh on bank's earning generation. EU and national recovery plans must be deployed urgently to boost growth and job creation.

The experience of the last year has shown the resilience of diversified and integrated bank business models, which have benefitted from a more robust earnings generation capacity and have been able to gain market share by supporting their clients across a broader range of financial needs, from cash to capital markets. Diversification as a factor of resilience is not embedded in the regulatory framework, which rather penalizes size, and should be taken into account by supervisors.

For banks to continue to efficiently support the European economy, they should not be handicapped by unnecessary regulatory pressure that would have recessive effects...

EU banks' earnings generation capacity is already affected by the combination of structural (competition by unregulated entities such as non-banks and BigTechs) and conjunctural (low/negative rates, decreasing credit quality and NPLs) factors. Such earning streams should be mobilized by the banks to the benefit of their clients, to restore a productive, innovative, job-creating, and greener economy.

For banks to continue to efficiently support the European economy, they should not be handicapped by unnecessary regulatory pressure that would have recessive effects:

- Contributions to the Single Resolution Fund should not be inflated by the significant increase in deposits resulting from the abundant liquidity creation by the ECB, and the flexibility embedded in the regulation to increase the IPC from 15% to 30% should be used.
- The Basel finalization package needs to be implemented in Europe in the respect of the "no significant capital increase" mandate, respecting the European specificities and the level playing field with other key jurisdictions, notably as regards to FRTB.

In the current environment, this is also crucial to ensure Europe's financial sovereignty, preserving the capacity of European banks to serve sovereigns and corporates, in the highly competitive capital markets activities.

LUÍS MÁXIMO DOS SANTOS
Vice-Governor, Banco de Portugal

Unusual crisis, unusual measures, big challenges

In November 2020 at the ECB Forum, in the recent past ordinarily held in Sintra, Portugal, the President of the ECB, Christine Lagarde classified the economic crisis caused by the Covid-19 pandemic as being a "highly unusual recession".

This is undoubtedly a deeply uncommon crisis for having originated in a pandemic (something we knew could be a real risk, but in fact only admitted in the abstract), due to its global and strongly synchronised nature, for a supply and demand shock materialising simultaneously and, of course, for the dimension of the damage caused to the economic and social environment.

But the response of the political, economic and supervisory policymakers has also been uncommon due to its speed, the high degree of convergence and coordination at Portuguese and European level, and to the fact that different instruments were used in hitherto unseen dimensions: monetary policy and budgetary policy, as well as employment policy, social policy, regulatory and supervisory policy.

In regulatory and supervisory terms, macro and microprudential instruments were used, and similar action was taken in terms of conduct supervision.

Acting in this way produced results that were very positive inasmuch as they avoided greater ills: financing capacity to enterprises and households was maintained and liquidity was ensured, productive capacity was preserved, more drastic falls in employment were avoided and drops in income were mitigated. On the other hand, the approval of an unprecedented volume of European funds to support the recovery of the European Union's economies, a large part in the form of straight grants, gives credence to forecasts for growth in the near future.

We should learn a lesson from this fact: the instruments at the disposal of public authorities are quite powerful if managed in a timely, coordinated and convincing way.

> **The near future will be very demanding for the European banking sector. The pressure on profitability and asset quality, for example, will be high.**

We are still at a stage of the crisis where we are hostages to the health situation and developments in the pandemic. This means therefore that we are in a situation of high and atypical uncertainty. The vaccination process, notwithstanding its difficulties and setbacks, has changed expectations for the better, giving a feeling of hope even to those sectors most affected by the pandemic, that is, those that depend more directly on people's mobility.

We know that a recovery path is forecast for 2021 and 2022, but its real dimension is still quite uncertain.

The European banking sector is currently much more capitalised and robust than during the financial crisis and therefore much better prepared to take on the pandemic-induced crisis. For example, Portugal has seen a significant reinforcement of capital ratios in recent years, a very considerable improvement in the quality of credit portfolios, a structural adjustment in liquidity that reduced the system's vulnerability to changes in international investors' risk perceptions, a significant reduction in operational costs and even a gradual recovery in profitability.

We do not know yet the depth of the structural changes that will be caused by the present crisis. How will consumers behave? How will investment be encouraged, especially in the private sector?

With the data already known, it seems clear that the asymmetries and inequalities tend to intensify within each country and across the European Union. If it is true that the effects of the pandemic crisis are cross-cutting, they are, however, quite far from being symmetrical, given for example the different composition of the economies of each Member State, clearly penalising those economies most dependent on tourism. In this context, it will be difficult to understand why the banking union is not completed sooner.

The global geopolitical framework is also at a stage of notable tension and readjustment, which in itself is a factor of instability. Even if the most optimistic scenarios come to fruition, the near future will be very demanding for the European banking sector. The pressure on profitability and asset quality, for example, will be high.

The time we live in requires banking management much more focused on each customer, their problems and potential. In turn, Portuguese and European authorities must remember that to be successful in their policies, notably in defining a moratorium exit strategy, they will once again have to be timely, coordinated and convincing.

DENIS BEAU

First Deputy Governor,
Banque de France

Challenges for the EU banking sector in the Covid context: no time for complacency

The Covid-19 pandemic has strongly hit the economic tissue worldwide. Nonetheless, the absence of major impacts on the banking sector vindicates the Basel III framework put in place over the last decade. The quick action taken by European supervisory institutions, like the dividend ban, the CRR "quick fix" or the release of the P2G, and macroprudential buffers by national macroprudential authorities also brought additional support. As a consequence, banks have been able to keep strong solvency and liquidity positions, while continuing to finance the real economy.

Indeed, credit has remained dynamic across Europe: for instance, in 2020, France has recorded a 13.1% growth of loans to resident Non-Financial Corporations (NFCs, including SMEs). Here again, the policy response to the crisis is to be credited, as governments have implemented ambitious measures to support the economy and lending, such as moratoria and state guaranteed loans (SGL). Banks have also been strongly committed: in France, they have distributed widely and swiftly the scheme enforced by French authorities (SGL have accounted for 130 bn euros in 2020, out of 436 bn euros of new loans to French NFCs).

The way these supporting measures will be removed is flagged as a risk for financial stability in Europe. While the exit strategy is to be carefully tailored, the cliff effect scenario remains a low probability event, given that the consequences of sudden exit from supportive measures are on the governments' screen. But the alternative risk, meaning the risk of overindebtness and "zombification", in particular of the corporate sector and the associated build-up of financial vulnerabilities must be also taken care of and not underestimated.

For banks, this means that, while for the time being the pandemic economic impact has not resulted in an increase of non-performing loans, globally for SSM banks, an increase in corporate defaults is not to be overlooked. Credit risks must be therefore proactively managed, and provisioning must remain prudent. In addition, uncertainty remains high and strong structural challenges still afflict the European banking landscape. The profitability of European banking institutions remains a source of concern: while they displayed returns on equity close to their main US competitors before the great financial crisis, they now lag far behind.

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

The causes of this discrepancy are manifold and so are ways of improvements. Among them is the shift to digital banking, which could ultimately lead to a reduction of operating costs and increase the ability of banks to compete with non-banking actors. Moreover, the European banking system remains too fragmented, and consolidation would provide significant improvements. The institutional setup being completed with and effective Single supervisory mechanism and European resolution framework, the conditions are now favourable for the emergence of cross-border banking and insurance groups.

Lastly, the pandemic is a reminder of the need to anticipate emerging financial risks, especially those related to climate change. As stated by the Network for greening the financial system (NGFS) last June, the sweeping disruption of the economy following the onset of the pandemic could illustrate to a certain extent what we could potentially experience in an increasingly unstable climate or following a disorderly transition shock.

These risks must be proactively tackled. Significant work initiated by the NGFS in recent years are finally finding their route towards regulatory developments, with Europe and France being front-runners: the European Banking Authority is mandated to propose venues to integrate ESG risks in the three pillars of the prudential frameworks while the European Central Bank will implement a climatic stress-test exercise in 2022, following the path of the Banque de France.

Initial reflections by the Basel Committee and the Financial Stability Board at a global level respectively on the adequacy of the current prudential framework to allow the inclusion of climate change-related risks and the way to close data-gaps are essential developments which needs to be forcefully pursued.

JONÁS FERNÁNDEZ ÁLVAREZ

MEP, Committee on Economic and Monetary Affairs, European Parliament

Time to complete the Banking Union for a strong recovery

The EU institutions have thus far responded adequately and in a timely fashion to the economic and financial challenges stemming from the impact of the Covid-19 health crisis and the resulting social distancing measures. The Commission quickly adopted a flexible interpretation of the Stability and Growth Pact in order to allow for the use of more expansionary fiscal policies by member states. In addition, it spearheaded the process of building support for national unemployment insurance (through SURE) and presented a revision of the Multiannual Financial Framework (MFF), supplemented by the Next Generation EU (NGEU).

Furthermore, the European Stability Mechanism established a Pandemic Crisis Support instrument, based on its Enhanced Conditions Credit Line, available to all euro area countries, by which to cover direct or indirect expenses derived from the pandemic, but still unused until now. In addition, the EIB has broadened its program of guarantees to support the efforts of the national development banks. All of these fiscal efforts have been backed by the ECB, particularly through the Pandemic Emergency Purchase Program (PEPP), which, together with previous asset purchasing programs, has allowed for the financing, at the end of the day, of public deficits through the secondary market.

In one way or another, the short-term response to survive the confinement economic impact have included direct financing by member states, with European coverage, as well as, starting in 2021, additional efforts to stimulate the economic activity financed directly and more thoroughly by the EU (MFF + NGEU). That said, the health crisis is lasting longer than expected and has been deepened by the subsistence of structural problems that already existed in the pre-pandemic world, thus likely leading to structural changes in our economy. This prolongation of the crisis is making difficult the functioning of previously planned support policies, which, in turn, is pushing member states to create new solvency support instruments.

It is now in our hands to avoid this and to finally complete the Banking Union.

However, the longer the health crisis endures, the bigger the public intervention needs to be in order to avoid an economic collapse. At the same time, underlying structural changes will happen more rapidly and will lead to necessary reforms in some sectors. Thus, the stretching of the health crisis makes it more difficult to implement micro programs that are more adjusted to the medium-term. This environment would therefore impede the so-called Schumpeterian concept of 'creative destruction'.

This being true, the current situation is also hampering a sufficiently 'micro' approach to the deployment of support measures. As such, we will observe an increase in the amount of Non-Performing Loans in the upcoming months that, at this moment, is difficult to measure. This will impact on bank's balance sheets and, for that matter, the stability of the entire financial system.
The EU has proposed certain measures to slow this impact through the Capital Requirements Regulation (CRR) 'quick fix' revision. Predictably, the revision of the CRR/CRD (Capital Requirements Directive), which stems from the implementation of the Basel Framework, should become more flexible to allow banking entities to absorb the increase of bad loans. This adaptation should also affect the management framework for banking crises, the BRRD, whose reform proposal is foreseen for late 2021.

At this time, the final impact of this recession upon the banking system remains unclear, with medium-term return rates currently unsustainable. For all of these reasons, the EU must swiftly prepare itself and invigorate the debate for the construction of the European Deposit Insurance Scheme, facilitating the implementation of a European crisis management framework. The Union must, among other things, revise the definition of "public interest" in order to facilitate access to European funds in case of a bank resolution or liquidation. Priority must be given to a strategy of "business for sale", thus reducing national discretions within the Banking Union.

Until now, the banking sector has been key in supporting the European economy, making part of the European solution. However, the prolongation of this health crisis will heighten the risk of a spillover into the financial sector. It is now in our hands to avoid this and to finally complete the Banking Union.

BOŠTJAN VASLE

Governor, Bank of Slovenia

New and old challenges for European banks

In less than a decade, banks in the EU have gone through post-crisis cleaning up of balance sheets, recapitalisations, and strengthening of regulatory and supervisory frameworks. The banks entered the COVID-19 crisis better capitalized and more liquid than in 2008, but many still had pre-existing fragilities such as subdued profitability, while others also had elevated NPEs. The current economic crisis reverses some of the favourable trends in the banking system and exacerbates pre-pandemic challenges.

The imposition of pandemic-related lockdowns led to a faster GDP decline than the 2008-2009 financial crisis. Due to a sharp decline in revenues, enterprises in many countries were urgently seeking liquidity relief, deferrals and new financing. Banks responded well to such demands. The flow of liquidity from banks to households and businesses has remained smooth also thanks to swift and wide-ranging policy measures.

These have: (i) provided banks with cheap access to abundant liquidity (ECB's TLTROs and PEEP), (ii) transferred some of the credit risk to governments (public guarantee schemes for deferred loans and new financing), (iii) provided favourable prudential and accounting treatment of EBA-compliant debt service moratoria, and (iv) increased banks' credit potential with the relaxation of capital and liquidity buffer requirements.

In the face of extensive support measures, the effects of the crisis on banks' balance sheets have so far been limited, though visible. The early signs of asset quality deterioration can be seen in the form of an increase in the volume of forborne loans and a rising share of stage 2 loans (in line with the IFRS 9), and some countries have reported moderate increases in the NPE ratio. Banks have started increasing loan-loss provisions, which together with further net interest margin compression has dampened their profits.

The negative impact of the crisis on banks is likely to become more visible this year and fully over the coming years, as various relief measures phase out or narrow. Banks have more insight and knowledge about their clients than the government, so it should soon be up to them to evaluate the eligibility of their clients for loan restructuring. Banks should recognise troubled loans in a timely manner, form adequate loan-loss provisions, identify viable firms and embark on case-by-case treatment of struggling clients.

For smaller banks, addressing structural changes and rising NPEs might be more challenging.

They should not hesitate to recognize incurred losses and dip into capital buffers, and some might have to consider raising fresh capital. It is important to support the timely resolution of NPEs, so that they do not accumulate on banks' balance sheets, where clear supervisor expectations regarding the recovery of capital buffers and development of a secondary market for distressed assets play an important role.

Damage to the banks' balance sheets will depend crucially on the duration of the crisis and thus the consequences it will have on the economy, unwinding of crisis intervention measures and the composition of bank assets. Smaller banks are in a less favourable position due to higher exposure to SMEs. Even before the current crisis, they had on average relatively high forbearance and NPE ratios, and in the last year they have notably reduced the coverage ratio of NPEs. While they have less staff and expertise to address increasing NPEs, they now have some experience from the previous crisis and detailed guidelines for monitoring of clients and management of NPEs.

The pandemic crisis 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. This further increases challenges to banks' business models, even more so for smaller ones. Searching for higher returns by focusing on riskier loan segments, as observed in the last few years, is not a viable path. In this crisis, banks have taken a step forward in digitalisation.

While this can help to streamline operations and offer new digital services, it poses a disproportionate cost burden on smaller banks. Partnerships with FinTech firms might help to overcome such challenges. Overall, the way forward is also further consolidation, which accelerated last year and is likely to continue in the coming years.

PER CALLESEN
Governor, Danmarks Nationalbank

Back to markets

The outbreak of the Covid-19 pandemic has caused significant declines in economic activity. As opposed to the financial crisis, banks have not been part of the cause of the crisis, and have so far not been substantially affected. Suspension of dividend payments and release of capital buffers have increased capital levels, and banks have made provisions expecting a large deterioration in asset quality with lower profitability as a result. Large losses are, however, yet to materialize.

This is not least due to extraordinary support measures from governments and the EU. Crisis-related discretionary fiscal support measures in 2020 amounted to close to 4 per cent of GDP, automatic stabilizers added a lot to this and liquidity support is close to 20 per cent of GDP. The support measures have helped prevent a wave of bankruptcies. Bankruptcy levels in 2020 were in fact below the previous year. Administrative delays, temporary relaxations of bankruptcy regulations and loan repayment moratoria in some instances have contributed to this. Bankruptcies can be expected to increase once the support measures are lifted, with higher NPLs in the banking sector as a result. This raises the question of how to best phase out support measures.

Support measures have been warranted for firms which have been prevented from doing business as a result of the lockdowns. Once restrictions are lifted, direct support measures towards firms should be phased out as well, and firms should go back to doing business on market terms. Business dynamics have been hampered by the lockdowns, and some unviable firms have been kept alive by support measures. Large reductions in revenue are not an unusual event for firms. A Danish study shows that, even in the best of times, 6 percent of firms experience a year-to-year drop in turnover of 30 percent or more. That has been the national threshold to qualify for government compensation for fixed costs.

Furthermore, the pandemic may lead to structural changes and a shift in consumer preferences. Some firms may experience decreased demand and ultimately default, and banks will experience losses. This is a natural part of the workings of a market economy. Firms default and new firms enter. We must not hamper this dynamic. Once restrictions are lifted, firms should do business on market terms – without government aid. As always, existing labour market policies etc. can assist transition.

A financial sector which is part of the solution and which can adjust dynamically to changing environments.

Once bankruptcy levels start to increase, banks will inevitably experience increasing NPL levels. The strong fiscal and monetary measures, temporary macroprudential and supervisory relief, dividend restraint and prudent bank behavior imply that this is manageable by viable banks and should not act as a squeeze on lending capacities.

In the long period in between the GFC and the pandemic, we have improved the financial sector a lot. Risk levels in the EU banking sector have been reduced, capital levels have increased and we have the system and institutions to resolve non-viable banks. The BRRD made great strides to ensure that orderly resolution can be applied without costly government funds, which would distort competition, break the link between facing risk and earning risk premia, invoke moral hazard and revoke the bank-sovereign nexus. Some cases might test the resolve of governments to apply the BRRD. Yet, the role of the financial sector during and post COVID-19 should be seen as an opportunity to demonstrate how we have built a financial sector which is part of the solution and which can adjust dynamically to changing environments, on market conditions. Harvesting this opportunity will be important for years to come.

KLAUS WIEDNER

Director, Financial systems and Crisis Management, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Addressing the fall-out of the Covid-19 pandemic on the financial system

The Covid-19 pandemic has led to a sharp economic downturn. Governments reacted promptly by taking measures to compensate income losses of households and, to a lesser extent, of businesses, which were mostly supported through liquidity measures such as moratoria, loan guarantees and public loans. EU regulators and supervisors took measures to bolster banks' lending capacity. This includes the Commission Covid-19 banking package, which addressed issues in the Union's accounting and prudential frameworks, aimed at ensuring that banks were able to continue lending during the most acute phase of the crisis.

These measures, combined with suspensions of the obligation to file for bankruptcy and the impact of lockdowns on courts, reduced corporate insolvencies to record lows – in the midst of a deep recession. This shielded banks from the impact of Covid-19 and kept many firms alive that would otherwise have quickly gone under. Some of these firms should perhaps have exited the market and there is a risk that the extensive public support might lead to a certain degree of zombification in the corporate landscape. However, this has been a risk well worth taking, which was mitigated by the condition that only firms in good financial health at the start of the pandemic were elegible for support. Furthermore, it may still be too early to tell which companies will be viable post-Covid and which might only survive as 'zombies'.

A key determinant of post-Covid business viability is the amount of corporate debt that was also driven by the extensive use of liquidity support measures. Higher debt levels may be affordable thanks to lower interest costs, but many companies with viable business models may need a restructuring of their debt. This is what banks and policy makers have to prepare for as crisis support measures are being phased out. Redesigned fiscal support measures focusing on debt restructuring for fundamentally viable firms will be key to avert a wave of insolvencies, which would transmit the Covid-19 shock to the banking system.

Banks and governments must continue to support viable firms. Banks' lending capacity will be preserved by keeping them sound and by addressing possibly rising non-performing loans.

The temporary suppression of economic activities, through lockdowns and social distancing measures, could then still morph into a crisis with the vicious cycle of business failures, bank retrenchment and public finance crises.

The EU finds itself in the comfortable position that the financial health of its banking sector remains strong, and private and government debt affordable thanks to low interest rates. Yet risks are tilted to the downside, with large disparities across Member States. As we know from the experience of the sovereign debt crisis, the euro area can be destabilised by problems in a small number of Member States.

It is therefore vital to to ensure that banks can continue to play a constructive role in the recovery following the economic downturn and to closely monitor possible risks to financial stability. Banks and fiscal authorities need to work together to identify debtor distress early and engage in timely and appropriate restructuring to prevent insolvencies of fundametally viable firms. If this objective would not be attained, banks' asset quality – and in turn their lending capacity – could deteriorate sharply as a result of the Covid-19 crisis.

Public authorities need to be mindful that banks may be capital-constrained and may need the right incentives to engage in restructuring. This requires an adjustment of support measures, and in many Member States also improvements to national insolvency frameworks, notably to facilitate preventive restructuring, in line with the 2019 Directive that Member States have to transpose.

However, a rise in non-performing loans (NPLs) will not be avoided entirely. Early and decisive action, as outlined in the Commission's Action Plan on NPLs adopted in December, should be taken now to:

(i) develop further secondary markets for NPLs;
(ii) improve the efficiency of insolvency frameworks across the EU;
(iii) support the voluntary establishment of national asset management companies;
(iv) allow possible precautionary public support measures, where needed, to ensure the continued funding of the real economy.

The end of the pandemic will not be the end of the crisis, but there are good ways of dealing with its legacy and to create the conditions for a swift recovery.

DIONY LEBOT

Deputy Chief Executive Officer, Société Générale

Only strong European banks can limit future sudden stops

The moment that turns a downturn into a deep recession is, in peace time, most often tied to a sudden-stop in cross-border financial flows; any dry up in liquidity translates rapidly into insolvency. With the Covid19 crisis, however, the sudden stop was triggered by measures imposed to protect public health. Vaccine rollout offers the prospect of reopening economies yet concerns linger that as temporary support measures are lifted, a large number of firms could still fail, triggering a wave of non-performing loans (NPLs).

Adaptability and well-adjusted policies suggest such fears are likely overdone. Ensuring a full recovery of the euro area, however, requires a much more determined effort to complete Europe's architecture.

When Covid-19 first struck the global economy back in early 2020, financial markets were gripped by fear, but large-scale and fast-track action by central banks and governments quickly dispelled it. Equally important, European banks entered the present crisis with capital levels twice as high as in 2008 and soon became a primary channel of support, rolling out government guaranteed loans and providing moratoria. With liquidity assured, many firms found the financial space required not just to stay afloat but also to invest in adaptations and others yet have sprung up. Just taking France as an example, new start-ups surprised with record numbers. Encouragingly, experience from last summer also shows that once social distancing measures are eased, economic restart can be swift, aided by pent-up savings.

Back in June, the ECB warned that a severe scenario could leave the euro area with a cumulated real GDP loss of 27.7% over 2020-2022 compared to 2019 levels, with NPLs near tripling from just under €500bn to €1,400bn. The ECB's latest projections see a loss of 14.9% in the severe scenario, 9.3% in the baseline scenario and 4.3% in the mild scenario. While still marked, these new scenarios nonetheless ease fears of the most adverse NPL outcomes. Banks, moreover, have built important provisions and cost of risk remains contained.

European banks entered the present crisis with capital levels twice as high as in 2008 and soon became a primary channel of support.

Once the health crisis allows economies to reopen, policymakers must calibrate the lifting of temporary measures while still rolling out sufficient support for the real economy to recover. This observation holds true also for banking measures. Last spring, the Commission's Banking Package offered temporary flexibility to accounting and prudential rules. This, combined with the decision to defer the transposition of the final Basel III package by one year to 1 January 2023, increased the capacity of both banks and supervisors to respond to the Covid-19 crisis.

The appropriate timing of when to roll back policy support is well known from previous crises, but the extraordinary nature of the current one, with its unprecedented sector heterogeneity and likely permanent changes to consumer and business behaviours, adds to the uncertainty that policymakers must take into account to prevent error.

Avoiding a replay of another partial recovery, that the euro area suffered in the wake of the previous crisis, furthermore, requires that European policymakers deliver on long overdue promises; a robust framework to tackle NPLs, completion of Banking Union and Capital Markets Union.

The EU Action Plan of December 2020 to prevent a future build-up of NPLs is welcome but far from sufficient to complete Banking Union, which most importantly requires single jurisdiction. The Capital Markets Action Plan of September 2020 is likewise encouraging yet also falls short in recognising the parallel need for public risk sharing, and notably a single safe asset, absent which the euro area financial architecture will continue to bear the high cost of fragmentation.

As warned by the ECB, reform policies are particularly important in addressing long-standing structural and institutional weakness and in accelerating a fair, green, and digital transitions. Europe today, moreover, has a unique opportunity to become a global green leader, lowering the risk of future sudden stops triggered by the natural world.

Strong European banks in a complete Banking Union are a prerequisite, not just to pave the way for the necessary private investment and jobs, but also to ensure that Europe is sovereign in its choice of economic growth model and to limit the risk of future sudden stops in cross-border financial flows.

SANTIAGO FERNÁNDEZ DE LIS
Head of Regulation,
Banco Bilbao Vizcaya Argentaria (BBVA)

Public aid, level playing field and the role of banks

Corporates and SMEs all over the world have suffered from the lockdown and the drop in demand. Bold support measures have been adopted by many governments, which postponed payment difficulties, but a wave of bankruptcies and non-performing loans seems difficult to avoid. 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.

In Europe there were significant differences in the degree and modality of support of national governments, some of which relied more on credits with partial public guarantee whereas others used direct aid to a greater extent. Indeed, different problems require different solutions, but variation in national approaches across Europe seem to reflect more the willingness to use the fiscal space of each country than the size and nature of the problems. Viable firms with temporary liquidity problems and/or debt or capital constraints may need a combination of public aid, fiscal incentives for the injection of fresh money and debt restructuring.

Non-viable firms require an efficient and quick resolution framework that facilitates a fresh start. The latter requires in many European countries improvements in the insolvency framework, making it swifter and more efficient.

In Spain several measures have been adopted in this regard in February 2021:

(i) a new direct aid line of €7bn will facilitate the repayment of fixed costs and debts of the most affected sectors;
(ii) a €1bn fund will be used to recapitalize SMEs, on top of another €10 bn line approved a few months earlier for bigger firms and
(iii) €3bn will be destined to restructuring financial debts with public guarantees (via term extension, conversion into equity loans and, as a last resort, direct grants to reduce loan principal). Regarding the latter a voluntary code of good practices will be agreed by financial entities. These measures are welcome, although perhaps they are late and too timid compared to other EU countries.

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Banks have a key role to play in distinguishing solvent from insolvent firms, in particular in countries where the average size of firms is small and previous knowledge of the firm becomes crucial. But direct support measures should come from the government. Banks will always have skin in the game as a result of the previous lending relationship with the affected companies. Incentives should be designed carefully for all the parties involved to play their role. In this process it is particularly important to avoid that a potential corporate crisis is compounded by a banking crisis that would exacerbate the exit problems.

Financial regulation has been relaxed to a certain extent to facilitate an anti-cyclical role of bank lending. The degree of effectiveness of the different measures adopted has been uneven, but in any case, this relaxation is by definition temporary, which reinforces the case for direct public support measures to compensate for the eventual return to normality of financial regulation, which should in any case be calibrated carefully by regulators and supervisors.

European institutions acted decisively and boldly in the early stages of the crisis, especially with the Next Generation EU funds. Now that the funds are beginning to flow to the recipient countries, we need to make sure that the additional measures adopted by national governments are harmonized to the extent necessary to ensure a preservation of the level playing field in the single market. And governments, banks, corporates and SMEs need to cooperate in a constructive way to create the conditions for a robust recovery.