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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. 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.