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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 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.