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### 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.

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.

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[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>