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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. 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.