Consequences for banks’ business from COVID-19 and policy responses

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Introduction

COVID-19 and the associated containment measures have given rise to an economic contraction that is unprecedented in peacetime, with a macroeconomic environment dominated by uncertainty.

Through precautionary behaviour, economic agents have adapted to these circumstances.

Many businesses (and households) have seen impaired cash flows, weak earnings and rising indebtedness.

Swift and unprecedented policy measures during the crisis have provided crucial support to the real economy, and have successfully helped contain the impact of the crisis.
Consumption and hours worked

EU final consumption expenditure (growth rate, LHS) and total hours worked (index, RHS)

Source: Eurostat, Haver Analytics and ESRB Secretariat calculations.
Note: Final consumption expenditure includes private and government final consumption. The blue line shows the growth rate, from the same quarter of the previous year, of the chained in 2015 million euros time series. In both cases, the EU comprises 27 countries, excluding thus the UK.
The impact on banks (1)

The main economic impact of the COVID-19 pandemic on the EU banking system has not yet materialised.

• The initial impact of the COVID-19 pandemic on the financial system was predominantly on financial markets, with large falls in asset prices and stresses in some markets (March 2020).

The impact of the COVID-19 pandemic on the real economy will take time to manifest on bank balance sheets, due to:

• The process by which rising unemployment and corporate insolvencies turn into non-performing loans and – ultimately – losses for banks, and
• The widespread use of debt service moratoria and loan guarantees.
The impact on banks (2)

Ultimately, stress in the households and corporate sectors will affect the banking system through a deterioration in asset quality.

- The share of government-guaranteed loans in total loans to non-financial corporations differs significantly from country to country.
- Potential cliff effects from the expiration of support measures are looming, despite some governments already extending the duration of their support (or considering to do so).

The concomitant rise in provisions will take a toll on banks’ profitability and, indirectly, on their capital positions.
Main drivers of bank profits during 2020

Return on assets and contributions by main items in the profit and loss accounts of banks (%)

Source: Goldman Sachs and ESRB Secretariat calculations.
Note: NII stands for net interest income and ROA for return on assets. Data taken from Goldman Sachs, covering a sample of 47 large European banks, headquartered in the EU (40), UK (5) and Switzerland (2). For the computation of the red and green bars, average assets between beginning and ending period are used. Green bars denote positive contributions to return on assets and red bars negative contributions to return on assets. A large impairment charge on goodwill in Q2-2020 was reclassified into impairments by the ESRB Secretariat.
In June 2020, the ESRB issued a recommendation restricting distributions by banks, investment firms, insurance companies and central counterparties until 1 January 2021.

The ESRB Recommendation covers actions by financial institutions that result in a reduction in the amount and quality of their own funds or in a reduction of their loss absorbing capacity.

• This includes payment of dividends, buy-backs of ordinary shares and paying variable remuneration.

The ESRB is currently carefully weighing up, in coordination with its members institutions, all the arguments for and against further action from a financial stability perspective, taking into account the consequences for all segments of financial markets.
Perspectives for the EU banking system

Issues related to the COVID-19 pandemic

- Preventing and managing a large number of corporate insolvencies.
- Ensuring usability of capital buffers.
- Identifying the most appropriate use of the recovery and resolution framework.
- Stress testing and balance sheet transparency.

Issues previously identified

- Challenges to business models and structural weaknesses.
- Exposures to real estate.
Preparing for corporate insolvencies

Over the coming months, the extraordinary measures to support businesses and households will have to be phased out.

Then, solvency issues in the corporate sector will become apparent and may develop into a major shock to the real economy and to the financial system.

Some important interrelated questions:

• What do we know about the likely development of insolvencies and their impact on the banking sector?
• Do we have the capacity for preventing and managing insolvencies of viable corporations with temporary liquidity issues?
• Are there best practices that could be adopted more widely across the EU?
Usability of capital buffers

The regulatory reform after the global financial crisis has created several capital buffers, of cyclical and structural nature, to be used in a recession.

However, there is indication of certain reluctance by banks to release these buffers and use the released amounts to maintain the provision of credit to the real economy.

We can take some lessons learnt from this crisis to consider possible amendments to the existing regulatory framework for banks’ capital.

It is important to ensure alignment of the risk-weighted capital requirements with the leverage ratio and the MREL requirements.
Despite the sizable public support measures, a sharp contraction of the EU economy has followed, with financial stability risks currently tilted to the downside.

A protracted weak economic environment may challenge banks’ resilience and necessitate the activation of recovery and resolution actions for a number of institutions in a short period.

A careful assessment of the macroprudential implications of the different alternatives to cope with potential difficulties in the banking sector is needed.

- The current recovery and resolution framework in a systemic crisis.
- State Aid, Asset Management Companies and precautionary recapitalisations.
- …
Stress test and balance sheet transparency

In normal times, stress testing focuses on the identification of risks building up.

During crisis times like now, stress testing’s objective is to build confidence that banks subject to them are resilient even if further losses were to materialise.

Stress test should reflect the impact from COVID-19 on the banking system, finding a (difficult) balance between severity and plausibility.

Balance sheet transparency is a complement of these actions, ensuring that the information disclosed by banks is accurate, timely and relevant.
Before COVID-19, the EU banking system was subject to challenges derived from the low interest rate environment, low profitability and overbanking.

The macroeconomic environment was creating fundamental challenges to traditional business models in the financial sector across EU, also magnifying existing structural weaknesses (legacy assets from the previous crisis, excess capacity and inefficient cost structures).

Profitability of the banking system was particularly affected, probably affecting also equity prices of EU banks.
Return on assets and price-to-book ratios of EU and US banks

**Return on assets (%)**

**Price-to-book ratio (units)**

Source: OECD, European Central Bank, Federal Deposit Insurance Corporation, Federal Reserve Bank of St. Louis and ESRB Secretariat calculations.

Note: the thinner blue line shows the return on assets netting derivative exposures of EU banks, in line with accounting practices in the US.

Source: Bloomberg and ESRB Secretariat calculations.

Exposures to real estate

One of the largest exposures types of banks are those to real state, for residential or for commercial purposes.

In 2016 and 2019, the ESRB issued warnings and recommendations to several EU countries to express its concerns about adverse developments in this area.

The usual assessment of real estate markets by the ESRB may be affected by long-termed structural changes triggered by the COVID-19 pandemic (through the use of remote working, for example).
To conclude

We are living in turbulent times, with a shock to the real economy caused by the COVID-19 pandemic not seen in peacetime.

Even if the banking system has so far not seen the materialisation of this shock, it will be affected as other financial institutions.

To prepare the banking system for that impact and to ensure it remains resilient to smoothly provide credit to the real economy, there are several actions by regulatory and supervisory authorities that can be beneficial.

The way how banks get through the cyclical impact of the pandemic and how they address existing structural vulnerabilities would crucially shape the banking system of the future.
Many thanks for your attention!