



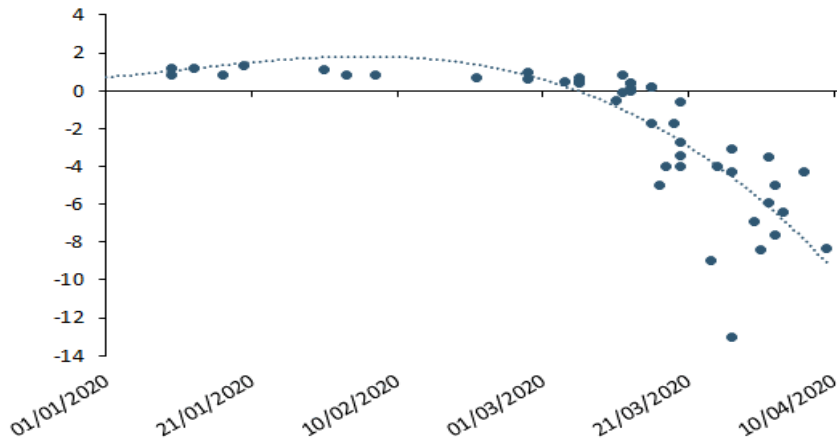
Discussant contribution – with focus on first insights into COVID-19 impacts on the EU Banking Sector

Andreas Pfeil | Risk Analysis and Stress Testing

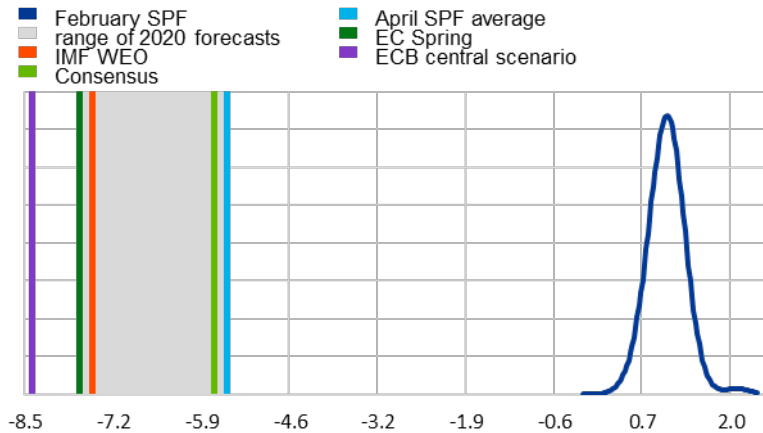
SUERF webinar on the ECB's FSR | 28 May 2020

Macro economic conditions have deteriorated quickly

EBA COVID-19 note: Evolution of analysts' GDP forecasts for the Euro area for 2020, since the beginning of this year



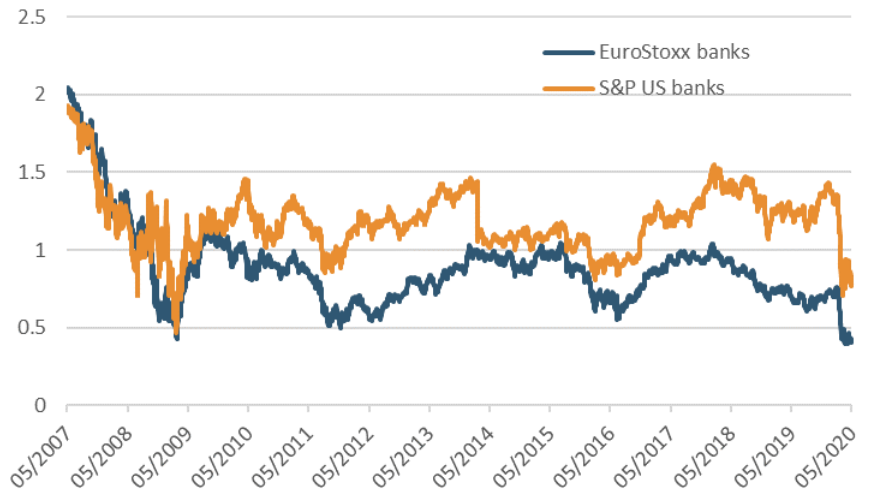
ECB FSR: Euro area real GDP growth forecasts 2020 year-on-year percentage change for the whole year



Source: ECB FSR,

- Data shows a strong **deterioration in business confidence** as well as in **GDP forecasts**.
- Whereas some sectors will be less affected, like pharma, others will face elevated challenges, like tourism, transport, etc.
- As shown in the ECB's FSR and the EBA's COVID-19 note stock indices plummeted and remain at low levels. Also **banks' valuations fell significantly**.

EU vs. US banks' price to book ratios



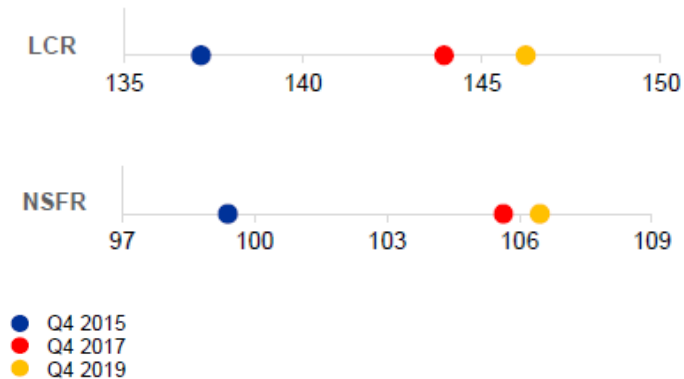
Sources (top left, bottom right): EBA COVID-19 note (incl. Bloomberg),

Following the COVID-19 spread in Europe, the focus in the beginning was on banks' operational resilience

- **Banks have operated without major disruptions.** They applied **contingency plans** to ensure business continuity based on elements such as **remote working** for large part of the staff.
- Banks also encouraged **customers to use digital and remote business channels** amidst temporary closures of some branches.
- Certain (temporary) challenges were reported related to the **handling of large volumes of applications for debt moratoria and guaranteed loans**, and the preparation of some **offshore units** to work remotely.
- The **responses of the EBA, competent and regulatory authorities** were aimed at alleviating operational challenges and at supporting banks' focus on key operations:
 - The **stress test** exercise has been postponed to 2021, and some parts of **(supervisory) reporting have been eased**.
 - **Recommendation to focus on the most material risks** driven by the crisis in the 2020 SREP assessments and in recovery planning.
 - Competent authorities encouraged to focus on **supervisory priorities and key risks** (including fair treatment of customers, AML, ICT risks). Etc.

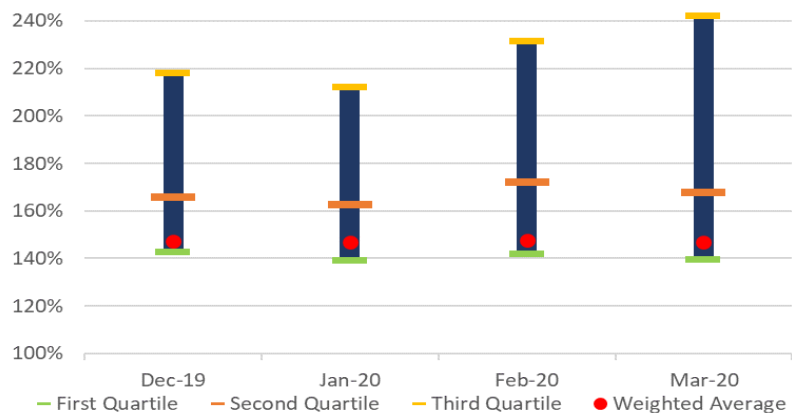
Banks maintain comfortable liquidity buffers, yet funding can become more challenging

Euro area banks' liquidity coverage (LCR) and net stable funding ratios (NSFR)



Source: ECB FSR.

EU banks' LCR recent evolution: YE2019 and first months 2020*



Source: EBA COVID-19 note (supervisory reporting).

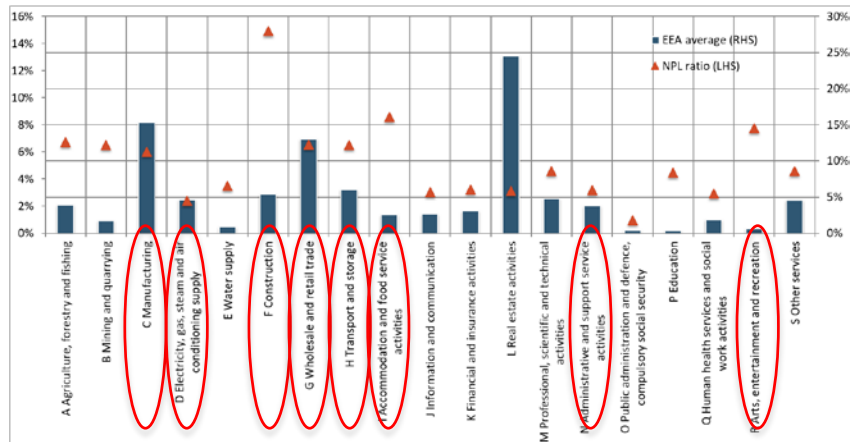
- Banks have entered the crisis with **solid funding profiles**, thanks to increasing reliance on **deposit funding, favourable funding conditions** in 2019 and early 2020 and, more recently, **significant take up of central bank funding**.
- The LCR levels were high at the start of the crisis and remained at **about 150% on average in Q1**.*
- Authorities made clear that **liquidity buffers can be used** in a crisis.
- Going forward, banks might face some **challenges**:
 - **Euribor rates are at levels not seen since 2016**, thus, reflecting tensions in interbank funding markets.
 - Spreads in wholesale funding markets have widened significantly. **MREL build-up might be more challenging and / or more expensive**.

* In the EBA COVID-19 note, UK banks are excluded from the sample. The full sample includes 161 banks, of which 31 are subsidiaries. The notes' sensitivities are calculated based on a reduced sample of 117 banks at the highest level of consolidation, which report both [COREP](#) and [FINREP](#).

Banks' asset composition will define how they are affected



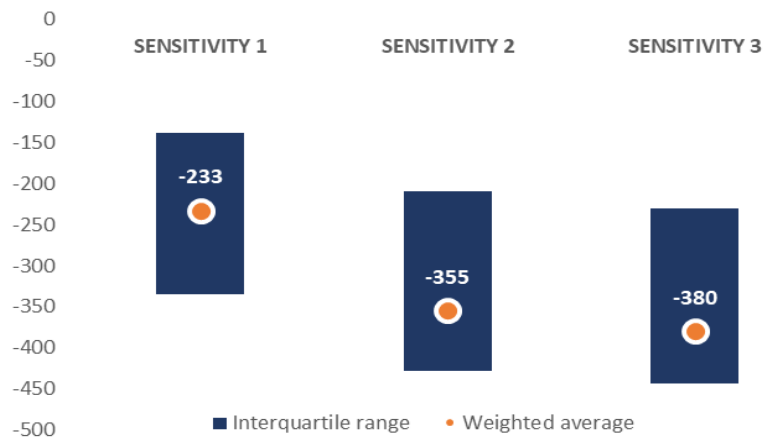
Breakdown of loans and advances to NFCs and NPL ratios by NACE codes (Q4 2019; presumably most affected sectors are marked in red)



Source: EBA COVID-19 note (supervisory reporting).

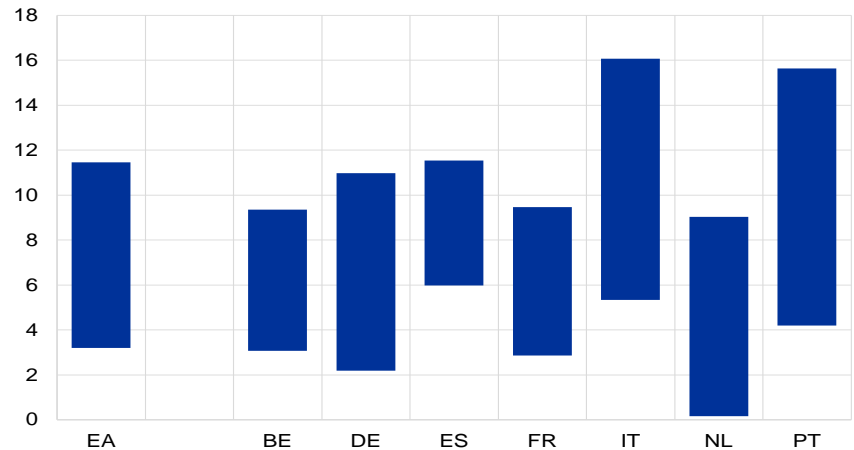
- Several of the presumably **most affected sectors** (NACE code level 1) include those with **comparably high NPL ratios**.
- In the **EBA COVID-19 note** a sensitivity analysis for **credit risk** shows that the **CET1 impact** ranges betw. **-233bps** and **-380bps**.*
- The **ECB's FSR** includes a **sensitivity analysis for NFC loan losses**.
- **** Public guarantees** might limit the impact on asset quality.

EBA COVID-19 note's credit risk sensitivity analysis – impact in CET1 ratio*/**



Sources: EBA COVID-19 note (supervisory reporting, Stress Test 2018, EBA calculations),

Euro area banks' loan losses as a consequence of NFC cash-flow disruptions**

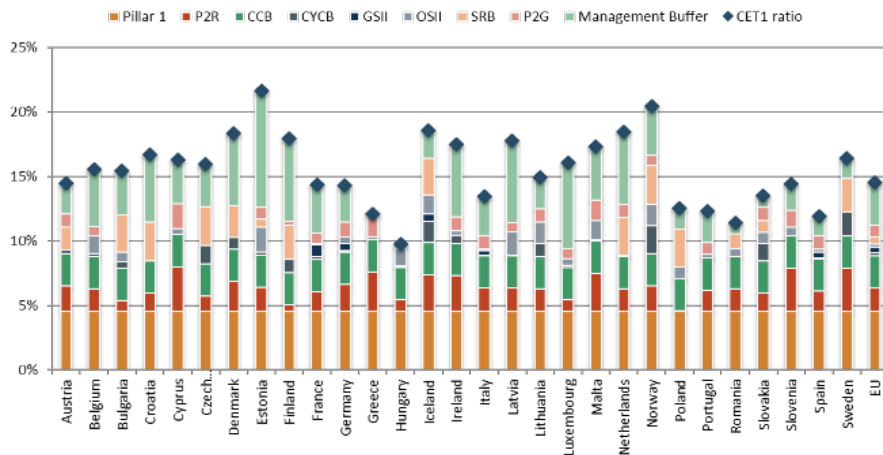


Source: ECB FSR.

* The impact depends on the applied sensitivity: 2018 ST adverse scenario in sensitivity 1, amplified for selected sectors in sensitivity 2 and selected sectors & countries in sensitivity 3. The note includes several more simulations, showing also EU banks' sensitivities e.g. to market risk as well as to elevated drawings of credit lines.

EU banks' strong capital position might suffer from elevated credit risk

CET1 ratio – capital stack, by country



Source: EBA COVID-19 note (supervisory reporting).

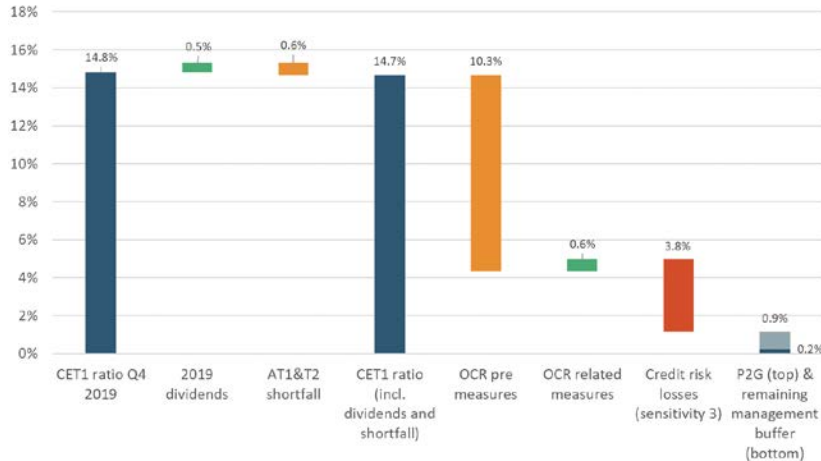
Capital-related measures:

- General message that capital buffers should be used.
- Reduction of macroprudential buffer requirements.
- Possibility of partially covering P2R with instruments other than CET1.
- Restrictions on dividend payouts.
- Possibility for banks to temporarily operate below P2G .

- The CET1 ratio reached 14.9% in December. The **management buffer** above OCR and P2G was **nearly EUR 300bn** (roughly **300bps** of RWA) in December 2019.
- The combined impact of the measures applied since the Corona outbreak is estimated at **around EUR 180bn**, corresponding to **about 200bps** of RWA.
- As the result, the management buffer above OCR and P2G increased to **400bps**, with the **possibility for banks to use additional 100bps** of P2G.

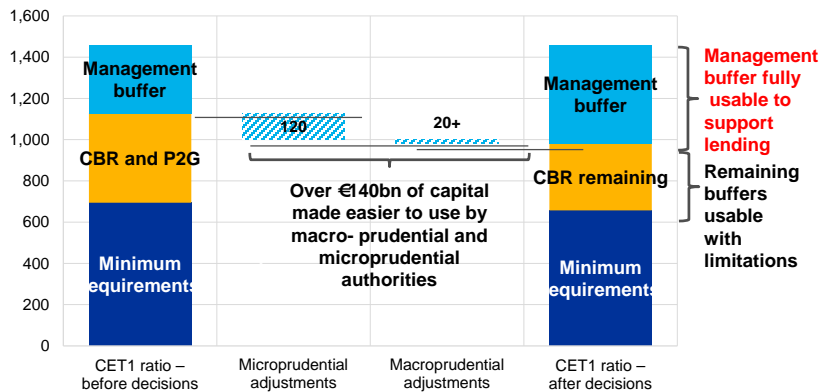
How do capital buffers compare with potential losses and can they help support funding the economy?

EBA COVID-19 note: From the CET1 ratio to the remaining free buffer after measures (dividends, OCR related measures, P2G) and credit risk sensitivity 3



Sources: EBA COVID-19 note (supervisory reporting, EBA calculations,)

ECB FSR: CET1 capital and capital buffers in the euro area (EUR bn, Q4 2019)



Source: ECB FSR.

- **500 bps of management buffer available** above OCR (400bps of management buffer above OCR and P2G + 100 bps of P2G temporarily usable).
- Considering the impact of sensitivity 3 on **credit risk**, the **remaining mgmt. buffer** is around **110bps** of RWA, which could be potentially used for additional lending (see also the caveats in the Annex).
- However, **there could be weaker banks** (those with pre-crisis problems or heavily exposed to the sectors more affected by crisis) facing more severe challenges. **Competent authorities should address quickly any idiosyncratic weaknesses** that could be exacerbated by the current crisis.
- **ECB FSR** (slides): “Overall impact [from capital relief measures] potentially big, but market stigma and fear of downgrades may limit the use of capital buffers [...]”

Conclusions: challenging times ahead

- **Banks have entered this crisis with stronger capital and liquidity positions than in the past.** Nevertheless, profitability has been subdued and NPL ratios are still comparatively high for some banks.
- **The global economy is facing unprecedented challenges.** In the absence of an effective vaccine, authorities are lifting social distancing restrictions only at a very gradual pace, and there is a danger of second or third “waves”. Under such conditions, GDP recovery might take more time than initially expected.
- **Regulators and supervisors have acted quickly to provide capital, liquidity and operational relief.**
- **So far, banks have successfully coped** with the pressure put on their **operating capacities.**
- **Ample liquidity buffers and cheap and abundant central bank funding** have allowed banks to weather **wholesale funding tensions.**
- **Despite public guarantees and loan moratoria, asset quality is expected to deteriorate in the coming months.**
- **Capital levels should help banks withstand the impact of COVID-19.** However, the extent to which banks will be affected by the crisis is expected to differ, e.g. starting capital levels or exposure to the sectors more affected by the crisis.

ANNEX

FURTHER INFORMATION: BACKGROUND & CAVEATS

There are some caveats related to the sensitivity analysis and capital related calculations

- **Comparison of capital buffers and losses is limited to credit risk.** There could be additional losses coming from market, counterparty and operational risk.
- **RWAs reflect December 2019 assets** and do not incorporate their likely expansion due, e.g., to the increasing use of credit lines by bank customers.
- **Sensitivities are based on the 2018 stress test**, which is not necessarily an accurate proxy of the impact of this crisis on credit risk.
- On the other hand, the **potential mitigating effects of pre-provision profits, loan moratoria, public guarantees and, more generally, fiscal and monetary policies are not taken into account.**

EU banks were better prepared to face the crisis, but pre-existing fragilities could be exacerbated

- **Liquidity buffers** are ample, with LCR at 150% in December 2019.
- **Capital buffers** are also sizeable, with CET1 ratio at 15% in December 2019, as against 9% in 2009. Leverage ratio at 5.5%.
- **NPL** ratio declined from more than 7% in 2014 to 3.1% in December 2019, but it remains at pre-GFC levels in some countries
- **Profitability never recovered** since the last crisis as a result of relatively weak interest income and high cost structures. Return on equity is around 6%, below the estimated cost of equity for many banks.

Why the EBA's thematic note . . .

- Providing a comprehensive picture of the conditions of the EU banking sector at the outset of the Covid-19 crisis (data as of December 2019, liquidity data as of Q1 2020).
- Assessing the impact of the measures adopted so far by prudential supervisors.
- Offering a very preliminary analysis of the effects of the crisis on bank risks.

. . . and how to interpret the information provided in the note

- Sensitivity analyses are simplified simulations based on a set of assumptions and the results are surrounded by significant uncertainty given the unclear evolution of the crisis.
- Impacts are not based on a fully fledged-scenarios ,nor the result of a stress test.
- Therefore, outcomes only focus on the EU banking sector as whole, not on specific countries or banks.
- The Spring EU-wide Transparency exercise will provide bank by bank data (publication in June).



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