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The Impact of COVID-19 on European Banks

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Despite Europe's largest economic contraction since the Second World War, swift policy action has averted a financial crisis. However, the risk of a prolonged, partial, and uneven recovery amid a highly uncertain outlook weighs on European banks, which are heavily exposed to economic sectors that have been hard hit by the pandemic. This article examines how the COVID-19 crisis is likely to impact banks' capital considering the mitigating effect of a wide range of pandemic-related policy support measures. Our analysis suggests that while banks remain broadly resilient, some of them might struggle to meet their threshold for the maximum distributable amount (MDA), which could create funding pressures related to hybrid capital. Effective policies are powerful in reducing both the extent and variability of capital erosion under stress. Based on these findings, the paper recommends: (1) continued but more targeted pandemic-related borrower support; (2) clear supervisory guidance on the availability and duration of capital relief and conservation measures; (3) swift balance sheet repair through debt restructuring and streamlined insolvency procedures; and (4) improved operational efficiency to raise structurally low bank profitability.

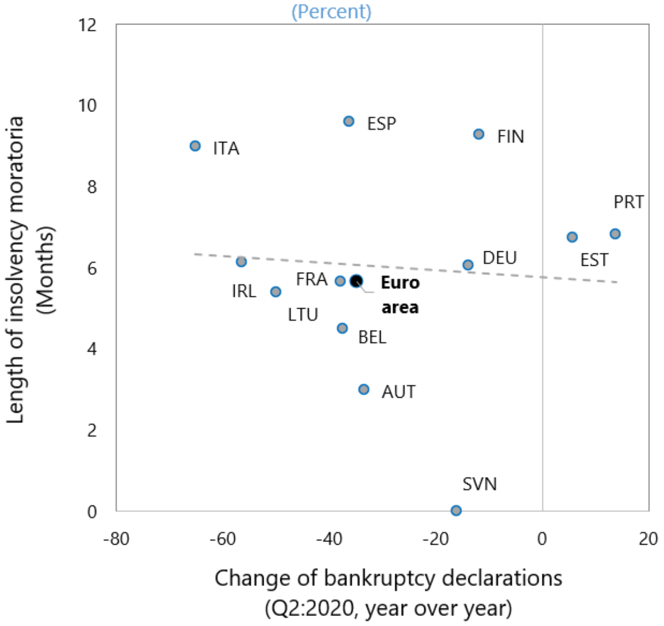
A robust post-COVID-19 recovery will depend on banks having sufficient capital to provide credit. Despite the combined health and economic crises, banks have so far been able to raise loan loss provisions and slowly absorb rising loan impairment charges without significant changes in their capital adequacy.

While unprecedented borrower support and regulatory flexibility have cushioned the immediate crisis impact on banks, these policies have not eliminated an underlying increase in credit risk as aggregate demand remains weak and economic slack is sizable. The deferral of insolvency proceedings has delayed defaults but also created a legacy risk of pent-up creditor claims and reduced asset recovery prospects [Figure 1]. The phasing-out of support measures could result in a surge of bankruptcies and rising loan impairments, further depressing banks' already low and shrinking profitability. This could amplify deleveraging pressures on weakly capitalized banks and those most exposed to highly affected sectors.

Traces of asset quality deterioration have already emerged, causing credit conditions to tighten on the back of higher risk perceptions. Many banks have significantly increased their loan loss provisions on precautionary grounds, and lending to non-financial corporates has slowed. Although non-performing loan (NPL) ratios continue to decline, other asset quality metrics show signs of weakening.[1]

Insolvency moratoria have suppressed defaults but also created a potential backlog of bankruptcies that could slow NPL resolution.

Figure 1. Selected Euro Area Countries: Length of Deferred Bankruptcy Proceedings and Change in Bankruptcy Rate
(Percent)



Sources: European Banking Authority; Eurostat; Haver Analytics; KPMG; Linklaters; Organisation for Economic Cooperation and Development; and IMF staff calculations.
Note: Data labels in the figure use International Organization for Standardization (ISO) country codes.

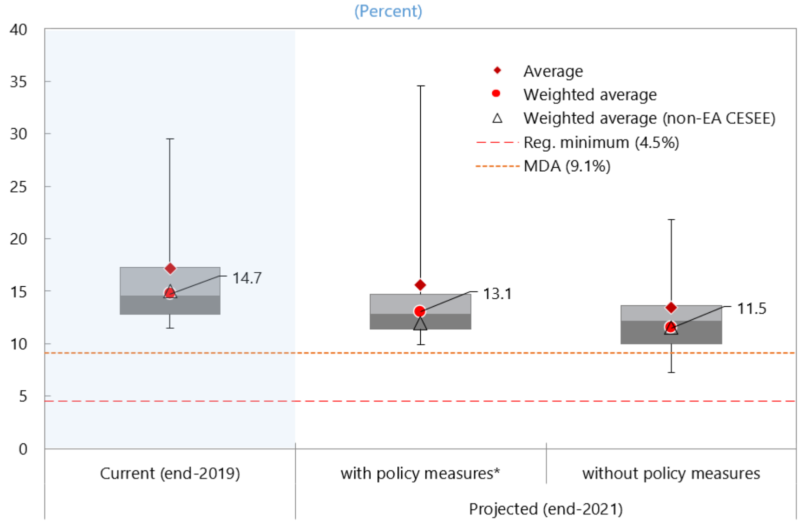
[1] Notably, forborne exposures and loans classified as "Stage 2" under the IFRS-9 accounting standard have increased markedly. As reported in EBA's recently published Risk Dashboard for end-2020, the share of "Stage 2" loans under moratoria (26.4 percent) is greater than that for loans under expired moratoria (20.1 percent) and nearly three times the ratio for total loans (9.1 percent).

In a new IMF study, we assess the impact of the pandemic on European banks' capital through three channels - profitability, asset quality, and risk exposures. Our approach differs from other recent studies by the European Central Bank and European Banking Authority, because it incorporates a wide range of policy support measures.[2] It also includes granular estimates of corporate sector distress and covers a larger number of banks: 467 banks in 40 European countries.[3]

We find that, while the pandemic will significantly reduce banks' capital, their buffers are sufficiently large to withstand the likely impact of the crisis. Using the IMF's January 2021 growth projections as a baseline, most euro area banks will remain resilient to the deep recession in 2020 followed by the partial recovery in 2021. The aggregate common equity Tier 1 (CET1) capital ratio is projected to decline from 14.7 percent to 13.1 percent by the end of 2021 provided policy support is maintained [Figure 2]. No bank will breach the current prudential minimum capital requirement of 4.5 percent, even if policies do not operate as effectively as expected. But there will be considerable cross-country variation, with the change in bank capital sensitive both to the size of the macroeconomic shock and the initial condition of a bank's balance sheet and its profitability. We find a larger capital impact on banks in countries that have been hit especially hard by the pandemic, and for banks with higher initial NPLs and large exposures to highly affected sectors.

Under baseline conditions, most euro area banks are likely to preserve considerable capital buffers.

Figure 2. Euro Area Banks: Aggregate CET1 Capital Ratio (before and after shock), Baseline Scenario
(Percent)



Sources: European Banking Authority; European Central Bank; European Systemic Risk Board; FitchConnect; S&P Global Market Intelligence; and IMF staff estimates.
Note: CCB = capital conservation buffer; CESEE= Central, Eastern and Southeastern European countries; CET1 = common equity Tier 1; MDA = maximum distributable amount (weighted average). Data labels in the figure use International Organization for Standardization (ISO) country codes. The grey shaded area of the boxplots shows the interquartile range (25th to 75th percentile), with whiskers at the 5th and 95th percentile of the distribution. Sample of 90 banks covered by the EBA Transparency Exercise ("EBA Coverage").
The analysis covers all three channels affecting the capital adequacy ratio under stress – profitability (net interest income and provisions), nominal assets (net lending and write-offs after reserves), and risk exposure (changes in credit risk weights).
*/ Debt repayment relief (moratoria) for businesses and households, public credit guarantees, deferred insolvency proceedings, and dividend restrictions (only in 2020).

[2] Note that the stress testing exercise in the IMF October 2020 *Global Financial Stability Report* (GFSR) also covers some European banks. Despite a similar top-down approach, the GFSR and this paper differ along several dimensions. While the GFSR explicitly accounts for only loan guarantee programs and capital relief, our study also controls for a broader set of policy measures. Moreover, we use a two-period model in which bank balance sheets evolve dynamically, with new lending conditioned on the capital position of the previous period as opposed to a static balance sheet assumption. See also recent studies by the BIS and OECD, which assess the resilience of banks in most advanced economies.

[3] The analysis is based on a large sample of European banks, including 90 larger euro area banks included in the EBA Transparency Exercise. We incorporate publicly available financial statement data from FitchConnect and S&P Market Intelligence to broaden the sample to smaller euro area banks and European banks outside the euro area.

Looking beyond the euro area, banks in Europe's emerging economies are likely to see greater capital erosion. The aggregate capital ratio is projected to decline from 12.8 percent to 10.8 percent by the end of 2021. In many of these countries, the buffer provided by policy support is estimated to be smaller than for euro area banks due to tighter government budgets.

But at least three important caveats are in order.

- *First, effective policies matter*. Supportive policies are extremely important in reducing both the extent and variability of banks' capital erosion. They substantially weaken the link between the macroeconomic shock and bank capital and lower the chances that banks cut back lending to conserve capital [Figure 3]. Aside from regulatory flexibility, these policies include a wide range of borrower support measures, including debt moratoria, and credit guarantees. They also include fiscal support in the form of grants, tax relief, and wage subsidies to firms.
- *Second, market-based capital thresholds are the more relevant benchmarks*. While there is no aggregate capital shortfall relative to the minimum prudential requirement, if policies are not fully effective, several larger banks may struggle to meet their threshold for the maximum distributable amount (MDA) even under the baseline scenario. Banks that cannot meet their MDA thresholds, which are higher than current regulatory minimum requirements, would be forced to stop dividends, and then suspend coupon payments to hybrid capital. Hybrid capital, which blends features of debt with equity and is senior to equity and is cheaper than equity capital. It is an important source of funds when the cost of capital is high, especially for larger banks, which hold about 25 percent of capital in such instruments. Triggering restrictions on payouts could drive away investors, possibly resulting in higher funding costs for banks. The aggregate capital shortfall with respect to the MDA threshold could be as much as €25 billion.
- *Third, the speed of the recovery is critical*. A protracted recovery due to repeated infection waves, renewed lockdowns and vaccine rollout delays could result in much higher provisioning expenses for bad loans and larger credit losses. If GDP growth in 2020–21 were 1.2 percentage points below the baseline forecast, the erosion of bank capital would become more pronounced. Even if policy measures are fully effective, more than five percent of the larger euro area banks (6 banks), would see their CET1 capital ratio drop below the MDA threshold. These banks are concentrated in Italy, Portugal, and Spain. Without policies, however, more than a quarter of larger euro area banks (25 banks) would breach their MDA thresholds, generating a capital need of nearly €47 billion. If we increase the severity of the adverse scenario (similar to the one the ECB examined in its Vulnerability Analysis) by tripling the additional output loss to 3 percent over the stress test horizon, about a quarter of the banks would risk breaching their MDA thresholds, even with effective policies in place.

Our results suggest a strategy that focuses on the following areas to ensure that banks can effectively support the recovery:

- *Continue pandemic support policies until the recovery is firmly established*. A premature winding down of borrower support could create "cliff edge effects" and risk choking off credit supply just when it is needed most. Over time, eligibility criteria should be tightened, with public support better targeted towards vulnerable households and illiquid but viable firms. Some direct equity support could also be considered for firms whose operations have been temporarily impaired by health risks or social distancing measures but are expected to become profitable again after the crisis.
- *Clarify supervisory guidance on the availability and duration of capital relief*. Many banks have been reluctant to dip into capital buffers since effective hurdle rates, such as the one for MDA, are much higher

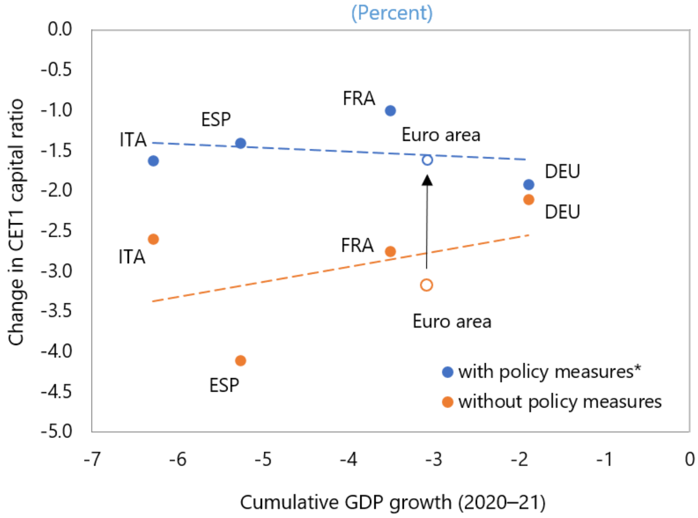
than the current prudential minimum. Supervisors should clarify the time horizon over which capital buffers can realistically be used, allowing banks to build back capital buffers gradually to preserve lending capacity. Beyond the specific concern about the MDA, there is a more general question as to whether the current "stacking" of banks' capital requirements provides sufficient flexibility to create releasable capital buffers during times of stress. Restrictions on dividend payouts and share buybacks should be maintained until the recovery is well underway.

- *Support balance sheet repair by strengthening NPL management and the bank resolution framework*. As supportive policies expire, prudential standards should be normalized – and clearly communicated to incentivize timely recognition of problem assets through greater balance sheet transparency and upgraded reporting. Banks would need to adequately provision for impaired loans and implement credible NPL reduction strategies. A robust secondary market for distressed assets should be fostered. The current system-wide stress test, due in July 2021, can help the EU authorities assess the need for precautionary recapitalizations. And insolvency regimes should be strengthened by addressing administrative constraints and establishing streamlined liquidation and debt restructuring procedures.

- *Address structurally low bank profitability*. Banks will take several years to build back capital organically through retained earnings unless their profitability improves markedly. Even if banks were to restore their long-term pre-crisis profitability of about 0.4 percent (without raising their leverage) and resume dividend payouts, it would take them more than 2.5 years on average to replenish their projected capital loss under our baseline scenario [Figure 4]. Banks will therefore need to enhance non-interest revenues and streamline operations to improve cost structures, including through greater use of digital technologies. Consolidation could improve banks' efficiency, while facilitating a better allocation of capital and liquidity within the banking sector. In this context, the recent ECB guidance on the use of supervisory tools to facilitate sustainable consolidation is pertinent and timely.

Effective policies help weaken the link between the macro shock and the impact on bank capital.

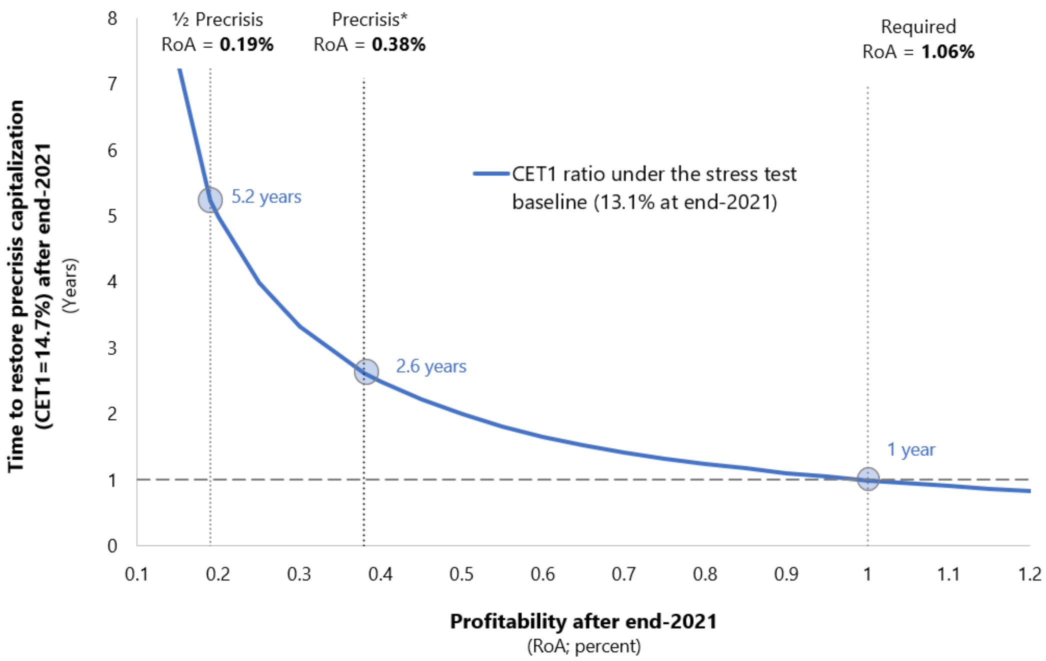
Figure 3. Euro Area Banks: Changes in Capital and Growth, Baseline Scenario
(Percent)



Sources: European Banking Authority; FitchConnect; and IMF staff calculations.
Note: Data labels in the figure use International Organization for Standardization (ISO) country codes. CET1 = common equity Tier 1. */ Debt repayment relief (moratoria) for businesses and households, public credit guarantees, deferred insolvency proceedings, and dividend restrictions (only in 2020).

Banks would take a long time to restore their capital buffers even under baseline conditions.

Figure 4. Euro Area Banks: Time to Restore Precrisis Capitalization (CET1=14.7%) through Profits after end-2021 1/
(Years)



Sources: European Central Bank; FitchConnect; and IMF staff calculations.
Note: CET1 = common equity Tier 1; RoA = return on assets.
*/ Long-term average until end-2019.
1/ Assumptions: average asset risk weight = 40 percent, taxes = 20 percent, dividend payout ratio = 15 percent.

Reference

Aiyar, Shekhar, Mai Chi Dao, Andreas A. Jobst, Aiko Mineshima, Srobona Mitra, and Mahmood Pradhan, 2021, "COVID-19: How Will European Banks Fare?," Departmental Paper No. 2021/008, European Department, March 26 (Washington, D.C.: International Monetary Fund), available at https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2021/03/24/COVID-19-How-Will-European-Banks-Fare-50214.

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