



Consequences for banks' business from COVID-19 and policy responses*

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Concerted responses by fiscal, monetary and prudential authorities to the COVID crisis have successfully avoided a systemic financial crisis in the spring. But the impact of the crisis on banks' balance sheets will only become fully visible, when the lagged effects on unemployment and firm insolvencies may strike, as governmental loan guarantees and moratoria expire. It will be important to avoid "cliff effects". As loan quality will deteriorate, banks will need to increase loan provisions, affecting banks' profits. To prevent an erosion of banks' equity, the ESRB has recommended banks not to pay dividends and not to buy back shares. These rules are currently being reviewed. Looking ahead, first, both banks and policy makers need to prepare for corporate insolvencies, and to avoid that viable but illiquid firms fail. Second, to enhance banks' capacity to absorb losses and to maintain banks' lending to the real economy, capital requirements and buffers will be reviewed. Third, for banks hit particularly hard, recovery and resolution frameworks need to be carefully assessed and applied, bearing in mind the crisis situation. Fourth, in the short term, stress tests and balance sheet transparency are key in building confidence in the banking system. More broadly, EU banks need to further improve cost efficiency, in an environment of structurally low interest rates. Developments in real estate markets need to be watched carefully, bearing in mind lasting structural effects from the COVID crisis on the demand for commercial and residential property.

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The economic contraction that we have seen in 2020 has been unprecedented in recent history, excluding war periods. The fall in GDP has been much larger than those seen in the global financial crisis or even during the oil crisis in the 1970s.

At the same time, uncertainty prevails and relates to two crucial aspects of the pandemic: (i) the evolution of the pandemic itself (Europe is now fighting the second wave after a summer with limited number of infections, and might be exposed to a third one), and (ii) the impact of the containment measures on economic activities and how economic agents will be able to adjust to them.

In view of these levels of uncertainty, economic agents have behaved (and continue to behave) with caution. We have seen savings of households reaching levels not seen before in statistical time series. Consumption has decreased abruptly, particularly in those sectors more sensitive to the pandemic, such as accommodation or restauration.

The policy response has been commensurate to the severity of the crisis and has involved fiscal, monetary and prudential authorities. Through this effort, the significant turmoil in March and April did not lead to a systemic crisis, which would have worsened the dramatic effects of the pandemic.

The impact on banks

The impact of the COVID-19 pandemic is still not clearly visible in the balance sheet of European banks, mainly for two reasons.

The first one refers to the usual timing of stress in the real economy to translate into losses to be absorbed by banks. Increases in unemployment and corporate insolvencies follow quickly after the onset of a recession. It then takes time for the related households and non-financial corporations to default on their bank loans. After all, the definition of non-performing loans has as main criteria non-payment over 90 days (the other criterion is the assessment of the borrower to be unlikely-to-pay).

The second reason is related to the policy response I have referred to before. The uptake of loan guarantees and moratoria have eased financial stress of households and non-financial corporations for some time. Indeed, if we observe the number of reported bankruptcies in 2020, it is not possible to find any sharp increase derived from the outbreak of the COVID-19 pandemic. But, at same point in the near future, the stress faced by households and non-financial corporations will lead to an increase in forborne (renegotiated) loans and non-performing loans. While government-guaranteed loans shift the ultimate risk-bearing to the government, the share of these loans over total loans differs significantly from country to country and is small in comparison with the outstanding amounts of loans.

From a financial stability point of view, the finalisation of loan guarantees and moratoria is of particular concern, as it may generate a “cliff effect” and increase the intensity with which stress in the real economy is transmitted to the banking system. The ESRB is looking carefully at the financial stability implications of the exit strategy from support measures.

Deteriorating asset quality will translate into higher provisions, taking a toll to the profit and loss account of banks, and, indirectly, to the potential use of retained profits to increase their capital position.

Restrictions to distribution of dividends

As part of the response by the ESRB to the COVID-19 outbreak, a Recommendation was issued in May restricting distributions by financial institutions in the EU. In view of the significant uncertainty about the length of the COVID-19 crisis and about its severity, the ESRB saw a need for financial institutions to maintain a sufficiently high amount of capital to mitigate systemic risk and contribute to economic recovery. The ESRB Recommendation is precisely addressing those actions by financial institutions that can result in a decrease in the amount and quality of their own funds or in a reduction of their loss-absorbing capacity. These actions include dividends, variable remuneration and buy-backs of ordinary shares.

The ESRB Recommendation is applicable until 1 January 2021. The ESRB is currently weighing up the pros and cons of further actions in this regard. In doing so, it is fully coordinated with its member institutions, including microprudential supervisors. The overarching principle remains the one of extreme prudence, also in line with the above-mentioned uncertainty about developments in the next months. I am confident that the ESRB will make the results of its discussions soon public, certainly before its previous recommendation expires.

Four COVID-related issues looking ahead

I would like to offer some thoughts about the main issues affecting the EU banking system in the short to medium run. Some of these issues are directly linked to the COVID-19 pandemic (corporate insolvencies, usability of capital buffers, recovery and resolution frameworks, stress testing and balance sheet transparency) while others had previously been identified.

1. Preparing for corporate insolvencies

Let me start with the main challenges faced by the banking sector derived from the COVID-19 pandemic.

As I have previously said, loan guarantees, loan moratoria and other support measures to households and to non-financial corporations will need, one day, to be phased-out.

These measures have been crucial to contain the economic and financial impact of the pandemic, but they cannot be in place forever. Since they are phased-out, the financial soundness of non-financial corporations will be revealed, with the potential to lead to a large wave of corporate insolvencies.

To the extent that bank lending is the main source of funding of European corporations (particularly, for SMEs), the expected large number of insolvencies can create substantial stress in the financial system. In this regard, there are three important questions which we, as macroprudential authorities, need to answer.

First, what do we know about the likely path of corporate insolvencies? Which sectors are going to be more affected and at which pace? These are crucial issues to identify the issue at stake, whether it is going to extend over time or whether it is going to be one-off event. Some academic publications have tried to look at this issue and have come with valuable findings for this task.

Second, do insolvency frameworks around Europe have the capacity (in terms of resources and absence of bottlenecks) to deal with an elevated number of corporate insolvencies? Here, it would be crucial as well to avoid bringing viable but illiquid corporations into insolvency due to a flawed assessment of the long-term viability of the corporation.

Finally, is there something we can learn from each other in terms of best practices? This is the most relevant aspect for policy-makers, since we could take policy actions based on experience in other jurisdictions in the past.

2. Usability of capital buffers

Prudential authorities have taken important policy actions to offer regulatory relief to banks, in the expectation that they would use the own funds associated with capital buffers to maintain the provision of credit to the real economy in the current difficult circumstances. Despite this effort, there is a perception that some capital buffers introduced by the regulatory reform after the global financial crisis are not usable in practice.

We need time and data to look carefully at this and, if appropriate, consider how the current regulatory framework can be improved so that capital buffers are used when needed. Do not forget that the main goal of capital buffers is to absorb losses.

Finally, in this assessment, it is important to consider how the risk-weighted capital requirements interact with the leverage ratio and with the MREL (Minimum Required Eligible Liabilities) requirement, to avoid unintended outcomes from the combined application of the three.

3. Recovery and resolution framework in use

The ambitious and large support measures taken by the governments to support the economy in view of the COVID-19 pandemic have, for sure, mitigated the impact on the financial system.

However, given the unprecedented size of the shock created by the pandemic (and despite the action of monetary policy), they might not be enough to avoid a weakening of the economic environment and could therefore add pressure to the financial soundness of banks, testing their resilience. For some banks, it may be possible that there is a need to trigger recovery and resolution actions in a short timeframe. Given these challenging perspectives, I think it is necessary to carefully assess, from a macroprudential perspective (considering the banking system as a whole), the different alternatives to dealing with forthcoming difficulties in the banking system derived from the COVID-19 pandemic.

The issues to consider here are wide-ranging and important. For example, the current recovery and resolution framework has not been used through a systemic crisis, with several banks experiencing difficulties at the same time. It is important to understand how the framework can work in such conditions and whether there are actions to be taken to enhance it. Besides, other solutions for ailing banks may involve precautionary recapitalisations and asset management companies. For that to be fully operational when needed (if needed), we need to make sure we are aware of the implications of these actions in terms of State Aid.

There are many other issues to be considered in this area, to help us understand the toolkit available, the financial stability implications of each tool and the interaction with other regulations. We need to use the time available to us to advance in these areas, hoping that we will not need to put our findings to work.

4. Stress test and balance sheet transparency

An important element to consider when thinking about challenges for banks (and regulatory and supervisory authorities) in the short-term refers to stress test, to be conducted by the EBA with the ESRB designing the adverse scenario.

While during normal times, stress test try to identify possible build-up of risks, during crisis periods (like the one

we have now), stress test are key in building confidence among market participants that banks subject to them are resilient enough to absorb losses to materialise in the short-term.

Designing a scenario in these circumstances is, more than ever, not an easy task. On the one hand, it is clear that the scenario must reflect the impact of the pandemic on banks and, also quite importantly, the scenario needs to find a balance between severity and plausibility. Having a very severe scenario that is, however, not plausible would make little service to financial stability in the EU.

In order to gain confidence on the EU banking system, transparency of bank balance sheets is a crucial and complementary element to stress test. To that purpose, we must ensure that financial information is accurate, timely and relevant, particularly in the current times characterised by uncertainty.

Structural issues

In more structural terms, before the outbreak of the COVID-19 pandemic, there were concerns about the EU banking system. The macroeconomic environment (low interest rates, low growth and low inflation) was fundamentally challenging the traditional business models of many financial institutions across the EU.

In the case of banks, these challenges were combined with existing structural weaknesses referred to legacy assets from the global financial crisis, excess capacity (often referred as overbanking) and inefficient costs structures. As a result, profitability of EU banks had been much below international peers for many years and equity valuations of EU banks were also subdued. The majority of EU banks were trading with price-to-book ratios below 1, typically seen as a signal of small confidence from investors.

Moving ahead, responding to these challenges would be key for the EU banking system to emerge as sound and to contribute to the recovery from the pandemic crisis.

Real estate

Real estate exposures are particularly important in the lending portfolio of banks in Europe and, as demonstrated in some countries during the global financial crisis, can be an important channel of contagion between the real economy and the financial system.

In 2016 and 2019, the ESRB issued several warnings and recommendations to EU Member States focusing on vulnerabilities related to residential real estate. In addition to them, it has published several assessments in the last years, covering also commercial real estate markets.

The ESRB is regularly assessing the financial stability implications of developments in real estate markets, also in the context of the assessment of compliance with its warnings and recommendations. For the future assessment, the structural changes imposed by the COVID-19 pandemic may need to be considered. For example, the extension of remote working modalities may impact the demand for commercial real estate. These are important developments that need to be carefully assessed from a financial stability point of view.

Conclusions

Let me conclude. Our economies are currently suffering an economic shock caused by the COVID-19 pandemic that we have not seen in the last 100 years, excluding periods of war. While banks have not yet suffered material losses from this shock, they will become affected by it, as other financial institutions will be.

I have outlined four policy issues directly related to the COVID-19 pandemic, where regulators and supervisors (together with banks) need to take action to ensure the banking system is best prepared to absorb the losses from the COVID-19 shock and to ensure the flow of credit to the real economy.

The way how banks absorb this impact and how they address existing structural vulnerabilities (challenges to traditional business models, excess capacity, legacy assets) is going to determine the banking system of the future. I hope this is a banking system that is sound and positively contributes to the economic recovery from the COVID-19 pandemic. ■

About the author

Francesco Mazzaferro has been the Head of the Secretariat of the European Systemic Risk Board (ESRB) since January 2011. Prior to that, he was the Project Manager of the ESRB Preparatory Secretariat, which started work in March 2010. He began his career in financial research in the Research Department of the Istituto Bancario San Paolo di Torino (today part of Intesa Sanpaolo) in Turin, Italy, in 1987. He joined the European Commission in Brussels, Belgium, in 1992, starting his international career in the Directorate General for Economic and Financial Affairs, where his work focused on the European Currency Unit and preparations for the introduction of the single currency. In 1995 Mazzaferro joined the European Monetary Institute – which later became the European Central Bank – in Frankfurt am Main, Germany, as the Officer of Policy Planning. In 1998 he became the Senior European Relations Officer in the European Relations Division. From 2000 he worked as Principal in the EU Neighbouring Regions Division, becoming the Head of Division in 2003. Mazzaferro studied law at the University of Bologna and wrote his Master's thesis on "EU law and legal aspects of the euro".

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