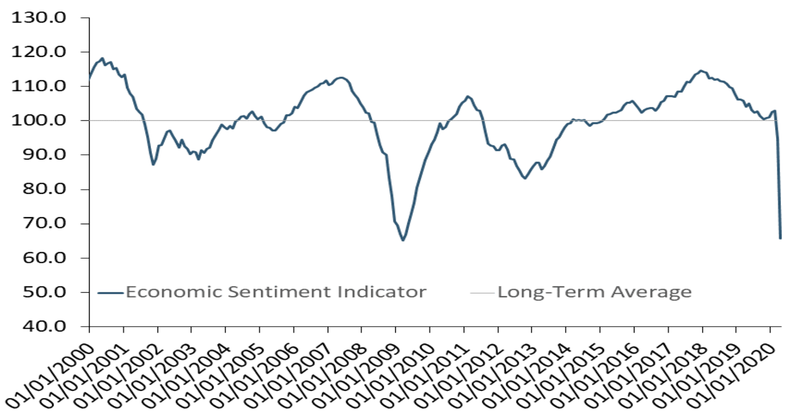
The EU Banking Sector: First insights into COVID-19 impacts

Mario Quagliariello| Director of Economic Analysis and Statistics

Assessing the preliminary impact of COVID-19 on the EU Banking sector | Online debate | FBF - EUI | 2 July 2020

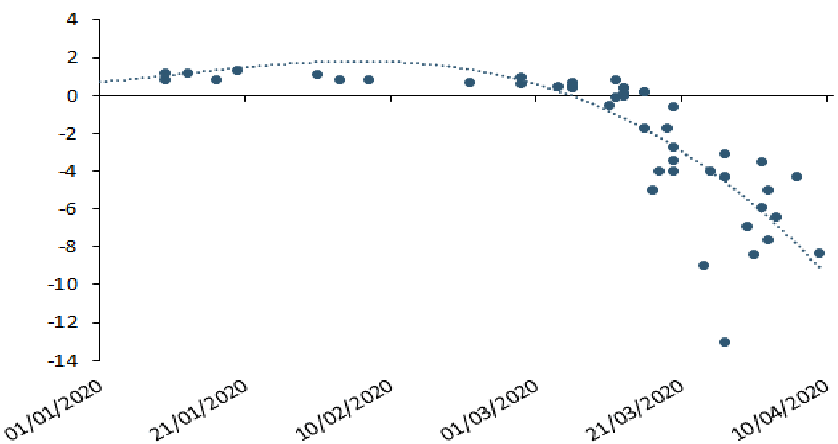
Macro economic conditions have deteriorated quickly

EU Economic Sentiment Indicator

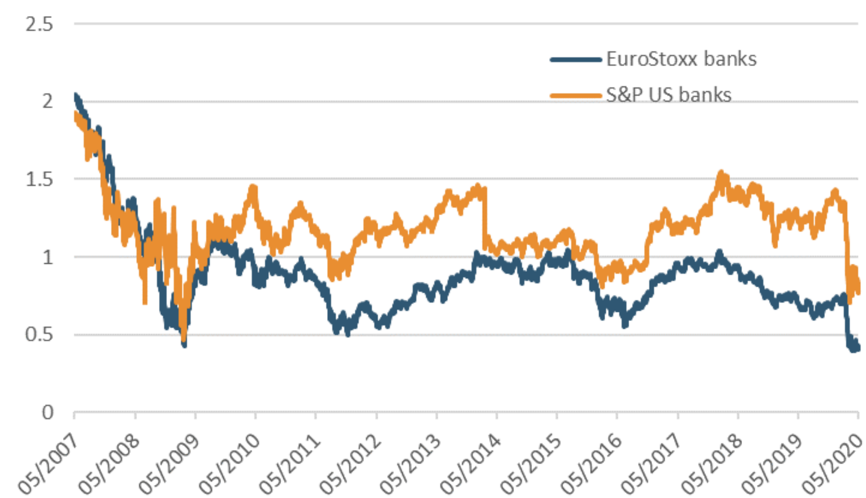


- Data shows a strong **deterioration in business confidence** as well as in **GDP forecasts**.
- Whereas some **sectors** will be less affected, like pharma, others will face elevated challenges, like tourism, transport, etc.
- Stock indices plummeted and, despite the recent recovery, they remain at low levels. Also **banks' valuations fell significantly** since the virus' outbreak.

Evolution of analysts' GDP forecasts for the Euro area for 2020, since the beginning of this year



EU vs. US banks' price to book ratios



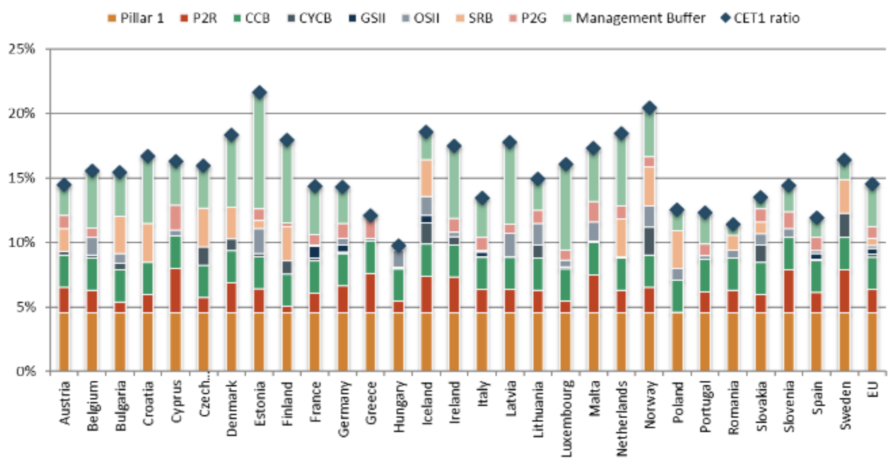
Sources: European Commission (EC) business surveys, Bloomberg,

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

- **Liquidity buffers** are ample, with LCR at 150% in December 2019
- Banks have entered the crisis with **solid funding profiles**, thanks to increasing reliance on deposit funding, favourable funding conditions in 2019/early 2020 and significant take up of central bank funding.
- **Capital buffers** are sizeable, with CET1 ratio at almost 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 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.

Impact of supervisory measures on bank capital

CET1 ratio – capital stack, by country



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

Capital-related measures:

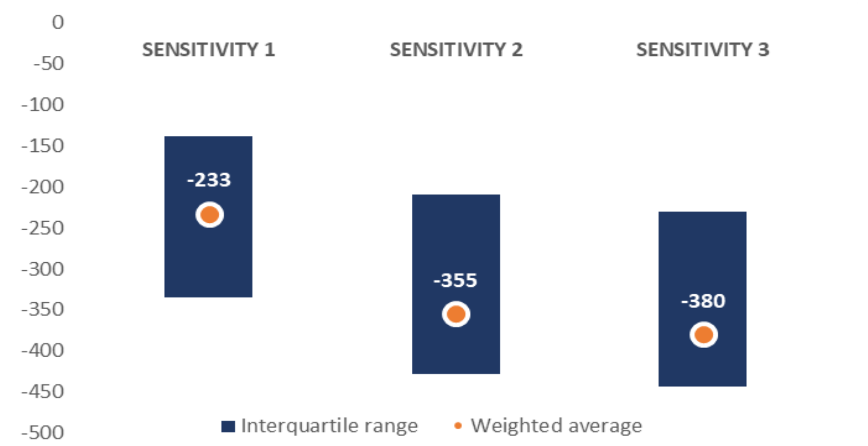
- General message that capital buffers should be used.
- Reduction of macroprudential buffer requirements.
- Possibility of partially covering P2R with instruments other than CET1.
- Restrictions on dividend payouts.
- Possibility for banks to temporarily operate below P2G .

- The **management buffer** above overall capital requirement (OCR, i.e. above P1 minimum capital requirement + plus P2R + combined buffer requirement) and P2G was about EUR 260bn (around **300bps** of RWA) in December 2019.
- The combined impact of the Capital-related measures – excluding the P2G related one – applied since the Corona outbreak is estimated at around EUR 100bn, corresponding to **about 110bps** of RWA.
- As the result, the management buffer above OCR and P2G increased to **410bps, with the possibility for banks to use additional 90bps of P2G.**

Banks' asset composition will define how they are affected

- In recent years, **banks have significantly increased their exposures to the riskier loan segments** such as SME and consumer lending.
- Several of the presumably **most affected sectors** include those with **comparably high NPL ratios**.
- **57% of EU banks' NFC loans are towards the sectors most affected by the pandemic** (i.e., accommodation, food services, manufacturing, electricity or transport).

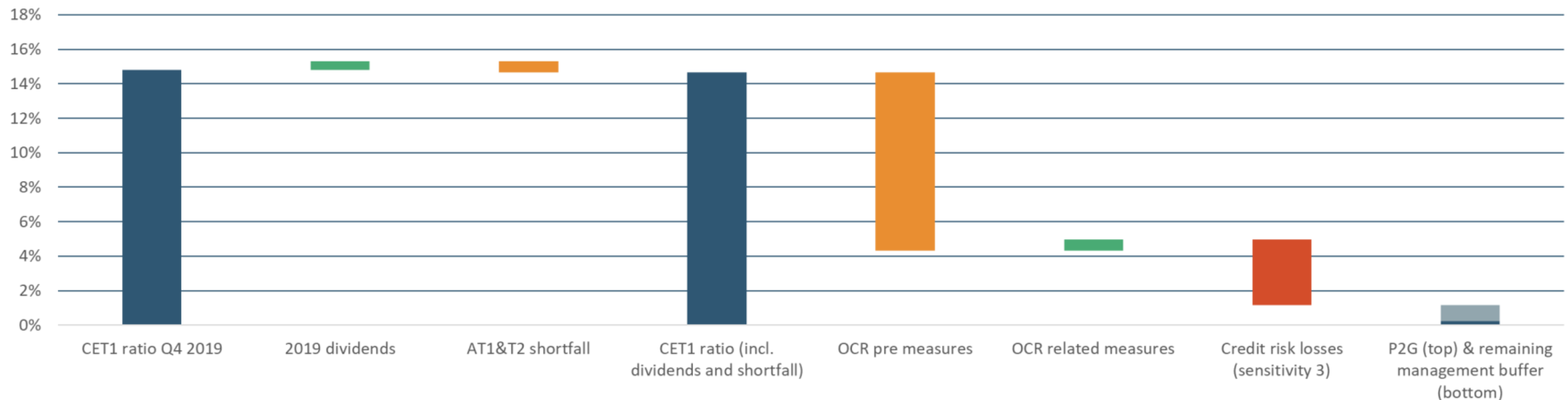
EBA COVID-19 note's credit risk sensitivity analysis – impact in CET1 ratio*



- EBA run **3 sensitivity analyses** for credit risk:
  - 2018 ST adverse scenario in sensitivity 1,
  - amplified for selected sectors in sensitivity 2
  - and selected sectors & countries in sensitivity 3
- The **CET1 impact** ranges between **-233bps and -380bps**.*

How do capital buffers compare with potential losses?

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,)

- **500 bps of management buffer available** above OCR (410bps of management buffer above OCR and P2G + 90bps of P2G temporarily usable).
- Considering the impact of sensitivity 3 on **credit risk**, the **remaining mgmt. buffer** is above **100bps** of RWA, which could be potentially used for additional lending.
- 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.

Some caveats

- **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**.
- **Profits not considered**.

Conclusions: challenging times ahead

- **Banks have entered this crisis with stronger capital and liquidity positions than in the past thanks to post-GFC reforms**. Nevertheless, profitability has been subdued and NPL ratios are still comparatively high for some banks.
- **Regulators and supervisors have acted quickly to provide capital, liquidity and operational relief**.
- 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.
- **More sensitive banks tend to be also those where the impact of capital measures is less pronounced.**
- **Banks long term challenges remain.** The pre-crisis identified challenges in the sector (low profitability, required transformation of business models, and the need to restructure capacity) remain and have likely accentuated as a result of COVID-19.

What is the role of stress testing in a crisis?

- Providing information to supervisors, banks themselves, (market participants?)
- Informing timely decision making at a time information can be limited
  - ✓ Closer monitoring of more vulnerable institutions
  - ✓ Market recapitalisation
    - ➢ Which banks?
    - ➢ What amount?
  - ✓ Public precautionary recapitalization of viable banks
  - ✓ Resolution/liquidation of not viable banks
- (Banks internal risk management)

- Which scenario?
  - ✓ Baseline only?
  - ✓ Playing more on the recovery?
  - ✓ Countercyclical adverse?
  - ✓ Adverse (things can always get worse)
- Pass/fail exercise?
  - ✓ Where to set the bar?
- Bottom-up doable for banks?
- Transparency of the results?
  - ✓ Restoring trust?
  - ✓ Market discipline?
  - ✓ Beauty context?
  - ✓ Self-fulfilling prophecies?

Sensitivity analyses are flexible but require the use of some simplified assumptions – only a second best

Advantages:

- The EU-wide stress test provides bank data that is **granular and quality assured**
- Analysis can be done **top-down** without involving banks
- Possible to assess the impact of **changing specific parameters** while keeping other aspects unchanged

Limitations:

- Based on **past projections** of risk parameters **and macroeconomic forecasts**, which are suitable to provide sensitivities but not the exact magnitude of losses from the COVID-19 crisis
- The mitigating impact from **government measures** was **not factored** in the calculation
- Due to lack of empirical evidence, the selection of highly affected **sectors and countries** is based on **judgmental** indicators

EUROPEAN BANKING AUTHORITY

Floors 24-27, 20 Av André Prothin, 92927 Paris La Défense

Tel: +33 1 86 52 7000

E-mail: info@eba.europa.eu

http://www.eba.europa.eu