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Policy Brief

EU banks' vulnerabilities

Capital conservation key to withstanding Corona crisis

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#Banking
#PrudentialRegulation
#Covid19

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COVID-19 will hit financial institutions with a substantial time lag, but the coming storm will be fierce. The EU banking sector is entering the troubled waters of the Corona crisis with four major vulnerabilities: (1) Market and (2) funding liquidity risks have been mitigated by bold policy measures at EU and national level. (3) Concentration risk in banks' sovereign exposures could be addressed by a European recovery fund. The immense economic fallout will further depress banks' already weak (4) levels of profitability. Losses will erode banks' capital base, putting their viability at severe risk. Monetary, fiscal and prudential emergency measures are keeping the real economy afloat but fail to enhance banks' resilience. To withstand the crisis, EU policymakers should require banks to suspend all discretionary distributions and preserve capital instead.

After attacking our health systems, social life and the real economy, COVID-19 will also spread to the banking system. Monetary, fiscal and prudential policy measures are shielding the financial sector from the economic fallout, but, depending on the depth and length of the recession, credit losses will reach banks to a greater or lesser extent. Whereas the Great Financial Crisis (GFC) of 2007/2008 emerged in the banking sector and went on to become first an economic and then a eurozone crisis, Corona has first brought the real economy to a halt which in turn will affect the banking sector in its ability to provide credit to companies and households. Before the pandemic hits financial institutions, now is the right time to take a snapshot view of the state they are in and reflect on what could be an appropriate policy response to banks' endangered viability.

This Policy Brief suggests that monetary, fiscal and prudential emergency measures are indeed keeping the real economy afloat but fail to enhance banks' resilience. Credit losses will erode banks' capital base and thus endanger their viability. To withstand the crisis, EU policymakers should require banks to suspend all discretionary distributions and preserve capital instead. Section 1 analyses the major vulnerabilities of European banks, assesses the effects of the policy measures adopted so far and concludes that they failed to address banks' deteriorating profitability. Section 2 critically assesses the recent legislative banking package proposal from the European Commission ("CRR quick-fix") and argues against overshooting prudential relief for banks that would endanger financial stability. Section 3 makes the case for banks' internal capital conservation to preserve their resilience.

1 Analysis of EU banks' major vulnerabilities and evaluation of recent policy measures

At the beginning of 2020, banks were more resilient than at the onset of the GFC. In the previous decade, financial institutions built up substantial capital and liquidity buffers to better absorb potential losses and temporary funding constraints. In parallel, the banks' regulatory environment has been strengthened to enhance financial stability: Following the global Basel III reforms published by the Basel Committee on Banking Supervision (BCBS) in December 2010, the EU put in place a harmonised EU banking framework (Capital Requirements Regulation and Capital Requirements Directive, CRR and CRD) and a European bank regulator (European Banking Authority, EBA) fostering convergence of supervisory practices. Furthermore, the EU institutions agreed to create a Banking Union built on three pillars: the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) became operational in 2014 and 2015, respectively, whereas the details of the European Deposit Insurance Scheme (EDIS) are still being discussed among EU co-legislators.

Since the outbreak of the Corona pandemic, European governments, the European Commission, European Central Bank (ECB) and banks' prudential supervisors have acted decisively. The emergency measures are maintaining the all-important flow of credit to the economy which in turn is mitigating the negative effects of the crisis on the financial system. However, given the magnitude of the unfolding recession, even these bold monetary, fiscal and prudential policy measures might not suffice for all banks to withstand the troubled waters ahead. Among the four major vulnerabilities of European banks (Table 1) discussed in this section, deteriorating profitability turns out to be banks' biggest challenge. Losses are eroding banks' capital base and thus endangering their viability.

Table 1: EU banks' major vulnerabilities and outlook (own illustration based on EBA Risk Dashboard)

Major vulnerabilities	Short-term outlook
Market risk Asset prices plummeting	Effectively mitigated by ECB measures but further market corrections likely and impact of sharp fall in oil prices to be closely monitored
Funding liquidity risk Banks' access to refinancing restricted	Manageable as long as banks dispose of eligible collateral to access central bank funding
Concentration risk Home bias in banks' sovereign exposure	EU governments to agree on solidarity measures ensuring debt sustainability for all Member States
Profitability Surging NPLs eroding banks' capital	EU policymakers to require banks to refrain from any sort of discretionary distributions and maintain capital instead to absorb losses

Vulnerability #1 – Market risk

This is the risk of losses arising from adverse movements in market prices. Banks are exposed to market risk insofar as they engage in transactions involving securities, bonds, derivatives, commodities and foreign currencies. When Coronavirus infection rates and COVID-19 victim numbers started to rise rapidly and the financial impact of the lockdown measures on economies became apparent in early March 2020, financial markets panicked. Asset prices plummeted and bond funds showed record outflows whereas risk premia for sovereign bonds of the most vulnerable euro countries spiked, taken together causing significant market losses for banks.

To calm down financial markets and avoid liquidity shortages, the ECB and prudential supervisors started to intervene heavily from mid-March 2020. EU Member States announcements of credit guarantees and direct aid to the real economy helped further stabilise asset prices, although fiscal responses have been uneven across the EU due to different budgetary constraints (see e.g. Redeker/Hainbach: "Flattening the Recession Curve: Fiscal Responses to the Corona Crisis"). Table 2 shows the most relevant policy measures taken to address the financial market slump. The ECB's enhanced asset purchases are likely to have had the biggest impact on banks' market risk.

Table 2: Market risk – Most relevant policy reactions in the EU (own illustration based on IIF)

Monetary policy	• ECB launched an additional EUR 120 billion under the asset purchase programme (APP) • ECB announced a EUR 750 billion bond buying initiative (PEPP) with no purchase limits • ECB included all commercial paper in the Corporate Sector Purchase Program (CSPP) • ECB enhanced or reactivated currency swap arrangements with other central banks
Fiscal policy	• EU Member States providing credit guarantees and direct aid to the real economy
Prudential measures	• SSM and EBA allowed banks to fully use capital buffers, to operate temporarily below the liquidity coverage ratio and announced relief in the composition of capital for Pillar 2 Requirements • SSM lowered capital requirements for market risk by reducing "qualitative market risk multiplier" • Basel Committee on Banking Supervision (BCBS) pushed the deadlines for the revised market risk framework to 1 January 2023 • European Securities and Markets Authority (ESMA) coordinated short selling bans in several EU Member States

Regarding the policy responses adopted to date, one measure deserves a critical note. In normal times without undue market stress, prudential supervisors ask specific banks to hold additional capital if the bank's internal market risk model under-estimates its real market risk. The corresponding capital surcharge compensating for the possible under-estimation of capital requirements is called "qualitative market risk multiplier". The recent decision by the SSM to reduce the qualitative market risk multiplier for the banks under its remit is thus benefitting only banks running unreliable internal market risk models. However, reducing capital requirements for banks showing an elevated risk profile contradicts the very objective of prudential regulation that is designed to ensure financial stability.

For now, ECB's asset purchases seem to have been effective in mitigating market risk for banks. However, further corrections are likely and the impact of the sharp fall in oil prices is to be closely monitored.

Vulnerability #2 – Funding liquidity risk

This is the risk that a bank is unable to meet its immediate and short-term obligations when they fall due. Banks can generally obtain funding from depositors parking their savings or from other financial institutions and the central bank in return for providing financial securities, also known as collateral. In times of stress, banks start to distrust each other and restrict interbank lending. Liquidity then becomes a scarce resource and its price, measured by interbank lending rates, increases. Looking at short-term and long-term interbank lending rates, we can observe that Euribor-1-month and Euribor-12-months rates started to spike in mid-March 2020, indicating restricted interbank lending, and stabilised thereafter. Compared to the excessive interbank lending rates measured at the height of the GFC, the recent increase seems modest.

The fact that short-term interbank interest rates fell to pre-Corona levels and that long-term interbank rates are still negative can be attributed to ample liquidity provided under monetary policy which has partly replaced interbank lending. Table 3 shows the relevant policy measures taken to address banks' funding liquidity needs. ECB's enhanced longer-term refinancing operations combined with the fact that interest rates on the main refinancing operations remained unchanged at 0.00% probably had the biggest impact on banks' funding liquidity risk.

Table 3: Funding liquidity risk – Most relevant policy responses in the EU (own illustration based on IIF)

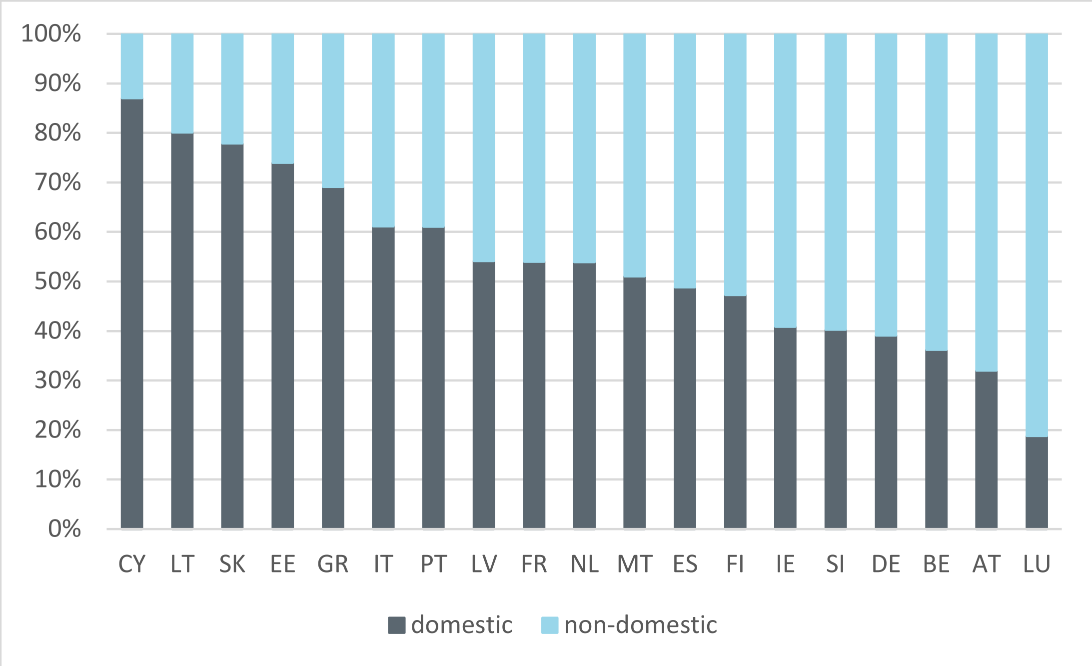
Monetary policy	• ECB eased lending volume and rates under the targeted longer-term refinancing operations (TLTRO III) • ECB announced pandemic emergency longer-term refinancing operations (PELTROs) as backstop after the expiry of LTROs • ECB launched an additional EUR 120 billion under the asset purchase programme (APP) to limit the tightening of European financial conditions • ECB announced a EUR 750 billion bond buying initiative (PEPP) with no purchase limits • ECB included all commercial paper in the Corporate Sector Purchase Program • ECB announced a package of measures to facilitate the availability of eligible collateral for Eurosystem counterparties to participate in liquidity providing operations • Interest rate on the main refinancing operations and rates on the marginal lending facility and deposit facility remained unchanged at 0.00%, 0.25% and -0.50% respectively • ECB enhanced or reactivated currency swap arrangements with other central banks
Prudential measures	• SSM and EBA allowed banks to operate temporarily below the liquidity coverage ratio

For now, banks seem to be well-funded and benign refinancing conditions as well as extended currency swap lines should shield them from immediate longer-term funding needs. Funding liquidity risk remains manageable for banks as long as they dispose of enough collateral to access central bank funding. Since the ECB eased eligibility conditions for collateral in Eurosystem credit operations and signalled its readiness to go further down this road, banks should not face any severe refinancing problems in the near future.

Vulnerability #3 – Concentration risk

This is the risk of potential losses from a single exposure large enough to threaten a financial institution's health or ability to maintain its core operations. To mitigate banks' concentration risk, prudential regulation generally foresees limits for exposure to one single counterparty. However, these exposure limits do not apply to euro area sovereign bonds denominated and funded in domestic currency because euro area banks may apply a risk-weight of zero for these exposures. As a result, eurozone banks are not required to hold any equity for their eurozone sovereign bond holdings. Figure 1 shows that the sovereign exposure of eurozone banks is significantly biased towards their home countries, constituting a substantial concentration risk. If and when financial markets start to call into question the debt sustainability of Italy, Spain and France, which already have high levels of public debt and are particularly suffering from the Corona crisis, this is also bad news for their banks. Any default by their home country would cause them substantial losses.

Figure 1: Sovereign exposure of banks as of 31.12.2019, by country (own illustration based on EBA data)



Seeking to break the sovereign-state-nexus, bank regulators are working on recalibrating the prudential treatment of sovereign risk but haven't been able to agree on any changes yet. Since the doom loop is still a reality, banks' concentration risk stemming from their exposure to vulnerable countries can only be mitigated by reducing the default risk of the sovereigns themselves. With its bold pandemic emergency purchase programme (PEPP) for public and private sector asset purchases with an envelope of EUR 750 billion (Table 4), topping the Public Sector Purchase Programme (PSPP) already in place, the ECB has successfully limited the increase in Italian, French and Spanish credit default swap prices that point to the probability of a country's default. Consequently, concentration risk for banks located in these countries is contained for now.

Table 4: Concentration risk – Most relevant policy responses in the EU (own illustration)

Monetary policy	ECB announced a EUR 750 billion bond buying initiative (PEPP) with no purchase limits
Fiscal measures	EU governments to agree on solidarity measures ensuring debt sustainability for all Member States (outstanding)

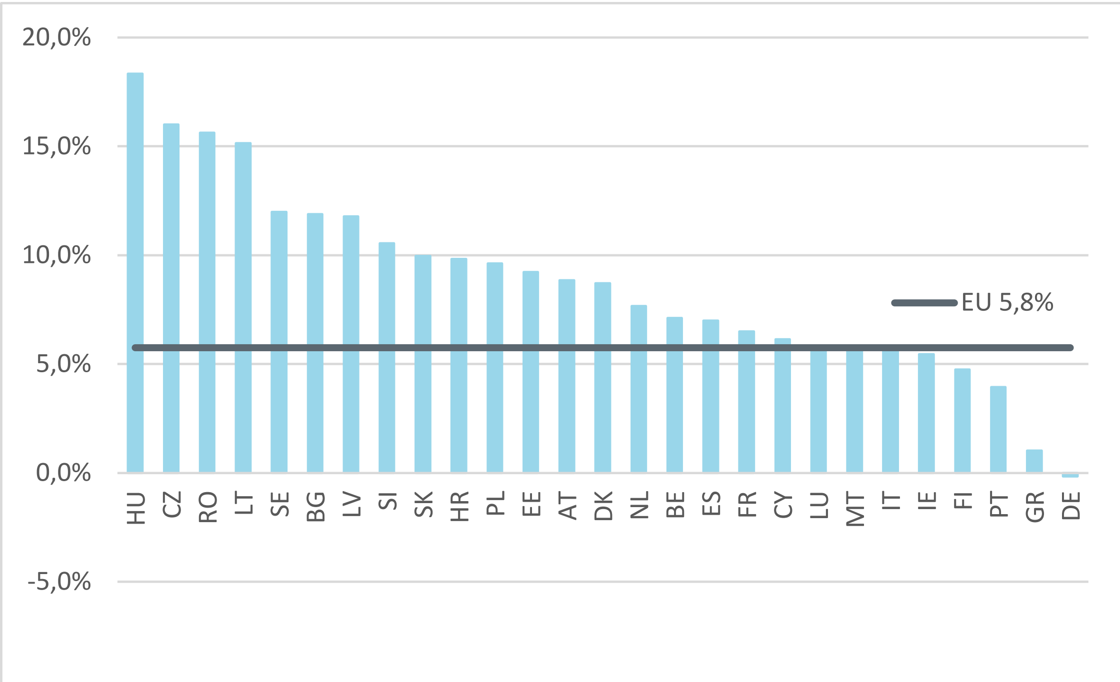
However, the ECB can maintain its expansive monetary policy only as long as it is necessary to fulfil its price stability mandate. In any case, monetary policy can only mitigate the risk premia on highly-indebted countries and the ECB is prohibited from engaging in all-out monetary financing. This is why the underlying problem of debt sustainability for all eurozone countries cannot be addressed by monetary policy instruments. Consequently, eurozone governments should swiftly agree on fiscal measures supporting the countries that are the most vulnerable and affected by the pandemic. On 23 April 2020, the European Council agreed to work towards establishing a recovery fund and tasked the European Commission to "urgently come up with a proposal". For the EU recovery fund to be effective in mitigating the debt sustainability risks of certain eurozone countries and thus addressing banks' concentration risk in home sovereign exposures, it is crucial that it does not increase Member States' debt levels. Anticipating the proposal of the EU Commission, the German chancellor Angela Merkel and the French president Emmanuel Macron on 18 May 2020 suggested EUR 500 billion in joint spending financed through EU bonds. Grund, Guttenberg and Odendahl outline in their blueprint for a Pandemic Solidarity Instrument how this recovery fund could work in practice.

Vulnerability #4 – Banks' weak profitability

Profitability is the ability to generate revenues in excess of expenses. Like any other company, banks are required to make profits in order to reward their shareholders and build up reserves that can absorb losses in an economic downturn. In general, banks generate revenues from fees on client transactions, the interest margin between loans and deposits, asset management services or proprietary trading. The bulk of banks' profits is meant to come from lending to companies, households and government in general. Depending on the size and riskiness of their business, banks are required to hold a certain level of capital: less for loans secured by mortgages, more for investments in venture capital firms or exposures in default.

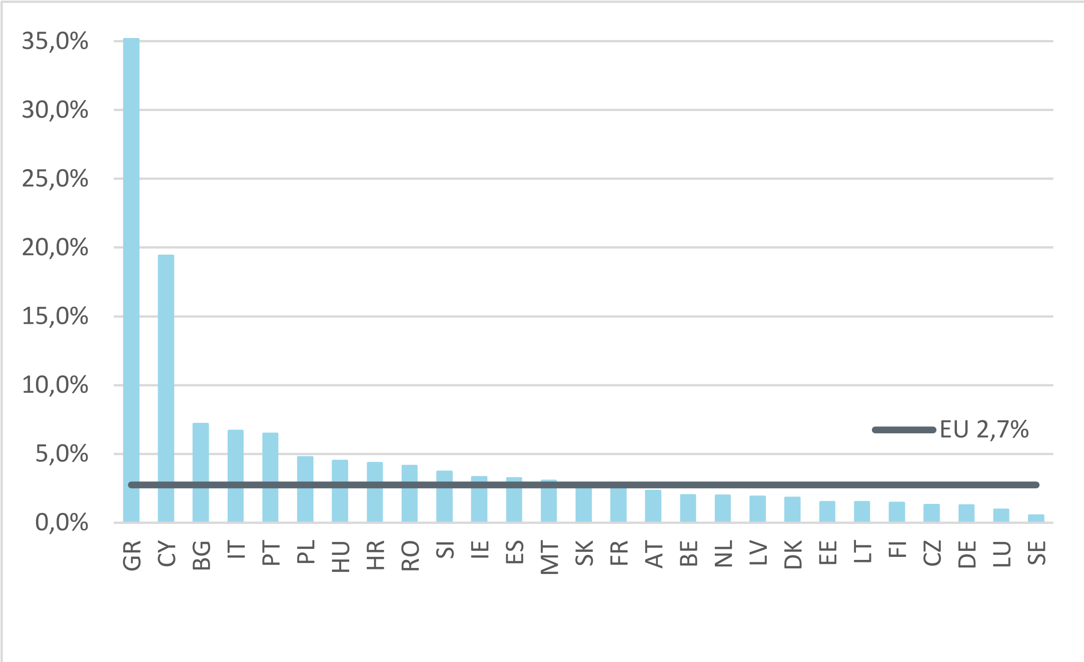
The profitability of European banks was already weak before the COVID-19 pandemic broke out. While EU banks on average estimated their cost of equity (the return required by banks' investors) at between 8% and 10%, their return on equity (banks' net income divided by banks' equity) stood at just 5.8% with German banks showing even negative returns (Figure 2).

Figure 2: Banks' return on equity as of 31.12.2019 by country (own illustration based on EBA data)



In many European countries, banks' profitability is still hampered by the high proportion of non-performing loans within total loans (NPL ratio). When borrowers are struggling to repay their loans, banks suffer in two ways: on the one hand, their profits shrink because of credit losses; on the other hand, their costs rise, because prudential regulation requires them to hold more capital, reflecting the increased riskiness of their loan book. After the peak of the GFC, EU banks' NPL ratio had decreased gradually to 2.7% on average, but post-GFC-balance sheet repair is still ongoing in some EU Member States, in particular in Greece, Cyprus, Bulgaria, Italy and Portugal (Figure 3).

Figure 3: NPL ratios as of 31.12.2019 by country (own illustration based on EBA data)



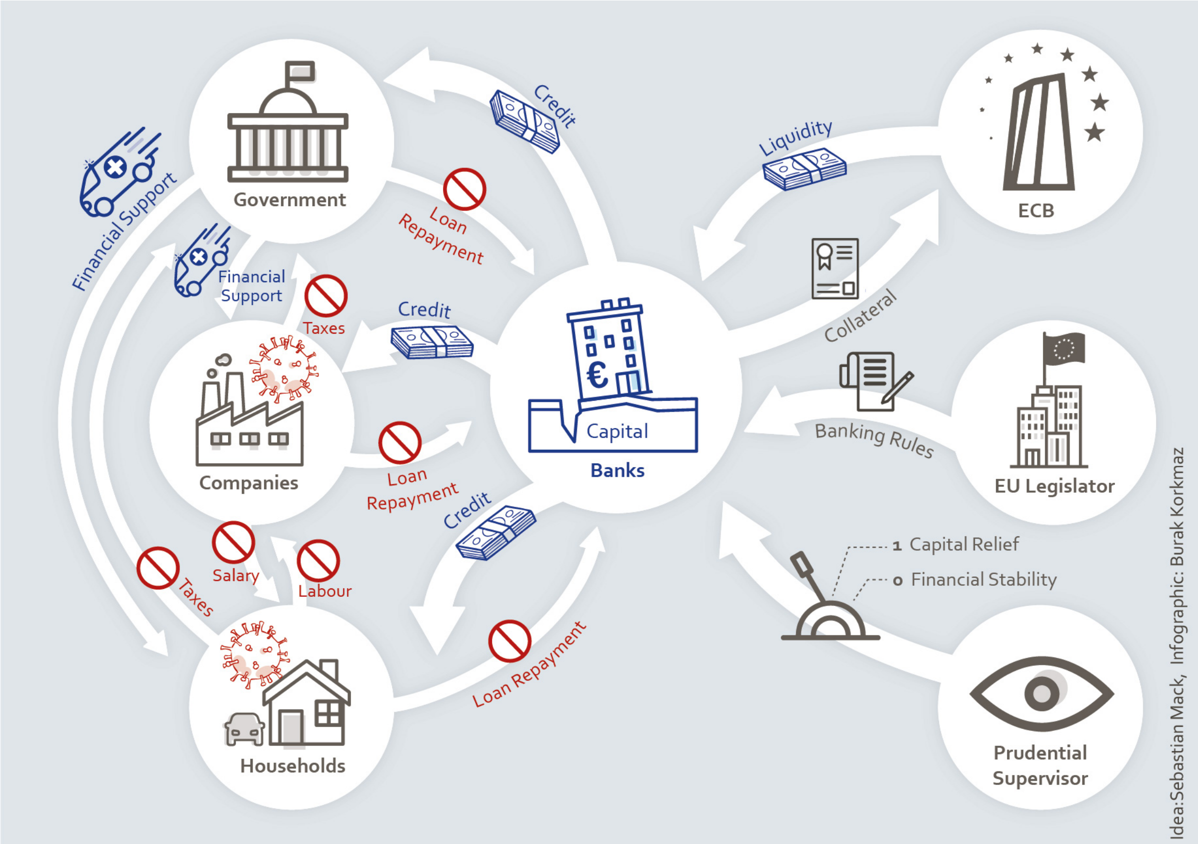
Now, the COVID-19 pandemic is again putting companies and households in difficulties. To bridge their financing needs during the economic lockdown, national governments and the European Investment Bank (EIB) are providing loans, grants and credit guarantees. In addition, ample liquidity made available by the ECB as well as capital relief measures granted by prudential supervisors are encouraging banks to sustain lending to the real economy. Table 5 shows the relevant policy responses to address the credit crunch in the pandemic fallout.

Table 5: Banks' profitability – Most relevant policy responses in the EU (own illustration based on IIF)

Monetary policy	• ECB kept interest rate on the main refinancing operations and rates on the marginal lending facility and the deposit facility unchanged • ECB launched an additional EUR 120 billion under the asset purchase programme (APP) • ECB announced a EUR 750 billion bond buying initiative (PEPP) to support money market mutual funds with no purchase limits • ECB included all commercial paper in the Corporate Sector Purchase Program (CSPP)
Fiscal policy	• National governments provided credit guarantees and direct aid to the real economy • Eurogroup freed up EUR 37 billion investment funds, EUR 28 billion structural funds, EUR 25 billion EIB working capital lending, EUR 20 billion EIB investments, EUR 8 billion to EIF • Eurogroup set-up EUR 100 billion employment insurance fund, an EIB instrument intended to supply EUR 200 billion in liquidity to companies, EUR 240 billion in credit lines from the ESM
Prudential measures	• SSM and EBA allowed banks to fully use capital buffers, to operate temporarily below the liquidity coverage ratio and announced relief in the composition of capital for Pillar 2 Requirements • SSM recommended that all banks avoid procyclical assumptions in their risk models to determine provisions • EBA clarified the application of the prudential framework with regards to classification of default, forbearance, and IFRS 9 • Macroprudential authorities released or reduced countercyclical capital buffers, systemic risk buffers and buffers for other systemically important institutions • SSM asked banks not to pay dividends until at least October 1, 2020. Banks should also refrain from share buy-backs aimed at remunerating shareholders • EBA called on banks to follow prudent dividend and other distribution policies, including variable remuneration • Single Resolution Board (SRB) gave banks more time to raise loss-absorbing capital (MREL instruments)

While these measures are easing the burden for banks by decreasing the risk of borrowers' default, the relief for banks is only of a temporary nature. The longer the shutdown and the slower the recovery, the more borrowers will be unable to repay their loans. The policy responses given so far are keeping the real economy afloat but they don't generate profits for banks that may offset the forthcoming losses. As a result, banks' loss absorbing capacity, i.e. capital, erodes, putting their medium-term viability at risk. Figure 4 summarizes the challenges banks are facing due to the pandemic-induced economic fallout.

Figure 4: Losses from pandemic fallout erode EU banks' capital and endanger their viability



Section 1 has analysed the four major vulnerabilities of European banks and evaluated the effects of policy measures adopted so far. (1) Market and (2) funding liquidity risks have been mitigated while (3) concentration risk could be tackled by a European recovery fund. However, recent policy measures fall short of addressing banks' deteriorating (4) profitability. Losses from defaulting borrowers will erode banks' capital, thereby endangering their viability.

2 European Commission's "CRR quick-fix" banking package puts financial stability at risk

Section 1 has shown that in absence of substantial profits offsetting the surge in non-performing loans, banks rely on sufficient capital to absorb forthcoming losses. According to recent estimates, the economic impact of the Corona crisis might exceed by far any past EU banking stress test and could thus deplete entirely the capital buffers of some banks (see e.g. BIS Bulletin No 11). To weather banks for this crisis, policymakers should consequently look for possibilities to at least maintain or even increase banks' capital. In the upcoming months, banks will need capital not only to absorb losses but also to hand out additional loans to finance the recovery. However, the European Commission on 28 April 2020 put forward a legislative banking package proposal ("CRR quick-fix") which would effectively lower banks' capital requirements (Box 1).

Box 1: Summary of EU Commission proposal for changes to the Capital Requirements Regulation (CRR)

Mitigating the impact of IFRS 9 provisions on regulatory capital

To mitigate the significant increase in the expected credit loss (ECL) provisions of banks as required under IFRS 9, banks are allowed to add back to their regulatory capital any increase in new expected credit loss provisions that they recognise in 2020 and 2021.

Leverage ratio

Banks' exposures to central banks can be excluded for a maximum of one year from the calculation of the leverage ratio requirement. The date of application of the leverage ratio buffer requirement for global systemically important institutions (G-SIIs) is deferred by one year to 1 January 2023.

Treatment of publicly guaranteed loans

Non-performing loans guaranteed by the public sector shall receive a preferential treatment under the minimum loss coverage requirement for non-performing loans (the so-called 'NPL backstop') which in normal times is meant to ensure that banks set aside sufficient funds to cover NPL risks.

Application deadlines for capital relief measures under CRR 2

The application deadline for specific capital relief measures introduced by the last revision of the CRR (exemption of certain software assets from capital deductions, preferential treatment for certain loans backed by pensions or salaries, revised SME supporting factor and new infrastructure supporting factor) is brought forward.

The Commission justifies its legislative proposal with the aim of maintaining bank lending to the real economy during the present acute crisis. While any reduction in capital requirements does give banks breathing space for additional lending, it comes with substantial risks. First, capital buffers should not fall below a level that jeopardise banks' solvency. Since micro-prudential supervisors and macro-prudential authorities already reduced capital requirements by EUR 120 billion and EUR 30 billion respectively, additional capital relief might undermine banks' resilience. Second, capital relief measures are only effective in encouraging bank lending if excessive capital requirements are the constraining factor and not investors' expectations as market analysts currently believe. Third, a legislative package consisting solely of capital relief measures is signalling to bank shareholders that capital requirements are flexible and, if banks go bust, there is less capital to cover losses which is putting not only shareholders and bond holders but also unsecured bank depositors and ultimately taxpayers at higher risk. This is even more true since the Single Resolution Board (SRB) overseeing bank crisis planning and management has given lenders extra time to build up their cushions of debt that can be bailed in if required in handling a failure.

Against this backdrop, policymakers are asked to strike the right balance between granting relief to banks to avoid a credit crunch and maintaining capital buffers to ensure banks' viability. Given the capital relief measures already adopted by prudential supervisors, the Commission proposal seems to overshoot the overall supervisory forbearance for banks, thereby endangering financial stability.

3 Capital conservation will be key for banks to withstand the crisis

Contrary to the European Commission's proposal on lower capital requirements, banks' loss absorbing capacity should be maintained so as to preserve their resilience. Capital conservation would mean preventing banks from distributing retained or current earnings, thereby reducing their loss absorbing capacity. Currently, banks are shrinking their capital base by paying dividends to their shareholders, coupon payments to holders of bonds that can be converted into capital (so-called Additional Tier 1 instruments) and excessive variable remuneration to their employees. With the objective of preserving appropriate capital levels, SSM and EBA have recommended to banks they suspend dividends, share buybacks and excessive bonus payments. However, due to legal concerns, the prudential supervisors were unable to bindingly require all banks to suspend distributions. Since individual banks fear their investors might view the voluntary cut in distributions as a sign of unsound financial health, they are hesitant to suspend all types of discretionary distribution. Consequently, to avoid any possible stigma effect for individual banks and ensure a level playing field in the internal market, there should be a hard requirement for strict internal capital conservation that applies to all financial institutions in the EU.

When the European Commission's CRR quick-fix proposal is negotiated in the near future by the Council and the European Parliament, the latter could amend the legislative text by introducing a binding suspension of distributions. If it is to be effective, such a requirement should apply to all types of distribution, including coupon payments on AT1 instruments which were not part of the recommendations of the EBA and SSM. Since the suspension of distributions interferes with property rights, it should be temporary in nature and subject to objective conditions. The European Commission on 19 March 2020 recognised that, because of COVID-19, the entire EU economy is experiencing serious disturbance. Based on this extraordinary situation, the Commission justified its temporary permission for EU Member States to provide State Aid to companies which is normally forbidden so as to avoid distortions in the internal market. The application of the suggested distribution suspension requirement could be subjected to the European Commission recognition of a serious disturbance having to be complemented by the European Systemic Risk Board (ESRB) issuing a corresponding formal opinion. Given that banks are indirectly profiting from State Aid paid to their borrowers and that prudential supervisors have already lowered substantially banks' capital requirements, a temporary distribution suspension seems to be a proportionate measure to ensure financial stability.

Conclusion

The financial losses from the economic fallout of the pandemic will erode banks' capital and endanger their resilience. So far, policy responses have concentrated on keeping the real economy afloat but have failed to improve banks' resilience. EU policymakers need to strike the right balance between providing capital relief in order to avoid a credit crunch and maintain prudential buffers to ensure banks' viability. The European Commission's recent banking package proposal seems to overshoot the supervisory forbearance for banks, thereby endangering financial stability. European co-legislators should instead require banks to preserve capital themselves by temporarily suspending the pay-out of dividends, AT1 coupons and excessive bonuses. Depending on the depth of the recession and the scale of economic losses, capital conservation alone may not be sufficient. Further measures to create additional bank capital such as establishing bad banks or injecting public money may well be necessary.

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