BRIEFING

for the BUWG

European Parliament

Banking Union: Corona crisis effects

The corona crisis has significant effects on many banks in the Banking Union. To support the Members of the Banking Union Working Group, this series of briefings reports on observations made and actions taken by supervisory authorities, credit rating agencies, banking federations, as well as other industry and academic experts, in order to point to relevant developments in the banking sector.

EBA: Preliminary assessment of the impact of COVID-19 on the EU banking sector

On 25 May 2020, the European Banking Authority (EBA) published a preliminary assessment of the impact of COVID-19 on the EU banking sector, based on supervisory reporting data submitted by EU banks that mainly refer to the fourth quarter 2019.

Many observations in that report are in line with those already published by others (e.g., banks entered unprecedented situation with significantly higher capital ratios and larger liquidity buffers than in the previous crisis; low interest rate environment, low average profitability, and overcapacities in the banking sector pose persisting challenges).

The crisis impact on asset quality is still a key concern for EBA. In recent years, banks have generally increased the portfolios with riskier assets (e.g. SMEs, consumer financing). Growing NPL volumes are very likely.

In quantitative terms, the estimated impact of credit risk losses on CET1 ratios ranges between around 230 and 380 basis points, EBA finds in its sensitivity analysis leaning on the 2018 EBA stress test scenario. While the EU banking sector could on aggregate cope with that impact, the capital ratios of weaker banks, or of those heavily exposed to the most affected sectors (e.g. transport, tourism, accommodation and food service, etc.), might not suffice to weather the upcoming challenges.

The EBA report furthermore finds that funding conditions have recently significantly deteriorated, with tensions observed in both the interbank and US dollar funding markets. Under those circumstances, banks have strongly increased their reliance on central bank funding.

Potential capital impact of credit commitments

As part of the preliminary assessment of the impact of COVID-19 on the EU banking sector, EBA also covered an issue about which there is so far mainly anecdotal evidence available, namely the role of banks' loan commitments (also known as lines of credit). In the context of the corona crisis, banks' corporate clients (and households) seem to increasingly draw existing credit lines to meet urgent liquidity needs.

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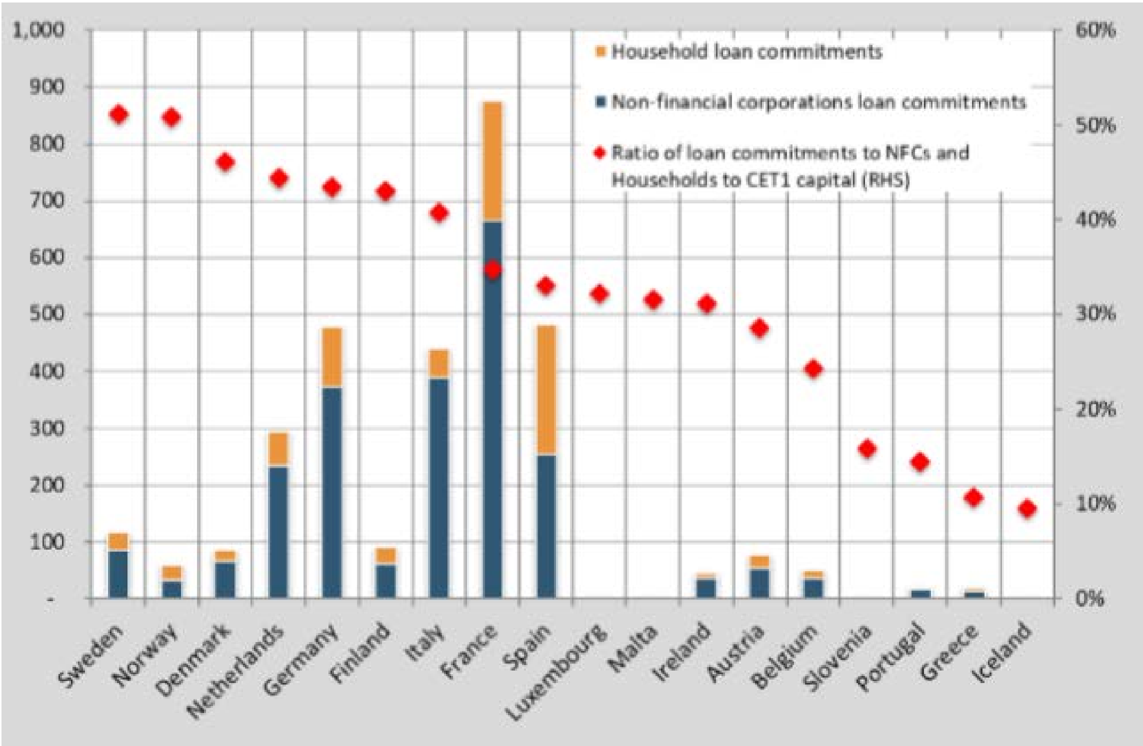
The EBA report points out that the drawing of credit lines by corporate clients and households potentially affects banks' capital ratios. Loan commitments form a significant part of all off-balance sheet items, and are on average of meaningful size, if compared to the available CET1 capital (see figure 1).

EBA's sensitivity analysis indicates that if 10% of credit lines were drawn, the CET1 ratio would fall by 12 basis points, which is a comparatively small effect. In the extreme case that all loan commitments were drawn, EBA estimates that this would result in an average decrease in CET1 capital of 127 bps.

However, for two reasons the results of that sensitivity analysis should be read with caution. First, the displayed average impact may deflect attention away from the fact that the impact would be notably higher in individual cases; the EBA report does not disclose the maximum impact, but it mentions the estimated interquartile range, which allows to conclude that 25% of the banks in the sample would be confronted with an impact of more than 184 bps of CET1.

Figure 1: Off-balance sheet loan commitments to non-financial corporations and households as a proportion of CET1 capital, by country, as at Q4 2019 (in EUR bn)



Source: EBA report "The EU Banking Sector: First insights into the COVID-19 impacts", p. 23 (figure 11)

Secondly, the sensitivity analysis is based on the assumption that there would be no increase in the probability of default for the drawn amount, which is certainly a very optimistic assumption.

The underlying contractual arrangements for the credit lines usually contain clauses that give a bank the ability to refuse a request to draw down a loan commitment if there is a significant deterioration in the borrower's business; nevertheless, on 27 May the FT cited data from 9Fin, a fintech data provider, which indicate that over the past four months more than 100 companies ranking below investment grade have drawn down roughly €32bn from credit commitments from global banks, nearly half of that drawn by companies in the consumer discretionary sector currently hit hard by the crisis; the FT cautions that the true figure is likely to be much higher, given that publicly traded companies are not required to report drawdowns immediately and privately held groups have no obligation to announce them.

Credit rating agencies do pay attention to the potential capital impact of credit commitments, as they can actually pose a significant credit risk to the underwriting bank.

Fitch [1] recently pointed to the relevance of loan commitments and the room for improvement regarding their disclosure:

"*Fitch believes that sound capitalisation will be important for the banks' resilience in the crisis, and capitalisation is an important rating driver. [...] Enhanced bank disclosure on the expected extent of RWA inflation from rating migration and drawn credit lines would provide useful insight to anticipate capital ratio trajectories for the coming quarters*."

The assumption in EBA's sensitivity analysis that there would be no increase in the probability of default for the drawn amount can be reflected in the context of some empirical study and findings:

Not long ago, Moody's for example published[2] the results of an empirical study that found that defaulted borrowers draw down more of their lines than non-defaulted borrowers, that they increase their usage when approaching default, and that usage ratios are generally higher during economic downturns.

In a similar vein, Acharya and Steffen, providing more data on the situation in the US, likewise found[3] that "*low-quality firms, however, are in general more likely to draw down their credit lines when credit markets tighten as they are closer to their default threshold*".

An earlier study [4] that analysed the situation in Spain during the previous financial crisis came to similar results, showing that firms heading into default drew heavily on their credit lines.

In view of those findings, one may find it very reasonable that other authors[5] suggested that *"[...] given the size of existing credit lines, authorities may need to develop policies to monitor drawdowns and availability.*

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This document is available on the internet at: www.europarl.europa.eu/supporting-analyses

[1] See Fitch Non-Rating Action Commentary: "*European Bank 1Q20 Results Will Highlight Pressure Points for 2020*", published on 22 April 2020.

[2] See Zhao and Yang: "*Usage and Exposures at Default of Corporate Credit Lines – An Empirical Study*", published by Moody's in September 2019.

[3] See Acharya and Steffen: " *'Stress tests' for banks as liquidity insurers in a time of COVID*", published on 22 March 2020 on VOX CEPR

[4] See Jiménez, Lopez, and Saurina (2009): "*Empirical Analysis of Corporate Credit Lines*", The Review of Financial Studies, Vol. 22 (12), pp. 5069-098.

[5] See Banerjee, Illes, Kharroubi and Serena (2020): "Covid-19 and corporate sector liquidity", published by the Bank for International Settlement in BIS Bulletin No 10 on 28 April 2020.