BRIEFING

for the BUWG

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.

Crisis preparedness and past underwriting standards

When the economic impact of the corona crisis was still looming on the horizon, the comforting message given was that EU banks' average capital ratios had significantly improved since 2008.

While virtually all banks have better capital ratios entering the crisis, their individual levels of profitability show large differences, giving very different headroom to cope in future with the impact of rising non-performing loans.

A new report by the ECB on banks' credit underwriting standards published on 10 June 2020 sheds some light on the question why banks perform very differently, highlighting weaknesses in the way banks have granted and priced new loans in recent years.

Obviously, the pricing of loans needs to reflect inherent risks to cover credit risk costs (expected losses) and other costs. In line with that principle, the ECB found that in most countries, pricing across lending portfolios (e.g. credit for consumption, loans to SMEs etc.) is generally risk-sensitive (with some exceptions).

Among the many interesting findings in the ECB report, two are therefore particularly alarming:

1) In its empirical analysis, within portfolios the ECB found **no significant relationship between pricing spread and expected losses at the individual bank level**. That observation points to a grave malfunctioning in underwriting processes. In a similar vein, the ECB also found that at portfolio basis, prices for loans to higher-risk borrowers seem to fall short in covering expected losses, as pricing spreads do not rise in proportion to the increase in expected losses. In other words: pricing models may simply be inadequate or results derived from the pricing model are superseded by other considerations.

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2) The statistical tests of the data showed **no evidence for better risk-based loan pricing of banks using the internal ratings-based (IRB) approach** for the risk-weighted assets (RWAs) calculation than that of other banks. The IRB approach hence seems to serve mainly capital relief purposes.

Comprehensive assessment of five Croatian banks

On 5 June, the ECN published the [results of a comprehensive assessment]() of five Croatian banks, following Croatia's request to establish close cooperation between the ECB and Hrvatska narodna banka (the central bank of Croatia).

That comprehensive assessment comprised the usual asset quality review and stress test. In the asset quality review, four of the five banks were subject to only an insignificant adjustment, and one – Hrvatska poštanska banka – was subject to a relatively small adjustment, which reduced its initial CET1 ratio of 20.2% by 1.5% to a CET1 level of 18.7%.

In the adverse scenario of the stress test, three of the five banks saw their comfortable CET1 ratios fall by only a third or less, but in two cases, the impact was much larger: the CET1 level of OTP banka Hrvatska was reduced in the stress scenario by 59%, and that of Hrvatska poštanska banka even by 69%. As in none of the cases the capital levels fell below the relevant thresholds, the ECB concluded that the comprehensive assessment overall **did not indicate any capital shortfalls**.

EIB's assessment of corona effects on EU corporates

Building on a previous analysis, the EIB published on 10 June a short [economic briefing]() that focusses in particular on corporate revenues, investment, and debt levels.

The EIB finds that, cumulatively, the crisis and the subsequent recovery process might lead to a decline of European corporate net revenues that could range from €1.9 trillion and €3.4 trillion (13% to 24% of EU GDP).

The EIB looks into different scenarios. The EIB finds that in one scenario, which assumes that the whole sample of firms in the EIB Investment Survey would tap external finance, even those that would not do so in normal times, the share of external financing could rise from about 30% to 60%. Firms have to choose between higher leverage, potentially exposing themselves to solvency issues but allowing for some investment, or lower leverage and a more aggressive cut in investment. The EIB expects the **impact on investment to be significantly higher than that of the 2007-2008 financial crisis**, and recommends that, going forward, aid for the corporate sector should complement liquidity support with more long-term equity instruments that avoid excessive leverage.

Banks' exposures to Home sovereign bonds

The financial crisis of 2008 drew attention to the 'sovereign-bank' nexus, namely the degree to which the financial standing of banks and Member States is interdependent. Costly rescue operations for banks led to significant increases of public debt, while the investment in sovereign bonds made banks vulnerable to rating downgrades of countries or sovereign entities.

As it was often not clear how many and which bonds issued by national governments banks actually held in their portfolio, the European Banking Authority (EBA) started in 2011 a so-called "transparency exercise" that provided more clarity on that matter. To foster transparency and market discipline in the EU financial markets, that exercise was since carried out on a yearly basis. The most recent results were published on 8 June 2020 ([Spring 2020 EU-wide transparency]()); its results refer to a sample of 127 large banks from 27 countries of the European Union and the European Economic Area.

Table 1 below summarises the data surveyed by EBA, and puts it into relation (as percentage of total assets, or portfolio of sovereign bonds held). The first column shows, at country level, how much of the banks' balance sheets is overall invested in Sovereign Bonds, in relation to total assets, and the second how much is actually invested only in Home Sovereign Bonds. The third column shows to what extent the banks' portfolio of sovereign bonds is concentrated in those issued by the Home sovereigns, shown as average at country level, while the fourth and fifth show the minimum and maximum concentration (the range) that the sampled banks on that country hold in home sovereign bonds.

The table illustrates well that **intra-country differences are way larger than inter-country differences**: in most countries there are banks that have very small and others that have very large portfolios of Home sovereign bonds. The level of exposures is, hence, more bank- than country-specific, though some country averages stand out as well.

Table 1: Summary of EBA results (percentages of total assets, or portfolio)

	Sovereign bonds / assets	Home Sovereign bonds / assets	Average concentration	Minimum concentration	Maximum concentration	Sample size
AT	11.4%	2.8%	24.4%	0.0%	98.5%	6
BE	24.1%	6.8%	28.2%	0.7%	84.8%	6
BG	6.6%	3.4%	51.4%	51.4%	51.4%	1
CY	11.3%	9.8%	86.9%	0.0%	98.4%	3
DK	4.9%	2.4%	49.1%	29.5%	100.0%	4
EE	9.8%	7.7%	78.5%	21.7%	95.8%	2
FI	16.2%	7.6%	46.8%	0.0%	92.8%	4
FR	11.3%	6.1%	53.8%	0.0%	89.6%	10
DE	10.8%	5.2%	48.1%	6.0%	97.3%	17
GR	11.3%	7.8%	69.3%	62.7%	76.6%	4
HU	0.3%	0.1%	27.3%	27.3%	27.3%	1
IE	8.7%	4.3%	49.1%	0.0%	63.9%	3
IT	13.9%	7.4%	53.2%	0.0%	100.0%	11
LV	18.5%	7.9%	42.5%	42.5%	42.5%	1
LT	23.3%	17.8%	76.2%	76.2%	76.2%	1
LU	26.8%	6.6%	24.7%	0.0%	50.7%	5
MT	14.0%	5.2%	37.3%	0.0%	46.6%	3
NL	11.5%	6.2%	54.0%	12.9%	98.1%	6
PL	25.3%	24.6%	97.0%	92.4%	99.5%	2
PT	21.6%	11.4%	52.9%	43.2%	69.4%	5
RO	40.4%	37.9%	93.9%	93.9%	93.9%	1
SI	21.9%	7.9%	36.0%	36.0%	36.0%	1
ES	12.9%	6.2%	47.9%	26.2%	93.4%	12
SE	4.8%	3.6%	74.4%	32.1%	98.6%	6
UK	10.7%	2.2%	20.6%	0.9%	83.6%	6

Source: EGOV calculations based on EBA data. For simplification purposes, the item actually recorded in the EBA results, namely the "*on balance sheet total carrying amount of non-derivative financial assets (net of short positions)*" are in this briefing equated with the term "sovereign bonds".