BRIEFING

European Parliament

Thematic digest: When and how to unwind COVID-support measures to the banking system

This document presents the summaries of four external papers commissioned by EGOV in November 2020 upon request of the Economic and Monetary Committee (ECON). Papers were delivered, analysed and published in March 2021. ECON has requested its Banking Panel to address the question of when and how to unwind COVID-support measures to the banking system.

The experts were asked, bearing in mind the broad range of measures implemented, the crisis situation still being experienced and possible long lasting effects of the support measures and of the COVID-crisis, to provide guidance on how and when to plan, decide and execute the unwinding of banking support measures. Policy recommendations should be mindful of the differing nature of support measures (supervisory, budgetary/fiscal, etc.) and of their potential effects.

On a general note, one may highlight the following:

- **All four papers highlight the negative implications for transparency as a result of supervisory relief measures.** While noting that these measures were neccessary from the prudential perspective (see Haselmann and Tröger in particular), the potential obfuscation of credit quality on banks' balance sheets has negative implications for financial stability. To this end, Lehmann is in favour of enforcing banks' existing obligations under the European Banking Authority (EBA) Guidelines, and notes that the implementation of IFRS 9 needs to become more consistent and predictable. Resti argues that banks should be incentivised to collect and process information timeously on individual borrowers when possible, by gradually reducing the portion of new loans that are covered by public guarantees and imposing conditions on firms allowed to benefit from additional moratoria. He also calls for further guidance on the circumstances triggering a significant increase in credit risk under IFRS 9. Haselmann and Tröger suggest using the 2021 stress test as a way of gauging asset quality in euro area banks, and call for an immediate return to realistic reporting methodologies under IFRS 9. Beck et al. advocate for the phasing out borrower relief measures, such as moratoria, before any other policies, with the objective of restoring banks transparency.
- The papers noted the need for policy makers to **consider how non-performing loans (NPLs) can be disposed going forward.** Lehmann argues that, given the nature of NPLs that can be expected post-

ECONOMIC GOVERNANCE SUPPORT UNIT (EGOV)
Authors: C. DIAS, K. GRIGAITÉ, M. MAGNUS, R. SEGALL, G. GOTTI, K. KOMAZEC
Directorate-General for Internal Policies
PE 659.641 - March 2021

EN

pandemic, an undifferentiated strategy of disposing of NPLs in loan markets may not be adequate, given the need for complex debt restructuring, in particular for SMEs. Resti here suggests that additional flexibility in default recognition should be allowed for viable firms that require added support. Moreover, he argues that "*measures cannot be simply reversed, but need to be replaced by more structural interventions to steer the banking system across a period of unprecedented economic and social turmoil*." Such structural interventions suggested by Resti include investment in judicial reforms to deal with liquidation procedures, removing impediments to the use of public asset management companies (AMCs), including reexamining State aid rules market for NPLs, and additional measures integrating deposit insurance accross the EU, encouraging cross-border bank mergers, and the development of a pan-EU AMC.

- In terms of **sequencing**, Beck et al. first suggest to phase out borrowers relief measures (moratoria first, and public guarantee schemes later) with the goal of re-enstablishing banks' balance sheet transparency. When a total undwinding is not possible, the authors argue for targeted support instead of the blanket measures now in place. In a second stage, once the crisis has settled, capital relief measures should also be lifted, with a clear and timely comunication by the regulatory authorities on the rebuilding of capital buffers.
- Some authors acknowledge that the COVID-19 crisis **may result in consolidation of the EU banking sector.** Haselmann and Tröger state that this could be *"an opportunity to address legacy problems of a sustained, welfare-decreasing undercapitalisation that haunted euro area banks already for a long time ... and may ultimately lead to a welfare-increasing consolidation of the European banking sector."* They argue that firms that have no realistic prospect of fulfilling regulatory capital requirement exit the market, and that others should be recapitalised, putting forth a proposal for supranational precautionary recapitalisation using European Stability Mechanism (ESM) funds. In this regard, in order to face the reshaping of the banking sector, Beck et al. advocate for cooperation at the national and supernational levels and for flexible use of European bank resolution schemes and national insolvency frameworks; these topics should be a priority before the publication of the stress-test results by mid-2021.

The summaries were drafted by EGOV in own responsibility. Further conclusions on the authors' views require consideration of the full papers.

The hyperlink on the title of the papers listed in this document links to the studies as published in the ECON homepage.

The *Economic Governance Support Unit* provides expertise in view of supporting the European Parliament and its relevant committees and bodies, notably in their scrutiny-related activities on economic governance and banking union. EGOV is part of the Directorate-General for Internal Policies of the Union (DG IPOL).

Contact: egov@ep.europa.eu

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

When and how to unwind COVID support measures to the banking system?

Author: Alexander LEHMANN

In this paper, the author addresses the questions of whether the flexibility granted in banking regulations and supervision has undermined the credibility of asset quality disclosures by banks, and when and how such support should be withdrawn in order to avoid the 'cliff-edge risks' of an abrupt policy change.

The author first details how national loan moratoria and guarantee schemes have underpinned the credit expansion in the euro area in 2020. These policies were supported by enabling measures taken by bank regulators and supervisors, in the form of amendments to EU regulation (e.g. the extended IFRS 9 transitional arrangement), supervisory policy (as in the EBA moratoria guidelines) and interpretive statements (e.g. on the default definition).

Despite being considered *"essential at first"*, the author suggests that these supportive measures have created some risks with regard to the credit risk framework. Firstly, the EBA guidelines on the treatment of moratoria have weakened the usual asset quality and disclosure standards, at least temporarily. Secondly, the recognition of forward-looking credit losses under the IFRS 9 accounting framework is of interest for sound risk management. Euro area banks' overall provisions over the course of the crisis are below those in other advanced markets and fell again in the second half of the year. Idiosyncratic borrower-level risk assessments have fallen behind collective provisions, which may undermine banks' ability to identify and offer restructuring solutions in the recovery. Accordingly, they may be poorly prepared to identify and handle more widespread defaults and to offer restructuring solutions to individual borrowers. Lastly, regarding the tolerance of higher NPLs, statements by the European Central Bank (ECB) suggested that previously-agreed limits for NPLs in individual banks, and paths for reductions, became more flexible in 2020. However, it is not clear whether this also implies greater tolerance for renewed increases in NPLs in other banks. Nevertheless, the author considers that the Commission NPL Action Plan, together with with the sounder prudential position of euro area banks, is likely to result in a more rapid workout process for NPLs than was observed in the previous crisis.

With the supportive policies set to expire in the near future, the author notes that the ECB and the EBA will need to address any perception among market participants that flexibility shown during the crisis implies that supervisors would continue to tolerate delayed recognition of loan losses and of non-performing assets. Simultaneously, this process will need to be well managed to avoid the 'cliff-edge' risks of an abrupt policy change, should a large volume of loans be reclassified as non-performing and the ensuing implifications for financial stability and continued credit provision. The author thus identifies three priorities in managing this process:

(i) Accurate default data and disclosure of such figures in the market are preconditions for sound supervision and macroprudential policy. Therefore, it is neccessary to enforce accurate reporting of defaults and other NPLs as national moratoria expire. Enforcing banks' existing obligations under the EBA Guidelines is seen primarily as a task for ECB supervision.

(ii) The implementation of IFRS 9 needs to become more consistent and predictable, which will likely be addressed by the ECB's focus on credit risk management. Additional supervisory focus on closing disclosure gaps and raising the consistency of disclosures by institutions may also be warranted.

(iii) Flexibility in the ECB's policy on banks' NPL reduction strategies is seen as sensible even though schedules for minimum provisioning should remain unchanged. Acknowledging that new NPLs will arise among corporate and SME loans that have only a recent history of arrears and are as yet outside foreclosure or insolvency enforcement, the author concludes that an undifferentiated strategy of disposing of NPLs in loan markets may not be adequate, given the need for complex debt restructuring.

When and how to unwind COVID support measures to the banking system?

Authors: Rainer HASELMANN and Tobias TRÖGER

Looking at relevant supervisory relief measures geared towards euro area banks, this paper models the potential impact of a pandemic-driven economic downturn on banks' balance sheets in order to gauge the magnitude of potential risks facing the financial sector in the aftermath of the COVID-19 crisis. The authors find that euro area banks are likely to face a significant capital shortfall and highlight ways forward that hinge on full transparency of losses and meaningful recapitalisation capacities for viable banks.

In the first step, the authors outline various supervisory measures implemented by the ECB Banking Supervisor to avoid a procyclical tightening of capital and liquidity requirements for banks during the COVID-19 crisis. These include direct supervisory measures, including recommendations regarding the application of reporting standards, and moratoria on loan repayments covered by public support measures. While acknowledging the neccessity of such measures, the authors are more critical of the ECB's recommendation to use highly optimistic macroeconomic assumptions in financial reporting. In combination with the broad recognition of moratoria in prudential regulation, there is a risk of banks concealing the deterioration of credit quality, with negative implications for transparency.

Given that banks' balance sheets may not reflect the full picture, the authors conduct a simulation, using German micro-level data, to better understand how retracting COVID-19 support measures would affect the banking sector. Using data regarding banks' loan protfolios and capital positions prior to the pandemic crisis, the authors simulate shocks of different magnitudes - one assuming that the pandemic recession is of the same magnitide as that experienced in 2009, and the second assuming that the downturn will be 1.5 times higher than that observed in 2009. Furthermore, given that the average levels of NPLs in German banks tend to be rather low by European standards, the authors suggest that the results of the simulation can be considered to illustrate lower bound effects.

Overall, the authors found that not only would NPLs increase in either scenario, but so would level 2 loans (performing "risky" loans), with corresponding implications for banks' loan loss provisions. The authors note that *"given that banks have to write off the expected lifetime loss for these stage 2 loans, this result already suggests a strongly procyclical impact in case supervisors would demand banks to rapidly comply with the IFRS 9 rules."* Moreover, the authors find that this *"implies a drastic decline of banks' Tier 1 ratio in the recession scenarios if COVID-19 relief measures were to unwound rapidly. Before the event, the sample banks had an average Tier 1 ratio of 17.31%. Under the factor 1 scenario and the factor 1.5 scenario, this ratio would shrink to approximately 11.07% and 8.46%, respectively. In this case, a considerable fraction of bank assets would not be covered by required regulatory capital: about 16% of bank assets in the factor 1 scenario and about 42% of bank assets under the factor 1.5 scenario."* These results suggest that a strict enforcement of regulatory requirements during the pandemic outbreak crisis would have likely triggered a new banking crisis, providing a rationale for the measures taken.

Nevertheless, the authors stress that the resulting lack of transparency ultimately jeopardises financial stability by impairing investor confidence. In order to address this, the authors suggest (i) an immediate return to realistic reporting methodologies under IFRS 9; (ii) for the ECB to continue supporting adequate provisioning through capital relief measures; and (iii) for the ECB, jointly with the EBA and the European Systemic Risk Board, to use the 2021 stress test to provide a realistic account of the asset quality of euro area banks. Moreover, the authors argue that the current crisis management framwork is suited to address many of the impending problems. For banks that have no prospect of fulfilling regulatory capital requirements, the authors suggest exiting the market. Other banks should then be recapitalised: *"supranational recapitalisation fund could acquire stakes in the largest banks of all EU Member States. All healthy banks should be included in such a program to avoid coordination and signaling problems ... and to avoid contagion."* The authors in principle endorse a proposal for supranational precautionary recapitalisations using ESM funds under certain preconditions.

When and how to unwind COVID support measures to the banking system?

Authors: Thorsten BECK, Brunella BRUNO and Elena CARLETTI

The paper examines the support measures deployed in the response to the COVID-19 crisis, giving special focus to the measures directly affecting bank lending, in order to maintain banks' ability to provide funds to the economy. Each policy is evaluated in its merits, interlinkages and possible drawbacks for financial stability with the purpose of understanding the best way of unwinding them. In fact, it is argued that *"deciding how and when to exit from relief measuresis certainly a great challenge. Acting too early may induce a credit crunch and impede the economy recovery. Waiting too long could create the premises for undesired feedback loops among the sovereigns, banks, and the real economyand,thus, heighten systemic risks. Making the right calls at the right time will require judgment and caution as well as coordination among different, national and international, institutions."*

The first part of the paper argues that the synergy of monetary, fiscal and regulatory policies enabled a virtuous circle between corporates, banks and sovereign. Banks, in fact, have increased lending and in the short-run income was stabilized and corporate default were contained. Nonetheless, the interlinkages between this broad support and the increase in sovereign debt raise concerns on whether the prolongment of the measures can turn the virtuous circle into a vicious embrace. For this reason, it is important to understand the impact of the relief measures on banks' balance sheets.

Therefore, the second part of the paper analyses the measures that affect directly the banking sector, namely borrower and capital relief measures, focusing on their positive effects as well as their drawbacks.

(i) Moratoria on loan repayment, amounting to 6% of European banks' loans as of June 2020, mitigate rollover and default risk. However, prolonged moratoria may reduce banks' transparency, moratoria can in fact mask borrowers' solvency issues into liquidity ones. Moreover, they can trigger delayed inadequate provisioning and worsen banks lending.

(ii) Public guarantee schemes (PSG), 1.2% of banks' total loans as of June 2020, shift the risk from banks to sovereigns. They allow financial institutions to operate at lower risk-related assets exposures, therefore decreasing expenses. However, PSG can reinforce the sovereign feedback loop.

(iii) Capital relief measures allow banks to temporary operate below the regulated levels of capital to facilitate operations and loss absorption. Nonetheless, banks have not made intensive usage of this measure. For instance, the CET1 ratio was 14.9% by the end of 2019 and increased to 15.2% one year later. One explanation for this behavior is the stigma related to the breach of capital requirements; financial markets pressure and fear of higher financing costs might have deterred banks from using their capital buffers. Moreover, banks might not want to face the regulatory uncertainty over the timing to restore their buffers.

Having established these premises, the authors outline an exit strategy that takes into account the interactions between different measures. They find, as a first-order objective, restoring bank balance sheet transparency via phasing out borrower relief measures such as moratoria. This would allow for re-establishing screening incentives for banks, promoting NPL recognition and adequate loan loss provisioning. Flexibility and a tailored approach that targets the sectors most hit by the containment policies are crucial in this phase; some industries may still need forms of support, but they have to be designed to mitigate the risk of moral hazard. If some measures cannot be phased out completely, the blanket support should move to a more tailored support. Moreover, the paper finds that, after the crisis, as certain banks may be found unviable and others will face reduced capital buffers, creative destruction (i.e. *"some ... may have to undertake a profound transformation towards new products, services and/or markets, and new firms are created in sectors and industries with growth opportunities"*) could follow. This process requires cooperation at different levels, but also a flexible use of European bank resolution schemes and national insolvency frameworks; this should be a priority before the publication of stress test results in mid-2021. The last stage of the exit process requires the rebuilding of capital buffers with a clear schedule and complemented by restrictions on profit distribution based on a bank-by-bank approach. Finally, irrespective of the chosen exit strategy, the authors argue that clear and timely communication is a key element as it allows banks sufficient space of maneuver for adjusting to the new policies.

When and how to unwind COVID support measures to the banking system?

Authors: Andrea RESTI

In his paper, Resti identifies that, despite a severe economic downturn in Q2, 2020, bank lending to non-financial companies experienced a material increase. Moreover, strong positive changes in loan growth occured for hard-hit industries. He attributes this to the wave of support measures taken since the start of the pandemic: direct measures, mostly taken at the supranational level and focused on easing capital requirements and isolating bank accounts from the adverse effects of the pandemic, and indirect measures taken mostly at the national level, aimed at supporting borrowers.

In order to understand when and how these measures can be rolled back without causing further economic and social disruption, the author surveys the main measures issued in the past year. He finds that direct measures have addressed: (i) bank capital adequacy, by releasing regulatory buffers and requesting that banks retain earnings and other distributions to reinforce their capital base; (ii) default recognition, allowing lenders to avoid treating moratoria and public guarantees as default triggers; (iii) NPL provisioning and clean-up, freezing the CRR prudential backstop on non-performing exposures secured by public sector guarantee; and (iv) provisions on loans experiencing a significant increase in credit risk, requesting banks to avoid being overly procyclical in identifying borrowers for which the probability of default has increased since loan origination.

Regarding indirect measures, the author differentiated between three types of measures: (i) immediate fiscal measures, like subsidies and tax exemptions, that increased public deficits and debt; (ii) contingent fiscal measures (e.g. state-sponsored loans, tax deferrals and public guarantees), which did not immediately increase the government's deficit, but may have a substantial impact on the public sector's accounts in the future; and (iii) fiscally-neutral measures, like moratoria, which do not entail costs for governments (neither immediate nor potential). The author notes that these three policy tools have been used to different extents by different Member States, which has a potential of leading to some imbalances. The paper concludes that *"indirect measures seem to have followed different patterns across Member States: where constraints posed by public-sector deficits and sovereign debt were tighter, the governments' response to Covid-19 was more focused on contingent and fiscally-neutral interventions. However, such measures are intrinsically fragile, since they might lead to greater fiscal unbalances (as deferred taxes may not be paid, and public guarantees must be honoured if called) and to a significant rise in bank loan defaults once moratoria are lifted"*.

Turning then to the question of when and how to unwind COVID-related emergency measures, Resti argues that the recovery can be expected to create both winners and losers. Moreover, it is argued that *"emergency instruments aimed at freezing payments, easing capital constraints and providing additional credit cannot simply be dismantled, but rather have to be replaced by measures aimed at smoothing the transition"*. Focusing on banking supervision and regulation and the expected rise in NPLs as support measures are scaled back, Resti suggests that, firstly, additional flexibility in default recognition should be allowed for companies that are on a path to recovery but that require added support. Second, significant investment in judicial procedures to deal with liquidation procedures should be undertaken. For those Member States that invest in such innovations, the author suggests rewarding them by easing the prudential backstop. Third, Resti suggests that AMCs have a role to play in developing an active secondary market for NPLs, but that State aid rules should be reexamined so as not to act as a constraint on the use of public AMCs. Fourth, in order to counteract the sovereign-bank loop, he suggests additional measures integrating deposit insurance accross the EU, encouraging cross-border bank mergers, and the development of a pan-EU AMC. Fifth, further guidance on the circumstances triggering a significant increase in credit risk under IFRS 9 is suggested, given some ambiguities identified by the author. Lastly, banks should be incentivised to collect and process information timeously on individual borrowers when possible, by gradually reducing the portion of new loans that are covered by public guarantees and imposing conditions on firms allowed to benefit from additional moritoria.