Pandemic continues to cast a shadow over the outlook for European banks’ credit risks

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The COVID-19 pandemic has led to an increase in the credit risk faced by European banks. Although the pandemic’s negative impact on the economy has been eased thanks to various support measures, there is still much uncertainty attached to how the crisis will play out. Banks in general are showing stronger resilience to risk than they did in previous crises. The state of the banking sector will be assessed in spring 2021 by means of stress tests. If the stock of non-performing loans increases, it could be difficult for banks to continue supplying credit to the real economy. The European Commission has proposed an action plan to reduce the number of non-performing loans.

Policy measures have for now curbed the increase in non-performing loans

The risks to the operational environment of European banks have increased in all

European countries. Economic growth has been weakened due to the constraints in place to control the COVID-19 pandemic and wariness on the part of consumers. Combined with the changes in the business environment that the pandemic has caused, this has meant the credit risks that banks face have increased. Attempts have been made to dampen the adverse economic effects of the pandemic through monetary policy, banking supervision and regulation, as well as through macroprudential policies. Furthermore, a broad range of public sector support measures has for now curbed the increase in non-performing loans.

According to the European Banking Authority (EBA), by the end of 2020 more than EUR 320 billion of loans were subject to payment deferrals (moratoria) granted by banks. This accounted for around 2.8% of the corporate and household loans granted by banks supervised by the EBA. Moreover, some EUR 340 billion in private sector loans were granted out of the State guarantee schemes by the end of 2020. Both the number of payment deferrals and the number of loans backed by various State guarantees vary considerably from country to country.

The number of non-performing loans is expected to increase this year

As the COVID-19 pandemic drags on, businesses have become less profitable and unemployment has risen. The expectation is that the number of non-performing loans will increase.[1] Some actors in the private sector are unlikely to be able to meet all their loan obligations because of the financial problems they have due to the pandemic. The indicators for the quality of the banks' credit portfolios reveal a deterioration in the creditworthiness of households and corporate borrowers. Because of the provisional support offered by the authorities, it is actually hard to judge the creditworthiness of bank customers. Estimates suggest, however, that approximately 30% of the loans to customers who have been granted payment deferrals come with a substantially increased credit risk (Stage 2 loans). The financial support measures granted to help with loans will gradually start to end in 2021. According to the European Banking Authority, almost 30% of the loans granted under the State guarantee schemes in the EU will have to be repaid by the end of the year.

Corporate surveys and economic statistics reflect the worsening situation in particular for SMEs in the travel and other service industries in many countries. The number of non-performing loans threatens to grow mainly in countries where the share of industries hardest hit by the pandemic is significant. In some countries the number of non-performing loans was high following the global financial crisis and before the pandemic even began.

Banks show stronger resilience to risk

The risk resilience of European banks has improved since the global financial crisis.[2]

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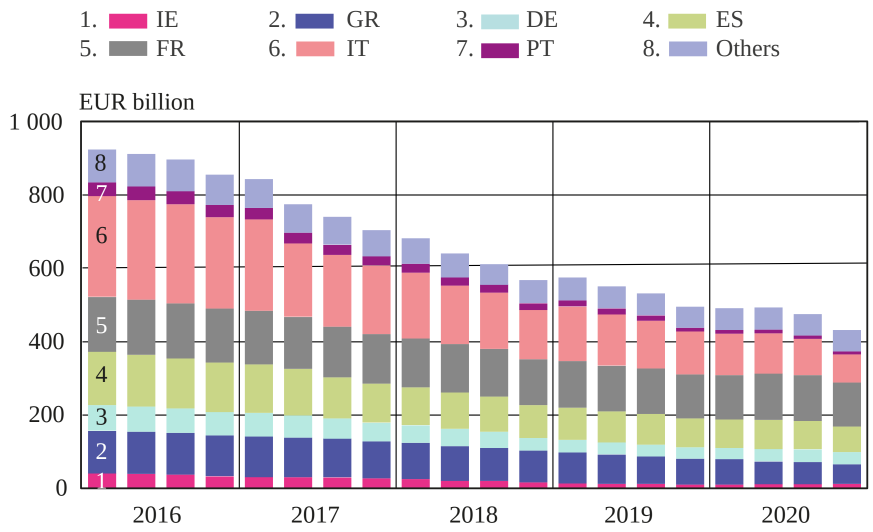
1. A non-performing loan is a debt the payment of which is at least 90 days late.
2. According to the European Central Bank, the Common Equity Tier 1 capital ratio (CET1) of banks in the euro area was 15.6% at the end of 2020, against 15.0% at the end of 2019.

Regulatory reforms have improved the capital adequacy of the banks and they are better placed to face possible economic downturns than they were in previous crises. The banks succeeded in nearly halving the number of non-performing loans on their balance sheets before the pandemic, when compared with the figure for 2014. Data from the Single Supervisory Mechanism (SSM) shows that, at the end of 2020, banks in the euro area had EUR 444 billion in non-performing loans on their books, which accounted for about 2.6% of all the money borrowed from euro area banks (Chart 1). At the peak of the debt crisis in the euro area, non-performing loans accounted for around 8% of all the loans granted by banks.

Chart 1.

Volume of non-performing loans with European banks has remained steady despite the pandemic



Source: SSM.

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In recent years, the strengthened solvency of the banks and their risk resilience have helped them continue to be able to lend money to the private sector more readily than in previous crises. The risk resilience of the big banks is measured in stress tests conducted by the European Banking Authority. A stress test exercise began in January 2021 and its results will be published at the end of July.

The banks have prepared for a rise in the number of non-performing loans with an increase in buffers

In addition to the support granted by the authorities, banks have also taken steps to prepare for a weaker economic situation and for a rise in the number of bad loans by strengthening their buffers against losses. Loan loss reserves grew substantially, especially during the first six months of 2020. By the end of 2020, the provisions recorded by European banks stood at EUR 115 billion, which is almost the figure for the reserves set aside after the global financial crisis.

In several countries, banks are recording poor profitability because of the large volume of loan loss provisions. At the end of 2020, banks' return on equity was 2.0%, compared with 5.7% one year earlier. Bad debts aside, the low interest rate environment and the sharp fall in lending are further reducing the revenues banks are receiving from their core activities. In addition, European banks continue to face many long-term structural problems associated, for example, with business models based on interest income and a wide network of branches as well as huge operational expenses. Banks also have to face the challenges of digitalisation and climate change. The pandemic has heightened these challenges.

Non-performing loans are hampering banks' ability to supply credit

Non-performing loans weaken the profitability of banks. When banks prepare for the losses due to non-performing loans, they make provisions for them in their accounts, and these reserves come out of their revenue. Profitability also suffers since the bank earns no interest on non-performing loans, as they would with conventional loans.

Non-performing loans also undermine a bank's solvency, as they tie up its capital more than conventional loans because of the bigger risk weights involved. A bank's capital adequacy is weakened when the number of non-performing loans in its credit portfolio increases.[3] The bank's solvency also suffers if the bank records a negative net profit due to non-performing loans, and that is why these types of loans make it difficult for banks to supply credit to the real economy.

One way to reduce the number of non-performing loans is for banks to sell them to asset management companies. Following the global financial crisis, it became evident that removing a large number of non-performing loans from banks' balance sheets can be a very slow process. This is, for example, because the parties buying the loans and the bank selling them cannot agree on a price.[4] The price demanded by the buyer for problem loans could mean the bank would have to record significantly more in loan losses and that its capital requirements would no longer be met. The bank's idea of what the loans are worth may be a lot more than what the buyer may have in mind.

In Europe, banks are the main source of financing for companies and households. In December 2020, the European Commission published a Communication 'Tackling non-performing loans in the aftermath of the COVID-19 pandemic', which aims to safeguard financial intermediation to support the real economy. The Communication proposes four measures for keeping the number of non-performing loans on the banks' balance sheets

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3. If loan loss provisions are booked in respect of a loan, the bank's balance sheet will record the portion of the loan that the provision does not cover. Such a procedure therefore also reduces the number of risk-weighted assets.
4. Removing NPLs from balance sheets can also be a slow process because of a bank's inadequate resources and inadequate legislation on debt recovery and bankruptcy. The secondary market is also not sufficiently developed in all countries.

under control. The proposed measures relate to the development of secondary markets, the reform of the EU's insolvency and debt recovery legislative framework, asset management companies, and precautionary public support measures for banks in the exceptional situation caused by the pandemic.

Investors buy non-performing loans from banks

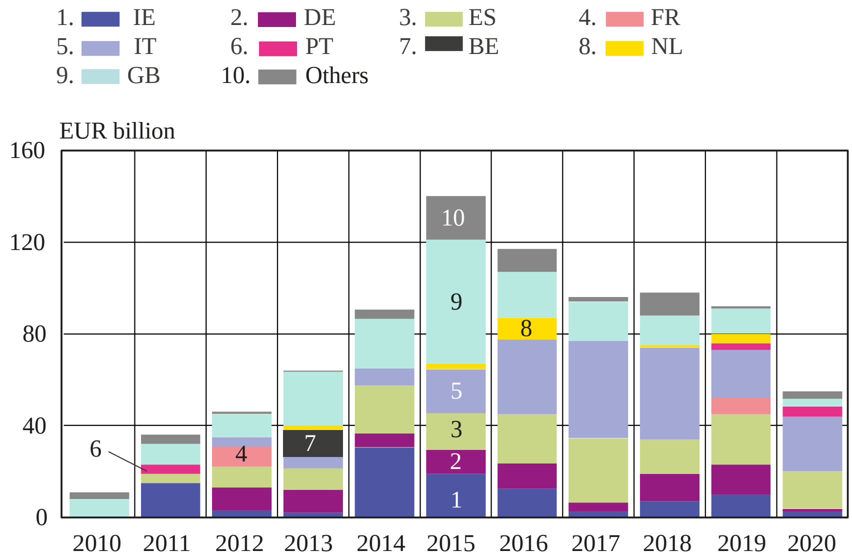
The development of the secondary market in non-performing loans is an important step, because a viable market enables the sale of the loans to investors. When these loans are removed from a bank's balance sheet the bank does not need to set aside additional capital to cover any future losses, and the capital that was previously tied down by a non-performing receivable can be freed up to grant new loans.

Removing NPLs from a bank's balance sheet makes it easier for an external party to assess the bank's creditworthiness. This in turn improves the availability of wholesale funding to the bank. Also, a lot of the bank's resources are tied up in updating repayment plans for non-performing loans, in debt recovery and in sales of collateral.

The European secondary market in NPLs developed mainly in the wake of the global financial crisis and was fairly active before the pandemic broke. The pandemic resulted in a slowdown in the sale of loans in 2020 (Chart 2). Under the Commission's plan, the aim will be to improve the functioning of the secondary markets, for example through better availability of consistent and transparent information on the loans.

Chart 2.

Owing to the COVID-19 pandemic, sales of bank loans in Europe in 2020 were down on previous years



Source: PwC.

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The euro area also faces structural challenges in the management of non-performing loans. Legal proceedings connected with the realisation of collateral used to secure loans can be time-consuming and complicated. The same goes for corporate debt restructuring. In the Commission's proposal, the goal would be to reform the corporate insolvency and debt recovery legislative framework by harmonising practices across different countries and thereby expediting the process of realising collateral. The aim is particularly to standardise the extrajudicial realisation of collateral. These procedures would, however, apply only to businesses.

Non-performing loans can be transferred to separate asset management companies

Non-performing loans can be transferred from a bank to an asset management company (AMC). In this way, the bad debts are entirely removed from the bank's balance sheet. These AMCs are sometimes called bad banks. An AMC benefits from economies of scale, meaning it can manage loans at lower fixed costs than individual banks. An AMC also often has more time at its disposal to sell the loans than the banks that originally granted them: they typically operate over several years and do not have the same capital requirements as banks. Furthermore, they can concentrate all their resources on the restructuring or resolution of non-performing loans.

An asset management company can be financed in different ways. In case of public financing, the EU's rules on State aid to banks must be complied with, i.e. the State must act as if it were a private investor. It is the Commission that ultimately approves State aid to AMCs. Some countries in Europe now have functional national AMCs. These have been active in the secondary markets for non-performing loans. These markets are used by companies for the resolution of their outstanding claims. The Commission is prepared to help Member States that want to establish national AMCs.

Countries are able to offer more flexible support to banks that have suffered from the pandemic

In principle, it is not allowed to grant banks State aid, as this would be seen as a distortion of the functioning of the common market. The essence of the crisis resolution framework for banks is that the banks' shareholders and other investors are liable for the costs of the restructuring if the bank has run into difficulties. If a bank needs State support, the crisis resolution authority must in normal circumstances order a crisis management plan to be drawn up or declare the bank bankrupt.

Nevertheless, State aid is allowed in the case of solvent banks in times of serious economic crisis. In spring 2020, the Commission decided that the coronavirus pandemic was an exceptional situation, and it was therefore justified to allow countries to grant banks precautionary capital support if the other strict terms and conditions set for State aid were met. At the same time, the Commission made a temporary change to the State aid framework: the banks' shareholders and other investors would not have to contribute to the costs of restructuring as they normally would, provided that the precautionary public support was used to address the problems caused by the pandemic.

Bank stress tests and asset quality reviews are ways to assess what European banks might need in terms of precautionary public support or other measures to strengthen their capital as a result of the pandemic, for example in order to prepare for future loan losses. The stress test being conducted by the EBA in 2021, referred to earlier, will be important, as it will provide information on possible capital shortfalls on the banks' balance sheets. The prevailing uncertainty and the existence of public support measures mean that interpreting the results of the stress test will be particularly challenging this time around.

Tags

credit losses, non-performing loans, COVID-19 pandemic, euro area, financial stability, COVID-19, banks, banking sector