Exiting from Covid-19 measures: policy challenges and the impact on EU banks

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“Exiting from Covid-19 measures: policy challenges and the impact on EU banks”

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The EU banking sector has shown remarkable resilience over the pandemic crisis. In the future, however, EU banks will still have to cope with high uncertainty related to the economic recovery and the impact it will have on the financial system.

The latest stress test conducted by the European Banking Authority confirms that the euro area banks are able to withstand a crisis even under severe assumptions. This hinges, among other things, on the mitigating impact of the public guarantee schemes and their continued positive impact on credit risk parameters.

Clear signs of vulnerabilities continue to affect traditional banks with high dependency on net interest income. With this in mind, a considerable gap remains between euro area and US banks on how they are perceived by investors, as testified by the significant difference in the price-to-earnings ratios. US banks recovered faster and continued to improve, suggesting greater prospects for the near future. This is – at least partly – explained by the uncertainties surrounding the recovery in Europe.

Although the immediate danger in the private sector has been averted, the exit from Covid-19 measures poses several policy challenges.

First, legacies from the pandemic need to be tackled in the best way to preserve sufficient lending capacity. The amount of legacy Non-Performing-Loans (NPLs) has been contained so far, but the economic outlook and implications of policy actions are still uncertain. In line with the results of the stress test, there will be a need to address the NPLs emerging from the pandemic efficiently, maximising the residual value. The European Commission has proposed an NPL action plan, which outlines ambitious reforms and measures to mitigate the build-up of new NPLs both at national and European level.

Second, the timing and sequence of withdrawal needs to be well calibrated. On the one hand, a premature withdrawal of regulatory and government support could turn viable banks and companies into non-viable ones, which would destroy the capacities that are pivotal for a fast and sustainable recovery. On the other hand, extended support of non-viable firms and banks can lead to misallocation of financial resources and slower economic recovery. Tensions may arise among the “optimal” regulatory responses – given the interplay among

government, regulatory and monetary policy measures in support of credit extension. Coordinating this interplay will require extraordinary efforts. Different assessment of risks or structural changes and inexperience in withdrawing the support measures can complicate matters.

Third, exiting from these pandemic measures also opens the door to defining a new state of the banking sector. The pandemic provides some lessons on how to best deal with certain regulatory measures such as prudential buffers, which can now be taken on board. At the same time, the phasing out of the pandemic policy measures will also interact with the ongoing regulatory developments, such as the implementation of the final Basel III package and full implementation of the revised Bank Recovery and Resolution Directive (BRRD).

Exiting from these policy support measures is not in itself conducive to the long-overdue structural changes in the EU banking sector that would secure banks' ability to support growth going forward. The completion of banking union – with its EU-wide coordinated approach – will help to create the right incentives for banks to implement these structural changes and reduce their related adjustment costs.

The treaty reform of the European Stability Mechanism with the early introduction of the common backstop to the Single Resolution Fund brings us closer to completing banking union. This backstop serves as a supplemental safety net, as it can lend funds to the Single Resolution Fund to finance a resolution in case failing banks deplete the Fund's resources.

However, several important building blocks are still missing. Key elements for the completion of banking union is the proper functioning of the crisis management framework and a common deposit insurance scheme. A European deposit insurance would facilitate further financial integration across Europe.

Europe will be best prepared for any future crisis only if it is equipped with a strong and uniform protection and crisis management framework. Strong political commitment to pursue greater legal and institutional harmonisation and centralisation will be necessary to make that happen.

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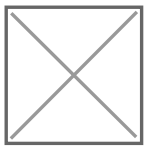

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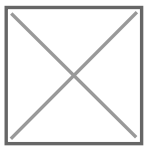

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