ANALYSIS

Coronavirus shock will further weaken bank profitability in the euro area

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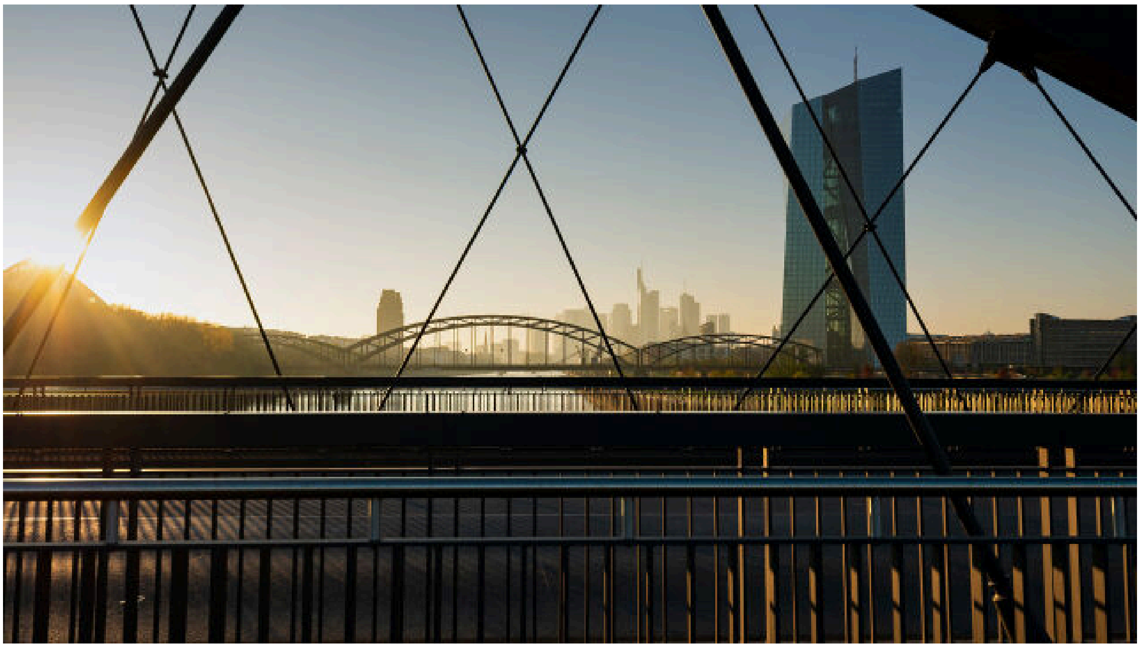
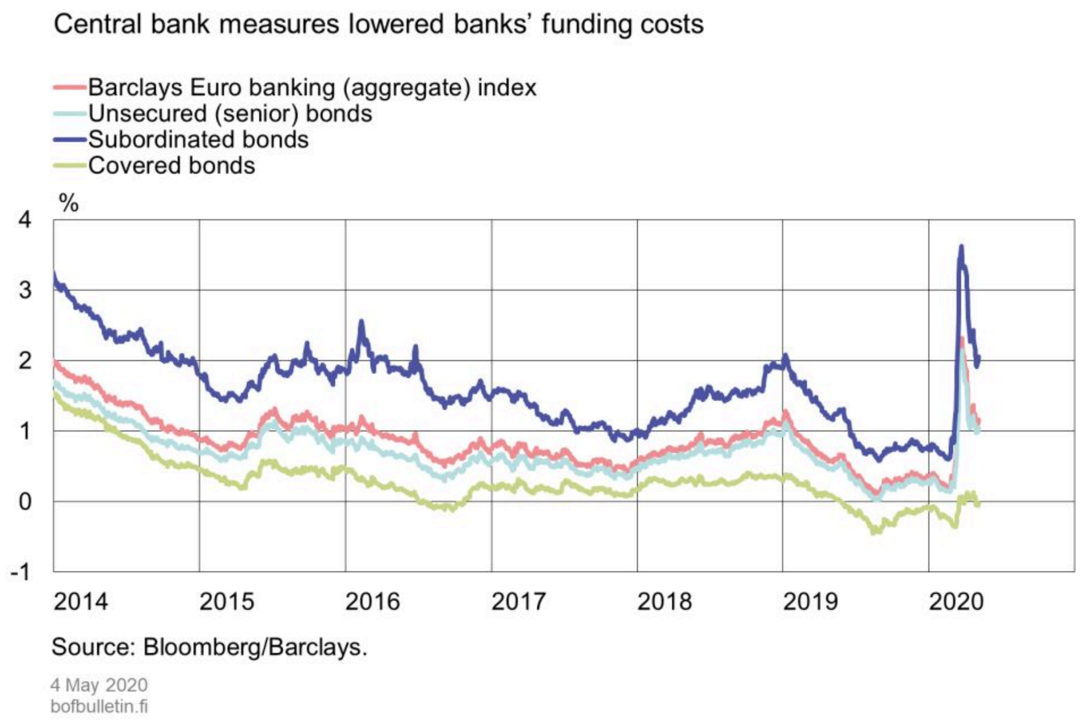
Expectations of a deteriorating economic outlook increased the risks to banks' operating environment even before the coronavirus pandemic spread to Europe. At the end of 2019, banks' return on equity was 5.2%, compared with 6.2% a year earlier. While some banks were experiencing profitability challenges already prior to the outbreak of the pandemic, profitability also differs greatly between countries, bank business models and individual banks. Due to the coronavirus pandemic, banks' income development will further deteriorate, and it is likely to fall well below banks' imputed cost of equity. The effects of the pandemic are widely reflected in the stock prices of European banks (Euro Stoxx Banks Index), which have fallen by 40% since the beginning of 2020.



Banks' capital adequacy position better than in previous crises

The regulatory reforms implemented since the global financial crisis have enhanced banks' ability to bear risk. The capital adequacy of euro area banks has strengthened and their dependency on short-term market funding has diminished. The credit stock of European banks has not grown sharply, and the banking sector has also worked determinedly to reduce the volume of problem loans.

Chart 1.



Government measures significantly increased lending capacity of banks

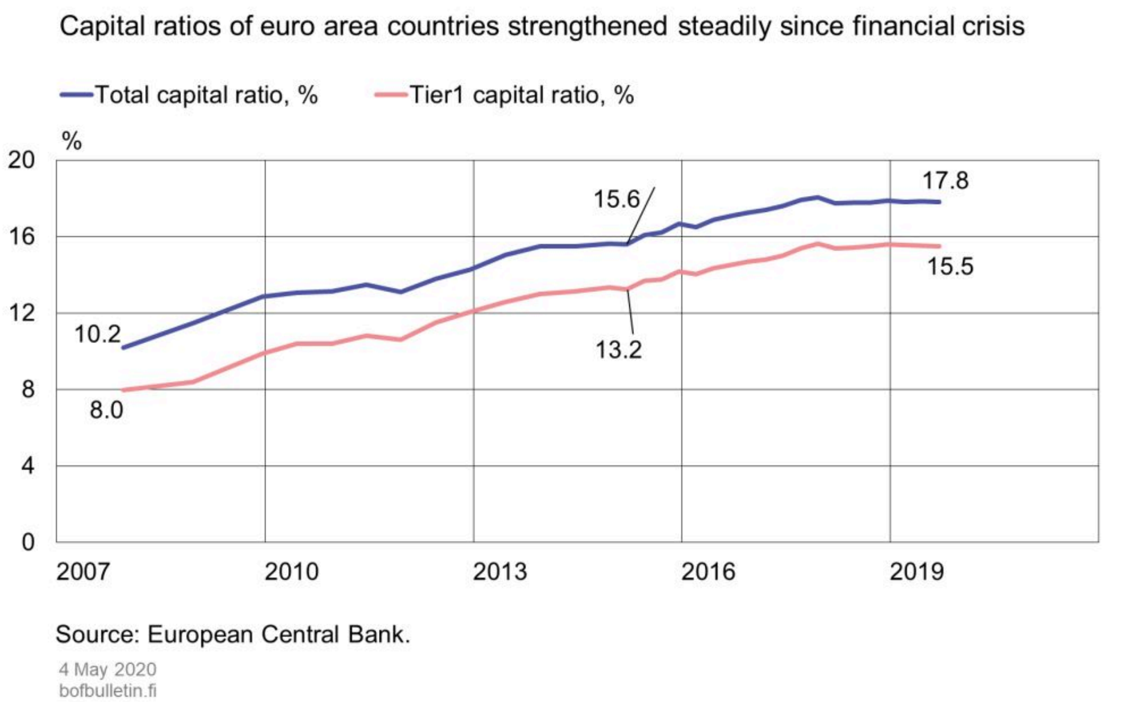
The decisions taken by supervisory and macroprudential authorities following the escalation of the coronavirus pandemic have eased the capital requirements of euro area banks. These relief measures have markedly increased banks' lending capacity to non-financial corporations and households.[1] Banks have also been urged to refrain from making distributions. In order to support banks' operational capacity, the European supervisory authorities have increased flexibility in reporting and regulatory interpretations.

Functioning of markets important – ECB operations support transmission of funding to non-financial corporations and households

The smooth functioning of the market is important for banks as it affects their own funding. Uncertainty and distrust have a rapid impact on the functioning of the market and on the price and availability of market funding. The coronavirus pandemic has raised the price of market funding for banks and non-financial corporations in the euro area and has occasionally weakened access to funding. Financing problems have been reflected in both short-term unsecured commercial papers and loans and long-term bonds. Following the escalation of the coronavirus pandemic, access to funding deteriorated in the dollar money market as well, but monetary policy measures taken by the FED and the ECB stabilised the situation at the end of March.

Central banking operations, such as new credit operations, collateral easing measures and purchase programmes, have facilitated banks' access to funding and reduced the price of market funding. Especially markets for low-risk instruments, such as covered bonds, have reopened.

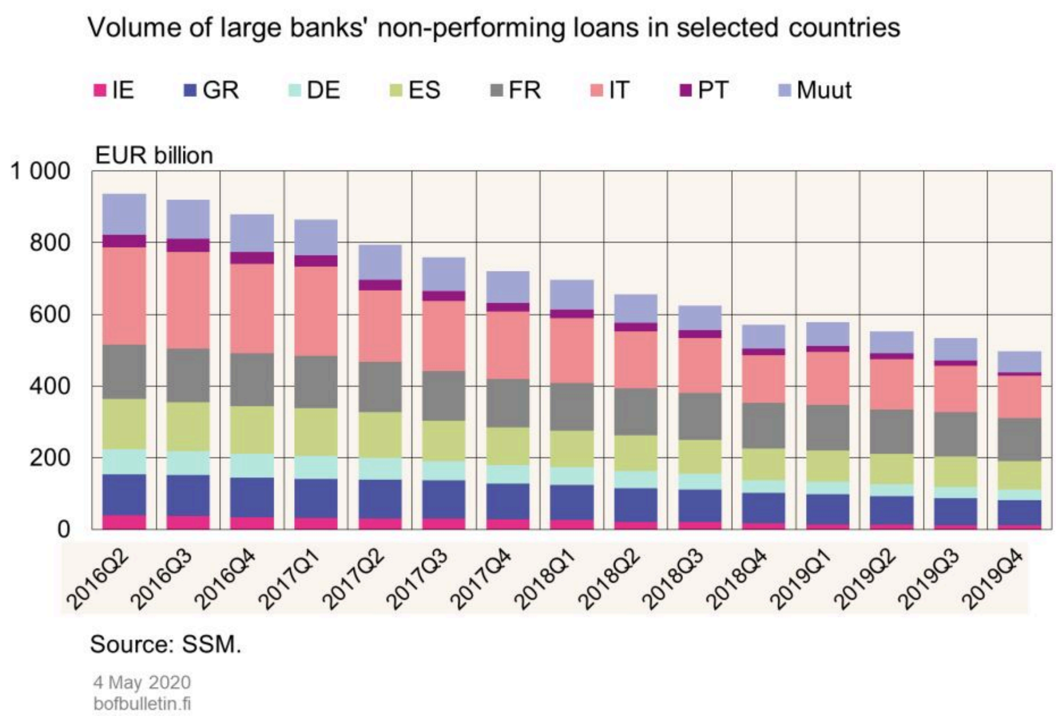
Chart 2.



Financial crisis cast a long shadow over problem loans – coronavirus pandemic will once more increase banks' credit risks

The number of non-performing loans of euro area banks continued to decline in 2019. According to the European Central Bank, euro area banks had EUR 506 billion of non-performing loans on their balance sheets at the end of 2019, which is about 13% less than a year earlier.[2]

Chart 3.



Despite the reduced volume of bad loans in several countries, loan losses and provisions continue to weigh substantially on the performance of some banks. These banks have an insufficient ability to strengthen their capital adequacy position through income financing, and they also face challenges in raising new capital.

The coronavirus pandemic increases the credit risk of banks. Both the containment measures to curb the pandemic and the exceptional uncertainty have significant effects on the real economy, and the slowdown in economic activity will increase banks' loan losses. The weakening outlook for economic activity and the prolongation of the exceptional measures are affecting the corporate sector, especially companies with small cash reserves. The prolongation of the crisis may also be reflected on the housing and real estate markets. The exposure of the banking sector to different sectors varies from country to country, and the different exposures will be reflected in each country's loan loss development.

Many countries have launched guarantee schemes to help profitable companies, where the state guarantees banks loans to corporations. Loans with a guarantee may account for a large proportion of new loans, as in many countries the size of these programmes is significant.[3] Guarantee schemes stimulate the funding of companies, but also transfer part of the credit risk from banks to the public sector.

Some euro area banks own significant amounts of public sector bonds in their own country. In many countries, measures to combat the coronavirus pandemic are expected to significantly increase government debt. This is reflected in the risk of bank-owned government bonds and reinforces the harmful link between banks and their sovereigns. Efforts to weaken this link must be actively continued in the future by offering banks safe and low-risk investment options alongside sovereign bonds. It is also important to finalise the EU Banking Union with a common European Deposit Insurance Scheme and to strengthen the Single Resolution Mechanism and the Single Resolution Fund. The development of the Capital Markets Union is also important in order to diversify financial intermediation in Europe, where the financial system has traditionally been very bank-centric. Due to the interconnections between intra-euro area trade and financial markets, favourable economic developments and stable financial conditions are important for all Member States.

Notes

1. The measures taken by supervisory authorities are estimated to free EUR 120 billion of core capital, which will enable up to EUR 1,800 billion of new lending to euro area households and corporations. ↑
2. On average, around 3.2% of the credit claims of euro area banks are non-performing loans. At the beginning of 2016, the corresponding figure was 6.9%. ↑
3. The size of the guarantee programmes is discussed in the April 2020 edition of the IMF Fiscal Monitor, https://www.imf.org/en/Publications/FM/Issues/2020/04/06/fiscal-monitor-april-2020. ↑

Key words

banks, COVID-19, COVID-19 virus pandemic, euro area, financial stability