# Business resilience in the banking sector

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## 1. Introduction

The crisis resulting from the outbreak of Covid-19 continues to rapidly develop, yet significant impacts to the economy are already anticipated and in turn are playing out. We analyse the potential impacts on the European banking sector in addition to proposing potential solutions to assist banks in navigating uncertainty.

### Macro-economic impact

All sources now converge towards a global downturn in 2020-2021. Its severity and length are yet to be fully assessed. But independent analysis suggests global growth in 2020 is expected to fall within a range of - 0.5% and - 1.5%[1]. The anticipated impact to the European economy may be higher.

Some significant vulnerabilities to the financial system have been identified and could lead to amplified turbulence:

- Companies have benefited from the accommodating monetary policies. Debt levels have consistently risen resulting in a large percentage of companies globally presenting signs of over indebtedness[2].
- The magnitude of the inflation in asset prices since 2008 is also concerning. This has led many experts to anticipate both a bubble forming and a subsequent burst occurring. A rush towards the purchase of so-called 'safe assets', such as treasuries, over the course of 2019 and subsequent inversion of the yield curve supports the assertion.

Economic impacts across numerous industries can be expected at many levels. These include:

- Failure of micro-companies and independents due to the lockdown of the general population and their associated activities resulting in reduced discretionary expenditure.
- Significant difficulties for SMEs, in addition to large corporate companies due to the slowdown of activities in the most impacted sectors. These include tourism, services and transport - due to lockdown and travel restrictions.
- Failure of risky investment funds and over-indebted companies, without specific support of the governments, due to a decrease in global revenues and the associated fall in asset prices.
- This poses a significant risk to the entire economic environment.

[1] McKinsey&Company:COVID-19-Facts-and-Insights-March-9-2020

[2] To be compared to 2008 crisis, where unstainable debt was mainly centered on residential mortgage, in a region of the world.

# 2. Expected impact of the crisis on the banking sector

## 2.1 Banking situation

### Solvency

Currently, no failure or solvency issues are anticipated for significant institutions in Europe. This is due to the regulatory efforts to strengthen balance sheets during the past decade. Constant monitoring by regulators on a case-by-case basis, supported by recommendations aimed at improving financial stability of all actors have enforced robustness.

The ratio that measures the highest quality capital, common equity Tier 1 (CET1), is currently reported as 14.37% for significant institutions in Europe, in the last publication of supervisory data by the European Banking Authority (EBA), for Q3 2019. The relatively sound position of European banks can also be observed in EU-stress-test wide exercise of 2018. CET1 ratio was reduced by 4.1% between 2017 and 2020, under the adverse scenario.

By analogy, knowing that the adverse scenario used for this stress test exercise, a shock to the GDP of -0.9% in 2018, -2.0% in 2019 and 0.5% in 2020[3], it is anticipated that in a first approximation, an impact of CET1 ratio similar to that of the 2018 stress test exercise.

However, the assumptions used in the scenarios of 2018 stress test exercise showed some differences with the current situation[4].

| | Starting 2017 | Starting 2017 restated | Baseline 2020 | Adverse 2020 | Delta adverse 2020 – 2017 | Delta adverse 2020 – 2017 restated | Starting leverage ratio | Leverage ratio 2020 |
|---|---|---|---|---|---|---|---|---|
| **Transitional CET 1 capital ratio** | 14.5% | 14.4% | 15.4% | 10.3% | -419 bps | -410 bps | 5.4% | 4.4% |
| **Fully loaded CET 1 capital ratio** | 14.2% | 14.0% | 15.3% | 10.1% | -416 bps | -395 bps | 5.1% | 4.2% |

EBA publication of 2018 EU-wide stress test results, with the effect of IFRS9

[3] See Adverse macro-financial scenario for the 2018 EU-wide banking sector stress test : https://www.esrb.europa.eu/mppa/stress/shared/pdf/esrb.20180131_EBA_stress_test_scenario__macrofinancial.en.pdf

[4] See main risks presented in the Adverse macro-financial scenario for the 2018 EU-wide banking sector stress test : https://www.esrb.europa.eu/mppa/stress/shared/pdf/esrb.20180131_EBA_stress_test_scenario__macrofinancial.en.pdf

### Liquidity

Regarding liquidity, no direct failure is anticipated.

- In the last publication of EBA supervisory data for Q3 2019, the liquidity coverage ratio was an average 145.16%[5] for significant institutions in Europe.
- Early implementation of LCR and NSFR in the sector have enabled most institutions to further include these metrics in the governance and strategy.
- Recent declarations and actions by the European Central Bank (ECB) indicate that they may be ready to support potential liquidity problems, providing financing facilities to institutions via various channels.

### Provisioning

The most direct impact will be on the provisioning of the banks. A significant increase in provisions is expected in the short-term, an effect amplified by the pro-cyclical effect of IFRS9 accounting norm.

- Transfer of assets to stage 3, and stage 2 (Significant increase in credit risk) will significantly increase the banking industry's forthcoming disclosures, leading to a life-time recognition of losses.
- The approach and methodology associated with the stage classification may make use forward-looking macroeconomic variables and will therefore be negatively impacted by the current situation.
- Calibration of IFRS9 risk parameters will also be highly impacted by the new macro-economic environment. Scenarios included in IFRS9 models will take into account the new macro-economic environment and the anticipated global downturn.

All these elements should not hide the fact there are weak small and medium sized banks in the European system which may fail - especially if the situation lingers or worsens. A single resolution mechanism could be used in this case, if applicable to the country in question.

[5] This is significantly higher than regulatory minimum (100%). ECB also stated that requirements for LCR ratio will be relaxed

### 2.2 Banking activities

The following activities are expected to be impacted or, in turn, show high levels of risk due to the anticipated downturn. They are expected to receive attention from both banks and regulators for the foreseeable future.

#### Origination

- Reduced lending volumes and increased risk levels at the point of origination. Banks will have to take these elements into accounts within their risk appetite, their processes and models.
- Decrease in asset prices should lead to a decrease in collateral values. Valuation of new collateral should be correctly updated and incorporated into models.
- Supervisory or government pressure to maintain loan facilities to companies - and especially SMEs.

#### Customer management

- Increased risk and delinquency levels reinforce the need for banks to correctly identify and monitor their portfolio, so that they can differentiate risks and implement actions to their benefit.
- Reduced cross and up-sell activity.
- Forbearance and payment holidays.
- Decrease in collateral values, which should be closely monitored by banks.
- Foreign exchange risk, concentration and contagion effects should also be considered.

#### Collections and non-performing exposure management

- Decrease in collateral values could lead to a modification of collection strategies, prompting additional security requirements, or revised recovery processes.
- Non-performing exposure and delinquency levels are expected to increase substantially in the next two years. NPL is also expected to be under high scrutiny from the regulator, as highlighted by the ECB.[6]
- Increase in forbearance and payment holidays. Some governments will and have already – as in Italy - allowed companies or individuals to postpone their credit repayments, effectively forcing banks to offer payment holidays. Banks will need to adapt their collection strategies, their affordability and early warning processes and models to cater for this situation.
- Collecting debts could also prove to be harder in courts, which could be softer on bad payers.

#### Operations and capacity

- Increased levels of operational risks due to closure of office operations.
- Smart working using remote connection.
- Banks are also expected to suffer capacity issues due to sickness, higher resource demands to manage risks and on-site work restrictions.

Regarding revenues, low or very low interest rates are expected to be the norm for the near future in Europe. Therefore, net interest income should stay relatively low for banks, compared to historical values. Banks should therefore seek-out diversified sources of revenues. To compensate for long-lasting or stagnating revenues, banks are expected to continue reducing their costs during the coming years through consolidation, or rationalisation of bank branches and back-office re-organisation.

[6] https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html

## 2.3 Banking regulation

### 2.3.1 Announced amendments

The EBA and ECB have already communicated mitigation decisions and recommendations[7] to relevant authorities regarding their supervisory work and the rules that banks must follow.

- The 2020 EU-wide stress test exercise is postponed to 2021. For 2020, the EBA will carry out an additional EU-wide transparency exercise in order to provide updated information on banks' exposures and asset quality to market participants.
- Non-essential visits by supervisors to banks could also be rescheduled and some arrangement made to deadlines for reporting data to regulators. In addition, the ECB is in discussions with banks regarding individual measures, such as adjusting timetables, processes and deadlines. For example, the ECB will consider rescheduling on-site inspections and extending deadlines for the implementation of remediation actions stemming from recent on-site inspections and internal model investigations, while ensuring the overall prudential soundness of the supervised banks
- The ECB is allowing banks to operate with less capital than usual and easing back on the amount of liquidity they need to hold.
  - The ECB will allow banks to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G), the capital conservation buffer (CCB) and the liquidity coverage ratio (LCR).
  - Banks will be allowed to partially use non CET1 capital instruments, for example Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 Requirements[8]
  - The EBA also recommends competent authorities to relax the counter cyclical capital buffers[9]. Consequently, cyclical capital buffers have been adjusted to zero in most countries, as it is their purpose to serve banks as additional cushion during economic hardships.

Regional regulators have also started to issue moratoriums on residential and / or commercial mortgage loans across EMEA.

[7] See EBA statement from 12/03/2020 https://eba.europa.eu/eba-statement-actions-mitigate-impact-covid-19-eu-banking-sector

[8] This brings forward a measure that was initially scheduled to come into effect in January 2021, as part of the CRD V

[9] This recommendation will have no impact in Spain, as countercyclical buffer is already set at 0%

### 2.3.2 Anticipated amendments

This paragraph tries to foresee potential changes in regulatory environment of financial institutions, in the medium to long term.

- Basel IV implementation could be accelerated, compared to its actual implementation calendar (2022-2027 for remaining measures).
- A new round of talks and recommendations, at BIS, European Commission and ECB level, to analyse the crisis, its causes and consequences, can also be expected at some point in the future.
- By comparison, the pace of implementation of Level 2 regulation (ITS, RTS by EBA) and Level 3 regulation (Guidelines from ECB and EBA) will probably be lowered.
  - Issued but not implemented regulation could be postponed, as is expected for IRB 2021 package[10] and guidelines on loan origination and monitoring[11], in order to alleviate banks' regulatory burden during the crisis and its aftermath. Six to 12-month delays can be expected, as a general indication.
  - Pace of publication of these regulations could also be slowed, due to a new focus on Level 1 regulations and NPL management of the banking sector.
- The consequences of new accounting standards IFRS9 will also be analysed after the crisis, specifically regarding its pro-cyclicity effect, related impact on bank income statements and global solvency.

[10] Guidelines on new default definition EBA/GL/2016/07, RTS on the materiality of default EBA/RTS/2016/06, PD and LGD Estimation and treatment of defaulted exposures EBA/GL/2017/16, Downturn LGD estimation EBA/GL/2019/03, RTS on downturn period definition EBA /RTS/2018/04

[11] EBA/CP/2019/04

## How we can help

The circumstances we find ourselves in are unparalleled and changing daily. The way we prepare to weather the impact in the short-term will be key to making sure its long-term effects are contained as much as possible – both for the customers in our care and for our own businesses.

If you'd like to discuss any aspect of this report or find out more about how we can support you through this crisis, please get in touch with your Experian account manager today.

While the road ahead may be rocky, and there will be new developments to navigate, we believe that by working together, and bringing you powerful data and tools, we can help you and your customers come back from this crisis strong, secure and ready for a brighter future.

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