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Evidence from Supervisory Measures for Bank Lending and Npls Control During COVID 19 Crisis

Rosaria Cerrone
Department of Management & Innovation Systems (DISA-MIS)
University of Salerno, Fisciano, Italy
ORCID 0000-0003-4224-2625

ABSTRACT

The highest impact of Covid-19 crisis on banks is related to their loan portfolios where many borrowers are facing sharp collapse in their income, and difficulty in repaying their obligations. Regulatory and supervisory authorities have issued statements or guidelines to banks on how to deal with the impact of the outbreak, including relation to easing loan terms and conditions for impacted borrowers. This paper aims to provide some policy views on the appropriate response to Covid-19. Supervisors and regulators should play an integral part contributing to public policy responses to the pandemic. Consistent with their mandate of ensuring safety and soundness, supervisors' action requires a balancing act where banks are encouraged to restructure loans and use the flexibility embedded in the prudential framework by financing viable firms. This paper presents the state of arts and some considerations about the future banks' conditions facing NPLs increase and their earnings reduction.

Keywords: COVID-19, crisis, banking industry, regulatory response, supervisory framework, capital ratios, capital buffers, non-performing loans, credit risk

INTRODUCTION

The outbreak of the Covid-19 pandemic in the first quarter of 2020 has prompted a series of emergency measures. The crisis has severely impacted economic activity with output losses often exceeding those observed during the last global financial crisis. Many borrowers quickly saw their income flow drastically reduce or dry up altogether due to Covid-19.

Against the backdrop of a highly uncertain economic recovery, renewed spikes in caseloads, and a reintroduction of emergency measures, borrower distress has been on the increase ever since. Policymakers have been quick to roll out borrower relief programs. In the case of Europe these programs have primarily taken the form of temporary payment moratoria, where decisions on which borrowers qualify are usually left to banks, combined with short-term legal measures to flatten the bankruptcy curve. Aggregate non-performing loans ratios have generally remained stable while these measures are in place, but policymakers and bankers anticipate that rising levels of borrower distress will inevitably translate into fresh pressures on asset quality in the banking sector that will become increasingly apparent in banks' earnings, capital, and financial statements.

Experiences in the aftermath of the financial crisis, which left many European countries with a persistent legacy of high NPLs, underscore the need for a quick and comprehensive policy response. Reflecting widely held views that the downturn would be short-lived and transient losses would be naturally recuperated over time, policymakers and bankers were slow off the mark in responding to the rising pressures on asset quality. Consequently, when NPLs levels started increasing the problem quickly spun out of control. Banks, that often had thin capital buffers, were frequently reluctant to recognize and provision for their true exposure to problem loans. This, in combination with weaknesses in regulatory and supervisory frameworks, caused reported asset quality indicators to drift away from economic realities and impeded timely supervisory follow-up vis-à-vis weak banks. In addition, profound weaknesses in insolvency and creditor right environments and in banks' operational readiness to work out rapidly rising volumes of NPLs prevented a resolute handling of non-viable borrowers. These borrowers were often kept afloat with questionable loan restructuring practices, breeding allocative inefficiencies as banks' credit stocks became locked up in underperforming economic sectors at the expense of more dynamic ones. Paradoxically, the lack of exit of non-viable borrowers coincided with significant missed opportunities in terms of salvaging distressed but potentially viable borrowers, that due to an absence of a rescue culture and inefficient insolvency systems were frequently pushed towards liquidation.

These experiences demonstrate the dangers of a delayed initial policy response, that allowed the underlying problems to fester, compromised the capacity of the banking sector to finance the real economy, and ultimately left countries trapped in a bad equilibrium of low growth and lackluster financial sector performance. Avoiding a repetition of the post-financial crisis scenario should be top priority for policymakers and regulators. This has required an alignment of three sets of policies, including (i) robust banking regulation and supervision to ensure the proper identification of NPLs and provisioning for credit losses, (ii) strengthening of banks' operational readiness to work out rising volumes of problem assets, and (iii) a legal environment that enables banks to work out bad loans and that avoids unnecessary losses by steering distressed but potentially viable borrowers towards liquidation.

The damage to businesses and economies is becoming more visible every day. Forecasting institutions and scenario planners are estimating significant contractions in global GDP. In the eurozone, GDP contracted by -3.6% in the first quarter of 2020. The severity of the outbreak and the response varies by country, factors which will affect the size of the contractions. For the second quarter, when the lockdowns were in full effect, the European Central Bank has estimated that the eurozone GDP contraction should be -13%. In Europe, according to this scenario, higher average risk costs are expected compared to previous crises, especially for Italy and Spain (though for Spain, not as high as in the 2011-12 sovereign debt crisis). Yet even for Germany and France, risk costs would double compared to previous crises.

The challenges associated with rapidly rising NPLs require a prompt, proactive, and comprehensive responses. First, effective NPL resolution requires the availability of economically meaningful data about banks' exposure to problem assets. Regulators and supervisors need this information to gauge the magnitude of the problem, inform their NPL resolution strategies, ensure that banks provision appropriately for credit losses, and follow up with banks with a high NPL exposure. Softening regulatory definitions and supervision only increases opacity without addressing the underlying problem. Strong regulatory definitions,

including the qualitative "unlikeliness to pay" (UTP) criterion and forbearance, are key for transparency and comparability amongst banks and jurisdictions. Past reforms, wherein countries adopted internationally harmonized regulatory definitions, need to be preserved.

These regulatory definitions need to be underpinned by robust supervisory enforcement, particularly in an environment where pressures on asset quality may incentivize banks to disguise the true extent of their difficulties to banking supervisors.

Weak banks that are short of capital space to fully recognize their exposure to problem loans may be particularly inclined to engage in questionable practices to present an overly optimistic picture on asset quality. These challenges may be exacerbated by industry and political pressures on the operational independence of regulators.

. Prolonging exceptional borrower relief and short-term legal measures carries hidden costs, including a weakening of repayment discipline, allocative inefficiencies associated with zombie borrowers, and a possible adverse impact on banks' liquidity. The temporary and extraordinary nature of these measures needs to be well understood by banks and by the general public to avoid that these measures are perceived as a new normal and become permanent fixtures. While the question when and how to phase out the measures does not have a simple answer, the general principle should be to unwind them as soon as circumstances permit, and with careful consideration for the financial impact on banks. Instead of phasing out borrower relief measures altogether when reaching the closing date, measures can also be gradually wound down. Expiring schemes can be replaced with a set of more targeted and better designed measures, including by ruling out borrowers whose financial difficulties predated the pandemic and borrowers whose difficulties are likely to evolve into longer term repayment difficulties.

It is vital that banks get operationally ready for resolving high volumes of bad loans. The task at hand requires dedicated workout units, separate from loan origination departments, endowed with adequate human and financial resources, and underpinned by robust information systems and bank-specific policies regarding the management and resolution of NPLs. Banks' own efforts may be complemented by regulatory requirements that banks with high NPLs articulate NPL reduction strategies (that are embedded in their risk and capital strategies and approved by the bank's management body) and agree with the banking supervisory agency on quantitative NPL reduction targets.

Banks need to aim for quality in undertaking long-term loan restructuring. Distressed but potentially viable firms will need proper restructuring that entails rearranging the borrower's liabilities and matching future repayment obligations with expected cashflows. Loan restructuring should not be used as a tool to merely delay the recognition of inevitable credit losses related to exposures to non-viable or uncooperative borrowers, that should be steered towards an orderly exit. Pressures to keep these borrowers afloat with low quality loan restructuring measures should be resisted, to avoid locking up the credit stock in underperforming economic sectors at the expense of more dynamic borrowers as occurred after the last financial crisis. Similarly, it is important that despite the highly uncertain economic outlook, banks make reasonable efforts to distinguish borrowers with transitory liquidity difficulties from those with deeper rooted solvency problems, which has far-reaching consequences for the type of restructuring measures that banks should consider.

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While unviable and uncooperative borrowers need to be dealt with resolutely, the depth of the recession puts a high premium on efforts to ensure that distressed but potentially viable borrowers are given an opportunity to rehabilitate. Their rehabilitation entails not only loan restructuring, but also operational restructuring, i.e. fundamental changes in a company's operations aimed at restoring the commercial viability of ailing companies.

Lastly, given the many stakeholders involved, policy coordination is a critical element of any strategy to address high NPLs. Nationwide NPL reduction strategies, designed and implemented with the active participation of private and public sector stakeholders, can help to accelerate the rate of NPL reduction. Key actors include banks and other private sector representatives (such as institutional investors and services) as well as a wide range of national authorities, including central banks and banking supervisory agencies, as well as finance and justice ministries, and civil society representatives, including consumer organizations.

The discussion in this paper contribute to the emerging literature on the policy response of governments to Covid-19 pandemic, considering the specific effort in a credit risk control and NPLs management strategies. This article contributes to studies that examine the efforts of financial regulators in helping financial institutions to withstand the negative effects of the pandemic on their balance sheets.

THE MEASURES TO SUPPORT BANKING SYSTEM AND REAL ECONOMY DURING COVID-19 CRISIS

The financial system is fortunately better equipped for rapid crisis management today than it was in past crises. Banks are in a much stronger capital position, partly as a result of regulatory reforms implemented since the global financial crisis of 2008–09. Financial institutions maintain significantly higher core tier 1 capital ratios today, and have higher provisions coverage ratios for NPLs, than in previous crises.

Another stabilizing factor is the trend toward canceling dividend payouts in 2020, a move recently urged by many regulators globally. The Fed and central banks have also offered considerable support in the crisis. The ECB, for example, has offered favorable refinancing terms in the form of a funding line with an interest rate of -1.0%. This money can be used for more lending or, alternatively, redeposited with the ECB at a rate of -0.5% (which would result in a risk-free carry trade of 50 basis points).

The European Banking Authority postponed the EU-wide bank stress test to 2021 to alleviate the operational burden for banks in 2020 considering the Covid-19 challenges (Baudino, 2020). In March 2020, global banking regulators decided to postpone the Basel-III reforms until January 2023, also to give banks and regulators access to sufficient resources to adequately respond to the coronavirus pandemic.

The consequences of pandemic are also considered in some studies concerning the impact of a pandemic on financial institutions and financial markets (Li et al, 2020; Meagher, 2020; Giese and Haldane, 2020). Giese and Haldane (2020) compare and contrast the resilience of the financial system during the 2008 financial crisis and 2020 Covid-19 pandemic. They show that banks are part of the solution for coping with a pandemic rather than part of the problem as was the case during the 2008 financial crisis.

Li et al. (2020) show that banks faced the largest increase in liquidity demands at the peak of the pandemic in March 2020. Firms drew funds on a massive scale from pre-existing credit lines in anticipation of cash flow and financial disruptions caused by the Covid-19 crisis. The increase in liquidity demands was concentrated at the largest banks who serve the largest firms.

World Economic Forum (2020) suggests that policy-makers should ensure that the financial system remains capable of safely meeting the public's need for financial services through digital channels, and that regulators and central banks should continue to coordinate policy on a global level to help maintain financial stability while issuing clear and consistent policy guidance.

The Capital Requirement Regulation quick fix which came into force in June 2020 moved forward certain capital benefits that would otherwise apply as of 28 June 2021[1]. The CRR quick fix also temporarily, for a period of seven years, exempts Covid-19 loan guarantees from CET1 NPE adjustment. Meanwhile, the derogation to exempt central bank reserves from the leverage ratio exposure measure was moved forward by a year, while adjustments were made to the offsetting mechanism to make the use of the exemption less penalizing in terms of additional leverage ratio requirements.

In September, the EBA communicated the phase-out of its guidelines on moratoria. However, in the light of the second Covid-19 outbreak and the resulting government restrictions in many EU countries, the EBA decided to reactivate the guidelines on moratoria by introducing a new deadline for the application of moratoria set to 31 March 2021, replacing the previous date of 30 September 2020, under two constraints: (i) the overall length of payment holidays granted under general payment moratoria after 30 September 2020 is subject to a cap of nine months at exposure level, and (ii) institutions are requested to notify the relevant competent authority or authorities about their plans for ensuring that assessments of customers' unlikeliness to pay in relation to exposures subject to the moratoria are performed in an adequate manner. The EBA has introduced these two new constraints in order to ensure that the support provided by moratoria is limited to bridging liquidity shortages triggered by the new lockdowns and that the mechanism of the unlikeliness to pay assessment is reinforced (EBA, 2021).

As concerns the ECB, several measures have been implemented to soften the burden on banks related to the Covid-19 crisis. These include measures to ease the capital requirements for banks by allowing them to temporarily operate below the level of capital defined by the Pillar 2 guidance (P2G)[2] the capital conservation buffer and the liquidity coverage ratio.

Banks have been required to build capital and liquidity buffers, including for the purpose of helping to withstand a significant adverse shock. The partial or full use of those buffers during a sharp downturn is essential to prevent pro-cyclical behaviour by the banking sector whereby lending is excessively curtailed in an effort to preserve capital. There is also a collective action dimension to this problem, because if all banks deleveraged at the same time, the recession

[1] This included the revised treatment of software assets, provisions on loans backed by pensions or salaries, the revised supporting factor for SME exposures and the new supporting factor for infrastructure finance.

[2] Pillar 2 capital consists of two parts. One is the Pillar 2 Requirement or P2R, covering risks which are underestimated or not sufficiently covered by Pillar 1. The other is the Pillar 2 Guidance or P2G, which indicates to banks the adequate level of capital to be maintained in order to have sufficient capital as a buffer to withstand stressed situations, in particular as assessed on the basis of the adverse scenario in the supervisory stress tests.

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might be deeper and thereby have a stronger adverse effect on both the quality of bank assets and bank capitalisation than would otherwise be the case (ECB, 2020 b).

In particular allowing banks to operate below the P2G help the economy in the current situation. P2G is a supervisory expectation about the bank's ability to maintain an adequate level of capital to be able to withstand stressed conditions. It should be built up in normal times in order to make banks' capital positions stronger in the event of a crisis. Allowing banks to operate below the level of capital defined by the P2G makes additional resources available to banks that should be used to provide more financial support to household and corporate borrowers and/or to withstand additional losses on existing exposures to those borrowers.

Banks will also be allowed to partially use capital instruments that do not qualify as CET1 capital, for example Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 Requirements (P2R). This brings forward a measure that was initially scheduled to come into effect in January 2021, as part of the latest revision of the Capital Requirements Directive (CRDV)[3].

In this context, it is important to considered if Additional Tier 1 capital instruments are working to absorb bank losses on a 'going concern' basis as they were intended to do, for example when the combined buffer requirement is breached. However, it appears that banks are concerned that skipping a coupon payment on such instruments would be interpreted by markets as an early indication of solvency problems to come further down the line, akin to what would be the case in the event of non-payment of other forms of bonded bank liabilities that are only relevant on a 'gone concern' basis. These negative incentives on buffer usability may become more and more difficult in a scenario of low profitability if banks perceive that the process of replenishing any buffers which have been partly of fully used will be protracted in nature.

The ECB's position to support European banks allow them to use their capital buffers, including the capital conservation buffer (CCB), but this isn't linked to a specific expectation regarding capital losses. In fact the CCB may be used to withstand potential stress, in line with the initial intentions of the international standard setter on the usability of the buffers defined in 2019. In the case of banks' capital falling below the combined buffer requirement (CCB, countercyclical capital buffer and systemic buffer), banks can make distributions only within the limits of the maximum distributable amount as defined by EU law (Andreeva, et al., 2020; Behn, et al., 2020). As concerns liquidity requirements, banks have made important efforts in recent years to achieve good levels of liquidity buffers (evidenced by the LCRs being well above the 100% minimum). The ECB allowed banks to go below the liquidity coverage ratio (LCR) requirement. It is key that banks make use of their liquidity buffers under stress, even if that means that their LCR falls substantially below the general 100% minimum level. This is important to ensure liquidity in the system and to avoid contagion effects that might trigger liquidity problems in other institutions, and, ultimately, the real economy. This position is the confirmation that the current environment corresponds to a situation in which the applicable regulation explicitly allows banks to use their liquidity buffers.

[3] Under the new CRDV banks can fulfil Pillar 2 Requirements with a minimum 56.25% CET1 as a general principle and the remaining P2R can be filled with Additional Tier 1 and Tier 2 instruments.

The importance of the ECB's position to allow banks to operate below P2G and LCR requirements is very relevant to avoid specific problems to real economy. In fact, by drawing down their capital buffers, banks can retain their ability to continue lending to households and businesses through the current period of stress. Other things remaining equal, maintaining support for the real economy will also reduce the level of credit losses affecting the banking system, thereby helping to mitigate the downward pressure on banks' solvency ratios (ECB, 2020 b). It is evident that banks will be requested to replenish their Pillar 2 Guidance on the basis of the evolution of economic conditions and the credit cycle. The timeline for P2G replenishment will depend on the economic outlook, taking into consideration factors such as banks' capital trajectories, asset quality, equity markets, etc. In any case, in order to facilitate bank lending to the economy, it will not be expected by ECB that banks will be able to operate above the level of their P2G any sooner than the end of 2022.

In relation to the LCR, the point in time at which the ECB would expect banks which have previously used their liquidity buffers to once again comply with the general 100% minimum level will depend on both bank-specific (e.g. access to funding markets) as well as market-specific factors (e.g. demand for liquidity from households, corporates and other market participants). In any case, the ECB will not expect this any sooner than the end of 2021.

Last of all, banks have been asked to refrain from paying out dividends until 1 January 2021 and now are recommended to have extreme prudence until 30 September 2021**.** By doing so it has benne endured that a large enough amount of capital was kept within the system so that banks would remain resilient and able to absorb losses if economic conditions deteriorated further. These supervisory measures were complemented by other initiatives taken by various authorities to support the banking sector, including an extremely accommodative monetary stance by the ECB, the extension of payment moratoria to bank customers and loan guarantees to banks by governments in several European countries, actions taken by the European legislator to alleviate the impact from expected credit-loss provisioning under IFRS 9, and the granting of preferential treatment to non-performing exposures guaranteed by the public sector (known as the "CRR quick fix").

Thus far, the combined impact of these measures can be assessed as positive in the sense that banks have been able to cope during the pandemic, negative feedback loops between the real economy and the financial system have been avoided, and bank lending has held up relatively well on aggregate, notwithstanding a tightening of credit standards in recent months.

Thanks to the existing rules the European banking sector entered this crisis well capitalised in aggregate terms and thereby better prepared to withstand a challenging macro environment than at the beginning of the great financial crisis. The second aspect to highlight is that the measures taken by different stakeholders to support the banking sector during the pandemic have been extraordinary and unprecedented and they were mainly designed to ensure that banks would be able to keep lending to the economy even through very harsh economic conditions, while at the same time mitigating pro-cyclicality.

From a supervisory perspective, banks have been encouraged to make use of their buffers and reassuring them that they would be given sufficient time to replenish them, even if in spite of

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the flexibility granted by the supervisor, many banks have not used the buffers due to a couple of factors, namely financial market pressure and underlying bank incentives.

Concerning financial market pressure, falling capital ratios can be associated with higher funding costs or lower market valuations for banks. Faced with the possibility of these market valuations, some banks' reaction to a worsening economic outlook could be to increase, rather than decrease, the capital targets which have been externally communicated to financial markets. If such behaviour is sufficiently common, particularly by banks in a comparatively weaker position, this may have the ultimate effect of offsetting at least partially the intended actions of the supervisor. However, the key point here is that without any regulatory relief banks could have responded in an even more pro-cyclical way, with higher capital targets associated with increased restrictions in credit supply (Gortsos, 2020; Gual, 2021. This behaviour is the result of the fact that banks may face trade-offs between supervisory and market-related incentives.

Moreover buffer usability is also influenced by the current legislative framework which requires that for any breach of the combined buffer requirement is associated with restrictions on dividend distributions by banks. This means that banks may have strong incentives to keep capital levels well above this threshold, even in the presence of recommendations by the supervisors not to distribute dividends.

The objective of not distributing dividends and share buy-backs was to maintain capital resources in the system so that banks could absorb losses arising from the pandemic while also being able to continue lending to the real economy. This prudential position is relevant both under the supervisory point of view, and under a corporate social responsibility point of view. In fact thanks to the ability to support real economy, banks are playing a role of crisis solver and not of its cause and this might important to improve the customer relationship and the reliance on banking system.

Credit risk management with the new NPLs situation

As the great financial crisis has shown, high levels of NPLs can limit banks' ability to support the real economy. In recent years, supervisors and regulators have helped steer the efforts to reduce the stock of non-performing assets on the balance sheets of banks[4]. Nevertheless, NPLs are expected to increase again in the coming months as the impact of the Covid-19 crisis on the real economy intensifies. Banks need to ensure that they have the operational capacity to swiftly and thoroughly address NPLs at an early stage. A comprehensive plan to tackle rising NPLs across Europe is essential to deal with the consequences of the COVID-19 shock (European Commission, 2020).

The results of the vulnerability analysis that ECB Banking Supervision carried out in July 2020 suggested that non-performing loans (NPLs) will increase in a severe scenario that includes a second round of lockdown measures (ECB, 2020 a). According to this study the results show euro area banking sector can withstand pandemic-induced stress, but if the situation worsens, depletion of bank capital would be material. In the central scenario**,** which already foresees a

[4] The NPL ratio of euro area banks stood at around 2.8% in the third quarter of 2020, down from around 7% at the end of 2015.

harsh recession, banks' average CET1 ratio, deteriorated only by 1.9 percentage points to 12.6% from 14.5%. As a result, banks could continue fulfilling their role of lending to the economy. In the severe scenario, banks' average CET1 is depleted by 5.7 percentage points to 8.8% from 14.5% by end 2022. In this scenario, several banks would need to take action to maintain compliance with their minimum capital requirements, but the overall shortfall would remain contained[5].

The key drivers of capital depletion are impaired credit exposures, market risk losses and lower profitability. As expected, the most profitable banks saw smaller declines in their CET1 ratios. This shows that banks that have strengthened their profitability through efficiency-enhancing measures can also benefit from greater resilience in times of stress.

In addition, supervisory flexibility regarding the treatment of non-performing loans (NPLs) was introduced to allow banks to fully benefit from the guarantees and moratoria put in place by public authorities to tackle the current distress (EBA, 2020 b).

This is a very relevant condition as there are potential cliff effects which might ultimately affect bank capitalisation when the loan guarantees and payment moratoria extended by governments to banks and their customers expire.

Supervisors support to credit risk control is in the right balance between helping banks absorb the impact of the current downturn, on the one hand, and maintaining the correct risk identification practices and risk management incentives, on the other, as well as ensuring that only sustainable solutions for viable distressed debtors are deployed.

It remains crucial, in times of distress, to continue identifying and reporting asset quality deterioration and the build-up of NPLs in accordance with the existing rules, so as to maintain a clear and accurate picture of risks in the banking sector. In relation to all exposures that benefit from government guarantees issued by Member States in the context of public interventions relating to the Covid-19 pandemic, banks can classify obligors as unlikely to pay when institutions call on the coronavirus-related public guarantees.

In the context of the financial turmoil triggered by the coronavirus outbreak, banks should be supported as they provide solutions to viable distressed customers. The stock of NPLs accumulated prior to the outbreak is obviously excluded from each current mitigation measures. However, it is evident that current market conditions may make the agreed reduction targets difficult to attain.

Banks are nonetheless still expected to continue with the active management of their NPLs and any foreclosed assets. Banks must take a proactive approach to managing the expected deterioration in asset quality (Gual, 2021), and from the perspective of financial institutions,

[5] Andrea Enria, Chair of the Supervisory Board says that: "The results show just how important it was that banks strengthened their capital position in recent years as a result of the post financial crisis regulatory reforms. The extraordinary and coordinated policy support measures have already helped mitigate the pandemic's impact on the economy. However, if the situation worsens along the lines of the severe scenario, authorities must stand ready to implement further measures to prevent a simultaneous deleveraging by banks, which could deepen the recession and severely hit their asset quality and capital positions."

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the conditions that the Covid-19 crisis triggered have specific implications for managing and mitigating credit risk. In the present crisis, changes in creditworthiness differ by sector and subsector to a greater degree than they did in previous recessions. To evaluate creditworthiness properly in the context of this crisis, banks must go beyond analyses of sectors or subsectors and assess individual borrowers. Business models can be very different from one company to another within the same subsector and will therefore be either more or less suited to survival and a faster recovery in the current environment (König and Winkler, 2020). Some businesses have a strong online presence, for example, and others do not. Banks cannot therefore conclude from a subsector analysis alone whether or not a specific borrower is in trouble. Furthermore, the conventional sources of data typically used in credit-risk assessments became obsolete overnight. The crisis presented itself as a powerful exogenous shock at the end of a largely global credit cycle. Both supply and demand were equally suppressed, and the data on which lenders relied in the past were no longer useful in evaluating the resilience of individual borrowers. A significant volume of bank loans were extended to some of the hardest hit sectors in the economy and these loans were covered by EBA moratoria and other COVID-19 forbearance measures. This means that banks need to make adequate arrangements as regards credit risk management. In this context, it is important that banks differentiate viable borrowers from distressed ones at an early stage, and that this effort regarding credit risk management is underpinned by a robust governance framework and backed up by prudent provisioning.

There are at least two reasons why this process of credit risk management by banks needs to be conducted in a timely and efficient manner. At the micro level, it allows the supervisor to engage with individual banks at an early stage before the negative effects on their balance sheets fully materialise. At the macro level, this aggregated process of greater visibility on banks' balance sheets should be associated with a less protracted recessionary impact than would otherwise be the case.

For their NPLs banks should consider market-based solutions together with adequate credit risk management. During the financial crisis the securitisation of NPLs was useful tool for NPL management by banks, so it remains an option going forward. Beyond this, one must not forget that non-market solutions, such as traditional workout agreements between banks and their customers, can also be helpful for the management of bad loans.

In this context, credit risk is a key priority for banks and supervisors are engaged in ensuring that deteriorated exposures are managed properly and in a timely manner to prevent a build-up of NPLs in the short term. Supervisors and regulators, ECB above all, emphasised the importance of identifying borrowers' financial difficulties at an early stage. This is crucial for banks to consider all available evidence and reflect on developing new alternative credit risk indicators which factor in the pandemic environment and the deployment of broad-based moratoria. In essence, banks need to perform a new credit analysis to determine whether a borrower's true credit situation indicates a more permanent credit deterioration, ignoring the government support and moratoria put in place to cushion the more temporary credit effects of the pandemic.

As the crisis reverberates through the real economy, banks should be better equipped to deal with the expected increase in NPLs. The new EU regulation on the minimum coverage for non-

performing exposures and the ECB's guidance on expectations for the provisioning of new NPEs, should facilitate the disposal of NPLs further down the line. Banks should be incentivised to build up their provisions as early as possible, thus preventing larger losses at a later stage. Recognising losses only when public support measures expire increases the possibility of cliff effects, diminishing banks' capacity to create value after the pandemic.

Systemic crisis solutions for NPL management, as purely market-based or possibly supported by the public sector, and leading to the outright sale or securitization, can be a helpful addition to, but never a substitute for, adequate credit risk management by banks.

SUPERVISORY PERSPECTIVE

The position of supervisory authorities is very relevant and its role in post-Covid 19 crisis might be directed to discretionary, risk-based approaches aimed at maintaining long-term financial stability. The fall in the capital adequacy ratios below certain thresholds may automatically trigger the activation of corrective actions or resolution mechanisms. Considering the particular condition of banks, the automatic activation of corrective measures should be reconsidered by supervisory authorities. It is evident that banks should submit a feasible medium-term capital restoration plan that provides for capital augmentation in a gradual way, taking into account any remaining market uncertainty and banks' ability to raise capital in such an environment. A close supervisory monitoring would ensure that the bank is satisfactorily meeting its capital targets, while maintaining a fundamentally sound financial condition, and that the decline in regulatory capital ratios would be temporary.

All crisis-related measures should be well tailored and targeted to problems caused by the crisis and not to issues attributable to pre-existing vulnerabilities. In fact no opportunities for moral hazard and foster poor credit risk management practices must be created. Supervisors will provide banks with guidance on the prudential implications of official measures enacted to support borrowers while ensuring that banks continue to assess the credit quality of exposures subject to these measures. In addition, supervisory policies and actions (included those related to capital) should only be targeted to problems created by the crisis and not to unrelated issues that could be due to bad bank governance and management.

Moreover supervisory authorities will provide guidance on using the flexibility embedded in regulations. A blanket reduction or suspension of micro-prudential prudential and accounting would only incentivize excessive risk taking and encourage banks to hide poor underwriting practices. Such flexibility includes using capital and liquidity buffers, relaxation of some macroprudential measures and dealing with prudential loan restructuring practices or with government-announced targeted loan moratoria.

As concerns banks' distributable profits the debate is on how to secure releasable buffers in a crisis. There have been a number of different proposals put forward to this end, but the basic idea is that a re-balancing of the structural versus cyclical elements of banks' capital stacking would give macroprudential authorities greater capacity to act in a countercyclical manner.

The current crisis is giving us an incomplete view of the degree to which the entire Basel III capital framework is effectively working as intended, because some of the elements have been insufficiently implemented (BCBS, 2020 a). For example, if cyclical macroprudential buffers had

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been built up more during the macroeconomic upturn in the run-up to the pandemic, the capacity for macroprudential authorities to act counter cyclically in a downturn would have been greater.

CONCLUSION

During the pandemic banks have shown resilience and have absorbed the first economic shock well as a result of both the regulatory reforms put in place following the great financial crisis and the achievements of the first years of single supervision within the banking union. Banks entered this crisis with much stronger capital positions, and additional capital space has been generated by the relief measures issued by the ECB and the national macroprudential authorities. The danger rate of the crisis resulting from Covid-19 is estimated to be lower than the one during the financial crisis of 2011-2013 because it benefits from: massive liquidity injections from Central Banks; plans to support the economy (moratoriums on loans, state guarantees on loans, freezing of layoffs, refreshments) activated by governments; shorter duration of economic crisis with a partial recovery in 2021; greater solidity of banks in terms of underwriting, stricter credit policies and early warning systems; active budgetary policies and Next Generation EU plan.

Capital conservation has also been aided by the recommendation on dividend distributions suspended throughout 2020. Following the recommendation, with the resumption of payments within prudent parameters, banks under ECB supervision communicated distribution plans in line with the envelope envisaged by the recommendation. This recommendation has been an exceptional policy response to the unprecedented uncertainty regarding the depth and length of the recession generated by the pandemic.

With the crisis supervisors made capital buffers available to banks to enable them to absorb losses and keep lending to the real economy. Together with monetary and fiscal policy actions, the measures had the desired effect. Compared with the effects of the great financial crisis, banks reported a much more moderate tightening of credit standards in reaction to the outbreak of the pandemic. However, this does not necessarily suggest an overly procyclical development. While it is essential that banks are ready to support the recovery, especially when public support measures are lifted, it is equally crucial that their lending policies are appropriately selective and correctly reflect developments in the risk environment. The supportive lending environment created by monetary policy should lead banks to accommodate the demand for credit coming from viable businesses and to look beyond any temporary stress in the liquidity position of borrowers. But they should also strive to identify at an early stage more fundamental solvency problems and proactively manage exposures towards distressed customers, approaching them with a view to finding workable solutions and bringing them back on to a sustainable path or triggering an early exit from the market when no other option is available. The strength and the quality of the post-pandemic recovery depends not only on the amounts of credit available but also on the ability of banks to channel financing to sustainable businesses via accurate risk management and pricing policies. One of the key lessons of the great financial crisis is that the deterioration in asset quality, if not actively managed at the early stages of a crisis, leads to a serious impairment of the banking sector's lending capacity, with severe adverse macroeconomic effects.

In mid-2020, European non-performing loans were 52% down from the peak of 2015, even if an increase in European stocks is expected in 2021 (Banca Ifis, 2021). Anyway the decline in the NPL ratio shows that banks have effectively remained focused on the need to address the existing stock of impaired assets, especially via intense NPL sale and securitisation activities. This progress must be praised, and reminds that banks must not lose control of asset quality again, monitoring, before supervisors, credit risk and credit management. There are also significant differences in how banks flag their exposures as forborne, which raises concerns that some of them are not taking an adequate approach in this area. Particularly worrisome is the large share of exposures that have been directly transferred from stage one (performing) to stage three (non-performing), without passing through stage two (underperforming). This could suggest that early-warning systems are ineffective.

It is crucial that banks recognise credit impairments without delay. Ample room for loss absorption is available to all banks, especially considering that the buffer flexibility granted includes the capital conservation buffer and remains valid until at least the end of 2022.

European banks need to make sure that provisioning decisions are not unduly postponed as this might negatively affect their profitability and lending capacity when the demand for credit picks up. As learned from the great financial crisis, if bank balance sheets are clogged with high levels of deteriorated assets for a prolonged period of time, banks will have a reduced capacity to generate income, will face higher funding costs and, as a result, will lend less to the real economy. Moreover, low-quality assets parked on balance sheets have been proven to hamper the transmission of monetary policy through the lending channel. This has resulted in varying degrees of effectiveness of monetary policy across the euro area since the great financial crisis. Communication and transparency are essential. A clear communication of supervisory expectations about banks' response to distressed borrowers and the regulatory approach in dealing with the temporary impact of the outbreak is essential. Enhanced reporting, including within banks, between banks (through credit registries and bureaus, if possible), and to supervisors, is needed. It would also be helpful to identify, quantify, and report forborne loans, and to introduce strict criteria for acceptable loan restructuring. Banks are also expected to conduct portfolio reviews and risk assessments on a regular basis to measure the impact of Covid-19 on their financial conditions. Engagement between banks and banking supervisors should also be enhanced, particularly in the midst of the crisis where banks' regular disclosures may not fully reflect the magnitude of the shock. Supervisors may need to take quick actions to address market concerns and stress. Supervisors are recommended to quickly introduce ad-hoc reporting of stock and flows specifically for affected loans so that financial stability implications can be more accurately assessed as the situation evolves. In addition, transparent banks' public disclosures are key to provide the public with a true picture of the bank's financial position and to inform supervisors about the measures needed to deal with the implications of the outbreak.

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