



# **SUSTAINABLE RECOVERY POST-COVID-19:** A TWIN PROPOSAL TO PRESERVE BANK RESILIENCE AND FUND THE EUROPEAN ECONOMY

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## INTRODUCTION

The spread of COVID-19 poses a serious threat to human health and fundamental challenges to the economy, due to lockdowns leading to a halt in economic activity and the slowing down of consumption and investment.

According to data from the EU Commission, Europe has entered the deepest economic recession in its history. In 2020, the drop in GDP will be 7.7% in the Eurozone and 7.4% throughout the European Union (EU). Greece, amongst the EU countries, will record the greatest GDP decline of 9.7%, followed by Italy (9.5%).

To contain the severe impact of the economic slowdown on businesses and individuals, governments and institutions have intervened with supportive policies and measures covering all economic sectors. The banking sector has been one of the main channels for transmitting these measures to the economy. If, in the financial crises of 2008 and 2012, banks represented the problem, in the COVID-19 crisis they represent part of the solution.

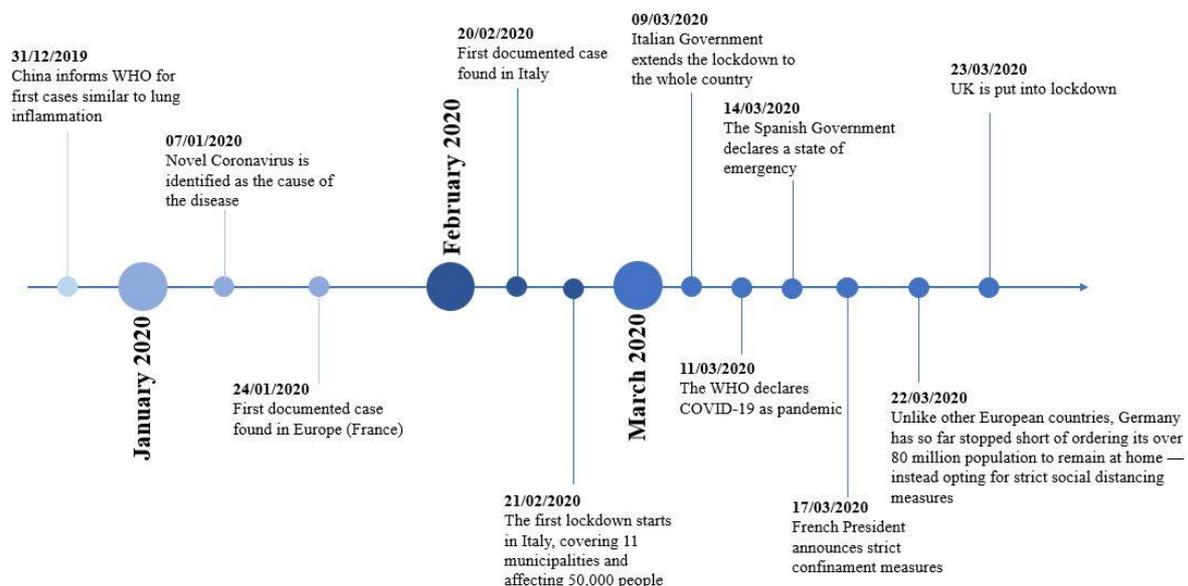
The policy paper reviews the policy interventions that EU institutions and governments put in place to reduce the risks of lockdown and the halting of economic activity. It assesses the consequences of COVID-19 on the banking sector in Europe, in terms of capital, asset quality, liquidity and profits. It also provides a proposal on how to build a recovery path for banks and for the real economy in Europe post-COVID-19. To do so, the paper analyses the evolution of banking risk and proposes avenues on ways to manage the possible worsening of the credit quality of bank loan portfolios, depending on both the residual amount of NPLs that European banks hold in their balance-sheets and the effect of the COVID-19 crisis on the real economy. In particular, the paper discusses a hybrid approach that includes: i) the creation of a Eurozone Bad Bank to manage the future increase in non-performing loans (NPLs), and ii) the implementation of a European pandemic equity fund to support firms that are not defaulting.

## AN IMPRESSIVELY SPEEDY SPREAD OF COVID-19 WITH UNCERTAIN CHARACTERISTICS AND CONSEQUENCES

There have now been more than nine million confirmed cases of coronavirus in 215 countries and at least 470,000 people have died. Since the end of December 2019, when the Chinese Government announced for the first time to the World Health Organisation (hereafter WHO) a new form of disease, in a few months since, the COVID-19 outbreak has spread all over the World. The first countries affected by the virus were those bordering China and in South East Asia. Three cases of COVID-19 were confirmed on 24 January in France, the first cases in Europe. Two patients were detected in Paris and one in Bordeaux. All three had travelled from Wuhan, China. The first official case of secondary transmission confirmed in Europe, occurred in Lombardy, Italy, on February 20, 2020.

Italy was the first European country to declare the lockdown of 50,000 people in Lombardy. On 9 March, the Italian government extended the lockdown to the whole country. On 11 March, the WHO declared COVID-19 a pandemic. The decision for lockdown was followed by other European countries, such as Spain (14 March) and France (17 March). Other countries, such as Germany, UK and Sweden, did not immediately opt for total lockdown, instead they decided to apply strict social distancing measures. In a second phase, most of European countries adopted a lockdown (Fig. 1).

**Figure 1. Evolution of COVID-19: The Timeline of the Events**



**Source:** Authors' elaboration based on Governments' announcements

In the chart below (Fig. 2) the propagation of pandemic is reported, showing an exponential worldwide evolution. Although the number of cases remains relatively small in Asia, in Europe and US the spread of the coronavirus grew faster.<sup>1</sup> Two main reasons could be identified: first, the virus could have changed, becoming more contagious and aggressive in Europe and in the US than in China (Pachetti et al., 2020)<sup>2</sup>; second, the lockdown measures may have been late in some countries (Ayadi et al., 2020)<sup>3</sup> and, in some cases, the types and intensity of containment measures and the preparedness of healthcare systems were poor.<sup>4</sup>

The coronavirus outbreak has not only generated a health crisis in several countries, but it has also led to major disruptions in the global economy. By the end of April, countries accounting for around 70% of world GDP were in some form of lockdown (Revoltella, 2020)<sup>5</sup>. The global economy has practically stopped and people, having had to rethink their daily habits, have drastically reduced their consumption. The COVID-19 crisis is likely to shrink EU GDP by 7.4% in 2020, with the greatest collapse being in Greece (-9.7%) and Italy (-9.5%) (European Commission, 2020).<sup>6</sup> The forecasts could be worse if activity restrictions extend to the third quarter of the year and if the government measures to support the real economy fail. Some economic sectors are exposed to a greater risk (e.g. oil & gas, aviation, travel & tourism, automotive and some retail sectors)<sup>7</sup> due to a vertical decrease in sales. Countries in which these sectors are more important will experience an increase in firm defaults, economic hardship and a profound deterioration in labour market conditions. Unemployment across the whole of the EU is expected to rise to 9% in 2020, in the wake of the Coronavirus pandemic and any subsequent lockdowns imposed by national governments, before declining again to 8% in 2021. Amongst EU countries, Greece is expected to suffer the worst unemployment rate of 19.9%, followed by Spain at 18.9%, whilst Germany is forecast to have the lowest unemployment rate, at 4% percent (European Commission, 2020).

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<sup>1</sup> For further details see Ayadi (2020) "[Time for a decisive coordinated response to a costly global covid-19 systemic crisis: towards a resilient global system](#)"

<sup>2</sup> Ippodrino, R., Pachetti, M., Marini, B., Benedetti, F., Giudici, F., Mauro, E., & Gallo, R. C. (2020). Emerging SARS-CoV-2 mutation hot spots include a novel RNA-dependent-RNA polymerase variant.

<sup>3</sup> For further details see Ayadi et al. (2020) "[Responses, Preliminary Assessment and Way Forward Study](#)".

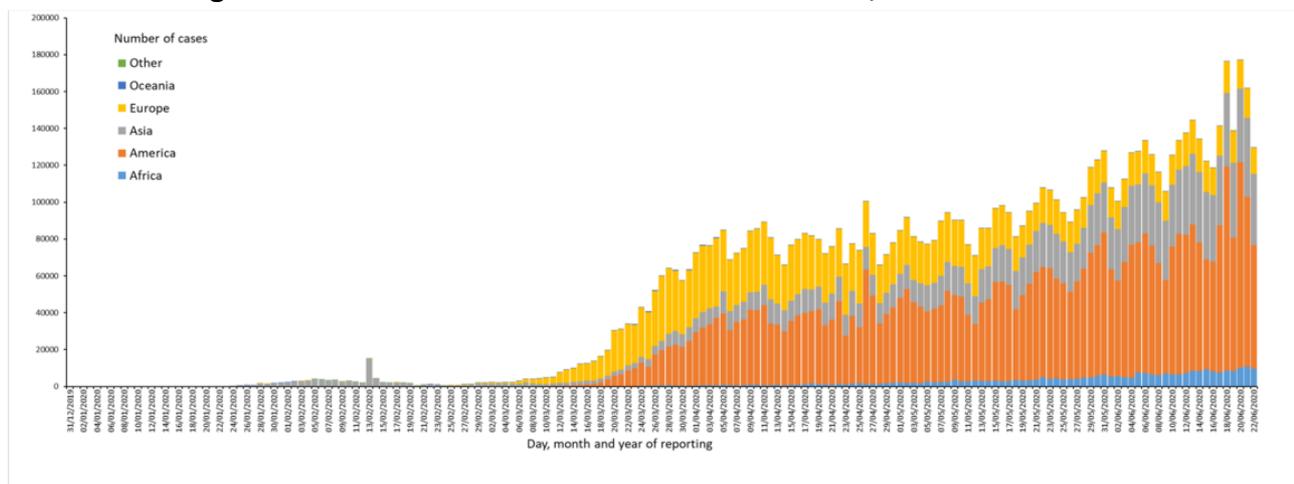
<sup>4</sup> For further details see [EMEA COVID-19 research](#).

<sup>5</sup> For further details see "[Covid-19 policy response and the role of the EIB, SUERF Policy Briefs No 8, May 2020](#)".

<sup>6</sup> For further details, see "[European Economy Institutional Papers of European Commission](#)", Spring 2020.

<sup>7</sup> Just as an example, the EU car market recorded in March 2020 a drop of 55.1% in registration of new vehicles (ACEA, 2020), the Price of oil loses the 30.7% since the start of the year.

**Figure 2. Distribution of COVID-19 cases worldwide, as of 22 June 2020**



**Source:** <https://www.ecdc.europa.eu/en/geographical-distribution-2019-ncov-cases><sup>8</sup>

Whilst social distancing and lockdown measures have helped flatten the epidemiological curves, several countries are facing “phase two” of crisis management. Governments are studying the best formula to restart economies using careful de-confinement policies. The reopening of economic activities is gradual; it started with companies in essential sectors and progressively including other activities, up to those involving more intense socialisation such as cinemas, theatres and concerts. Two baseline scenarios can be expected: a U-shaped scenario and a L-shaped scenario.<sup>9</sup> Much will depend on measures taken by Governments and National and International Authorities during the COVID-19 crisis.

<sup>8</sup> Data completeness depends on the availability of information from the affected areas. All data should be interpreted with caution, as the outbreak is evolving rapidly. In addition, due to the unavailability of date-of-onset data and different testing policies per country, this figure might not be reflective of the evolution of the epidemic.

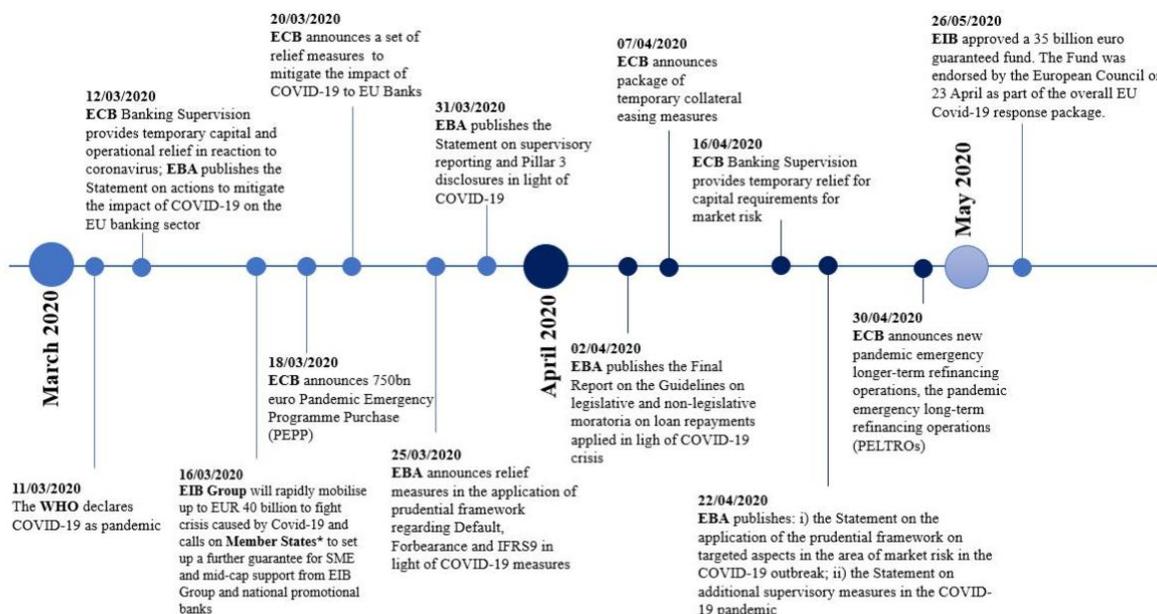
<sup>9</sup> Banking Stakeholder Group (2020) COVID-19 banking measures and recommendations towards a sustainable recovery

## BANKING AUTHORITY AND GOVERNMENT MEASURES TO MITIGATE THE IMPACT OF COVID-19

Amidst the COVID-19 crisis, the European Commission declared that the EU will respond to the Coronavirus crisis *“using every available euro in every way possible to protect lives and livelihoods”*. The measures issued by the European Commission to fight the COVID-19 are several; from EU budget flexibility, to emergency support to finance emergency aid, through the provision of grants, up to SURE which is a new EU solidarity instrument to help workers retain income and help businesses stay afloat and retain staff, with the aim of keeping the unemployment rate under control. Moreover, the European Stability Mechanism (ESM) has made available about 240 billion euros to support the domestic financing of direct and indirect healthcare, and cure and prevention-related costs due to the COVID-19 crisis, without additional requirements to access lines of credit. The European Commission also revised its temporary framework for State aid, to allow capital injections by EU Member States into non-financial firms affected by the COVID-9 outbreak. Finally, in May, the European Commission proposed a Recovery Fund – The Next Generation EU – of 750 billion euros, financed by debt issued by the EU, a part of which will be used as loans and another part as a non-repayable fund.

In what follows, we focus on the measures and responses the European Central Bank (ECB), the European Banking Authority (EBA), and National banking authorities and Governments have made available to support the banking system, in order to maintain and increase its funding to the real economy in the context of COVID-19 (Fig. 3).

**Figure 3. Measures by Regulators and Supervisors to support the banking system and the real economy**



\*European Member States set up guarantee schemes to support SME, Mid-cap and Large-cap companies

Source: Authors' elaboration

## Bank Capital

Immediately after the WHO announced COVID-19 as a global pandemic, on 12th March, the ECB introduced a number of measures to ensure that banks could continue to fund the real economy to face the crisis. During recent years, banks have built up capital and liquidity buffers, as required by Basel III Accords and European Regulation, for use in times of stress, like the current one.<sup>10</sup> The ECB allowed banks to operate temporarily below the level of capital defined by the Pillar 2 Guidance, the capital conservation buffer and the liquidity coverage ratio (LCR) (ECB, 2020). The main aim of this loosening of minimal rules is to enable banks to better support the real economy. The ECB requested banks not to pay dividends or buy back shares until at least October 2020, using these amounts to reinforce capital and boosting the capacity of banks to absorb losses. In this way, banks can face the

<sup>10</sup> Dr Andrea Enria, in an interview on 20 April 2020, said the ECB “activates the precise provisions that were put in the new regulatory framework building after the last crisis, to make sure that banks that have built up buffers in good times can then use them in bad times when there is a moment of stress” For the whole interview:

<https://www.bankingsupervision.europa.eu/press/interviews/date/2020/html/ssm.in200513~2e431c1b43.en.html>

possible increase in risk-weighted assets (RWA) that would be driven both by the need to increase lending to support their customers and by the increase in the riskiness of their portfolios.

In response to the extraordinary level of volatility in financial markets, on 16 April, ECB published measures for a temporary reduction in capital requirements for market risk, by allowing banks to adjust the supervisory component of these requirements; subsequently, on 22 April, the EBA published supervisory measures aimed at softening the potential impact of market turmoil on market RWA and on the additional valuation adjustments of fair-valued financial instruments.

## Bank liquidity

On 16 March 2020, the European Investment Bank Group (EIB) announced the rapid mobilisation of up to 40 billion euros to fight the crisis. These funds aim to support SME and mid-cap companies. The EIB, together with the European Investment Fund (EIF), which specialises in supporting SMEs, worked actively through financial intermediaries in the Member States and in partnership with national promotional banks. The financing package consists of three instruments: i) a guarantee scheme to support SMEs; ii) liquidity lines to banks to ensure additional working capital; iii) dedicated asset-backed security purchasing programmes to allow banks to transfer credit risk linked to the SMEs loans. The guarantee fund was approved on 16 April. Moreover, the EIB asked the Member States to set up additional guarantee schemes to support the real economy. Several European Governments responded to this request and implemented additional guarantee schemes to support SMEs and larger companies. The state guarantee allows banks to be faster in providing lending to businesses.

Additionally, on 18 March 2020, the ECB announced a €750 billion Pandemic Emergency Purchase Programme (PEPP). This purchase programme will be active until the end of 2020 and will include all asset categories eligible under the existing asset purchase programme. In addition to the purchase programme, the ECB introduced more favourable conditions for the TLTRO-III, which will be applied in the period between June 2020 and June 2021.<sup>11</sup> On 7 April, the ECB adopted an unprecedented set of collateral measures to mitigate the tightening of financial conditions across the euro area, increasing the risk tolerance and easing the conditions for the use of credit claims as collateral.<sup>12</sup> On 20 April, the ECB announced another liquidity measure to support banks in financing

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<sup>11</sup> FOR FURTHER DETAILS SEE [“ECB ANNOUNCES EASING OF CONDITIONS FOR TARGETED LONGER-TERM REFINANCING OPERATIONS \(TLTRO III\)”](#)

<sup>12</sup> This includes the possibility of accepting, as collateral, loans with lower credit quality, loans to other types of debtors, those not accepted in the ECB’s general framework, and foreign-currency loans.

the real economy, through the new pandemic emergency long-term refinancing operations (PELTROs), with seven different tranches from 19 May up to 3 December 2020. The aim of these liquidity measures is to have a positive effect on bank liquidity, spurring bank lending.

## Asset quality

After the introduction of measures to directly support the real economy - in particular, SMEs that are the backbone of Europe's economy and represent 99% of all businesses in the EU (European Commission, 2020) - the supervisors issued measures to support bank credit risk management. On 20 March, the ECB announced measures to increase flexibility for banks. The aim is to provide sustainable solutions to temporarily distressed debtors. The flexibility introduced includes the treatment of NPL, in particular banks can fully benefit from guarantees and moratoriums established by national authorities, noting that loan loss provisions are affected by excessive volatility which could produce the excessive procyclicality of regulatory capital. From a prudential point of view, the ECB recommended all banks to avoid procyclical assumptions in their models, in order to determine loan loss provision. Five days later, the EBA published a statement on the application of the prudential framework regarding default, forbearance and IFRS9. The EBA underlined that, the loans on which public or private moratoria are applied, are not automatically classified as forbearance loans or identified as default. However, the obligation remains for banks to assess the credit quality of their exposures and the identification of situations where repayment is unlikely. It is crucial to provide true information about the quality of a bank's credit portfolio, and to ensure that banks are adequately capitalised.

## Other measures

In addition to the measures on capital, liquidity and asset quality, the EBA published several statements on operational capabilities, allowing banks to focus on their core activity in supporting the real economy. The EBA decided to postpone the stress tests and other reporting exercises to later dates<sup>13</sup>; however, this flexibility should not compromise access to the most important information<sup>14</sup>, recommended competent authorities to focus solely on the most material risks and vulnerabilities driven by the crisis for the 2020 SREP assessment and, with regard to the recovery plan, suggested

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<sup>13</sup> See the "[EBA statement on additional supervisory measures in the COVID-19 pandemic](#)"

<sup>14</sup> For further details see "[Statement on supervisory reporting and Pillar 3 disclosures in light of COVID-19](#)"

banks to focus purely on submitting key elements of their recovery plans.<sup>15</sup> Finally, in light of the great importance of digital operational resilience in the crisis, the EBA has highlighted the importance of complying with the EBA Guidelines on ICT and security risk management, applicable from 30 June 2020.<sup>16</sup>

## THE EVOLUTION OF BANKING RISKS IN EUROPEAN COUNTRIES PRE AND AMIDST COVID-19

*The starting point: A resilient banking system facing the shock*

During the past decade, a lot has been done to increase the soundness and the resilience of the European banking system. Prudential and market conduct rules have been harmonised and comparison between banks across the European countries can be made more comfortably.

Although the European banking system seems healthier and more resilient to the macroeconomic shocks, as compared to the situation prior to the financial crisis, banking system characteristics differ across countries and, therefore, the COVID-19 crisis may impact them differently.

It is important to note that during the last decade, European banks have continued building a solid capital position, strengthening their balance-sheets. The recapitalisation process of the last decade made the banking system more resilient and robust. The Tier 1 ratio increased from 10.2% in 2009 to 16.6% at the end of 2019. This suggests that, today, banks are sounder.

However, the situation is not the same across all European countries. In 2019, countries, such as Italy, Portugal, Spain and Austria, although showing CET1, Tier 1 and Total Capital Ratio well above the regulatory capital requirements, CET1 ratios were below the Euro-area average. Whereas, other countries CET1 ratios are well above the Euro-area average such as in the case of Luxemburg, Ireland, Belgium and some Eastern European countries (EBA Risk Dashboard, 2020).<sup>17</sup>

In terms of asset quality, the NPL ratio decreased in the EU, from 6.68% in 2015 to 2.75% in 2019. A constant reduction in the NPL ratio depended on two main reasons: i) the cleaning up of bank balance-sheets through the sale of a large amount of NPLs, in particular bad loans spearheaded by more facilitation to sales of distressed assets; ii) the economic recovery of recent years, in which the

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<sup>15</sup> See the "[EBA statement on additional supervisory measures in the COVID-19 pandemic](#)"

<sup>16</sup> See the "[EBA statement on additional supervisory measures in the COVID-19 pandemic](#)"

<sup>17</sup> <https://eba.europa.eu/risk-analysis-and-data/risk-dashboard>

new flow from performing loans to NPLs has decreased overall. Moreover, there has been harmonisation of the default definition. Although the average value of NPLs in Europe is lower than 3%, there are countries still showing a very high level of NPLs, such as Greece (35.2%) and Cyprus (19.4%), and other countries have a NPL ratio lower than half of the European average, such as Norway (1.3%), Sweden (0.5%) and Luxemburg (0.9%) (EBA Risk Dashboard, 2020).

Considering the bank business models<sup>18</sup>, differences in the NPL ratio emerge. Although during recent years a decrease in NPL ratio is observed in all business models, Figure 4 shows that the greatest reduction took place in diversified retail business models (both Type 1 and Type 2). Banks that adopt the Wholesale and Investment business models show the lowest NPL ratio, in line with their core activities. In recent years, Focussed Retail Banks showed a decreasing trend of NPLs, however they emphasised a lower reduction in the NPL ratio, compared to other business models.

Looking at profitability, the return on equity (ROE) stood at a weighted average of 5.80% in 2019, showing a decreasing trend – in 2017Q1 and 2018Q1 it was 7.3% and 6.8%, respectively. Across European countries, the average value of ROE largely differs, from 0.08% in Germany to the 10.36% of Slovenia (EBA Risk Dashboard, 2020).<sup>19</sup> The negative trend depends primarily on both the non-conventional monetary policy of recent years, with low/negative interest rates and the tough banking competition that forces banks, on the one hand, to decrease their loan prices and, on the other, not to reduce funding costs (e.g. the interest rate on customer deposits). In addition, banks' profitability is mainly weighed down by structural factors. Improving cost efficiency is one of the key challenges for banks. The cost-to-income ratio has deteriorated in the past decade. However, also in this respect, the picture is extremely varied at the level of individual banks. Another reason affecting banks' profitability is the continuous presence of NPLs, as highlighted before. Moreover, banks continue to face earnings headwinds due to low returns on NPLs, which tie up capital, absorb operational capacity and incur legal and administrative costs.<sup>20</sup>

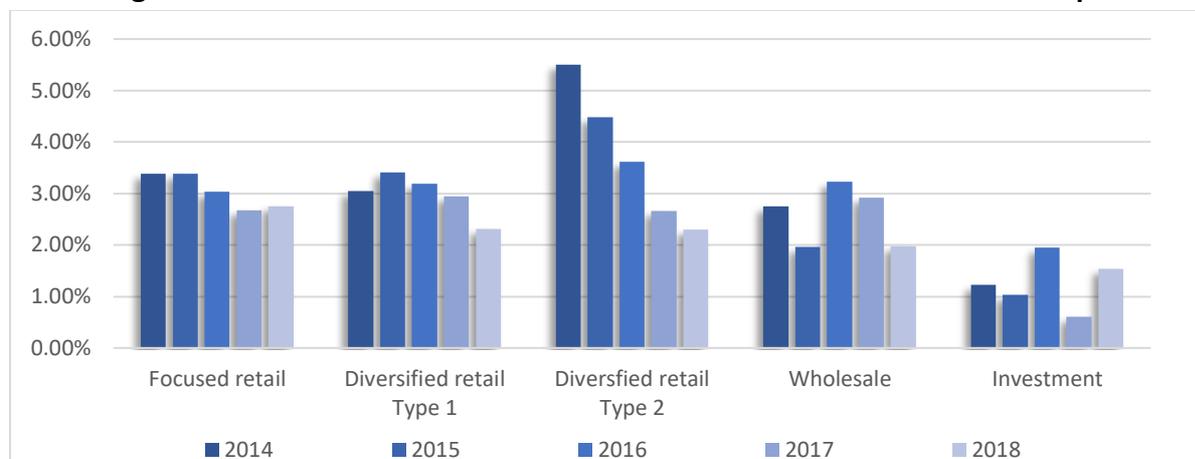
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<sup>18</sup> The definition of business model used in this analysis is reported in Appendix and the classification is based on Ayadi et al. (2019) available at <https://euromed-economists.org/banking-business-models-bbm-monitor-2019-is-online/>

<sup>19</sup> Data refers to the significant European banks (SSM banks) at 2019Q4 and are available at <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200407~c2e39fb2a5.en.html>

<sup>20</sup> Keynote speech by Luis de Guindos, Vic-President of the ECB, at the ABI annual conference "Banking Union and Basel III – risk and supervision 2019" Rome, 25 June 2019.

**Figure 4. The evolution of NPL ratio across Bank Business Models in Europe**



**Note:** Authors' elaboration on SNL data (last available year 2018) based on Ayadi et al (2019) classification

Conversely, when we look at the LCR, all countries exceed the 100%, as required by regulations, but also in this case, the situation across Euro-area countries differs, with an underlying average value of 150%, with some countries above average, e.g. Malta, Slovenia, Romania and Cyprus; others below average, e.g. the Netherlands, Greece and France; and some countries on average, e.g. Germany, Poland and Italy. The favourable funding conditions of 2019 allowed banks to issue a high volume of unsecured instruments, in particular MREL and TLAC eligible bonds.

Looking at the cost to income ratio, it increased during recent years, passing from 59.3% in 2015 to 64% in 2019, showing a worsening of bank cost efficiency. The cost efficiency is not the same across European countries, ranging from 84.4% in Germany to 39.7% in Lithuania at the end of 2019 (EBA Dashboard, 2020).

The snapshot underlines a variegated European banking sector and it suggests that the starting point before the coronavirus crisis is different across countries.

*The effect of COVID-19 on the banking system: Fragile resilience insufficient to support a sustainable recovery*

The COVID-19 crisis will negatively impact the banking sector, in terms of capital, asset quality and profits. The lockdown has affected several economic sectors and, in many countries, unemployment rates are rising rapidly together with over-indebtedness of individuals and SMEs.<sup>21</sup> The

<sup>21</sup> Liu Y., Garrido J. and DeLong Chanda (2020) "[Private debt resolution measures in the wake of the pandemic](#)". International Monetary Fund.

forecasts emphasise an uneven economic recovery across the EU. Accordingly, banks that are exposed to the most affected sectors and operating in the countries with higher unemployment rates and, where over-indebtedness of individuals and cooperate sector is ramping, will be more impacted by the crisis.

In light of this economic environment, bank revenues are deteriorating. Fee and trading income, in the short term, has slowed down more than the interest margin; this is because fees and commissions are affected by declining transaction volumes and reduced asset management fees and also by investment fund outflows. Despite the net interest margin being more resilient in the short-term, in the long-term perspective, low interest rates do not help bank income statements and continue to erode the net interest margins.

In the future, COVID-19 will have multiple and different effects on bank profits, both on net interest income and net and fee commission income. Whilst retail banks are more exposed to the decrease in net interest margins, investment banks will be more impacted on their net fee and commission income. For example, fees related to client trading might rise, whilst those related to M&A operations might shrink (EBA, 2020)<sup>22</sup>. Market turmoil affects the net trading income of investment banks. Although in the early days of a recession, net trading income increases, the equity and derivatives business lines are negatively affected by the volatility of financial markets and the large fall in equity markets.

Bank returns also tend to decline following the increase in the cost of credit, due to the rise of NPLs, posing additional challenges for banks that have already disposed of their existing NPLs. The increase of NPLs, in addition to profit, negatively impacts bank capital requirement and the possible needs of recapitalisation may reduce bank lending, hence aggravating the crisis. A prolonged stressful situation might easily deplete the voluntary and regulatory capital buffers (on top of the minimum requirements) with which banks enter this crisis, especially for those banks that were already showing lower levels of capital in 2019. In the future, the capital reduction due to the COVID-19 crisis could translate into two alternatives for re-establishing the appropriate ratio between assets and net worth: collecting new capital and reducing dividends, or reducing the supply of credit. However, when losses occur in the middle of a systemic financial crisis, raising new capital becomes extremely difficult and, as a consequence, banks usually react by reducing their supply of credit (Ayadi et al., 2017).

The rise in bank credit losses adversely affects bank profit and capital, and could lead to a credit crunch in Europe, when banking sector support for the real economy is crucial for the recovery.

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<sup>22</sup> For further details see [“Thematic note - Preliminary analysis of impact of COVID-19 on EU banks – May 2020”](#)

In recent years, banks adopted several strategies to reduce their costs and improve efficiency. Amongst others, digitalisation plays a crucial role. The traditional bank business model is challenged by several factors and the increase in competition from shadow banks and new digital entrants is one of them. The COVID-19 crisis and the lockdown have led to an impressive acceleration in the digitalisation process (e.g. the use of online banking, e-commerce and e-payments). Banks that react quickly to this transformation will be better able to use and exploit the benefits of more advanced technologies. However, this process will increase some bank risks, such as the cyber and operational risk<sup>23</sup>

It is plausible that the consequences of lockdown will be different across EU countries, depending on several factors: the impact of the epidemic, the initial economic situation, the composition of the bank loan portfolio (EBA, 2020)<sup>24</sup> and bank business models.

## PROPOSALS TO SUPPORT THE REAL ECONOMY AND THE BANKING SECTOR

One of the biggest risks is that the economic crisis generated by the COVID-19 crisis may turn into a financial crisis (e.g. banking or sovereign debt crisis). The actions taken by authorities and governments are necessary conditions for an economic rebound and are mainly aimed at fighting short-term liquidity problems in order to contain bankruptcies. However, the increase of banking loans raises a firm's leverage through greater debt and, therefore, their default risk (and the bank risk exposure), leaving firms little room to invest and to grow, amidst looming uncertainty. A legitimate question that arises is whether the banking/monetary measures applied to combat the COVID-19 crisis are paying off. The answer is not straightforward. It is too early to say how much banks will actually be willing to expand their balance sheets. In the long-term, liquidity measures would not be sufficient to support firms in preventing and managing defaults. Moreover, the increase in NPLs would start to be visible at the end of the second or third quarter of the year.

Two complementary mutually reinforcing proposals are considered for reducing, in the medium to longer term, the risk to the EU economy of a significant number of insolvencies and contributing to preserving the continuity of economic activity during the COVID-19 outbreak and

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<sup>23</sup> For further details see Carletti, E, S Claessens, A Fatas and X Vives (2020), *The Bank Business Model in the post-Covid-19 World*, The Future of Banking 2, CEPR Press.

<sup>24</sup> For further details see "[Thematic note - Preliminary analysis of impact of COVID-19 on EU banks – May 2020](#)"

supporting the subsequent economic recovery, hence reducing the risk to the banking system and strengthening financial stability: i) the capital injection into a firm's equity, to support businesses in growth and investment; ii) the realisation of a Eurozone bad bank to manage the increase of NPLs in a bank credit portfolio.

Looking at the first tool, as mentioned in a previous section, the European Commission has already permitted Member States to intervene in providing equity for firms through state aid, which is usually not allowed to ensure there is fair competition amongst firms and countries. However, EU countries which are fiscally stressed (e.g. Italy and others), will hardly be able to intervene to help their businesses. On the contrary, recapitalisation with government funding will be consistent and robust in those countries that show a strong fiscal situation, such as Germany and Austria.

In the post-crisis period, under-capitalised companies operating in fiscally stressed countries will face the competition of well-capitalised companies in those countries demonstrating a better fiscal situation. The level-playing field, pursued by European authorities for decades, would be very remote. This possible context would generate an increasing gap between EU economies, hence reinforcing macro-imbalances.

In light of this scenario, one possible path would be the creation of a pan-European equity fund<sup>25</sup> supported by the EU. The fund, which would aim to underwrite the new equity issued by businesses across Europe and to inject equity into SMEs that typically do not have access to capital markets, should have restrictive rules in order to direct funds only to worthy companies. The fund would support only those firms which encountered problems due to COVID-19 and not those which were already financially stressed before the crisis (so-called *zombie firms*). Only financially viable firms should receive support, with their viability assessed in consideration of both their past (pre-COVID situation) and future (post-COVID situation). Moreover, equity would be directed towards supporting broader social goals, such as climate neutrality and social cohesion, as defined by the European Commission.

The economic rationale of the equity fund is that it would allow European companies to invest and compete, based on profitability and independently of the fiscal capacity of their countries. The pan-European equity fund would be directed both to large firms and to SME firms, and, prior to the issuance of equity, investors will participate proportionally in a firm's profit and eventual losses.

On the other hand, the idea of a European bad bank comes back into focus. It could be the only way to definitely support banks in managing their NPLs sustainably, allowing them to clean up their balance sheets from both the NPLs deriving from the financial crisis and those originating from the

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<sup>25</sup> In line with the proposal in <https://voxeu.org/article/implementing-european-pandemic-equity-fund>

COVID-19 crisis. This solution may have positive effects, not only on credit portfolio quality, but also on both bank capital and bank profits and, consequently, on EU banking stability.

Already in 2017, Andrea Enria, at that time EBA Chairman and today the Chair of the ECB Supervisory Board, proposed the creation of a European bad bank (in the form of an Asset Management Company – AMC) to buy billions of euros of toxic loans. This proposal becomes even more reasonable in light of the possible consequences that the crisis may have on the balance sheets of EU banks.

In recent years, supervisors and regulators have published several guidelines and rules on how banks have to manage NPLs.<sup>26</sup> Although we recognise the importance of supervisory pressure on banks to proactively manage their NPLs, improving the provisioning coverage and their management systems, these measures are not sufficient to permanently manage NPLs. It is important to note that the legal systems and judicial procedures across EU countries are very different and the recovery process of bank NPLs requires dissimilar amounts of time. Moreover, in the NPL secondary market there are several problems concerning market failures, such as the information asymmetry and inter-temporal pricing problem that can derive from the illiquidity of the market.

It is only the private sector that seems insufficient in eliminating the problem of NPLs. Historical examples have demonstrated that, sometimes, public intervention is crucial for solving a problem, particularly when consumer protection issues emerge from unfair debt collection practices. In the case of public intervention, leaving complete freedom to Member States can lead to very different approaches that can increase the gap and reinforce fragmentation; whilst a coordinated approach at a European level can lead to common results, necessary for the construction of the single market.

The realisation of a Eurozone bad bank may be able to remove market failures, thereby increasing transparency and diversifying NPL supply. Someone could object that the presence of a bad bank could lead banks to engage in improper behaviour (e.g. moral hazard) or that the BRRD rules do not allow the definition of such a bank. The answer suggested by Hansen and Quagliariello (2017)<sup>27</sup> is the introduction of a claw-back clause, which means that the bad bank has a defined time period to sell the NPLs acquired from the banks and whether the sale takes place at least at the price at which the bad bank purchased the NPLs from the banks (economic value), in which case nothing happens, or

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<sup>26</sup> The most important are: i) the new definition of default (EBA, 2016); ii) the ECB guidelines (2017) in which ECB stresses the importance of timely provisioning and write-off practices related to NPLs and the Addendum (2018) in which the ECB details the expectations when assessing a bank's level of prudential provisions for NPLs; iii) the guidelines on management of non-performing and forborne exposures (EBA, 2018) with the aim of achieving a sustainable reduction of bank NPLs, to strengthen the resilience of their balance sheets; iv) finally, the European Commission (2019) issues the calendar provisioning the indications on the time within which a position classified as a NPL must be fully covered.

<sup>27</sup> See "[Why the EU needs an asset management company](#)" for further details

whether the bad bank sells the NPLs at a lower price, in which case the loss (the difference between the selling price and the economic value paid) would go back to the bank.

However, without any warrant, the structure of a bad bank can only partially help banks in managing NPLs, because the risk of a selling price lower than the economic value remains with the banks, so the NPLs are not removed from the bank balance sheet until the final sale. The claw-back, in the form of warrants to national government, could be another possible solution. In this case, the sale of NPLs to the bad bank is guaranteed by the national government, which will only intervene if the final sale takes place at a lower price than the economic value paid by the bad bank. The warrant reduces the uncertainty of an overhanging contingent liability and avoids any burden-sharing across EU countries – it is the Member State that injects capital, if necessary. Nevertheless, also in this regard, the problem related to the fiscal condition of each EU country emerges. Only those countries less fiscally stressed could intervene with state aid to support banks that have sold their NPLs to the bad bank, causing differences in the banking sector competition.

In light of these evidences, we believe that a pan-European fund that intervenes when the claw-back clause is activated could be the solution, at least for NPLs that will emerge following this latest economic crisis derived from the containment measures adopted by governments. In this way, the fiscal differences across EU countries would be removed and the risks would be shared across Member States, as in the case of the risk to firms supported by the European equity fund.

The pandemic could provide the occasion for a new starting point for a Europe built on risk/burden sharing, to continue building the single market at the risk of fragmentation. The European equity fund and the European bad bank, funded with resources from all EU countries, could help to create a common perception of shared responsibility and solidarity across Europe. They would fit into several programmes announced during the COVID-19 crisis, primarily the Recovery Fund. The two tools proposed in this paper would have a positive impact, both on the firms' leverage and on banking stability.

On the one hand, the European equity fund would support firms over a long-time period, reducing the number of bankruptcies and, consequently, the new flow of NPLs into a bank's balance sheet. Moreover, the equity fund would be a new tool to ensure competition across countries and sectors, removing the problem related to the fiscal condition of each European country and the European political bodies may address funds to those firms more willing to invest in the social goals identified by the EU.

On the other hand, as suggested by Ayadi et al. (2017), the European bad bank would provide several benefits, from the maximisation of the recovery rate on legacy assets, to the reduction of the risk of procyclicality in the banking sector due to the increase of NPLs. Moreover, the presence of EU bad banks would allow the elimination of the market failures on the NPL secondary market, reducing its opaqueness.

Finally, but no less important, the Bad bank and the Equity fund will promote accountability, since its profits would be channelled back to European people, possibly helping to fill the, as yet, not totally funded Resolution Fund. This would avoid relying on taxpayers' money, should a major shock occur.

Over the long-term, these measures would strengthen euro stability, in conjunction with the financial stability of the EU. Both firm risk and bank risk would be directly shared across Member States, strengthening cohesion across EU countries.

## APPENDIX

The update of the database is comprised of up to 15,176 bank-year observations of 3,380 banks, covering more than 95% of assets of the EU plus EFTA countries from 2014 to 2018. The BBMM categorises the European banking industry following a behavioural approach that defines banks by the interaction between their funding (liability) and activity (assets) profiles and uses a state-of-the-art clustering methodology.

The analysis results in five business models which can be summarised as follows: retail focussed, retail diversified (type 1), retail diversified (type 2), wholesale and investment.

- i) **focussed retail**, i.e., banks that use customer deposits as the primary means for funding loans and maintain relatively high levels of loss-absorbing capital; these institutions follow the traditional financial intermediation model;
- ii) **diversified retail**, i.e. banks that are still retail-oriented, and yet more diversified than focussed retail banks, either on the asset side (type 1) or the liability side (type 2). More specifically, **type 1 BM** groups retail-oriented banks, whose asset side, along with loans, also present more trading assets than focussed retail banks; **type 2 BM** includes banks that have significantly more trading assets than focussed retail banks, also are more reliant on debt and short-term market funding.
- iii) **wholesale**, which groups together banks that are heavily wholesale oriented and largely active in the interbank markets;
- iv) **investment**, banks that have substantial trading activities; this includes large universal banks with a significant investment banking division as well as pure investment banks.

# ABOUT EMEA

**The Euro-Mediterranean Economists Association (EMEA)** is a Barcelona-based regional think-tank established in 2012 that serves as a leading independent and innovative policy research institution; a forum for debate on the political and socio-economic reforms in Mediterranean and Africa; and promoter of actions and initiatives that fulfill objectives of sustainability, inclusiveness, regional integration and prosperity. It strives to contribute to the rethinking of the Euro-Mediterranean and Africa partnerships in view of the new dynamics of an emerging multi-polar world.

EMEA has a large network of economists, high-level experts and institutional partners (research institutes, think tanks and universities) in the Euro-Mediterranean and Africa. EMEA builds on the collaborative research network MEDPRO (funded by the EU's Seventh Framework Programme (2009-13) and provides forward-looking thinking and political and socio-economic integrated analyses on the Euro-Mediterranean region. EMEA is also the promoter and co-funder of the Euro-Mediterranean Network for Economic Studies (EMNES), co-funded by the European Commission (DG NEAR) between 2015 and 2019. EMNES is a regional network composed of 30 institutions and more than 100 experts and researchers in the Mediterranean region.

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