Covid-19 economic crisis: banks emerge as part of policy solution

As social distancing emerges as a key measure to fight the spread of the global Covid-19 pandemic, it is clear that Europe and the US are headed into a deep economic recession in 2020. Moreover, without effective public health and economic policy responses, weak economic conditions risk enduring well beyond the first half of this year.

We anticipate a challenging operating environment for European banks but note at the same time that banks will have to be a key piece of the puzzle as authorities seek to minimise long-term economic loss. Hence the flurry of announcements that have emerged to support the financial system.

The policy reaction has been strong as far as the financial system is concerned, and it may get stronger over time as the extent of the economic damage becomes evident. That notwithstanding, we expect private and public sector borrowers eventually to come under pressure due to their elevated debt loads. Temporary cash flow relief may delay the emergence of credit losses but more marginal borrowers, especially SMEs and the self-employed, will struggle to recover from months of missed income. This will eventually result in deteriorating loan quality for European banks, unless their most vulnerable clients are supported by government grants and social security measures.

The rapidly deteriorating operating environment will also translate into lower revenues from falling volumes across business lines that will at least initially more than offset rising margins. Combined with higher provisions, this will hit profits and possibly capital. The balance of risks will change throughout the crisis, with operational and cyber risk more relevant in the earlier stages due to the direct impact of the virus on operations. Asset risk will manifest itself over a longer timeframe, especially in view of forbearance measures. Regulatory risk will likely resurface once the early, acute phase of this economic crisis is over and regulators can assess the full scale of financial damage.

Our rating actions on European banks over the coming months will therefore be skewed to the downside. We do not expect the crisis to result in a material increase in probabilities of regulatory action on senior bank debt. This category of debt can only be bailed-in in resolution, a possibility that remains remote even if the outlook were to deteriorate further.

Bank resolution is ill suited to be deployed during an economic crisis, though it may emerge at a later stage to resolve specific banks that fail to emerge strong enough. On the other hand, more junior layers in the capital structure are closer to the regulatory action frontier, and we believe that losses and capital depletion will eventually increase the risk to these securities, starting with AT1.

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Flattening the curve, flattening the economy

In our recent report (**Covid-19 impacts on European banks: pre-existing financial health condition matters**), we set out our expectation for Covid-19 to turn from being primarily a Chinese and Italian problem to a challenge for all European banks, as an increasing number of governments start to fight community transmission with drastic curbs on economic activity.

Lockdowns are emerging as the strategy of choice for containing Covid-19 infections

As the Covid-19 infection has spread through communities, it has become increasingly evident that the capacity of healthcare systems around Europe to cope with exponentially growing numbers of patients needing intensive care is the key variable determining the extent of government responses. Delaying infections and flattening the pandemic curve is now the main public health policy target in Europe.

Social distancing measures, going all the way to full lockdowns, are in place in most EU countries and being tightened by the day. Within the euro area, the most draconian measures are in place in Italy, Spain and France, putting a particular burden on their banks. So far, Germany is trying to strike a finer balance for its economy based on a more robust healthcare system and a lower mortality rate to-date. Outside of the euro area, the UK has been a notable laggard in its policy response, although it is catching up fast, with the Prime Minister putting the country into lock-down as of 23 March.

There is no guarantee that a swift return to economic normality will be possible even after the exponential rise in cases in individual European nations is momentarily contained and visibly slowed (hopefully to be seen by the time we exit spring and enter summer). The longer the lock-down, the bigger the economic dislocation and the longer it will take to get back to normal. The ability to gradually lift restrictions and support recoveries after the second quarter will hinge on governments applying effective testing and social tracing capabilities as well as enhancing hospital capacities and advancing safe antiviral treatments to mitigate risks as transmissions continue (at expected slower rates) over the summer and/or if a new wave of transmission hits in the second half of 2020.

Every month of lockdown could shave 2pp off GDP growth

Lockdowns suppress virus transmission but come at a huge economic and political cost, as unemployment rises, consumer discretionary spending collapses and investment comes to a halt. Depending on the nature and duration of the measures, the economic impact can be severe. On average, in line with a recent ECB update, we assume roughly a 1.5pp to 2.0pp decline in annual growth for each month an EU country is in lockdown, which for the euro area implies deeply negative growth for 2020, with risks significantly tilted to the downside. A recent IFO study puts the 2020 GDP loss for Germany alone anywhere between 7% and 20%, depending on the length and nature of the shut-down – assuming no policy action.

Hopes of a V-shaped economic rebound in the 2H 2020 appear too optimistic. Even though Scope anticipates a moderate rebound in Q3 euro area GDP, recovering some of the Q1 and Q2 losses, there remain substantial risks to the longevity of any recovery in the second half of 2020 as economic and financial system turmoil could remain heightened and renewed virus transmission could come as containment measures are eased and seasonality reverses for transmission ease in the northern hemisphere by the fall and winter. The need to manage subsequent infection outbreaks may lead to further trade and services frictions, intermittent isolated lockdowns, and maintained border closures.

Market rout, deterioration in public finances, collapse in confidence further weigh on bank outlook

Even in the relatively optimistic scenario of one-off, short-lived shutdowns in European countries, large fiscal interventions are needed to prevent a freefall in activity and limit longer-term damage to economic capacity (specifically, avoiding a liquidity crunch turning into a credit crunch). This will strain government finances and weaken public debt sustainability over the longer run – which is of particular concern for countries with already high debt and/or weak growth potential. Euro area banks with large government bond holdings are caught in the middle as the public sector assumes the financial liabilities of corporations and households, especially in highly-indebted countries such as Italy but also in countries with high household leverage such as the UK, Scandinavia or the Netherlands.

In addition to the direct supply-side and demand-side economic impacts from coronavirus-related lockdowns and changes in consumer behaviour, the financial market rout in March has obliterated consumer and investor confidence, and there are fears that a 2008-like bank-driven deflationary deleveraging process may have been set in motion.

We do not believe this is the case, for two reasons. First, the banking system today is much stronger than it was, with lower balance-sheet leverage and sounder liquidity positions. Secondly, and perhaps most important, central banks today are a lot more reactive than they were, having shed many of their taboos over the past decade. The extensive monetary policy reactions in the UK, euro area and the US show that monetary policymakers are fully focused on avoiding a credit crunch this time around.

Bank profit warnings likely, timing to depend on business model

So far, a few banks such as Danske Bank and Austria's Raiffeisen Bank International have issued explicit profit warnings as a direct consequence of the economic slowdown. Having screened our coverage for potential impacts from the current crisis, we expect more to come in coming months, potentially ahead of the next reporting season which starts mid-April.

With respect to the European banks we rate, we continue to screen for potential impact channels and risks. These include:

- **Business continuity and the ability to serve customers under operational stress**. Banks that have developed effective remote banking capabilities will be able to weather a shutdown better than digital laggards. It is difficult at this stage to gauge the impact, but technology leaders are well placed to improve their positions, especially if they are part of well-established large banking groups.

- **Revenue pressure**. With the collapse in the financial markets, revenues from assets under management are likely to decline. Investment banking origination volumes, after a very strong start of the year, will likely stay muted, while investment will decline as economic uncertainty clouds the outlook. At the same time corporates will draw down existing credit lines, which will improve banks' net interest income (NII) but at the expense of rising risk. Consumer and mortgage credit are likely to see a material slowdown in production, as unemployment rises, consumer spending collapses and real estate markets dry up.

  At the same time, the NII outlook has further worsened, with additional rate cuts by the Fed and the Bank of England and expectations for the current unfavourable rate environment to persist for a long time. While yields have been rising and the curve steepening, central bank purchase programmes are likely to keep curves flat. Some banks may report trading losses as a result of the market meltdown across equities, credit and rates. The latter could materialise as early as the Q1 reporting season.

- **Asset quality** is a function of the broader economy and will take a hit, depending on the effectiveness of the policy response from public health, fiscal and monetary authorities – as well as from the financial system itself. The deterioration may not come immediately because of government intervention to support strained borrowers, at least temporarily. But we expect deterioration to emerge eventually, probably starting towards the end of the year. Default rates among corporates, SMEs and households could rise significantly as a result of an insufficient or badly-managed policy response.

- Against a more challenged revenue and cost of risk outlook, **we expect euro area banks to further tighten cost control to manage their often oversized cost bases** by delaying investments that are not critical. Stronger banks that are able to continue with large-scale digitisation programmes will likely improve their competitive positions relative to peers in this environment
- **Liquidity positions** will deteriorate as customers draw on their credit lines, but central banks have moved early to provide bank funding at very low cost. We expect liquidity support to remain firmly in place throughout the crisis and in its aftermath. However, many corporate clients, e.g. airlines and companies in the leisure industry will urgently need direct equity support, loan guarantees or government grants to survive without materially downsizing their operations to avoid defaults. Likely political opposition to bail-outs and large scale nationalisations will further complicate the picture, even though EU State aid rules have been suspended for now.
- **Banks' capital positions will also deteriorate** as liquidity draws and higher expected losses on loan portfolios trigger RWA inflation even before actual defaults materialise. Unlike in the previous crisis, the ECB, Fed and BoE have all responded quickly with dedicated commercial paper facilities to take some of the pressure off banks. Supervisory relaxations of countercyclical, systemic and Pillar 2 buffers offer some comfort to bank investors. The ECB estimates this will free up EUR 120bn of capital for euro area banks, incl. EUR 30bn from changing the composition of capital. However, the capital conservation and some systemic buffers remain in place. While there is room for liquidity ratios to decline from current levels that are mostly well above 100%, it is not clear how much they should be falling below that threshold without raising concern.
- **The relaxation of pro-cyclical provisioning rules** such as IFRS 9 in the euro area and the UK will allow banks to manage loan forbearance and credit migration in a flexible manner this year. While such forbearance does not necessarily improve the underlying capital position and will store up problems for later, it does considerably reduce the risk for now of regulatory intervention for investors in bank debt.
- **Increasing sovereign exposures**. In the recent past, many banks, especially in the euro area periphery have reduced their exposure to their domestic sovereigns by diversifying their bond portfolios. We sense this trend may be about to change, as governments find themselves forced to issue more to fund increased spending and at the same time guarantee significant parts of banks' loan books. This risks reinforcing the bank/sovereign doom loop. While the ECB has offered a EUR 750bn backstop of additional asset purchases (incl. euro commercial paper) until the end of the year, other euro area crisis mechanisms such as the ESM or the EU's own budget have yet to be activated.
- **Heightened cyber risk**. As more bank employees and clients embrace remote working, the risk to banks' cybersecurity is higher – especially for institutions less used to offering remote working possibilities. This comes from employees having to use their own personal devices rather than bank-procured (and bank-protected) devices and potentially from lack of cyber risk awareness and training (a key element of cyber risk management) among the workforce.

M&A will eventually re-emerge

Opportunistic as well as strategic M&A will eventually re-emerge in fragmented EU banking markets as battered bank equity prices offer banks with the strongest balance sheets an opportunity to pinpoint where they would like to increase their market shares. Regulators are also likely to orchestrate mergers to eliminate weaker players.

Risks to AT1 asset class are increasing

The risk profile of AT1s is ambiguous. While lower regulatory capital ratios will reduce the distance to MDA triggers, this is likely to be offset by lower combined buffer requirements and, in certain cases, the ability to fill certain buffers with subordinated debt instead of equity in the euro area. It is also unlikely that regulators will enforce additional triggers related to MREL requirements in this situation. However, with the recent market repricing of the AT1 space, non-call risk has also increased materially, as the economics of any call decision have worsened.

The policy response has been strong, and will likely get stronger

Governments, central banks and bank supervisors are acting more swiftly

In Europe, as well as in the US, governments and central banks have begun to understand the significant gravity of prevailing economic circumstances and acted more swiftly recently to support industries and households affected by the coronavirus pandemic. Central banks deployed liquidity injections, increases in asset purchases, bank lending facilities, and rate cuts to ensure that the entire system stays liquid and that banks keep the taps open.

Improved monetary policy response, including funding for the banking system

After announcing a strong liquidity package on 12 March that included additional net asset purchases of EUR 120bn, the introduction of a temporary LTRO facility and more favourable terms for its forthcoming TLTRO III programme, the ECB ramped up its response on 18 March with a EUR 750bn Pandemic Emergency Purchase Programme (PEEP) of private and public securities until at least the end of the year.

The Bank of England held two policy meetings in two weeks, slashing its deposit rate by 50bp first to 0.25% and then to 0.1%. It also decided to increase asset purchases by GBP 200bn and launched a term funding scheme for SME loans (initially set at 5% of the banks' loan books and immediately raised to 10%). Available for a year, this new scheme will offer four-year funding at an ultra-cheap rate and will fund at least 5% of banks' stock of real-economy loans. Additional sources will be available for SME lending, too.

Banks get a break from supervisors on capital

At the same time, supervisory authorities have relaxed rules around capital and NPL recognition (under certain conditions) and announced that the upcoming 2021 stress test will be postponed.

The ECB's banking supervision arm announced that banks will be allowed to operate below the level of capital defined by Pillar 2 Guidance (P2G), while bringing forward the application of CRD5 art.104, which allows banks to fulfill their Pillar 2 Requirement (P2R) with a mix of common equity, AT1s and Tier 2. The ECB estimated these relaxations amount to EUR 120bn of capital relief (CET1) for banks, providing room for banks to absorb some losses without triggering supervisory action.

The SSM also clarified that banks will be able to fall below capital buffers and called for national authorities to relax the countercyclical buffers and systemic buffers, though it is clear that breaching the capital conservation buffer will trigger MDA restrictions on the payments of dividends, bonuses and AT1 coupons.

Supervisors ready to use flexibility on NPL recognition and provisioning

Finally, the SSM announced on March 20 a much softer supervisory stance on NPLs, confirming it will exercise flexibility allowed under the EBA guidelines with respect to the classification of unlikely-to-pay (UTP) obligors under Covid-19-related public guarantees, allowing banks to delay booking provisions against these loans for the first seven years. This treatment will also apply to UTP loans covered by moratoria imposed by law.

At the same time, the ECB encouraged banks to opt in for IFRS transitional arrangements (allowing IFRS 9 impacts to be temporarily filtered out of capital) and recommended not to overweight the current short-term adverse economic scenario in their IFRS 9 modelling. This latter recommendation echoed a similar one by the Bank of England.

The Bank of England also moved forcefully to cut the countercyclical buffer to zero (from 1% and set to increase to 2% by the end of the year)

Both the EBA and the Bank of England have announced that a 2020 stress test is now off the cards.

Governments move to extend spending and guarantees

With surprisingly little delay, European governments moved to approve increased spending to reinforce healthcare systems capacities on the one hand and offer cash flow support to locked-down populations on the other hand. Many governments also moved to offer guarantees on bank loans, complementing liquidity measures with an effective solvency backstop.

With few exceptions, governments have stopped short of sending people cheques to make up for the loss of income, which is understandable given budgetary constraints (though these may be dis-applied in the short term).

Italy announced a large cash flow relief package for individuals and companies

In Italy, the government announced economic measures to counter the economic collapse that will inevitably be caused by the country-wide lock down. The initial stimulus package of EUR 25bn (1.4% of GDP) embraces a wide spectrum of measures that aim at protecting individuals and companies from the impact of a period of economic black-out.

Measures to support the cash flow of individuals and companies include a temporary suspension in tax payments, the suspension of pension contribution for all companies, as well as a direct subsidy of EUR 600 a month for freelancers. Companies that are forced to halt production can claim ordinary unemployment insurance for up to nine weeks.

In addition, a moratorium on first-home mortgages has been introduced for freelancers suffering a drop of over one third of income in the first quarter. Italy's package also included a strengthening of the central guarantee fund to allow SMEs to access bank funding. The Italian government announced that the liquidity measures would inject EUR 340bn of liquidity into the economy.

France offered loan guarantees to SMEs

Other European countries followed in Italy's footsteps with equally forceful measures. France deferred corporate tax payments for one month and set aside EUR 8.5bn to cover unemployment subsidies to people temporarily laid off. The decree also provides for the suspension of rents, water, gas, and electricity bills payments for small firms. The fiscal effort of EUR45bn in total is worth 1.9% of the country's GDP. Moreover, the French national promotional agency Bpifrance launched an emergency credit facility to lend up to EUR 5m to SMEs and EUR 30m to mid-caps and guarantee up to EUR 300bn in loans.

Germany to guarantee up to 80% of corporate loans through KfW

Germany took the boldest line by pledging "unlimited liquidity" to prevent businesses from failing. The package entails a number of liquidity-assistance programmes oriented not only to SMEs but also to bigger firms with revenues up to EUR 2bn. These programmes will be funded by KfW and will be worth c. EUR 500bn in guarantees. The government will also allow businesses to defer billions of euros in tax payments, and employees to access compensation schemes more easily. The federal government is also discussing a further EUR 156bn stimulus package that is further augmented by guarantee and equity investments in struggling companies that could bring the entire invention to EUR 300bn, or 10% of GDP.

The UK earmarked over GBP 300bn for small business lending

The UK unveiled a GBP 330bn coronavirus business interruption loan scheme (CBILS), which includes a six-month grace period where it will directly take on credit risk by lending to small businesses via the British Business Bank and its partners. The British government also announced a GBP 20bn stimulus package (on top of the GBP 12bn originally allocated) consisting of tax cuts and grants for firms in difficulty.

Spain also announced a material package offering liquidity support

Likewise, the Spanish government anticipated strong actions to support both firms and households. EUR 14bn will be allocated to offset the delay in corporate tax payments; all people temporarily laid off (ERTE) will be eligible for unemployment benefits, and freelancers experiencing heavy losses will have access to a special benefit for one month. The direct fiscal effort stands at EUR17bn, or 1.4% of GDP). Furthermore, Instituto de Crédito Oficial (ICO), the State development agency, will increase its net debt position by an extra EUR 10bn in order to provide further guarantees of up to EUR 100bn to bank lending to companies (the Spanish Prime Minister expected loans of up to EUR 200bn).

Banks are at the centre of the policy response

Many of the abovementioned measures rely, in one form or another, on transmission by the banking system. Authorities are rightly focusing on preventing a credit crunch that could significantly worsen the economic downturn. The ECB's actions will keep the banking system liquid, while the SSM announcements will ensure that capital or asset-quality concerns do not constrain banks from lending. Unlike in 2008, the banking system has little fault in the current crisis, and given its role in money intermediation in Europe, keeping the bank taps going will prove to be a crucial piece of the puzzle.

Overall, we consider the authorities response strong, and are comforted that both governments and central banks are rapidly shedding their taboos in the face of the emergency. While supportive, it is unlikely that any measure can avoid a recession at this point, but it is equally clear that policy support is vital to keeping the economic fabric on life support and facilitate a rebound once the public health emergency phase is over.

Liquidity support is helpful, but it may not be enough in the end

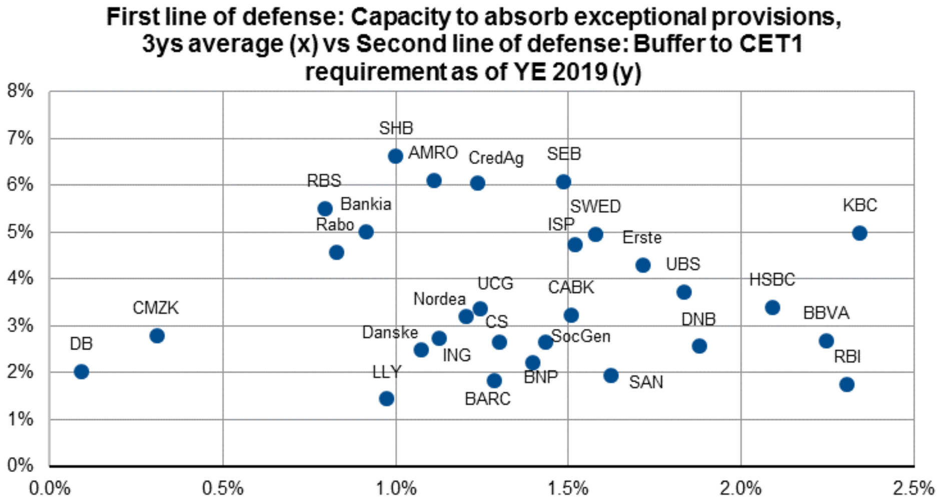
A key question mark remains about the longer-term impact on borrower viability. Many of the announced measures will temporarily keep borrowers afloat but they do not compensate businesses for lost revenues. In other words, they offer temporary relief to companies and partial longer-term relief to the banking system but will not avoid the bankruptcy of more marginal borrowers, especially if lockdowns turn out to be protracted.

We expect monetary and fiscal authorities to step up their game in coming weeks as the extent of the longer-term economic disruption becomes more evident.

Negative impact on some bank ratings, depending on banks' own fundamentals and vulnerability

We continuously monitor our European bank ratings, looking for validation of our working assumptions. Banks with low capital and profitability buffers and more vulnerable business models are most likely to see downward rating migration in coming months.

Figure 1: Most European banks could absorb over 100bp of loans in excess provisions a year without eating into their capital bases



Source: SNL, Scope Ratings

Our base case is that loan losses and RWA inflation will stop short of putting bank credit in jeopardy for most banks, especially for the more senior layers of banks' capital structures.

We continue to see bank resolution and senior debt bail-in as extremely unlikely scenarios for most banks, and in particular under circumstances of systemic stress caused by an external shock

As our rating approach is rooted in the likelihood of regulatory action, we see a higher risk to the ratings of going-concern capital instruments, where regulatory action leading to coupon risk suspension could materialise early on (and possibly before banks hit MDA triggers).

Upside risks:

The key upside risks to our baseline are epidemiological, and include:

- a vaccine of effective cure being developed fast, materially reducing the likelihood and severity of further shutdowns in the year.
- evidence that there is already a very high level of infection in the population, true-case fatality rates are extremely low, and herd immunity can be reached fast. This however will require a significant scaling up of testing capacity, including for anti-bodies.
- Evidence that a reasonably flattened epidemiological curve can be obtained through a more moderate set of social distancing measures, allowing for a gradual reopening of economic activities sooner than expected.

Downside risks:

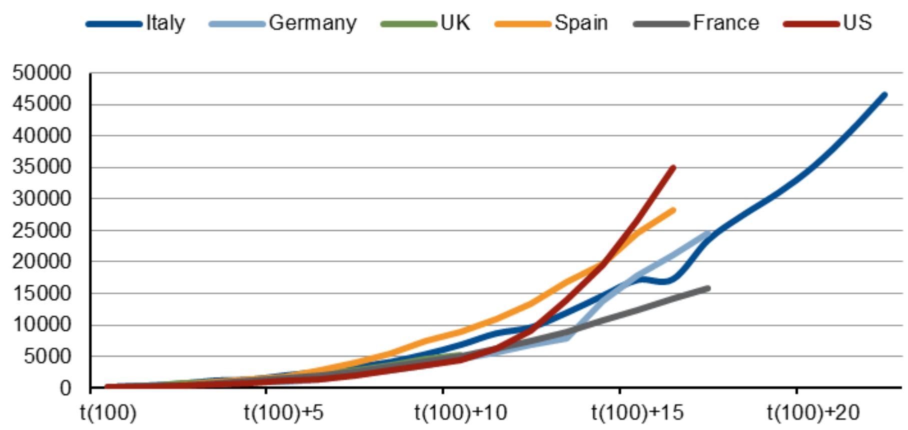
Key downside risks to our baseline, which could accelerate the pace of rating downgrades, include:

- Evidence that the current set of social distancing measures is not sufficient to limit contagion, requiring a further tightening of social distancing measures across Europe.
- Policy mistakes, ranging from curtailing liquidity supply to the banking sector to early withdrawal of fiscal support to affected countries.
- Severe second-order impacts from the market rout, revealing that despite the new sets of regulations from the past decade, and the apparent shift of risk from banks to the shadow banking sector, banks remain the ultimate bearers of financial risk in Western economies.

Appendix I – how the infection is developing in several EU countries and in the US

Given the degree of integration and cross-border mobility in Europe, we do not believe there is any reason to assume that some European countries will be materially less affected than others. Data shows that once the infection starts to spread widely - t(100) in the chart below, or the first day when 100 tests return positive – the curve rapidly turns exponential.

Figure 2:Number of confirmed COVID-19 cases in major EU countries and the US



Source: ECDC, Scope Ratings

The rate of replication, which ultimately determines the slope of the contagion curves, can be slightly different, reflecting differing demographics, degree of social interaction and hygiene norms, but these are unlikely to vary materially within Western Europe.

Given exponential growth in the number of cases (and consequently in the number of patients needing hospitalisation and intensive care) healthcare systems will rapidly be overwhelmed unless the curve is flattened in time.

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