

BANKING SYSTEM IN TIME OF COVID-19: A REVERSE ANALYSIS ON LOSS ABSORPTION CAPACITY, LENDING TO THE ECONOMY AND MARKET VALUATION

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Changing more than a name

THE PAPER IN A NUTSHELL

Estimate

- the maximum capacity to absorb losses before breaching minimum capital requirements
- the capacity to support the real economy
- the minimum level of profitability in order to have a return for investors equal to or greater than the cost of capital
- Sample of banks in Germany, France, Italy, Spain, UK and US

Conclusions: banks

- are currently much better capitalized than in 2008/9
 - appear to be able to support the economy
 - but will be unlikely to earn their cost of capital
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SHORT-TERM TRADE-OFF BETWEEN LOSS ABSORPTION AND ADDITIONAL LENDING

- Loss absorption better now than in 2008/9, but:
 - How much of potential COVID losses are (or will be) covered by government guarantees?
 - COVID losses currently not being apparent yet
- Capital relief to foster lending, but:
 - Higher lending can reduce loss absorption (subject to caveat above)
 - Can push bank closer to MDA trigger
 - Pushing on a string?
- Are banks turning into utilities, i.e., passing on government funds to an economy in desperate need?
- But: what about recovery phase, role of banks as allocators of capital? How can we get back to a market-based/funded banking system?

LONG-TERM TRADE-OFF BETWEEN FINANCIAL STABILITY AND EARNING THE COST OF CAPITAL

- $ROE = \text{leverage} * ROA$, lower leverage requires higher ROA to cover cost of capital
- But: risk-adjusted cost of capital lower with higher capital buffers?
 - Off-setting effect: lower bail-out expectations
- “it seems very difficult for banks to be sufficiently profitable to attract investors or generate enough capital by themselves to expand their business”
- How to increase ROA?
 - Shrinking banking system? Exit of weak banks
 - Higher interest rates? Not really on cards
 - Diversification of income streams? But how?
 - Improve cost efficiency? Digitalisation, mergers

COMBINING SHORT- AND LONG-TERM

- Need for an exit strategy from public support, capital relief towards loss recognition and reallocation (within corporate and financial sectors)
 - Remove fiscal support for corporations? Implications for banks
 - Force banks to recognize losses, reverse capital relief etc.? Implications for corporate borrowers
- Need for coordinated approach across different policy areas and authorities
- How to make banking sector attractive for investors?
 - Not: allow pay-outs as if there were no tomorrow
 - Rather: address underlying symptoms
- Important role for SRB, ESM etc.; need for European solution

LEARNING FROM PAST ERRORS

- Crises are opportunities!
- One of these has been used: European recovery fund
- Vision of a European banking system replacing national banking systems, following (cross-border) consolidation and restructuring
- Need for completion of banking union
- Development of European capital market
- Now is the time for preparation!

THANK YOU

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