
The Commercial Banking Sector in Eurozone after the Pandemic: The Paths to Recovery

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Abstract:

Purpose: The aim of the paper is to address the situation in the Eurozone commercial banks' sector during the pandemic and the mechanisms of the COVID-19 impact on the sector. It discusses the decline of profitability because of the pandemic, the growth of non-performing loans (NPLs) in banking sectors of some Eurozone member countries, as well as the management of the situation.

Design/Methodology/Approach: The literature review and meta-synthesis from extant studies was used. Based on the review, a causal link between the current situation in the Eurozone banking sector and the possible paths of its recovery were identified.

Findings: Commercial banks in Eurozone were affected by the consequences of the pandemic situation, especially in terms of lending activity and profitability, what may lead to a considerable increase in non-performing loans. The diversity of the situation in different countries increases the difficulty of prediction. There are some positive, neutral, and negative scenarios possible to happen. It is still a great role for the banking authorities to manage the post-pandemic situation and to provide proper recovery plans, especially dedicated for those small and medium sized banks, which are not covered by the solutions provided by the banking union.

Practical implications: The paper analyses the current situation in the banking sector in Eurozone. It also presents the possible scenarios in the future and the paths leading the banking sector to recovery. Such analyses are significant for the post-pandemic policies implemented both, on Eurozone and national levels.

Originality/Value: The identification of the main problems in the Eurozone banking sector because of the COVID-19 pandemic. The research findings may contribute to better understanding the need of implementation of bank recovery solutions, like the accomplishment of the banking union or the proposal of the securitization framework for banks' non-performing exposures.

Keywords: COVID-19 pandemic, Eurozone banking sector, non-performing loans.

JEL classification: F36, G21, G28.

Paper Type: Research paper.

Conflict of interest: The author declares that there is no conflict of interests regarding this manuscript's publication.

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1. Introduction

Banking sectors are treated as crucial sectors in every economy. They have a special status protected by regulations. These institutions are organizing money circulation, credit intermediation, and are the main intermediary in the financial market in every country. Furthermore, banks in Europe possess a special status, where economies are based on the bank-oriented model of financial markets (so called ‘continental model’). They are a key source of funding for businesses and retail consumers. It leads to the premise that their financial health is a vital factor for many economies across Europe.

The important role of banks was also apparent during the COVID-19 pandemic. They are classified as the most important institutions that try to withstand the impact of the worsening economic situation in many countries. Usually, banks were expected to provide an and important role in absorbing the shock and providing credit to household and corporate sectors (Nathaniel and Van der Heyden, 2020). The pandemic, however, has a significant impact on the banking system in almost every country in the Eurozone. The spread of the pandemic is resulting in implementing “lockdowns” in many countries, what has an enormous impact on economic activity and daily life of European citizens, worsening their situation. Consequently, banks react by tightening credit standards and changing their foregoing activities, namely, searching for new sources of income. With time, since the beginning of 2020, the situation of Eurozone banks becomes worse and necessary becomes the help from the European Central Bank (ECB).

The pandemic outbreak and its economic consequences were significant for Eurozone member countries. In such a situation, banks were expected to provide help and play important roles in absorbing the shock and providing credit to the household and corporate sectors. The efforts of commercial banks were facilitated by the ECB (which increased the scale of quantitative easing policy), the European Commission and Parliament, and national governments. On the other hand, banks are under a big pressure from the new economic situation triggered by the pandemic. In such a context, it is important to assess the current situation in the banking sector and to sketch the possible scenarios for the future. Based on these presumptions were defined these research questions:

- 1) How the pandemic COVID-19 impacted on the commercial bank’s profitability in Eurozone countries?
- 2) What is the level of nonperforming loans in the Eurozone banking sector during the COVID-19 pandemic and what are the potential problems caused by this category of assets?
- 3) How the post-COVID-19 situation exerts impact on the Eurozone banking sector and what kind of post-pandemic scenarios are possible?

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- 4) What are the regulatory actions planned (or already undertaken) by the European institutions dedicated to the banking sector which aim at the improvement of the financial situation of Eurozone commercial banks?

It should be noted that the current situation is very dynamic, and it is difficult to forecast the further situation on the European banking market. Many of these processes are a derivative of the health situation and lockdowns implemented by governments and other decision makers in European countries. The main role of the article is to provide an overview of the banking sector in Eurozone during the first phase of the COVID-19 pandemic. Due to the unclear current situation, this article holds only a general view, and further and more accurate research might be done in the future. It is still too early for an insightful analysis, as the presented data and accessible information are related only to 2020. It is, however, essential to recognize the main mechanisms of the banking activity at the outset of the specific time of the pandemic. The processes are quite different compared to the nature of the precrisis banking functioning. Such a short-term and initial analysis might contribute to the further research of these problems.

2. The Impact of COVID-19 Pandemic on Banking Sectors in Eurozone

Commercial banks are crucial institutions in Europe, where the model of financial markets (so called ‘continental model’) is bank oriented. Banks are situated in the center of the financial system and they link the system with the real economy. It is a result of historical aspects and legal system, but also is based on current characteristics, e.g., the Eurozone economy’s structure. The European Commission highlights that small and medium-sized enterprises are the backbone of Europe’s economy (https://ec.europa.eu/growth/smes_en). It is an important feature because small firms usually depend on bank loans, which are relatively cheaper compared to the capital market commissions (Gambacorta *et al.*, 2014). Banks are also important for retail customers. They have bigger trust in banks than in anonymous capital markets. These institutions provide services in almost every aspect of the economy and they are critical for stimulating economic growth, especially by increasing the funds for investment and improving the quality of investment.

The condition of Europe’s largest banks before the pandemic was good. These banks are very well capitalized, they had less complex business models, and limited risk appetite as several years before, during the financial crisis of 2007-2009. Moreover, their supervisors have become more supportive in difficult times (Corner, 2020). Similarly, like the biggest banks, the small and medium-sized banks entered the pandemic with good condition. They have relatively few bad loans, ample liquidity buffers, and a good solvency position (ECB, 2020). Some economists, however, argue that despite the good situation, the banking sector in the Eurozone has some structural weaknesses and banks in some countries are far from immune (Bjerde, 2021). Among the main weaknesses might be the enumerated situation that the Eurozone economy is generally overbanked, non-banking institutions create strong

pressure on the banking sector, and banks must operate in the low interest rate environment (Lehmann and Martin, 2020). The existing situation caused that banks are important players for the economic mechanisms of exiting from the COVID-19 pandemic.

The good banking situation resulted in the possibility of banks to play supportive roles during lock-down time. All countries affected by the pandemic implemented unprecedented initiatives and measures, aiming crucial challenges, dealing with health emergency needs, supporting economic activity and employment, preserving monetary and financial stability, and preparing the ground for recovery (Gortsos, 2020). The COVID-19 pandemic crisis has a global dimension, and it exerts an impact on every people aspect of society, economy, and industry. The banking industry can act as a source of stability, providing help for the real economy. It means that banks are participating in many countries in the process of exiting from the COVID-19 pandemic crisis. Their main role is to provide the needed funding which are necessary in the present, abnormal circumstances. Among the main actions which have been undertaken might be enumerated, liquidity supports for endangered firms and support flow of credit investments in government bonds. Banks struggle to keep their distribution channels open and to manage the revenues and customers' expectations in the environment of low interest rates and growing pressure from their balance sheet challenges.

Despite banks playing a positive role, the pandemic exerted a great impact on these institutions and impaired their financial efficiency. The economic deterioration in the Eurozone, together with the engagement of banks in countercyclical lending during the COVID-19 pandemic exposed banking systems to many challenges. They are, however, different in the respective banking sectors, depending on the precrisis characteristics of the banking sector in a particular country (Demirguc-Kunt *et al.*, 2020). The essential feature accompanying banks is that these institutions are susceptible to unwarranted withdrawal of deposits during panics, spread of contagious micro- and macroeconomic shocks, and many other mechanisms which are leading to bank failures or even banking crises (Calomiris, 2015). Especially endangered are those banks which focused on lending to small business and consumers. These two groups of bank customers are suffering the most.

The main determinants of the decline of credit activity during the pandemic were the consequences of the lockdown, the near-zero interest rates (because of the monetary policy), what affected the bank's profitability, and the growth of credit risk (Ferrando, 2020; Acharya and Steffen, 2020). It is assessed that the aggregate spending was at the level of several dozen percent (depending on the severity of the government restrictions on mobility and economic activity in a particular country) (Andersen *et al.*, 2020). However, it must be highlighted that the decline in bank credit activity was confined by the monetary policy and prudential measures. Without such actions, the situation might be much more severe (Altavilla *et al.*, 2020).

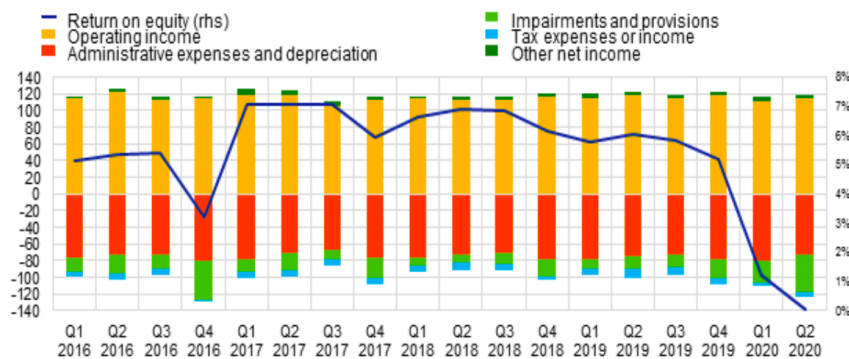
Because of lockdowns in many countries, millions of companies felt into bankruptcy since the outbreak of the pandemic (Morris *et al.*, 2020). In result, it led to the growth of nonperforming loans (NPLs) in many banks. It is assessed that the COVID-19 related NPLs are different to the lost credits after the GFC 2008/09. The current business losses are larger as the lock downs impact the economies of many countries, regardless of their former situation (Lehmann and Martin, 2020). Such condition exerts a big pressure on banks and their financial situation. The financial situation is worsening even those banks, which are not exposed to the riskiest investment assets and were not engaged in financing nonviable entities. It will be difficult to make profits in an environment with interest rates fluctuating near zero and when the future of the situation in the global economy is gloomy. Some of the difficulties are created by governments and other authorities.

According to the implemented policies, banks are obliged to provide payment holidays on credit cards, mortgages, and other assets, which create stress on banks' loan books (Buehler *et al.*, 2020). The governments offer some help for banks and participate in the offered programs, so there is a chance that finally the situation of credit losses will not be the worst effect of the pandemic crisis.

3. The Situation of Commercial Banks' Profitability

Major indicators of banking activity are related to banks' profitability. The profitability of banks can be expressed by the return of equity (ROE) ratio. In the Eurozone, the banking sector was observed a decline of profitability as a consequence of the first wave of the pandemic, and the ROE ratio declined below zero in 2020. As can be seen, the ROE for the period of Q1.2016–Q2.2020 is the lowest since the pandemic outbreak (Figure 1).

Figure 1. Return on equity and composition of net profit and loss by reference period in Eurozone banking sector (EUR billions, percentages)

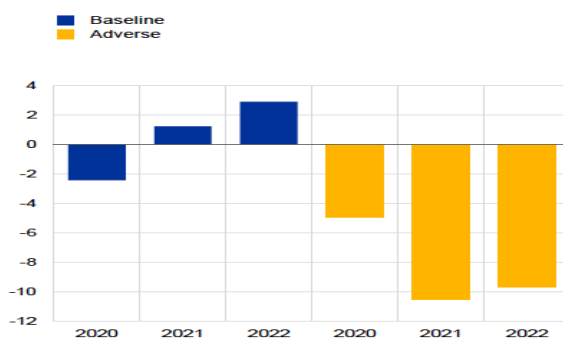


Source: European Central Bank:

<https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr201006~e14289abd6.en.html>.

The prospect for the next years is also negative, and it is mainly the consequence of the slower economic growth in 2020. Despite the slowdown, some different scenarios are possible. Figure 2 presents the baseline and adverse scenarios until the end of 2022. The decline of profitability in the adverse scenario is driven mainly by the credit risk losses and the higher probability of default caused by the default of loans (growth of the level of NPLs) (ECB, 2020). The length of the pandemic and the accompanying lock down will exert a great pressure on the economy and on the banking sector. The longer is the pandemic means the worse is its impact on economies and therefore on their banking sectors.

Figure 2. The profitability of European banking sector during COVID-19 pandemic – two scenarios



Source: European Central Bank, *Financial Stability Review*, November 2020, p. 80.

The profitability of Eurozone banking sector and the forecast of the profitability until 2022, presented in Figures 1 and 2, are related to the situation after the first wave of the pandemic. The profitability of commercial banking is undermined mainly by the low interest rate, what is the consequence of the lax monetary policy and unconventional quantitative easing (QE) (Bonatti *et al.*, 2020). It is still a big question which scenarios – the baseline or adverse have a higher probability to perform, however, it should be expected that the situation after the second wave will be much more severe. When assessing the economic situation, there are many factors supporting the negative scenario. Here might be enumerate, slowed economic growth (which may persist in the first part of 2021), negative interest rates (undermining banks' net interest margins), and asset quality problems and bad debt (Ewing, 2021; International Banker, 2020). The growth of the NPL will have a great impact on the banks' ROE indicators. An important question is how the low interest rate environment and the fiscal stimulus (anti-crisis shields) from government to the real economy can mitigate the situation in short- and long-term (Carletti *et al.*, 2020).

4. The NPLs Sequence of Problems and Scenarios for the Post-Pandemic

Banks in the Eurozone played essential roles in exiting from the difficult situation caused by the pandemic time. The unconventional monetary policy implemented by

the European Central Bank, together with the favorable financial conditions for businesses should enable the pandemic-hit companies to improve their balance sheets, regain creditworthiness, and come back to proper operating in post-pandemic time. The public support for the real economy was coordinated with banks, which in the face of lower profitability had relaxed the NPL provisioning and the recognition of NPLs related losses (Lehmann and Martin, 2020).

Such policy was helpful for many businesses during the pandemic, but it may have a negative impact on the banking sector in the longer post-pandemic time. It is possible that when the support from the private sector is over, there might be a growth of financially distressed companies in some Eurozone countries that might lead to the growth of NPLs in some banking sectors across Eurozone. The main problem is that the financial help offered to private business during the pandemic does not enable to distinguish those companies which are sound and are able to return to productivity after the pandemic from those which are illiquid and unable to recover. The last group of businesses should be closed.

The situation, however, is different in different countries. In some countries, it is faster to distinguish between these companies which can recover when receiving financial help from those which are nonviable and unable to recover. In other countries, it is very difficult to implement the same type of division. Among the first countries are such states like Germany and Finland, whereas among the second group is Greece (Demary, 2021). It means that despite the low level of NPLs in the banking sector in the Q1 2021, it can change during the next months and years. Table 1 shows the level of NPLs in the selected Eurozone countries for 2019, 2020, and the forecast for 2021.

Table 1. *The NPL ratio in the banking sector in 2019, 2020, and forecasts for 2021 in selected Eurozone countries*

Country	2019 Q2	2020 Q2	Forecast for December 2021	
			Lower	Upper
France	2,6	2,3	4,5	5,4
Germany	1,3	1,2	2,0	2,3
Spain	3,4	2,9	6,6	8,2
Netherlands	1,8	1,9	2,4	2,9
Italy	8,1	6,3	13,9	17,4
Portugal	8,3	5,5	14,1	17,3
Eurozone	3,1	N/A	4,7	5,4

Source: *Own elaboration on the basis of Ozyurt S., Utermöhl K., European Banks. Could EUR300BN of additional NPLS crunch the recovery in Europe? Allianz Research, 16 July 2020; Tackling non-performing loans in the aftermath of the COVID-19 pandemic, Communication from the Commission to the European Parliament, the Council and the European Central Bank, 16 December 2020.*

There is a question how the post-COVID-19 situation exerts impact on the Eurozone banking sector. The important feature of the EU banking sector is that the structures

of banking vary in different Eurozone countries. Some of them face lower credit losses due to the better condition of the economy (Germany), while in other countries the situation is much more serious (Italy or Greece), where the levels of NPLs are higher and the pandemic exerts stronger influence. The diversity of the situation in different countries increases the difficulty of prediction. Despite this limitation, it is possible to identify some scenarios.

In the positive scenario, the economic activity after the pandemic will be restarted and can be the expected process of stable recovery. Such a scenario is optimistic, but it has a relatively low probability in the Eurozone. In Europe, many countries were struggling with the unbalanced growth before the COVID-19 pandemic. It means that after the post-pandemic time, the problems will continue to exist in these countries. The situation will impact on the banking sector as well. The tentative calculations suggest that in the case of the eurozone banks, the bank's market implied losses because of COVID-19 pandemic range from 7% to 43% of bank capital and reserves (Reinders et al., 2020). It is estimated that in the next three years the European banks will face losses of more than € 400 billion of credit losses (Morris and Walker, 2020; Oliver Wyman, 2020).

In the worst scenarios, it is predicted even double of that value of losses which are forecasted for the abovementioned positive scenario. Banks will experience bad loans and further revenue decline. Especially important is what will happen when the two negative scenarios occur, namely, the adverse profitability (Figure 2) and the upper NPLs ratio (Table 1). It can be harmful for the banking sector as the COVID-19 pandemic increased sharply the risk of some Eurozone banks' failure (Couppey-Soubeyran *et al.*, 2020). Moreover, it is predicted that the recovery from the pandemic will be slow. When linked with the new level of public debt, it might lead to the stagflation in Eurozone (Bonatti *et al.*, 2020).

There is, however, still a possible negative worst scenario, when the problems faced by the government, central banks, economies, and the banking sector, will lead to deep structural problems, and finally asymmetrical recovery might trigger tensions and lead to some negative political decisions, undertaken by the weakest Eurozone countries. In such situations, the short-term economic problems might turn into a threat for the further existence of the current form of the Eurozone.

5. Solutions for the Banking Sector Recovery

The recovery from the pandemic is crucial for the Eurozone as a whole and for every single country, and it will exert big pressure on different parts of the economy. The process of exiting from the pandemic will vary in speed and intensity across industries, countries, and regions. There is no doubt that the safety and soundness of the financial system and economy will depend on the bank's financial resilience (McKinsey and Company, 2020). And vice versa, the situation of the banking industry will depend on the economic recovery of the real economy in the post-

pandemic future. Regardless of which of the abovementioned scenarios is more accurate, similarly like during the pandemic, also in the time of recovery, the banking sector will play a crucial role. It is especially prevailing in the Eurozone, where the whole financial sector is banking oriented. The possible scenarios of recovery, they will depend on the standing of the crisis.

It becomes obvious that the worsening financial situation must be addressed by some measures undertaken by the authorities. The first important step is to clearly establish the NPLs situation and to find a solution for this problem. The second one is to define the recovery plans which are most suitable in the post-pandemic situation. If banks are undertaken by state aids, well-defined restructuring plans must be prepared. The third step is to prepare the long-term viability scenarios. The worsening of the situation in some entities will become a catalyst for consolidation in the banking industry. Banks must be encouraged to merge if they are not able to improve their situation in the long run. The process of M&A might be beneficial for banks as it helps to improve the profitability (disposal of NPLs, creating synergies that improve cost efficiency, and stimulate the banks' digital transformation) (Carletti *et al.*, 2020).

Regarding the first important issue, recovery plans and NPLs disposal, from a theoretical point of view, there are many possibilities of action, depending on the nature of the bad loan problem. If banks face short-term liquidity stresses, there might be implemented such measures as, short-term loan relief (reduced payments, moratoriums, extension of maturity dates, or capitalizations of deferred debt payments). If a borrower is facing long-term (permanent) solvency problems, there must be implemented different solutions (like conditional debt forgiveness, loan splitting, interest rate reduction, rescheduling with NPV reduction) (Boot *et al.*, 2021; World Bank Group, 2020).

The economic situation in Eurozone experiences a sharp downturn and triggers an unfavorable condition for the NPLs situation. It means that some policy actions are necessary to address the threats. Some experts highlight that NPLs resolution and a better framework for bank crisis management are necessary (Lehmann and Martin, 2020). Among the crucial aspects are highlighted the improvement of transparency on loan quality, the creation of secondary loan market structure, and the framework for bank NPLs securitization (COM(2020)822 final). The main activities undertaken by the EU authorities, and strongly recommended since the pandemic outbreak, embrace two initiatives:

- Proposal for a Directive on credit services, credit purchasers, and the recovery of collateral².

² Proposal for a Directive of the European Parliament and of the Council on credit services, credit purchasers and the recovery of collateral, COM(2018) 135 final – 2018/063 (COD).

- Commission proposal of the securitization framework for bank nonperforming exposures.

The first solution is dedicated for establishment in the EU liquid cross-border secondary market for NPLs. It is important to increase the market transparency and establish an environment which leads to the improvement of the quality and comparability of NPLs data. This solution enables banks to transfer their NPLs to credit purchasers. The second initiative is an activity oriented to the prevention of NPLs accumulation on the bank's balance sheets. The main aim of the initiative is to remove regulatory obstacles and implement a securitization framework for bank nonperforming exposures.

The second important issue for management the post-pandemic situation in banking is the recovery plans, especially dedicated for those small and medium sized banks, which are not covered by the solutions provided by the banking union. It is important to provide such a solution for the banks' failure that they are able to exit smoothly from the market, with minimal impact on the economy and customers, especially retail depositors and borrowers. It is argued that in the case of the Eurozone market, such a solution could be provided by the third pillar of the banking union, namely, the European Deposit Insurance Scheme (EDIS).

Before the pandemic, the authorities failed to implement the solution, but in new circumstances it is unambiguous that this is the best solution for managing future banking failures or even crises (Mecatti, 2020). Another possible solution, which is suitable for the whole banking sector (including small and medium sized banks) is to create an asset management company on the Eurozone level or the Eurozone Restructuring Agency. The first solution would be dedicated to removing the nonperforming assets whereas the second one for separating weak banks into viable and unviable financial institutions. Both solutions, despite their specificity, are good mechanisms leading to the recovery of bad loans and to the establishment of a single banking market in the Eurozone and resolve many problems accompanying the current banking system (Beck, 2017; Haben and Quagliariello, 2017; Langfield and Pagano, 2016).

The post-pandemic time might lead the banking sector to the acceleration of the M&A processes. This is especially important for the small and medium sized banks. Such a process might be treated as the third step, leading to the long-term banking viability, but it is a consequence of the previous phase, namely, the solution of treatment of the endangered banks. The empowerment of the banking union and creation of EDIS may lead to cross-border banking consolidation (Morris *et al.*, 2020). The additional reason for such solution is that the Eurozone banking market is very fragmented, and the adverse business conditions in the pandemic time pose additional pressure on the banking activity performance and trigger the pressure for improving the economies of scale in the market. It is a need empowered by regulators, policymakers, and even the European Central Bank (Walker, 2021). The

consolidation process is confirmed by the first deals, which were implemented since 2020, namely, the Spanish Caixa Bank merger with Bankia, the Italian Intensa Sanpaolo acquisition of the Unione di Banche Italiane (Sardana, 2020; Toplensky, 2020).

6. Concluding Remarks

This article bears in with the problems in the Eurozone banking sector, triggered by the COVID-19 pandemic. It becomes obvious that the pandemic reversed the positive processes, which occurred since the 2008/2009 global financial crisis, and accelerated some of the negative mechanisms which already threatened the sector. The pandemic will deepen and lengthen the period when the Eurozone experiences very low interest rates. It extends the extant period of very low profitability of the banking sector in the Eurozone. As lockdowns are lifted, the economy will struggle to come back to normal functioning. There is a need that the banking sector contributes to the post-COVID-19 recovery action (Blanchard *et al.*, 2020). It is highly possible that there will be many difficult situations in the businesses, and the banking sector should continue its intermediary function and provide the necessary financing services for the real economy. Among the main areas should be selected: helping workers to adjust to the new normal, helping firms in their short-term problems, restructuring unsustainable debts, and providing new investment loans.

Some of the abovementioned actions might be based on the needs and adequate to the circumstances created by the environment, especially the regulatory actions and the stimulus provided by the European Central Bank. There is, however, still a long path to coming back to pre-pandemic normality. Before playing the traditional role as intermediaries for the participants of the real economy, banks must combat their own problems. Especially, they must confine the negative impact of the NPLs. Many regulatory actions have already addressed these challenges. The incumbent approaches are based on the premise that the first and primary tools for addressing NPLs in the Eurozone are market-based solutions (e.g., nonperforming exposures, securitization, Mergers & Acquisitions). If banks will not be able to cope with their problems and if necessary, the public help and other forms of state aid provided by the Member States will be implemented.

The description focused on the bank's internal financial situation. It has not embraced the changing environment. The essential aspect is that the COVID-19 pandemic accelerates the process of digitalization of banking services. Almost all aspects of the banking industry are becoming digital – the services offered to bank customers, internal processes (remote work), and the transformation of bank operating and business models (Carletti *et al.*, 2020). Moreover, the expectations of banking services customers are changing. It creates a new environment for the further development of the banking sector and at the same time poses a new challenge for incumbent banks. They can adjust to the new environment only in part. Some of their activities will be permanently taken over by their fintech competitors.

It means that in the post-pandemic time it will be even more difficult for banks to come back to normality and to their traditional activities in new economic circumstances.

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