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Absorbing the Shock of COVID-19 in the Financial Services Sector

The Covid-19 pandemic has caused acute strain on domestic demand and consumer spending, which will continue to stress financial institutions and their loan books. It has been estimated that GDP in the Eurozone area could fall by between 5% and 12% in 2020.

We look at the unprecedented policy initiatives by the European Central Bank (ECB) and the Central Bank of Ireland (CBI) to maintain liquidity in the financial markets and the resulting efforts of domestic banks and stakeholders in executing these policy imperatives.

Central Bank of Ireland and European Central Bank

The CBI's response has been in tandem with ECB movement on monetary and fiscal policy measures, agreed to safeguard liquidity conditions, protect the flow of credit to the real economy and prevent a pro-cyclical tightening of financial conditions.

At ECB level, this has amounted to a number of policy agreements impacting on all Eurozone constituents, some of which are outlined below, along with specific Central Bank measures.

1. Long-Term Refinancing Operations

The ECB announced on 12 March that the conditions of the Targeted Long Term Refinancing Operations (TLTRO) programme would be modified to stimulate credit supply and incentivise lending from banks to the private sector. Basically, this is the giving of low interest loans to domestic banks, which they then must pass to SME's and consumers, (excluding mortgage loans). TLTRO conditions will be further eased by reducing interest rates 50 basis points below the average interest rate on the Eurosystem's main refinancing operations prevailing over the period from June 2020 to June 2021.

These programmes are designed to funnel the monetary easing associated with negative rates to firms and households that rely on access to bank credit, especially now when credit is desperately needed to bridge a prolonged period of economic inactivity. The ECB's Bank Lending Survey, published at the end of April, reports that banks across Europe are using liquidity gained from the TLTRO programme to grant loans to the non-financial private sector, which is positive news for the 'real economy'. The CBI forecasts that Irish banks could potentially borrow approximately €20 billion through one of these operations.

The ECB also decided to introduce seven additional LTROs, called Pandemic Emergency Longer-Term Refinancing Operations (PELTROS). These will provide liquidity support by providing a backstop after expiry of the bridge LTROs conducted since March 2020.

2. Quantitative Easing, Asset Purchases and the €750 billion Pandemic Emergency Purchase Programme (PEPP)

After the 30 April meeting of the ECB governing council, the ECB announced that: *"since the end of March we have been conducting purchases under our new pandemic emergency purchase programme (PEPP), which has an overall envelope of €750 billion, to counter the severe risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the coronavirus pandemic.*

Since November 2019, the ECB has completed monthly asset purchases of c€20 billion. In March, the ECB announced a brand new temporary asset purchase programme of private and public sector securities. The PEPP is a broad, flexible quantitative easing programme which will run to the end of 2020. The ECB has emphasised that it is prepared to further expand it if needed. This measure aims to help countries in issuing new borrowings by keeping interest rates at very low levels. Lower interest rates should encourage banks to lend in a competitive to assist companies and aid recovery.

3. Bank Dividend Freeze

To preserve liquidity, the ECB had requested Eurozone banks to conserve capital and freeze dividend payments for 2019 and 2020, as well as halting the practice of share buy-backs.

This maintains maximum capital preservation and space to absorb capital losses. In response, both AIB and Bank of Ireland announced the deferral of dividend payments to shareholders and the situation will not be revisited until October 2020.

4. Counter Cyclical Capital Buffer

The CBI also acted to enhance the ECB's temporary measures by reducing the Counter Cyclical Capital Buffer (CCyB) from 1 per cent to zero from 2 April. The CCyB is one of the measures introduced in 2015 to strengthen banks' resilience and ensure they hold sufficient capital to maintain the flow of credit during periods of financial stress. By increasing/decreasing capital requirements in line with cyclical financial system changes, the CCyB ensures additional capital is in place to absorb losses. The release of the CCyB frees capital that may otherwise have to be used to meet banks' capital requirements. In other words, the "rainy day" savings are released to enable the purchase of umbrellas.

Releasing the buffer, is designed to assist the banking system to both absorb COVID-19 related losses and support the economy. Per the Central Bank, new lending capacity could range from €10–16 billion if this mechanism is fully utilised. That is a significant. In context, new lending to Irish residents amounted to about €30 billion in total in 2019.

Irish Retail Banks' Response

The main retail banks in Ireland have adopted a range of solutions and products to support customers that are experiencing difficulty in an attempt to assist with business liquidity.

Payment Breaks

At the end of April, the Banking and Payments Federation of Ireland (BPFI) announced that Irish banks and non-bank lenders will be able to extend payment breaks from 3 to 6 months. BPFI members include the five main retail banks, together with non-bank lenders and specialist lenders as well as credit servicing firms. Over 22,000 SME payment breaks have been processed by BPFI members since the initial 3 month relief was first granted in March.

Borrowers availing of the extended breaks will not be classified as having missed payments on the CBI's Central Credit Register. Similarly, the Irish Credit Bureau advised its members that there should be no impact on credit records of borrowers availing of a payment break.

CBI messaging to date is that lenders will be expected to offer longer-term sustainable restructuring solutions to borrowers under financial pressure at the end of the 6-month period. The CBI has also re-emphasised that the typical protections afforded in legislation and codes of conduct will continue to apply to borrowers facing difficulties and regardless of whether or not they avail of any payment breaks during the crisis.

Flexible Commercial Loan Repayment Arrangements

As well as payment breaks, the banks are offering interest only payment breaks to business account holders. Those whom avail of the break will have their loan term unaffected as the deferred payments will be spread out over the course of the remaining period. While this will increase the cost of credit over the life of the loan, it frees up cash for imminent business needs.

Working Capital and Short Term Loan Facilities

Banks are also offering new or extended overdraft facilities and lines of credit to business customers to solidify cash-flow availability without the burden of fixed repayments.

Short-term loan facilities are accessible across the banking sector with fixed-rate facilities up to capped amounts without early repayment fees available. Interest-only options and seasonal adjustments can be tailored to flexibly address either immediate or forecast requirements.

State Backed Funding though Irish Banks

Loans of up to €1.5m per eligible enterprise will be available through AIB, Bank of Ireland and Ulster Bank under the Strategic Banking Corporation of Ireland (SBCI) COVID-19 Working Capital Scheme offered by SBCI in partnership with the Department of Business Enterprise and Innovation, the Department of Agriculture Food and the Marine and with supported by the InnovFin SME Guarantee Facility, with the financial backing of the European Union under Horizon 2020 Financial Instruments.

In addition, the Government announced, on 2 May, that the SBCI Credit Guarantee Scheme would be repurposed, and the Irish Government will guarantee up to €2 billion of loans granted by Irish banks to small and medium size enterprises. The State will guarantee the banks against 80% of losses. The banks will be responsible for the other 20%. The details will need to be clarified as currently, information available from different sources on this proposal are not consistent.

Notwithstanding the above welcome initiatives, it is also worth noting that CBI has also emphasised to banks that they should "*continue to apply sound underwriting standards, pursue adequate policies regarding the recognition and coverage of non-performing exposures, and conduct solid capital and liquidity planning and robust risk management.*" As such, while certain tools are being sharpened to assist with the task at hand, it is not the case that there is a licence to do anything and everything. From the banks' perspective, it will also be important that they assess the impact that payment breaks, increased credit, temporary forbearance, and overall impairment on borrowers' ability to repay loans according to terms will have on their own balance sheets in the future.

Conclusion

The responses discussed above are focused on maintaining maximum possible liquidity in the wider financial system in the face of the COVID-19 impact.

The ECB are making available up to €3trillion in liquidity through refinancing operations, maintaining the lowest interest rate ever offered (-0.75%) and are offering funds below the ECB's deposit facility rate to amplify the stimulus package. In light of this, the CBI and domestic banks' roles in channelling this assistance directly to those who can benefit most in the real economy is vital.

It remains to be seen if the unprecedented levels of support provided to the financial sector will be sufficient, or whether they will need to be further supplemented in the coming months.

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