ECB to step up intervention as European banks face rise in non-performing loans

Nick Beams
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The president of the European Central Bank (ECB) Christine Lagarde has again indicated that its provision of ultra-cheap money is likely to be stepped up and will extend long into the future as the second wave of the COVID-19 pandemic spreads across Europe and banks face a significant rise in non-performing loans.

Delivering the keynote address to the ECB's annual central bank forum, held online this year, Lagarde said all sectors of the economy "need to have confidence that financing conditions will remain exceptionally favourable for as long as needed—especially as the economic impact of the pandemic will now extend well into next year."

The ECB has already purchased more than €640 billion of bonds under its €1.35 trillion pandemic emergency purchase program (PEPP). It has also lent almost €1.5 trillion to banks through its targeted longer-term refinancing operations (TLTRO) at interest rates as low as minus 1 percent.

Both programs are expected to be extended at least until the end of next year with a further €500 billion to be added to the PEPP.

In her address, Lagarde took a swipe at critics of the program from within sections of the financial establishment, particularly in Germany, who have complained that the ECB program is keeping companies alive that should be allowed to go under.

Concerns about "zombification" or "impeding creative destruction" were misplaced and policies that protected viable businesses until activity could return to normal would assist productive capacity, not harm it, she said.

Lagarde warned that even if the second wave of the pandemic proved to be less intense than the first, it posed no less a danger to the economy and its effects could even be worse. If the pandemic was regarded not just as a one-off event then "we could see more lasting changes in behaviour than during the first wave."

"Demand weakness and economic slack are weighing on inflation, which is expected to remain in negative territory for longer than previously thought," she said.

The language of ECB pronouncements is always somewhat convoluted because while its real concern is the stability of the banking and financial system, under the terms of its mandate it has to present its actions as being necessary to return inflation to a target of near to 2 percent.

And concerns over financial stability remain ever-present under conditions where the pandemic continues to spread.

They were voiced in a comment published in the *Financial Times* at the end of last month by Andrea Enria of the supervisory board at the ECB.

He noted that while anecdotally, only a small fraction of loan repayments had shown signs of distress with expiration of moratoria on bank loans in some EU countries, the economic outlook was uncertain. Enria warned, "We cannot rule out a weak recovery with a significant build-up of bad loans.

"The European Central Bank estimates that in a severe but plausible scenario non-performing loans at euro area banks could reach €1.4 trillion, well above the levels of the 2008 financial and the 2011 EU sovereign debt crises."

Enria called for the establishment of asset management companies, known as "bad banks," which takeover non-performing loans (NPLs), saying that when they were used after crises bank balance sheets were cleared up more quickly.

He commented that vast amounts of taxpayer money were used in the aftermath of the financial and sovereign debt crises, "but Europe was ineffective is using consolidation to remove excess capacity and foster a radical refocusing of business models. The result today is a fragile banking system, with rock bottom equity market valuations."

Enria did not elaborate on the reasons for this, but they lie in the competitive conflict between European and US banks. European banks, having plunged into the orgy of speculation in American financial markets leading to the crisis of 2008, sought to cover up the extent of the hit they had taken lest it weaken their position vis à vis their rivals which had been bailed out by the US government. Consequently, they were in a weakened position when the pandemic struck.

Enria called for an integrated European response rather that a "plethora of uncoordinated national initiatives" under conditions where "EU banks are segmented along national lines, making them less efficient and more fragile."

Indicating the conflicts within the administration of the European financial system, the call from the ECB for a system of "bad banks" was rejected by Elke König, the chair of the Single Resolution Board (SRB), the EU agency charged with winding down failing lenders, in an interview with the *Financial Times* earlier this month.

However, she warned that banks had to do "intensive work" to sort out viable from unviable entities and that there was "misalignment" within the present system.

The SRB was set up following the sovereign debt crisis of 2011–2012 but, as the *Financial Times* noted, with the risk of a surge in non-performing loans it was "still working with an incomplete system of EU bank-crisis rules which must operate over a patchwork of different national arrangements."

König warned that non-performing loans would start to show up in the first and second quarters of next year and said her message to the banks was "be aware NPLs are coming and the best thing to do is address them early… That is the best thing we can do for the time being, and then it is steering through the fog."

In other words, the key regulators have no clear plan to deal with a crisis, the conditions for which are building up.

And, if the actions of Deutsche Bank are anything to go by, the major banks are determined that nothing should stand in the way of their pursuit of profit, no matter what the risks.

The *Financial Times* carried a report on Monday that the major German bank had rejected a request from the ECB, made in the summer, that it suspend part of its leveraged finance operations because it was not properly monitoring risks in that area.

The ECB defines high levels of leverage as where the total debt, including unwithdrawn credit lines, exceeds six times earnings before interest, tax, depreciation and amortization.

Leveraged finance is a major part of Deutsche Bank's business generating €1.2 billion in revenues in the year to September, a rise of 43 percent year on year.

Thumbing its nose at the ECB, Deutsche Bank declared that it was "impractical" to carry out the request, which was non-binding according to the report.

Another area of concern is the purchases of government bonds by major banks. According to a report by S&P Global Ratings in September, European banks held €1.6 trillion of home-country government bonds at the end of June, an increase of 15 percent from the end of February. Purchases have been taking place at a rate seven times faster than over the same period in 2019.

The concern here is that the large holdings of government debt can set off a so-called "doom loop" if there is a sell off of bonds, due to worsening conditions in the economy of the country that has issued them, resulting in a hit to banks' balance sheets and a further worsening of the economic downturn.

This was the situation that developed in the European sovereign debt crisis of 2011–2012, which was only brought under control when ECB president Mario Draghi committed the central bank to do "whatever it takes."

At present, the general view is that "this time it's different" because the increase in bond-buying by the banks is the result of the extraordinary situation created by the pandemic.

But such views ignore one of the central features of the pandemic experience—that this apparent accident was a trigger event, which has intensified contradictions building up within the capitalist financial system over the antecedent period.