European & US banks at the peak of the corona crisis
Repercussions for balance sheets

The recession triggered by the coronavirus pandemic continues to bring about large-scale balance sheet changes both at euro-area and US banks, following the initial impact in March. In the second quarter and particularly in April and May, at the peak of the slump, lending to companies surged further. However, most firms just kept the enormous additional liquidity on their bank accounts to prepare for weaker revenues. Lending to households was much less affected, even though consumer loan business suffered substantially as growth turned into a contraction.

Banks also took precautionary measures themselves and strongly lifted their liquidity buffers at central banks. Similarly to the corporate sector, a large part of that was funded through the same channel, i.e. through the ECB and the Fed. However, the extent to which banks financed rising public deficits differed notably on both sides of the Atlantic. While government bond purchases accounted for almost a third of the balance sheet expansion in the euro area in April and May, net purchases in the US were smaller and happened not before June. Furthermore, capital market liabilities fell significantly at US banks but stayed broadly flat in the EMU.

Within the euro area, loans to non-financial corporations are much higher than a year ago in France, Germany and Spain, yet still lower in Italy. Retail loans, too, are up in France and Germany and flat or down in Italy and Spain. Funding from the ECB surged the most in relative terms in Germany and France, but is still far below the share in total assets reached in Italy and Spain.

Over the next couple of months, corporate loans and deposits may gradually come down as firms make use of their vast liquidity piles. Retail lending will probably remain somewhat sluggish and depend on the medium-term labour market impact of the crisis, which will also determine retail deposit momentum. Banks’ liquidity reserves at central banks are set to decrease, while their government bond holdings are expected to rise considerably, particularly in Europe.
European & US banks at the peak of the corona crisis

While the lockdown month of March already resulted in some major shifts on the balance sheets of European banks – notably a surge in liquidity buffers both of the banks themselves and of their corporate clients –, the trough of economic activity only came in April and May, before countries slowly emerged from the most restrictive containment measures. Banks’ balance sheets in the euro area continue to reflect these extraordinary circumstances.¹

Assets of EMU banks

With regard to total assets, following the jump in March, growth remained very strong in the next month but slowed down significantly in May. The expansion (EUR +529 bn in April and May combined) was solely driven by higher loans (EUR +249 bn), liquidity held at the central bank (EUR +228 bn, hence going from a yoy contraction in February to enormous growth), and bond holdings (EUR +222 bn), while remaining assets fell by EUR 104 bn. These include derivatives whose value had surged in March due to the tremendous market volatility which has receded since then. External, i.e. non euro-area assets also declined by EUR 63 bn.

Which components stood behind the overall rise in lending volumes? Primarily, it were corporate and interbank loans which gained EUR 128 bn and EUR 111 bn, respectively, in the first two months of the second quarter. Corporations reversed their initial demand for short-term credit which had ballooned in March but contracted subsequently. Instead, they now mostly took out loans with medium and longer tenors (1-5 and > 5 years). For firms expecting a protracted recovery, this “prolongation” of the debt profile is an understandable precautionary measure.

At the same time, the yield curve has normalised a bit since March – longer-term corporate loans (especially those with a rate fixation period of > 10 years) have become somewhat more expensive, while interest rates declined for loans with rather short rate fixation periods of 3 months to 3 years. For loans to self-employed and non-corporate businesses, the opposite holds true though: interest rates declined only for medium and longer rate fixation periods, while they remained unchanged for short ones. Small firms in general benefited more from the further relaxation of the monetary policy stance as rates for loans up to EUR 1 m fell substantially, whereas larger corporate loans became slightly more expensive.

¹ See also Schildbach, Jan (2020). Crisis impact on bank balance sheets in the euro area. Talking Point, Deutsche Bank Research. May 4.
Back to lending volumes, loans to the public sector on the other hand barely rose at all in April and May, despite governments’ booming expenditures. This may reflect the fact that central governments, which bear the brunt of the fiscal stimulus spending and the lower tax intake (at least initially), fund themselves by and large through bond issuance (see next paragraph) rather than loans, and state and local government entities have not yet been hit as hard. Similarly, growth in loans to households remarkably lessened. However, this was only due to consumer loans which have hit a wall and are now down yoy, whereas mortgages continue to grow at a healthy pace.

Banks also loaded up on debt securities. Corporate bond holdings make up only a small part of the total though. Even excluding government bonds and bank bonds, corporate debt accounts for no more than 15% of the rest (securitised assets, e.g., are substantially bigger). But the only area which has really seen major change is banks’ government bond holdings which increased by an enormous EUR 166 bn within just two months. They are now 15% higher than a year ago, up from shrinkage 3 months before. Of course, this is the result of a massive rise in bond issuance by (central) governments. Correspondingly, the ECB is willing to buy such securities in the secondary market, through its EUR 1.35 tr Pandemic Emergency Purchase Programme (PEPP), in addition to the resumed “normal” Quantitative Easing in the form of the Asset Purchase Programme (APP), with EUR 20 bn in investments per month and EUR 120 bn on top until the end of the year. As intermediaries, banks are thus supporting the state and central banks in financing the Keynesian countercyclical fiscal impulse.

The breakdown of banks’ government debt positions is somewhat patchy. Nevertheless, it shows that the increase in bond holdings is broad-based. Maturities of < 1 year jumped by EUR 77 bn or more than 50% in April and May, and longer maturities by EUR 89 bn. As of March (latest date available), central governments accounted for 84% of total public-sector debt securities held by banks, hence these issuers may have also dominated the surge in April and May.

Cross-country differences – assets

Are there noteworthy differences between the four major euro-area countries underneath these aggregate developments? With respect to lending to non-financial firms, Germany, France and Spain are in one camp, Italy in another. In the former three, volumes are far higher than a year ago, in the latter, they are still contracting. Admittedly though, the relative increase was the smallest in Germany, as it already had the highest growth rate going into the crisis, and momentum even slowed a bit in May. On the retail lending side, there was no trend change in any of the large countries. France and Germany continue to expand at a robust pace, in contrast to Italy and Spain where outstanding volumes are stagnating or shrinking slightly.

Government bond holdings rose much more in absolute terms in France (where the yoy increase was also by far the highest) and Italy than in Spain and Germany. The swing in general is impressive: in February, the yoy comparison had still been negative in the latter two countries and only mildly positive in France and Italy. However, even after the recent strong expansion, French banks have just caught up with their German and Spanish peers in terms of the absolute volume of public debt held – despite France having the largest national banking sector in the euro area. Furthermore, in all three countries, the volume...
of government bonds on bank balance sheets is only roughly half the figure in Italy.\(^2\)

Finally, the surge since March in banks’ liquidity held at central banks was almost exclusively driven by French banks (EUR +165 bn). Nevertheless, German banks still hold even more deposits at the ECB and both French and German banks hold 5-6 times the amount of their Spanish and Italian counterparts. This underscores how much customers trust these banks, how much they save and invest (including capital flight from Europe’s periphery to the core), and as a result how banks suffer to a different degree from negative interest rates.

## Liabilities of EMU banks

How did the banks refinance the substantial rise in assets? Two ways are relatively straightforward, as higher liabilities are directly linked to higher assets: in the business with non-financial corporates, and in the relationship with the central bank. Corporate deposits (i.e., overwhelmingly sight deposits) went up by EUR 217 bn in April and May as firms continued to draw on credit lines and increased liquidity buffers to prepare for weaker revenues. Interestingly, companies had not yet been forced to reduce these buffers (the buildup had not even slowed down) in spite of the economic slump already lasting 2.5 months, from mid-March to end-May. This is encouraging with regard to the corporate sector’s resilience.

Liabilities vis-à-vis the central bank have been another important funding channel for banks recently. Following a drastic surge in March, they increased again in April and, less so, in May, by a combined EUR 174 bn in the latter two months. They are now about 50% higher than a year ago. Of course, the ECB has made these funds even more attractive by reducing interest rates under certain conditions to -1%.

Deposits from households constitute the third main component of the rise in funding – and the only one which is not related to a similarly large increase on the asset side. Retail deposits climbed EUR 183 bn in April and May, but this meant only a moderate acceleration from the pre-crisis growth rate. For households, so far, it seems that precautionary saving (and the forced suspension of consumption during the lockdown) outweighs any income loss. Again, this is a positive sign of households’ balance sheet strength even though the picture might still become more clouded in the next few months. The labour market is going to feel the full impact of the crisis and spending on consumer goods will rebound, with shops open almost everywhere and fiscal stimuli such as temporary cuts in the value-added tax kicking in.

On a side note: deposits from the different layers of government declined meaningfully, by EUR 30 bn, in line with the rising expenditures and lower tax receipts of the public sector.

## Cross-country differences – liabilities

Among the large individual countries, Germany recorded below-average growth both in corporate and household deposits, and France was the biggest driver, with Italy and Spain somewhere in between. By contrast, German banks, together with the French, lifted their ECB funding the most in relative terms (it has now almost doubled compared to a year ago), however, they came from a lower level than the other two countries. The ratio of ECB funds relative to total liabilities in Germany and France was already elevated before the crisis.

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assets remains much higher in the South (7-8%) than in the two core countries (2-3%) – a likely indication of investors’ relative attribution of trust. In the case of Italy, the ECB dependency ratio has reached an all-time record, exceeding even the peak level during the European sovereign debt crisis.

Balance sheet trends at US banks

How do these developments compare to the US? Here, the full second-quarter figures are already available and they look similar, in many ways. Total assets were up considerably, by USD 782 bn during the last three months. One major driver was corporate lending (including commercial real estate) which expanded by USD 187 bn. However, this masks quickly changing trends in the past few weeks. From mid-March to early May, outstanding volumes virtually exploded, but since then, they have been coming down slowly. At the same time, the crisis had a dampening effect on retail lending where steady, moderate growth suddenly turned into a contraction. Hence, the second quarter saw loan books shrinking by USD 107 bn. Most of that was due to consumer loans which made the largest swing from solid expansion to shrinkage yoy, whereas residential mortgages are still higher than a year ago. The most pronounced contribution to asset growth in Q2 though came from liquidity holdings at the central bank which US banks widened massively (USD +561 bn), following a surge already in March. In fact, funds at the Fed more or less doubled from February to April, before retreating somewhat in June.

On the liability side, aggregate deposit growth was exceptionally strong (USD +1,546 bn), again after a major increase in March. Momentum slowed a bit in recent weeks, but remained elevated. In contrast to Europe, there is no sector breakdown available, nonetheless, the bulk of these figures probably also stems from the private sector.

EU-US differences

However, there were two notable areas were US banks’ reaction deviated from that of euro-area banks: i) the former did not engage as much in large-scale Treasury purchases as their European counterparts bought domestic government bonds. US banks increased their investments between March and June by only USD 134 bn, and these transactions entirely took place in the month of June for which data on European banks does not even exist yet. ii) US banks’ deposits actually increased much more than total liabilities in Q2, but that was partly compensated for by a fall in other borrowings, i.e. bonds and short-term money market debt (USD -490 bn) which, in turn, had boomed in March. In the EMU, outstanding debt securities hardly changed at all, at least in April and May. Finally, reducing their liabilities further, US banks also shifted capital back to their foreign offices which they had brought home in the phase of the biggest stress in March and particularly April.

Outlook

As the latest figures from the US indicate, corporate loan growth may slow down significantly in the next couple of months both in the US and Europe as firms make use of their liquidity piles (and those which find out that they do not need as much capital, repay some of the debt). Annual loan growth might even turn negative at some point. However, given the renewed surge of infections, the outlook in the US is more uncertain. Lending to households in both regions should remain more stable. Current dynamics in mortgage markets may well continue or weaken only moderately. Still, other forms of household credit such
as consumer loans and debit balances are likely to suffer more. Consumer confidence will probably stay subdued for several more quarters given the uncertain medium-term labour market impact of the crisis. This will also determine the path for retail deposits, whereas corporate deposits are set to decline gradually from their exceptionally high levels, in line with the economic recovery. Similarly, banks’ holdings of liquidity reserves at the central bank (and the corresponding funding) should abate as confidence grows. Their purchases of government bonds may pick up further though, especially in Europe.

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