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IWH issues warning of a new banking crisis

The coronavirus recession could mean the end for dozens of banks across Germany – even if Germany survives the economic crisis relatively unscathed. An analysis by the Halle Institute for Economic Research (IWH) shows that many savings banks and cooperative banks are particularly at risk. Loans worth hundreds of billions of euros are on the balance sheets of the financial institutions concerned. IWH President Gropp warns of a potentially high additional burden for the already weakened real economy.

The economic crisis caused by the coronavirus pandemic could massively affect the German banking sector. It is anticipated that thousands of companies throughout Germany will be unable to repay their loans. The loan defaults could impact Germany's banks so severely that they themselves struggle to survive. In an optimistic scenario, in which the German economy recovers quickly, at least 6% and therefore dozens of domestic financial institutions would still be at risk. Whereas in a pessimistic scenario of a prolonged economic downturn, an analysis by the Halle Institute for Economic Research (IWH) shows that up to 28% and therefore hundreds of banks would face serious difficulties. A look at their balance sheets makes it clear how important these banks are for the economy. The loans held by these institutions amount to 127 billion euros in the optimistic scenario and 624 billion in a more pessimistic scenario.

“Even if things go very well for the German economy, we believe a new banking crisis is probable,” says IWH President Reint Gropp, who wrote the study along with the IWH financial market researchers Michael Koetter and William McShane. “Understandably, the state has recently been dealing with the real economy, but it should not overlook the potential threats which are lurking in the financial sector.” If many loan defaults occur and the core capital ratio of the affected banks thereby falls under 6%, they will be restructured, merged with other institutes or closed down altogether. In any case, it would be impossible for them to issue new loans. This could put an additional heavy strain on the already weakened real economy, says Gropp, warning: “The danger is quite high that a banking crisis could trigger a second recession.”

When the forecasted banking crisis will begin depends on several factors. For example, companies will delay insolvency while banks may conceal problem loans. Savings banks and cooperative banks in particular should expect loan defaults because they tend to lend to companies which are now doubly at risk. On the one hand, they are small and therefore generally more vulnerable than large companies. On the other hand, these companies in particular operate in sectors which have been hit hard by the coronavirus lockdown, such as retail and the hospitality industry.

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Gropp recommends that federal policymakers and banking supervisory authorities prepare themselves now for the fact that the economic crisis may get worse. He says the state could compel banks to hold more core capital or help them to do so. Gropp goes a step further, stating: “We believe that a consolidation of the German banking market in which too many financial institutes have been vying for yields which are too low, would increase productivity in the medium term and thereby stimulate the economy. Using tax revenue to rescue the banks without systematically restructuring their corporate lending portfolio should be ruled out.”

The IWH researchers combined the key figures of more than half a million German companies with the balance sheet data of over 1,000 domestic banks. The sample covered 89% of savings banks, 81% of cooperative banks and 15 commercial banks, including all large systemically important financial institutions. The researchers investigated the extent to which the corporate lending portfolio of each bank is vulnerable to economic fluctuations. With the volume of loans which are likely not to be repaid in future, the researchers forecasted how much core capital of the banks will melt away.

Publication

Reint E. Gropp, Michael Koetter, William McShane: The Corona Recession and Bank Stress in Germany. [IWH Online 4/2020](#). Halle (Saale) 2020.

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