Nationalising NPLs via European bad bank a complex and sub-optimal solution

Discussions about a bad bank or a TARP-like programme to pre-emptively lift troubled assets and/or NPLs from European banks to prevent a liquidity crisis from becoming a solvency crisis are premature and could taint the region's banks.

The ECB has reportedly been examining the idea of a euro area bad bank to relieve lenders of NPLs ahead of a cycle of asset-quality deterioration as a result of Covid-19. "Pre-emptively establishing a bad bank even before a new NPL trendline has started to emerge would be a complex task," said Dierk Brandenburg, head of the financial institutions team at Scope Ratings.

"Particularly as fiscal and monetary support measures have not had time to bed down and before any empirical data has emerged on how banks' customers will respond once measures such as moratoriums and government-backed loan or grant schemes have ended and the extent of corporate, SME and household defaults becomes clearer."

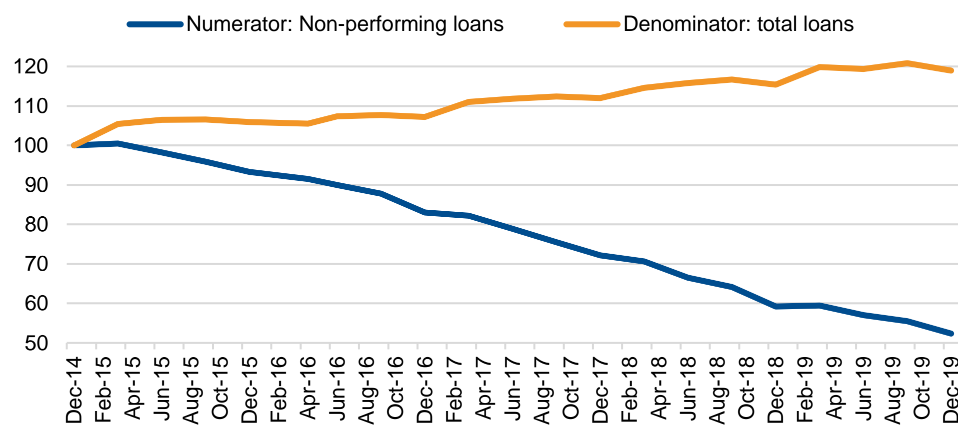
Any large-scale nationalisation of NPLs would come on top of significant government support programmes for private-sector borrowers during the Covid-19 crisis. A bad bank would therefore add to already sharply rising exposures by governments to private-sector assets potentially at risk of default. Leaving problem assets as much as possible with private investors – e.g. through NPL securitisation in the case of banks – may be a better way to maximise recoveries post-crisis.

The ECB's approach is consistent with the fact that elevated and unresolved NPLs are associated with more severe recessions. "Output has on average been lower in crises with elevated NPLs compared to those with low NPLs while among crises with elevated NPLs, output was on average lower in countries with unresolved NPLs compared to those with resolved NPLs," the ECB wrote in an April working paper ('The dynamics of non-performing loans during banking crises: a new database').

The conclusion? Reducing pre-crisis vulnerabilities and promptly addressing NPL problems during a crisis are important for post-crisis output recovery. However, the strong fiscal, monetary and regulatory response early on in this crisis combined with better capital ratios of the banks should help to avoid a severe credit crunch.

Dealing with legacy NPLs and preventing under-provisioning for new NPLs have long been a focus for European banking regulators, even as European bank NPLs have come down in a more or less straight line since the euro sovereign crisis (see Figure 1). From an operational perspective, current European NPL numbers look manageable.

Figure 1: Ratio of non-performing loans and advances



Total numerator and denominator. Dec 2014 = 100. Source: EBA, Q4 2019 Risk Dashboard

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The NPL ratio for EU banks declined to 2.7% by the end of 2019, according to EBA data. Notably, the ratio fell even though total loans and advances also declined. Coverage improved (to 44.7%) while IFRS 9 data showed an improvement in asset quality too. At the same time, the aggregate EU bank CET1 ratio reached 14.8%.

Plotting a future course

Default rates and provisions expected to rise

The key question is what happens from here. The EBA expects default rates and provisioning needs will rise and is concerned that the worsening financial position of corporates and households might affect existing loan portfolios and efforts to manage NPLs. The big US banks reported increases of more than USD 20bn in reserve build when they announced their Q1 results. “While provisioning among European banks will undoubtedly increase, a proportional read-across from the US to Europe is not necessarily a reliable guide,” said Brandenburg.

European bank regulators have long worried about unresolved legacy NPLs running into a new crisis and a substantial rise in new NPLs, which they fear will heap untimely pressure on the solvency of European banks. Forcing banks’ hands last year to deal assertively with legacy NPLs by imposing formal resolution deadlines points to the level of regulatory stress. The current scenario is right out of the ECB playbook.

It may also explain why European regulators moved so early in the unfolding crisis to allow banks to operate below Pillar 2 Guidance, brought forward changes to the composition of Pillar 2 Requirements under CRD V, released various buffers, guided banks to suspend dividends and share buybacks, and loosened NPL recognition under IFRS 9.

EUR 172bn of capital retention actions

The ECB estimates that these actions will result in EUR 172bn of capital retention. Even without this additional retention, European banks were already much better capitalised, less leveraged and more liquid than they have been at any time since the financial crisis.

“One early sign of customer behaviour can be seen from the increase in companies drawing down contingent credit facilities on a precautionary basis. While this detracts from bank capital it does not necessarily presage a linear build-up in NPLs. Lifting out new NPLs may make sense after the crisis has peaked to kick-start credit expansion, but that could be one to two years away,” said Brandenburg.

Increasing equity buffers seems to be firmly on the minds of policy makers. Writing in an FT op-ed, Minneapolis Fed president Neel Kashkari called on big US banks to raise USD 200bn in equity – equal to the amount he said US taxpayers injected into the banks in 2008 – to ensure they are part of the solution to the Covid-19 crisis, can endure a deep economic downturn and won’t need to be bailed out.

Under Kashkari’s domino-effect scenario, the economic costs of the Covid-19 crisis will end up with the banks, which will have to continue paying interest on their own liabilities while absorbing customer losses, hence eroding their equity. Banks with assets greater than USD 100bn could in aggregate lose hundreds of billions of dollars of equity, according to severe scenarios under stress tests conducted by the Minneapolis Fed.

Hazards of keeping lending channels open

Contradictions of monetary guidance

One of the contradictions for the banking sector contained in official guidance and Covid-19 monetary stimulus lies in the pressure authorities are piling on banks to continue lending in order to cushion economic impacts. "The motivations behind continued bank lending are clear on paper but adding to corporate indebtedness at a time customers are less likely in aggregate to be in a position to stay current on their bank facilities may be hazardous," Brandenburg said.

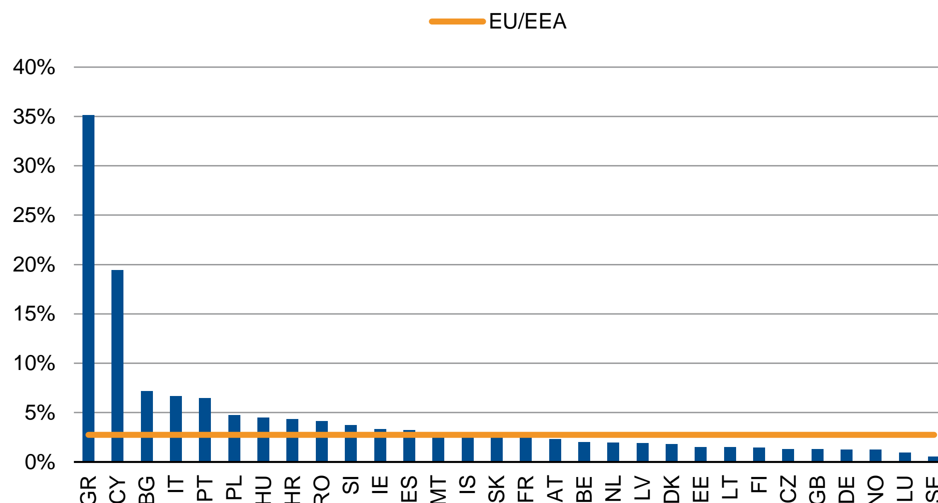
In Europe, offering TLTRO III as low as -75bp for eligible counterparties, keeping liquidity taps open via standard LTRO facilities, easing collateral standards, and offering sovereign loan guarantees shows how determined governments are to push banks to lend to economic safety. If NPLs across the euro area have in aggregate ceased to be systemically dangerous, pressuring banks to continue lending into a recessionary environment will with a reasonable degree of certainty reverse the multi-year downtrend, albeit with a time-lag.

In fact, on the basis that banks have favoured riskier lending categories over the past few years that might contribute to additional future defaults, the EBA issued this advice in its Q4 20119 Risk Dashboard: "Banks might focus on managing existing credit lines of potentially distressed borrowers rather than extending new lending …" Such advice cuts across current monetary guidance.

Tarring banking sector with outlier brush

"The only exceptions to the broad legacy NPL experience are Greece and Cyprus, plus a small number of idiosyncratic single-name outliers. ECB pre-emptive actions inferring rising solvency fears across the sector risk tarring the euro area's banking sector with the same brush as its outliers," Brandenburg said.

Figure 2: Country NPL dispersion (as of Dec 2019)



Source: EBA Q4 2019 Risk Dashboard

From an operational perspective, imposing conditionality on official bad bank purchases that depend among things on private-sector buyers acquiring to acquire NPL portfolios looks optimistic. Pricing dynamics are unlikely to work for forced sellers in a market that will be skewed in favour of buyers who will be heavily incentivised to bid low.

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