A euro area bad bank supporting asset quality could reassure investors

At this time, the concept of a pan-euro area (EA) bad bank for NPLs is vague, speculative, and may not go anywhere. It has already been talked down by various market participants as pie-in-the-sky. Senior ECB representatives have expressed some positive thinking on it but their European Commission (EC) counterparts, wary about state-aid connotations, have been generally dismissive.

Observers point to a similar EBA proposal more than three years ago. That plan was not followed up on, not least due to political, legal, operational and financial hurdles. The message from market participants is that what has worked in the past will work again in the future: national bad bank schemes attracting market interest through NPL securitisation, portfolio sales and other routes.

However, this time around, the concept of a pan-EA bad bank may have more merit as long as it relates to exposures affected by the pandemic-related economic shock and not to the legacy stock of exposures stemming from the last crisis. The features of expected asset-quality problems are different, the effects of the pandemic are not limited to a few countries, and the overall political and regulatory landscape appears to be different from previous crises.

Pressured by the unprecedented situation and with more threatening and unpredictable geopolitical conditions in the background, there seems to be a new-found constructive dynamism in political and regulatory thinking to find pan-European solutions rather than automatically falling back again on circling the national wagons. At least for now. Addressing current and especially future bank NPL exposures through a common EA bad bank could be a part of these solutions. Considering it now rather than later, at a potentially more panicky time, would be beneficial.

Highlighted below are some key arguments underpinning the creation of a pan-EA bad bank, and some of the major obstacles (none of them unsurmountable). By far, the main obstacle is political. To have a better chance of being accepted, any new bad bank should probably shun pre-pandemic legacy NPLs (ca. EUR 500 billion still outstanding), which remain clustered within a narrowing group of peripheral markets and for which little appetite to mutualise across borders can plausibly exist.

Why a forward-looking pan-EA bad bank could make sense this time

In previous crises, banks' asset-quality troubles have generally emerged from lending segments where previously built bubbles had burst – such as commercial real estate to which the banking sector was over-exposed through no fault but its own. Banks and supervisors were forced to engage in ex-post battles to stem the growing tide – sharply higher provisions, forced recapitalisations, restructurings, etc.

This time, it is not banks' own lending mistakes leading to the troubles (although some zombies remain alive and kicking). The banks are about to experience asset-quality problems stemming from sectors which before the pandemic were not necessarily riskier than others, such as airlines, hospitality, tourism, transportation, or energy. Massive disruptions in global supply chains and global trade, business bankruptcies, or a spike in unemployment would not have surfaced so abruptly were it not for the pandemic.

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Knowing a few months in advance that the loan-quality landscape is about to worsen markedly should enable regulators to plan better than in the past. Steps towards more supervisory leeway have already been taken, including a more liberal use of capital and liquidity buffers, delaying IFRS 9 for loan-loss provisioning reporting, and NPL recognition. Creating a separate bad bank-like public asset management company on a pan-EA basis as a logical step to manage banks' growing asset-quality troubles would fit well in the overall regulatory plan to address the economic shock caused by the pandemic.

Equally, the negative effects on the economy caused by the pandemic are not limited to a set of countries, such as the peripherals euro area in the last crisis. Italy, Spain and Greece are being affected but so are France, Germany, Benelux and Austria. A pan-EA bad bank would not only help, say, Italian banks deal with growing NPLs; it would equally support Austrian, Dutch, or German banks, among others. Consequently, political sentiment in Germany, Austria, or Netherlands could be marginally less hostile to a EA bad bank than it was in the pre-pandemic years. But this remains a big question mark.

A pan-EA bad bank would also help alleviate market unease with regards to the EA banking sector, especially if hurdles to its implementation can be credibly addressed. Beyond the current negative noise – which is more of a 'can't do' rather than 'shouldn't do' nature – it is difficult to assume that market confidence in, say, Italian banks' asset quality would not be more positive if a pan-EA bad bank were involved rather than a domestic one. It can be plausibly assumed that there are investors in securitised assets who would be more tempted by EA risk across a credit segment or related credit segments than by Greek or Italian risk in isolation. Again, as long as the underlying assets are not related to legacy situations.

Unlike the EBA's 2017 bad bank proposal, which was aimed at the entire EU and would have thus involved numerous supervisory authorities while mostly targeting legacy NPLs in a smaller number of countries, a new bad bank would focus solely on EA banks. For the last six years, these have been governed by the Banking Union's Single Supervisory Mechanism (SSM), with the ECB as direct lead supervisor for the 115 most significant institutions. Aside from the supervisory level playing field, there is also more homogeneity in NPL regulatory reporting standards within the SSM. The criticism of the earlier EBA initiative, that it would have relied on different bad-loan reporting standards, is less justified this time.

The prophylactic effect of a pan-EA bad bank

Most of the forthcoming asset-quality problems will not stem from banks' idiosyncratic mistakes, unbridled risk appetite, or regulatory arbitrage like in past crises. They will mirror the virus-related systemic shock to the economies of the countries in which they operate. By the same token, the aftermath of the pandemic will require banks to be fully committed to credits and investments helping businesses and individuals survive and rebuild. The sole purpose of current supervisory leeway is to enable banks to pursue this mission without the need to be looking over their shoulders at intransigent supervisors wagging their fingers as has been the case in the decade since the global financial crisis.

Were a pan-EA bad bank to be established, it should probably accept solely NPLs resulting from virus-related situations in the core markets they operate in, and nothing else. There should be clear NPL selection criteria based not only on the prudential classification but also on the nature of the loans. In a positive way, this could have a prophylactic effect on banks' new lending activities, discouraging them from taking unnecessary risks in areas that do not directly contribute to post-pandemic economic survival and rebuild.

Eligibility for assets being admitted into the bad bank could also include ESG criteria (e.g. green over brown assets, social sustainability criteria etc.).

Far from being just a rear-guard protection scheme, a pan-EA bad bank could be a driver towards banks focusing on sustainable strategies and shunning unattractive social and economic goals. This could plausibly be better accomplished through one pan-EA body than through negotiating similar goals with a multitude of national bad banks, each potentially dependent on national governments more or less in sync.

Hurdles in the way

The EC is rightly concerned that a pan-EA bad bank could raise thorny issues related to state aid. But the same provisions that were accepted by the EC when it approved national bad bank schemes could be transposed to a pan-EA initiative. Like existing national schemes, a pan-EA body would not be itself the ultimate end-investor. Through one route or another, discounted NPL exposures would ultimately end up in the market.

Like the national schemes that grew out of the aftermath of the global financial crisis, all losses would be borne by the lending banks; not by the bad bank, the European Stability Mechanism (if the ESM finances it) or, by extension, taxpayers.

One obstacle harder to surmount are the differences in insolvency regimes across EA countries. Whether this could be dealt with or not would remain to be seen. But where there is a (political) will, there is a way. The new-found European solidarity in support of economic survival and revival on a pan-EU basis could be a factor in favour.

Because, in the end, the answer has to be political.

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