Is a euro area bad bank a good idea?

In the second of their Point and Counterpoint credit dialogues, Sam Theodore and Keith Mullin debate the merits, de-merits, advantages and disadvantages of the idea of a euro area (EA) bad bank, which would absorb bad loans accruing from lending to support recovery from the Covid-19 economic crisis.

Sam Theodore:

The idea of a pan-EA ‘bad bank’ sounds like the right thing to me, although I am aware most people in the market range from sceptical to dismissive. Of course, the devil is in the detail, and there are many challenges, mainly political (like Germany’s unwillingness to mutualise other countries’ bad bank debt).

But in the end, none of the challenges is insurmountable: where there is a will there is a way. Controversial for many as it is, we have just seen the European Commission’s surprise EUR 750bn funding plan to help EU economies navigate the post-pandemic crisis and help preserve jobs and livelihoods. This time the dynamics are really different to last time and we cannot rely on the same tools that were used before. I am happy to summarise my pro arguments, but first I would be interested, Keith, if you have a different take?

Keith Mullin:

Taking a quick step back from the bad bank idea, Sam, I have grave misgivings about politicians and monetary and fiscal authorities ‘kitchen-sinking’ their response to Covid-19, essentially by throwing massive amounts of debt at the problem while at the same time driving a process of officialisation across all aspects of economic activity i.e. forcing drastic economic shut-downs through the force of law.

On the monetary side, central bank stimulus has been undermining the proper functioning of financial markets ever since the GFC. The bazooka programmes announced to mitigate Covid impacts have forced a colossal ‘new’ distortion in capital market pricing that has kept markets artificially functional but created an unseemly divergence between financial asset prices and the real economy.

As part of this environment of central control and distortion, the ECB has told banks not to pay dividends, to run down capital buffers and lend into the worst recession in decades, where natural instincts would tell them to do the opposite.

If the ECB is so keen to undermine the robustness of the banking sector that has taken more than decade to build up, it should follow through and nationalise bad debt stemming from madcap recession lending and remove the burden from banks. Which nominally backs up your support for the bad bank. Except I find the network of perverse incentives at play here hard to accept. Moral hazard is immense. You can tweak the structure of a bad bank any way you like, but guess who will end up footing the bill for huge swathes of unrecoverable and irresponsibly extended debt that will ultimately have to be cancelled? Taxpayers.

In dialogue:

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Sam Theodore:

I don't dispute for a second that "the proper functioning of financial markets" has been on public life support since the GFC, but like it or not in the current conditions market confidence is almost entirely pegged on the belief that State bailouts and direct intervention are here to stay and bear fruit, all over the capitalist sphere. Not on the hope that Adam Smith's "invisible hand of the market" will win the day.

If governments and central banks offered no or little support during the pandemic, we would probably end up with a degree of misery and deep structural inequality unbearable under the current contract between society and governments. Remember the welfare-state social contract that post-war Western European governments pursued to avoid the re-emergence of the horrible pre-war history. But I digress.

The Banking Union already has three pillars (although the third, the deposit insurance scheme, may be a step too far and not that necessary in my view). Having a fourth pillar for bad loans would make sense, as long as these bad loans do not result from banks' flawed lending, but from the impact of the pandemic crisis on businesses and individuals. I fully agree with you Keith, taxpayers should not be on the hook. Ultimately, loan losses should be borne by the lending banks or by market investors, not by that hypothetical public bad bank

Keith Mullin:

But then policy makers can't have their cake and eat it. How can you have a situation where banks are brow-beaten into doing the bidding of politicians against their better judgement but are then left to deal with the wreckage of potentially huge NPLs, resulting in capital deficits and operating losses? It's a lose-lose that will undermine their investability.

I see two options, only one of which I find workable. Either eligible bad debt (i.e. debt captured by official Covid-19 lending quotas) is automatically transferred to the ECB or to governments with no recourse back to the banks and written off as additional components of monetary or fiscals stimulus or sold through official market schemes at massive discounts (the bill ultimately footed by taxpayers). This is the unacceptable option.

Or: moral hazard and moral suasion are removed from the picture, banks remain fully accountable for their credit decisions and set underwriting standards consistent with their internal credit models i.e. in line with realistic probability of default or expected-loss analysis and not using fabricated outputs that follow official guidance to underplay the real numbers. If, as in the normal run of the cycle, NPLs accrue, then it's reasonable to expect banks to own the problem and subsequently either to try and offload soured portfolios to the market through outright sales or through securitisation. Potentially assisted by government schemes such as Hercules in Greece or GACS in Italy to incentivise the process.

Sam Theodore:

This is what may well happen after all; it is a well beaten track. But the magnitude of the asset-quality problem may be bigger this time and the governments supposed to assist with guarantees – you named Italy and Greece – may be unwilling or unable to step in again on their own. And the EU's future may be at stake.

On the other hand, the market has been commiserating about the non-investability of banks for more than a decade. And yet investor appetite seems to be limitless, at least on the credit side, and throughout the capital structure. If the concept of a pan-EA bad bank is being seriously considered, it should stick just to NPLs resulting from the pandemic crisis in the primary markets they operate via direct lending (e.g. not junior slices of, say, US CLOs turned sour). The ca. EUR 500 billion of legacy NPLs from the last crisis should not be included.

And the acceptance of pandemic-hit NPLs in this hypothetical bad bank should be contractually tied to the ceding banks' commitment to support the post-pandemic economic rebuild through loans and investments. But – and it goes without saying – all lending should be done on the prudential underwriting criteria set up by regulators and banks after the last crisis. Not on flawed political considerations.

Keith Mullin:

I think we agree of aspects of this topic, Sam, if not on the actual solution. Lending, to your point, that follows prudential underwriting criteria would hopefully align with my point about lending having to be free of moral suasion and other silent control drivers from supervisors, which undermine proper risk management at the individual bank level. I take your point about banks being part of the solution to this crisis. But while governments and private banks both contribute to and benefit from broad economic well-being, both agents play different roles. Their fundamental motivations are different and they should not be confused.

When all's said and done, as this dialogue has shown, where lines of accountability and responsibility end up being drawn is ultimately a matter of opinion. And as in most economic and financial matters, this is political.

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