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Scope Insights – The ECB's latest bank lending survey[1] revealed that euro area (EA) banks continued to tighten credit standards in Q3 for business loans, mortgages and consumer loans. Possibly not by coincidence, the same day as the survey was published, an opinion piece by Andrea Enria, Chair of the ECB's Supervisiory Board, called for the establishment of a pan-EU public asset management company as an effective solution for managing bank NPLs.

- **Concept of an AMC is timely and makes a lot of sense**
- **To overcome hurdles, NPL acceptance should follow three key eligibility criteria**

Euro area (EA) banks continued to tighten credit standards in Q3 for business loans, mortgages and consumer loans, the ECB's latest bank lending survey revealed. Except for mortgages, new loan demand declined. A declining trend is expected for Q4 as well, for mortgages too.

This clearly shows that faced with the mounting uncertainties of the health and economic crisis, banks are adopting an increasingly cautious risk outlook (both macro and borrower-specific).

From a prudential risk angle, bank caution is understandable. But from the angle of loan growth to support struggling businesses and households and to spur economic rebuilding, less so.

Possibly not by coincidence, the same day the ECB survey was published, an opinion piece in the Financial Times authored by Andrea Enria, Chair of the ECB's Supervisory Board [2], openly called for the establishment of a new pan-EU public asset management company (AMC) as an effective solution for managing bank NPLs.

Or, as an alternative, a network of national AMCs which could support a symmetric recovery of EU economies. In both cases, funding should be provided or guaranteed by a European body, benefiting from the EU's credit standing. And transfer prices should be uniformly based on standardised and verified valuation methodologies.

[1] https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr201027~da272988b3.en.html

[2] https://www.bankingsupervision.europa.eu/press/interviews/date/2020/html/ssm.in201027~31fda4bb8e.en.html

Several months ago, ***The Wide Angle*** highlighted the pros and cons of a pan-EA public bad bank for NPLs[3]. This report updates and builds on the earlier views, as the odds of an AMC being created are shortening; just about.

From the vantage point of observing close to three decades of European bank asset-quality dramas, the concept of an AMC handling NPLs is timely and makes a lot of sense. Its implementation would boost market confidence in the European banking sector because investors' main concerns at present relate to the outlook for asset quality. Fully understandable, as the experience of the difficult post-crisis decade has amplified market fears for the pandemic age.

Despite obstacles…

The European Commission (EC) has expressed reservations in the past about a public AMC for NPLs, related to State-aid concerns. However, the same conditions the EC accepted when it approved national bad bank schemes, or bank-specific public rescues, could be transposed to a pan-European initiative. Like existing national schemes, the pan-European AMC should not itself be the ultimate end-investor. Through one route or another, discounted NPL exposures would need to ultimately end up in the market.

As well, any losses should be borne by the lending banks (or by the respective banks' national schemes, if in place). Not by the European AMC itself, by its financing or debt-guaranteeing body, or, by extension, by European taxpayers.

Differences in insolvency regimes across Europe represent a major stumbling block to a pan-European AMC. Some compromises will need to be agreed on how to deal with such differences, as harmonising insolvency laws across the EU is not an easily achievable goal. But where there is a (political) will, there is a way. The new-found EU solidarity in support of financing Europe's economic recovery and growth could be a factor in favour.

A big caveat is that the political will is not that evident at all levels. Some national supervisory authorities, even those that are part of the Single Supervisory Mechanism (SSM), may not be overly inclined to cede control of their banks beyond what had been agreed when the Banking Union was established seven years ago.

…An AMC could work this time

In the past, banks' asset-quality problems have generally emerged either from lending segments where previously built bubbles have burst – such as commercial real estate – or from bank-specific reckless risk-taking. Banks caught with massive asset-quality problems had to go through substantial hikes in provisions, painful recapitalisations, divestitures and restructurings.

This time, however, asset-quality problems, should they develop in the coming quarters, would stem less from the banks' own mistakes or reckless lending but rather from the impact of the pandemic on businesses and household finances. This makes this economic crisis quite different from previous ones, justifying a new, proactive and more co-ordinated approach to dealing with problems with banks' loan portfolios.

Recognising the gravity of the pandemic crisis, European governments and central banks have been providing unprecedented support to their economies. Banks, which are not the culprits of the crisis, need to play a central role in supporting economic recovery and growth. Supervisory authorities have taken steps to ease their task, such as encouraging a more liberal use of capital

3 https://www.scoperatings.com/ScopeRatingsApi/api/downloadstudy?id=7bfc6771-7509-4ec8-a47e-117171768192

and liquidity buffers, delaying IFRS 9 for provisioning, as well favouring smoother NPL recognition. In the same vein, establishing an AMC for NPLs would fit well in the overall regulatory plan to address the economic shock caused by the pandemic.

Unlike previous crises, the pandemic's impact on the economy is not limited to a specific set of countries, such as countries in the euro area periphery after the GFC. Italy and Spain are in trouble, but so are France, Benelux, Austria, and Germany. A pan-EA AMC would not help only Italian or Spanish banks, should their NPL books grow, but banks in the other countries as well. This may be a reason why negative sentiment in countries like Germany, Austria, Netherlands, or France could be marginally less material to such a European AMC.

Three conditions to make an AMC more palatable

There are likely to be some serious obstacles to establishing a pan-European AMC. To increase its chances of success, there should be three key eligibility criteria.

First, limiting the AMC to the EA would make its acceptance easier. Some national authorities within the SSM would certainly have diverging views, and compromises may be necessary. But the headwinds would be much stronger if non-EA members of the EU were candidates. In any case, Nordic banks fare comparatively better on asset-quality indicators, so their authorities may be reluctant to join. The SSM itself would probably be wary of certain CEE banking systems joining the AMC.

Second, were an AMC to be established, it should only accept bank NPLs resulting from pandemic-related situations in the EA 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 and rationale of the loan. 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 recovery. Adding an ESG factor to NPL eligibility for the AMC could enhance the prophylactic effect.\

Third, the EUR 500bn in NPLs still in the system from the last crisis should not be eligible for AMC consideration. Their resolution – e.g. legacy NPLs in Italy or Greece – should follow the existing course of action, via national schemes and securitisations, to avoid mixing them up with the newer cohorts of pandemic-related troubled credits. Again, such a course of action may make the acceptance of a pan-EA AMC more palatable to national governments and banking authorities.

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