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Towards an innovative European solution to bad loans

According to the vulnerability analysis published by the ECB[1] on July 28, 2020, the banking sector will be sufficiently resilient to resist the coronavirus crisis. However, the analysis of the ECB also found that lending growth will be instrumental in the recovery[2], estimating that a broad deployment of bank's buffers and supervisory flexibility could bring as much as an additional 3% GDP growth by 2022.

It is thus essential to ensure that loan deterioration does not hamper growth. To this end, the legislative work on NPLs carried out before the crisis must continue. Moreover, avoiding the impact on the deteriorating loan book (partly inherited from the financial crisis) on growth requires, as Andrea Enria (head of the SSM, then at the EBA) has proposed since 2017[3], that we set up a European "bad bank" (technically, an Asset Management Company, AMC).

Is a bad bank a solution for the COVID bad loans?

The nature of the NPLs from the Covid crisis is such that a traditional AMC may not be fully appropriate. In the previous crisis, the fact that the bad loans had clearly identifiable collateral (real estate) made them easy to transfer and be managed by AMCs. More importantly, the relationship and information sharing between the bank and its client were not as valuable.

However, this crisis is different. Although many bad loans will be from large loans to corporates, a substantial share of the NPLs are likely to be small loans to SMEs with little collateral. Moreover "soft" information is key[4] in this context, and thus keeping the relationship between the bank and the SME is central to promote lending.

Nevertheless, it is clear a bad bank could bolster lending and help mitigate the economic downturn. An innovative solution is required. I would suggest we need to find solutions that preserve the existing banking relationship, such as the purchase of collateralized debt obligations by the AMC instead of individual loans, to foster the creation of NPL markets, of which some tranches would be left within the bank itself to ensure some skin in the game.

A European vs National solution

The idea of an "EU bad bank" is not currently viewed favorably by regulators and national politicians[5]. Instead, the current debate points towards the EU level replaced by efforts towards a "network" or "federation" of bad banks. Each Member State would establish their own AMC, but they all would follow common rules on matters such as governance or funding. There would be no risk sharing, yet the network could, it is argued, gain the economies of scale that are often key for bad banks.

This language of "coordination" is familiar to us from other European efforts. Before we had a Single Supervisor, many advocated for further coordination of national supervisors. With each new scandal (now Wirecard) there is always some call for "more coordination" between national regulators, rather than a European centralized action.

But the drawbacks are evident. Experience shows that enforcing common interpretation of European rules would be impossible. In matters such as asset transfer prices, which are the core driver of this kind of aid, it is hard to see Member States tying the hands of their own AMC.

Also, as the Wirecard example shows, we would face massive regulatory nationalism, where each regulator generally seeks to "wash their dirty laundry at home", and thus avoids, for far too long, uncovering information (such as low asset prices) that may shed negative light on national champions.

Finally, the widely different levels of available funding at each country would make for vastly different levels of recapitalization in different banks and thus lead to further fragmentation of the financial services market.

Thus, innovative AMC´s, if needed, should be set up at a European level. The European legislative framework (BRRD) already allows for the creation of EU-wide AMCs to be funded by the Single Resolution Fund. However, since the aid would be granted outside of resolution, we would need to leverage other sources of funding, such as the ESM, the EIB, or private funding at the pan-European level.

Following the BRRD, aid outside of resolution would be allowed through precautionary recapitalizations if it is not granted to offset losses that have already been incurred or are likely to be incurred. With the ECB's recent analysis potentially serving to draw these lines, we should prevent aid from compensating banks for pre-Covid toxic assets.

In sum, an innovative European AMC would be essential to maintain loan growth. The following months co-legislators at European level should focus on making it possible. ●

1. https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728~7df9502348.en.html
2. https://www.bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog200728~0bcbafb-8bc.en.html
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