EU DEBT

The Model Bad Bank

European institutions are thinking over how best to rid Europe's banks of their bad loans. Current thinking, guided by Germany, favors isolating debt in national bad banks. Spain's Sareb bank could be the perfect model.

Sandra Louven
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Has Madrid hit on a winning formula? Source: Fotolia

It’s an enormous figure, and one that haunts Europe’s economy. Around €920 billion ($987 billion) in bad loans are poisoning the balance sheets of Europe’s banks. That’s more than 7 percent of annual economic output in the European Union.

Banks in Greece, Cyprus, Portugal and Italy have accumulated the most problem loans, although the rest of the euro zone is also suffering. It’s no wonder that finance ministers and central bankers are desperately searching for a way to bring these risks, which are curbing overall economic growth, under control.

In March, Andrea Enria, head of the European Banking Authority, a watchdog, proposed a way out. He suggested that a European bad bank could be set up to collect, bundle and securitize non-performing loans (NPLs) and sell them on the capital market with a state guarantee. Any losses would be borne by the banks or countries from which the bad loans originated.

This leaves the banks to focus on the good stuff with new lending. Since the financial crisis in 2008, many financial firms have set up their own bad banks to wind down bad loans, as have some countries. Germany’s own banking association runs a private one.

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But Mr. Enria’s idea of a pan-European bad bank is controversial – above all for German officials who don’t want to be saddled with winding down loans that were made in countries on the periphery of the euro zone, such as Italy or Spain. German Finance Minister Wolfgang Schäuble would not be sad to see the back of Mr. Enria’s plan.

Instead, the Germans want EU members to keep winding down their bad loans separately, albeit with better co-ordination among them. Elke König, head of the European Resolution Authority and a former German banking regulator, thinks Europe should come up with one set of rules for how EU nations should do this, a sort of European framework that governs the establishment of national bad banks. Such a move would mean Germany would not have to contribute much to bailing out its spend-happy southern European neighbours, a political bugbear for the likes of Mr. Schäuble.

At their most recent meeting in Malta in February, EU finance ministers made it clear that nothing would come of the single European bad bank plans for the time being. They found the proposals too complex and felt that there was too much of a danger that the idea could ultimately lead to the communitization of risks.

“The idea has merit in principle, but in practice it would take a long time to get such a bad bank up and running,” said Jordi Gual, chairman of Spain’s CaixaBank. “I believe that we should use the tools that we already have in place to support the weak banks. NPLs are a legacy issue and as such we should look to use existing rules such as state-aid regulations.”

Instead, the European Union is thinking along German lines and wants to help the affected countries set up national bad banks, and is looking for a “European blueprint” for this.

Such a blueprint already exists: the Spanish bad bank Sareb has shown that it is possible to reduce bad loans. Lessons can be learned from the project’s successes, but also from the mistakes made. It’s no surprise that the managers of Sareb are in demand as business partners. Central bankers from Italy and Portugal have already requested meetings in Madrid.

While the Spanish model may not have fulfilled all ambitious expectations, it has performed its most important task of stabilizing the financial sector. The country’s banking industry is considered to have been turned around. This is due in large part, although not entirely, to Sareb.

The bad bank was founded in late 2012 and bought up property assets and loans from nine troubled savings banks, for a total of €50 billion. Cheap mortgage loans and a construction boom had driven up banks’ real estate holdings in Spain. When the bubble burst, the government had to rescue or wind up many institutions. The European Stability Mechanism, an intergovernmental organization created in 2012 to provide financial assistance to euro-zone countries in difficulties, supported Spain with a loan of €41 billion.
Sareb received a comparatively small sum from the government: about €2 billion. Private investors, mainly banks and insurance companies, contributed a further €3 billion. As private creditors provided 55 percent of the capital, the bad bank is not regarded as a state-owned bank and its liabilities are not included under Spain’s national debt. Sareb bought the savings’ banks portfolios at a price that was only about half of their original value. The banks had to write off the difference. The bad bank paid with its own bonds, which are guaranteed by the Spanish government.

Bad Banks

<table>
<thead>
<tr>
<th>Country</th>
<th>Non-performing Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>45.9 %</td>
</tr>
<tr>
<td>Cyprus</td>
<td>44.8 %</td>
</tr>
<tr>
<td>Portugal</td>
<td>19.5 %</td>
</tr>
<tr>
<td>Italy</td>
<td>15.3 %</td>
</tr>
<tr>
<td>Slovenia</td>
<td>14.4 %</td>
</tr>
<tr>
<td>Ireland</td>
<td>13.6 %</td>
</tr>
<tr>
<td>Spain</td>
<td>5.7 %</td>
</tr>
<tr>
<td>Austria</td>
<td>5.3 %</td>
</tr>
<tr>
<td>EU average</td>
<td>5.1 %</td>
</tr>
<tr>
<td>Malta</td>
<td>4.4 %</td>
</tr>
<tr>
<td>Slovakia</td>
<td>4.2 %</td>
</tr>
<tr>
<td>Germany</td>
<td>2.5 %</td>
</tr>
</tbody>
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Sareb’s task is to refurbish the properties if necessary and sell them on at the highest possible price. It has 15 years in which to do this, after which it should no longer be required. “Sareb alone didn’t rescue the Spanish financial system, but it helped,” said Manuel Romera from IE Business School in Madrid.

Alexander Lehmann from the think tank Bruegel has written that Sareb played a crucial role, as a central contact for investors, in creating a functioning market for non-performing assets. According to data from the consultancy KPMG, Spain has become the third most active market in Europe for the sale of loan portfolios.

Sareb has given three pieces of advice to the central bankers from Italy and Portugal who are making enquiries in Madrid. One is not to put all bad loans in a single bad bank. When Sareb was created, Spanish banks had €167 billion worth of bad loans on their books. However, it bought up only the portfolios of those institutions that had failed stress tests. Healthy banks such as Banco Santander had to deal with their problem securities alone.

Sareb had to begin operating virtually overnight due to pressure from the European Union. “There were four of us when we started – the whole bank could fit in a taxi,” a spokesperson joked. However, as Sareb also had to pay interest on its bonds from day one, it was under

Sources: Companies, EBA
significant pressure to achieve a return as quickly as possible. “It was hard, but it helped,” he said.

The second piece of advice is therefore: Don’t wait too long with a bad bank. The sooner it becomes active, the faster the market will calm down. However, the Sareb managers also admitted that they had made mistakes. They said that the price at which a bad bank buys inventories from banks is vital to success. “We bought at a high price,” Sareb admitted. “Today our assets are worth three billion less than we paid for them.” Consultancy Oliver Wyman set the price on the basis of stress tests conducted on the banks.

Sareb had to write off the loss of value from 2015 onwards. Losses were consequently so high that they ate up all of the bank’s capital. Sareb was therefore forced to convert even subordinated liabilities into capital. “We wouldn’t have been able to survive,” the bank said.

The European Union has also criticized the Spanish central bank’s rules for Sareb. It was concerned about Spain, as the Spanish state would be liable if the bank failed – and Sareb’s liabilities account for 4 percent of Spain’s economic output. Madrid therefore changed the rules at the end of 2016, so that bad debt charges will no longer be reflected in the income statement. Sareb will be able to continue operating, but has said that it will continue to record losses.

Sareb had originally expected to achieve a return of 15 percent and to pay it back to its creditors, together with the capital employed. The spokesperson admitted: “We probably won’t be able to repay all of the capital.”

However, experts do not see this as the failure of the model. “It’s not the task of a bad bank to generate profits. It should help to solve a problem – and that’s what Sareb has done,” said Manuel Romera from the business school in Madrid.

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