CENTRE FOR EUROPEAN POLICY STUDIES
ECMI
European Capital Markets Institute

Good banks, bad banks and the like

ECMI Commentary No. 21/11 February 2009

Karel Lannoo

In the same week that two leading Spanish banks announced a profit for 2008 of €14 billion, the three largest Belgian banks announced a loss that exceeds that figure. How was this possible? Both countries are part of the EU and the eurozone. Banks in both countries are thus subject to the same financial rules and the same monetary policy. The banks of both countries are (or were) internationally very active in EU and non-EU countries. And the comparison goes even further. The Spanish bank Santander was also involved in the takeover of ABN-AMRO, but it did not collapse as a result, while Fortis (and Royal Bank of Scotland almost) did.

Large differences thus remain in the risk management of European banks, and in the way bank regulation is implemented. The Spanish banks, certainly the two largest Santander and BBVA, are proud of their extreme conservatism and discipline in their risk management. In addition, they are largely classic banks, which are financed by client deposits that are invested in loans to enterprises and consumers. Hence they have not ventured into the large-scale market activities that have caused problems for many banks today.

With respect to bank supervision, although the basic rules are the same in the EU, member states can make use of national exceptions. In addition, every member state can impose stricter rules on local banks, on the condition that this does not impose a barrier to banks that are licensed in other member states.

The Spanish banking supervisor, the Banco de Espana, drew its lessons from the Spanish bank crisis of 1977 and imposed stricter capital requirements on local banks than what is the norm in the rest of Europe. In addition, in good years, the central bank requests banks to put aside more provisions for bad loans. In 2006, for example, a year of strong economic growth, the Spanish banks put aside five times (!) more in provisions than the British, Belgian or Dutch banks. In bad years, banks can take back a part of the provisions, which, in today's context of a rapidly cooling-down real estate market in Spain, is no luxury item.

The result is that the level of capitalisation of Spanish banks, which is own funds as a percentage of balance sheet total, is almost double that of the European average. Spanish banks had 7.2% own funds in 2007, as compared to 4.3% for the EU (or 3.5% for France, 2.6% for Germany, 4% for Belgium and 3.8% for the Netherlands). The stock market capitalisation of the above-mentioned Spanish banks stands even today far above those of most of their European counterparts.

Karel Lannoo is Chief Executive Office at the Centre for European Policy Studies in Brussels.
This commentary was previously published in *De Standaard*, 9 February 2009.

ECMI Commentaries provide short comments on ongoing developments affecting capital markets in Europe. ECMI researchers as well as external experts contribute to the series. The views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

Available for free downloading from theECMI website (http://www.eurocapitalmarkets.org and the CEPS website (http://www.ceps.eu) • © Karel Lannoo 2009

What does this mean in the current debate about 'bad banks' and the demand for more European oversight? We first need to re-define what a 'good bank' is, before talking about 'bad banks'. In this sense, the Spanish example can be very revealing, as banks in Spain are classic banks in their core activities – 'narrow banks'. Strict regulatory and supervisory standards should be set on these activities. Everything that falls outside these activities can be done, but can fail. Investment banking, asset management, etc., would be much less regulated, but completely separated from the traditional banking activities. To avoid domino-effects, strict anti-trust and competition policy rules should be imposed. The bad assets of banks, mostly securitised mortgage loans, should be brought into such entities – in the current circumstances with special protection towards the creditors, a form of Chapter 11 of the US bankruptcy code. The 'bad bank' idea, however attractive it may seem in theory, is almost impossible to implement in practice, as events over the last months have shown. Imagine the implications of national bad bank proposals for free competition in the EU. And imagine what conclusions would be drawn by a horse-trade exercise in defining and pricing bad assets at the EU level.

The Spanish example is also relevant for the debate about a more European structure for financial oversight, in the sense that this country, and possibly others, will be less eager to delegate certain responsibilities. If Spain had followed the basic norms of European regulation and supervision, its banks would have been in trouble today as well. More integrated European oversight, if it happens, will need to be elaborated very carefully and accurately. This means a watertight structure, an accountable management and a clear division of responsibilities. It is, however, certainly not impossible, as it succeeded for monetary policy with the European central bank.