“Bad Banks”: International experiences and the Spanish case

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A viable bad bank solution for the Spanish financial sector requires a more precise definition of its terms and structure.

The banking sector recapitalization and the likely creation of a bad bank are necessary conditions for economic recovery. A viable and effective bad bank should maintain and promote activity in the real estate sector. International evidence shows that many countries have adopted bad banks to find solutions for different types of banking crises. In Spain, the main obstacles to the creation of a bad bank at previous stages of the restructuring process have recently been removed. The approval of new regulation increases transparency and forces institutions to make larger provisions on repossessed assets. However, a more precise definition of some key elements, including capital structure, type of assets to be transferred, value of the assets and management incentives, among others, are still missing.

Introduction: The rationale for creating bad banks

Five years after the onset of the deepest global crisis witnessed within the last eighty years, many countries are still looking for solutions to manage one of the main problems of this crisis: the existence of a significant amount of “toxic assets” in the banking sector. Even though the factors underlying the real estate bubbles in the US, Ireland, the UK and Spain were significantly different, and the analysis of each country’s situation requires the introduction of idiosyncratic factors, the accumulation of unsold housing, unfinished real estate constructions and unaffordable household mortgage loans, are common factor in all of these economies.

The backlog created in the real estate market becomes even more important when analyzing the large spillover effect that this sector has on the economy and the financial sector. In all these countries, but probably to a greater degree in Spain and Ireland, the relation between housing finance and the banking sector became closer and closer as the boom period progressed. The bancarization of these economies, the rapid indebtedness of households and developers funded exclusively by banks, and the increasing reliance of these banks on wholesale funding, help us to explain and understand the magnitude and evolution of these examples. In Spain, the picture in December 2008 reflected this situation.

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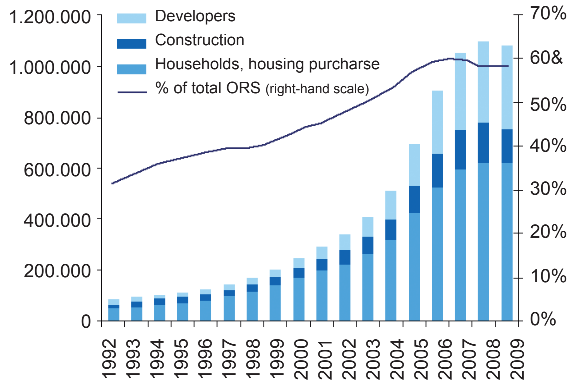
Exhibit 1

Breakdown of Spanish Banks' Loan Portfolio

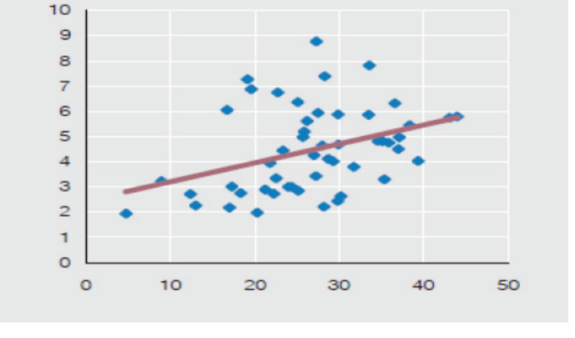
in million euros



Source: AFI and Bank of Spain.

Exhibit 2

Relationship between share of construction and developer loans in the portfolio (%, x axis) and Non-Performing Loans (%, Y axis), June 2009



Source: Bank of Spain.

When the bubble exploded, banks' balance sheets were full of real estate and mortgage assets, representing between 20% and 30% of the Spanish loan portfolio[2].

[2] For a detail analysis of the Spanish real estate bubble, causes and consequences, see Berges and García Mora (2008) and García Mora (2010).

As the business cycle deteriorated, home transactions started to decline and the default rate of developers that were unable to pay back their loans increased significantly. Besides this direct impact, the economic deterioration lead to a large increase in unemployment, with a special negative impact on those households with a higher proportion of their income dedicated to debt service. As a consequence, by December 2011, 20% of the assets held by the banking sector were either non-performing loans or repossessions (Berges 2012).

The different definition of toxic assets played an important role in the schemes implemented in these countries.

While in some economies (e.g. the US) the exposure to the real estate and mortgage sector was essentially based on investments in mortgage-backed securities and other structured products with underlying real estate exposure, in the Spanish case, it was direct exposure to mortgages and developers' credit. The different definition of toxic assets played an important role in the schemes implemented in these countries. Underlying all the solutions there was a common understanding that these economies needed to recognize prospective high losses on developer and mortgage loans. However, whereas in those countries with "market valued toxic assets", the impact was immediate and transparent, in countries with a higher credit exposure (accounted at "book value"), the recognition of a substantial price decline would require more time. As a consequence, although the final objective was to allow a quick restructuring of the financial institutions to facilitate the maintenance of the integrity of the payments system while allowing for resolution or bankruptcy schemes, this process has taken place with a very different timing.

The initiatives undertaken can be summarized in two types. Firstly, those specific solutions in which the "unhealthy" bank splits its business into a good and a bad bank; and secondly, the general solutions in which the government creates one big bad bank and many "unhealthy banks", transferring their "toxic assets" onto itself.

In both cases, one of the most popular solutions to deal with this problem was the creation of the so-called "bad bank" or Asset Management Agencies. The "bad bank" was envisaged as a way of cleaning up balance sheets, allowing banks to get rid of problematic assets and thereby becoming a "good bank". Although there have been many different schemes –depending on its size, the legal framework, the assets transferred, the capital structure, etc.-, and there are no two similar cases in the world, the initiatives undertaken can be summarized in two types. Firstly, those specific solutions in which the "unhealthy" bank splits its business into a good and a bad bank; and secondly, the general solutions in which the government creates one big bad bank and many "unhealthy banks", transferring their "toxic assets" onto itself[3] .

Bad banks can differ significantly depending on many different factors. As an example, there are at least seven aspects that should be considered:

- The number of contributors.
- The nature of asset transfer (mandatory or voluntary).
- The legal framework: Bank, SPV, Fund, etc.
- The type of assets to be transferred: mortgage loans, developer loans, repossessions, other assets and liabilities.
- The capital structure: Public vs. Private capital.
- The funding structure: Existence of Government guarantee Bonds.
- The pricing methodology underlying asset transfers: book vs. market value and discount applied.

International experience: Some recent examples

The creation of bad banks is not something new to this crisis. In recent history, there are many examples of countries adopting a "bad bank", trying to find solutions for different type of banking crises. From the ones implemented in the late eighties and early nineties in the US –as a result of the saving and loans crisis and the resolution trust, or in Germany –with the implementation of the "equalization claims" in East Germany, or the Swedish case in the mid-nineties. We will focus on six cases that have taken place recently.

One of the cases widely used during this crisis, as an example of a successful solution, has been the Swedish scheme established in 1995, which certainly minimized the public cost and the timing needed to hollow out toxic assets. However, there are exogenous factors that go beyond the framework adopted and that must be considered when judging its effectiveness. Indeed, in the late nineties, the world economy and the EMU lived one of the most dynamic and persistently positive business cycles of the last decades, with an important impact in the Swedish real estate and banking sectors. This situation clearly differs from

[3] An analytical theory of different bad bank schemes –an outright sale of toxic assets to a state-owned bad bank and a repurchase agreement between the bad bank and the initial bank- can be found in Hauck-Neyer-Vieten (2011). They conclude that although both schemes can reestablish stability and avoid a credit crunch, an outright sale will be less costly to taxpayers than a repurchase agreement only if the transfer payment is sufficiently low.

the current cycle and the huge spread between supply and effective demand for real estate. In the Swedish case, the government did not create a unique bad bank. Initially, every financial institution created, on a voluntary basis, its own AMS. Securum, which is probably the most famous one, was established by Nordbanken, with €8 billion of assets under management. Its capital structure was composed by 25% of equity injected by the Treasury, and funding from the central bank. The assets were transferred at book value. Since Nordbanken was a public bank, the valuation methodology –and the discussion over whether or not it should be based on book or market value- and the definition of the capital structure were not that relevant. However, years later Securum had to undertake other private initiatives, which was done only after the original shareholders had fully lost their investments.

The Irish model is probably the best example we have among the "unique and compulsory bad banks"[4]. The Government announced in April 2009 (passed into law by December of that year) the creation of an asset management company –NAMA (National Asset Management Agency)- to purchase large property loans at "long term economic value" (Honohan, 2012). This was done with a detailed valuation approach, so that time was needed for the scheme to be implemented. The government therefore decided to implement in a sequence of tranches, starting with the largest loans. The mechanism was easy: when purchases were made, losses would have to crystalize and recapitalization would be done. However, since it was done on a dynamic basis, initial estimations of valuation and capital needs underestimated final figures.

With the participation of six financial institutions, NAMA was created as an SPV (Special Purpose Vehicle), and therefore not subject to banking regulation. It was launched with an initial capital of 100 million euros (49% public) and a 40 times leverage ratio. NAMA acquired the toxic assets of those six banks with a 77 billion euros book value at a "Long Term Economic Value" which was equivalent to a 30% discount with respect to the book value. The banking sector received as a result public debt that could be discounted at the ECB to get liquidity, and the Irish Treasury had to inject the shortage of equity banks had as a result of the write offs and the capital needs generated by the discounts applied.

The German model was also based on the creation of an SPV, but in this case each bank could, on a voluntary basis, establish and create its own Asset Management Vehicle (AMV). The toxic assets were transferred to the SPV with a 10% discount over book value that was used to cover administrative and management costs. In exchange, the banks got SPV bonds guaranteed by the State Fund for the Stabilization of the Markets ("Finanz markt stabilisierungs fonds"). Even though initially this solution could have been interpreted as too beneficial for the original banks, the banks had to compensate the SPV on a yearly basis for the difference between the transfer value and the fundamental value divided by the number of years with guarantee (settled as 20 years). Additionally, if this compensation was not enough to cover potential losses, original banks had to cover with a cap defined by the dividend they were planning to distribute. Therefore, the German case minimized transfers from public to private sectors. The key factor of the model was based on the accounting methodology used and the deferring of potential losses without an initial write off.

Finally, the United Kingdom on October 2010 created a unique aggregated holding company (also SPV) named Asset Resolution Limited (UKAR) to bring together the Government-owned businesses of Bradford & Bingley plc (B&B) and Northern Rock (Asset Management) plc (NRAM), with 72,2 billion pounds of loans. The British case is clearly a different one, since it is not a scheme open to financial institutions with potential problems. UKAR serves as a holding institution for

[4] See Honohan (2012) for a deep review of the recapitalization of failed Banks in Ireland.

toxic assets only when a resolution and liquidation process takes place

Among the idiosyncratic and specific solutions, ING obtained the support of the public sector to guarantee its portfolio of toxic assets coming from US mortgage investments. The model used was a hybrid between the Irish and the German described above. The volume of toxic assets (30 billion euros) was transferred to an SPV at a 10% discount. The Dutch Treasury absorbed 80% of the potential losses generated by the SPV, whereas ING supported the other 20%. In exchange, ING paid the Treasury an ex-ante defined fee for the guarantee obtained.

The UBS case was very similar to the ING case described above, but with a different protection scheme. UBS had 60 billion swiss francs in toxic assets (also coming from “subprime” exposure) that were transferred at book value to an SPV created with 6 billion euros of capital and 54 billion swiss francs in funding from the Central Bank.

A hybrid scheme was created for Citigroup. It was divided into a good (bank Citicorp) and a bad bank (Citi Holdings). This structure was probably done with the final objective of splitting the management in order to increase transparency, rather than for risk management and capital deconsolidation purposes. In fact, the volume of toxic assets transferred to Citi Holdings (300 billion dollars) was backed by 50 billion dollars of equity, out of which Citigroup had a 90% share and the US Treasury and the FDIC the other 10%. The funding was provided by the Federal Reserve. First losses would be absorbed by Citi up to the total equity they injected. And only when Citi would have lost their total share, additional losses would be absorbed 10% by Citi and 90% by the Public sector. Therefore, this case was a combination of the Swiss model -“full first loss”- and the Dutch model -“partial second loss”.

The Spanish case:

Why now and not before?

There are several reasons that explain why a bad bank was difficult to create in Spain during previous stages of the restructuring process. Basically they are linked to the low amount of impairments recognized in real estate assets. This situation made it very difficult to transfer these assets at market prices to the bad bank. The only way to do this would have been with a significant initial recognition of losses by the banks. Therefore, either the bad bank would have been non-viable –in case assets would have been transferred at prices higher than market value- or the banks would have been non-viable if the transfer would have been done at market prices.

Facing this dilemma, the strategy adopted to close this gap was based on a radical change of regulation affecting provisions on real estate assets, which had two basic milestones: in 2010 and in 2012. The aim of this new regulation was two-fold: to generate more transparency by identifying the exposure to real estate risk, and to force larger provisions on repossessed assets.

In the initial stages of the financial crisis, repossession of real estate guarantees was subject to a fairly loose regulation, at least not adapted to the extension and depth of the crisis. By then, when banks executed guarantees, they had to recognize the real estate assets repossessed at the lowest value of debt outstanding, net of provisions, or the appraisal value of the asset.

This led to an under-recognition of losses, since many repossessions were made at a very early stage, and in some cases structured as a purchase of the asset through a “dación en pago” –dation pro solution, which basically is based on a process in which the debt is cancelled through transferring the property of the asset, which acts as a guarantee. Since provisions for repossessed assets were assumed to be implicit in the impairments recognized on loans, and the regulation didn’t expressly mentioned the "purchase" or "dation" as repossession alternatives, the level of provisions on these assets was very low.

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Recent regulatory initiatives

The solution to this problem was address through with a change in the accounting rules for banks at the end of 2010, by introducing new provisioning requirements for all assets received to cancel loans, regardless of the legal form they had. As a consequence, the new regulation required banks to hold a minimum provision when receiving the assets of 10% of the original debt, and an additional 10% each of the two following years, to a maximum of 30% provision –when those assets were retained on balance more than 24 months.

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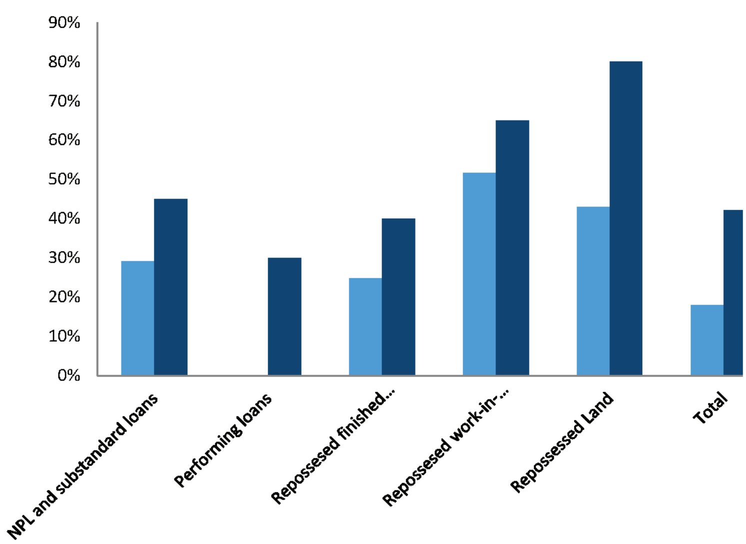
However, given the conditions and prices in the real estate market and the expected returns of potential investors, these valuation rules resulted in an accumulation of assets on banks' balance sheets. By that time, any sale done at "market prices" would have led to the recognition of losses definitely greater than the 10%-20%-30% provisions booked.

Probably only some big banks were able to recognize additional impairments to adjust

Exhibit 3

% of provisions on RE assets



Source: A.F.I.

sale prices and reduce the stock of assets, as a consequence of their healthy organic profit generation. But the majority of the financial sector was focused on the restructuring process, mergers and recapitalization, and not articulating the best strategy to reduce the volume of reposed assets.

Under these conditions, in February 2012 the new government required additional provisions for exposure to real estate: both assets and loans. The objective was to focus the new strategy on “problematic assets”, including under this category repossessed assets, non-performing loans and the so-called “substandard” category (those performing loans defined as under surveillance by the supervisor). The level of provisions was set based on the asset type underlying the loans. With some guarantees, –i.e. land- provisions in P&L were reinforced by an additional requirement based on a capital add-ons or buffers. At the same time, the new regulation required banks to segregate repossessed assets into an asset management company before the end of 2012.

The market soon reacted identifying that the provisions could be adequate for “problematic assets” but “normal” assets still had a very low provisioning level –set at 7% in the February regulation. This situation led to a second regulatory change in just four months, which set an average 30% provision for performing loans linked to real estate activity. Even though this percentage differed according to the type of collateral used –land, work-in-progress, finished houses.

The new requirements in provisions defined by the regulatory changes done in February and May had to be fulfilled by the end of 2012, with every bank required to present a mandatory plan, including timeframe, to the supervisor.

At this point in time, June 2012, the net valuation of the assets and loans related to the real estate sector was assumed to be –or would be at end of the year— close to its market value. This situation made easier the constitution of a bad bank, as the transfer would not generate additional losses.

Finally, the process accelerated with the negotiation of the “Banking sector financial aid” received from the European Union to recapitalise the banking sector. The conditions established in the Memorandum of Understanding signed by the Spanish government -articles 21 and 22- set the requirements regarding the management of real estate toxic assets for those banks receiving public support. In fact, they were forced to segregate the real estate problematic assets and transfer them to an asset management company.

Pending topics

The MoU was transposed to Spanish law by another Real-Decree approved at the end of August. Although the details of the Spanish Bad Bank were supposed to be defined in this new regulatory initiative, this was not the case. This law established some general issues, but there are still many substantial topics pending regarding the definition and structure of the “bad bank”.

The new regulation established that only banks receiving public support would have to transfer their problematic assets to a single asset management company (AMC) –the “Bad Bank”-, in which the State (through the FROB) will have at most a 49% equity share. The rest of the banking sector will have to transfer their repossessed assets to their own AMC, according to the Real-Decree approved in May.

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Here emerges one important question, which is “Which” banks will be required to make the transfer. As defined in RDL 24/2012, both banks that actually have public support as well as others which could need it under a restructuring or resolution process are forced to transfer assets to the AMC.

A second question could be related to “What” kind of assets are they going to transfer. Since the type of assets to be transferred has a very vague definition, it could include repossessed assets, real estate loans, equity holdings in real estate sector companies, or even other “problematic” assets from other sectors. The scope and volume of assets segregated will take into account the viability of the institution after segregation and also the loss-absorption capacity of capital and other hybrid instruments to impair assets prior to the transfer to the AMC. It is assumed that the scope of segregation will be broader for more problematic banks. By this, the supervisor would avoid further provisioning (and recapitalisation) in the future as a consequence of an even worse business cycle, and therefore a higher NPL ratio that could question the viability of the institution.

Thirdly, what would be the value of the assets to be transferred?. As happened with other international experiences, in the Spanish case, the valuation of assets and loans to be transferred to the AMC will be established after a detailed stress-test exercise by independent experts is done. In the regulation there is only a vague reference to a “long-term economic value”, which tries to overcome current market conditions that could force prices down. The viability of the bad bank would require valuations similar to the market conditions these assets would have to face when sold. However, here arises another controversial situation, since the lower the initial value, the higher the impairment losses that would have to be recognized by banks, and the greater the recapitalization needs. The only way to avoid further losses or recapitalization needs in the future would be to apply conservative haircuts in the valuation process. This discount could be even larger than the provision levels reached by the regulatory changes explained before, in order to generate some “buffer” on the AMC to face potential losses on sales and operating expenses.

The lower the initial value, the higher the impairment losses that would have to be recognized by banks, and the greater the recapitalization needs.

Fourthly, the capital structure would be crucial in order to analyse the strategy this vehicle is going to follow. Even though the Public sector (through the FROB) will have less than 50% of the equity, there are many questions regarding who will invest in the AMC and, more relevant, at what price and with what kind of conditions. Besides, the funding structure, according to the MoU, will be probably based on government guaranteed bonds, which could be discounted at the ECB.

Finally, management of the AMC is key to its success. A clear incentive and governance mechanism must ensure that there is an active and segmented management on all types of assets. Together with this, a global strategic plan should be defined identifying the objective and strategy the AMC is going to follow for every type of asset, accompanied with a clear schedule.

The creation of a “band bank” and the recapitalization of the banking sector is a necessary condition for the economic recovery. However, for that to happen and make the bad bank viable, it should have as one of its objectives to maintain and promote some activity in the real estate sector. Otherwise, further deterioration of debtors could increase significantly, with the subsequent losses increasing debt restructuring, additional financing and other measures will be helpful to avoid the need for additional impairments and that will require establishment of clear goals and incentive schemes for all the economic agents involved in the process.

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