Strategies for Managing Banks' Legacy Assets: part 1 (of 2) context, setting the scene, Spain 2012

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Part 1 of 2-part series

Setting the 2012 scene for legacy asset management

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Abstract
This two-part working paper series represents a distillation of practical approaches with regard to the successful management of so-called "legacy assets" which include both impaired as well as non-performing loans, particularly in those in the real estate and property sectors. This two-part set uses case examples, based on developments in Spain during 2012 with the eventual foundation of SAREB, drawing on national, other European and North American experiences as well as expert practices. The set should be considered in their entirety. **Part 1 outlines the context in Spain in 2012 during the height of the credit-sovereign crisis.** Part 2 provides an assessment of the strategies, implementation issues and decisions that led to the eventual establishment of SAREB.

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1.1 Introduction

The proper management of impaired assets as well as resolution of the related problematic loans and assets is amongst the most critical and complex tasks of successful bank restructuring. If several banks are involved a national approach should be considered.

In 2012 the need to resolve the very large burden of legacy portfolios, which are at the heart of Spain's continuing financial crisis, was acute. This situation had led the Banco de España (BdE) to engage support from expert institutions from amongst other central banks (such as Sweden's Riksbanken) as well as expert practitioners (eg BlackRock, ERC, Oliver Wyman).

The basis for bank stabilization and asset resolution strategies require an integrated and pragmatic approach from the central authorities guiding individual banks within an overall central, appropriately funded programme.

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This two-part working paper set draws on several sources. Primarily, it taps the experiences of expert practitioners with regard to establishing successfully resolution approaches across Europe. As such it captures better practices with regard to bank stabilization and asset resolution from over 35 national bank restructurings, bad banks and related agencies in addition to academic and expert literature. This working paper takes into account the realities of the Spanish market in 2012. It builds upon the discussions with BdE; the Fund for Orderly Restructuring of the Banking sector (FROB); industry associations (such as the Confederation of Spanish Savings Banks - CECA); individual banks and market participants operating in Spain that eventually led to the foundation of the Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (SAREB).

1.2 Summary

In Spring 2012 the single most important issue facing the Spanish banking market was the bid/ask price gap that affected the non-performing loan market. This situation was acute for property and real estate related exposures as well as repossessed assets. Half-hearted attempts at industry consolidation, questionable M&A activities and an unwillingness to Until that point, the Regulator and the Spanish authorities had resisted taking a proactive and directed approach as suggested by other experienced central banks and experts.

The suggested approach was based on the (bad) bank resolution schemes successfully deployed in the Nordic markets over the last thirty years; in particular Securum (1992) and Swedbank's Baltic initiative (2009) as well as experiences for Ireland and the US, amongst others. The suggested approach had two components:

1. Encouraging individual banks to pursue a full set of asset resolution strategies while;
2. Establishing a central financing agency (if not asset management company) as an overall strategic umbrella to break the vicious cycle of financing to bridge this price gap and facilitate resolutions.

This perspective along with the challenges for the banking sector in Spain are discussed in the remaining sections of this working paper (1.3 – 1.6) in terms of the implications to the legacy portfolios and transaction dynamics; while Part 2 of this working paper set expands on the strategic options and implementation requirements.

1.3 Context in Spring 2012

In Spring 2012 the Spanish banking system had become encumbered, a situation exacerbated by the questionable and delaying actions taken by the central authorities. Up until 2012, the Spanish authorities had taken a 'wait & see' approach, which empirically and historically has not proven to be beneficial in precedent and historical cases.

Spain has always prided itself on the independence and professionalism of BdE and its inspectors. However, an overheating economy, particularly in the construction sector and local government, fuelled in part by the adoption of the Euro and less than stringent lending policies by individual banks particularly amongst the cajas as well as generous oversight, meant that the banking system became imperiled. The causes for this acquiescence are well documented elsewhere but included: political forces within BdE; questionable supervision practices; unhealthy relationships between the banks and their owners, government agencies, questionable credit-worthiness of individual borrowers and religious organizations as well as pride.

Furthermore, Since 2009, several rounds of capital injections and bank mergers, organized by the Spanish authorities, had reduced the immediate risk of a system wide collapse of the Spanish financial sector; yet at significant costs and without addressing the root cause. For example the: disposal of CAM for €1.0; inability to resolve NovoCaixaGallicia as well as; the failure of Bankia (a sort of 'emperor without clothes') caused consternation and criticism - domestically and abroad.

By 2012, a one-off provisioning exercise and capital add-on rules generated an additional €50 billion (bn) impact to the banks' tier 1 capital with regard to the €320bn identified legacy asset base. The ultimate proof as to the appropriateness of this provisioning level result would have been the ability of Spanish banks to sell their legacy assets to outside investors in open market transactions. Yet, these transactions did not occur, as hoped for; and as the authorities had been warned by foreign experts.

Despite healthy interest, investors remained concerned that more losses were embedded in the real estate portfolios (even at their then current depressed levels). Also defaults rates across all asset classes (e.g., in the retail and SME portfolios) were higher than expected; which destabilised the banks further. Against this backdrop of pervasive uncertainty, only a few small-sized mortgage loan transactions had been completed; as the bid/ask pricing gap remained too wide. Market participants mainly attributed this low transaction volume to price discrepancies between the banks' expectations (driven by 'book value') and investors' high return requirements (driven by IRRs): both academically questionable metrics in such circumstances. The dynamic is such that while banks were interested in offloading land plots and unfinished developments, investors were most interested in cash-flow generating situations.

Investor pricing power was not helped by a number of other important and limiting factors. The continuing decline in property prices continued to fuel uncertainty and hence higher Internal Rate of Return (IRR) requirements. The lack of financial leverage, apart from vendor financing, remained an impediment. The servicer market remained under-developed. Additionally, the compilation of data-tapes and formation of data-rooms by the originating banks remained a challenge for a variety of reasons (e.g., antiquated systems; ineffectual processes; compounded by the effects of the recent merger wave resulted in a variety of IT systems and file structures that were not easily managed). Also important was the effects of an overworked Spanish enforcement system. All these factors contributed to investors having to model (from opaque sources) longer cash-flow recovery periods; thus depressing prices offered and their confidence in the value of legacy assets.

Such a dislocated non-performing loan (NPL) market had the effect of stalling the Spanish banking system altogether. It had reached a point in 2012 of curbing new lending, limiting earnings, eroding capital bases, and ultimately calling into question the banks' as well as sovereign solvency. These factors had a corrosive effect on: consumer/voter confidence; as well as economic activity and in the political arena.

Given precedent situations and circumstances elsewhere, the Regulator was advised to pursue strategies that are conducive to restoring the conditions of a functioning NPL market. If successful (as has been in well managed precedent examples elsewhere – i.e., Sweden, US), these strategies would trigger an overall resolution process for the whole Spanish banking sector; as fresh capital would enter the market and as a result legacy assets would finally be removed from balance sheets.

International examples of the management of banking crises suggest that pursuing asset resolution is most successful after bank stabilization has successfully crystallized the losses. [This perspective is the subject of Part 2 of the Working Paper set]. However, if bank stabilization allowed the banks to "sweat out" losses over a longer time horizon, then the asset resolution process would likely fail; extending the economic recovery process. Hence the need for some form of "bad" or "bridge" bank to manage the process and transition.

In bank stabilization the usual (time and tested) strategic approaches are:
- asset protection schemes (APS),
- internal restructuring units (IRU),
- special purpose vehicles (SPVs) and
- asset management companies (AMCs).

Within these approaches the scope of asset resolution strategies encompass: workout; straight sale; SPV sale and; AMC sale as the main alternatives. The information and due diligence requirements are relative standard across all the strategic alternatives.

With regard to deconsolidation/de-recognition, all these resolution structures are relatively straightforward; especially if no vendor financing is required and asset management is properly separated from the seller-bank's influence. However, in the absence of external debt financing (as was the case in the Spanish market in 2012) stronger structuring skills were required.

By 2012 many issues affecting the Spanish banking market, the 'price gap' remained the predominant one. [See Part 2 of this Working Paper set]. A catalyst was required to break the vicious cycle of: declining property prices leading to increase in provisions; the twin effects of higher investor risk premiums/absence of leverage leading to few transactions; as well as fuelling uncertainty and psychological 'fear' factors. International precedents demonstrate that state sponsored financing programmes, which provide leverage and equity participations, could be designed and successfully implemented to bridge that 'price gap'. The most notable examples are in the United States (e.g., Resolution Trust Corporation - RTC, Public-Private Investment Program: P-PIP) and Ireland (e.g., National Asset Management Agency - NAMA).

For Spain, as other markets which have suffered equivalent banking crises, a central financing agency (CFA) could be established to facilitate market transactions of the legacy assets (i.e., NPL portfolio sales to third-party investors) through the implementation of a standardized framework encompassing all aspects from asset eligibility and transparency standards to auction mechanism rules. This CFA should be independent. In Spain, a CFA could form part of an existing agency, such as FROB or the Deposit Guarantee Fund (DGF). State guarantees for 70 to 85% of the financing of the acquiring SPVs could be issued alongside 49% equity participation. The government's minority equity portion (and upside potential) being required to counter any subsidy arguments (i.e. higher leverage at low interest rates for investors, thus higher sales prices for banks vs. higher risk for the taxpayer) vis-à-vis the taxpayer and supranational authorities. Asset management would be carried out by a market-oriented servicing platform established by the majority private owner(s) and with appropriate (i.e. bank remote) corporate governance.

With regard to competition issues these would be addressed with the relevant authorities. Local policy issues could be satisfied by allocating budgets of participation rights to individual banks per annum. Recent international examples (such as in Germany, Ireland, and the US) provide relevant precedents. Such an agency would reduce the potential for debt and deficit impact as well as providing a cost- and time-effective resolution of the Spanish banking sector.

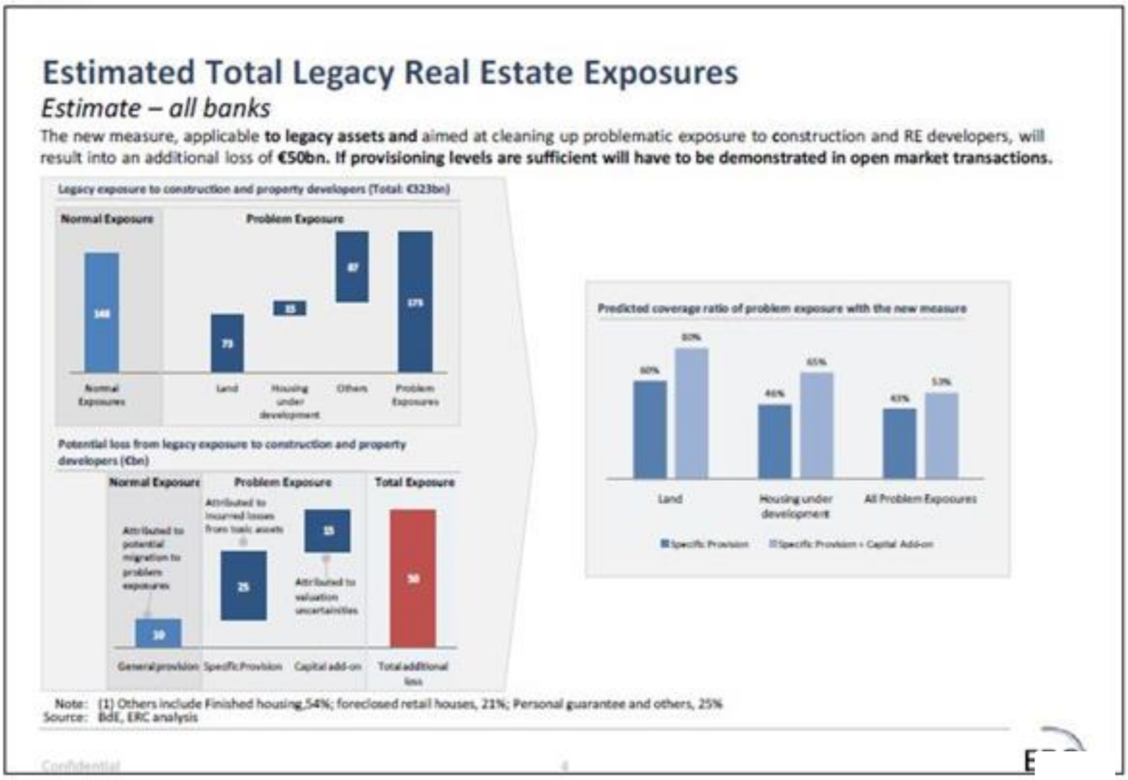
Timing is critical as a banking crisis intensifies, a central financing agency might not suffice and an asset management agency might be needed to speed up deconsolidation and resolution (potentially partly sponsored by the European Stabilization Mechanism and/or International Money Fund). Here, the merits of a centralized approach versus a decentralized one were considered and factored in to the original design and set-up of the agency. Given the Spanish context in 2012 a decentralized approach was more appropriate, where individual bank AMCs would be taken over by a central resolution agency as it would be better able to provide for a more comprehensive deconsolidation solution (i.e., including performing loans) and leave the banks with some upside potential through their respective minority equity stakes.

Eventually SAREB was formed, taking into account many of the aspects discussed at the time and encompassed in this working paper.

1.4 Legacy portfolio

After several rounds of capital injections and bank mergers during 2012, the immediate risk of a financial system collapse has been managed by BdE. In 2012 approximately €50bn additional tier 1 capital on the €320bn legacy asset base was absorbed (Exhibit 1).

Exhibit 1



The ultimate proof was if the new provisioning levels and capital add-on were sufficient to enable the ability of Spanish banks to sell their toxic assets in open market transactions. Although the new provisioning levels (including add-ons) introduced in late 2011 appeared steep after the recent initiatives, they needed to be seen in context. By end 2012 transaction levels remained low and by inference the provisioning levels were inappropriate.

In BdE's definition, repossessed properties are not part of the legacy portfolio; a definition that needed to be reconsidered as the underlying assets do not differ materially (land as collateral vs. land on banks' books). The 55% default rate on developer loans appears high, but not atypical compared to other markets. Default rates may well increase for other loan/asset classes (e.g., private mortgages, SME and corporate books) yet will most certainly not reach these mid-century levels (mid-teens to mid-twenties are realistic). Such additional pressure further reduced the banks' ability to incur additional losses through transactions.

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Provisioning levels and valuations always have an important impact on the resolution of the legacy portfolio. Property valuations are challenging in crisis environments. A few examples demonstrate the dynamic. In Spain at the end of 2011 there was a stock of approximately one million properties that remained unsold; yet property prices are still in decline. Thus, new developments will only make sense in the very best of locations. The following example exemplifies the situation.

- It is a reasonable assumption that the non-performing book of land and unfinished developments is concentrated in "B" and "C" locations as well as the "rest".
- These segments would contain mostly non-income producing situations (i.e., land, unrented, or partly rented commercial property and finished but unsold housing).
- A valuation of land in "B" and "C" locations is probably close to zero given a declining market with a time horizon of at least 5 years (depending on one's assumptions).
- This low valuation level is particularly true for non-income generating assets with no clear usage and no cash flow yet encumbered with maintenance costs, interest and tax commitments.
- There is a risk that even unfinished developments in "B" and "C" locations could have equally low valuations due to demolition and other related costs (under certain circumstances).
- If there was scope for redevelopment, speed to control would be critical factor for any investor (either by agreeing a deal with the borrower or through improvement through the judicial system to reduce the impact of a 2 to 4 year foreclosure process).
- Depending on one's assumptions for leverage, investors are more than likely to have IRR expectations ranging from the teens to the twenties. For example, an increase in leverage ratios at 5% interest rates would get prices up as the WACC would be reduced; but this dynamic would require significant appetite for risk and/or a long investment time horizon (e.g., a pension funds could be interested in a land bank in Spain).

In this dynamic there is a spectrum of investors with differing profiles, characteristics and return expectations. Any resolution strategy should seek to attract a full range of investors from across this spectrum (Exhibit 2).

Exhibit 2

Investors' Perspective

Investors	Examples of buyers	Investment thesis	Pros	Cons
Distressed debt investors / Hedge funds	• Apollo LLC • Cerberus • Anchorage • Avenue Capital	• Opportunistic investors, looking for distressed portfolio to be purchased at high discounts • Looking for attractive returns (30% and above)	• Already active in NPL portfolio markets • Acting with their own servicing partners, which won't require the help of the seller • Ability to deploy capital easily and purchase quickly	• Expect high return after costs of servicing loan portfolio, leaving limited upside for the sellers • Quick investment timeframe (2-3 years max.) • Could require unsecured vendor loans that will be left non performing at the end of investment timeframe
Loan servicing companies	• Local or international players (e.g. CB Richard Ellis Loan Servicing, Hatfield Philips)	• Recently, loan servicers have raised capital to invest in distressed loan portfolios that they usually manage on behalf of HFs and distressed investors	• Could be less demanding in terms of returns as they earn fees for managing the loans • Proven know-how	• Still expecting high returns on investments (20%+) • Quick investment timeframe (2-3 years max.) • Could require unsecured vendor loans that will be left non performing at the end of investment timeframe
Pension funds, insurance companies	• US asset managers (e.g. BlackRock) • Allianz, Axa • EM Sovereign funds (GIC, Qatar)	• Asset managers looking for safe investment and diversification of portfolios • New investment themes being investigated, including structured finance opportunities • Investments in NPL portfolio could be part of the exercise	• Lower returns required (8% to 15%) but guaranteed • Could invest both in debt or equity in SPVs or bad banks (e.g. investment in NAMA bonds) • Longer term amortisation possible	• See NPLs as risky assets, and never invested thus far • Would require for Spain to set up excellent servicing entities to attract such buyers, rather looking for safety than high returns • Guaranteed returns must be provided, limited de-risking for sellers
US & European Banks	• Santander • BNP Paribas • Wells Fargo	• Already managing their own NPL portfolio • Would likely consider aggregating NPLs from other banks, benefiting from synergies and economy of scales • Reluctant to sell their own portfolios so far, as would likely require 15-20% returns	• Economy of scales and synergies would lower required returns compared to HFs	• Still higher returns than institutional investors • Picky when selecting assets, as most banks announced they will deleverage their balance sheets over the coming 2 years

Source: ERC analysis

Confidential

This spectrum extends from hedge funds (with higher IRR expectation and shorter durations) as well as insurance companies, pension funds and even sovereign wealth funds (which may be willing to consider larger deals over a longer time period given their lower IRR limits). Banks at this stage of the cycle are a purely theoretical market participants.

Spain in 2012 was caught in such a predicament and unable to attract sufficient investors from any single source nor from across the spectrum – domestic or foreign.

1.5 Transaction history and dynamics

The transaction data in the Spanish market during the 2011-2012 period indicate that the focus of activity remains on deals in unsecured debt; with occasional small transactions on the secured lending side. These transactions tend to be straight sales, with some degree of direct or indirect vendor financing (Exhibit 3).

Exhibit 3

Transactions Precedents and Outlook

Spanish NPL market

27 NPL deals since January 2012, reaching €8.2bn

Date	Seller	Volume (€m)	Type of portfolio	Buyer
Apr-12	Confidential	305	Consumer	Confidential
Feb-12	Confidential	90	Mortgage	Confidential
Feb-12	Banca Cívica	846	Consumer	Confidential
Feb-12	Confidential	250	Mortgage	Confidential
Feb-12	Confidential	-	Servicing Platform	Confidential
Jan-12	Confidential	170	Mortgage	Confidential
Jan-12	Confidential	100	SMEs	Confidential
Jan-12	Confidential	240	SMEs	Confidential
Jan-12	Santander	150	Mortgage	Confidential
Jan-12	La Caixa	900	Consumer	Confidential
Dec-11	Confidential	450	Consumer	Confidential
Dec-11	Barclays	500	Secured / unsecured SMEs	Confidential
Aug-11	Santander	300	Consumer	Confidential
Aug-11	Confidential	760	Consumer	Confidential
Jul-11	Bankinter	150	SMEs	DE Shaw
Jul-11	BNP	500	Consumer	Confidential
Jun-11	Bankia	200	Performing consumer	Confidential
Jun-11	Barclays card	150	Consumer	Link Finanzas
Jun-11	Barclays Cap	100	Consumer	Confidential
May-11	Cajamar-Caja Sol	200	Mortgage	Cerberus
Apr-11	Santander	280	Mortgage and Corporate	Cerberus
Mar-11	RBS	280	Mortgage	P. Weinberg
Mar-11	MBNA	500	Performing consumer	Apollo
Mar-11	BBVA	500	Consumer	DE Shaw
Feb-11	Citigroup	600	Consumer	[illegible] Capital
Feb-11	Unnim	20	Mortgage	Aktua
Jan-11	Santander	550	Consumer + Servicing	Lindorff
Jan-11	Orange	280	Consumer	Confidential

Source: PwC

With €10bn more of announced or expected sales in 2011

Seller	Type of portfolio	Volume (€m)
Bank	Corporate	1 600
Bank	Secured SME:	250
Bank	Prime Secured SME	550
Bank	Secured residential	200
Bank	Unsecured	700
Bank	REOs residential	500
Bank	REOs comm.	400
Bank	Secured residential:	500
Bank	Unsecured individuals	500
Bank	Unsecured SMEs	500
Bank	Unsecured:	1 500
Bank	Secured	250
Saving Bank	Unsecured	1 000
Saving Bank	Secured	600
Saving Bank	REOs	550
Bank	Unsecured	550
Bank	Unsecured	600
Saving Bank	Unsecured	500
Saving Bank	Secured & REOs	200

- Limited amount and volume of transactions mostly resulting from the difference in pricing expectations between buyers and sellers
- To a certain extent, the impact of Bank of Spain's relaxation of provisioning requirements for certain secured loans in July 2009 allowed banks to postpone such NPL portfolio sales
- Given the overall deterioration of the Spanish economy and the rise in NPL stock over the last year, it seems unlikely the pricing gap will close any time soon

There were several dynamics at work in the Spanish market of 2012. In part banks were trying to compensate for losses in secured transactions with gains in unsecured ones. Also, the small transaction sizes were a reflection of difficulties with regard to data and file compilation. This situation is a by-product of historical practice, compounded by the effects of the recent merger waves which left dispersed as well as dysfunctional IT and branch systems. In addition, an underdeveloped servicer market and an overworked judicial system contributed to these difficulties. Yet the main obstacle for the many international investors keen to enter the Spanish NPL arena was the absence of leverage outside of direct or indirect vendor financing (i.e. providing finance to the acquirers of individual properties sold by the acquirer of the bank's portfolio).

From a regulatory perspective the prevailing practice of cross-financing of NPL transactions by Spanish banks is not a desirable solution as the risks are simply repackaged and mostly remain in the system (apart from the small investor equity portion).

1.6 Conclusion

The situation facing the banks in Spain, especially the cajas, as well as the Regulator have fundamentally been no different than any other modern economy undergoing similar economic distress in its banking sector.

The combination of: easy credit, lax oversight, inappropriate management, asymmetric interests and pride led to conscious decisions to ignore the situation for what is was. This reluctance resulted in actions, as well as inactions, that have compounded the negative effects and dynamic of this serious situation. Systemic failure was real risk, with implications reaching beyond Spain's national borders. This reluctance led to unnecessary costs, time delays and loss of credibility for institutions and individuals. The growing number and value of legacy assets attest to this development and its detrimental dynamic.

Well tested solutions were available and had been suggested yet consciously ignored by the Spanish authorities for reasons of self-interest and political expediency up until 2012. The inexorable momentum of developments, in addition to the advice and support provided by foreign experts and advisors, led to the adoption of some aspects of value-protecting actions. These strategies and their implementation are discussed in detail in Part 2 of this Working Paper series.

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About

Raktas

Raktas is a specialist firm that provides growth and restructuring solutions to build businesses as well as transform companies and financial institutions; usually with an implementation component. Services are directed at decision-makers that believe their organizations are facing complex situations and resource constrained.

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Justin Jenk is a business professional with extensive, practical experience from a successful career as a manager, advisor, investor and board member. He has an established track-record of delivering value-added solutions. He is a graduate of Oxford and Harvard.