Strategies for Managing Bank's Legacy Assets:part 2 (of 2) Assessment of strategies and their implementation

Jenk, Justin

Oxford, Harvard

February 2015

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Raktas Working Paper

Strategies for Managing Bank's Legacy Assets: an example from Spain 2012

Part 2 of 2-part series

Assessment of strategies and their implementation

Keywords: legacy assets, legacy asset management, non-performing loans, pricing, asset resolution, bank stabilization, bad bank, bank resolution, strategy, resolution strategy, competition, implementation, Spain, BDE, SAREB, US, Resolution Trust Corporation, TARP, Sweden, Securum, Swedbank, Ireland, NAMA, Germany, SoFFin, FMSA, IRR, decosolidation, derecognition, financing, purchase, Asset Protection Schemes, SPVs, Internal Restructuring Units, Asset Management Company, Workout, Valuation, Pricing, Central Financing, Asset Management

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 paper 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.**

Contents

2.1 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 has 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 (e.g., BlackRock, ERC, Raktas)

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.

This two-part working paper set draws on several sources. Primarily, it taps the experiences of 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).

2.2 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 Part 2 working paper (2.3 – 2.10) in terms of the implications to the legacy portfolios from possible resolution strategies and implementation considerations

2.3 Context in Spain 2012

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

2.4 Overview of main resolution strategies

In managing banking crises, international examples reveal that governments have tended to focus their approaches on a two-step process. In the first step, measures are taken to stabilize the banking system to avoid bank insolvencies. The second step is to follow strategies for asset resolution to cleanse the banks' balance sheets.

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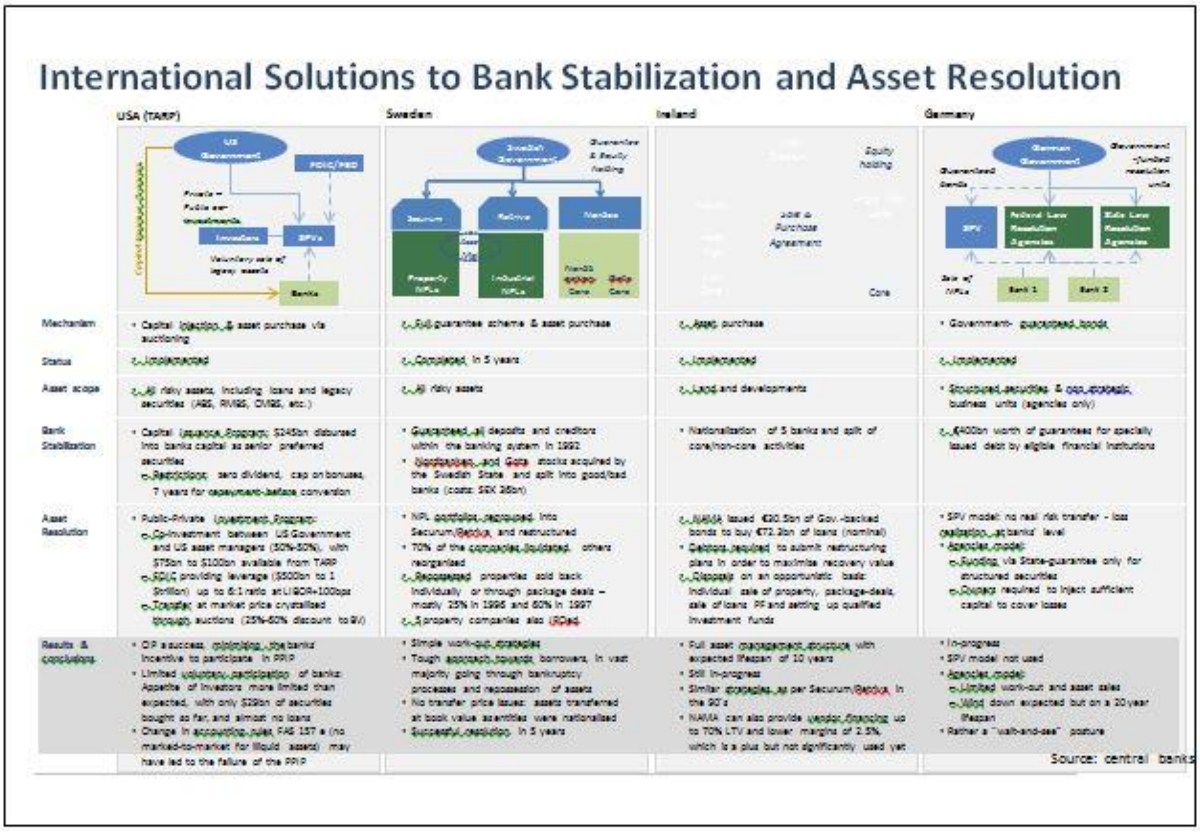
While there have been many bank stabilization/asset resolution approaches taken by governments during the last 50 years a sub-set of (better) precedent examples seemed more relevant given Spain's situation in 2012. These precedent examples include: the United States with the Resolution Trust Corporation, TARP, Public-Private Investment Program (P-PIP); Sweden with Securum/Retriva; Ireland with NAMA and; Germany with FMSA (Exhibit 4).

Exhibit 4: International solutions



These precedents examples are synthetically assessed below.

United States
The US authorities have proven to be the most adept at managing systemic banking crises. The US approaches (over the last four decades) are instructive given their focus on market-driven resolutions. Of particular relevance is the concept of participations pioneered by the RTC and used in TARP and its P- PIP.

The Resolution Trust Corporation's (RTC) was an asset management company established by the US authorities in 1989. It was an effective organizational and governance structure, giving it operational independence and staffed with skilled personnel. It resolved or closed 747 'thrifts' (saving banks) with total assets of $394 billion. It was funded by a special agency (REFCORP). RTC pioneered the concept of equity participations, allowing RTC to benefit from gains in the banks' portfolios through a series of structured products (i.e., MIFs, Mortgage Trusts, N-series, a Land Fund, etc.). RTC created funds composed of pools of legacy assets that were offered to investors. These funds were vendor financed (up to 75%).The RTC experience (and that of the earlier RDC, of the 1930s) have been utilized in the recent TARP programme.

The current Toxic Asset Relief Program (TARP) initially provided preferred capital injections and asset protection schemes to avoid a banking collapse. This was coupled with a relief on 'mark-to-market' accounting rules for illiquid assets. In a second step, in an attempt to help the banks to clean their balance sheets from the toxic assets, the Public-Private Investor Programme (P-PIP) was established to provide leverage and equity capital to facilitate toxic asset transactions. While TARP's bank stabilization effort has been judged a success, as most of the capital injections have by now been repaid and preferred dividends received; the P-PIP has been viewed less favourably, as it did not meet its ambitions. Only $30bn of transactions out of an initially foreseen one trillion dollars have been completed. P-PIP's failure to encourage further asset resolutions is widely attributed to a critical design element: changes in accounting rules that allowed the banks to avoid marking their assets to market. The banks had an incentive to delay crystalizing their losses over time.

Sweden

In Sweden, an equally directed (and for the time radical) route was followed. In 1992 a systemic banking crisis, based on a speculative property bubble, was avoided by a combination of: blanket state guarantees (that were provided to all the banks) to stabilize the banks as well as a proactive and structured resolution approach. During 1992, Swedish property prices declined rapidly (nearly 50% peak to trough), producing enormous credit losses on the banks' balance sheets. Simultaneously, the Swedish economy went into recession.

Very quickly the Swedish authorities decided to move into an asset resolution phase. Nordbanken and Götabanken were nationalized. Next, their core banking activities were separated to form one new banking entity: now known as Nordea (which today is the largest bank in the Nordic markets and most successful in Europe). At the same time, two fully recapitalized Asset Management Companies (AMCs) were established (Securum and Retriva) to house the non-core Non-Performing Loans (NPLs) and legacy assets. For asset resolution, the Securum portfolio was focused on real estate and property related assets (comprising about 2,500 commercial properties with an estimated market value of SEK 15bn-20bn; (circa €2bn-€2.5bn). Retriva's portfolio was focused on corporate and industrial holdings. The combined portfolios amounted to an equivalent of 3% of GDP. Securum was established as an independent entity, wholly owned by the state but with independent professional management independent governance and a 15 year planning horizon. This long time horizon had an important and positive signaling effect to the market. Securum was operational within three months.

Speed to resolution was deemed important to realise the overall resolution objective. Both AMCs followed a rapid path of 'loan to asset' conversion; resolving these assets through a combination of straight sales and IPOs of the real estate portfolios and industrial companies. A "valuation board" was formed and used to establish and ensure transparent valuations. After the loan-liquidation phase, efforts focused on generating value in the assets. These disposals were achieved by selling liquid properties at the best possible price as soon as possible, as well as preparing illiquid properties for sale in specialized property SPV, which were eventually sold via IPOs as the market recovered. The speed of sales and valuations were criticized at the time. The subsequent positive performance of Securum and achievement of its objectives vindicated these decisions.

Securum started out with a large portfolio of loans in default. The number of borrowers on its client register was about 1,000. By the middle of 1994, just 18 months after it was established, 70% of the 800 limited companies were declared bankrupt or liquidated with most sales being concluded by 1996. Securum's activities were wound down by 1997. The direct financial impact at that point was negative but over subsequent years the programme has resulted in a breakeven and eventually positive result.

These decisions were in themselves amazing given: the state-ownership of Nordbanken, the Social Democratic government of the time and cultural context of Sweden at that time. They reaffirmed best practice of bank resolutions. The Swedish authorities' swift and determined actions laid the basis for this effective system wide resolution strategy. Securum has become touchstone of subsequent successful resolutions the world over, especially during the Credit Crunch/Sovereign Crisis. Adoption of this philosophy and actions was instrumental at saving Swedbank and the collapse of the Baltic economies during the period 2009-2011.

Ireland

In 2008 the banking system in Ireland was initially stabilized by a series of capital injections accompanied by the establishment of a national AMC (National Asset Management Agency - NAMA) in April 2009. The purpose of NAMA is to act a resolution entity; operate acquiring property development loans from Irish banks in return for government bonds; and managing the restructuring and resolution of the legacy portfolio legacy exposures related to property developers, commercial real estate (CRE) and land assets. This legacy portfolio was equivalent to approximately 30% of Irish GDP. These legacy assets were acquired from the six main Irish banks at fair market value.

NAMA was established using a "Master SPV" structure. The Irish government avoided NAMA being a budgetary item as long term, third party institutional investors owned 51% of the company. Thus NAMA avoided consolidation into the national budget. The government maintains governance oversight through the board of directors. NAMA essentially has three separate functions: restructuring, asset management and financing.

NAMA was designed to manage the largest real estate problematic exposures (about 85 groups, with over €77 billion in notional value) drawn from the six largest banks. NAMA did not address the remaining overhang of smaller ticket legacy real estate and developer loans. The originating banks were left to manage the smaller ticket exposures on their own (for which it transpired the local banks lacked the skills and capacity to manage – as the government had been warned by foreign advisors).

The process and prices for asset identification, valuation and transfer was well designed and highly structured to provide transparency, efficiency and avoid 'moral hazard'. Asset identification, documentation and valuation methods were made uniform, streamlined and centrally directed with full use of digital resources. For the transferred assets, valuations were made using NAMA's own "Long Term Economic Valuation"; a controversial method at 'mark-to-market'. As a result the transfers were at discounts to book value of on average 56%; with individual banks remaining liable for additional losses. A certain liquidity was provided to the banks initially in the form of bonds (yet it was insufficient for the needs of the banks which had to seek further support from the government). A vendor financing programme has been added to facilitate higher bid prices.

Foreign experts and advisors warned the authorities that their efforts remained too limited in scope, scale and speed; yet they were ignored. In subsequent developments, the Irish government was forced to effectively nationalize the whole banking system. Policy decisions and subsequent macro-events forced Ireland to realize it had a full blown national crisis and was forced to seek assistance from the "Troika" (IMF, ECB and EU). Arguably this deepened crisis could have been avoided if advice had been heeded at the beginning.

Today, NAMA is part of an overall strategy to resolve the legacy assets, cleanse the banks' balance sheets and establish a new competitive market based on at least two "pillar" banks (i.e.; a reorganized AIB and BOI). NAMA is continuing its operations with asset resolution being effected by a combination of workout and true sale transactions.

NAMA is the most radical approach of bank stabilization/AMC to date. The underlying belief is that by crystallizing losses upfront will speed up the adjustment process as was the case in Sweden a decade earlier)(with Securum) and subsequently with Swedbank and its Baltic Crisis of 2009-2011.

NAMA operates in an environment of intense transparency, heightened by the role of the Troika and has attracted a fair amount of criticism such as the steep discounts applied to asset purchases (on average 56%); a larger than anticipated operating budget, valuation and derecognition approaches, etc. Despite constraints and limitations, NAMA has registered notable success and remains on track to its agreed objectives. NAMA was operational within five months. Its creation had an important signaling effect.

As to performance, while still too early to tell indications are that NAMA has been at least a partial success. A final assessment needs to be considered in terms of NAMA and the broader economic impact. In the 21 month period to December 2012, NAMA has assessed 700 business plans (covering 97% of its loans), made 6,000 individual credit decisions approved close to €1 billion in advances of working and development capita and approved asset sales of more than €7 billion. NAMA maintains that it is on track to reach its publicly stated goals of repaying €7.5 billion of its debt by the end of 2013, €16.5 billion by the end of 2017 and €7.0 billion by end of 2019.

Germany
In 2008 capital injections and balance sheet guarantees were used to stabilize the banking sector in Germany after the fall-out of the US real estate crisis. This left German banks with toxic CDO and ABS structures of some €300bn with the German regional state banks ("landesbanks") most severely affected. In addition, Hypo Real Estate (HRE) had to be nationalized to avoid a systemic bank failure due to the resulting interbank lending squeeze. In addition, new legislation was enacted to create a voluntary programme with the establishment of a financing agency (SoFFin) and resolution structures: AMCs (for the landesbanks) and SPVs (for privately owned banks). A programme was formalized under the control of a national agency - FMSA (Federal Market Stabilization Fund). This programme would allow for full deconsolidation of non-core and toxic assets as well as for loss recognition over time. In addition, the government had intended to facilitate mergers in the landesbank segment. By 2010 two AMCs were created for each participating bank: WestLB/EAA and HRE/FMS Wertmanagement.

The SPV approach was not utilised. It was seen as too expensive, as it required upfront loss recognition of 10% and a further recognition of the difference between "fundamental value" (a proxy for market value) and book value over time. Furthermore, the German authorities have managed to lessen the impact of loss crystallization at the banks by passing specific legislation that makes the AMCs a "legally privileged" entity. The banks could opt to wait and not crystalize losses before an eventual default of the structure.

The success of the AMC approach has been limited as the intended potential mergers between the landesbanks could not be resolved politically. One of the imposed conditions has been the commitment for the core banks to be sold to new owners. Instead the individual states have opted to save their landesbanks by keeping them outside of the SoFFin umbrella thus avoiding consolidation (e.g. HSH, Bayern LB, LBBW). KfW managed to sell IKB to Lone Star with massive vendor financing. To date In Germany, true asset resolution has not materialized, as the programme's elements create an incentive to delay loss recognition (e.g. original capital contribution and additional unlimited guarantees) for future losses of EAA for the owners of WestLB (e.g. the State of North-Rhine Westphalia and the Savings Banks association).

While the German government's objectives of stabilization have been met, resolution of the toxic portfolios remain incomplete: left to the private sector for the stronger commercial banks and in the case of the FMSA banks obviated. FMSA has been successful in its limited objectives (warehousing rather than resolution). This situation has fostered a large set of "zombie" banks; caught in wind-down mode rather than true asset resolution.

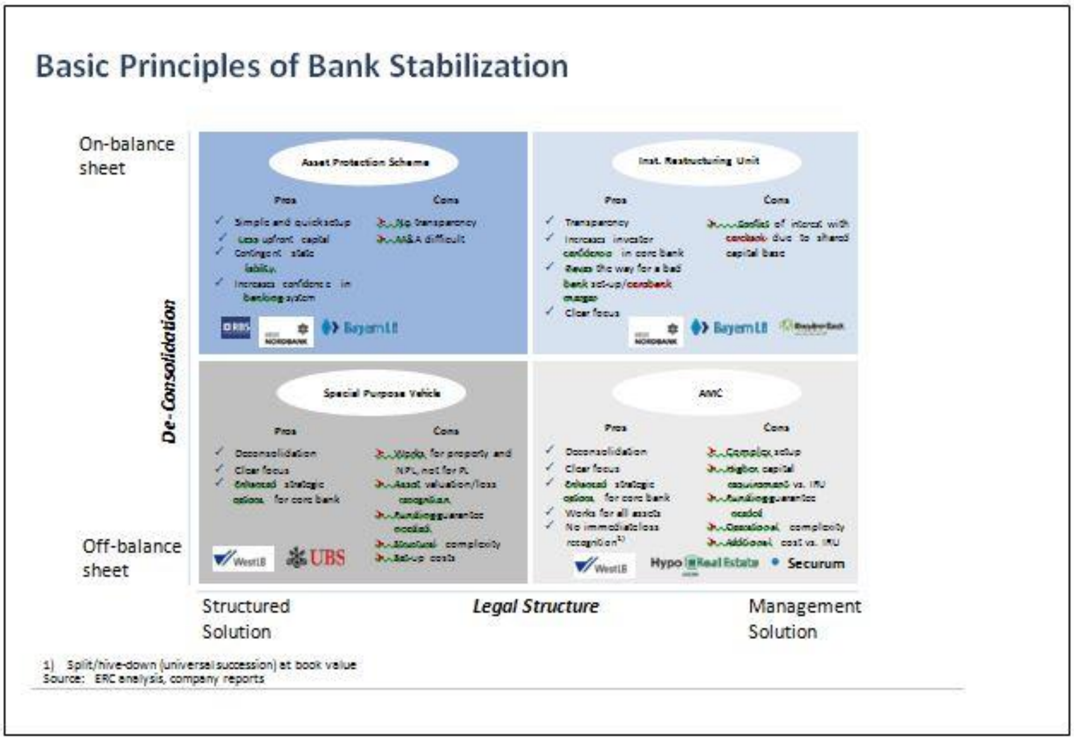
2.5 Bank Stabilization

From the international examples, two basic principles that shape strategic approaches can be derived:

1. Deconsolidation (i.e., on balance sheet vs. off balance sheet) and
2. Legal structures (i.e., structured vs. management solutions).

These strategic approaches can be categorized into four broad types: Asset Protection Schemes (APS); SPVs; Internal Restructuring Units (IRUs) and AMCs, (Exhibit 5)

Exhibit 5: Basic principles of Bank Stabilization



While structured solutions are generally intended to solve for capital relief, management solutions are intended to demonstrate transparency and a willingness to implement asset resolution strategies through increased management focus .

As can be derived from individual bank stabilization efforts, the application of these two principles are not mutually exclusive. In many cases they follow a pattern from structured solutions to management solutions. These solutions have different objectives and outcomes for the individual banks (Exhibit 6).

Exhibit 6: Bank stabilization – selected examples

Bank Stabilization – Selected Global Examples

Adopted Strategy	Bank	Restructuring Solution	Precondition (ECA Approved where applicable)	Non-core/ Problem Assets	Performance/ Asset Reduction
Asset Protection Scheme (APS)	RBS	• State will bear 90% of any loss over £60bn • £26bn capital injection • Additional £8bn contingent capital	• Predefined targets for new lending to consumers and businesses • Penalty for exiting the scheme	• £282bn	• Pool of assets under the scheme decreased from £282bn in 2009 to £69bn at the end of 2011 • No state payment by the state triggered yet
Institutional Restructuring Unit (IRU)	HSH Nordbank	• €3bn capital injection • €10bn guarantee	• Wind down plan • Good bank BP	• €80bn	• 26% asset reduction in 2 years
	BayernLB	• €10bn capital injection • €10bn guarantee	• Wind down plan • Good bank BP	• €62bn	• 55% asset reduction in 2 years
	Dresdner Bank	• IRU	• Shareholder pressure (Allianz AG)	• €35	• 100% reduction in 3 years
Special Purpose Vehicle (SPV)	UBS	• Problem assets transferred to StabFund, a newly setup SPV 100% owned and 90% funded by Swiss National Bank (SNB) • $5.3 billion capital injection in UBS	• Independent valuation of assets to be transferred • UBS to provide remaining 10% funding for StabFund	• $59bn	• Proceeds from asset sales helped reducing SNB's exposure by 45% within the first 1.5yrs of StabFund
Asset management Company (AMC)	Hypo Real Estate	• €7.7bn capital injection • €124bn guarantee • Bad bank separation (FMS Wertmanagement)	• Wind down plan • Sale of good bank	• €175bn	• 7% asset reduction in one year
	WestLB	• €5bn capital injection • SPV formation • €5bn guarantee • Bad bank separation (EAA)	• Wind down plan • Sale of good bank	• €77bn incl. €23bn SPV	• 34% asset reduction in two years • Sale of good bank failed, €100bn assets to be placed in EAA
	Securum	• State guarantee for all deposits • Setup of nationwide bad bank Securum/Retriva, recapitalization 25bn SEK • Formation of "good bank" Nordbanken (Nordea)	• Nationalization of failed banks	• SEK50bn	• Disposed all assets in five years facilitated by market upturn

Source: ERC analysis, Company reports — Indicates that the bank also adopted the respective strategy

In circumstance of industry-wide weakness, very few banks can effect such resolutions on their own. For example, Dresdner Bank was able to resolve its legacy portfolio on its own, yet UBS required government assistance. The case of Securum (as previously discussed) demonstrates how a well-structured, centrally driven strategy can realize effective asset resolution and see the return of a vibrant and healthy bank (Nordea) that helped restore confidence in the crisis effected Swedish banking sector of the mid-1990s. These experiences were later applied in 2009 in the case of Swedbank which during the current crisis successfully resolved on its own its legacy portfolios in Sweden and the Baltics republics. Yet, it is important to note that government assistance forms a part of almost all the approaches to varying degrees.

These approaches revealed a policy challenge for BdE: to encourage appropriate stabilization strategies for individual banks while realizing the resolution of the overall legacy portfolio.

This pattern reflects the Spanish regulators' strategy and direction to foster asset resolution in order to demonstrate progress in solving the banking crisis. Given the situation, asset resolution strategies for the legacy portfolio need to be prioritized; at least for a set of weaker Spanish banks.

2.6 Asset Resolution

Overall banks can follow four main asset resolution strategies: (i) Workout; (ii) Straight Sale; (iii) SPV Sale; (iv) AMC Sale. The main considerations in applying one or the other of these resolution strategies are: loss recognition; deconsolidation; liquidity; upside potential; and competition (Exhibit 7). These considerations are always shaped by the applicability of relevant regulations, practices and laws at both a national and EU level.

Exhibit 7: Comparison of Resolution strategies

Comparison of Asset Resolution Strategies

	Work-out	Straight Sale	SPV Sale	AMC Sale
Loss Recognition	Over time	Immediate	Depends	Depends
Deconsolidation	Yes	Yes	Yes	Yes
Liquidity	Over time	Immediate	Immediate	Immediate
Upside Potential	Yes	No	Possible	Possible
Competition Issues	No	Approval needed	Approval needed	Approval needed
Transfer Issues	No	Yes[1)]	Yes[1)]	Limited[2)]
Applicability to the Spanish Situation	Dominant option	External financing issue	External financing issue	External financing issue

Vendor financing does not lead to deconsolidation/risk transfer; Financing by another Spanish Bank shifts the legacy assets from one bank to the next; international banks not interested yet; State financing/guarantees as a short-term back stop needed

1) E.g. banking secrecy, data protection, borrower consent, cross-collateral, banking licence (undrawn commitments, guarantees), derivatives, lender pools
2) Hive down/Split (universal succession) circumvents most problems apart from borrower consent in some cases, sub-participations/guarantees as mitigants
Source: ERC analysis

Workout strategies are the traditional way of dealing with problematic assets on an individual basis. Banks strengthen their own internal work out (so-called "intensive care") or restructuring units as well as legal departments (with a focus on foreclosure) to effect resolutions on an individual borrower level. This strategy is most effective in situations where time to resolution is not an issue. The belief being that balance sheets can be managed to match operational profit generation and investor needs. In Spain, during the period of 2012, this assumption not valid. However, it is conceivable that workout will remain the dominant strategy due to a lack of incentives and alternatives.

Under normal circumstances straight sale is the preferred option outside of workout, due to its simple and clear characteristics. Assets are sold (commonly to an SPV set-up by the investor) for cash or cash equivalents. However, one major precondition for straight sales to work is the availability of leverage for the investor; as it allows for higher bids to close the gap between investor and bank IRR assumptions. Vendor financing is an option, but it faces deconsolidation issues as the amount of vendor financing would have to be well beyond the threshold of expected portfolio losses. From a regulatory perspective a safe limit would be found around 50% level. A work-around would be an agreement by the SPV to finance resulting property sales to investors.

In an SPV/AMC sale, a joint venture approach with the investor is taken, where the bank tries to retain upside potential through a minority shareholding (and/or cash flow waterfall arrangements, return hurdles, etc.) in the Asset SPV/AMC. In this approach there are several main differences. The eligibility of asset classes where performing non-strategic loans can only be accommodated in an AMC only. For the asset management structure in an SPV, the asset management is effected through an investor owned/appointed servicing platform; while for an AMC, the bank platform can be retained by the investor.

In both SPV/AMC cases, the ability of the selling bank to influence resolution management has to be effectively blocked in order to allow for appropriate de-recognition. As in the above straight sale, deconsolidation/external financing remains the key issue limiting theses exit strategies. The joint and several liability with the originating "good" bank is an additional constraint for the AMC sale as it dependent upon the amount of hived down/spun-off liabilities.

In terms of regulatory capital relief, each transaction would have to be analyzed individually. In general, derecognition of the assets would lead to capital relief, while the recognition of losses as a result of the transaction would counteract this effect.

Spanish accounting rules and laws are similar to other EU countries and, in the case of accounting rules, are based on IFRS. In countries where successful bank resolution structures have been applied, such as Sweden, Ireland or Germany, <u>significant and specific amendments to these rules, policies and laws were implemented in order to allow the appropriate implementation of successful resolution structures</u>. For example, even in the US, the authorities' decision to change mark-to-market accounting for illiquid assets (FAS 157) was the main reason to keep toxic assets on balance sheets and limit the success of P-PIP.

BdE has a tradition of robust interpretation but a reluctance to set industry wide precedents. At its discretion, BdE has the authority to interpret the application of IFRS rules for Spanish financial institutions. It can therefore facilitate the creation of practical resolution structures. The establishment of a central financing agency and/or AMC, as recommended by expert practitioners, and precedent examples, would avoid the need to significantly alter prevailing accounting rules since it would facilitate the execution of SPV/AMC sale transactions which would result in complete derecognition and deconsolidation of the assets. The key national accounting rules and legal issues with regard to de-recognition and deconsolidation of assets remain a source of resistance rather than inspiration for reluctant participants and regulator; the latter often conveniently forgetting that it sets the rules.

A ranking of these alternatives from an individual bank's perspective is highly dependent on its loss absorption capacity and the intended speed of execution.

- The fastest and likely most expensive solution is the formation and subsequent sale of an AMC, as it enables the bank to dispose of all legacy asset classes in one transaction.
- However, in reality it is more advisable to begin with a focused workout approach, i.e. by forming an IRU and targeting individual solutions. In this approach value can be added quickly through workout initiatives coupled with an attempt to offload individual pools of assets through targeted straight sale or SPV/JV solutions. The remaining rump portfolio would be disposed of through a hive-down and sale of the resulting AMC. The important criteria are the financial impacts of non-resolution and time available to achieve it.

From the Regulator's perspective helping the banks to help themselves is always the preferred route. However, in the case of an intensifying crisis (as was the case in Spain 2012), the Regulator might be well advised to sidestep other alternatives and implement the AMC solution upfront in order to avoid systemic failure (as was the motivating factor in the case of both Sweden and the United States) or be forced to act in a reactive, ultimately unnecessarily costly fashion in the future (as was the case in Ireland).

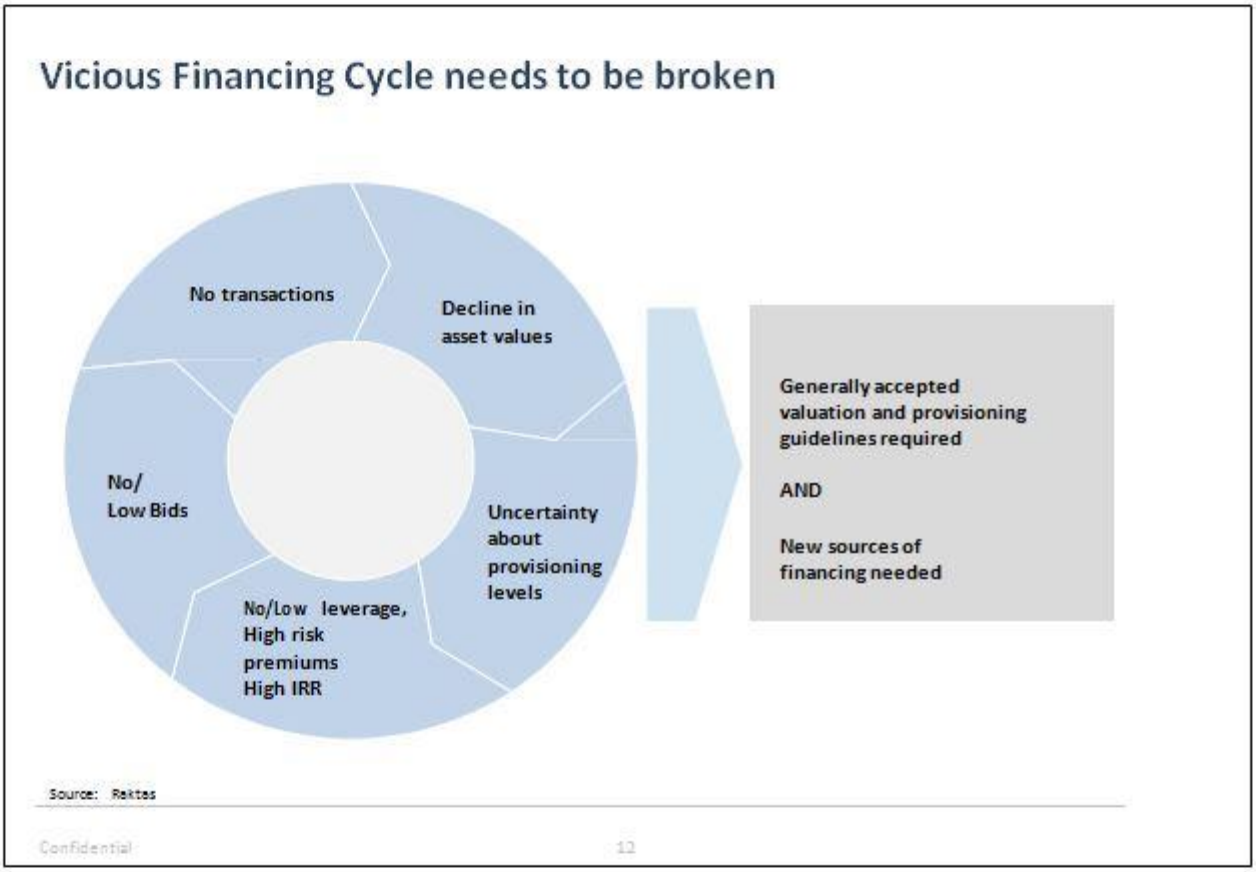
2.7 The Role of a Central Agency

The role of a central agency is discussed in terms of the financing and possible asset management solutions: the break the vicious cycle of financing and central solutions.

<u>Breaking the vicious cycle of financing.</u> Financing is a fundamental constraint that limits asset resolution; especially at scale. It sets in motion a vicious cycle of financing (Exhibit 8). In an environment of declining asset values and low transaction volumes, the resulting uncertainty has a negative impact on resolution. It

leads to high investor IRR requirements and lack of leverage. The banks have little incentive by domestic or foreign banks to finance NPL trades (at least not at high leverage ratios). As a result, the gap between bid and ask prices on individual transactions is too high, preventing transactions. These factors place additional pressures on the price discovery process; leading to a further decline in asset prices as a result as the market tries to find an equilibrium point.

Exhibit 8: Vicious cycle of financing



<u>Central solutions for the Spanish banking crisis.</u> By 2012, the Spanish government should consider three main options to develop an overall strategy to resolve the large pool of legacy assets.

1. Rely on the recent provisioning guideline to help bridge the valuation gap.
2. Tackle market failure by providing a central financing solution.
3. Create an asset holding structure as a fallback.

Any solution needs to be tailored to take into account the specific situation and the national context. International examples do provide useful lessons, both positive and negative in nature. These solutions are assessed below; but some form of AMC seems most appropriate (Exhibit 9)

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Exhibit 9: Central solutions

Central Solutions for the Spanish Banking Crisis

	Wait-and-See (No Central Solution)	Financing Agency	Asset Management Agency
Hypothesis	New provisioning levels will be high enough to incentivize Banks to sell toxic assets	Open market leverage ratios too low and risk premiums too high to close the valuation gap	Even with agency financing, reserve prices will not be met; agency has to step in as buyer of last resort to stabilize the market
Advantage	No additional cost	Potential to stop the market decline and provide liquidity	Signal to the market, that a certain price level will be defended
Disadvantage	Loss of momentum and further market deterioration	Potential downside risk, if asset price deterioration continues	Potential long holding period until prices recover; downside risk, if the do not
Recommendation	Risky, since investor expectations for further declines are not addressed	Provides some buffer against further declines and might therefore work	Last resort to stabilize the market

Source: ERC analysis

These solutions are assessed below.

Wait and See

A "Wait and See" solution, while attractive for a number of reasons (as it relies on market forces and requires little state intervention or support) might be appropriate based on an assumption that the recent provisioning initiative is sufficient. The "lawn-mower" approach (i.e. a one size fits all haircut) to provision requirements on land and unfinished developments will most likely lead to over-provisioning in a few selected situations. Therefore the potential exists for certain banks to enjoy extraordinary profit generation by selling those few assets at prices above the provisioning levels to all equity investors. It is difficult to predict the appropriateness of this solution. Implementation of the provisioning initiative will take some time. Also the granted exemptions to merger banks will most likely limit the asset pipeline that could come to the market. Time pressures on the economy need to be considered as well.

Central Financing Agency

Therefore to overcome these time and efficacy issues, a central financing agency could be established immediately to facilitate a more proper functioning of the NPL market. In would provide timely assistance by: creating a larger asset pipeline and allowing investors to increase their bid levels. In a positive scenario, the resulting liquidity would help to arrest uncertainty with regard to asset prices and therefore mitigate decline factors. Obviously this intervention could be seen as a subsidy to banks and investors with taxpayers (Spanish or European) funds. Therefore, it would be an important design element that this agency be structured to participate in any upside of the intended market recovery as well as being limited in scope as to its portfolio and duration.

Asset Management Agency - general

There is a chance, that the bid/ask gap cannot be closed at this stage even with the combination of new provisioning initiatives and financing subsidies. In which case the Spanish government will face the decision to either: (i) reiterate on the provisioning exercise and/or; (ii) allow the agency to step into failed auctions to acquire assets at "fair value" (to be defined in a central valuation initiative). This entails creating a fully-fledged and focused Asset Management Agency for resolution of the legacy assets. This agency is seen as an end-game solution. It would seem that the design of any financing agency should have these AMC elements already incorporated at its outset, to be activated, if and when required.

Depending on the discussions with global authorities (i.e., the ESM and IMF) another possible consideration might be to sidestep these staged approaches and move forward into a full-fledged AMC model immediately. There are advantages and disadvantages to establishing this national AMC either through a centralized (i.e., Securum or NAMA style), or a decentralized (FMSA like) approach.

Asset Management Agency – centralized version

In the centralized approach, assets are to be transferred at market prices and managed centrally by a newly created asset management platform which would have full responsibility for managing the resolution portfolio. Following characteristics reflect better international practices: Ireland's NAMA is an extreme form. The centralized asset management agency should have the following characteristics:

- Established as a separate and private company, preferably as an SPV with the government having a 49% participation (compliance with ESA 95).
- Have an independent board of directors and clear corporate governance to protect government interests.
- Be granted an open-ended government guarantee and fully capitalized to manage its designated portfolio of problematic loans and assets.
- Operate as a centralized asset management company with incentive mechanisms to agreed objectives, targets and KPIs to facilitate sustainable, market-based resolutions.
- Utilizing a core team of appropriate professional staff with additional capacity being most cost efficiently filled by the use of subcontracted services based on need.

Asset Management Agency – decentralized version

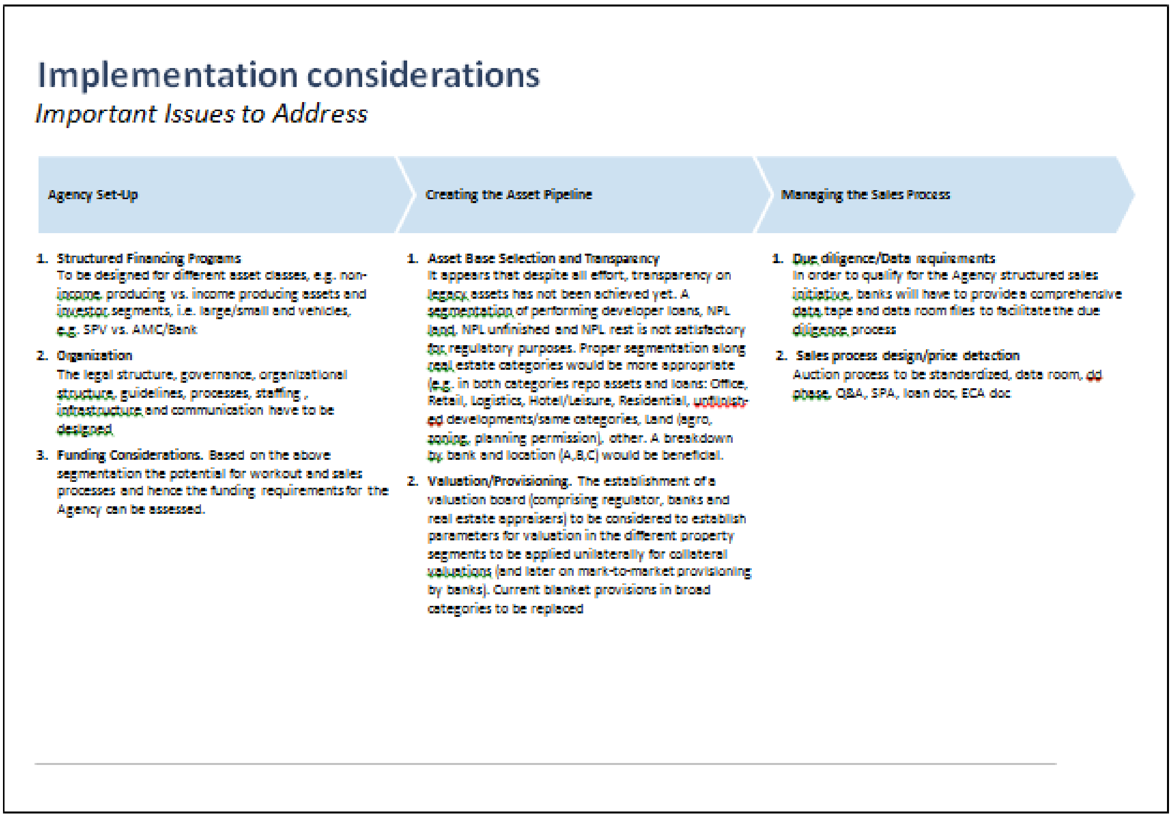
In a decentralized approach the same basic organization requirements would be needed as each bank would hive-down or spin-off its legacy assets at book value (fully provisioned according to the provisioning rules) into a subsidiary AMC which is subsequently sold the central AMC. This approach reflects the experiences in Sweden and Germany. In the German model there is no sale, original shareholders would continue to be fully liable for future losses, which works in the case of German states as shareholders, but not for commercial banks or its shareholders). Asset business plans would be created de-centrally and would have to be signed off by a central asset management committee under pre-defined circumstances.

The advantages of the decentralized approach are that it would cover all asset classes (including. performing loans), enable the selling banks to retain upside potential while limiting the downside to this equity stake. It would also ease the problem of central asset management platform creation as it would rely on existing bank workout staff and systems with a small credit committee like structure on top to govern asset resolution, where the de-centralized AMCs would resort to the resolution strategies characterized above aided by a central financing agency to foster investor appetite.

2.8 Implementation Considerations

The main implementation considerations are with regard to: the agency set-up; the creation of the asset pipeline; and the management of the sales process (Exhibit 10). Competition issues are considered separately.

Exhibit 10: Implementation considerations



There are three main implementation areas discussed below: Agency set-up; Creating the Asset pipeline; Managing the sales process.

Agency-Setup

The central agency requires a core financial functionality. Yet it would probably also best be served by full asset management functions to effect restructuring as well as resolution activities.

The core of the agency set-up is a structured financing programme which establishes the ground rules for the agency's involvement in future legacy asset transactions. The program would be structured around the key financing offer, such as a percentage of leverage and percentage of equity participation by the agency (such as 85% and 49% as used in P-PIP).

In essence the state would issue guarantees for all debt instruments. The asset holding SPV would issue bonds to the selling bank. The agency and the investor would acquire shares in the SPV for cash. In addition the central agency would have to provide its share in the servicing fees of the asset management platform run by its co-investors.

In order to qualify for the programme, investors would have to be approved (e.g. by becoming part of a investor board) and bound to participate in the standardized auction process to be established. Participating banks would be required to create transparency of their asset pipeline and follow the standardized auction process. The standardized auction and asset pipeline processes are described in the following sections. Standardization is intended to minimize costs in general legal and advisory fees which are better spend in data quality and data room preparation.

The agency set-up for the financing agency could be organized in different ways, but it would need to be an independent entity.

In Spain 2012, the financing agency could be an extension of the FROB budget since it focuses on guarantees and equity participations. It could also be appended to the DGF.

In case that an extension of activities is required to lead restructuring and resolution activities then a dedicated AMC would need to be established. This asset holding agency would incorporate the existing financing capabilities, in addition to adding both an asset holding SPV structure and a servicing platform (outsourced).

Funding was the most important aspect in both cases. It was estimated that the book value of legacy assets was €220bn (after provisioning and add-ons; €138bn performing and €82bn non-performing) a complete offloading would need € 44bn in new equity and € 176bn in guarantees. These estimates exceed the current FROB or ICO capacities by a wide margin. Unless transactions are expedited in the escalated central asset management model (as described above), the investment could be staged with some recycling effects on guarantee fees and dividends. Obviously the effect of such initiative on the national debt and deficit implications need to be considered; potentially following an 'Irish' solution (e.g.,51% of NAMA held by investors).

While this staged approach has merit (i.e. financing agency first, asset management as a fall-back), it needs to be designed such that key milestones for escalation are established and can be implemented quickly to avoid poor signalling, lost time, and increased costs.

Creating the Asset Pipeline
Currently, the transparency of the asset base available for sale is quite limited. BdE focuses on developer loans and classifies them into "performing" and "non-performing"; where the non-performing part falls into the sub-segments land, unfinished developments and rest. Clearly, from a management perspective a much deeper segmentation will be required in order to assess volumes of transactions that might come to market.

From a credit perspective this deeper segmentation should be as follows:

- Performing loans should at the very least be broken into performing and sub-performing (i.e. in arrears < 30, 60, 90 days).
- Non-performing should follow the logic of: workout, termination, foreclosure, 1st, 2nd, 3rd auction.
- In addition, the segmentation should be done by exposure type, e.g. mortgage loan, leasing, credit line (drawn, un-drawn) and guarantees (performance vs. payment).
- Collateral information would have to take into account: 1st vs. 2nd lien mortgages, cash and state guarantees and other.
- Property information would have to be structured around property categories (office, retail, logistics, hotel/leisure, residential, land) and include completion status and year, location, square meters, rental status and income, valuation, valuation date and valuer-appraiser.
- Land would in addition have the categories of agricultural, zoning, building permission (type).

With this information at hand, more transparent and investor-oriented data tapes can be constructed and asset pipelines can be developed on both an individual bank level and on an aggregate level.

At a minimum, under and scenario/strategy individual originating banks need to be encouraged, if not directed, to develop accurate data-tapes, based on collateral databases. Such information is usually sufficient to meet the minimum investor's requirements as part of an established due diligence process. It also obviates unnecessary time delays and costs as the banks' systems will not produce the requisite level of information. Such a data-tape standard could be imposed as part of any participation in a central financing agency programme. At a more structured extreme a complete information system could be imposed, as would be the case for a centralized or national AMC. This system would set the only means possible by which the banks' legacy portfolios would be assessed and agreed for transfer. The experience from NAMA reveals that such a system is a necessary precondition for future resolution success; despite its time to establish and costs (set-up and administration).

Valuation and provisioning always need to be synchronized. A "lawn-mower" approach does provide some incentives to act, i.e. active steps towards resolution vs. passive strategies. However, proven best practices to determine accurate provisions on NPLs is to apply cash flow discounting based on fair value of the underlying collateral for each individual exposure and asset.

In the absence of a liquid market property valuation has its challenges. For income generating properties the issue is less complex as the arguments would centre around yield requirements and the availability of financial leverage per asset type and location. For non-income generating property, the absence of comparables is much more difficult to overcome, since key valuation parameters would have to be estimated, e.g., for land one would have to take a view on time to market, construction time, construction cost, sales price and discount rate in order to arrive at a sensible valuation. Market practice in Sweden and the Baltic states suggests that the establishment of a national valuation board to determine values for the main valuation parameters is an efficient way to remove some uncertainty about asset valuation and provide a basis for provisioning instructions and transaction reserve prices.

Managing the Sales Process
Once the data-tape and asset valuation is established, a standardized sales process should be put in place. This process would have to be run as an auction to preserve the competitive argument needed when taxpayer money is deployed. After a standard non-disclosure agreement (NDA) is signed by the investors, an information memorandum and data-tape are issued with a requirement for an indicative bid. Based on the indicative bid, bidders are allowed into the data room phase, where asset files can be reviewed and questions asked via a standardized Q&A process. In parallel, using an agreed sales and purchase agreement (SPA), negotiations as to the key commercial points (e.g. reps and warranties, caps, de minimis) will need to be agreed. The process would conclude with a binding bid including an executable SPA and filing for the competition authorities.

2.9 Competition implications

It is outside the scope of this working paper to suggest a rational consolidation strategy for the Spanish banking market. However relevant issues can be identified and are discussed below.

Both bank stabilization as well as resolving the overhang of legacy assets have a competition dimension. In an EU context, the European Competition Agency's (ECA) approval along transparent lines is a necessary pre-condition of any merger or nationalization. Any proposed commercial merger or nationalization must take these criteria into account. In the case of nationalization, a wind-down plan for the non-core/legacy assets needs to be approved and the disposal of the remaining core banking franchise within a proscribed date (in keeping with the principle of proportionality). Furthermore the disposal of any assets from the non-core must also be approved by the ECA. Precedent examples would suggest that a proactive discussion of any plan would allow for a more pragmatic design of the conditional exemptions to take into account the market conditions.

In the four precedent international examples only the German and Irish governments have had a predetermined competitive landscape. The Swedes were more concerned with preserving the status quo, although there was a wave of second tier bank mergers after the crisis; yet preseving the four bank oligopoly that remains today.

Governments and regulators need to consider whether they wish to actively steer certain constellations or create the environment and conditions that will allow market forces to act naturally. While consolidation is often viewed as a means to shift the burden and costs of restructuring and resolution directly on the sector and shareholders it invariably has an impact on competitiveness. Also the ability of all the banks to cope is far from certain.

Since 2009, Spanish governments and BdE have been successful in demutualising the cajas and forcing their initial consolidation (45 cajas merging into 11 banks today). This policy and process has been mirrored by the actions of the FROB with has seen its active intervention in three former cajas and one commercial bank with the subsequent disposal to date of two of these to commercial banks. Also FROB has made equity injections into another three former cajas. Furthermore, the domestic commercial banks have been encouraged to consolidate and there are six such larger institutions today.

For an economy of Spain's size and dynamism it is possible to imagine that this overall consolidation process needs to continue over the next few years as natural process to return the sector to economic health. Inevitably, the competitive landscape will be affected by the continuing dynamics of the credit/sovereign crisis and resolution strategies undertaken

2.10 Summary and Conclusions

Since the financial crises started in 2008, BdE and the Spanish authorities have taken steps to stabilize the banking sector. However a significant pool of non-performing and repossessed assets remains to be resolved. The functioning of the NPL market is impeded by a number of factors; most particularly a lack of financing. This factor and others allow individual banks to avoid crystallizing their losses.

This vicious cycle needed to be broken. Insufficient resolution actions (at an individual bank level and system-wide) threatened to prolong and even deepen the effects of the current crisis; which could be made worse by macro and external events beyond the control of the Spanish government.
Precedent examples reveal that governments taking proactive and directed approaches have realised their objectives to fix and restore the banking sector; limiting the effects of the crisis as well as reducing the time and cost elements and impact of debt and deficit levels. Such approaches harness the resources of supranational agencies to facilitate restoration of the banking sector to its proper function.

Making available appropriate financing within an overall resolution framework would provide the necessary support and pre-conditions to facilitate the necessary asset resolution phase for the Spanish banking sector. BdE was advised to consider taking a proactive and directed approach at two levels:

(i) Encouraging individual banks to pursue a full set of asset resolution strategies, while;
(ii) Seeing to the establishment of at least an independent central financing agency (with sufficient capital) and the ability to expand rapidly its functionality and scope. This central agency, a resolution AMC, would be the most appropriate framework to manage the current legacy portfolio and best positioned to meet future challenges in a timely, resource and taxpayer efficient manner.

Adopting such a twin-approach resulted in the creation of SAREB and ongoing resolution of many of the banks and cajas. Taking into account proven, precedent examples and following this twin-approach has allowed Spain to navigate its way through the current crisis. It is conceivable that following this advice earlier would have saved both time and money, for the banking sector and Spanish taxpayers as well as citizens better served.

This call for adopting proven practices, rather than delaying for reasons of self-interest and political expediency is the main conclusion for decision-makers in such situations in the future.

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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.

Justin Jenk
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.