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# A Study of Bad Banks (EIB-LSE Capstone Project)

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Panagiotis Asimakopoulos

Yumeko Hyugaji

Camille Lot-Baillis

Yamunu Ranatunga

Lim Ping Wong

*Master of Public Administration*

*London School of Economics and Political Science*

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# Outline

1. Introduction of Project

2. Background

3. Methodology of Research

4. Analysis of Bad Banks

5. Analysis of Restructuring Teams

6. Comparative Analysis

7. Recommendations

8. Conclusion

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# Our Project

- Capstone Program with EIB
  - Research project of LSE Master of Public Administration course, with the EIB (TMR/RRF) as client
  - 6 months group project
  
- Terms of Reference (provided by EIB)
  - An analytical overview and comparison of European bad bank (BB) models
  - A comparative analysis of bad banks versus restructuring teams (RT)
  - Possible applications of the experience and lessons learnt from bad banks to good banks

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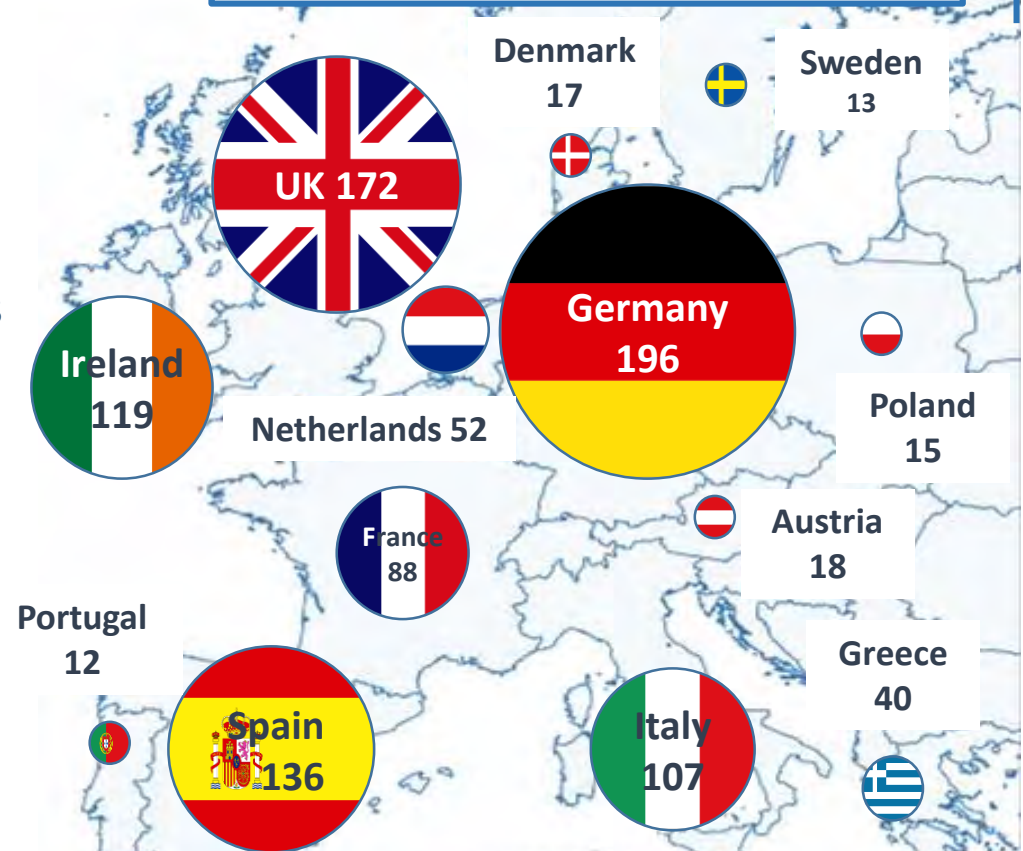
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# 2008 Financial Crisis and NPLs

- Sharp rise in Non Performing Loans (NPLs), resulting in lack of confidence from investors
- Tools used by authorities were
  - Debt guarantees
  - Recapitalization
  - Liquidity support
  - Treatment of impaired assets
- Over EUR 36 tn was used...

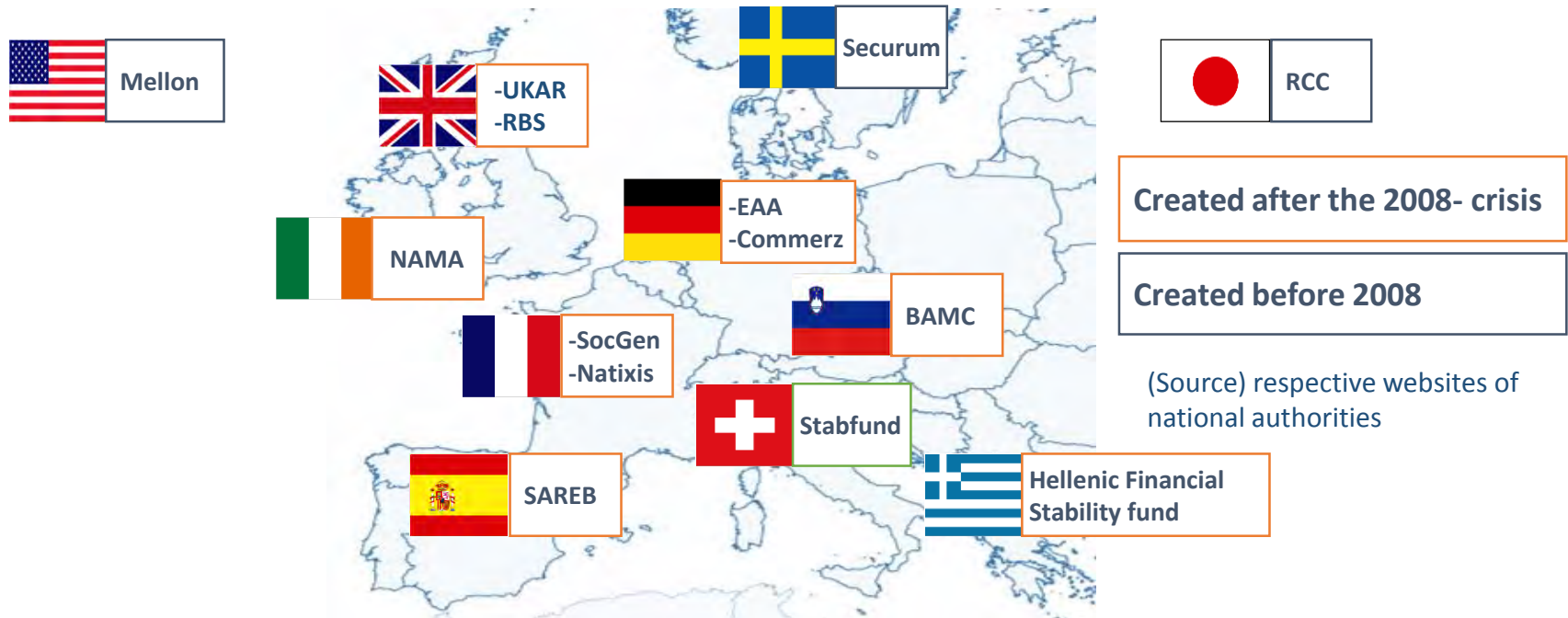
Total amount of NPLs in Europe...  
EUR 1,048 bn (end of 2011)



However, treatment of NPLs continued to be a major issue...  
And bad bank schemes were widely introduced

# What are Bad Banks?

- A BB segregates the NPLs in FIs from the healthier assets into a separate entity.
- Ultimate objective is to maximize the value of the core-operations and minimize the amount of NPLs, contributing to the stability of the financial system
- We looked into 14 cases, shown below.



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# Methodology



# Detailed Desk Research

- 14 BBs in 11 countries were selected due to
  - Project focusing mainly on Europe
  - Sufficient access to resources and information

BBs discussed (in alphabetical order of country)	
France	Societe Generale
	BPCE (and Natixis)
Germany	Erste Abwicklungsanstalt (EAA) under Soffin
	Commerzbank
Greece	Hellenic Financial stability fund (HFSF)
Ireland	National Asset Management Agency (NAMA)
Japan	Resolution and Collection Corporation (RCC)
Slovenia	Bank Asset Management Company (BAMC)
Spain	Company for the Management of Assets proceeding from Restructuring of the Banking System (SAREB)
Sweden	Securum
Switzerland	UBS under Stabilisation fund (Stabfund)
United Kingdom (UK)	UK Asset Resolution Ltd (UKAR)
	Royal Bank of Scotland (RBS)
United States of America (USA)	Mellon Bank (and Grant Street National Bank)

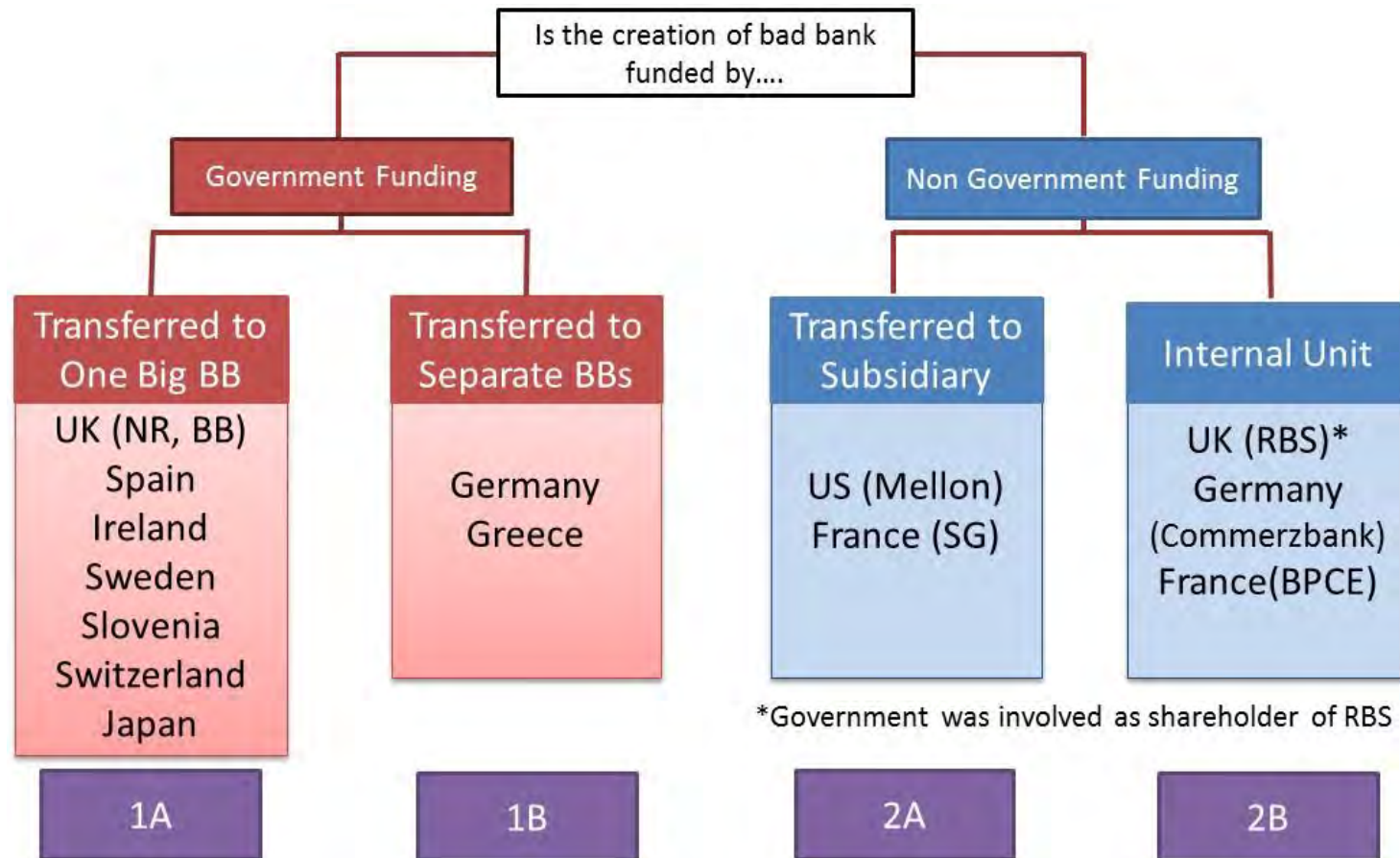
# Interviews

- Complementary method to detailed desk research
- Enabled to gather rich data based on first hand experiences
- Useful with RTs due to lack of adequate literature
- Conducted in non-attributable condition (face-to-face and telephone based)

	Institution	Date of Interview	Location
<b>BBs</b>	RBS	18 <sup>th</sup> Dec. 2013	London
	EAA	27 <sup>th</sup> Jan. 2014	Dusseldorf
<b>RTs</b>	EIB	22 <sup>nd</sup> Nov. 2013	Luxembourg
	IFC	14 <sup>th</sup> Jan. 2014	Washington, DC
<b>Specialized financial consultancies</b>	AgFe	6 <sup>th</sup> Dec. 2013	London
	Alvarez and Marsal	21 <sup>st</sup> Jan. 2014	London

# Map of Bad Bank Schemes

- We identified 4 schemes based on 2 questions
  - Is the BB govt. funded?
  - Is the BB a new separate entity?



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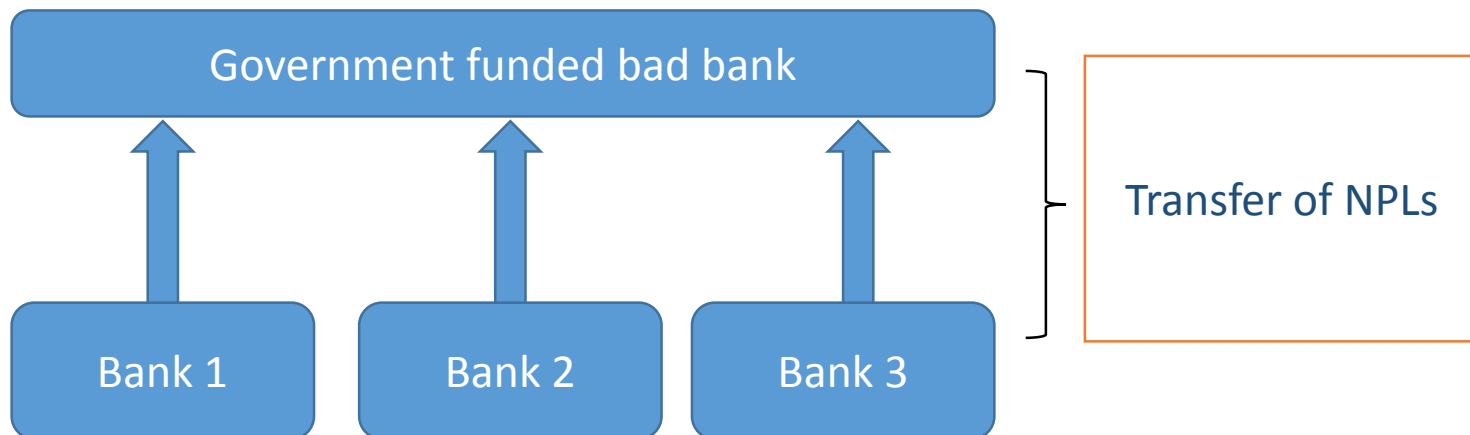
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# Big Bad Bank (1A)

## 1. Structure

- **New legal framework**
- **Government's role:** Funding the BB, supervising operations and acting as major shareholders
- **Time frame:** Set
- **Profits and losses:** Taxpayers and private investors
- **Market response:** Share price increase (share of banks covered by NAMA soared after announcement)



# Big Bad Bank (1A) cont.

## 2. Transfer method and management of the assets

- **Transfer:**  
Specific transfer rule dictated by legal framework  
BB purchases loan books financed by govt. bonds, assets reflect a discounted price of the book value (Spain: haircut of about 63%)
- **Valuation:**  
External bodies, overviewed by relevant govt. agency
- **Management:**  
Hold, sell or restructuring

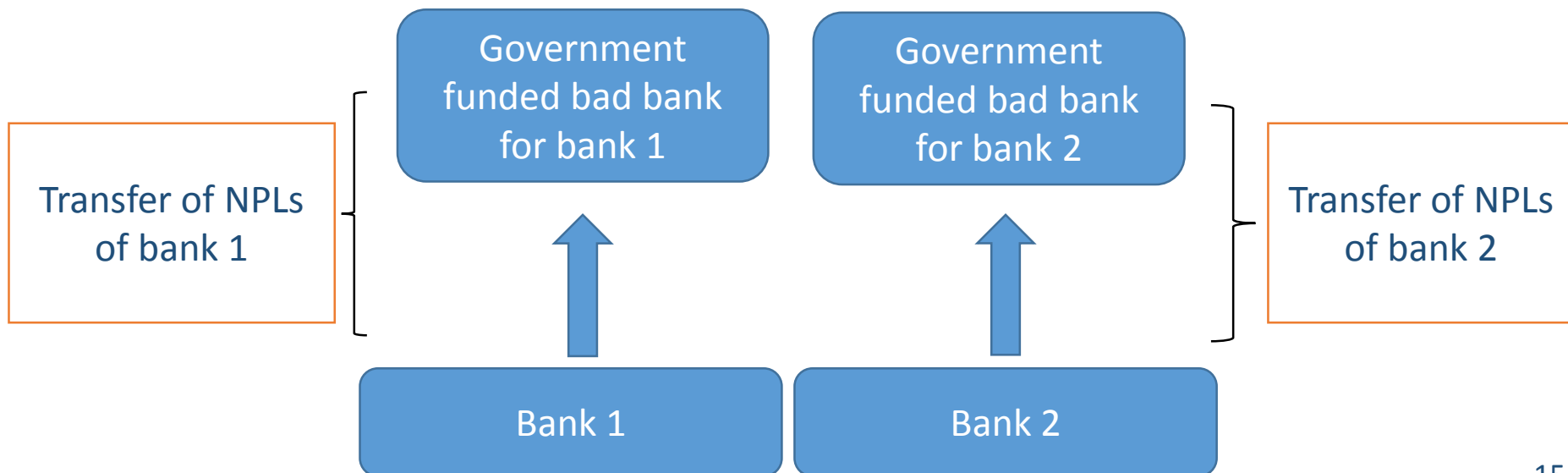
## 3. Governance

- Separate and independent board of directors (appointed by govt.) + various committees (management, audit, risk management, etc.)
- External monitoring by representative bodies of govt. (Stability Funds etc.) and third parties, and internal monitoring by board of directors, committees

# Separate Bad Bank (1B)

## 1. Structure

- **New legal framework**
- **Government's role:** Providing bond guarantees on assets
- **Time frame:** Set (German EAA), as soon as possible (Greece)
- **Profit and losses:** Private investors and taxpayers
- **Market response:** Cannot assess as original bank does not exist anymore





# Separate Bad Bank (1B) cont.

## 2. Transfer method and management of the assets

- **Transfer:**  
Specific transfer rule dictated by legal framework  
Germany EAA scheme transfers at book value, in Greece transfer is done by discount value, valuated by private liquidators
- **Management:**  
Hold, sell or restructure (EAA), winding down by contracted private liquidators (Greece)

## 3. Governance

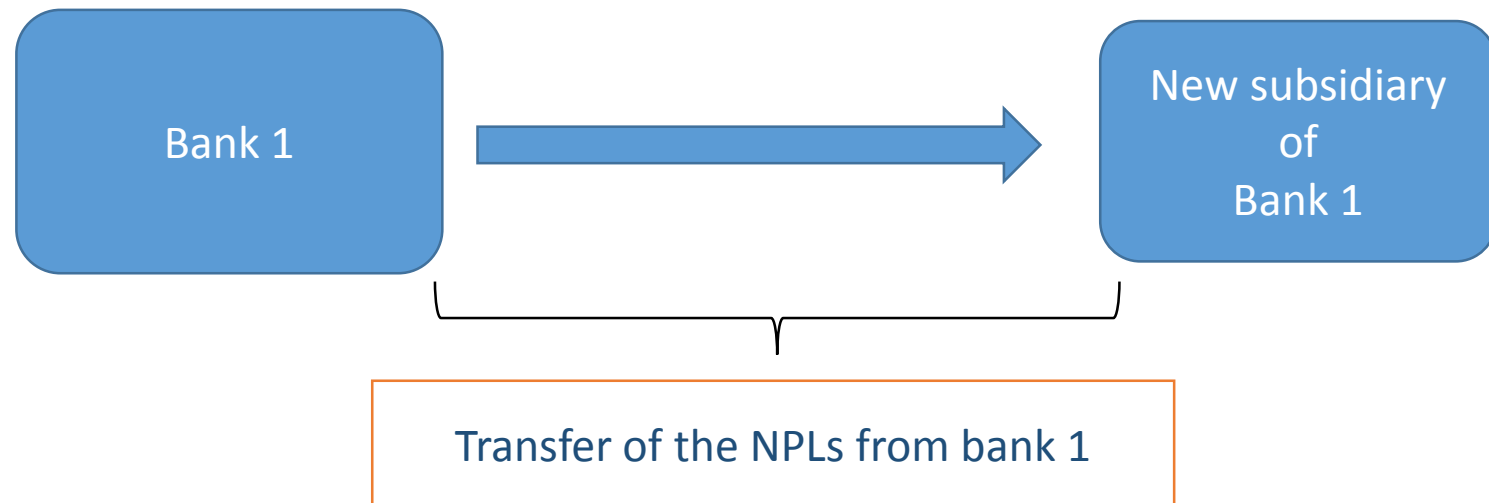
- Separate and independent board of directors
- External monitoring by Soffin and external auditors (EAA), relatively weak monitoring by the HFSF (Greece)

# Subsidiary Bad Bank (2A)

## 1. Structure

(example by Mellon bank and Grant Street National Bank (GSNB) in 1988)

- **Shareholders:** Private investors
- **Time frame:** No specific time-frame (as soon as possible)
- **Profits and losses:** Both affect bondholders and shareholders of GSNB and Mellon
- **Market response:** Share price of Mellon increased



# Subsidiary Bad Bank (2A) cont.

## 2. Transfer method and management of the assets

- **Transfer:**  
Purchase of NPLs with book value of \$1 billion discounted to \$640 million
- **Valuation:**  
External (by new independent CEO)
- **Management:**  
Selling the loans or getting the cash back from debtors

## 3. Governance

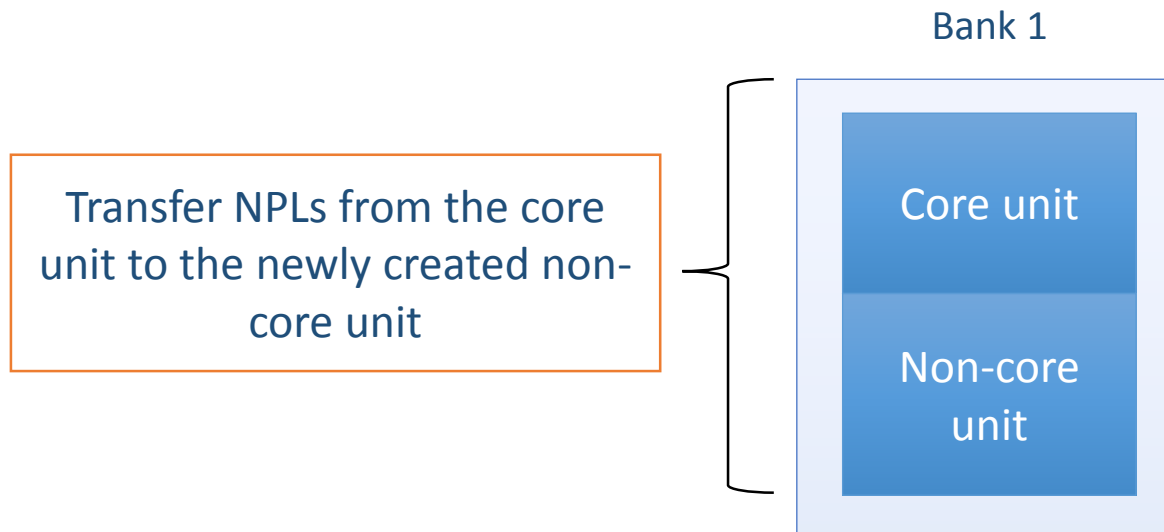
- Separate and independent board of directors and committees
- Incentivized and independent work out team contracted from another Mellon subsidiary

# Internal Bad Bank (2B)

## 1. Structure

(example by RBS, Capital Resolution Division)

- **Shareholders:** Govt. and private investors
- **Time frame:** Set
- **Profits and losses:** To shareholders
- **Market response:** RBS share price decreased by 7% when this scheme was announced



# Internal Bad Bank (2B) cont.

## 2. Transfer method and management of the assets

- **Transfer:**  
Internal transfer of most high-risk assets: £14.8 billion core unit and £23.5 billion from 2008 non core unit (Substantial write off in 2013)
- **Valuation:**  
Done internally
- **Management:**  
Hold, sell now or restructure (depending on capital efficiency)

## 3. Governance

- No separate board of directors or committees but direct reporting line
- Staff not involved with core unit operations

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# Analysis of Restructuring Teams

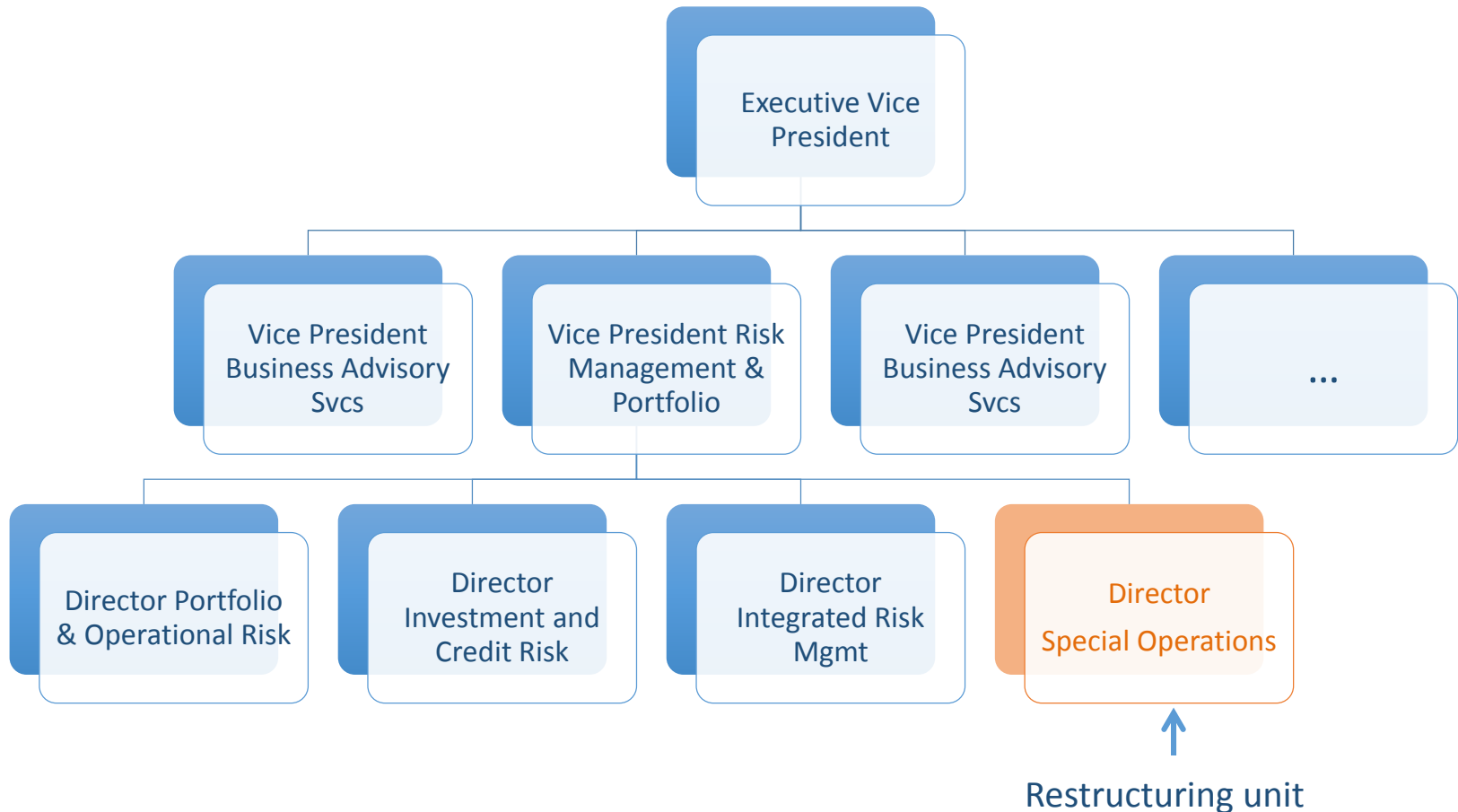
## 1. Structure

Objective → To maximize the recovery of assets presenting expected or unexpected losses by conducting debt restructuring and workouts

- **Creation:**  
From the need to absorb a greater degree of systematic risk (Latin-American crisis in the 90s in the case of IFC)
- **Time frame:**  
None
- **Actors:**  
Minimum intervention by govt.  
Interacts with governing bodies and operational units

# Analysis of Restructuring Teams (cont.)

Example: IFC's organizational structure



Restructuring team is separated from the operational units



# Analysis of Restructuring Teams (cont.)



## 2. Transfer method and management of the assets

- **Transfer:**  
All asset transfers to restructuring teams are triggered by down-grade of the counterparty rating and there is no limitation by asset type  
All RTs are based on the transfer rules → Not always complied with
- **Valuation:**  
Done internally and conducted using the nominal value
- **Management:**  
Rescheduling the payment, recapitalizing part of the debt, converting debt to equity and a rescue fund  
Assets kept unit until the team is satisfied with their recovery

# Analysis of Restructuring Teams (cont.)



## 3. Governance

- Well defined with various bodies: board of directors, management committees, risk committees
- Reporting is done in a hierarchy structure
- Staff recruited both internally and externally based on financial expertise, negotiation and language skills. Dedicated staff not involved in other operations
- Strong internal checks (quarterly review in the IFC) and external checks by auditors at the organization level

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# Conditions for Comparison

## Comparison between bad banks

- Clear structure and governance
- Transparent transfer and management of assets
- Minimizing cost to taxpayers
- Minimizing opportunistic behaviour

## Comparison between bad bank and Restructuring Team

- Clear structure and governance
- Transparent transfer and management of assets
- Minimizing opportunistic behaviour

# Comparison between Bad Banks

## 1. Clear Structure and Governance

- Govt. funded schemes tend to be created in severe financial situations
- Govt. funded schemes have a legal framework
  - Clearly defining the structure
- All schemes have time-frames (set or as soon as possible)
  - Trade-offs between clear signal to market and pressure to sell
- Internal BBs do not have much disclosure
  - Unclear information tends to make market react negatively
- Govt. funded BBs have independent boards and staff (from the loan originators) while Internal BBs (2B) have no separate board of directors
  - Conflict of interests

# Comparison between Bad Banks (cont.)



## 2. Transparent transfer and management of assets

- Except for the Internal BB (2B) all have external parties valuating the NPLs
- All assets are transferred at a discount to book value (except EAA)
- Legal framework dictating the rules in govt. funded schemes
  - Transparent transfer and fair valuation

# Comparison between Bad Banks (cont.)

## 3. Minimizing costs to taxpayers

- In govt. funded schemes the risk is shared between private investors and taxpayers
  - Govt. funded schemes are inherently more costly to taxpayers compared to non-govt. funded schemes
- Big BB (1A) is the most costly to taxpayers (time, direct funding for creation and purchase of assets, legal expenses etc.)
  - Taxpayers are more exposed to losses than the separate BB (1B)

# Comparison between Bad Banks (cont.)

## 4. Minimizing opportunistic behaviour

- Creation:
  - Govt. funded BBs are financed by govt. money while shareholders bear the losses in non-govt. BBs
    - Causes moral hazard particularly in Big BB (1A)
  
- Transfer:
  - Most cases have external valuation
    - Ensures true valuation of assets (discounted value makes banks bear initial losses) and prevents under reporting of NPLs



# Comparison between Bad Banks and Restructuring Teams

## 1. Clear Structure and Governance

- BBs are solutions put introduced as post-crisis tools while RTs have been established in prevision of future shocks
  - RTs have clearer perception of structure and identifiable reporting line
- RTs have less actors involved (compared to govt. funded BBs)
  - Less opaque in structure
- Both BBs and RTs hire people internally and externally
  - Subject to a trade-off between hiring knowledgeable people and avoiding conflict of interest (with originators and workout team)

# Comparison between Bad Banks and Restructuring Teams (cont.)

## 2. Transparent transfer and management of assets

- Asset transfer in govt. funded BB is dictated by law
  - Clear, transparent and always complied with, while rule in RTs have risk of not being complied with
- BBs conduct transfers on an one-off basis while RTs constantly transfer NPLs
  - NPLs are not accumulated in the core-operation in RTs
- RTs are less constrained by time
  - RTs have more strategies available to them to manage the assets

# Comparison between Bad Banks and Restructuring Teams (cont.)

## 3. Minimizing opportunistic behaviour

- RTs are not subject to a set time-frame while BBs are resolved eventually
  - Staff in RTs do not have incentives to delay the management of NPLs

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# Lessons Learnt from the Analyses

## Challenges



## SOLUTIONS

Conflict of Interests and need of strict monitoring
Lack of transparency in handling of assets
Accumulation of NPLs
Under reporting of NPLs leading to loss of market confidence
Moral Hazard
Opportunistic behavior of staff
Recruiting experts
Maximizing recovery

Independent governance and clear reporting line
Dedicated staff separate from loan originator
Existence of clear transfer rules which are complied with
Continuous transfer
External valuations and transfer at discount value
Limited role of Government
Incentive for team members
Wide range of strategies
No specific time frame



Successful elements from BBs and RTs for good banks

# Potential New Designs for FIs

## Decentralized Approach

**Every bank should have an internal bad bank with elements below**

- An unit independent from loan originators
- Clear and direct reporting line to the board of directors
- A transparent transfer rule which is complied with, enabling continuous transfer of assets
- Experienced and incentivised staff
  - Staff who know about the institution and loans, and
  - External experts
- No time frame to ensure continuity of the unit
- Active management with wide range of strategies

# Potential New Designs for FIs

## Centralized Approach

### **Creation of a Centralized Bad Bank on an EU scale, for each sector**

- Creation of several specialized BBs by sector
- Independent board and management
- Maximum recovery due to use of expertise leading to scale of economies
- Incentivize the staff working in this consolidated BB due to improving expertise
- Funding for this centralized design through ex-ante contributions (in line with Single Resolution Mechanism of EU banking union)

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# Conclusion

- We identified key lessons learnt from various BB schemes and RTs in International Organizations
- We believe that...
  - Banks should move from crisis oriented reactive management of NPLs to more proactive measures using the elements we identified
- Possible designs we recommend are
  - Every bank should have an internal BB with the elements discussed
  - Creation of a centralised BB on an EU scale for each sector



Thank you!