Carving out legacy assets: A successful tool for bank restructuring?

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Non-performing loans (NPLs) potential threat for EU banks

EU banks are facing € >1 trillion NPLs

Source: EBA (Sept-2016)
Non-performing loans (NPLs) potential threat for EU banks

Source: ECB
Market failures NPLs

- Inefficient judicial systems
- Information asymmetry (buyers and sellers)
- Pricing problem (inefficient markets)
- Incentives for banks to postpone loss taking
Secondary market NPLs

Secondary market for loans is relatively small in the EU (€ 280bn).

Loan sales in Europe 2015/2016

Source: Deloitte
Policy responses

• Enhance bank supervision
  • Proper accounting of NPLs
    • Harmonization of NPL definitions (EBA)
    • Enhanced disclosure on exposures
  • Guidance for banks to develop NPL strategy (ECB)

• Improving the legislation and procedures
  • Reforms of insolvency law and procedures
    • Shorten time between financial distress and liquidation
  • Tax reforms to encourage banks to recognize losses sooner

• Carving the NPLs out of the banks’ books
  • Creating secondary market
    • Set-up asset management company, corporate restructuring and securitization
Data description

• Sample
  • 79 euro area banks
  • All received capital support from government
  • 2007-2016

• Data sources:
  • State aid: DG Competition decisions
  • Financial: Annual reports
Main causes capital shortfalls?

Legacy assets incl. NPLs main issue during sample period

- Financial assets - Loans (52%)
- Financial assets - Securities (23%)
- Financial assets - Loans/Securities (17%)
- Non-financial assets (6%)
- Operational (1%)
Resolution tools used

Total: 79 Aided banks

None (17)

Sale of business (entire) (12)

Sale of business (part) (24)

Bridge bank (15)

Other (9)

Asset separation (28)

On-balance sheets

Carve outs
Effectiveness: Long-term viability

Return on risk-weighted assets after first intervention (2007-15)
Effectiveness: Financial and economic stability

Loan growth after first intervention (2007-15)
Effectiveness: Cost of measures

Costs and capital consumption (2007-15)

- Capital injection
- Regulatory capital before injection
- Cumulative losses (peak)
- Net value
- Immediate deleveraging (T0-2)

<table>
<thead>
<tr>
<th>None</th>
<th>Sale of business (entire)</th>
<th>Other (Guarantees)</th>
<th>Sale of business (part)</th>
<th>Bridge bank</th>
<th>Asset separation</th>
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<tr>
<td>On balance sheet</td>
<td>Carve-out</td>
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Effectiveness of resolution tools

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<td><strong>Transfer value</strong></td>
<td>Book</td>
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<td>Long-term viability</td>
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<td>Loss</td>
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<td>Moral hazard</td>
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Conclusions & policy remarks

- NPLs risk for banks in several EA countries
- Bail-in makes it even more important to minimize the total losses
- Avoid direct sales (sale of business [part or entire]), which have the highest expected losses
- No resolution tools option for small portfolios of NPLs and sufficient margins
- Other tools option for effective resolution, though all have some disadvantages (guarantees [moral hazard], bridge bank [capital], asset separation [liquidity])
- Remaining questions on impact of internal or external management of legacy assets
- Liquidity facility needed for some resolution tools (e.g. asset separation)
References:

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