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

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Executive summary

THE SEPARATION OF so-called legacy assets from the remaining healthy business of a bank has become a central concern in risk management and supervision. In the European Union, non-performing loans amount to over €1 trillion and an additional stock of non-core assets that is at least as large is also being offered in the secondary market.

BANKS HAVE EMPLOYED various organisational models to separate these assets from their core business. At one extreme, banks have tasked specialist staff to focus on workout or selective sales, while the bulk of these assets remain on the same balance sheets. To do this, appropriate incentives have to be set for bank staff, and a number of failures that are inherent to the market for loan sales have to be addressed.

AT THE OTHER extreme, in situations of serious distress, countries set up external asset management companies (AMCs), either specific to an individual bank, or working across the industry for specific types of loans. As the transfer to another entity crystallises the value loss of legacy assets, this option requires a capital injection and restructuring of the bank's balance sheet.

PAST EU EXPERIENCE has demonstrated the effectiveness of AMCs, in particular when they work with a large part of the banking sector and are focused on specific loan types. Asset separation in conjunction with an asset management company can also be an effective tool for bank resolution, but the difficulties inherent in setting up an AMC and achieving a track record in restructuring should not be underestimated. Countries are well advised to prepare the legal basis for such entities.

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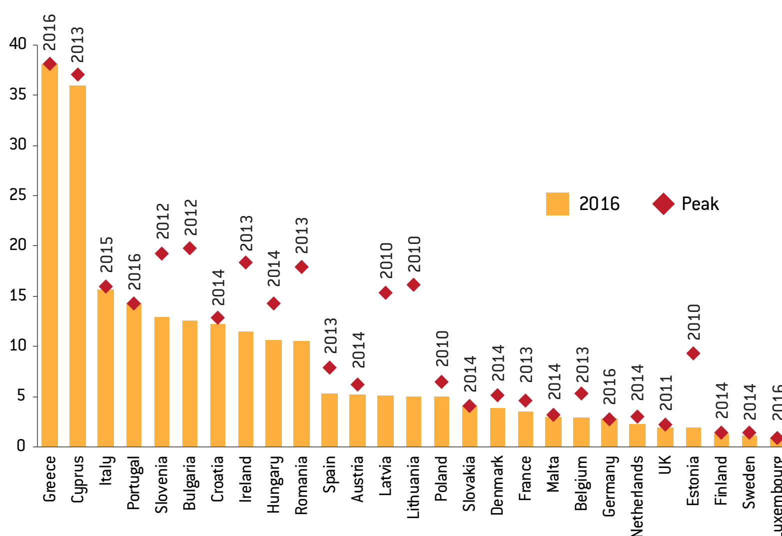
1 Introduction

Eight years after the financial crisis, the European Union banking system continues to labour under the burden of an outsized stock of non-performing loans (NPLs). Unlike the United States, the EU has not succeeded in speedily cleansing bank balance sheets of a substantial overhang of delinquent loans, which are estimated by the European Banking Authority (EBA) at slightly over €1 trillion, or 5.4 percent of gross loans (Figure 1). The effort to separate these 'legacy assets' from banks' core business is central to the rehabilitation of Europe's banking system. It complements, and is closely linked to, the other two prongs of banking system rehabilitation: raising capital coverage and improving the transparency of bank asset quality.

Within Europe's banking system, excess NPLs have tied up bank capital, eroded profitability and held back the development of new business. The flip side of the still dysfunctional credit channel is that companies with excess debt are not offered the necessary debt restructuring, and new and more productive firms seeking to start up business confront credit constraints. The debt overhang has been estimated as contributing about one third of the decline in investment during Europe's financial crisis (Ozcan *et al*, 2015).

Figure 1: Gross non-performing debt instruments in the EU, % of total gross debt instruments



Source: Bruegel, based on ECB consolidated banking statistics, peak year to 2016 Q2.

For our purposes, we understand 'legacy assets' to comprise the stock of non-performing loans as determined in line with the EBA's asset quality methodology[1]. This is appropriate in the sense that loan delinquency in the euro area stood at only 2.8 percent of gross loans in 2008, the year before the crisis, and then shot up to 6.6 percent in 2014 (European Central Bank consolidated banking statistics). NPLs either remained on banks' balance sheets after the crisis, or re-emerged once restructuring solutions and other types of forbearance failed to return non-performing exposures back to health.

This definition may fall short in two important respects. First, as banks revisit their business models and seek to overcome a long history of entrenched low profitability, they increasingly shed so-called non-core assets alongside NPLs. The banking industry will see NPLs as part of a much larger pool of these non-core assets that they seek to divest, and advisory firms

1 Commission Implementing Regulation (EU) No. 680/2014.

estimate that the total stock of assets to be divested is about twice as large as the NPL stock mentioned above. Second, loan delinquency in bank assets is only a partial reflection of the legacy of the crisis. Debt distress among households and companies remains the underlying problem, and if unresolved could in future impair loans that are as yet performing.

That said, the separation of NPLs from the core of a bank's business and balance sheet is a pre-condition for the recovery of the EU banking system, in particular in seven key countries that account for almost 70 percent of the euro-area NPL stock. In this light, EBA officials and the ECB have called for greater use of asset management companies (AMCs), and for greater transparency in their treatment under state-aid provisions (Haben and Quagliariello, 2017; Constâncio, 2017).

Options for asset separation will also come into focus as Europe's banks draw up their resolution plans. The Bank Recovery and Resolution Directive (BRRD) envisages separation of assets into a special purpose vehicle as one of the tools that could be employed by a resolution authority in the effort to salvage an institution that is deemed critical to the economy[2]. A government-backed asset management vehicle would manage these assets with a view to maximising the value recovered (World Bank, 2016a). This provision is clearly informed by the positive experience that several EU countries, most notably Ireland and Spain, had with 'bad banks'. However, it is far from clear that asset valuation and transfer could be done swiftly in a bank resolution. Nor is it clear that the AMC, as an essential intermediary, could be set up at short notice. These institutions have only been effective for certain narrowly defined types of assets. As implementation of the BRRD continues, it is particularly timely to examine alternative options for asset separation during resolution and prior to a bank becoming distressed.

We first set out the rationale for this separation (section 2), and then review why market-based asset transfers are impeded by a number of obstacles (section 3). Debt crises in Europe and elsewhere have demonstrated the success, and failure, of a number of alternative options for asset separation. Separation can happen either within the bank or, more effectively, in the form of a transfer to a separate entity, most decisively a 'bad bank'. We review these options in section 4. We then evaluate the experience of Europe's most significant asset management companies in Spain, Ireland and Slovenia. This experience offers a number of lessons on costs and trade-offs (section 5), and on how Europe might progress in the ongoing effort to rid the financial system of legacy assets, and equip it for renewed growth. Section 6 concludes with the recommendation that preparing the legal basis for an asset transfers and asset management companies is not just sound resolution planning but will also assist in the recovery of the banking sector.

2 The rationale for the separation of legacy assets

NPLs erode banks' earnings and capacity to re-build capital because of the higher risk weights in calculating capital costs, ongoing provisioning charges and diminished returns. Apart from the financial impact, there is a pervasive change in the internal management of the bank as human resources and managerial capacity are diverted away from operational units that generate new lending, and loan workout becomes increasingly central to the culture of the bank. NPL management and workout require specific skills that are scarce within banks and

2 BRRD, Art. 42, available at : http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN.

the industry as a whole. These skills are only demanded infrequently in the immediate aftermath of a financial crisis, and in general banks set poor incentives for their staff to manage a value-maximising workout strategy.

NPLs are therefore an important factor in explaining the broader problem of the entrenched low profitability of the EU banking system. Addressing low profitability will inevitably require a strategy to separate NPLs from bank balance sheets (ESRB, 2016). ECB simulations suggest that simply replacing NPLs with sound exposures would lift return on equity in the most affected countries by several percentage points (Constâncio, 2017).

When NPLs are widespread across several systemic banks, they negatively impact economic activity by depressing credit supply, and in turn delay debt and loan workout. This macroeconomic effect of bank NPLs has been a key concern for bank supervisors, and shaped their work in the early stages of the euro-area banking union.

In 2014 the EBA issued harmonised standards for the definition of loan quality, which also differentiated loan performance from forbearance – the modification of the original loan terms. In the 2014 comprehensive review[3] these standards then enabled a first comparable assessment of loan quality across the entire EU, and shaped the capital-raising effort that has been going on since then[4].

In 2017, the ECB will give a crucial fresh impetus to the NPL workout and asset sale process in the euro area's most significant banks that it supervises. Proposed new guidelines on NPL management envisage detailed targets for NPL reduction, and would require banks to establish strategies and operational capacity for NPL resolution, for instance through better staffing of workout units. These guidelines have been welcomed by credit rating agencies and the investor community, and the guidelines will likely be replicated by national competent authorities for the other banks in the euro area (Demertzis and Lehmann, 2017).

3 Market failures in asset sales

Outright sales by banks into the European secondary market for loans are of course the most straightforward option for asset separation. Data on NPL sales in Europe is generally poor, as these transactions are included in data covering the much larger market for loan portfolio sales. Deloitte (2017) estimates that concluded transactions in secondary loan markets in 2016 amounted to €103 billon. This would be less than five percent turnover within a total stock of assets that comprises €1,062 billion in EU NPLs and an additional stock of non-core assets that is at least as large. Loans to SMEs and corporates, which are prominent in European NPL stocks, barely figured in these loan transactions. The composition of the assets that are transacted, the nature of the predominant sellers and the costs involved in due diligence underline a number of inherent failures in this market:

- **Information asymmetry.** A core element in the business model of a bank is to acquire proprietary information about individual borrowers, and to pool this information across different borrower classes and over time. Loan documentation is often specific to the bank and its internal systems, as are the tracking of payment histories and efforts in loan remediation. Attempts to divest individual distressed assets or entire loan portfolios therefore confront the fundamental problem of information asymmetry, which is familiar from

3 See https://www.eba.europa.eu/documents/10180/669262/2014+EU-wide+ST-aggregate+results.pdf.

4 IFRS 9 will become the EU's new accounting standard from 2018 and will force banks to adopt a forward-looking assessment of loan quality. Unlike in previous frameworks, loan impairments and accounting for loan performance under supervisory standards will be delinked.

all markets that depend on asset quality (ECB, 2016b). It is well known that in the absence of mechanisms to bridge these gaps, the buyer will offer a price that reflects the assumed composition of loan quality, and on that basis the selling bank will select poorer quality assets that match this lower price. The market partially does not clear.

- **Market illiquidity.** At present, European secondary loan markets remain shallow, and underdeveloped for a number of asset classes. This is a particular problem for certain collateralised lending, such as to SMEs. Here the market price may be considerably below the real economic value. A first-mover in this market would be at a disadvantage, and possibly impact the valuation of other parts of the portfolio through the supervisory treatment of 'loss given default'.
- **Problems in coordination of multiple creditors.** The distressed loans of larger companies and SMEs will typically be held by multiple lenders, often from across the EU. Lenders, and investors who might acquire such loans, will face a collective action problem in coordinating a restructuring solution. Such a solution will likely be superior to individual strategies that might result in unnecessary enforcement and value destruction[5].
- **Absence of loan servicers, and inadequate regulation.** Finally, in most EU member states the market for loan servicing is absent or underdeveloped. Maintaining assets, such as residential homes, or engaging in restructuring discussions with borrowers, are crucial functions that financial investors typically seek to sub-contract. While there are well-founded concerns over the conduct of servicers, prudential bank supervision may have unnecessarily complicated this industry.

In combination these factors result in substantial valuation gaps between book values and what investors are prepared to bid. It is unlikely that loan sales can be an option for the separation of substantial stocks of non-performing assets in the short term. This is particularly true should several institutions become distressed and enter resolution.

4 Structural solutions for asset separation

Banks have implemented a range of structural solutions, both internal and external, to achieve the separation from their core business of certain problem assets. These solutions have been implemented both ahead of acute distress, and in the attempts to resolve such distress. The aims are the same: to clearly split off a certain set of well-defined assets, and thereby give greater confidence to investors and depositors about the bank's core business and solvency, and to reshape its business model in the process (McKinsey, 2012).

4.1. Internal solutions

All banks typically have a **workout department** to which all loans are migrated at a certain stage of distress. Such units will have specialist staff experienced in restructuring and with access to the required internal legal support. The ECB NPL guidelines set out best practices in this area, specifically in terms of management capacity, data quality and engagement with investors. Such units will work towards early restructuring of distressed assets, and resolution or foreclosure in coordination with other lenders once the borrower has been deemed non-viable. A workout group is an essential feature of any banking business, though it cannot salvage the business once loan distress has become systemic.

A more determined structural solution to the separation of legacy assets could lie in a

5 The principles for a global approach to multi-creditor workouts were published by the International Federation of Insolvency Professionals (INSOL): http://www.insol.org/pdf/Lenders.pdf.

separate business **('non-core' division), or internal 'bad bank'.** Such a unit would be exclusively tasked with the run-off of distressed assets and be subject to clear performance targets. There are likely to be organisational benefits from a more focused tracking of value recovery, and greater rewards for restructuring skills. Investors might gain some confidence that legacy assets are being addressed if performance targets are publicly disclosed. Ultimately, the consolidated balance sheet will of course remain at risk.

An option that partially achieves separation of legacy assets from the core balance sheet might be the **asset protection scheme**. Here certain assets are 'ring-fenced' within the bank's balance sheet and guaranteed by the government. This measure has been employed in a number of European crisis situations, and secures institutions against further value loss (see Box 1 for the case of RBS). Its effectiveness will depend on the sovereign credit rating, and how well it would withstand contingent liabilities from the guarantee.

Box 1: Non-core divisions within RBS and UniCredit

In 2013, UniCredit split its assets into core and non-core to accelerate a 'run-down'. This was the first such comprehensive internal separation for a major bank in Italy. The segregated assets were composed of non-performing assets and those that were technically performing but were exposed to higher risk or had experienced repeated credit events. Some problematic real estate assets were also included. The book value of these assets was €87 billion, of which 63 percent was impaired. At the end of 2016 the bank took a substantial additional charge on this portfolio of €8.1 billion, and said it expected that the group NPL ratio would be reduced from 15.1 percent at end-2016 to 8.4 percent within three years[6].

At the end of 2008, the Royal Bank of Scotland (RBS) established an internal non-core unit with separate management and a direct reporting line to the board. Assets with a book value of €270 billion (£258 billion) were deemed non-core and were set to be run down by 2013. In that year the 'non-core' part of the balance sheet had been reduced to 4 percent, compared to 21 percent when the division was created, and only £12 billion in assets was returned to the original core divisions. In 2009, RBS also placed £325 billion of distressed assets within a UK asset protection scheme (APS), and subsequently reduced its share in risk to 6 percent. This made RBS liable for £19.5 billion of potential future losses, the UK government covering the remaining risk. To engage in the APS, RBS paid the taxpayer a £6.5 billion fee (2 percent of total value of assets in the APS), over seven years. The group's NPL ratio has been reduced from 8.8 percent at the peak in 2013 to 2.1 percent at the time of writing. Cumulative impairment charges on the still publicly owned bank in the nine years since the 2008 public rescue stand at £40 billion.

4.2 External solutions

In the end only a complete separation of the affected assets into a legally distinct balance sheet will meet the dual objectives of preventing the further drain of questionable assets on the capital and profitability of core assets. Based on such a separation, investors and depositors may regain confidence in the core business that remains. **Asset management companies** have played an essential role in European crises, and in overcoming the pervasive market failures in asset transfers. The key decision is whether to establish the AMC around the assets transferred from a single distressed bank, or to have a centralised (multi-bank) AMC.

Crisis resolution of course frequently involved the familiar tool of the **bank de-merger**. In such cases, the troubled bank is split into a good bank (or a bridge bank) and a bad bank. The

6 https://www.unicreditgroup.eu/en/press-media/press-releases-price-sensitive/2016/unicredit--2016-2019-strategic-plan.html.

latter would only have a mandate for maximising value in recovery and would subsequently be sold or liquidated, with the deadline set by law. In some cases, the regulator might extend the deadline to avoid fire sales. This resolution option *"ensures the prudent continuous provision of banking services related to the assets and liabilities taken over in view of its subsequent sale to an eligible third party purchaser"* (ECB, 2011). Box 2 illustrates its potential success in the case of Parex in Latvia.

Box 2: The good-bank/bad bank spilt of Parex in Latvia

Latvia's banking crisis was the predictable result of a sharp and sudden stop of the excessive capital inflows into the country up to 2007. During the 2008-09 financial crisis, Latvia experienced a dramatic boom-bust cycle. NPLs peaked at 22 percent for firms, and about 20 percent for households. While most banking sector assets were managed by the subsidiaries of Swedish banking groups, which made their restructuring expertise available, Parex was Latvia's second largest bank, with assets amounting to €4.9 billion in 2008, and was domestically owned.

Following a bank run and a 36 percent fall in deposits, the bank was nationalised, and benefited from total state support amounting to €1.6 billion. In 2008, the bank was split into two. The European Commission approved in September 2010 a restructuring plan that entailed a split of the Parex Banka into a good and a bad bank – Citadele and Parex, later renamed Reverta. The bad bank retained the remaining non-core and non-performing assets and began work with the aim of maximising the repayment of state aid by end-2017. Between August 2010 and December 2016, Reverta recovered €736 million from the restructuring of distressed loans, sales of bonds and disposal of real estate properties, corresponding to 65 percent of its assets[7]. Citadele was privatised in 2015 and has since returned to profitability, and was listed on the local stock exchange in late 2016.

Centralised asset management companies (or systemic 'bad banks') offer the benefits of economies of scale in restructuring and collateral enforcement and in applying uniform valuation criteria

By contrast, the **centralised AMC** (or systemic 'bad bank') will have the benefits of economies of scale in restructuring and collateral enforcement and in applying uniform valuation criteria. Where such an AMC is created as part of wider sector restructuring, and where it is publicly owned, it will be in a position to impose conditions on bank restructuring for those banks that transfer assets. Spain's Sareb is an example of an AMC that emerged in the context of a comprehensive bank restructuring (Box 3). Given the market failures that are inherent in loan transfers, where several systemically important banks are in distress the centralised AMC will be more effective in presenting uniform valuation criteria to investors and to create liquidity in otherwise shallow distressed debt markets.

The central AMC could be an employer that attracts scarce restructuring expertise. Experts are required for various sectors and asset classes. The AMC can pool these skills and in the process give its staff clear incentives and performance targets. Given its necessarily finite lifetime, it is essential to offer staff appropriate incentives to undertake restructuring that is both speedy and maximises the value recovered.

At the same time, the single centralised AMC is more likely to be exposed to political pressure, including to hold-off from active restructuring, which would damage the credit culture. The Slovenian Bank Asset Management Company (BAMC), for instance, was the subject of repeated debates in the parliament. Therefore, a large centralised AMC might not necessarily be suitable for restructuring large complex corporate exposures, which might call instead for the direct involvement of private equity type investors who specialise in restructuring.

Public funding and ownership of such institutions is normally inevitable. This is because a

7 https://globenewswire.com/news-release/2017/01/11/905010/0/en/Reverta-EUR-60-m-paid-to-the-State-Treasury-last-year.html and Reverta's website.

private investor who would take on a large portfolio of distressed assets would be exposed to considerable risks in the financial system and to legal risks in restructuring and enforcement. Attracting a private investor would likely require far-reaching government guarantees (Klingenbiel, 2000). Public ownership by contrast would essentially overcome this principal-agent problem, and effectively internalise the social welfare objective within the incentive structure of the AMC. The fact that both Spain's Sareb and Ireland's Nama have been majority privately owned likely points to the strong moral suasion exercised by the national governments on their respective banking sectors as key investors (Table 1).

Box 3: Experience with systemic asset management companies*

- Between 2012 and 2014, **Spain** partially utilised a €100 billion euro-area financial sector programme to recapitalise and consolidate its savings banks (*cajas*), following the bursting of the earlier real estate bubble. The transfer of distressed mortgages into Sareb, the central asset management company, was compulsory for those banks that received public capital injections. This programme certainly succeeded in stabilising the financial sector, and banking sector deleveraging came to an end in late 2016. Sareb acquired €106 billion in real estate assets at adjusted book value. This was subject to an average 52 percent 'haircut' based on the earlier asset quality review. Recent losses underlined the need for further provisions. As the central asset management institution tasked with restructuring real estate assets, Sareb was a catalyst in building a market for distressed assets. It played a key role in attracting investors and in developing four servicers with restructuring expertise. It was given wide discretion in maximising value recovery over the 15 years of its lifetime (Medina Cas and Peresa, 2016). Sareb has underperformed profitability targets, in part because of higher provisioning charges, though European Commission (2016) points to the recovery in the real estate market which may support profitability over the lifetime of the agency.
- As in Spain, **Ireland's** central asset management agency, Nama, was instrumental in the resolution of NPLs, which focused on distressed loans to property developers. Nama was set up in 2009 to pool distressed commercial property assets from the six banks that had benefited from a blanket guarantee and subsequent public capital injections. Its portfolio was considerably larger than that of Sareb, accounting for over 18 percent of GDP, though this also comprised large commercial real estate assets that Irish property developers had acquired in the UK and elsewhere in Europe. Asset disposal and repayment of liabilities to the government have been more rapid than initially expected (Medina Cas and Peresa, 2016). The NPL ratio remained elevated at 14.2 per cent in September 2016, though that stock of loans contains a substantial amount of restructured accounts. Until 2016, banking sector deleveraging continued, and profitability remained weak (EU Commission, 2017).
- The NPL crisis in **Slovenia** was primarily felt by businesses, not households. Excess corporate debt emerged during the pre-crisis years when largely state-owned banks funded themselves from European wholesale markets, a source that dried up abruptly in 2009, and exposed unsustainable debt in an increasingly uncompetitive and poorly managed corporate sector (World Bank, 2016b). The stress test of the country's principal banks, and their subsequent recapitalisation by the state in late 2013, demonstrated the need for a more comprehensive strategy on NPLs and excess debt. BAMC, the newly established bad bank, had a sound governance structure, though it did not have full political support for controversial restructurings of large distressed companies. Initially, the government's strategy was also undermined by insufficient support from the two principal state-owned banks. At the time of writing, NPL levels are falling from still elevated levels through sales to the BAMC, and to other investors. Private sector credit continues to contract, and companies in the tradable sector, which are largely profitable, have increasingly turned to cross-border borrowing.

* This box largely draws on Demertzis and Lehmann (2017).

Table 1: Single-bank and centralised asset management companies

	Participating entities	Year est.	Planned closure	Ownership	Gross book value at inception, € bns	Implied haircut on transferred assets (%)	Assets classes and eligibility of participating banks
Sector-wide asset management companies							
Ireland: NAMA	Allied Irish Bank, Anglo Irish Bank, Irish Nationwide, Bank of Ireland, Irish Life and Permanent	2009	2020	51% private, 49% public	74	58%	Individual loans with land and real estate as collateral. Mandatory participation based on exposure to eligible assets.
Spain: SAREB	Bankia, Novogalicia, Banco de Valencia, Catalunya, Caixa, Banco Gallego, Liberbank, BMN, Caja 3, Banco CEISS	2012	2027	55% private, 45% public	107	45.6%	Loans and real estate. Mandatory partcipation based on receipt of state aid.
Slovenia: DUTB	NLB, NKBM, Abanka, Banka Celje	2013	2022	Government of Slovenia	4.9	71%	Non performing assets from systemically important banks. Application could be initiated by the bank, the Bank of Slovenia or DUTB.
Hungary: MARK Zrt.		2016	2026	National Bank of Hungary	n/a	n/a	Non-performing receivables secured by commercial real estate and real estate assets offered by financial institutions on a voluntary basis.
Bank de-mergers							
Germany	FMS-W (Hypo Real Estate)	2010	Originally by 2020, though likely to be extended.	Federal Government of Germany	175.7	0%	Non-performing loan receivables secured by commercial real estate and real estate assets that served as collateral for such receivables.
Germany	EAA (West LB)	2010	2027	German Federal Govt./NRW state	178	0%	Real estate loans and ABS.
Austria*	HETA (Hypo Alpe Adria)	2014	2020	Republic of Austria	18		Retail loans.
Austria*	KA Finanz (Kommunalkredit)	2009	2040	Republic of Austria	6.7		Loans, securities and CDS.
Portugal*	Banco Espírito Santo (Banco Espírito Santo)	2014	No later than after sale of bridge bank (originally 2 years).	Portuguese State	7		Troubled assets of BES and of other entities of the Group.

Source: Bruegel. Note: * The AMC continued as legal owner of the distresssed assets in the context of a bad bank split, see Gandrud and Hallerberg (2014).

5 Criteria for evaluation

The criteria for the success of any option in asset separation should be whether the beneficiary bank will return to profitability, and is able to regain the confidence of funding markets and of its depositors. Where asset separation is employed in the context of bank resolution, the test will be whether the restructured bank returns to long-term viability[8]. Funding costs, the credit rating and the discount of market value over book value will give some indication of success, albeit only after several years. A bank de-merger, such as Parex in Latvia (Box 2), can be effective, though systemic crises will require centralised institutions and principles for asset valuation and transfer[9].

Clearly, this will be influenced by the soundness of the overall strategy for the entire banking sector, and a broader economic recovery, as underlined by the experience in Spain.

From the perspective of European prudential supervision it is sensible that banks be tasked to set up internal divisions that address loan distress at an early stage, to fully resource the workout function and where possible to prepare to engage with investors in the secondary markets. This will now be done through the ECB guidelines on NPL management.

The objective for the bank and its owners is a workout that maximises value recovery, fully reflecting the costs of delays. There may well be a political interest in a speedier or more-focused workout strategy, given the numerous linkages that debt-distressed enterprises have to other parts of the economy.

Internal workout units are an essential business function, and clearly not a solution where the bank is in crisis or close to resolution. More costly structural solutions will be considered as distress intensifies. The so-called non-core units fall short of full legal separation but they have been effective in shielding the bank's main business from the risk of the distressed portfolio, as illustrated by the case of UniCredit. Such solutions may ease pressures on the bank's funding and risk assessment, though they cannot be imposed by the supervisor. A bank-specific AMC can be appropriate where a fully resourced internal workout unit is overwhelmed, but it will result in a further correction in valuations and a need for additional capital.

As the bank plans for resolution – or approaches it – the options are drastically narrowed. Resolution plans that are based on the asset separation tool will need to address three key questions:

- Which assets will be targeted for separation? Answering this question is equivalent to defining the new bank's business model and franchise value, and the bank's future profit drivers. The scope of asset separation should be neither too wide, as this would erode the business rationale of the bank, nor too narrow, as a core institution that emerges will need to be free of lingering doubts about problem assets.
- How will asset transfers be valued? Ideally, the resolution authority can rely on a comprehensive valuation of assets, distinguishing those that remain within the core bank from those that are targeted for workout or foreclosure by a separate asset management company under the resolution plan.
- Is there a receptive market for asset sales, or is an AMC in place and prepared to value and take over such assets speedily in a crisis situation? Both potential sources of demand will of course be strained once bank distress is more widespread. Investors who were thought of as potential buyers might themselves emerge as sellers.

8 For this the Commission's original restructuring Communication provides a definition in recital 13: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0819(03)&from=EN.

9 European Commission (2015) finds that most of the 112 banks that benefitted from state aid up to late 2014 showed improvements in their operational and risk indicators, though the study does not disclose the types of restructuring tools that were employed.

These issues in resolution planning underline the need to address two policy priorities for the current early phase of implementing the BRRD framework.

The first is to give resolution authorities the authority to carry out regular *ex-ante* valuations of potentially vulnerable banks without sparking concerns among market participants. Assets transferred to a publicly owned entity will need to be valued conservatively to limit any further capital loss.

The second is to establish the framework for asset management companies. Setting up a national AMC is complex, time consuming and will require numerous legislative acts and budgetary allocations (Ingves and Seelig, 2004). This cannot be an instrument employed in the short term, prompted by a resolution situation. However, much preparatory work can be done. Countries might be well advised to put in place the legal basis for such an institution, ideally facilitated by greater clarity within the EU on asset valuations and the application of the BRRD (Constâncio, 2017).

Given the renewed European debate about asset management companies it is important to evaluate the record of those bad banks that have been set up in recent years. The focus on a comparatively narrow asset class of real estate by Sareb and Nama has been helpful in designing restructuring solutions. By contrast, the efforts of BAMC in Slovenia may have been hampered by overly complex restructuring problems in large enterprises, and by a lack of support from the government and the key banks as participants in the financial restructuring of corporate borrowers. The definition of clear valuation of distressed assets is a crucial role of an AMC, and the further provisions that Sareb has had to undertake in recent years underline the need for a conservative valuation from the start. Ultimately, political support for restructuring will be essential.

6 Conclusions: next steps in asset separation and making resolution tools effective

As of 2017, ECB bank supervision will rightly focus on the overhang of NPLs within the euro area's largest banks. Standards for internal management of problematic assets, and targets for reduction, might gradually be adopted by smaller banks and their supervisors, and in EU countries outside the banking union. Investors and bank funding markets similarly call for a strategy to separate legacy assets in the effort to return the sector to profitability.

This dynamic is reinforced by the option envisaged under the BRRD to employ asset separation as a tool in the recovery of banks that are deemed important. This would require a central asset management vehicle, though such entities currently exist in only four EU member states.

Banks confront a number of obstacles in sales of loans directly into the secondary loan market. This market remains illiquid and ill-suited to many types of NPLs. The valuation gap between banks' book values and what investors are prepared to offer is also a reflection of asymmetry in information, of uncertainty about the framework for workout and higher return expectations of a different investor class.

Banks have established various organisational models to address these problems. However, only a legally separate entity can overcome the inherent market failures that confront loan sales: information asymmetry, market illiquidity and the risk of 'fire-sale valuations' and coordination problems in restructuring. Separate asset management companies that are mandated with the workout, restructuring and loan sales functions have played a valuable role in a number of euro-area countries. That said, resolution authorities and banks drafting

‘living wills’ should not assume that such institutions can be established at short notice when required, in particular if financial stress becomes more widespread in the banking system. Arguably, such an asset management company is an essential part of financial market infrastructure, and the legal basis should be defined well ahead of when it is actually required. That would amount to both sound resolution planning and a strategy for banking sector recovery.

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