Bad Banks as Support Instrument for Crisis Deactivation

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Abstract

After last financial crisis in more countries special banks (or funds of bad debts) of bad debts where created. There can make quick and effective restructuration (recovery) of bankrupt financial institutions and enterprises. This paper presents types of activity in European Union and answers the following questions: how should the bank be organized, who can give the founder's capital for the bad bank, how long the bad bank (fund) should be active. The case studies of Greece and Poland showed differential models and effects bad bank (fund) as instruments of crisis deactivation.

Keywords: crisis deactivation, bad bank, bad debts, recovery

1. Introduction

Bad debts are not always created due to the fault of financial institutions. The broad discussion on state interventionism during a crisis and the scope of state aid for financial institutions became the basis of a new paradigm in management, i.e. the pre-eminence of recovery processes over bankruptcy processes in the economy. During the latest subprime financial crisis, governments provided financial assistance for banks on an unprecedented scale, both in the USA and the European Union. The European Commission is currently promoting a second chance policy for bankrupt entrepreneurs. The search for effective instruments of financial crises deactivation has led in many countries to the creation of bad-debts banks (or funds). Such banks can quickly and effectively restructure bankrupt banks and other financial institutions, and even companies of the real economy. However, this is an expensive solution. But today, allowing for mass bank failures threatens the loss of stability and financial security of the country. Questions also arise, what should be the organizational form of such action, who should provide financing, whether financial supervision should free the bank from certain regulations regarding risk standards, such as to absorb losses, and how long should a bank operate? This article attempts to answer these questions.

2. Types and Functions of the Bad Banks

As a result of the recent international financial crisis, the concept of using so-called „bad banks" as an anti-crisis measure is being discussed again. It is difficult to identify a broadly accepted definition of "bad banks" in the literature. It seems, that the approach to the definition should be broad, i.e. include different organizational forms and not only the form of a licensed bank. (Understanding…, 2014) Definition of bad banks (developed at Cambridge University), states that it is „a bank that takes assets (assets that have lost their value) and bank loans (debts that are unlikely to be paid back) from other banks or organizations and deals with them in order to help with economic problems: The Treasury is creating a bad bank that will take on the toxic assets that have damaged the global banking system." Author of this article defines bad banks as „a licensed bank or a special fund in the form of share company or a separated division of a commercial bank, whose aim is to heal balance sheets of financial institutions or companies. It is achieved through buyout of bad (toxic) assets for a price higher than the current market value, or for its nominal price. " Such actions contribute to a significant improvement of balance sheets of respected banks or enterprises – if the bank's or fund's operations also aim at enterprise debt relief.

There are several strategies of financing bad-debt buyouts by banks or asset restructuring funds, and include (figure 1): (Masiukiewicz, 2013a; Masiukiewicz, 2013b)

- State subsidies (e.g. Poland and Sweden), (Jackson, 2008; Ustawa z 3.02.1993)

- Central bank funding, (Good bank, bad bank, 2014)
- Bank deposit insurance fund funding, (Ernst&Young, 2014)
- Commercial financial institutions funding, or through private-public financing schemes (share in the bad bank's equity), (DziałaniaJaponii…, 2014)
- Resources from sale of previously acquired assets after restructuring and debt recovery,
- Funds obtained from the resale of bad debts (eg. after the partial restructuring). (Masiukiewicz, 2013a)

Japan has considerable experience in fighting banking crisis. In 1990s the government conducted a large campaign to save the banks. This campaign included, among others, transfer of bad loans to a special government agency (RCB). (DziałaniaJaponii…, 2014)European Union countries need a wider access to the Japanese experiences.

3. Bad Banks in the EU Financial Markets

The international financial subprime crisis has caused significant losses and a high risk of bankruptcy for a number of European banks. (Roubini, Mihm, 2011; Good bank, bad bank, 2014) The aid programs in Europe was carried out by governments in partnership with central banks and the European Central Bank. Belgium, France and Luxemburg joined together to save Dexia Bank, and in the cases of other key banks the interventions were made by countries where the bank was headquartered. Table 1. shows the most important financial institution rescues. The scale of public intervention in the recent financial crisis, judged by many economists as necessary, was the starting point for the anti-crisis programs and concepts for new regulation of the financial sector. (Powstanie…,2014)An important instrument for rescuing the banks in the crisis was the creation of bad banks, bridging banks and bad debt redemption fund (Table 1.). European banks are disposing real-estates banking bad loans. The value of these assets is estimated at EUR 583 bn. Nine largest banks with toxic assets account for 46% of bad debts. Cusham& Wakefield report suggests that the deactivation of bad assets will last for several years.(Powstanie…,2014)Example of using bad banks as anti-crisis measures in the European Union countries suffering from the subprime crisis are shown below.

Basing on the earlier experiences, the Bank of England in Great Britain implemented new legal regulations (Banking Act 2009) enabling establishing bridge banks. First bridge bank was established out of Dunfermline Building Society (DBS). The bridge bank was wholly owned by the Bank of England. In 2009 the DBS owned deposits worth GBP 2,3 bn and loans worth GBP 2,4 bn. Split between "healthy" and "toxic" assets and their transfer to the bridge bank was also done in the cases of Northern Rock (the bank was nationalized in the result of the crisis) and Bradford & Bingley. The healthy assets were in part sold to the Nationwide Building Society (together with branches and employees) and in the other part transferred to the DBS bridge bank – mainly the so-called social house loans with good credit quality. The "toxic assetmainly mortgage loans, were designed to liquidation through the so-called Building Society Special Administration Process (BSSAP) with KPMG as the advisor. The bridge bank managed its assets for six months and following that it sold the assets to the Nationwide Building Society. (Taxpayer's „bad bank", 2014; Understanding…, 2014) The bad banks, which have specific situation and has been active for some time period, should be temporary released by the financial authority, from the capital adequacy requirement.

3.1. Case of Greek Crisis

The last crisis in Greek had apogee as banks run (compared to the recent trot of 100-200m euros a day) unavoidably ensures at some point: depositors, distrusting the deposit insurance system, take out their savings and stash them at home rather than waiting for a bail-in or a bankruptcy. (Daviosdottir S., 2015) In the period between 2011 and 2013 as many as 7 banks in Greece were liquidated (including ATE, Proton, Postbank and 3 cooperative banks). Legal frameworks for bank liquidation were developed, which introduced two resolution methods, and transitional credit institutions were created (bridge banks) Purchase and assumption (P&A) solution, i.e. acquisition of one bank's assets by another bank, were also introduced. (Ernst & Young, 2014) The liquidation process of the banks in threat of bankruptcy was supervised by the National Bank of Greece. The bridge bank were provided with equity by the Hellenic Financial Stability Fund financed by the Greek Banking Deposit InsuranceFund (TEKE). This assistance was recognized as a public aid and therefore required the European Commission's approval. The logic behind this solution was to split the „bad" and the „good" assets. This was to be followed by a transfer of good assets to another bank (through P&A) or to a bridge bank (assets of two banks were transferred to a bridge bank with this purpose).

Assets of the five other banks were acquired through the P&A procedure by other, for the time being „healthy" and well-functioning banks. „Bad assets" were retained in the banks undergoing liquidation processes. Together with the „healthy assets" also fixed assets (such as IT systems or branch network) were taken over. In accordance with existing legal regulations, a bank's liquidator should endeavor to sell assets rather to restructure them. Within the 'bad assets', as much as 30% were corporate loans with deferred maturity of more than 90 days, which could be repaid by providing the debtors with financial support or debt restructuring. Approximately 5% of the non-deferred loans coming from the three cooperative banks in liquidation, whose assets were wholly retained for liquidation and the rest were defaulted loans. Two methods of servicing assets were employed in the liquidators' management:

a/lease of IT infrastructure and former employees to the entities undergoing liquidation process by the acquiring entities,

b/ use of own employees and infrastructure existing before the start of liquidation.

The special bad bank, for example, got in circa 1/3 assets and liabilities from "old bank" and to the new bank (as healthy) 2/3 good balance sheet was transferred. Table 2 presented the example of balance sheet operations.
A split would wipe out most of the assets owned by the Hellenic Financial Stability Fund and by the European Financial Stability Facility amounting to 17 bln euros (7% GDP).(Daviosdottir S., 2015) The Greek government would have to put in equity, at least 8% of the balance sheet of the new bank. Performing loans were moved to the new bank and non-performing loans were left in bad bank. The strategy concerning instrument of bad banks was very important. It wasn't of course panacea but it could be an important step towards stabilizing and stimulating the economy. The above examples demonstrate the significant role the bad banks played as a deactivation instrument during the latest financial crisis.

3.2. Role of Funds of Bad Debts for Economy crisis. Case of Poland

In the 1990s, a profound economic reform and transformation of the economy from socialistic to market economy, a deep banking and economic crisis occurred in Poland. From 1991 to 1997 five commercial banks and 147 cooperative banks bankrupted. Simultaneously 17 commercial and 36 cooperative banks were liquidated. This banking crisis was caused by poor quality of loans and hundreds of bankruptcies of companies, mainly of state-owned enterprises. The Parliament adopted a special Act introducing new bank and enterprise restructuring instruments accompanied by the possibility of public subsidies (in the form of bonds) from the state budget for their rescue. The implemented concept of restructuring bonds was the key financial leverage of the recovery process of banks and enterprises and allowed to remit bad loans resulting from such subsidies. (Masiukiewicz, 2011)The implemented regulations enabled the minister of finance to issue restructuring treasury bonds (with 10-years maturity), which were then transferred as public aid to 11 state-owned banks with the purpose to execute restructuring and recovery programs in enterprises being their debtors and not meeting their obligations. The amount of aid was determined and was paid in the form of bonds to each of the banks basing on its restructuring plan developed for the bad corporate loans, which was submitted to the minister of finance.

Two Acts constituted the legal basis for these measures: on Restructuring of Enterprises and of Banks (Ustawa z 3.02.1993) and on the Restructuring of the Cooperative Banking System. (Ustawa z 24.06.1994) The restructuring bonds denominated in Polish Zlotys (PLN) were issued in four series in years 1993 and 1994, and then transferred to ten state-owned banks to increase equities and reserves of these banks. In 1996 two further series of bonds were issued for BGZ S.A bank (a state-owned-cooperative bank affiliating cooperative banks).The total value of state assistance to banks in years 1990-1996 (adjusted to 2005 prices) amounted to PLN 36.3bn.
This method of deactivating the toxic assets proved to be very effective. None of the banks, which received the public aid, collapsed whereas 131 cooperative banks whose toxic assets were not taken over bankrupted. Implementation of the concept of restructuring bonds and creation of bad debts restructuring departments in banks worked in practice. A decision to create a bank of bad debts operating on the countrywide basis would create a number of legal and organizational problems. A bank would have to obtain banking license, which is a lengthy process. Such bank would not meet the credit risk standards and norms, and therefore it would have to receive the financial supervisor's consent to operate without meeting these norms. Acquisition of bad debts fromother banks would result in a lengthy process of learning the documentation, state of the legal protection etc.. Leaving the restructuring and debt-collection activities inside the banks with bad loans did not require any of such additional efforts.

Poland did not suffer from the latest subprime crisis, but in order to increase the soundness of the country's financial system, the parliament voted in 2013 in favor of creating a special stabilization fund financed from a bank levy which is paid by banks and cooperative saving unions. The fund is managed by the Bank Guarantee Fund. The stabilization fund may provide assistance to banks in crisis situation. This aid may be given in the form of recapitalization, financial guarantees, buyouts of shares, bonds and other securities issued by banks. (Masiukiewicz, 2014) In connection to the current crisis in the majority of cooperative savings unions a conception was developed in Poland to create a special bad debts fund for these unions. (Ernst & Young, 2014) This proven scenario could be quickly applied in this case. As the scale of this problem is significant, the conception foresees creation of creating a separate special purpose company, which would conduct restructuring of the deteriorated saving unions. A special task-force responsible for analysis of the feasible solutions was created in the Polish Banks Association. The initial assumptions are such, that the Banking Guarantee Fund would became he majority shareholder in the 'bad bank' and that banks would delegate their experts to restructure the cooperative credit unions. In addition, the plan assumes split between healthy and toxic assets and development of a program of debt-collection, debt-restructuring and debt-remission. Generally speaking, the aim of this idea is to retrieve as much funds as possible in order to cover losses in the saving unions' balance sheets, preventing bankruptcies and maintain financial stability of the whole financial system. (Ernst &Young, 2014; Powstanie…, 2014) By creating a 'bad bank' for the saving unions, the banking industry could move the whole problem outside of the industry and thereby to avoid the domino effect.

4. Conclusions

The issue of the scope of state assistance for the banking sector during the crisis is continuously a subject of discussion in the European Union, mainly in the context of the doctrine of public good in banking. During the latest financial crisis a view dominated that bank rescues were necessary as banks were seen as public good. Another reason was protecting financial stability in Europe. This allowed to prevent any bankruptcies in Europe during that period and to orderly liquidate some of the European banks. The European Commission has prepared a Resolution and Recovery Regime directive introducing new bank liquidation regime in Europe. Establishing bad banks or funds purchasing bad debts became a popular and widely used mechanism of saving financial institutions in danger of bankruptcy during the latest financial crisis. Isi s an effective tool, given that such fun or bank receives adequate funds for restructuring other banks suffering from crisis. The example of bad banks in Greek showed that this instrument of crisis deactivation is effective. Unfortunately, in many crisis situations the only institution that may promptly respond to the situation and provide necessary funds quickly enough is the state budget. It is important to conduct further studies on the bad banks functioning in practice in order to develop optimal business model.

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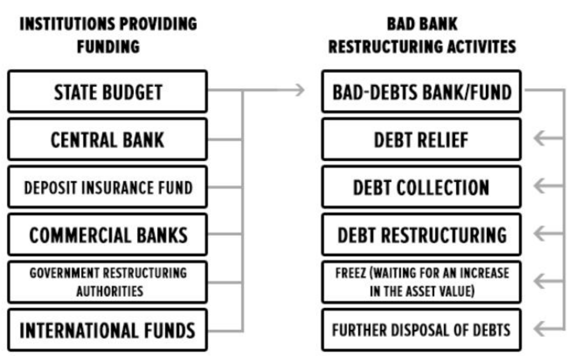
Fig. 1: Institutions Providing Funding and the Competences of a Bad Bank



Source: own

Table 1: Bad Banks in the EU Countries

No	Country	The restructured entity	Mechanisms	Results
1	Belgium, France, Luxemburg	Dexia Bank	Multi-step reduction of assets, establishment of a bad bank for "bad" assets	A large scale, complex relief mechanism
2	Greece	7 banks	Establishment of a bridge bank, acquisition of the selected banks by healthy entities and liquidation of the other banks.	Restructuring of a number of entities, including three cooperative banks
3	Ireland	Anglo Irish Bank, Irish Nationwide Building Society , Newbridge Credit Union	Bank merger and establishment of an entity to liquidate the assets. Acquisition of the credit union's assets by the bank	Restructuring of a number of financial institutions
4	Spain	Banks with bad mortgage loans	Bad debt Sareb fund	Acquisition of real estate assets worth EUR 50,8 bn
5	Germany	West LB , HRE Bank	Establishment of a non-bank liquidation institution	Effective liquidation of the „bad" assets.
6	Sweden	Nordbanken ,,Gotabanken	Establishment of the company named Securum, which acquired toxic assets from two banks for their book value	Effective liquidation of the „bad" assets.
7	Great Britian	Northern Rock, Bradford & Bing-ley, Dunfermline Building Society	Nationalization. Establishment of an asset management company named UKAR. Establishment of a bridge bank.	Buyout of bad debts from credit institutions. Evolution of restructuring measures

Source:own prepared in the base: (Ernst&Young, 2014; Fottrell, 2009; Jackson, 2008;Neumann, 2014; Stasiuk, 2013)

Table 2: The Example of the Balance Sheet of a Typical Greek Bank – Split of Domestic and Semi-Foreign Funds (in bln euros)

Balance sheet	Old banks	New bank	Bad bank
1.Total assets	172	120	52
Include:			
a/loans to customers	144	104	40
b/other (equipment)	22	10	12
2.Total liabilities	158	110	48
Include:			
a/deposits	110	110	0
b/ ECB funding	40	0	40
c/other	8	0	8
3.New liabilities			
a/equity (incl. funds from HSF)	14	0	0
b/greek government equity	0	10	0

Source: own prepared in the base: (Daviosdottir S., 2015*)*