OLIVER WYMAN

Financial Services

Bad bank strategy

It's harder this time

The good bank-bad bank structure has been widely adopted in Europe following the financial crisis. This structure separates the bank's troubled assets into a separate legal entity – the "bad bank" – thereby allowing management to "draw a line" under the errors of the past and focus on rebuilding the remaining "good bank".

In some cases, the structure is an independent initiative of the troubled bank. In other cases, such as the UK's Asset Protection Scheme, it is part of a government bailout mechanism. The bad bank purchases troubled assets at or above market price, thereby improving the capital position of the remaining good bank.

Exhibit 1: Assets of European bad banks

Bad bank	Volume of assets at inception* (EUR BN)
Asset Protection Scheme (RBS)	320
Lloyds Banking Group (planned but not executed)	300
Internally managed portfolio (Dexia Group)	190
FMS Wertemanagement (HRE)	170
Internally managed portfolio (BayernLB)	95
EAA (WestLB)	80
Internally managed portfolio (HSH Nordbank)	75
NAMA (BoI, AIB, Anglo, EBS, IL&P, INW)	55
Internally managed portfolio (Commerzbank)	40
Internally managed portfolio (Natixis)	35
Internally managed portfolio (ING Group)	30
StabFund (UBS)	30
Internally managed portfolio (KBC Group)	25
Royal Park Investments (Fortis)	15
Kaupthing Bank	10

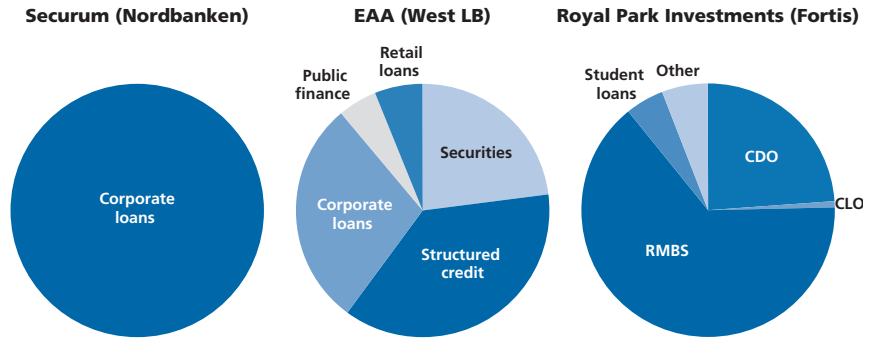
* Rounded to nearest €5 BN; fair value at inception where available, otherwise book value with haircuts applied at / before transfer; conversion rate as of November 2010; Source: Individual institutions

The bad bank approach is not new. Following its use at small failed institutions in the United States, Sweden successfully employed the strategy on a larger scale during its 1990s banking crisis and, at about the same time, an industry-backed bad bank was established in Japan. These are generally thought to have been successful applications of the strategy, and many are optimistic that today's bad banks in Europe will not only restore confidence in banking sector but also avoid significant losses for taxpayers.

This optimism may be well placed but not if it is based solely on past experiences. Today's bad banks will not be as easy to wind down as those of previous crises. The most obvious reason is the far greater complexity of the assets involved. Many of today's bad banks contain a variety of illiquid, hard-to-value assets that present greater challenges

than the real estate and land development portfolios of the past. Exhibit 2 contrasts the original Securum of Sweden, which handled a portfolio of vanilla loans to corporates (mostly secured against real estate), with two current bad banks.

Exhibit 2: More complex and diverse assets in today's bad banks



Source: Securum Source: EAA Source: Royal Park Investments

The scale and scope of this banking crisis also far exceed those of Japan and Sweden in the early 1990s, which were purely domestic and benefited from a global economic recovery in the mid-nineties. Developed economies now face an extended period of sluggish growth and fiscal contraction. This will subdue the value of bad banks' assets and increase political sensitivity to writing them off at taxpayers' expense. Whereas Sweden's Securum was wound up in five years, today's bad banks may be with us for a generation.

Liquidation strategy

The complexity of their portfolios and difficult economic context make the job of today's bad banks unusually difficult. In this paper, Oliver Wyman aims to help by outlining an approach to formulating liquidation strategies.

The first step should be to systematise the available options. Any alternative to outright disposal should be carefully argued as it may implicitly assume a competitive advantage over the market in, for example, restructuring capabilities. Exhibit 3 provides an illustrative segmentation of potential strategies for liquidation.

Exhibit 3: Illustrative classification of liquidation strategies

	Short term	Medium term	Long term
Sell	■ Sell single security ■ Sell as part of portfolio	■ Sell on condition – Value – Market sentiment	
Restructure	■ Convert, swap ■ Exercise rights ■ Cancel	■ Litigate ■ Seize collateral	Renegotiate, grant payment holiday
Hold			Hold and hedge Hold and monitor Hold only

To select the best option, expected revenues must be traded off against costs which, aside from tax, fall into three categories:

Operating costs: Some strategies will require more skill and infrastructure investment than others. The deliberate build-up of real estate expertise at Securum was costly but worthwhile given the scale of the portfolio. This may not be so for many asset classes in the fragmented portfolios of today's bad banks.

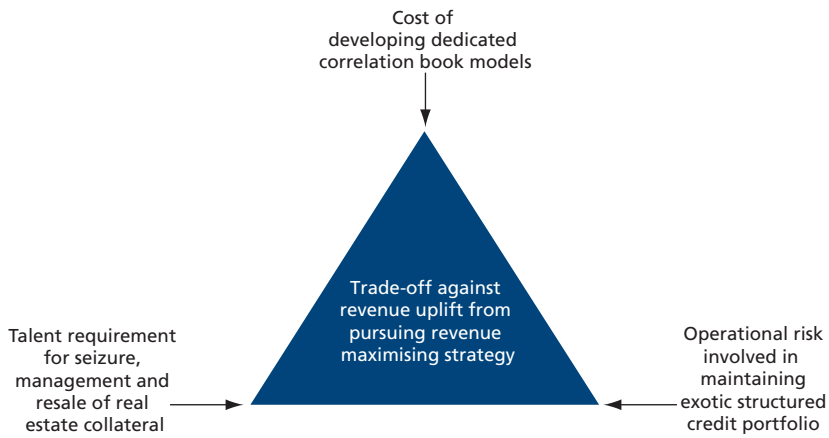
Risk: Not all stakeholders are willing to accept the levels of retained risk that would support the pure optimization of returns. Furthermore, bad banks may be subject to selected or even full regulatory capital requirements that introduce an additional risk cost. Lastly, some regulators require up-front capitalization of expected loss (and, possibly, a portion of unexpected loss). This may reduce possible returns depending on time-horizon.

Liquidity: One aim of the good bank-bad bank construct is to liberate liquidity for use by the good bank. Where the construct requires the good bank to provide liquidity as and when needed, this becomes a constraint on the liquidation strategy and its return potential. For bad banks that are allowed to run negative equity balance sheets, liquidity provision always carries the risk that temporary support turns into capital loss on the day of wind-up.

The optimal trade-off and hence, the liquidation strategy, will vary over time. This is because the above costs will change. For example, capable staff in certain asset classes may become scarce as the economic cycle turns and outside opportunities draw away key managers. Also, developments in bank regulation may change the regulatory capital cost of holding certain assets. The liquidation plan should be reviewed periodically to ensure that any such changes are captured and that the strategy remains optimal.

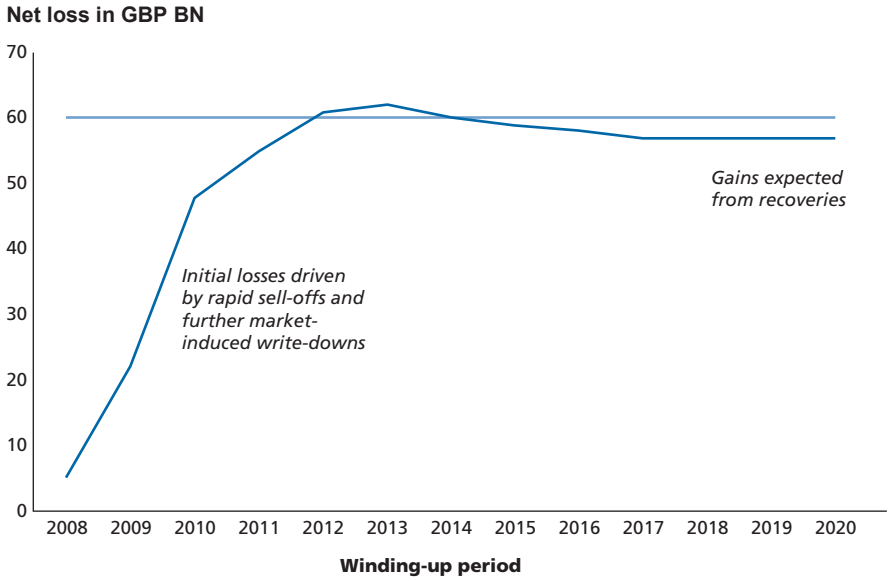
Even without variation in underlying costs, the optimal trade-off at inception will not remain ideal after a few years when the remaining assets are a fraction of the original portfolio. At this point, maintaining the original number of specialist teams is unlikely to be economically viable. The challenge is to ensure that the cost base shrinks with the portfolio. Given the break-even scale for each sub-portfolio, this is likely to require block-sales or deliberate strategy switches as these thresholds are reached.

Exhibit 4: Example trade-offs for a bad bank holding complex structured assets



The projected loss profile for APS (RBS's bad bank) illustrates the impact different strategies can have on portfolio return (see Exhibit 5). As can be seen, there is a substantial loss up front as assets are sold rapidly at a discount to their purchase price. Where it is feasible to extract inherent value over the long-term, this is included in the plans, shown by the slight projected decrease in the overall loss over later years.

Exhibit 5: Expected losses of APS assets
Expected losses of RBS assets covered by the APS, as per end of year 2009 (in GBP BN)



Source: Asset Protection Agency

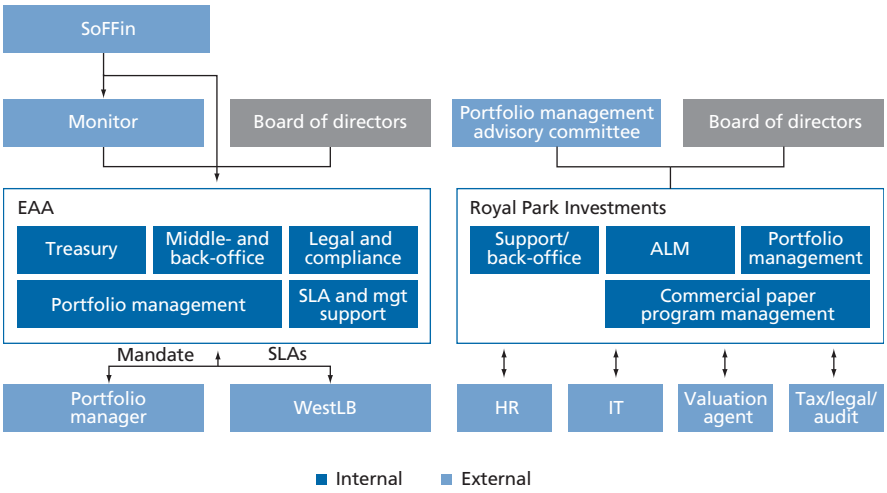
Cost reduction

These cost constraints would seem to severely restrict what can be done to realize the value thought to reside in many non-performing portfolios. Yet there are measures that can reduce these costs and thereby help to extract more value from bad portfolios.

Third party suppliers: Third party specialists can be engaged to value, manage or liquidate specific sub-portfolios where the build up of internal infrastructure or staff would be too expensive. Currently, hedge funds play a significant role in managing and reporting some of the structured credit portfolios. They offer fairly standardised infrastructure but often do not cover all the analytics and reporting requirements of regulated banks.

Offers have also been developed by investment banks and boutique firms, mostly focussing on infrastructure and MIS. These are often more tailored to the specific bad bank set-up. Accounting and legal firms are well positioned to support valuation, tax and legal issues. Exhibit 6 depicts the use of external supplies at two bad banks.

Exhibit 6: Using third party providers
Examples: EAA and Royal Park Investments



Source: EAA, Royal Park Investments

Pool or swap assets: Pooling or swapping sub-scale portfolios would allow expensive staff or infrastructure to be shared, thereby maintaining the economies of scale required for the optimal management of individual portfolios. This is probably the best opportunity for unit operating cost reduction at bad banks.

Use good bank resources: Resources from the good bank's management can sometimes be employed to maintain scale across the combined good-and-bad bank. An example of this is EAA, shown above. However such an approach is not without challenges. It requires intra-bank service level agreements to be formulated and it threatens to divert the attention of the good bank's management, contrary to the intended purpose of creating the bad bank.

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Many of the bad banks established during this crisis are likely to take 20 or more years to wind down. Throughout this period, they must continuously choose the optimal liquidation strategy according to the trade off it creates between returns and operating costs, risks and liquidity burdens. As the portfolios shrink over time, these choices will become increasingly tough. To make them more palatable, bad banks should begin to pursue the cost mitigation opportunities outlined above.

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Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialised expertise in strategy, operations, risk management, organisational transformation, and leadership development.

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