"Bad banks" and their role in the deleveraging process

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1. Introduction

A good bank/bad bank scheme is a well-established banking crisis management tool, repeatedly used in the past throughout financial systems. Moreover, it has received legal recognition and is expressly contemplated in the 'resolution toolbox' of the EU resolution directive[1] (the 'BRRD'). The spin-off of an ailing institution into two vehicles – whether those vehicles are actual companies or not – may not be, in itself, enough as a resolution tool, but it is a relatively frequent step and resolution strategies often involve its use. The fundamentals of the idea are rather simple: damaged or legacy assets demand effort and management to maximise recovery and, when commingled with the healthy part of a banking business, they are not only unproductive but also drag in financial, technical and managerial resources that would more profitably be devoted to assets that can deliver better returns and, above all, to the origination of new business. Therefore, it is often – though, needless to say, not always – useful to establish a separation between legacy assets and healthy ones, and to put each under the appropriate managerial structure, so that the bad assets may be divested in an orderly fashion, turned around, or liquidated in the least harmful way possible, whereas the good ones, unencumbered, may form a new, viable institution.

While 'good banks' are invariably banks, 'bad banks' often are not. This is because in order to maximise recovery, managers of bad banks need to be freed from the constraints of banking regulation that apply to banks which are a going concern. This is easier, of course, when the bad bank and the good bank operate as separate legal entities, but that need not be the case.

In this article we shall briefly examine the notion and its use in the crisis management of banks, in particular since 2007, and with special focus on the Spanish case which, in addition to being the closest to the author's experience, is, to his knowledge, the most relevant in recent history in terms of the volume of assets involved.

[1] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms. See, in particular, Article 42 and references to the "asset separation tool" and asset management vehicles.

2. Shaping the notion[2]

As commented, the essence of the good bank/bad bank technique consists in the separation of a bank's troubled assets (the term 'asset' is to be construed here in the widest sense possible, meaning strictly assets, portfolios or entire business lines) from the performing ones. In our opinion, the application of the good bank/bad bank technique does not require the use of separate legal entities, but it does require the setting up of different managerial structures, which is not the necessarily the same thing. In other words, whether or not the good and the bad banks are different legal entities, they should operate as entirely separate business units under different rules.

This principle of managerial isolation helps us to differentiate the good bank/bad bank technique from other tools available and used for resolution or restructuring purposes which also involve the identification – but not necessarily the segregation – of a perimeter of troubled assets.

A salient example of the latter are asset protection schemes.[3] An asset protection scheme requires the identification of a set of assets that the scheme will apply to. But those assets are normally not managed separately. Moreover, it may be of the essence in the asset protection scheme rules that assets subject to protection are not managed separately. The beneficiary of an asset protection scheme is generally required not to discriminate protected assets from unprotected ones so as not to alter recovery rates.

Bad banks (or asset management companies) and asset protection schemes or, in other words, separation (or asset removal) and protection are two alternative forms of asset support. In some respects, asset separation can be seen as the more, and an asset protection scheme the less, invasive solutions to the same problem. Market conditions and circumstances should dictate when to use one or the other. According to O'Brien and Wezel,[4] asset separation may become

[2] For an introductory yet systematic approach, see G Brenna, T Poppensieker and S Schneider (McKinsey & Co) (2009): www.mckinsey.com/insights/financial_services/understanding_the_bad_bank.

[3] An asset protection scheme is an agreement or a statutory instrument pursuant to which a guarantor (generally, a public institutions), guarantees the value of a given set of assets of a bank, be it in the context of the transfer of control to a new investor or in another scenario. We have briefly examined and provided further reference on the nature of asset protection schemes in a previous work (in Spanish), see F Mínguez, "Herramientas Contractuales de Apoyo Financiero a Entidades en Crisis: los Esquemas de Protección de Activos" ("Contractual Tools of Financial Support to Ailing Institutions: Asset Protection Schemes") in A Recalde et al (editors), *Crisis y Reforma del Sistema Financiero* ("Crisis and Reform of the Financial System") (Madrid, Thomson Reuters – Universidad Autónoma, 2014).

[4] E O'Brien and T Wezel, "Asset Support Schemes in the Euro Area", *ECB Financial Stability Review*, May 2013.

desirable in contexts of depressed marked prices, when there is little market access, when the amount of impaired assets is really too large for the bank's resources and when management may benefit from economies of scale (provided a single or a reduced number of asset repositories are established, as seems invariably to happen).

On the other hand, splitting a bank into two or more units does not necessarily imply that those units are defined on managerial criteria. The units may be homogeneous and established just for the purposes of facilitating a sale (such as in the case of the break-up of a large organisation into smaller, homogeneous units).

Banks may set up, on their sole initiative, legacy units that function as bad banks, either within their own legal structures or as separate legal entities within their consolidated groups. Operationally, these may offer perfect examples of the good bank/bad bank principle and may achieve the same management goals. Nevertheless, in such examples, the concept falls short from delivering its full results, which may be achieved only when there is some regulatory back-up permitting the exclusion of the legacy assets from the banking regulatory perimeter.

In other words, although the concept may be expanded, the examples that are of primary interest for us for the purposes of this chapter are those experiences backed by some regulatory coverage or directly regulatory-driven.

3. Pre-2007 experiences

According to commentators, the first notable use of the good bank/bad bank technique was that by Mellon Bank (now part of Bank of New York Mellon) as early as 1988. That year Mellon Bank spun off $1.4 billion of bad loans to a newly created institution – chartered as a bank, albeit it did not take deposits – named Grant Street National Bank. Mellon's shareholders received, by way of dividend, a share in Grant Street per share in Mellon.[5] Although the structure did not benefit from any particular regulatory reliefs, it received some endorsement from the Federal Reserve (which accepted that Grant Bank could be chartered). Once isolated, and equipped with most of Mellon's collection teams, Grant Bank could concentrate on recoveries. By 1995, Grant Bank was dissolved.

However, possibly the best known, and – according to the general consensus – most successful to date, application of the notion (in the restricted sense

[5] Allegedly, the effect on Mellon's share was positive.

contemplated here) took place in the aftermath of the Swedish banking crisis. The Swedish authorities created two bad banks (actually special purpose vehicles, not banks this time) to receive the non-performing assets from, respectively, Gota Bank and Nordbanken (still in business as Nordea). A similar approach was followed in Finland, also in the early 1990s.

One of the Swedish asset management companies, Securum, became a kind of archetype, although it was based on on earlier precedents. Securum[6] was entrusted with the management of roughly Skr 50 billion in impaired assets[7] – an astonishing amount for 1992 Sweden – and given a 15-year mandate to divest them. Although it was 100% owned by the Swedish state, management was independent and entirely professional, and the company was freed from any banking regulation constraints. Though divesting its assets was its primary purpose, Securum was legally able to manage its legacy in a wider sense and could turn around assets or develop them to maximise return, even if that required additional investments. By 1994, a good part of the task had been successfully accomplished, and in 1997 Securum itself was wound up.

4. Ireland and NAMA

Post-2007, much attention was gathered by the creation of the Irish National Asset Management Agency (NAMA). Pretty much in line with what happened in other countries, and very particularly in Spain, the Irish real estate market collapsed shortly after the outbreak of the general financial crisis, causing serious trouble to the six Irish banks at the time and, ultimately, to the Irish state itself.

Over a process spanning several years NAMA took care of a face value of €77 billion in loans for a transfer value of €31.8 billion (hence a 57% average discount). Consideration to contributing banks is satisfied in the form of bonds guaranteed by the Irish state. Assets were acquired in the form of loans exclusively. Hence NAMA became the direct owner of properties only after the relevant enforcement and repossession processes.

NAMA was established as a public statutory body by means of an *ad hoc* act (the National Asset Management Agency Act 2009) which also governed the process of separation of assets from the banks subject to the measure. NAMA, as an

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[6] The Securum case was discussed, among others, by Bergström, Englund and Thorell in a 2003 paper commissioned by the Stockholm based Centre for Business and Policy Studies, a summary of which is available at: www.sns.se/sites/default/files/securum_eng.pdf.

[7] The number of obligors was, however, fairly limited by comparison to what happened later in Spain, for example; less than 1,500.

agency, is under the control of the Irish Treasury. However, the actual structure of the Irish bad bank is rather more complex. NAMA holds 49% of a company named National Asset Management Agency Investment Ltd (NAMAIL), the other 51% of which is held by private investors. Nevertheless, there is a shareholders' agreement between NAMA and the private investors that entrusts NAMA with certain veto rights[8]. The structure under NAMAIL consists in a multiplicity of vehicles with servicing, debt-issuance or asset-holding functions.

The transfer of assets into the NAMA structure was carried out on a case-by-case (bank by bank) basis, pursuant to an *ad hoc* due diligence and valuation. This is why, although the primary vehicle was established as early as 2009, it was not until 2011 that NAMA gathered the whole portfolio it currently has under management. This time-span had an impact on asset valuation, so the final discount applied for transfer purposes (an estimate of the assets' long-term value) was larger than expected.

After its long implementation process, NAMA seems to be successfully fulfilling its role, deleveraging at reasonable speed and making consistent profits.

5, The Spanish experience: Sareb

5.1 Background

As early as 2009, the profile of the Spanish banking crisis and where the core of the problem lay were apparent to most well informed observers. As logic dictated, in view of the composition of the balances of the banks, a very significant proportion of real estate or real estate backed assets turned out to be non-performing. The problem was therefore quite similar to Ireland's but of a different size by several orders of magnitude.

Given that, regardless of size, the problem seemingly stemmed from an identifiable group of assets or asset classes, it was also quite logical that a good bank/bad bank scheme was postulated relatively early in the process as a natural remedy. However, it took some time to put things in operation for reasons related initially to regulatory decisions and later to fiscal issues.

Sparing any political angle to the matter, it seems evident now that Spanish regulatory authorities were, in the early stages of the crisis, either reluctant to

[8] Such veto rights and the general structure were approved by Eurostat for the group headed by NAMA not to be considered a part of the public sector for national accounts purposes. However, for the purposes of corporate accounts, NAMA is deemed to have control over NAMAIL (see NAMA various annual reports at www.nama.ie).

disclose the estimated amount of assets affected or misled about what that amount was. Whatever the cause, they thought the creation of a bad bank was not appropriate. If they really thought the dimension of the problem was much lower than it was later considered to be, a bad bank would probably have been unnecessary since there would have been reasons to believe banks could cope with their troubled assets by other means. If they were aware of the magnitude of the matter but, for whatever reason, were not willing to disclose it, a bad bank did not make sense either, simply because a condition for the success of the good bank/bad bank strategy is that it provides a real relief to banks by taking in all, or most, of their impaired assets. If a significant amount of troubled assets is left out, it is hard to see the point of the exercise of separation.

After 2011, the regulatory strategy shifted dramatically: banks were required to clean up their balance-sheets as much as possible and to make substantial provisions for nearly all real estate-related asset categories in a broad sense. Troubled asset classes were clearly labelled as such and the problem was thus disclosed. There was relative consensus, by that time, about the convenience of setting up a bad bank. The problem then turned on its funding or, more precisely, how to make up for the heavy losses banks were to book when writing off, wholly or partially, their assets upon their transfer to the bad bank.[9] Spain was, at the time, under serious budgetary stress and struggling to overcome the fiscal crisis that affected the peripheral euro economies. Ireland, Greece and Portugal had already been forced into wide-ranging EU rescue packages and all the pressure was now on Spain and, next in line, Italy.

By mid-2012, Spain applied for a €100 billion[10] EU credit line for the restructuring of the banking sector. The facility was granted upon Spain's acceptance of certain conditions, as had been the case with the rescue packages for other euro countries, but these were limited to the policy area concerned:[11]banking regulation and banking policy matters. The conditions were set out in a memorandum of understanding entered into between Spain and the European Union. One of the conditions imposed by the memorandum of

[9] In fact, assets could have been transferred at *any* nominal value but, at some point, the loss implicit in the difference between the book value and the fair value (even after several years of accounting for impairment and making provisions and write-offs, the real estate portfolio or banks was deemed to be overvalued) would have to arise. It was then a matter of choice: banks could be requested to mark-down their assets prior to the transfer and, as a result, become unable to meet regulatory capital standards or plainly insolvent (hence becoming candidates for a bail-out), or losses could crystallise once in the bad bank which, in turn, risked tbeing insufficiently capitalised from the outset.

[10] Of which only a part was used.

[11] Spain did not apply for a general bail-out programme and hence was not subject to general economic policy conditions as Ireland, Portugal and Greece had been.

understanding was that certain impaired assets of banks that were bailed out or had received or were expected to receive public support in the context of the 2012 stress tests[12] had to be transferred to a bad bank (more technically, an "asset management company").

The memorandum of understanding was signed in late June 2012 and the legislation implementing it was enacted as early as August 31 of that same year by means of Royal Decree-Law 24/2012 (later re-enacted as a parliamentary act, Act 9/2012).[13] Mere legislative references may fail to convey the magnitude of the accomplishment: Royal Decree-Law 24/2012 was not a typical piece of executive legislation, but a fully-fledged act on bank resolution, incorporating most of what was already in the text of the BRRD, as then available.

As noted above, in the introduction, the BRRD contemplates – and had already contemplated in its earlier drafts – the transfer of assets into an asset management company as part of its resolution toolbox. Royal Decree-Law 24/2014, anticipating that, provided for the regulation of asset management companies as such a resolution tool and, furthermore, mandated that one such company be immediately set up and that certain banks should transfer assets identified as problematic to the new company. The company was effectively incorporated shortly before end of 2012 as Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria SA (better known by the acronym 'Sareb').

Time was of the essence in the process and, of course, it proved to be a constraint that influenced the design of Sareb.

5.2 The vehicle

Coming only a short time later, Sareb owes a lot to NAMA's example. The Irish precedent was the primary reference for the Spanish authorities (and their advisers), whether it was to apply the same solutions, or consciously to depart from them.

[12] On the basis of the results of stress tests carried in 2012, significant Spanish banks were classified into four groups: Group 0 were the healthy banks, ie banks that successfully met the test; Group 1 were the banks that, at the time, were already state-owned due to previous bail-out processes; Group 2 were the banks that failed the test and were deemed to need some form of public support to be kept in business; and, finally, Group 3 were the banks that, while falling short of the test's requirements, were believed to be able to overcome the situation on their own. The banks that had to transfer assets to an asset management company were those in Groups 1 and 2.

[13] Subsequently repealed upon the enactment of Act 11/2015, implementing the BRRD.

Unlike NAMA's, Sareb's legal nature and regime were not developed entirely *ad hoc*. There was simply not enough time to cope with the technicalities inherent to the implementation of a newly designed type of institution. Following the path of Securum, Sareb is incorporated as a public limited company (*sociedad anónima*) with very few special provisions. It has a limited life span (15 years from its incorporation) and it has received certain waivers from general company law provisions that are normally only available to listed companies.

The share capital in the company is held by the state (through the Fondo de reestructuración ordenada bancaria or 'FROB', meaning the fund for orderly bank restructuring') and private investors on a 45/55 basis. Hence, Sareb is a private company for the purposes of EU national accounts classification. The private investors (holding 55% of the capital and voting rights) mainly come from the healthy part of the financial system.[14]

Sareb is, in addition and at least theoretically, the first of a kind. As noted neither Act 9/2012 nor Act 11/2015 regulate Sareb as such, but asset management companies in general. However, Royal Decree 1559/2012 of November 15 2012, in addition to developing the legal regime of such companies in general does contain certain provisions applying to Sareb specifically (hence, at least in theory, not necessarily applying to any future asset management company). This special regime does not really create a unique set of rules departing to those applicable to companies in general, but rather consists in an extension to Sareb of certain features that are typical of listed companies (see further below).

In contrast with the complexity of NAMA, the structure of Sareb is rather simple. There are no substructures[15] involved. The Spanish bad bank is single vehicle, encompassing the assets, the liabilities arising from the transfer and the management structure.

5.3 The transfer

The assets transferred to Sareb were real estate or real estate-related, mostly in the form of non-performing loans to developers. The value for transfer purposes was €50.8 billion, of which €11.3 billion corresponded to properties and the remaining €39.4 billion corresponded to loans (assets were valued at discounts ranging from 45% to 80% of their face or original appraisal values). The law

[14] Some other institutional investors hold minor stakes.

[15] Save for the FABs to what we will later refer.

foresaw the possible acquisition of shares in real estate companies as well, but this possibility was not used in practice. Assets under a certain threshold (€100,000 for properties and €250,000 for loans) were exempted from transfer, on the assumption that banks were able to divest those themselves quite efficiently.[16] Banks had to mark the assets down to their transfer value, if necessary, in their own books, prior to the transfer – hence losses crystallised at that point.[17]

Unlike in the case of NAMA, and because of the time constraints imposed by the memorandum of understanding, the transfer was a one-off process,[18] virtually simultaneous with the incorporation of the vehicle. No due diligence was carried out beforehand, nor was there an asset by asset appraisal or valuation. Rather, the transfer value was determined in the context of an exercise carried out by Bank of Spain, and Sareb carried out retrospective due diligence, having a 36-month period to put return any assets not meeting the transfer criteria (this put right of return was exercised in practice, leading to adjustments that, while not very significant in the overall context, were not immaterial).

On the basis of the transfer values at its inception, Sareb is larger than NAMA (€50.8 billion in the case of Sareb as opposed to €31.6 billion for the Irish institution) but the difference in size is not commensurate with differences between Spain and Ireland in terms of GDP, population or the size of the banking sector. The differences in structure and complexity of the assets are more relevant. Sareb is not only bigger than NAMA but also more complex. Whereas NAMA received only loans concentrated to a significant degree in relatively few obligors, Sareb had to cope with some 200,000 assets[19] in the form of properties (of various classes) and loans secured by another 400,000 properties. The Spanish exercise was, therefore, more demanding in terms of analysis and due diligence, due to a much higher degree of granularity.

While, as noted above, there is little originality in the vehicle, legal effort was put in making the transfer secure. Although there is a contract between Sareb

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[16] An assumption likely to hold, since assets under that threshold normally correspond to individual dwellings that banks commercialise through their extensive networks of branches, or to individual mortgages.

[17] As a matter of fact, due to the application of extraordinary accounting rules earlier that year, assets had already been marked down, so the transfer to Sareb did not result in significant additional losses.

[18] Technically, the transfer of assets took place in two stages. A first stage by the end of 2012, comprising the banks that, at the time, were already majority owned by the FROB (the Group 1 banks) and a second stage in February 2013 with Group 2.

[19] Due attention should be paid to the fact that the notion of 'asset' when we come to counting them is not unproblematic, so that figure is always an approximation. By way of example, a loan to a developer (a single asset) may become, after repossession, a much larger number of residential properties (houses) to be sold one by one, so that single asset could be considered, functionally, a multiplicity.

and each contributing entity, regulating the particulars, the transfer of assets to Sareb was ultimately made by operation of the law; a statutory transfer subject to certain provisions that represent relevant exemptions to general, common statutory rules applicable to asset transfers. In this respect:

- The transfer was mandatory for the contributing banks and subject to no consent from any third party.

- The transfer was not subject to insolvency claw-back provisions.

- No third-party rights (such as rights of first refusal) could be opposed to the transfer.

- Even if some of the assets might be held to constitute a productive unit or a 'business', no labour law, tax or social security liability could be attached and, in particular, no employee could claim a right to be employed by Sareb as a result of the transfer.

- Sareb is not affected, in the context of insolvency proceedings against its debtors, by the statutory subordination that might otherwise have affected the transferor if the transferor was a party related to the insolvent debtor.

On the other hand, the transfer was a true sale for the banks that ceased to be involved with the assets transferred; Sareb assumed all the risk and rewards, notwithstanding banks' transitional role as servicers.

5.4 Funding

The basic source of funding of Sareb is through bonds issued to the asset transferors as consideration for the assets. The bonds are guaranteed by the Kingdom of Spain and, as such, may be posted as collateral for European Central Bank funding.

As noted above, equity (share capital) is distributed in a 45/55 proportion between the FROB (the Spanish state) and private investors. The capital base was reinforced with convertible financing for an amount of three times the share capital (€3.6 billion for €1.2 billion). Convertible bonds were also issued in a 45/55 basis to the FROB and private investors (although the individual private investors' holdings in convertibles and capital are not exactly the same). Banco

Santander is the largest capital and convertibles holder, with 17.3% and 16% of the share capital and the convertibles, respectively, as at Sareb's inception.

5.5 Governance and management structure

As a company, Sareb has the same governance structure as any other Spanish corporation. All shares are equal in rights and every shareholder has the same rights to attend and vote at the general shareholders' meeting, which therefore reflects strictly the 45/55 capital composition.

The company is not listed and may not be in its present configuration, since shares may only circulate among certain categories of institutional investors. Nevertheless, the law imposes a governance structure that is virtually the same as that applying to listed companies.

The board of directors must have between five and 15 seats, of which a minimum of one third must be assigned to independent directors. Currently, Sareb has 14 directors, five of which are independent. The FROB is a director. Under the board of directors, there is a structure of supporting committees, established by mandate of Section 23 of Royal Decree 1559/2012 (management, risks, investments and assets and liabilities). In addition, like listed companies, the company has an audit and an appointments and compensation committee, consisting of a majority of independent directors and chaired by one of them. Sareb must report to the public at large along the same lines listed companies do.

The Bank of Spain does not have over Sareb the same supervisory powers it has over credit institutions (exercised within the framework of the Single Supervisory Mechanism) or other financial intermediaries. However, it oversees the company's activities, monitored the asset transfer exercise and has authority to dictate Sareb's accounting standards. This last point has led to debate during Sareb's early stages. Not being a listed company and not having consolidated accounts[20] (hence, not falling within the scope of the International Financial Reporting Standards under EU Regulation 1606/2002), the company would have had to abide by the accounting standards set out in the Spanish Code of Commerce and the General Accounting Plan. Being freed from regulatory constraints – in particular, banking provisioning and asset impairment criteria – was viewed as one of the main advantages of a vehicle of this kind. However, Item 10 of the seventh additional provision to Act 9/2012 (introduced by Act 26/2016) foresaw a series of specific rules, to be developed by Bank of

[20] Sareb has no subsidiaries.

Spain. This authority fulfilled that mandate by issuing Circular 5/2015 which sets, among other particulars, provisioning criteria tailored for Sareb which, while being different from banking standards, are more stringent than the general ones.

At its inception, the massive transfer of assets from the contributing banks and time constraints left little choice but to keep the transferors as servicers. Sareb lacked the resources to take over management functions and, moreover, it was never the intention to let the structure grow to the point where it would be able to manage the vehicle's huge portfolio using solely internal means.[21] The first major project undertaken by Sareb – apart from the due diligence – was the re-engineering of it servicing structure. The contributing entities were, in the course of 2014, replaced by four general servicers selected in a competitive process and each awarded a long-term servicing contract.

Being a company, and hence subject to private law, Sareb has ample leeway to manage its assets and divest them as it thinks appropriate. It currently operates both in wholesale and retail property markets, and has become a relevant player in the secondary market for loans and loan portfolios. Though these are more delicate operations from the perspective of a vehicle born to liquidate, Sareb is also able, with no restriction, to transform and turn around assets to make them more fit for the purpose of being divested, even if that requires further investments.

Although the company has not yet reached breakeven (mostly due to the application of Bank of Spain's 2015 criteria) it has already divested assets by the thousands and has repaid several billions in debt according to the relevant schedules.

6. "Bad banks" as deleveraging tools: the debate

Asset separation seems to be an advisable technique when banks are faced with a stock of impaired assets that go beyond a certain level, paired with markets that are depressed or otherwise do not offer prospects for quick divesting. These circumstances often amount to a system-wide problem, as was the case in Sweden in 1992 and, more recently, in Ireland or Spain.

Asset reparation provides transferring banks – albeit possibly at the cost of crystallising losses – first with capital requirements relief and a boost in liquidity, to the extent that assets are swapped for cash or low risk-weight

[21] That said, Sareb's internal structure grew quickly to some 300 employees.

bearing securities easily convertible into cash, and, perhaps more importantly, with free management resources which may be re-applied to return-making activities.

If the bad bank is engineered so as to provide a clear break, with no further involvement of the transferring banks with the assets (other than, eventually, as servicers), the deleveraging effect on the banking system is immediate. Needless to say, from a wider perspective, the bad bank is not, by its mere creation, a solution to the problem posed by the assets, merely a change of co-ordinates. The assets leave the banking sector but do not vanish. Someone must bear their risk thereafter and that someone is, very often, the taxpayer. Even though NAMA and Sareb – as the latest and most relevant examples – have been designed to meet Eurostat tests and it must be accepted that they operate under no undue public sector influence, it is no less true that, in both cases, the Irish or Spanish taxpayer owns roughly a half of the vehicle and, which is more relevant, stands behind its balance sheet in the form of public guarantees.

The implementation of bad banks, at least in the versions for which NAMA and Sareb (and Securum before them) provide examples, has led to debate in the respective jurisdictions, and even to bitter argument. In Ireland, the creation of NAMA was the object of open criticism from economists and other commentators. Some objections are, in fact, not addressed at bad banks in particular but to bank bail-outs in general.[22] Others may be better described as technical. For instance, the Bank of Spain, while not expressing any objection in principle against the tool, considered it not appropriate for a long time in the Spanish context. From another angle, some commentators held that Sareb, rather than being half public and half privately owned, should have been made fully public and given a different, more social, mandate. Some academics in Ireland, in a commentary published in *The Irish Times* argued that they would have rather seen banks subject to outright nationalisation, than the limited intervention NAMA represented:

> *We can summarise our arguments in favour of nationalisation, and against the Government's current approach of limited recapitalisation and the introduction of an asset management agency, under four headings. We consider that nationalisation will better protect taxpayers' interests, produce a more efficient and longer lasting solution to our banking problems, be more transparent in relation to pricing of distressed assets, and be far more likely to produce a banking system free from the toxic*

[22] Eg the position of Joseph Stiglitz about the NAMA bill, expressed publicly at Trinity College on October 7 2009.

> *reputation that our current financial institutions have deservedly earned.*[23]

The public or private nature of the vehicle – or the appropriateness of its mere existence – are not the only matters for debate. When, as was the case in Spain, the vehicle has to co-exist with the rest of the system, part of which has not been subject to any form of aid, competition and conflict of interest issues may arise. Unlike in Ireland – where all the banks were given the opportunity to transfer impaired assets into NAMA – in Spain only certain institutions could contribute to Sareb. The healthy part of the system was not only not given the opportunity to transfer assets but, with some salient exceptions, become the private shareholders and subordinated bondholders of the vehicle. And it is worth bearing in mind that, in this context, 'healthy' means unaided rather than untroubled. Spanish banks saw the establishment of a €50 billion competitor in the same market where they were meant to divest their own legacy assets.

On the other hand, it has been said that economies of scale dictate that there is little logic in implementing a large number of asset management companies within a system. A single vehicle appears to be a better option. But, beyond a certain point, the management of that single vehicle may become very complex, as it inherits and concentrates not only troubled assets themselves, but also the problems banks face to make them liquid.

7. Conclusion

The good bank/bad bank arrangement has been repeatedly used in the past to cope with banking failures and crises. And asset separation has proven a good strategy, backed by success in several contexts. The salient examples discussed in this chapter are too recent and have not carried out their mandates for long enough to establish whether they too will be successful. Moreover, it may not be easy to call this experience a success, since there will always be little chance to see the results that alternative strategies might have delivered.

Theory states that when certain circumstances concur, as was the case in Ireland and Spain (a system-wide crisis, accumulation of large stocks of legacy assets and stagnant markets) asset separation is advisable. Some virtuous effects of asset separation are automatic, namely the relief to contributing banks, but their ultimate success (even in merely operational terms) depends on a multiplicity of factors: correct asset valuation at inception, establishment of an

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[23] *The Irish Times*, April 17 2009 (www.irishtimes.com/opinion/nationalising-banks-is-the-best-option-1.747194).

efficient management structure and, last but not least, a well-defined management and strategy.

At least when these vehicles attain a certain size, due attention should be paid to potential side-effects in those parts of the financial system that do not benefit directly from the scheme and over the economy at large.