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## GUIDING PRINCIPLES FOR BANK ASSET SUPPORT SCHEMES

### Executive summary

In the context of the deliberations at the ECOFIN Council and the Economic and Financial Committee and as a contribution to the EU Commission's "Communication on the Treatment of Impaired Assets in the Community Banking Sector", published on 25 February 2009, the Eurosystem has drawn up guiding principles for bank asset support measures. Such measures could complement the government actions that were initiated in late 2008, relating to banks' capital and new debt issuance.

The Eurosystem has assessed the features and implementation modalities of asset support schemes and has developed a number of guiding principles aimed at the attainment of the following objectives: (i) safeguarding financial stability and restoring the provision of credit to the private sector while limiting moral hazard; (ii) ensuring that a level playing field within the single market is maintained to the maximum extent possible; and (iii) containing the impact of possible asset support measures on public finances. From the central banks' perspective, the overriding consideration at the current juncture is the maintenance of financial stability and the restoration of an adequate flow of credit to the economy.

The Eurosystem identified seven guiding principles which can be seen as sufficiently broad to apply to all schemes falling under the wide category of asset support measures. These guiding principles are elaborated further below and can be summarised as follows:

- (i) regarding the *eligibility of institutions*, participation should be voluntary and, if the number of institutions has to be constrained, institutions with large concentrations of impaired assets could be given priority, especially if asset removal schemes are adopted;
- (ii) the definition of *assets eligible for support* should be kept relatively broad due to the diversity of balance sheet compositions of euro area banks, the somewhat different state of the credit cycle across Member States, and the likelihood that the amount of impaired assets will continue to grow for some time after the announcement of any scheme. It is also important that the eligibility criteria for the selection of assets do not provide banks with the wrong incentives;

- (iii) the *valuation of eligible assets* is a key determinant of the prospective success of any scheme. In order to monitor the preservation of a level playing field, transparency of valuation is of the essence. It would be appropriate to follow a range of approaches and it would be preferable that common criteria be adopted across Member States. Independent third-party expert opinions should first be sought, to the extent possible and when deemed appropriate. Where practical, models which use micro-level inputs may be used to estimate the economic value of, and probabilities attached to, the expected losses. Asset-specific haircuts on book values of assets could also be used when the assessment of market value is particularly challenging, or when the situation requires swift action;
- (iv) an adequate degree of *risk sharing* is a necessary element of any scheme in order to limit the cost to the government, provide the right incentives to the participating institutions and maintain a level playing field across these institutions;
- (v) the *duration* of the asset support schemes should be sufficiently long, possibly matching the maturity structure of the eligible assets;
- (vi) regarding the *governance of institutions* that receive support, those firms should continue to be run according to business principles, in order to prevent distortions of the effective allocation of credit to the private sector or the level playing field vis-à-vis institutions not participating in the scheme. Schemes that envisage well defined exit strategies should be favoured;
- (vii) it would be reasonable to *condition* the public support schemes to some measurable yardsticks, such as commitments to continue providing credit and appropriately meet demand according to commercial criteria. However, any chosen set of conditions should not be applied in a mechanical manner. Banks participating in asset support schemes should be monitored in this regard.

In addition to these guiding principles, the Eurosystem assessed in more detail two specific approaches for asset support schemes, namely asset removal schemes (ARSs), where the assets are transferred to separate institutions (e.g., “bad banks”), and asset insurance schemes (AISs), where the assets remain on the banks’ balance sheets (see the Annex for the main characteristics of these two models). Against the background of past experience, and given the policy objectives, the Eurosystem considered specific criteria under which one of these schemes may be the preferred option. Criteria that can be identified which would favour the ARS model include the higher degree of uncertainty regarding the banks’ future asset quality, the concentration of impaired assets in few institutions within the financial system and circumstances where a “clean break” for the participating institutions could be deemed most appropriate, despite the higher upfront costs. At the same time, criteria that could favour the choice of the AIS model are a large share of hard-to-value assets, such as asset-backed

securities, among the impaired assets, and circumstances where the state of public finances would favour a cost profile for a scheme that puts less pressure on the government fiscal position in the short term.

In general, the *ex ante* evaluation of the potential success of any scheme is extremely challenging in a situation where banks' asset quality is likely to deteriorate further. In this context, the Eurosystem took note and considered the merits of recent initiatives that can be categorised as *hybrid* schemes, in that they involve asset transfers, financed by means of public sector guaranteed loans, and sophisticated risk sharing arrangements between the governments and the participating banks.

## **1. Introduction**

Since October 2008, governments in the euro area have committed to and provided substantial guarantees for bank liabilities and made capital support available to banks, in order to cushion the impact of past and expected future losses. This notwithstanding, the extent of the flow of new write-downs and asset impairments, together with increasing risk weights on assets that are still performing, has had a negative impact on banks' capital beyond what was expected only a few months ago. Of great concern is the fact that these additional losses could soon erode the effects of support measures that have already been implemented. Against this background, and with measures supporting the liability side of banks' balance sheets already partially in place, the focus of public support measures has shifted to initiatives that could cushion the impact on banks of deteriorating asset quality, should the liability side measures prove inadequate. Behind this lies the ultimate objective of helping to relax banks' capital constraints, and thereby support the flow of lending to the household and non-financial corporate sectors.

The Eurosystem has drawn up guiding principles for bank asset support measures. It has assessed the features and implementation modalities of such schemes and has developed a number of guiding principles which can contribute to the attainment of the following objectives:

- (i) safeguarding financial stability and restoring the provision of credit to the private sector while limiting moral hazard;
- (ii) ensuring that a level playing field within the single market is maintained, to the maximum extent possible;
- (iii) containing the impact of possible asset support measures on public finances.

From the central banks' perspective, the overriding consideration at the current juncture is the protection of financial stability and the restoration of an adequate flow of credit to the economy.

## **2. General guiding principles pertaining to the use of asset support schemes**

Bearing in mind these objectives, the Eurosystem has identified some general guiding principles that could help steer the design of and the choice between possible asset support measures. It is important, however, to stress that past experience shows that the actual approaches chosen differed case-by-case, partly depending on the specific circumstances of the troubled institutions. They also often combined elements from the two main models, namely asset removal schemes (ARS) and asset insurance schemes (AIS).<sup>1</sup> Moreover, it should also be recognised that due to the pragmatic case-by-case manner in which such measures are likely to be implemented, and in light of their complexity, it is particularly challenging to issue general guidelines that ensure the attainment of the aforementioned objectives.

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<sup>1</sup> Given the complexity of the various approaches, it is very difficult to comparatively distinguish between them and to condense their many facets.

### *Common guidelines for asset support schemes*

i) Eligibility of institutions. The scope of institutions eligible to participate in such schemes is an important issue for a number of reasons. In light of the objective of maintaining a level playing field, the schemes, which are voluntary in nature, should in principle remain open to all institutions which are in possession of eligible assets. However, from a public finance perspective it would be advisable to limit the participation on the basis of some criteria. The choice of criteria therefore needs to be carefully balanced.<sup>2</sup> As a general guiding principle, participation should be voluntary, and the institutions with large concentrations of impaired assets could be given priority if the number of eligible institutions is to be constrained. In general, eligibility criteria should be more restrictive for ARS than AIS. In the case of ARS, due consideration should be given to the perception of the systemic relevance of the institutions involved. Moreover, banks could be encouraged to set up individual schemes.

ii) Eligible assets. Given the differences in the composition of individual institutions' balance sheets, business models and financial condition (e.g. near insolvent, solvent but illiquid institutions), it is challenging to define and put forward broad recommendations on the scope of eligible assets to be included in any asset support measure. Rather, a more pragmatic case-by-case approach would be preferable. In case asset-backed securities and securities investments are included, it will probably be necessary to make foreign currency denominated assets eligible. The prevalence of these type of assets among the banks' problem assets, and the diversity in the composition of loan books, as well as the somewhat different state of the credit cycle across Member States, suggest that the best course of action would be to keep the definition of eligible assets relatively broad. Such a guiding principle must also take account of the likelihood that the credit downturn has not yet reached the bottom of the cycle and that the amount of impaired assets will continue to grow in the future, after the announcement of asset support schemes. It is also important that the eligibility criteria for the selection of assets do not provide banks with the wrong incentives. In particular, only assets outstanding at the time of announcement of any schemes should be included.<sup>3</sup>

iii) Valuation of eligible assets. The pricing of eligible assets is a crucial and complex issue that is likely to determine the success of any asset support scheme. In order to monitor the preservation of a level playing field, transparency in valuation is of the essence. On the basis of past and recent experience, the Eurosystem concluded that more complicated pricing schemes, such as competitive bidding processes, are not suitable for dealing with distressed assets of a highly heterogeneous and often complex nature. Rather, it would be appropriate to follow a range of approaches and it would be preferable that common criteria be adopted across Member States. Independent third-party expert opinions should first be sought, to the extent possible and when deemed appropriate. Where practical, models which use micro-level inputs, may be used to estimate the economic value of, and probabilities attached to, the expected losses. Such an approach should, in principle, yield the best estimate of the value of

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<sup>2</sup> If, for example, eligibility is restricted to large systemically relevant institutions, level playing field problems may be created and smaller non-participating banks may be adversely affected.

<sup>3</sup> In this regard, care must be taken to avoid a "gold rush" effect, where banks rush to originate assets as details of a scheme emerges, but in advance of the cut-off date.

the assets and, importantly, provide a fair value assessment of the costs of the support measures. Asset-specific haircuts on book values of assets could also be taken when the assessment of market values is particularly challenging or when the situation requires swift action. In general, the method or methods to be chosen for the valuation of impaired assets will depend on the nature of the assets.

iv) Risk sharing and incentives to participate. The issue of risk sharing is also key for the effectiveness and efficiency of asset support schemes. The risk-sharing features of asset support mechanisms are prominent either in the manner in which the independent asset management companies (AMCs or “bad banks”) are capitalised in the ARS model, or in the size of the first loss pieces and the fee to be applied in the AIS model. A guiding principle should be that an adequate degree of risk sharing is a necessary element of any scheme in order to limit the cost to the government, to provide the right incentives and to maintain a level playing field across the participating institutions. However, the extent and features of risk sharing are best decided on a case-by-case basis, and past experiences can provide useful guidance.

v) The duration of the scheme. Past experience shows that bank asset repair usually takes a very long time, and more impaired assets are likely to emerge after a scheme is launched. A guiding principle is therefore that the duration of the scheme should be sufficiently long and depend on the amount and nature of the eligible assets and, in particular, their maturity structure.

vi) Governance. A guiding principle pertaining to the governance of asset support schemes which refrain from outright nationalisation – and which should be borne in mind even if nationalisation becomes necessary – is, that after receiving public support the institutions should continue to be run on the basis of business criteria. To the extent possible, the preservation of private ownership is preferable for several reasons. These include, in the short term, the high costs involved in nationalisations and, in the medium term, the risk of banks’ objectives being diverted from profit maximisation to alternative goals that might distort the market structure and jeopardise the level playing field. Schemes that envisage well defined exit strategies should be favoured. These considerations may, for example, influence the design of a scheme, especially in the case of an asset removal model, as an individual “bad bank” approach – where each troubled bank forms a special vehicle to manage impaired assets – may better adhere to these principles than a national aggregator bank, into which the impaired assets of all participating institutions are placed. Should the individual “bad bank” remain under the management of the parent bank, the role of the state is effectively contained.

vii) Conditionality of support. Given that an ultimate aim of the asset support measures is to help banks restore an adequate flow of lending with the support of private sector equity capital, and, to the extent possible, avoid large scale and expensive direct government ownership, a guiding principle should be to condition asset support measures on commitments to continue providing credit to appropriately meet demand according to commercial criteria as the situation stabilises. Such conditionality might be needed because the self-interest of the

privately-owned banks could otherwise lead them to focus on preserving and rebuilding their own equity. Guidance on other possible conditions, for example pertaining to restrictions on dividend policies and executive compensation, could also be considered. It may, however, be difficult to define guidelines for the definition of such conditions, and any chosen set of conditions should not be applied in a mechanical manner. As a general principle, banks participating in asset support schemes should be monitored in this regard.

### *Criteria concerning the choice between asset support schemes*

Although it is to be expected that asset support measures need to be, to a large extent, designed on a case-by-case basis depending on the specific characteristics of the troubled institutions (e.g. balance sheet structure, financial condition of the institution, the overall magnitude of the problem and the complexity of asset valuation), certain criteria can nevertheless be identified which could allow for a preference to be expressed between the two main approaches (ARS versus AIS). These are classified below in line with the general aims of these schemes as stated at the beginning of this note.

i) From a financial stability perspective, the choice between the two approaches would mostly depend on the expectation of the future development of the banks' asset quality. In particular, the higher the probability that the pace of deterioration of asset value and credit quality, and associated bank asset impairments and capital erosion, could accentuate in the foreseeable future or spread to other asset classes, the more appealing would be the option to formally separate the assets of the banks using the ARS approach and to define the set of eligible assets rather broadly. It can be argued that markets may perceive such a "clean break" for participating institutions in a positive light. On the other hand, if it could reasonably be expected that the pace of deterioration of banks' asset quality would moderate in the period ahead, then the more discretionary and flexible AIS model could be favoured (also in view of the less significant short-term costs, see point iv below). This would be particularly the case if the scheme were to be supplemented by a clause that caps the risk weights of the insured assets and thus eliminates the risk of capital erosion through this channel.

ii) From the perspective of effectiveness of the measures, criteria for choosing between approaches could be the degree of asset concentration across banks and the type of distressed assets that are located in the financial system. Should the assets be concentrated in a small number of banks, the ARS approach could be more effective in relieving the problems, while the negative implications of such a scheme (mainly in terms of the cost structure, see point iv below) would remain more limited. Regarding the types of impaired assets, a large proportion of securitised loans and structured credit products could favour the AIS model because of the complexities involved in both the pricing and management of such assets by the independent AMCs that are a part of the ARS model.<sup>4</sup>

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<sup>4</sup> It is worth mentioning that in the past, assets transferred to AMCs have almost entirely consisted of loans extended to households and to the corporate sector and there is relatively little experience on asset-backed securities being transferred to and managed by independent AMCs.

iii) From the point of view of the preservation of a level playing field, on the one hand it could be argued that the scope of the cross-border activities of the participating institution could have a bearing on the choice of the approach. In particular, the more extensive the cross-border activities of an institution, the more an ARS scheme that involves upfront government action to remove the impaired assets from the balance sheet and provide a more immediate relief for the participating institutions might distort the competitive environment in the host countries. In such cases, *ceteris paribus*, the AIS scheme could provide a more gradual approach with less immediate concerns for the preservation of the level playing field. On the other hand, if AIS were to be used extensively and risk sharing and other details are not appropriately coordinated, level playing field considerations may also emerge.

iv) From the perspective of the size and time profile of the expected costs of the scheme, both for the government and for the participating banks, in their pure form the two approaches are very different. The expected cost structure associated with the ARS scheme would involve large upfront costs to the government – in terms of the necessary capital support to the AMC – and for the participating institutions in the form of impairment losses that would need to be recognised when the assets are sold. Afterwards, revenues could be reaped by the capital providers to the AMC as the assets are gradually restructured and sold. The expected cost profile for the AIS approach is the reverse, entailing low costs both for the government and the participating institutions at the early stages, with gradually increasing costs if and when the guarantees are invoked. Once the assets have been ring-fenced, or transferred to a special vehicle, they would not be subject to further write-downs as they could be classified as held-to-maturity assets. Alternatively, or mark-to-market accounting may be suspended. From the government's point of view, there would be an additional delay in any cost materialising since the participating institutions would bear the first losses. Although in the short term, the AIS approach would thus minimise the upfront outlays for the government, the risks associated with the effectiveness of such measures (e.g. moral hazard, reduced confidence effects) could result in higher contingent liabilities for the government. In the case of the ARS approach, it can be argued that despite the higher short-term costs, the medium to long-term contingent liabilities for the government would be lower, although they would also depend on the future course of the credit cycle. Finally, the ARS model can be designed in a way that limits the immediate budgetary outlay for the government; such schemes more closely resemble *hybrid* schemes.

v) Hybrid schemes. Many of the models adopted, both recently and in the past, combined elements from both the ARS and AIS approaches. Such *hybrid* schemes have been recently adopted in some European countries, both inside and outside the euro area to support the assets of credit institutions. One way of doing this has been through a special vehicle financed in large part by loans from the public authorities or by loans from the bank itself, guaranteed by the government. These schemes have the merit that the removal of assets from the troubled bank's balance sheet is accomplished in a manner that limits the upfront cost to the government in a way that bears similarity to the AIS model.



## **Annex: key features of asset removal and asset insurance schemes**

Two main types of approaches to asset support can be identified.<sup>5</sup> First, initiatives that aim to remove the assets from bank balance sheets, either by direct government purchases or by transferring them to independent asset management companies (AMCs or “bad banks”); and second, initiatives to keep the assets on the balance sheet but insure them against tail risk.

### *Asset removal schemes (“off-balance sheet” approach)*

The approach to managing distressed assets involves either splitting the respective assets of each individual institution into two separate entities, or pooling the distressed assets from several financial institutions into an independent asset management company (AMC, aggregator bank, or “bad bank”). Such measures have been applied in several past episodes of financial instability. Transferring the non-performing assets into a separate institution should allow banks to concentrate on running the healthy parts of their businesses and to access external funding on more favourable terms, while the distressed assets are managed by independent specialists.

The main specific features in the design of such initiatives are related to the capitalisation/ownership structures of the AMC, as well as to the time profile of the costs that accrue to the various parties when the assets are moved from the banks into the AMC.

Regarding the capitalisation/ownership issue, the banks which transfer assets into the AMC have also typically been required to contribute to its capital base, with the remainder of the capital coming from public sources. The “optimal” degree of public-private partnership should strike a fair balance between risk sharing by banks and not placing an excessive burden on their remaining (“good”) operations.

When purchasing the assets from banks, in addition to using its equity capital, the AMC can also fund asset purchases by issuing government guaranteed bonds which are redeemed as assets or gradually sold. Alternatively, it can issue its own debt and use the combined debt and capital to acquire assets from banks. The funding can also be in the form of non-recurrent loans, extended either by the participating banks under a state guarantee or by the central bank.<sup>6</sup>

Regarding the timing of costs, the need to capitalise the AMC upfront means that large payments materialise for the shareholders at an early stage of the operation. On the other hand, once the AMC has become operational, the capital providers receive interest and dividend payments from the future returns on the assets – which may be kept until redemption

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<sup>5</sup> It should be noted that this distinction provides a somewhat extreme classification as in practice the schemes applied often combine elements of both approaches.

<sup>6</sup> The advantage of such an approach for the loan-issuing bank is that no losses on assets are recorded, while capital can be freed for an equivalent amount of risk-weighted assets due to the zero risk weight implied by the state guarantee. For the government, the arrangement resembles more an asset insurance scheme, as costs are conditional on the use of loan guarantees, unless capital is separately provided for the AMC.

or resold – as managed by the AMC or by dedicated asset managers on its behalf.<sup>7</sup> For the participating banks, asset transfers off the balance sheet imply that upfront impairment losses must be recorded, as the transfer prices are lower than current bank valuations. Should banks perceive the impairment losses as substantial, this could reduce their incentive to participate in the schemes or report truthful valuations, at least in cases where a significant part of the bank ownership remains with private shareholders.

From an operational perspective, it is paramount that along with sufficient legal rights to purchase and manage the assets and, when needed, to retrieve the underlying collateral, an AMC has access to expertise in asset valuation.<sup>8</sup> In addition, the AMC should be adequately capitalised so that the scope for purchase of distressed assets is sufficiently wide to relieve banks of their most problematic assets. Finally, the objectives of the AMC should be carefully formulated at the outset, as trade-offs may be difficult once it has become operational. For example, it might not be possible simultaneously to try and minimise losses to the main shareholders (the taxpayer), to sell the assets quickly, and limit the impact on financial markets and asset prices.

#### *Asset insurance schemes (“on-balance sheet” approach)*

The idea behind the second type of measure is to isolate the distressed assets on the bank’s balance sheet and put a floor on the valuation losses by invoking a government insurance scheme (or an implicit guarantee). The insurance promises to pay, against a fee, the loss on defaulted assets that go beyond a pre-specified first-loss amount which is to be borne by the bank itself, while the ownership of the assets remains with the bank. The fee can be either in the form of cash or preferred shares, to be issued to the government.

Although the assets would formally remain on the bank’s balance sheet, in practice, the assets would be ring-fenced and managed separately from the rest of the bank’s assets.<sup>9</sup> The benefit of such an approach is that the bank’s expertise can still be used. However, potential conflicts of interest arise from the simultaneous pursuit of ring-fencing and employing management expertise, which could lead to principal-agent problems and complicate the task of managing the bank.

Regarding ownership and risk sharing, the asset insurance schemes are typically designed with a “tiered” loss absorption structure. The banks themselves remain liable for the first losses that accrue in the pool of insured assets, while government support only begins when this set level of losses has been exceeded. Even then, the guarantee is typically incomplete

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<sup>7</sup> The expected future cash flows for distressed assets are typically derived almost entirely from the expected net recovery rate of the distressed asset, which in turn mainly include the value that can be obtained by realising the collateral at some point in time. Given the ability of the AMC to hold the assets until maturity, the returns are conditional on the rate of recovery of the underlying asset markets. In the past, some AMCs have even been able to report a profit at their closure.

<sup>8</sup> This is because insufficient property rights might allow bank shareholders to contest the modalities of the AMC, which could threaten the credibility of the entire scheme.

<sup>9</sup> The management of such distressed assets typically involves holding them until maturity, or different work-outs, such as renegotiating loans and replacing existing credits with ones of longer maturity, joint creditor work-outs and debt-equity swaps.

(e.g. limited to 90% of the losses). This ensures that the banks have an interest in managing the assets well, as they bear a fair amount of the losses that accrue on the distressed assets.

The main benefit of such a model is that, despite the large financial commitment to insure asset values, the scheme requires no initial public spending, nor do the banks have to report materialised losses, as the assets are not sold. Rather, the costs for the government materialise gradually over time – if the insurance is invoked – and for the participating banks as the fees fall due. The *ex ante* announcement of the risk weights to be applied to the insured assets also removes an important factor that could contribute to the deterioration of regulatory capital ratios in a situation where asset ratings are declining.