

Box 2

THE IMPACT OF “BAD BANKS” ON MFI BALANCE SHEET STATISTICS

The financial crisis has prompted European governments to implement a series of measures to ensure that financial institutions are able to perform the crucial role of providing financing to the economy. In some euro area countries, the measures implemented in order to alleviate the stress on banks' balance sheets and reduce uncertainty regarding their asset holdings have included the adoption of legislation allowing the creation of “bad banks”. In the broadest sense, “bad banks” are dedicated schemes set up and backed by governments to facilitate the removal from credit institutions' balance sheets of assets that are at risk of severe impairment or are difficult to value. Such entities were created, for instance, to assist in the resolution of the financial

crises in Finland and Sweden in the mid-1990s. There are many different structures that can be established in order to achieve this objective, so it is difficult to offer a clear-cut classification of the different types of “bad bank”. This box is based on the schemes already announced for Ireland and Germany.¹ It offers a stylised description of the implications that these schemes have for MFI balance sheet statistics, distinguishing between the transfer of loan portfolios and the transfer of other assets, particularly securities.

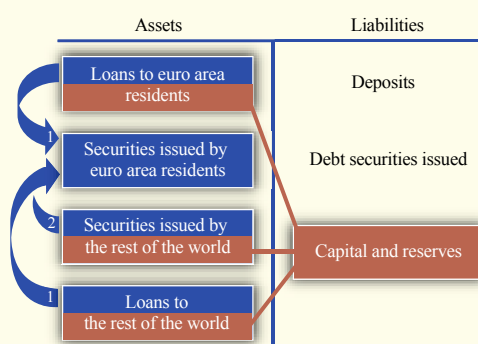
Main statistical issues

The creation of “bad bank” schemes raises the question of their statistical classification and the treatment of the associated asset transfers in MFI balance sheet statistics on stocks and transactions (i.e. flows). The Eurosystem’s statistical framework allows for the detailed monitoring and quantification of the impact that these operations have on M3 and its counterparts.² Looking at the types of “bad bank” scheme announced thus far, it appears that these entities will not take deposits and will not, therefore, form part of the money-creating sector (i.e. the MFI sector), instead being classified as belonging to the money-holding sector (i.e. they will be regarded as non-monetary financial intermediaries other than insurance corporations and pension funds (OFIs) or as part of general government).³

Schemes involving the transfer of loan portfolios

The transfer of loan portfolios will, in principle, take the form of a credit institution selling part of its loan portfolio to a special-purpose entity, similar to a true-sale securitisation transaction. This transaction will be recorded in the MFI balance sheet statistics both as a reduction in the outstanding stock and as a negative flow of loans to the relevant counterpart sector (see Chart A).⁴ The loan portfolios will, in general, be transferred for less than the amount recorded on the balance sheet of the originating credit institution, thereby requiring a write-down in connection with the sale. Since write-downs are not considered financial transactions, this will result in a decline in the volume of outstanding MFI loans which exceeds the recorded flow. By the same token,

Chart A Stylised representation of the MFI balance sheet and the positions affected by “bad banks”



Source: ECB.

Notes: The blue sections of the boxes illustrate the part of the asset transfer that affects the financial transaction recorded in the MFI statistics. The red sections of the boxes correspond to the write-down incurred in connection with the asset transfer. While the transfer of securities issued by euro area residents would also imply a write-down, this is not indicated for presentational reasons. The label “1” refers to asset positions involved in the transfer of loans, and the label “2” refers to asset positions involved in the transfer of other assets.

- 1 For detailed information on the scheme in Ireland, see: www.nama.ie. For details of the scheme established in Germany, see the box entitled “The German government’s ‘bad bank’ model” in the May 2009 issue of the Deutsche Bundesbank’s Monthly Report.
- 2 This has been greatly facilitated by the entry into force of the updated Regulation of the ECB concerning the balance sheet of the monetary financial institutions sector (ECB/2008/32) and the new Regulation of the ECB concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions (ECB/2008/30).
- 3 If such entities were to be classified as belonging to the central government sector, they would be money-neutral.
- 4 See the box entitled “The impact of MFI loan securitisation on monetary analysis in the euro area” in the September 2005 issue of the Monthly Bulletin and the box entitled “The importance of accounting standards for interpreting MFI loan statistics” in the March 2008 issue of the Monthly Bulletin.

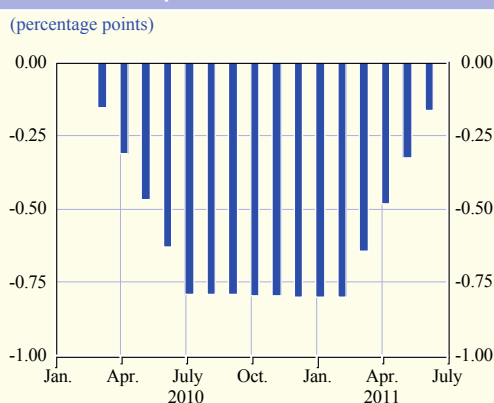
the impact of the write-down will usually be reflected in a decline in the stock of capital and reserves, as illustrated by the red lines in Chart A.⁵ Thus, the transfer of assets will frontload losses on those holdings and thereby foster transparency with regard to credit institutions' capital positions.

The consideration received by the credit institution in exchange for the portfolio transferred will most likely consist of debt securities issued by the "bad bank" with a government guarantee, as illustrated by the blue arrow labelled "1" in Chart A. Depending on the sectoral classification of the "bad bank" and the terms agreed for the asset transfer, the securities obtained will increase MFIs' holdings of debt securities issued by general government or the OFI sector.

While these transactions lead to the reduction of credit institutions' loan books, they do not change the financing obtained by the non-MFI sector. Consequently, it may be necessary, for analytical purposes, to treat the impact of these transactions in the same way as the corrections for the derecognition of loans (i.e. the removal of loans from the MFI balance sheet as a result of their sale or securitisation) that are regularly published as part of the Eurosystem's monetary statistics. The information currently available on the "bad bank" schemes announced thus far suggests that loans to the corporate sector will be affected. By mid-2010 the annual growth rate of MFI loans to euro area non-financial corporations is currently expected to be around three-quarters of a percentage point lower than it would be without these transactions. Chart B provides an illustration of the mechanical impact that the offloading of loans onto "bad bank" schemes could be expected to have on the pattern of growth in loans to euro area non-financial corporations.

Looking ahead, the statistical impact that transactions with "bad bank" entities have on the annual growth rate of MFI loans to euro area non-financial corporations needs to be taken into consideration when assessing developments in credit. For example, this impact could postpone the turning point in the growth rate of loans to non-financial corporations, thereby complicating the process of comparing loan dynamics with historical regularities.⁶ At the same time, a positive economic impact on the growth rate of loans can be expected as a result of the alleviation of capital stress through the implementation of the "bad bank" schemes. However, this impact cannot be ascertained in quantitative terms.

Chart B Illustration of the impact of "bad bank" schemes on the annual growth rate of MFI loans to non-financial corporations in the euro area



Source: ECB estimates.

5 The impact of the write-down may instead be recorded in remaining liabilities, depending on the accounting standards of the relevant Member State.

6 See the box entitled "Loans to the non-financial private sector over the business cycle in the euro area" in the October 2009 issue of the Monthly Bulletin.

Schemes involving the transfer of broader asset categories

Assets other than loans that are at risk of severe impairment (or have been extremely difficult to value with any certainty in the wake of the financial crisis) could also be transferred to “bad bank” schemes.⁷ The assets most likely to be transferred (e.g. asset-backed securities and collateralised debt obligations) would typically be recorded on the MFI balance sheet as holdings of either debt securities issued by euro area residents or debt securities issued in the rest of the world (with MFIs’ net external asset position being affected in the case of the latter). Such transfers would, as in the case of loans, tend to depress the holdings of the relevant debt securities and reduce their transaction volumes (i.e. their flows). Here, too, the consideration received by the credit institution would probably consist of debt securities issued by the “bad bank” with a government guarantee, as illustrated by the blue arrow labelled “2” in Chart A.

Conclusions

The introduction of “bad bank” schemes in a number of euro area countries is expected to affect MFI balance sheet statistics and some of the counterparts of M3 derived from them. Depending on the progress made in the approval and implementation of the relevant schemes, the impact of these measures could begin to be seen in euro area monetary statistics for March 2010, and their impact will increase in the course of the year. These direct effects need to be taken into account when assessing credit developments such as the amount of financing provided by banks to the various sectors. The statistical framework in place in the Eurosystem will allow the impact of these measures to be ascertained and allow corrections to be made to the relevant monetary data for analytical purposes.

⁷ In some Member States, credit institutions may have the option to dispose of entire business areas. The implications of such a decision for the MFI balance sheet need to be assessed on a case-by-case basis.