'Bad Banks' in Ireland, Spain and Germany: Diverging Fortunes

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Sovereigns – Euro Area
'Bad Banks' in Ireland, Spain and Germany: Diverging Fortunes

During the course of the financial crisis, several EU countries established so-called "bad banks" to insulate their banking systems from impaired assets that threatened individual bank solvency and wider confidence in the respective banking systems. We have compared and contrasted the three largest European "bad banks" – Ireland's NAMA (Baa1 positive), Spain's Sareb (unrated) and Germany's FMS Wertmanagement (FMS-WM, Aaa stable) – and conclude that they diverge significantly in terms of financial performance and success in divesting their impaired assets.

All three entities were originally established with a life span of 10-15 years, with the objective of selling the impaired assets they acquired from the financial institutions without incurring further costs for the country's taxpayers. We rate FMS-WM and NAMA in line with their respective governments, given the explicit government guarantee on their debt. Given the diverging performance and the relative size of their balance sheet, we only consider Sareb to still be a constraining factor on the debt rating of its sovereign, Spain.

» **NAMA** (National Asset Management Agency), the largest of the "bad banks" in relation to the size of the economy, is the most advanced in selling its assets. It has redeemed 70% of its senior obligations and is on course to repay them in full by 2018 – two years ahead of the original schedule. The entity is also likely to realize a profit for the Irish state when it is wound down. We no longer consider NAMA's debt as a material contingent liability for the Irish government.

» **Sareb** (Management Company For Assets Arising From the Restructuring of the Banking Sector) is in the early stages of reducing its portfolio, having been established only at the end of 2012. It is likely to post the third consecutive year of losses in 2015, after nearly depleting its capital in the first two years of operations. The continued write-down of asset values also raises some concerns over the overall asset quality of its portfolio. It will likely remain a contingent liability for the Spanish government for several years.

» **FMS-WM** (FMS Wertmanagement) has been reasonably successful thus far in reducing its assets. However, given the complexity, illiquidity and long maturity profile of its portfolio, the speed of asset disposal will likely be slower in the coming years. In addition, in 2014, FMS-WM was tasked with winding down another portfolio and no longer has a set date for the end of its operations. FMS-WM has large debt refinancing needs given the short maturity of its liabilities. But its debt is part of Germany's government debt and any potential future losses can be easily absorbed by the government.
Real-estate portfolios of NAMA and Sareb contrast with FMS-WM’s more diversified and complex portfolio

NAMA and Sareb are both entities that were set up to house the real-estate related assets and loans of several banks – five in the case of Ireland, nine in Spain – while FMS-WM is the “bad bank” for the impaired assets of only one institution, Hypo Real Estate. Also, only 15.5% of its assets were linked to real estate at the start of its operations. It also has a far more geographically dispersed and more complex portfolio than the others (see Exhibit 1). NAMA was by far the largest “bad bank” in relative terms: its original balance sheet amounted to 19.6% of GDP, compared to less than 5% and 7% of GDP for Sareb and FMS-WM, respectively.³

Exhibit 1

<table>
<thead>
<tr>
<th>Key characteristics</th>
<th>NAMA</th>
<th>Sareb</th>
<th>FMS-WM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of establishment</td>
<td>Dec-09</td>
<td>Jul-12</td>
<td>Jul-10</td>
</tr>
<tr>
<td>Assets Transferred</td>
<td>Real estate loans and property assets of 5 financial institutions</td>
<td>Real estate loans and assets of 9 financial institutions</td>
<td>Assets of Hypo Real Estate group (HRE), incorporating real estate (15.5%), infrastructure (10.2%), public sector (49.3%), structured products (25%)</td>
</tr>
<tr>
<td>Total assets transferred from banks, € billion</td>
<td>74</td>
<td>50.8</td>
<td>175.7</td>
</tr>
<tr>
<td>Average discount on asset values at transfer</td>
<td>57.0%</td>
<td>63%</td>
<td>0%</td>
</tr>
<tr>
<td>Life of entity as envisaged at inception</td>
<td>Repayment of all senior bonds by 2020</td>
<td>15 years</td>
<td>2020</td>
</tr>
<tr>
<td>Geographical composition of assets at inception</td>
<td>54% in Ireland, 38% in UK</td>
<td>100% in Spain</td>
<td>Wide dispersion with 28% of public-sector segment in Italy and 58% of structured products portfolio in the US</td>
</tr>
</tbody>
</table>

Source: Companies’ annual accounts

NAMA most advanced in selling down assets

NAMA, the first of the bad banks to be created in late 2009, is also the most advanced of the three entities in selling the assets on its balance sheet. It reduced the size of its portfolio of loans and other receivables by close to 60% between its inception and June this year. Germany’s FMS-WM, established seven months later, has managed to reduce the size of its winding-up portfolio by close to 42% by June 2015, while Spain’s Sareb reduced its portfolio by 15.6% in the first two years of its operations, a slightly slower pace than the other two entities managed to achieve over the same time period.

Exhibit 2

NAMA most successful in reducing portfolio

Reduction in portfolio size, indexed to 100 at size and year of establishment

Source: Companies’ annual accounts

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NAMA has been able to significantly accelerate asset disposals since early 2014. This is mainly due to the recovery in Irish house prices, which have started to increase from Q2 2013 onwards, albeit from a depressed base. Up to 2013, NAMA mainly focused on selling its UK assets, which accounted for around 38% of the portfolio at the outset, and where real estate prices held up better than in Ireland (see Exhibit 2).

In contrast, Sareb’s assets are exclusively located in Spain, where house prices have yet to recover in a meaningful manner. Around two thirds of Sareb’s portfolio is located in the autonomous regions of Madrid (22% as of end-2014), Catalonia (18%), Valencia (17%) and Andalucia (9%), which have seen only a moderate increase in house prices over the course of 2014 and 2015. Absent a stronger acceleration in real estate prices, the speed of asset disposals will probably remain slower than it has been for its two peers.

Exhibit 3
Positive house price development in UK helped NAMA’s asset sales
Index 2009 Q1=100, % year-over-year

FMS-WM has so far been reasonably successful in reducing the size of its portfolio, which is by far the largest of the three entities’ portfolios in absolute terms. However, 62% of the assets that remain on its balance sheet (as of October 2015) have a maturity of more than ten years and many are complex and illiquid securities. Going forward, we therefore expect a slower pace of asset disposals than in past years. This has already been evident since 2014, with only €12.8 billion being divested and a further €3.9 billion in the first half of this year, compared to €17.8 billion and €23.8 billion in 2013 and 2012, respectively. So far, around 73% of FMS-WM’s portfolio reduction came via contractual and extraordinary redemptions, rather than active sales.

NAMA no longer a material contingent liability for Irish government
All three entities benefit from explicit guarantees on their bonds by their respective governments. FMS-WM is fully incorporated into the general government sector, hence its liabilities are already recognized as obligations of the German government. In contrast, both NAMA and Sareb have been structured to ensure that their debt obligations would not add to the government’s debt burden, by having private-sector entities as the majority shareholders. We have therefore considered the entities as contingent liabilities to their governments since their inception.

However, NAMA has managed to reduce its debt load significantly, especially since last year. It has repaid €21.1 billion, or nearly 70% of the original €30.2 billion in senior bonds that were due by October 2015, and is now targeting the full redemption of all senior debt by 2018 – two years ahead of the original schedule. Given NAMA’s strong financial and divesting performance to date, we no longer consider it to be a material contingent liability for the Irish government. Instead, it is more likely that it will produce a profit for the Irish state, with the company itself expecting a cumulative profit of €1.75 billion.
Sareb’s financial performance and asset quality remain under pressure

In terms of the speed of asset disposals, Sareb’s performance has not been materially different from that of NAMA, although it has managed to reduce its debt burden at a somewhat faster pace than NAMA did at the same point in time (-9.5% in the first two years of operations, NAMA: -6.8%).

But Sareb’s financial performance continues to be negatively affected by write-downs on its assets. Its original capital of €1.2 billion has already been nearly depleted, standing at only €354 million at the end of 2014, after having absorbed losses over the prior three years. Following new accounting requirements that were recently introduced by the Bank of Spain – Sareb’s supervisory authority – Sareb expects further write-downs in 2015 and 2016. While the size is unclear at this point in time, Sareb assumes that it will have to convert part of its subordinated bonds (€3.6 billion, subscribed by broadly the same group of investors as in the capital) into capital. It seems unlikely that private shareholders would be prepared to inject further capital into Sareb beyond what they have already contributed. Therefore, any further capital requirements beyond the remaining subordinated bond cushion would most likely have to come from the government.

Besides the possible need for further capital injections, the continued write-down on the asset values raises concerns over Sareb’s overall asset quality, also because the economic environment has, if anything, turned out more positive than expected at the time of the original asset transfers in late 2012 and early 2013. Back then, the assets were transferred from the banks’ balance sheets with significant sector-specific haircuts on their face value, which on average amounted to 63%. The transfer also followed an extensive and detailed asset quality review by international firms and under the auspices of the ECB, the EC and the IMF. Overall, we expect that Sareb will remain a contingent liability for the Spanish government for several years to come. However, its debt burden is at manageable levels, standing at €46 billion at the end of 2014 (approximately 4% of GDP).
FMS-WM’s debt load is included in Germany’s government debt

A profitable exit is also less certain for FMS-WM, given the weak credit quality, long maturity and illiquid nature of many of its remaining assets. Moreover, while the entity has posted small net profits since 2012, losses in coming years cannot be excluded. However, FMS-WM differs from the other two entities in that any loss will be compensated directly by SoFFin (through a loss compensation agreement) and ultimately by the German government, as was the case in 2010 and 2011, when FMS-WM accumulated (combined) losses of €13 billion. While large in nominal terms, there is little risk that Germany’s public finances would be materially affected, even in adverse scenarios. FMS-WM’s debt load remains high in nominal terms at around €130 billion and its refinancing needs are substantial, with an average maturity of its liabilities of around three years. But its debt is already fully incorporated into the German government’s debt burden. On a relative basis, FMS-WM’s debt level amounts to just over 4% of German GDP.
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Endnotes

1 The additional portfolio (of €30.4 billion) originates from DEPFA Bank plc, a HRE subsidiary.

2 NAMA and Sareb were explicitly set up with a structure that ensures that their debt would not be included in general government debt, given the difficult situation of the two sovereigns at the time. We have considered the liabilities of both entities as contingent liabilities for their sovereigns. The German government as the ultimate guarantor had to such concerns, reflecting its strong government finance position.

3 FMS-WM’s figures only include the wind-down portfolio of €175.5 billion, whereas total assets stood at €333 billion or 12.8% of GDP at end-2010.

4 The guarantee and loss compensation are provided indirectly via the government-owned Financial Market Stabilisation Fund – FMS (SoFFin).

5 NAMA holds 49% in its investment holding company, with three private investors holding the remaining 51%. NAMA has a veto right over decisions taken by the company. In Sareb’s case the government ultimately holds 45% of Sareb’s equity, with the remainder held by mostly Spanish financial institutions and insurance companies.

6 In addition to the senior bonds NAMA has close to €1.6 billion in subordinated debt outstanding, on which it started to pay interest in 2014. The bonds are callable annually from March 2020 onwards.

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