



BAD BANKS IN THE EU: THE IMPACT OF EUROSTAT RULES

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Highlights

- At least 12 European Union member states used publicly created asset management companies (AMCs), otherwise known as a 'bad banks' to respond to the recent financial crisis. This tool remains an option for future bank resolutions under the EU Bank Recovery and Resolution Directive.
- We assess the design of AMCs in the recent crisis and why their form has changed. Through its role as definer of statistical concepts used under the Stability and Growth Pact, Eurostat has affected the design of AMCs. Increasingly stringent rulings on whether AMCs count as debt have pushed member states to create similar types of AMCs, namely those with majority private-sector ownership.
- We argue that privately owned AMCs act differently to publicly owned ones. In particular, private AMCs usually impose larger haircuts on the price they pay for the assets they acquire. This has positive benefits for how profitable the AMC will be and how much it will help in avoiding the creation of zombie banks and zombie bad banks.
- There are important caveats. The effect of Eurostat's accounting rules on decision-making is stronger in countries with more strained budgets. Also, when the public owns a failed bank, Eurostat rules are likely to have little impact on AMC ownership decisions. Governments tend to use publicly owned bad banks to resolve publicly owned failed banks. This is because it is difficult to compel private sector involvement in these situations.

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An under-appreciated component of the increasing Europeanisation of responses to troubled banks is the emerging role of Eurostat, the European Union's statistical agency, as the *crisis accounting rule-maker*. As part of its role of monitor of the Excessive Debt Procedure, from 2009 Eurostat began to implement new rules on how crisis response policies would (or would not) count against member state public budgets. Almost three years before what Posen and Véron (2014) identified as the Banking Union's starting point – the mid-2012 euro-area summit statement – these rules began to develop a European-style of responding to financial crises. The rules gave elected member-state politicians strong incentives to choose certain policies over others – particularly policies with private-sector involvement.

We chart this process by focusing on asset management companies (AMCs) – bad banks – that have been used to acquire and dispose of troubled assets from failing banks in order to restructure them and return to financial stability. From the onset of the Global Financial Crisis, there have been three models of ownership and funding for European AMCs: (1) *mixed*, (2) *slim private majority ownership*, and (3) *large majority private ownership*.

We further show that ownership choices are not simply 'window dressing' but alter the way AMCs operate and their likely efficiency at returning the banking system to health. Eurostat rules and the need to encourage private-sector involvement lead majority privately owned AMCs to acquire assets at higher haircuts. This realises losses sooner, avoiding the problem of zombie banks, and makes it more likely that the AMC itself will be profitable. Majority publicly owned bad banks, especially those that are part of publicly owned banks that are being resolved, tend to impose small or no haircuts on the assets they acquire. These AMCs have less incentive to sell off these assets because they would have to record large losses. They therefore face a greater threat of becoming 'zombie bad banks'.

How can Eurostat accounting rules shape policy responses to financial crises?

Eurostat's interpretation of the European System of Accounts (ESA) – the central document specifying how member states' policies affect public budgets – creates incentives for governments to choose certain policies over others in order to limit increases in public debts and deficits.

When the recent crisis began, the ESA (ESA version 1995) did not provide clear guidance on how to classify a number of new policies used to respond to the crisis. Eurostat needed to develop new procedures for assessing how these policies would affect member state budgets. The initial result of this effort was a 15 July 2009 decision on 'The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis'¹, followed on 10 September 2009 by a more detailed statistical guidance note². See Box 1 for details. Together these documents clarify how certain policies affect debts and deficits under the more general ESA 1995 rules. The 2009 documents dealt specifically with bank recapitalisations, liquidity support, guarantees, direct government asset purchases and exchanges, as well as support to "certain new bodies", such as asset management companies.

Box 1: Additional (September 2009) requirements for exempting AMCs from the public sector for debt calculations

Eurostat's September 2009 guidance note expanded on the 51 percent private ownership rule by adding the following three requirements for an AMC to be treated as being outside of the public sector and as a contingent liability for debt calculations:

- They were temporary institutions.
- They had a reasonable business plan that would ensure no or minimal losses.
- A large haircut was applied to the purchase price of acquired assets and the haircut required public recapitalisation of the affected bank. This recapitalisation would be counted against the public budget.

1 The decision is available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/FT%20-%20Eurostat%20Decision%20-%209%20July%202009%20_3%20_final_.pdf. Accessed September 2014.

2 The guidance note is available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Eurostat_guidance_note_FT-10_September_2009.pdf. Accessed August 2014.

The rules made distinctions between what policies, and implementations of these policies, counted as 'financial transactions' and 'contingent liabilities'. Financial transactions, such as exchanging cash for an equivalently valued asset, do not count as immediate expenditure because the value of the assets held by the government have not changed. Recapitalisations would count as financial transactions if the bank had not suffered a loss over more than one accounting period and the purchase was not an exceptional one-off transaction in the context of a crisis. Contingent liabilities are liabilities that governments incur – such as guarantees to, and ownership stakes in, certain types of AMCs – but which are not treated as immediately impacting the public debt. Contingent liabilities only count against the debt when some event happens, such as a guaranteed bond not being paid back by the issuer.

Over the rest of the crisis, subsequent Eurostat rule changes, which we discuss in more detail below, identified the types of policies that can be considered financial transactions and contingent liabilities.

European politicians are sensitive to these accounting decisions. Changes in recorded debts and deficits affect (a) enforcement actions taken under the Excessive Deficit Procedure (EDP); (b) the need for and costs of financing from investors and international financial institutions; and (c) support from voters who are sensitive to threats to fiscal sustainability. Responses to crises can greatly strain public budgets, increasing pressure from all three of these sources. Because of this, Eurostat's accounting rules affect the public costs of policy choices during financial crises.

The European sovereign debt crisis hampered a number of member states' access to sustainable debt financing and threatened, through contagion, to shut out others as well. For those in international bailout programmes, there was pressure from international actors to minimise gross debt. One focus of the Troika – the European Commission, European Central Bank, and the International Monetary Fund – in negotiations over bailout programmes to member states such as Ireland, Greece, Portugal, and Spain, was 'debt sustainability' to re-establish access to private market funding. As a condition of financial assistance, the Troika required measures from these countries to contain their gross debt³.

Finally, though voters want financial stability, many of them are also taxpayers and so are hesitant to

3 From interviews with officials at the ECB in October 2014. Interviewees emphasised that gross rather than net debt was their primary concern because they believed that market actors paid more attention to gross debt figures. These are comparatively more reliable than net debt figures as net debt calculations require many more assumptions about future asset values. Uncertainty around these assumptions is particularly large during a crisis. See also Dyson (2014, 463-464) for a discussion.

spend public funds on bank bailouts. Increased spending that threatens public finance sustainability could lead to tax increases or to cuts in popular programmes such as pensions. Voters do not want the government to make costly bailouts because these might jeopardise the ability of the government to provide this spending. Voters therefore are sensitive to increases in gross debts and deficits.

Incumbent politicians face a dilemma. They might want to assist banks in order to re-establish financial stability and for a number of other reasons, such as to bolster banks that are important for their local economies (see Deo *et al*, 2014 and Reinke, 2014). They nonetheless also face opposing pressures in terms of possible EDP enforcement actions, more expensive and more constrictive financing, and the possibility that the electorate will vote them out of office for giving banks costly public bailouts.

How can incumbent politicians try to balance these competing pressures? One strategy is to select policy responses to financial crises that are accounted for in such a way that they are largely treated as not increasing debts and deficits. Governments select from a variety of policies that have differing effects on the government budget. They can make capital transfers to banks, by for example buying equity. If they were to buy the equity above market prices, such as at book value, these transfers would hit both the government's deficit and, if funded with borrowing, the gross debt as well. Another general policy option is to provide contingent liabilities. Unlike immediately realised liabilities, such as the government directly borrowing money that it then lends to banks, contingent liabilities such as guarantees have no immediate effect on the public debt or deficit. In the medium to long-term they could, however, prove costly if the guarantees are called in. Note that financial transactions that purchase assets at market value do not impact on the public deficit, but do increase the gross debt if they are funded through government borrowing. Given this background, one can expect that elected politicians will prefer contingent liabilities and financial transactions that do not require borrowing, over financial transactions funded with borrowing, and they will least prefer capital transfers, especially if they are funded with borrowing.

What policies count as contingent liabilities and financial transactions is not defined *a priori*. Instead Eurostat's accounting rules effectively *define the accounting rules of the game*. As such, Eurostat makes specific crisis responses more or less attractive to politicians. The cumulative result is to create an emerging European model of responding to failing banks. Note that this effect should not be evenly felt across countries as Eurostat's rules most strongly affect governments that face the greatest pressures to minimise increases in public debts and deficits.

Table 1: Publicly created Asset Management Companies in the EU (2008-2014)

Bad Bank Name	Country	Failed Bank Name(s)
Banco Espírito Santo (BES)	Portugal	Banco Espírito Santo
Erste Abwicklungsanstalt	Germany	WestLB
Dexia	Belgium/France/ Luxembourg	Dexia
Družba za upravljanje terjatev bank (DUTB), sometimes referred to as Bank Asset Management Company (BAMC)	Slovenia	Nova ljubljanska banka and Nova kreditna banka Maribor
Finansiel Stabilitet	Denmark	Numerous banks including EBH Bank, Gudme Raaschou Bank, Løkken Sparebank, Fionia Bank, Straumur Burdaras Investment Bank hf, Roskilde Bank, Eik Bank Danmark, Amagerbanken
FMS Wertmanagement	Germany	Hypo Real Estate (HRE)
Heta Asset Resolution	Austria	Hypo Alpe-Adria Bank
KA Finanz	Austria	Kommunalkredit Austria AG
National Asset Management Agency (NAMA)	Ireland	Allied Irish Banks, Bank of Ireland, Anglo Irish Bank, Irish Nationwide Building Society, and EBS Building Society
Parvalorem/Parups/Parparticipadas	Portugal	Banco Português de Negócios (Parvalorem: loans and credits, Parups: real estate and investments, Parparticipadas: subsidiaries)
Propertize	Netherlands	SNS Reaal
Royal Park Investments	Belgium	Fortis
Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (Sareb)	Spain	Bankia, Catalunya Banc, Banco de Valencia, NCG-Banco Gallego, Liderbank, BMN, Caja3 and Banco CEISS
Société de Financement de l'Economie Française (SFEF)	France	Provided liquidity assistance to numerous banks
UK Asset Resolution	United Kingdom	Northern Rock and Bradford & Bingley

The three stages of European asset management companies

A useful way to see this process in action is to look at the types of publicly created asset management companies that member states have used to deal with failing banks' toxic assets. AMCs acquire, manage, and dispose of distressed assets, such as non-performing loans. As such, they can play an important role in bank restructuring. They are used to separate distressed assets that are weighing down a bank's balance sheet from performing assets that would otherwise form the basis of a financially solvent 'good' bank.

Table 1 lists the 15 AMCs created by 12 EU countries between 2008-14 to assist at least 37 failing banks. These are all of the publicly created AMCs we are aware of used in the EU from 2008 to 2014. Clearly, asset management companies have been a widely used part of the response to the crisis.

Publicly created AMCs are not all the same. There are many design choices that politicians can make. We focus especially on their ownership and funding structures. These choices affect when their costs are realised and who pays for their losses or benefits from their gains. As we discuss in the next section, they also shape how they operate. AMCs can have a wide spectrum of ownership structures, ranging from entirely publicly owned to entirely privately owned.

Eurostat's rulings play a significant role in shaping government decisions to choose particular AMC structures. We can identify three AMC stages in Europe during the recent crisis. The first stage existed before the 2009 decisions were implemented and was characterised by a variety of AMC ownership types. Following the 2009 decision, member state governments tended to create AMCs with a minimal majority share (51 percent) of private ownership. In the most recent stage, it appears that bailed-in shareholders of the failed banks will own AMCs created to resolve them. Table 2 summarises the three stages and lists examples from each. There are a few notable exceptions to these trends that illuminate limitations in the effect that Eurostat accounting decisions have on choices for the public to create privately owned AMCs.

Stage 1: Mixed ownership types

The first stage predates the implementation of Eurostat's 2009 decisions. Some AMCs in this period were created with significant private sector involvement. One example is Royal Park Investments, which was used to restructure the failed Fortis bank. The Belgian government created Royal Park Investments in May 2009, which it co-owned together with the remaining healthy part of Fortis – known as Ageas – and the French bank BNP Paribas. The Belgian government's 43 percent stake in Royal Park Investments gave the AMC a majority private ownership structure⁴. France created a public-private institution to assist banks⁵ in 2008 called Société de Financement de l'Economie Française (SFEF). SFEF was owned by the French government and the six main French banks. The banks owned 66 percent of SFEF, so it also had a majority private ownership structure (Grossman and Woll, 2014, 591).

In contrast to these institutions and those created in the subsequent AMC stages, European governments established a number of fully publicly owned AMCs that assisted largely privately owned banks. An important example is Denmark's Finansielt Stabilitet. The Danish government created it in

4 See <http://online.wsj.com/news/articles/SB10001424052702303289904579196360863759896>. Accessed September 2014.

5 SFEF provided liquidity to troubled banks, rather than acquiring their assets. It was nonetheless classified alongside AMCs for Eurostat accounting purposes as what were initially described as 'certina new bodies' for assisting banks.

October 2008 and fully owns the AMC⁶. Similarly, the original plans for the Irish National Asset Management Agency (NAMA) laid out on 7 April 2009, anticipated that it would be entirely publicly owned⁷.

Germany passed legislation enabling bad banks⁸ on 3 July 2009, shortly before Eurostat's decision. Two AMCs resulted from this legislation in late 2009 and 2010: Erste Abwicklungsanstalt (EAA) and FMS Wertmanagement (FMS WM). These were created to clean up toxic assets from WestLB and Hypo Real Estate, respectively⁹. The public owns these institutions: provincial governments and state-owned banks in the case of EAA and the German Federal Government in FMS WM's case. The institutions also received extensive public guarantees. The public is fully responsible for losses from either.

It is important to note that while these two AMCs were entirely publicly owned, this does not appear to have been what German policymakers initially intended when they created the bad bank legislation. The law was designed to bail-in a failed bank's owners such that they would own the new bad bank. This would in theory allow for high private sector ownership. Overall, key German politicians wanted very high levels of private bank involvement in bank rescues (see Woll, 2014, Ch. 6). Indeed, it was well reported at the time¹⁰ that German politicians were critical of France's SFEF for being *only* 66 percent privately owned and were disapproving of Eurostat's 15 July decision that allowed SFEF to not count against the public debt¹¹.

So why did EAA and FMS WM end up publicly owned? Despite German politicians' efforts, WestLB and HRE were not able to be restructured with a private solution. Instead, the public sector took over the

6 See <https://www.finansielstabilitet.dk/Default.aspx?ID=750>. Accessed October 2014.

Also, though entirely state owned, Finansiell Stabilitet does have some private sector participation. Up to 2 percent of its losses are to be financed by the banking sector (Woll, 2014, 159).

7 See <http://www.budget.gov.ie/Budgets/2009Supp/Documents/Annex%20H%20-%20NAMA%20-%20Indicative%20Term%20Sheet%20-%20Proposed%20Asset%20Management%20Company.pdf>. Accessed September 2014. There was a provision made in this proposal for special purpose vehicles of the type implemented later (see below). But these were for 'some' of NAMA's loans, not all of them as was actually implemented.

8 The Finanzmarktstabilisierungsförderungsgesetz law went into effect on 23 July. See http://www.bgbl.de/banzxaver/bgbl/start.xav?startbk=Bundesanzeiger_BGBl&jumpTo=bgbl109s1980.pdf#_bgbl_%2F%2F%5B%40attr_id%3D'bgbl109s1980.pdf'%5D_1411976869399. Accessed September 2014.

9 Each of these institutions began operating well after the Eurostat ruling – Erste Abwicklungsanstalt in December 2009 and FMS Wertmanagement in October 2010 – the German legislation enabling these types of institutions was enacted in Summer 2009.

10 See Euroactiv <http://www.euractiv.de/finanzen-und-wachstum/artikel/eurostat-andert-schuldenerfassung-001890>, Frankfurter Allgemeine <http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/eurostat-eu-rechnet-die-staatsverschuldung-schoen-1825443.html>, and Zeit <http://www.zeit.de/online/2009/30/eu-kosten-bankenrettung>. Accessed September 2014.

11 Many saw Eurostat's 15 July decision as very much influenced by direct French lobbying not to classify SFEF as counting against the public debt (Woll 2014, 123).

failed institutions. Woll (2014) and Culpepper and Reinke (2014) discuss how factors such as Deutsche Bank's high international mobility prevented a private sector solution to Germany's banking crisis. At the same time there were strong political motivations to save WestLB and HRE. Deo *et al* (2014) discuss the motivations that sub-national politicians and, relatedly, public savings banks – Sparkassenverband Westfalen-Lippe and Rheinische Sparkassen- und Giroverband – had to save WestLB. These Sparkassen already were important owners of WestLB before the crisis. Allowing WestLB to fail outright would have harmed them considerably and the economy of the North-Rhine Westphalia region generally. HRE was regarded as highly systemically important for Germany's *pfandbrief* market.

German politicians, with very small bond yields, were under low budgetary pressure relative to the strong political pressure to save these failed institutions. Consequently the banks were nationalised, and their resolution was assisted by AMCs that were also publicly owned, as effectively necessitated by the German bad bank legislation (Woll, 2014; Deo *et al*, 2014).

Table 2: Stages of Asset Management Company and related institutions design in the EU

Stage	Time period	Created from private banks	Created from publicly owned banks
<i>Mixed, including Majority Public Ownership</i>	Until mid-2009	Finansiel Stabilitet, NAMA original structure, Park Royal Investments, Société de Financement de l'Economie Française	Erste Abwicklungsanstalt, FMS Wertmanagement
<i>Slim Private Majority Ownership</i>	Mid-2009 to mid-2014	NAMA special purpose vehicle, Sareb	Dexia * DUTB*, Parvalorem/Parups/Parparticipadas*, KA Finanz*, Propertize,* UK Asset Resolution*
<i>Large Majority Private Ownership</i>	Mid-2014 onwards	Banco Espírito Santo (BES)	Heta Asset Resolution*

*: exceptions to the move towards more private sector ownership. Note that all exceptions are for AMCs created to resolve publicly owned banks.

Stage 2: Slim private majority ownership

In July 2009 Eurostat ruled that AMCs with less than 51 percent private ownership would not be classified as contingent liabilities, but would be counted against the public debt. In September 2009, Eurostat set out further rules for the budgetary treatment of AMCs. This ruling had an immediate effect on the ownership structure of existing and subsequently-created AMCs.

The effect of Eurostat's ruling on NAMA's structure is particularly notable. At the time of the ruling, the NAMA enabling legislation had not yet been passed. If passed as originally proposed, under the new rules NAMA would have had a dramatic impact on Ireland's already strained public finances. It would have been an entirely publicly owned entity and so counted against the debt. To prevent this, very soon after Eurostat's decision the Irish government began to consider different designs. They ultimately chose a plan that did not change the ownership structure of NAMA itself. Instead, NAMA would create a special purpose vehicle (SPV) that was initially 51 percent privately owned by Irish banks. This entity would acquire distressed assets. The design change was explicitly made in response to Eurostat's ruling in order to keep the liabilities associated with buying these assets off the government's balance sheet. As stated by NAMA:

*"The National Asset Management Agency is structured in such a way that the debt it issues to purchase acquired loans is not treated as part of Ireland's General Government Debt under European accounting rules"*¹².

Eurostat's ruling had further implications for NAMA and bank resolution. The Irish government effectively nationalised many of NAMA's private investors from 2010. This pushed the public's stake in NAMA well above 51 percent and would have led NAMA to be counted against the country's debt. To avoid this, the Irish government rushed through a number of sales of the nationalised banks' stakes in NAMA to private overseas investors¹³.

This move was particularly urgent in part because of Eurostat's decision that capital injections into Anglo Irish Bank (among other banks) constituted spending and not investments, and these injections meant that the Irish budget deficit increased from almost 14 percent of GDP in 2009 to over 30 percent of GDP in 2010, the highest level of any member state during the crisis.

New institutions created after Eurostat's 2009 decisions and subsequent rulings¹⁴ have tended to take on particular structures that are not required by Eurostat, but which Eurostat's rules strongly incentivise. An important example of this is Spain's *Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria* (Sareb). Created in November 2012, Sareb was designed through a process

12 See <http://www.nama.ie/about-us/group-structures/>. Accessed September 2014.

13 See <http://www.independent.ie/business/irish/mystery-buyer-lined-up-for-ilandp-stake-in-nama-to-keep-debt-off-books-26846296.html> and <http://ftalphaville.ft.com/2012/04/23/970601/the-crumbling-walls-of-nama-another-irish-accounting-reel/>. Accessed October 2014.

14 For example, see the 2013 edition of the *Manual on Government Deficit and Debt*, which specifies how to implement ESA 2010. ESA 2010 superseded ESA 1995.

that included the Spanish government negotiating variously with the Troika, the European Stability Mechanism (ESM), and Spain's bank bailout and restructuring entity (Fondo de Reestructuración Ordenada Bancaria, or FROB). The Troika and FROB in particular were keen to minimise Sareb's impact on the Spanish public budget. As such, there was a back and forth between FROB and Eurostat to ensure that Sareb's design would be approved as a contingent liability and have minimal immediate impact on the Spanish public budget. The result is that Sareb is 55 percent privately owned and meets the three other criteria that Eurostat laid out in 2009¹⁵.

The German bad banks were ultimately classified as being in the public sector and not contingent liabilities because of the public ownership of the institutions that they were restructuring. This was only after, as described in the Eurostat ruling¹⁶, the German Ministry of Finance initially tried to classify EAA, used to clean up WestLB, as a contingent liability. It was not until 2010 that Eurostat examined the Ministry of Finance's original classification. Clearly the government preferred that the AMCs should not increase the public debt. It was Eurostat's decision and subsequent enforcement in conjunction with the German statistical agency – Destatis – that forced this change¹⁷.

Eurostat decisions have had other effects on the ownership structures of already existing AMCs. Their rulings about how other crisis response policies would be accounted for created incentives for governments to change the ownership structure of their AMCs. The Belgian government divested its direct minority stake in Royal Park Investments following a Eurostat decision. In March 2013, Eurostat ruled that Belgium's recapitalisation of Dexia, another troubled bank, should be treated not as a financial transaction without an impact on the deficit, as the Belgian government had requested, but as a non-financial transaction¹⁸. The Dexia recapitalisation would then have an immediate affect on the public budget, pushing Belgium's deficit over 3 percent of GDP. The gross debt burden continued to worsen and approached 100 percent of GDP¹⁹. In April 2013 the Belgian government sold its stake in Royal Park Investments to improve its deteriorating budget situation²⁰. The sale reduced gross public debt by about 0.2 percent of GDP²¹ and changed the AMC from having a small majority private

15 From interviews with European Stability Mechanism staff conducted in July 2014.

16 See http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/471529_let%20WR-BMF_EAA.pdf. Accessed September 2014.

17 Ibid.

18 See the original ruling at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/BE-Dexia-recapitalisation_advice-2013-03-19.pdf. Accessed September 2014.

19 See <http://www.bloomberg.com/news/2013-04-27/credit-suisse-lone-star-to-buy-fortis-bad-bank.html>. Accessed September 2014.

20 See <http://uk.reuters.com/article/2013/04/27/uk-ageas-rpi-idUKBRE93004320130427>. Accessed September 2014.

21 See <http://www.bloomberg.com/news/2013-04-27/credit-suisse-lone-star-to-buy-fortis-bad-bank.html>. Accessed

ownership to being entirely privately owned.

Stage 3: Bailed-In bad banks

Eurostat has subsequently continued to tighten the rules for what types of AMC's can be considered outside of the state sector and treated as contingent liabilities for member states. Major changes were implemented in ESA 2010, which was in fact published in 2013 and implemented from mid-2014. The new rules expanded the definition of publicly controlled AMC's²² specifically to include institutions that are nominally banks, but are in effect public bad banks that do not conduct normal banking business. The hard 51 percent ownership rule was expanded to focus not just on nominal equity ownership, but also who is effectively in control of the assets and who bears most of the risks from the AMC entity. This means that an AMC that is entirely privately owned, but that is largely backed by state guarantees, such that the state is shouldering most of the risks, is now considered a public AMC and is no longer treated as a contingent liability²³.

Though a relatively new AMC stage, we have already seen this process play out in the August 2014 restructuring of failed Portuguese bank Banco Espírito Santo (BES). The bank was split into a good bank, recapitalised by the public, and a bad bank. Rather than being a public entity, the bad bank is effectively owned by bailed-in junior BES shareholders and bondholders²⁴. This minimises its impact on the public budget and potentially imposes a considerable proportion of the total costs of restructuring BES on the private sector owners of the failed bank.

Exceptions and lessons

There are a number of exceptions to the general trend towards the creation of AMC's with private majority ownership. These exceptions are worth considering in some detail because they illuminate challenges for future European attempts to minimise the use of public resources for bailouts in the developing Banking Union. In particular, they illustrate that (a) member state governments may make considerable attempts to skirt the spirit of Eurostat rules and (b) it may be very difficult to assist banks with the least costly policies under Eurostat rules – i.e. using significant private sector participation – if state ownership of failing banks is high.

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22 Reflecting the broader focus, Eurostat now uses the more general term “*financial defeasance structure*”.

23 See Part IV.5 in http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-GQ-14-010/EN/KS-GQ-14-010-EN.PDF. Accessed September 2014.

24 See: <http://uk.reuters.com/article/2014/08/04/uk-portugal-bes-cenbank-idUKKBN0G30TA20140804>. Accessed September 2014.

Creative accounting

One major exception to the post-2009 private ownership trend is Austria's KA Finanz. This case illustrates the pliability of Eurostat's rulemaking process and how it often plays catch up with member state governments' use of new policies to skirt the spirit of the rules. KA Finanz was designed in such a way that it followed the letter of Eurostat's 2009 guidance note, but not the spirit. At the end of November 2009, the Austrian government split up struggling Kommunalkredit Austria AG into a good and bad bank. The bad bank was called KA Finanz and was wholly owned by the Austrian public²⁵. However, it was able to stay off of the public balance sheet. Rather than becoming an AMC as specified in Eurostat's guidance note, KA Finanz was officially classified as a bank and was given a banking license even though it did not take new deposits or issue new loans. In name it was a bank, in practice it was an AMC. Eurostat responded to this move by updating the rules under ESA 2010 so that future AMCs could not be treated as off-budget simply by being given a banking license²⁶.

Limited policy options when states own troubled banks

The other wholly publicly owned AMCs created after Eurostat's decision all share the same characteristic: they were designed to restructure *publicly owned banks*. Public ownership of the failed banks makes it difficult to share ownership of the AMCs with the private sector. We saw earlier that German politicians clearly intended to create privately owned AMCs, but their failure to engineer private solutions to HRE's and WestLB's difficulties, and the high level of public ownership of WestLB before the crisis, led to public takeovers and then publicly owned bad banks when the public owners were bailed-in.

Slovenia's Bank Asset Management Company (referred to by its Slovenian acronym DUTB) illustrates economic constraints that can limit the government's ability to involve the private sector in AMC ownership and therefore costs. DUTB was created in March 2013 as a largely traditional AMC with full government ownership. It acquired assets from two majority state owned banks: Nova ljubljanska banka and Nova kreditna banka Maribor²⁷. Why would the Slovenian Government create a fully publicly owned AMC given the large negative implications for the country's budget after the 2009 Eurostat decision? Indeed, immediately realised liabilities for the state from assisting Slovenian banks increased from under 5 percent of GDP in 2012 to about 14 percent in 2013. The answer likely lies in the ownership structure of the Slovenian banking sector. Approximately 40 percent of loans are issued

25 See: <http://www.kafinanz.at/EN/About%20us/About+us.aspx>. Accessed August 2014.

26 Information from a July 2014 interview at Eurostat.

27 See http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Final_Findings-SDV-SI-12-13_September_2013.pdf (p. 14) and <http://www.dutb.eu/en/assets-management>. Accessed November 2014.

by state owned banks and many other banks are controlled by the state (OECD 2013, 9). Because of this high level of state ownership in the banking sector, a majority privately owned AMC, or other policies that would have been considered beyond the direct public budget by Eurostat, were not realistic options. At the same time, public assistance was needed to avert potentially much more publicly costly failures of state owned banks.

A similar issue contributed to other exceptions to the private ownership trend. Portugal and the United Kingdom created wholly publicly owned AMCs in 2010. Austria created one in 2014. UK Asset Resolution was an outgrowth of the 2008 nationalisations of Northern Rock and Bradford and Bingley²⁸. It is effectively an institution for managing assets that the UK public already owned. The Dexia bad bank was created by hiving off its Belgian operations into a good bank called Belfius in 2011²⁹. Dexia was also effectively publicly owned. By the end of 2008 the Belgian and French governments and associated entities such as France's Caisse des dépôts et consignations controlled about two thirds of the company (Dexia, 2008, 5). Similarly, Portugal's three-part asset management vehicle Parvalorem/Parups/Parparticipadas was created to restructure Banco Português de Negócios, a bank that in contrast to BES had been nationalised in 2008. Austria's Heta Asset Resolution was built as a fully owned subsidiary of Hypo Alpe-Adria Bank (Hypo) in 2014. Hypo was fully nationalised in 2009, so the Austrian state owns Heta Asset Resolution. The bad bank was created only after the government was unable to secure voluntary private sector participation that would have minimised the institution's impact on the public debt according to Eurostat rules³⁰. In an unusual measure designed to minimise the public budgetary effects of restructuring Hypo and bail-in Hypo's creditors, the national government annulled guarantees extended to the bank by its home province Carinthia³¹.

These cases are not just illustrative of the limits of having private sector involvement in bank restructuring in countries with high state ownership in the banking sector or very troubled banks. A systemic crisis may so damage a country's financial institutions – even if they are all privately owned – that few if any could participate in the ownership of an AMC and remain viable. The problem could be ameliorated by the development of a truly European financial market in which healthy banks based in other member states could be involved in restructuring across national borders. However, Europe is a

28 Northern Rock Asset Management was created in January 2010 to deal with Northern Rock's bad assets and was later folded into UK Asset Resolution when it was created in October 2010. See <http://www.n-ram.co.uk/about-us>. Accessed October 2014.

29 Dexia's Belgian operations were bought by the Belgian Government.

30 See <http://online.wsj.com/news/articles/SB10001424052702304104504579374842733926408>. Accessed October 2014.

31 See <http://www.reuters.com/article/2014/06/11/austria-hypo-idUSL5N00S1CW20140611>. Accessed October 2014.

long way from such an integrated financial market (see Sapir and Wolff, 2013).

Economic impact of AMC ownership

How could greater private ownership of an AMC impact on its cost-effectiveness and its contribution to reestablishing a stable and vibrant financial system? Beyond sharing risks with the private sector, we argue that increasing private ownership, especially under Eurostat's post-2009 rules, tends to improve the effectiveness of AMCs compared to publicly owned AMCs by incentivising larger haircuts on asset acquisitions. To understand the role that AMC ownership plays in haircuts and how haircuts affect outcomes, it is important to consider what makes an AMC more or less successful, both in terms of its own operations and in its contribution to the broader goal of re-establishing a stable and vibrant financial system.

An individual AMC's total return is broadly the result of (a) the quality of the assets that it manages, (b) the haircut applied to the transferred assets, and (c) how well the assets are managed. Clearly, higher quality assets – eg performing loans – will be easier to manage effectively and eventually sell. Nonetheless, AMCs are supposed to manage bad assets so that the good bank with a portfolio of performing assets can regain its footing. So by design, AMCs should hold low-quality assets.

It is possible to make a positive return, or at least minimise losses, on fairly poor quality assets by applying a haircut during their acquisition and managing them well. For example, if an asset is worth 60 percent of its original book value, but the AMC acquired it for 50 percent, then it may very well make a positive return. The AMC will be even more likely to maximise the value from these assets if it also has competent staff that are skilled at marketing distressed assets and collecting from borrowers that are in arrears.

Haircuts not only contribute to AMCs' individual profitability, but also to their contribution to the wider goal of returning a financial system to health and vibrancy. AMCs that impose large haircuts realise losses sooner in 'good banks'; this helps avoid the problems of zombie banks. On paper these institutions are solvent, but they are in reality weighed down by non-performing assets and are unable to supply credit to the economy.

Haircuts also help to avoid zombie bad banks. AMCs that have not imposed appropriate haircuts tend to be more reluctant to actually dispose of bad assets because they will have to admit losses. Such AMCs could be turned into 'bad asset warehouses'. Governments, reluctant to record losses, use these

AMCs to store assets, preventing the AMC from being wound down in a timely fashion.

Majority privately owned AMCs, especially if the AMCs are designed to actively attract voluntary private investors, are more likely to impose larger haircuts on acquired assets and manage these assets better. It is unlikely that private investors will voluntarily invest in an AMC that does not do this. The AMC will be less likely to make a positive return.

In addition to pressures from private investors, Eurostat's post-2009 rules actually require off-budget AMCs to impose large haircuts. Under the rules, haircuts must be accompanied by recapitalisation of the good bank. This enables the good bank to have sufficient capital, despite realising losses from the haircuts. The rule does force governments to record some costs of creating the AMC, though these may be less than the budgetary impact of keeping the AMC on the public balance sheet.

Table 3: AMC public ownership stakes and haircuts on transferred assets

Name	Maximum public ownership stake in AMC (%)	Haircut on transferred assets (%)	Haircut source
Banco Espírito Santo (Portugal)	0	Assets not transferred	Lima and Marsh (2014)
Erste Abwicklungsanstalt (Germany)	100	0	Braakmann and Forster (2011, 11)
Dexia (Belgium/France/Luxembourg)	95	Assets not transferred	Dexia (2014)
DUTB (Slovenia)	100	71	authors' calculations from DUTB (2014)
Finansiel Stabilitet (Denmark)	100	Unknown	
FMS Wertmanagement (Germany)	100	0	Braakmann and Forster (2011, 13)
Heta Asset Resolution (Austria)	100	Assets not transferred	Hypo Alpe Adria (2014)
KA Finanz (Austria)	100	Assets not transferred	
NAMA (Ireland)	Core: 100, Master SPV: 49*	58 (average through 2011)	Braakmann and Forster (2011, 17)
Propertize (Netherlands)	100	37	authors' calculations based on Wallace (2014)
Parvalorem/Parups/Parparticipadas (Portugal)	100	0	European Commission (2012)
Royal Park Investments (Belgium)	43.5	Haircut on original transfer unknown, 17 (for 2009 'refill')	authors' calculations from European Commission (2009, 4)
Sareb (Spain)	45	45.6 (average for loans), 63.1 (average for foreclosed assets)	FROB (2012, 11)
SFEF (France)	34	10-40 (depending on asset type)	Braakmann and Forster (2011, 14)
UK Asset Resolution (United Kingdom)	100	Assets not transferred	

Note: 'Assets not transferred' indicates that the AMC was created with an existing portfolio of assets rather than having assets transferred to them. In effect this means that no haircut was applied to the assets as they continue to be recorded at book value.

* Excludes period after bank nationalisations and before foreign investor ownership stakes were increased. See above for details.

Assessing underlying asset and managerial quality is a difficult task. Measuring haircuts is far more straightforward. Haircuts are the percentage difference of an asset's book value compared to the price that it is acquired for. Table 3 shows the highest public ownership share that each of the European AMCs had and the haircuts that they applied to assets that were transferred to them. Overall, majority publicly owned AMCs imposed very low (if any) haircuts on their assets. Many of the publicly owned

AMCs, such as Dexia in its life as a bad bank, Heta, and UK Asset Resolution imposed effectively no haircut because they were created with an existing portfolio of bad assets recorded at book value. Good assets were split off. Majority privately owned AMCs, on the other hand, almost always imposed relatively large haircuts.

There are at least three reasons why the privately owned AMCs tend to impose larger haircuts. The first is to encourage private sector buy-in. Sareb and NAMA were both relatively successful at attracting private sector investors. NAMA in particular imposed an average 58 percent haircut on the assets that it acquired. As we saw earlier, even after the Irish government nationalised many of the bank owners, it was able to quickly attract new foreign investors. Sareb has arguably been even more successful at attracting private investors. Its shareholders include 27 investors among which are large internationally active institutions such as Banco Santander, Deutsche Bank and Barclays (IMF, 2013).

Second, as we mentioned previously, Eurostat's rules from 2009 require large haircuts for AMCs that are off the public budget. Eurostat's most recently tightened rules concerning who holds the majority of the AMC's risks reinforce the reliance on haircuts. Before this, countries could entice private investment by not only imposing haircuts, but also guaranteeing investments. For example, though Belgium's Royal Park Investments was 56.5 percent privately owned, a considerable proportion of this equity was publicly guaranteed (European Commission 3-4). Under Eurostat's new rules, such guarantees would be less attractive to politicians because they would cause the whole AMC to count against their debt. Royal Park Investments' relatively small 17 percent haircut, would likely need to be much larger under the current government accounting rules in order to attract private investors that would not expect public guarantees.

Third, majority privately owned AMCs tended to be used to clean up private banks. Large haircuts imposed on publicly owned banks force large immediate losses for the public that politicians may not want. Further immediate costs will also likely come from a need to recapitalise the good bank. Imposing large haircuts on private banks is comparatively easier because in general more of the costs will be borne by the private sector with less immediate effect on the public budget. We can see in Table 3 that almost no publicly owned AMC imposed any haircut, while all of the privately owned AMCs did.

As before, however, there are notable exceptions that illustrate how Eurostat's framework functions. Banco Espírito Santo is an unusual case that is entirely owned by the failed bank's shareholders and creditors, but also shares similarities with publicly owned AMCs such as Dexia and Heta, in that the

failed bank's good assets were hived off into a publicly owned good bank called Novo Banco. As such there were no transferred assets on which to apply a haircut. This setup nonetheless shares costs with the private sector since BES's losses as a bad bank will be borne by private investors and creditors. Nonetheless, BES's private owners might be reluctant to book these losses and might instead warehouse them.

DUTB and Propertize are notable exceptions of publicly owned AMCs that imposed large haircuts. DUTB actually imposed the largest average haircut in Europe at 71 percent. We can see how accounting rules encouraged this sizable haircut. The Slovenian government was unable to get private sector support for its AMC in 2013. Given that DUTB would then be entirely counted against the public debt and Slovenia was on the brink of needing an international bailout, the Slovenian government was under intense pressure to minimise DUTB's budgetary impact. A very large haircut was one of the only options left to do this. The Dutch Ministry of Finance imposed a medium-sized haircut based on the real estate services firm Cushman and Wakefield's valuation of nationalised SNS Reaal's property portfolio transferred to Propertize (Wallace 2014). Nonetheless the European Commission estimated that the asset transfer constituted €859 million in state aid to SNS Reaal because the assets were transferred above market value³².

Conclusions: implications for the future European banking union

Eurostat is likely to be especially important during future resolutions of banks that are formally outside of the Single Resolution Mechanism – the vast majority of the EU's banks – and are instead resolved by individual member states. In particular, Eurostat's recently tightened rules complement the new European Bank Recovery and Resolution Directive's (BRRD) goal to minimise the public costs of bank restructuring. One of the four recovery and resolution tools for cleaning up failed banks prescribed by the BRRD is the 'asset separation tool'. This involves assets being transferred from a failed bank to an 'asset management vehicle' – eg AMC. This vehicle can be wholly or partially publicly owned under the BRRD³³. Eurostat's decisions, however, incentivise member states to choose a version of the asset separation tool that increases private-sector participation more than they are required under the BRRD. Eurostat's decisions also incentivise larger haircuts on transferred assets.

³² See http://europa.eu/rapid/press-release_IP-13-1280_en.htm. Accessed November 2014.

³³ For the full text of concerning the asset separation tool see Article 42 in the BRRD: <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0059&from=EN>. Accessed September 2014.

Economic limitations, such as state ownership in the banking sector and the lack of a fully integrated European financial market, along with attempts by politicians to circumvent accounting rules, will likely continue to dampen the effect that Eurostat's rules have on bank resolution decisions. Nonetheless, these rules, and Eurostat's monitoring of them, will play an important part in limiting the cost to the European public of resolving failed banks.

There is still more work to be done on how Eurostat has affected member state choices in response to the crisis. It has in fact been instrumental in incentivising member state choices in other financial assistance areas. A key example is the role Eurostat played in replacing the European Financial Stability Facility (EFSF) with the new ESM. The EFSF funded itself by issuing member state guaranteed bonds. If counted as contingent liabilities, these guarantees would push member states' costs into the future. At the same time the guarantees removed risks from private sector creditors. However, in January 2011 Eurostat ruled that because the EFSF was effectively controlled by member states, any EFSF borrowing would count as member state government gross debt, not as a contingent liability³⁴. This made the institution politically unpalatable. Any action that it took would increase member state gross debt proportional to their contributions. This ruling was one reason to replace the EFSF with an institution designed differently to minimise the national budgetary effects of providing assistance to troubled countries. The ESM, as an independent institution with autonomous decision-making powers, met Eurostat's requirements³⁵. The ESM's structure and accounting rules limit the costs for member states to paid-in capital, for which borrowing increases their gross debt, and call capital that, until called, is a contingent liability. ESM borrowing – the bulk of its resources – does not directly affect government budgets.

34 See http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-27012011-AP/EN/2-27012011-AP-EN.PDF. Accessed October 2014.

35 From an interview with a Eurostat official in July 2014. In addition see http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Eurostat_Decision_on_ESM.pdf. Accessed October 2014.

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