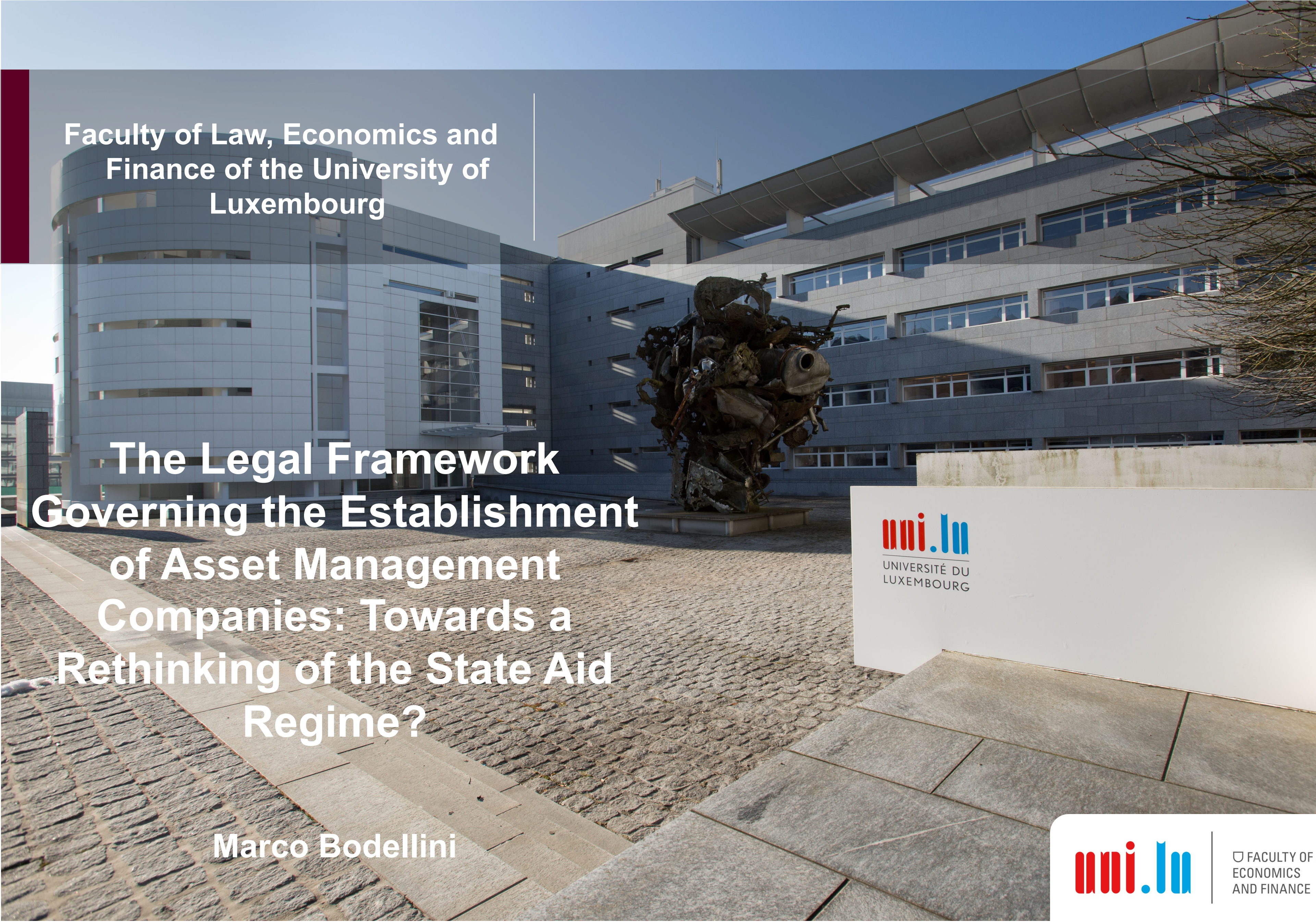

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The Legal Framework Governing the Establishment of Asset Management Companies: Towards a Rethinking of the State Aid Regime?

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Non-performing loans (NPLs) and Asset Management Companies (AMCs): the Starting Point(s)

1
- Covid-19 pandemic expected to provoke surge in NPLs, which can endanger functioning and stability of banking systems. This might happen when relief measures will be lifted.

2
- AMCs proven to be effective tool to manage NPLs. They were used by several EU member states.

3
- AMCs have both advantages and disadvantages.

4
- Structure, funding and NPLs transfer price are key aspects. Even more so in Banking Union, where the level playing field among banks in different states must be ensured.

Advantages of AMCs

- The main advantages of transferring (and pooling) NPLs of many banks to AMCs are:

1) increase effectiveness of NPL resolution by bridging the intertemporal valuation gap, pooling expertise and reducing funding costs

2) clean bank balance sheets by reducing uncertainty about financial strength and increasing the ability to continue lending

3) contribute to the promotion of secondary markets for NPLs

Disadvantages of AMCs

- The main disadvantages of transferring (and pooling) NPLs of many banks to AMCs are:

1) can result in the loss of knowledge about the debtor

2) lack of a clear mandate and inconsistent adherence to it may reduce the effectiveness of AMCs

3) too-high NPL acquisition prices can result in taxpayer losses

Key elements for effective AMCs

- Key elements in the design of AMCs:

a) Homogeneous portfolios of NPLs to maximise economies of scale (positive track record with commercial real estate loans and large corporate exposures)

b) Fair transfer price reflecting as much as possible (without exceeding) real economic value of NPLs

c) Capital and funding structure, involving banking system and, if necessary, also public sector

d) Independent governance to protect AMCs from political intrusion

Transfer price

NPLs **transfer price** is **key** for the success of AMCs and avoid **triggering State aid regime** which might lead to the **classification of** banks as **failing or likely to fail** (FOLF) and thus to either liquidation or resolution.

a) transfer price higher than book value, banks not affected, but AMCs likely to suffer losses (or lower gains) once disposing of these assets. Possible negative effects for taxpayers

b) transfer price “too-low”, banks will need recapitalising; if not possible crisis management procedures to start

Transfer price and State aid regime

- **Transfer price** might trigger **application of State aid regime**.

- **Relevant** to check **if AMC is publicly supported**. AMC supported by State aid is "an **AMC** that is **partially or fully publicly-owned** (or even privately owned but with actions that are imputable to the State, or benefiting from a State guarantee), **buying assets at a transfer price higher than the estimated market value**".

- If so, **transactions involve State aid** (difference between transfer price and estimated market value) and need **to be authorized by Commission**.

Commission authorisation conditions

- Impaired Asset Communication:

  a) **Transfer price not exceeding real economic value**. Real economic value is ''**underlying long-term economic value of the assets, on the basis of underlying cash flows and broader time horizon**''.
  b) **Losses resulting from the write-down of NPLs** from their net book value to the transfer price **not covered by impaired asset aid**.
  c) **Valuation** performed **by independent experts** and validated by authority.

- Banking Communication:

  a) **Restoring bank's long-term viability**.
  b) **Limiting State aid** to the minimum **through burden sharing**.
  c) **Limiting distortions of competition**.

Four scenarios

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Depending on conditions and **price** at which a publicly supported AMC purchases NPLs, **four different scenarios** can occur.

1) **Without State aid**. If a **publicly supported AMC** buys NPLs at **prevailing market price**, acting as a market buyer, it does **not** provide any **State aid**.

2) Through **asset separation tool in resolution**. **Additional support might be provided by resolution fund when** considered **necessary for the application of resolution tools;** yet a number of **conditions need to be met.**

3) **With State aid in insolvency proceedings**. Banking Communication allows, under conditions, **provision of liquidation aid to facilitate exit of non-viable institutions in an orderly manner to avoid negative effects on financial stability**. Conditions: limitation of liquidation costs, limitation of competition distortions and burden sharing.

4) **With State aid through precautionary recapitalisation.** Solvent and non-FOLF bank **can benefit from State aid without being determined as FOLF, when aid is granted in the context of a precautionary recapitalisation and some requirements are met.**

Transfer of NPLs to a public AMC through precautionary recapitalisation

- Precautionary recapitalization:

a) can take place **in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability**;
b) is limited to **solvent institutions that are not FOLF**;
c) is of a **precautionary and temporary nature**;
d) is conditional on **final approval under the EU State aid framework**;
e) must be **proportionate to remedy the consequences of the serious disturbance of the economy**;
f) should **not** be **used to offset losses that the institution has incurred or is likely to incur in the near future**;
g) should be **limited to injections necessary to address capital shortfall** established in national, EU-wide or SSM-wide stress tests, AQR reviews or equivalent exercises conducted by the ECB, the European Banking Authority (EBA) or national authorities, where applicable, confirmed by the competent authority.

How to structure the transaction to avoid triggering State aid regime

- **Through an impaired asset measure in precautionary recapitalisation, bank to sell NPLs at a price higher than market price** (but not exceeding real economic value); capital position preserved by reducing upfront loss.

- Precautionary recapitalisation can be **any combination of "recapitalisation aid … and impaired asset aid** (as a price contribution to a higher price at which the bank transfers impaired assets to the AMC …)".

Commission Temporary Framework

- **Commission** relaxed rules on State aid to face COVID-19 emergency through **Temporary Framework**, also dealing with precautionary recapitalisation.

- **If banks need extraordinary public financial support** in the form of liquidity, recapitalisation or impaired asset measure **because of Covid-19** and conditions of Article 32(4), point (d) (i), (ii) or (iii) BRRD are met, **institutions receiving support not deemed FOLF.**

- Also, **if such measures were to address problems linked to Covid-19, they would benefit from point (45) of Banking Communication**, (disapplication of burden sharing for shareholders and subordinated creditors when this would endanger financial stability or lead to disproportionate results).

CONCLUSIONS

a) **Buyers unlikely to pay price reflecting the real economic** value of NPLs, taking advantage of rules requiring banks to increase loss provisioning

b) **Use of publicly supported AMCs or network of publicly supported national AMCs can overcome market failures** (illiquidity, information asymmetries, price gap) and consequences on economy and society

c) **Questionable whether precautionary recapitalisation suitable tool** to handle surge in NPLs affecting many banks. Precautionary recapitalisation is a measure to face single (or a limited number of) idiosyncratic crises

d) **Commission could rethink the way State aid rules are applied** in relation to the purchase of NPLs. Accordingly, appropriate to **reconsider the treatment of NPL purchases at prices that reflect their real economic value**

Thank you