The €1 trillion challenge in European banking

How to wind down nonperforming and noncore assets
Contacts

Amsterdam
Jeroen Crijns
Director, PwC Netherlands
+31-6-5156-6470
jeroen.crijns
@strategyand.nl.pwc.com

Brussels
Gregory Joos
Partner, PwC Belgium
+32-4739-10353
gregory.joos@be.pwc.com

Düsseldorf
Peter Gassmann
Managing Director, PwC Strategy& Germany
+49-170-2238-470
peter.gassmann
@strategyand.de.pwc.com

Frankfurt
Stephan Lutz
Partner, PwC Germany
+49-69-9585-2697
stephan.x.lutz
@de.pwc.com

Michael Maifarth
Partner, PwC Germany
+49-69-9585-2318
michael.maifarth
@de.pwc.com

Marc-Alexander Schwamborn
Partner, PwC Germany
+49-69-9585-5824
marc-alexander.schwamborn@de.pwc.com

London
Alan Gemes
Partner, PwC UK
+44-79-0016-3290
alan.gemes@pwc.com

Miles Kennedy
Partner, PwC UK
+44-77-3831-3619
miles.x.kennedy
@pwc.com

Joerg Ruetschi
Principal, PwC UK
+44-79-0016-3597
joerg.ruetschi@pwc.com

Madrid
Raquel Garces Sañudo
Partner, PwC Spain
+34-91-411-8450
raquel.garces.sanudo
@strategyand.es.pwc.com

Milan
Roberto Bartocetti
Director, PwC Italy
+39-34-8260-7297
roberto.bartocetti
@strategyand.it.pwc.com

Munich
Philipp Wackerbeck
Managing Director, PwC Strategy& Germany
+49-170-2238-659
philipp.wackerbeck
@strategyand.de.pwc.com

Benjamin Baur
Manager, PwC Strategy& Germany
+49-170-2238-692
benjamin.baur
@strategyand.de.pwc.com

Vienna
Andreas Putz
Partner, PwC Strategy& Austria
+43-664-5152-908
andreas.putz
@strategyand.at.pwc.com

Zurich
Daniel Diemers
Partner, PwC Strategy& Switzerland
+41-79-6200-929
daniel.diemers
@strategyand.ch.pwc.com

Utz Helmuth
Principal, PwC Strategy& Switzerland
+41-77-409-4571
utz.helmuth
@strategyand.ch.pwc.com
About the authors

Dr. Philipp Wackerbeck is a managing director with PwC Strategy& Germany in the financial-services practice. Based in Munich, he is head of the risk, capital, and regulation team in Europe, the Middle East, and Africa.

Benjamin Baur is a manager with PwC Strategy& Germany. He specializes in balance sheet restructuring, asset wind-down processes, nonperforming loans, and valuation in the financial-services sector. He is based in Munich.

Thorben Wegner is a senior associate with PwC Strategy& Germany. Based in Frankfurt, he works with financial-services clients on risk and capital management strategies, including credit portfolio management, balance sheet restructuring, and stress testing.

Also contributing to this report were Johanna Barth, manager, PwC Strategy& Germany; Felix Becht, manager, PwC Strategy& Germany; Jeroen Crijns, director, PwC Netherlands; Stefan Linder, senior manager, PwC Germany; Stephan Lutz, partner, PwC Germany; Sebastian Marek, principal, PwC Strategy& Germany; and Andreas Putz, partner, PwC Strategy& Austria.
Executive summary

The European banking industry today faces multiple challenges, including recessions in various countries, increased regulatory activity, and a sustained low-interest-rate environment. The levels of nonperforming loans (NPLs) and noncore assets in the continent’s banking sector remain stubbornly high, a legacy of the 2007–08 financial crisis, and one that remains a vital concern for the financial sector and the overall economy. Banks must wind down these weak assets to improve their chances for future growth. Many are doing this by shifting the troubled assets into separate entities set up strictly for the purpose of selling off the NPLs and noncore holdings.

To assist Europe’s banking executives in this effort, we conducted a study of wind-down operations across the continent and identified factors that make them effective in reducing the burden of NPLs and noncore assets. Our study encompassed 18 of the region’s largest wind-down units, which were selected for their broad coverage of the diverse European market, strong data, and significance within their respective markets.

We found that effective wind-down entities share a number of key traits. In addition to adopting a more appropriate organizational structure, they follow four operational imperatives:

1. A fresh start supported by a tailored operating model, accurate asset valuations, and a comprehensive wind-down plan
2. Loaded batteries in the form of appropriate levels of funding and liquidity throughout the wind-down life cycle
3. Proficient execution supported by the staffing, policies, processes, and governance structures necessary to achieve performance goals
4. A coherent ramp-down plan that enables a measured, incremental reduction in operations executed in lockstep with the wind-down of assets
Banks that wind down their nonperforming and noncore assets in this manner not only improve their financial health, but also muster the resources needed to navigate existing market disruptions and build a strong foundation for growth.
Weighing down the banking sector

A decade after the financial crisis of 2007–08, Europe’s banking sector is still weighed down by large portfolios of nonperforming loans (NPLs) and noncore assets. Many banks have spun off these troubled assets into separate wind-down entities, which include internal wind-down units, stand-alone bad banks, and national wind-down solutions. At the end of 2016, NPLs across Europe amounted to €1 trillion (US$1.2 trillion), according to the European Systemic Risk Board (ESRB), and banks are also flagging more and more portfolios as noncore. It will take years to unwind these nonperforming and noncore assets.

The average NPL ratio for banks in the European Union (E.U.) member states is 4.8 percent. This is considerably higher than elsewhere in the world: For instance, according to World Bank data, banks in the United States have an average NPL ratio of 1.3 percent, and in Japan it’s 1.5 percent. NPL ratios in Europe vary significantly by bank and by country. For example, NPL ratios range from near zero in Sweden and Finland to almost 50 percent in Greece and Cyprus.

Further, the coverage ratios on Europe’s existing NPL inventories suggest that banks have inflated hopes for recovering the value of these assets and avoiding write-offs. In some E.U. countries with low NPL ratios, such as Germany, Belgium, and Sweden, the banks have not covered more than 20 percent of their NPL inventories. This indicates they have high expectations for recovery. In E.U. states with high NPL ratios (15 percent or more), such as Portugal, Italy, and Ireland, more than 10 percent of NPL assets are uncovered (see Exhibit 1, next page). If the cures and recoveries fall short of the banks’ expectations, these uncovered exposures could directly translate into additional capital losses for the banks.

European authorities have identified NPL levels in Europe as a key concern for the banking industry. To that end, the Council of the European Union has put forward a plan involving 14 actions grouped around the four larger themes of supervisory policies, insolvency and debt recovery framework, secondary markets, and restructuring the banking sector. The aim of the plan is to reduce the number of NPLs and
Exhibit 1
NPL and coverage ratios in Europe, by country

Note: As of Q2 2016.

Source: European Banking Authority

prevent more from emerging, with guidance from various authorities including the European Central Bank, the European Banking Authority, the European Commission, and the ESRB.

In addition to the inherent risk it represents, the large NPL inventory is a substantial drag on the profitability of Europe’s banks. Unaddressed NPL reduces credit limits and ties up capital. It significantly limits the capacity of banks to reinvest in profitable businesses and to fund new innovative, income-generating businesses.

Noncore asset portfolios are on the rise in Europe because, in response to low interest rates, new regulatory requirements, and refocused business models and strategies, more and more banks are reviewing the coherence of their portfolios and, in many cases, refining their focus on specific asset classes. This trend is evident even among Europe’s large commercial banks, which have traditionally pursued business across many different asset types, industries, and geographies. As a result,
banks are flagging increasingly large portfolios of healthy assets as noncore and seeking to divest these assets in a way that maximizes their value in order to generate funds for strategic reinvestment.

In sum, wind-down operations are already a prominent feature in Europe’s banking landscape and are highly likely to attain greater prominence in the near term. High NPL levels across Europe, looming banking regulations, and the need to divest noncore assets indicate a growing need for Europe’s banks to develop and hone their ability to structure, launch, and manage wind-down operations. For many European banks, wind-down expertise will be an essential tool for enhancing their risk profiles and profitability.
Our analysis of the current wind-down landscape across Europe found that the performance of wind-down entities varies widely. The success that an institution has in shedding its NPLs and noncore assets is influenced by asset structure, organizational setup, and operational performance. Our examination also revealed that due to recent regulatory changes in relation to resolution activities, the options for choosing a wind-down structure may be narrowing.

We studied 18 entities with assets in excess of €700 billion. These entities constitute a large majority of Europe’s wind-down operations and encompass three different structural models — internal wind-down units, stand-alone bad banks, and national wind-down solutions (see Exhibit 2, next page).

Each of the three wind-down structures is distinguished by three characteristics (see Exhibit 3, page 11):

- **Consolidation**: Is the wind-down entity’s assets carried on or off the balance sheet of the originating bank?
- **Scope**: Do the entity’s assets come from one source or multiple sources?
- **Risk carrier**: Is the risk associated with the entity’s assets publicly or privately held?

**Internal wind-down units** are typically found in financially sound banks that are strategically divesting noncore assets to raise capital, intensifying their focus on core activities, and/or investing in promising new businesses. The salient characteristic of internal wind-down units is that they are fully owned and operated by their parent bank.

The assets in the internal unit remain on the balance sheet of the bank, a condition that simplifies the initial separation and subsequent transfers. The wind-down unit can utilize the core functions of its parent bank, and staff can easily be transferred between the unit and the main bank.
### Exhibit 2
Overview of bad banks and wind-down units in Europe

<table>
<thead>
<tr>
<th>Name</th>
<th>Type</th>
<th>Country</th>
<th>Wind-down time horizon</th>
<th>Total assets at peak (€ billions)</th>
<th>Total assets 2016 (€ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMS Wertmanagement</td>
<td>Publicly held stand-alone bad bank</td>
<td>Germany</td>
<td>2010–20</td>
<td>342</td>
<td>177</td>
</tr>
<tr>
<td>Erste Abwicklungsanstalt</td>
<td>Publicly held stand-alone bad bank</td>
<td>Germany</td>
<td>2009–27</td>
<td>123</td>
<td>61</td>
</tr>
<tr>
<td>KA Finanz</td>
<td>Publicly held stand-alone bad bank</td>
<td>Austria</td>
<td>2009–21</td>
<td>21</td>
<td>12</td>
</tr>
<tr>
<td>Heta Asset Resolution</td>
<td>Publicly held stand-alone bad bank</td>
<td>Austria</td>
<td>2013–20</td>
<td>18</td>
<td>10</td>
</tr>
<tr>
<td>Propertize</td>
<td>Publicly held stand-alone bad bank</td>
<td>Netherlands</td>
<td>2013–23</td>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>Sareb</td>
<td>National wind-down solution</td>
<td>Spain</td>
<td>2012–27</td>
<td>54</td>
<td>40</td>
</tr>
<tr>
<td>National Asset Management Agency (NAMA)</td>
<td>National wind-down solution</td>
<td>Ireland</td>
<td>2009–18</td>
<td>32</td>
<td>7</td>
</tr>
<tr>
<td>Bank Assets Management Company (DUTB)</td>
<td>National wind-down solution</td>
<td>Slovenia</td>
<td>2013–</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>RBS Capital Resolution (RCR)</td>
<td>Internal wind-down unit</td>
<td>U.K.</td>
<td>2009–</td>
<td>418</td>
<td>155</td>
</tr>
<tr>
<td>Credit Suisse strategic resolution unit</td>
<td>Internal wind-down unit</td>
<td>Switzerland</td>
<td>2015–</td>
<td>108</td>
<td>75</td>
</tr>
<tr>
<td>UBS noncore and legacy portfolio unit</td>
<td>Internal wind-down unit</td>
<td>Switzerland</td>
<td>2012–</td>
<td>355</td>
<td>64</td>
</tr>
<tr>
<td>Commerzbank internal noncore unit</td>
<td>Internal wind-down unit</td>
<td>Germany</td>
<td>2009–</td>
<td>172</td>
<td>27</td>
</tr>
<tr>
<td>HSH Nordbank internal noncore unit</td>
<td>Internal wind-down unit</td>
<td>Germany</td>
<td>2009–</td>
<td>83</td>
<td>22</td>
</tr>
<tr>
<td>Lloyds internal noncore unit</td>
<td>Internal wind-down unit</td>
<td>U.K.</td>
<td>2009–</td>
<td>332</td>
<td>13</td>
</tr>
<tr>
<td>BayernLB internal noncore unit</td>
<td>Internal wind-down unit</td>
<td>Germany</td>
<td>2009–16</td>
<td>59</td>
<td>*</td>
</tr>
<tr>
<td>Deutsche Bank internal noncore operations unit</td>
<td>Internal wind-down unit</td>
<td>Germany</td>
<td>2012–16</td>
<td>113</td>
<td>*</td>
</tr>
<tr>
<td>Barclays internal noncore unit</td>
<td>Internal wind-down unit</td>
<td>U.K.</td>
<td>2014–17</td>
<td>604</td>
<td>**</td>
</tr>
</tbody>
</table>

*Closed on Dec. 31, 2016
**Closed on June 30, 2017

Source: Bank financial reports; Strategy& analysis
Europe’s largest internal wind-down units held more than €350 billion in assets in 2016.

An internal unit may draw on the capitalization of its parent bank, and its write-offs and losses are passed back to the parent bank. However, the clear organizational separation ensures that the restructuring and winding down of assets occur independently of client relationships and other potential constraints. Thus, the bank avoids the conflicts of interest that arise when client-facing units are tasked with winding down weak assets.

Europe’s largest internal wind-down units held more than €350 billion in assets in 2016, according to our analysis. Prominent examples are the internal unit of Commerzbank, with assets of about €27 billion, which has been winding down its commercial real estate, public finance, and Deutsche Schiffsbank portfolios, and the internal unit of HSH Nordbank, with assets of about €22 billion, which is winding down noncore ship, real estate, and aircraft loans, as well as asset-backed securities, as noted in the two institutions’ most recent annual reports.
As these examples show, different kinds of assets, drawn from various industries and geographies, can be assigned to internal wind-down units. Their mix of NPL and noncore assets also differs widely, depending on the individual situation of their parent banks.

**Stand-alone bad banks** enable their originating banks to remove unwanted assets from their balance sheets. This separation of assets protects the originating bank from wind-down shortfalls and enables it to focus on growth and profitability. The stand-alone bad bank exists strictly to hold the troubled assets from one specific institution.

Typically, stand-alone bad banks are established when very high NPL ratios combine with other external and internal factors to create an urgent need to give a bank a fresh start. For instance, when a bank can no longer secure funding in the marketplace and must seek public funds for support, the government often mandates that the bank’s toxic assets be placed in a stand-alone bad bank that is fully separate from the parent bank and its healthy assets.

Most stand-alone bad banks are government owned and operated (see “Is the demise of the publicly funded stand-alone bad bank imminent?” next page). Germany’s FMS Wertmanagement (FMS-WM), for example, was launched in 2010 to wind down more than €333 billion in nonperforming assets from Hypo Real Estate Holding Group. At the end of 2016, FMS-WM held €177 billion in assets. Other examples of this type of wind-down entity are Germany’s Erste Abwicklungsanstalt, the stand-alone bad bank of WestLB, and Austria’s Heta Asset Resolution, the stand-alone bad bank of Hypo Alpe Adria.

**National wind-down solutions** are entities set up with a requirement that all of a country’s financial intermediaries — banks, insurers, and asset managers — contribute. These contributions are used to recapitalize struggling banks or to acquire NPL portfolios from them.

In 2015, Europe’s national wind-down solutions held nearly €100 billion in assets. Italy’s Atlante is an example of this third type of wind-down entity. The fund’s purpose is to restore stability and confidence in the Italian banking system. Atlante’s equity of €4.25 billion was provided by Italy’s strongest financial institutions. In 2016, Atlante assisted Banca Monte dei Paschi di Siena by agreeing to invest €1.6 billion in junior mezzanine notes secured by the struggling bank’s €28 billion NPL portfolio. Other examples of national wind-down solutions to deal with NPLs are the National Asset Management Agency (NAMA) in Ireland, UK Asset Resolution (UKAR) in the U.K., Sareb in Spain, and DUTB in Slovenia.
Is the demise of the publicly funded stand-alone bad bank imminent?

by Stephan Lutz

Although many European banks still have troubled assets on their balance sheets, it seems unlikely that banking authorities will create many new publicly funded stand-alone bad banks, particularly because two policy changes are hampering their ability to set up these entities.

First, the regulations governing the winding down of assets are becoming more formalized and harmonized across Europe. For example, the Bank Recovery and Resolution Directive requires that current shareholders and creditors contribute significantly to loss absorption and recapitalization before public funding is provided. The mechanisms for this process are the so-called bail-in tool requiring banks to recapitalize and absorb losses from within, followed by the setup of either a bridge bank or a wind-down entity that, unlike a conventional wind-down unit, operates in a mode more akin to bankruptcy.

Second, there has been increasing debate over the last couple of years about the transfer of risks from banks to the general public via entities such as publicly funded stand-alone bad banks. As the issue of public funding becomes more politicized, policymakers are more likely to consider it only as a last resort.

Stephan Lutz is a partner in the financial-services risk and regulation practice with PwC Germany.

National wind-down solutions hold portfolios composed mostly of nonperforming assets from multiple institutions. These entities vary by the type of asset wind-down activities they undertake and the extent of their operational involvement, which can range from funding alone to an active managerial role (see “A pan-European wind-down proposal,” next page).
A pan-European wind-down proposal

Andrea Enria, chairman of the European Banking Authority, is seeking a pan-European version of the national wind-down solution. In early 2017 he proposed the establishment of a single E.U. asset management company (AMC) to create a more liquid market for Europe’s nonperforming assets and to accelerate wind-down activities.

Under Enria’s proposal, a bank could transfer its NPL portfolio to the AMC, which would attempt to sell the nonperforming assets for a fixed period of time. If the assets failed to realize the AMC’s target price, the bank would reimburse the AMC.

Although there is a consensus that Europe’s NPL levels must be lowered, Enria’s proposal has raised several concerns. The establishment of a pan-European national wind-down AMC would open up political questions such as who absorbs the losses and how the initial valuation of the assets is determined, as well as how the AMC would be structured from a regulatory and legal standpoint. However, even if the initial proposal is rejected, it could serve as the basis of a standardized blueprint for AMCs on the national level.
Head-to-head comparisons of existing wind-down entities are difficult: The composition of their portfolios, the market conditions in which they operate, and their performance targets differ on an entity-by-entity basis. We can, however, gauge the performance of wind-down entities by comparing their stated goals and their outcomes. When we do, we find that the performance of wind-down entities varies widely.

Most of the wind-down entities established in the aftermath of the financial crisis are still in operation, but some have completed their mission. In 2013, the UBS stabilization fund, which was formed in 2008 and operated under the authority of the Swiss National Bank, was successfully reacquired by UBS, which consolidated its remaining assets into the bank’s internal wind-down unit. Barclays, BayernLB, and Deutsche Bank have recently closed their internal wind-down units, with the remaining assets being reintegrated into the core banks. Other entities have wound down a substantial portion of their assets and are yielding positive results. FMS-WM, for example, is successfully unwinding its portfolio in a manner that maximizes its value. In 2015, it generated a profit from ordinary activities of €410 million and reduced its balance sheet by €12 billion; in 2016, its results were strongly influenced by a portfolio acquisition from DEPFA Bank.

Other bad banks took some time to gain speed. Hypo Alpe Adria, which was nationalized in 2009, did not pick up steam in winding down its portfolio until 2015, when its nonperforming assets were consigned to a stand-alone bad bank, Heta Asset Resolution, in conjunction with an asset quality review and a structured wind-down plan.

When we examine the commonalities among wind-down entities that are achieving their performance goals, we find four common traits. These traits are operational imperatives that apply across wind-down entities and the environments in which they operate. They can help ensure the successful initiation and enhancement of wind-down activities, a mandate that is especially urgent in the current environment of heightened focus on NPLs and noncore assets. The four imperatives are as follows:

**Four operational imperatives for wind-down success**
1. A fresh start

In many ways, a wind-down entity is the polar opposite of a conventional bank; indeed, conventional banking strategies can hinder the management and performance of wind-down organizations. Thus, these entities require a fresh start in terms of their operating models, asset valuations, and wind-down plans.

A tailored operating model for a wind-down entity provides the clearly defined decision rights and goals needed to guide operations. It incentivizes wind-down activities and rewards asset disposal. And it assigns end-to-end responsibility for processes to a dedicated asset manager or team. In addition, such an operating model includes cultural elements, such as a greater emphasis on risk minimization versus risk taking and on collective performance versus individual performance (see Exhibit 4, next page).

Accurate asset valuations ensure that a wind-down entity has a reliable view of the nature and value of its assets — a view that, depending on the types of assets, the originating bank may lack. Wind-down planning and execution rely on accurate asset values. Moreover, when asset valuations do not accurately reflect credit deterioration or liquidation costs, they can scare away potential investors. To avoid these problems, asset quality reviews (AQRs) are an essential tool.

AQRs enhance the credibility of a wind-down entity’s balance sheet and enable a more realistic assessment of future losses. In 2015, for example, Heta Asset Resolution conducted an AQR that resulted in asset value adjustments suggesting an expected capital shortfall of as much as €7.6 billion. This provided a realistic starting point for the stand-alone bad bank’s wind-down plan and allowed it to avoid unrealistic performance expectations.

When a wind-down organization’s assets are mainly nonperforming — and, thus, likely to be inflated — an extensive AQR may be needed. In the case of noncore assets, which typically have more accurate values, a lighter review may be warranted. In either case, AQRs should be conducted by independent third parties using tailored sampling to ensure the credibility of asset values in a cost-effective manner.

The final component of a fresh start is the wind-down plan, which guides operational execution. A comprehensive strategic plan articulates the mission and goals of the wind-down entity. It sets parameters for credit and risk management, liquidity, capital, and operational capacities, and it ensures that they are properly aligned.
A wind-down plan provides a set of guidelines and objectives that employees, shareholders, and other stakeholders can use to ensure that plans and activities are aligned with the organization's ambitions. It provides a foundation for setting capitalization levels, creating clear goals and incentives for employees, and reviewing performance on an ongoing basis.

A comprehensive wind-down plan should include several high-level scenarios based on likely macroeconomic and operational assumptions. Each scenario should support the development of strategies that specify wind-down activities and time lines for specific asset classes and quality levels, including measures such as hold-to-maturity, sale, negotiated settlement, credit restructuring, and asset repossession.

### 2. Loaded batteries

The unwanted assets and often undiversified portfolios of wind-down entities can render them particularly susceptible to downturns in the economies and markets in which they operate. National wind-down entities and stand-alone bad banks can find themselves cut off from
funding if they miscalculate their needs, and internal wind-down units can harm their parent banks. Thus, their initial funding and liquidity levels are especially critical.

Funding and liquidity levels in wind-down entities must be carefully calculated, regularly evaluated, and constantly maintained. They should be based on the wind-down plan, and reasonable buffers should be established to avoid operational disruptions.

3. Proficient execution

All wind-down entities must manage the strategic trade-off between rapid asset disposal and value maximization. Essentially, this is a trade-off of time and capital, and it differs depending on asset characteristics and the key goals of the wind-down organization and its stakeholders.

The optimal balance between time and capital is fundamentally different for two primary activities of wind-down entities: credit sales and credit collections. Each activity has its own execution enablers (see Exhibit 5, next page).

Credit sales, which are most common in internal wind-down units, involve the sale of individual loans, secured assets, and entire portfolios. They lean toward the time side of the trade-off. Execution can be fast-paced, but it is often accompanied by a major haircut in asset value and high transaction costs. An example of a successful credit sale is the sale of FMS-WM’s U.S. commercial real estate portfolio, which included 15 credit files in metropolitan areas in the U.S. with a nominal value of $1.2 billion. The sale was conducted using a competitive bidding process, and it generated proceeds that substantially exceeded the book value of the portfolio.

Credit collections, which tend to be the province of stand-alone bad banks, involve hold-to-maturity strategies, credit restructuring, and the repossession of the collateral. They typically require more time to execute, but they can yield higher returns (as long as the additional revenues exceed the capital cost of carrying the assets) or may be a final option when there is no liquid market for loans. When credit collections involve repossessions, effective execution often extends to the maintenance of properties and/or the completion of development projects. In such cases, wind-down entities need to field additional asset management capabilities, such as facility management expertise.

People, policies, processes, and governance structures are the key enablers of both credit sales and credit collection activities. Wind-down
### Exhibit 5

**Execution enablers in wind-down entities**

<table>
<thead>
<tr>
<th>Activity</th>
<th>Effectiveness enablers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit sales</strong></td>
<td>– Competent sales team</td>
</tr>
<tr>
<td><em>(sales of credit portfolios, assets, or single positions)</em></td>
<td>– Loan servicing</td>
</tr>
<tr>
<td></td>
<td>– Good data quality</td>
</tr>
<tr>
<td></td>
<td>– Financing</td>
</tr>
<tr>
<td></td>
<td>– Clear policies, processes, and governance</td>
</tr>
<tr>
<td><strong>Credit collections</strong></td>
<td>– Competent collectors</td>
</tr>
<tr>
<td><em>(hold-to-maturity, including potential restructuring or repossession)</em></td>
<td>– Legal access to collateral</td>
</tr>
<tr>
<td></td>
<td>– Good data quality</td>
</tr>
<tr>
<td></td>
<td>– Effective marketing</td>
</tr>
<tr>
<td></td>
<td>– Clear policies, processes, and governance</td>
</tr>
</tbody>
</table>

Source: Strategy& analysis

entities often need to hire experts in specific functions, such as credit sales, that may not be relevant in conventional banks. Policies and incentive structures need to be tailored to support wind-down operations. Processes need to be adjusted to the new conditions: In risk management, for example, a full-fledged process that recalculates every deal can be replaced by a speedy, light-handed verification process. Governance structures must be flexible enough to enable an efficient wind-down process, but strong enough to ensure compliance with external regulation and internal guidelines.

### 4. A coherent ramp-down plan

Because the mandate of wind-down entities is to work themselves out of business, they need to ramp down their operations as they dispose of their assets. Hence, the ability of a wind-down organization to identify and minimize operational inefficiencies is critical to its success. This requires a ramp-down plan that exploits efficiency gains as they emerge.

Ramp-down plans are challenging to execute because operating costs usually decline at a slower rate than asset volumes and interest income. Non-interest-bearing loans must continue to be serviced and collected,
for instance, and corporate functions are still required. Additionally, it
can be difficult to retain key employees and attract new experts as
wind-down activities ramp down.

To successfully execute a ramp-down plan, a wind-down entity must be
downsized in increments without hampering overall operations. This
can be achieved in various ways: For instance, assets with short-term
disposal horizons can be bundled together and assigned to a specific
team. Then, when 90 percent of that asset portfolio has been wound
down, the team can be dissolved and the remaining 10 percent of assets
can be transferred to a remaining team as the unit switches from wind-
down to liquidation mode.

Another means of lowering costs without hampering operations is to
outsource a wind-down entity’s functions as its assets are divested.
Functional candidates for outsourcing via service-level agreements
typically include IT, communications, forensics, asset valuation, and
collections. Internal wind-down units have the additional option of
shifting functions to their parent bank as their assets decline.

Retaining key employees is another important consideration during
the ramp-down process. Because such employees need to be kept and
motivated until the last day of operations, they should be identified
based on various criteria, such as the critical roles they play in the
execution of the wind-down strategy. Specific retention measures can
be developed and tailored to the needs of the employees and the
business.

When assets are reduced to a level where the costs of operating the
wind-down entity exceed the potential gain, there are three basic
options: The entity can continue to wind down assets and simply bear
the increased costs; it can sell the residual portfolio (which is likely to
require a significant haircut); or it can outsource the remaining
operations to specialist servicers (see “Ramping down with external
loan servicers,” next page).
Ramping down with external loan servicers

External loan servicers can be an effective means of transforming fixed costs into variable costs as portfolios shrink. Typically, these servicers assume the day-to-day management of loans for a fee, and the assets they manage remain on the balance sheet of the wind-down unit. Some servicers also offer white-label solutions that operate under the brand of their clients.

The external loan servicing market is less mature in the E.U. than in the U.S., mainly because the E.U.'s secondary securitization market is less established. In Europe, most external servicers focus on retail assets and commercial mortgage-backed securities (CMBS), but new service offerings, including the management of on-balance-sheet commercial loans, are emerging.

Deals such as the November 2016 acquisition of Hatfield Philips International, an NPL- and CMBS-focused servicer, by U.S.-based Situs and the January 2017 Mount Street acquisition of Erste Abwicklungsanstalt’s portfolio management subsidiary serve as evidence of the viability of external loan servicers in the European market. This ongoing consolidation will reduce servicing costs and might ultimately reduce fees, making the external service option more attractive to wind-down entities.
Conclusion

Europe’s banking industry remains beset with nonperforming and noncore assets. These assets must be wound down so that banks can ensure their financial health and muster the resources needed to respond to current and future market disruptions. But it’s critical that banks choose the most suitable wind-down structure, taking into consideration the increasingly complex and harmonized regulatory frameworks, and develop the ability to effectively and efficiently launch and manage wind-down entities. Banks that do this work well will be able to build a strong foundation for future strategic growth.
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