

## **Asset Management Companies and How Toxic Assets are Handled**

*We, the Law firm of **Olisa Agbakoba & Associates**, remain committed to our promise to be publishing an online periodical (a newsletter), in which developments would be explored as they occur, albeit from legal perspectives. Issues explored in this edition borders on the credit crunch. Of course, any person (including corporate entities) would ignore its impact at their own peril...*

Asset management basically refers to managing money for individuals through stocks, bonds and cash equivalents etc. The asset management system sprang from maintenance management systems and its aim is to optimise asset use and manage all maintenance efforts involved in making the assets as confidential, accurate and efficient as possible. The principles of asset management apply equally to all physical assets such as infrastructure, property, heritage, plant and equipment.

The term “asset management company” (AMC) in regard to toxic assets refers to any organisational unit created to manage and recover financial assets acquired from troubled or failed financial institutions. Such entities include asset workout departments or units of banks, bank-owned subsidiaries or affiliated companies, private companies, and government owned asset management agencies.

Toxic assets are at the core of the world credit market paralysis today and dealing with them is crucial to reviving bank lending, restoring trust in the financial system and giving the Nigerian economy a firm footing from which to climb out of recession.

The assets consist mostly of debt instruments backed by subprime mortgages that are now worthless or worth much less than expected due to the collapse of the home price bubble. Banks have already taken heavy losses on these assets. But many are still being carried on their books, aggravating doubts in the market about the banks and sowing mistrust. Toxic assets are high risk financial paper whose contents are uncertain, obscure and totally disadvantaged. The term is shorthand in the media’s quick flow of opinion and analysis and it works to heighten sense of danger and urgency.

In order to prevent these toxic assets, also known as non-performing loans{ (NPLs) of the banking system from posing a big challenge to the restructured institutions, the CBN in 2004, initiated the establishment of an ASSET MANAGEMENT CORPORATION (AMC) which would purchase such NPLs as contained in Soludo’s 13-point agenda, which he delivered on July 6, 2004 as follows:-

- (i) Requirement that the minimum capitalisation for banks should be N25 billion with full compliance before end-December 2005 (that is, 18 months notice rather than 12 months normally given in many countries).
- (ii) Phased withdrawal of public sector funds from banks, starting in July 2004.
- (iii) Consolidation of banking institutions through mergers and acquisitions.

- (iv) Adoption of a risk focused, and rule-based regulatory framework.
- (v) Adoption of zero tolerance in the regulatory framework; especially in the area of data/information rendition/reporting.
- (vi) The automation process for rendition of returns by banks and other financial institutions through the electronic Financial Analysis and Surveillance System (e-FASS).
- (vii) Establishment of a hotline, confidential internet address ([Governor@cenbank.org](mailto:Governor@cenbank.org)) for all Nigerians wishing to share any confidential information with the Governor of the Central Bank on the operations of any bank or the financial system. Only the Governor has access to this address.
- (viii) Strict enforcement of the contingency planning framework for systemic banking distress;
- (ix) Work towards the establishment of an Assets Management Company as an important element of distress resolution;
- (x) Promotion of the enforcement of dormant laws, especially those relating to the issuance of dud cheques, and the law relating to the vicarious liabilities of the Board members of banks in cases of failings by the bank.
- (xi) Revision and updating of relevant laws, and drafting of new ones relating to the effective operations of the banking system.
- (xii) Closer collaboration with the Economic and Financial Crimes Commission (EFCC) in the establishment of the Financial Intelligence Unit (FIU), and the enforcement of the anti-money laundering and other economic crime measures. Greater transparency and accountability will be the hallmark of the system.
- (xiii) Rehabilitation and effective management of the Mint to meet the security printing needs of Nigeria, including the banking system which constitutes over 90 percent of the Mint's business. In due course, we will not need to print our cheques abroad.

Unfortunately, the CBN's proposed Asset Management Corporation during consolidation programmes was not passed by the National Assembly and according to Soludo, this is the time for the National Assembly to approve the AMC where banks could go to sell or deposit some of their distressed assets. According to him, the CBN has opened its windows as lender of last resort and will be able to extend credit up to 360days, saying that it will not allow any Nigerian bank fail. They have arrangements to take off some of those assets from their balance sheets and then free them up from those assets. Meanwhile the enabling bill has been brought again before the House.

## **Current Moves by The E.U, UK And USA in Handling Toxic Assets**

EU finance ministers on 10<sup>th</sup> February 2009, reached only an uneasy compromise on how to handle what is emerging as one of the biggest problems afflicting the financial sector – ‘toxic’ assets.

Despite multi-billion euro injections of capital into ailing banks and state-backed deposit guarantee schemes, banks and other financial institutions are still refusing to extend credit to businesses and households because of assets of uncertain worth still on their balance sheets. Banks are reluctant to come clean about what are more politely described in official EU documents as “impaired assets” because this would mean revealing potentially huge losses on those investments that have suffered the most severe drop in value – repackaged sub-prime mortgages and other securitised credit instruments.

A paper from the European Commission on the treatment of impaired assets, dated 6 February, estimates the total losses from write-downs of assets since the middle of 2007 at \$1,063 billion (€822bn), while the International Monetary Fund has put the potential total losses for the financial sector at \$2,200bn (€1,702bn). In an attempt to restore lending and get capital markets working again – an essential step to boost economic activity in the wider economy – governments have taken a range of measures to “clean up” toxic assets so that they do not prevent banks from lending.

There are basically two approaches. One, the model favoured by the British and the Dutch, offers an insurance ‘wrap’ or state-backed guarantee against losses on impaired investments. The other, favoured by Germany, is to create a “bad bank” into which banks transfer their toxic assets, leaving their balance-sheets “clean” so that they can resume lending and counter-party trades.

Allbusiness.com defines the term “bad bank” as a specially chartered bank, acting as a self-liquidating trust, chartered by a bank holding company to hold non-performing assets owned by a federally insured bank. Transfer of bad loans improves the asset quality of the seller.

The concept behind the term "Good Bank Bad Bank" harks all the way back to depression days. In the 1930's, as bank after bank began to fail in the wake of stock market crash of 1929, the US government rode in on a white horse and acquired the failing bank's devalued assets. This allowed the still viable part of the bank to go forward with those of its assets which still retained their value, and with fresh funds. It then was able to satisfy its depositors, while shedding its underperforming portion, like a snake shedding its skin. With the government left literally holding the almost empty bag. This concept became even further refined during the savings and loan crisis of the 1980's. Once again, with government assistance and approval, savings institutions were allowed to extricate themselves from the consequences of their own poor business judgment and some bad breaks in the economy. The rationale and driving force behind the governments providing a safety net to banks was twofold: first, to protect the depositors and second, to help break what could be a catastrophic death spiral in the US economy.

The challenge for the EU, which wants a single market for banks and financial services, is to ensure that these different approaches do not lead to distortions of competition.

Following a discussion on 10 February, finance ministers reached an outline agreement on the key principles for treating impaired assets. These include a “correct and consistent approach of valuation” in order to maintain a level playing-field and a requirement that banks keep a portion of the risk from the toxic assets on their balance sheets. “Specific conditions” may, the finance ministers agreed, have to be imposed on banks' management to limit moral hazard (the fear that a bank might act irresponsibly in the expectation of being protected from risk).

In the UK, a plan has been hovering in the breeze for the last few days to establish a bank to handle the billions of pounds of worth "toxic debts". The UK Government is to allow banks to swap their 'toxic' debts for either cash or shares to stave off possible bankruptcy. Under the scheme, banks will agree with the Government on the amount they expect to lose from particular debts. The Government will then sell insurance against 90 per cent of the institutions' additional losses from the debt.

By taking control of the debts, the UK taxpayer will be liable for any losses, although the UK Chancellor Alistair Darling could not say how much money will be needed for the latest bailout. Last year the UK Government pledged £500billion to rescue the banks and ensure they started lending again. This has not happened fast enough to stimulate the UK economy, which is in recession.

The banks are also racking up bigger losses, with Royal Bank of Scotland reporting losses of more than £20 billion – the biggest loss in UK corporate history. Other measures announced overnight to support UK banks include extending the Government's £250 billion Credit Guarantee Scheme until the end of the year to support inter-bank lending. The Government will also move to accept consumer car loans in exchange for government bonds to keep the car industry going.

As the banks' troubles continue, the Government has offered to take a bigger stake in Lloyds and has indicated it could take stakes in Barclays and HSBC under its Asset Protection Scheme. However, analysts in the City of London believe if this latest rescue doesn't work, the Government will have to look at nationalising the major banks.

Continuing the trend of "state-owned" banks and interventions to try and breathe some life into a very ailing economy, the "toxic bank" will function to "fence off" an area where all that remains of the UK banks don't want to go. The billions of pounds of very bad debts that no one can handle yet won't go away. Under the terms of the toxic bank scheme, a new state-controlled insurance company is to be established to provide cover in the event of bank customers defaulting on loans as well as allowing banks to have their bad loans underwritten. The terms are yet to be announced, but it is understood that the banks will be required to pay a fee to have their bad loans underwritten by the taxpayer, and only up to a certain level.

All of these measures are being made to encourage the partly state owned banks as well as the wholly state owned Northern Rock building society to begin to ease up on their self-imposed lending restrictions.

The government's hope is that by creating a "toxic bank" they would witness a lowering of the risk ratio on current loans. This would allow the banks to begin lending again without fear. The formation of an insurance trust would prevent the loans being written off, in the hope that they would come good in time. Estimates are that there are 260 billion pounds of toxic assets spread across British industry, which the banks would have difficulty in reclaiming. This in fact means that the UK banking system is technically insolvent if only temporarily.

In London, on February 18, it was reported by REUTERS that the Royal Bank of Scotland ([RBS.L](#)) may need to pay over 5 billion pounds (\$7.1 billion) for a UK government insurance scheme designed to cap any losses on toxic assets set to be unveiled. RBS is 70 percent owned by the UK government, and is expected to put up to 160 billion pounds of assets into the scheme, which may charge a one-off fee of 3 percent to 4 percent, according to analysts' estimates.

Other banks, notably Lloyds Banking Group ([LLOY.L](#)) and Barclays ([BARC.L](#)) also face hefty fees for insuring billions of pounds of assets. Up to 500 billion pounds of assets could be put in the scheme, analysts estimate. Although the fee would dent capital, the plan would significantly reduce the risk weighted assets (RWA) held by the banks as it would cap the amount of potential loss. The RWA reduction would therefore provide a long-term boost to banks' capital ratios.

The UK government is hammering out the details of the scheme. It is likely banks will face the first 10 percent of losses on assets, and the government will then absorb the bulk of any further losses. The government hopes the insurance scheme will give banks the confidence they need to reopen lending lines cut off by the [credit crisis](#). In addition to covering toxic structured credit assets, the plan will also insure against big losses on commercial property and other corporate loans, higher risk mortgages and other loans.

In the United States, dealing effectively with toxic assets has become the latest challenge in the struggle to get financial markets working again and to ward off a protracted slump. On Monday (9 February) the US administration announced its own scheme worth up to US\$2,000bn (€1,547bn) to clean up toxic assets, with US\$500bn (€387bn) to create a bad bank. The US government is taking a new tack with its bailout effort that involves trying to attract private capital for a "bad" bank.

The proposed bank would buy up toxic mortgage-related assets that have been clogging up the balance sheets of U. S. banks.

The US under the Bush administration, considered spending US\$700 billion to acquire toxic assets of the credit market. It was called the Emergency Economic Stabilisation Act of 2008 or more colloquially the "Bailout bill". It provided the treasury department with \$700 billion to help the US financial system by purchasing troubled assets and providing loans for struggling companies.

The Bush administration's bailout effort was blasted for failing to help homeowners and for handing out more than US\$250-billion to banks without making them accountable. Now, instead of being completely government-funded, as was previously considered, the bank would be seeded with only some money from the government's US\$700-billion bailout fund, while the rest would come from private investors. Such a bank would limit the exposure to US taxpayers, who are already on the hook for the largest banking bailout in the country's history.

The Obama administration hopes to strike up a partnership with the private sector in buying toxic assets from distressed banks in a new effort to stabilise Wall Street institutions and to kick-start lending by reluctant financial institutions. Plans are still underway to provide government support to hedge funds, private equity funds and other niche players in purchasing banks' troubled assets.

Although details are still being thrashed out, the Treasury will offer some form of guarantee against a further slump in the value of the complex technical assets which include mortgage-backed securities, bundled loans and other credit-linked derivatives. US Treasury Secretary Timothy Geithner is keen to turn a new page in rescue efforts. A consensus has emerged that his predecessor, Henry Paulson, failed to find a panacea for the ailing banking industry.

The Treasury's new effort is likely to involve the creation of a so-called "bad bank", which government officials prefer to describe as an "aggregator bank", to suck up troubled assets. Although the Treasury would provide seed funds, officials want much of this entity to be funded by the private sector in return for a degree of protection against down-side risks.

The Treasury's package is likely to include fresh cash injections for banks, tied to tighter requirements for accountability on how public money is spent.

Ghana has a well-developed banking system that was used extensively by previous governments to finance attempts to develop the local economy. By the late 1980s, the banks had suffered substantial losses from a number of bad loans in their portfolios. In addition, cedi depreciation had raised the banks' external liabilities. In order to strengthen the banking sector, the government in 1988 initiated comprehensive reforms. In particular, the amended banking law of August 1989 required banks to maintain a minimum capital base equivalent to 6 percent of net assets adjusted for risk and to establish uniform accounting and auditing standards. The law also introduced limits on risk exposure to single borrowers and sectors. These measures strengthened central bank supervision, improved the regulatory framework, and gradually improved resource mobilisation and credit allocation.

Other efforts were made to ease the accumulated burden of bad loans on the banks in the late 1980s. In 1989 the Bank of Ghana issued temporary promissory notes to replace non-performing loans and other government-guaranteed obligations to state-owned enterprises as at the end of 1988 and on private-sector loans in 1989. The latter were then replaced by interest-bearing bonds from the Bank of Ghana or were offset against debts to the bank. Effectively, the government stepped in and repaid the loans. By late 1989, some c62 billion worth of non-performing assets had been offset or replaced by central bank bonds totaling about c47 billion.

By the end of 1990, banks were able to meet the new capital adequacy requirements. In addition, the government announced the establishment of the First Finance Company in 1991 to help distressed but potentially viable companies to recapitalise. The company was established as part of the financial sector adjustment programme in response to requests for easier access to credit for companies hit by ERP policies. The company was a joint venture between the Bank of Ghana and the Social Security and National Insurance Trust.