Good and Bad Bank

By Chris Iacovides[1] and Andri Antoniou[2]

The events that unfolded last Thursday in Cyprus, created intense anxiety and concern with regard to the future of our banks, particularly in respect of Laiki Bank ("Laiki"), home and abroad.

We all hear about having to separate Laiki into a "Good" and "Bad" bank and the legislation approved by the House of Representatives on Friday 22.3.2013, namely the **Bank Recovery and Resolution Directive 2013** ("the Law").

Special Receiver

The Central Bank of Cyprus (the "Competent Authority"), pursuant to the provisions of s14(1), has recently appointed Ms. Andri Antoniadou and Mr. Constandino Christofide as Special Receivers for Laiki and Bank of Cyprus respectively, each with different mandates. Both Receivers are qualified accountants with several years experience in the banking sector.

We extend our best wishes to both and believe that they will carry out their difficult mandates professionally and competently.

In respect of Laiki, Ms. Antoniadou has undertaken the difficult task of dividing the bank into good and bad bank by implementing the law and regulations of the Competent Authority.

The bad bank will inherit the toxic assets i.e. non-performing loans and/or those that are experiencing delays with payments as well as the bank's liabilities against debenture holders[3] and creditors. In this way, the healthy part of the bank's business and assets including deposits which are government guaranteed (up to €100,000) will be released and ultimately will be transferred to the good bank.

With regard to the good bank, things are expected to be much more straightforward as Ms. Antoniadou, although under her control, is expected to allow it to trade autonomously without any intervention and/or hindrance. She will concentrate all her efforts on the immediate realisation of all secured but non–performing loans, in order to generate cash with a view to repaying the bad bank's lenders and creditors.

Unfortunately, the law in its current form will not bring about the desired result and in this regard, it's vital for the Government and Parliament to amend existing legislation, such as:

1. Changes to **The Transfers and Mortgaging of (Immovable) Property Law of 1965**, inter alia enabling realisation of securities without any hindrance from cautions (commonly known as memos), which might have been registered subsequently to the granting of security. It goes without saying that the caution will provide priority against other unsecured creditors.
2. **Bankruptcy Law Cap 5** – Changes to be made in respect of possession orders against the "home" of a bankrupt which represent a substantial amount of mortgaged properties and for debts to be written off post discharge.
3. The delays experienced in regards to applications for forced realisation through the Land Registry which, in most cases, take more than 12 years, warrant immediate reorganisation and modernisation of the Department. One way of achieving this would be to privatise the procedure; something similar has been effected in relation to other government services such as process servers who are now private individuals as opposed to civil servants.
4. Introduce changes in relation to court applications, fast track the procedure with a view to judgements being handed down expeditiously.
5. The creation of a Companies Court to also deal with bankruptcies.

In a recent publication InBusinessNews presented data it obtained from Parliament, which can be found at www.sigmalive.com/inbusiness/news/financials/36428, in respect of the financial position of Laiki.

For one to understand a bank's balance sheet we set down below a simple example:

Good Bank v Bad Bank

If we assume that our bank has assets of €105m (mortgages, loans, cash etc.) and €95m in liabilities (deposits, debentures, other financing) then its capital is €10m. Assets are all those things that have monetary value and in theory these could be sold in an effort to raise cash, on the other hand, the liabilities are represented by all those commitments for payments our bank has to others. The capital is the difference between the two and it represents the net book value which belongs to the bank and in essence, to its shareholders.

If we assume that the assets belong to two categories: €60m are made up of good assets such as loans serviced regularly and €45m from "bad" assets, such as loans that are non-performing and problematic or secured properties that, for some reason, are not easily realisable. Allowing for a reasonable write off say of €5m of problematic assets, this will reduce their value to €40m. In reality however, if an urgent sale is necessary, these would be very difficult to be sold for more than €20m as no one is interested in purchasing them.

Be that as it may, if one was to put these figures under the microscope, one will conclude that €40m of the bad assets are not likely to yield more than €20m with a strong possibility that this could reduce to nothing in the future! As a result of this, it is very doubtful that any investor will want to invest in the banks' shares. Equally remote, is the likelihood that anyone will be interested in lending our bank because allowing for the write off, the bank becomes insolvent and at risk of collapse.

In such an eventuality, the shareholders do not stand to receive anything and the creditors will certainly lose a significant amount, if not all, of their money.

The Solution for the Bad Bank

How can the problem of a "bad" bank be solved? There are 2 models: one is that which is about to be deployed in the case of Laiki, the alternative, is for the Government to create a large "bad" bank, where troubled banks can look to dump their "toxic" assets.

It is inevitable that eventually the ("bad") bank will go into insolvent liquidation, while the "good" bank, which will be relieved from its toxic assets will turn profitable, restore investors' confidence and as a result investors and lenders will return with their cash thus enabling it to service the needs of its customers.

Nevertheless, this model has its delicate point: what is the most appropriate way of dividing our bank's obligations, we believe this will be the million dollar question! There are two schools of thought (we do not propose to discuss these in our current article).

The simplest solution, in our opinion, is the proportional allocation of liabilities i.e. the "good" bank takes on 60% of the debts and/or liabilities.

Whichever methodology one deploys, there is no perfect way, the subject presents a minefield as any legislation that may be introduced to regulate the apportionment is likely to face judicial reviews, unless of course the Special Receiver can propose and obtain approval to a Scheme of Arrangement acceptable to secured and unsecured creditors pursuant to the provisions of **s198 of Cap 113 of the Laws of Cyprus**.

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[3] Debenture holders are lenders to the bank.