

With property prices tumbling here, some portion of the more than €100 billion in bank loans to the construction industry will undoubtedly turn sour. How will the banks deal with troubled assets tied to these loans?

One approach might be for the banks to manage the assets themselves. Banks usually have an intimate knowledge of the borrower's business, and can sometimes use this knowledge to restructure the debt and save the borrower from bankruptcy.

However, if the borrower is unlikely to repay the loan, the best strategy is often for the bank to sell the loan to a special company created to handle bad debts. This allows the banks to concentrate on what banks do best – making new loans.

In some countries that have had severe property busts, these asset management companies have been state-owned agencies. In this country, one could imagine an agency like the National Treasury Management Agency buying nonperforming loans from the banks and then managing and disposing of the properties that are collateral for these loans. These distressed properties could be disposed of gradually, thereby avoiding fire-sale liquidations.

A key question would be what price the agency should pay the banks for the loans? Buying the assets at inflated prices would amount to a back-door recapitalisation of the banks. Similarly, many of the proposals currently doing the rounds to reignite the housing market using government subsidies to first-time buyers involve disguised bail outs of banks and developers.

Best practice is for the banks to recognise the losses on these loans up front and sell the assets at fair market value. If banks do not have sufficient capital to take the hit, then they should raise new capital to plug the hole. Dealing with impaired assets properly will be critical for our economic recovery.