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Is a Bad Bank Always Bad?

On a small number of occasions during the past several years, bank holding companies have chosen to clean up the balance sheets of their subsidiary banks by collecting nonperforming loans and spinning them off to a separate subsidiary. The new entity, sometimes referred to as a "bad bank," then becomes the locus of the company's workout efforts, and simultaneously allows it to create a healthier balance sheet for the primary bank, or the "good bank."

On the surface, this form of corporate restructuring appears to be little more than a reshuffling of assets among different holding company subsidiaries. Viewed in this light, it is difficult to see why any bank holding company would go through the trouble. However, there may be regulatory reasons as well as market incentives for choosing this form of corporate reorganization. In this *Letter*, I discuss the basic characteristics of the good bank/bad bank spinoff and present arguments both for and against this mechanism. I also consider factors that may contribute to greater use of this approach in the future.

The good bank/bad bank split
While there is no such thing as a typical good bank/bad bank spinoff, the process generally starts with a perception by management that nonperforming loans are imposing a particularly heavy burden on the bank. This situation may arise as the result of acquiring another bank or completing an FDIC-assisted purchase of an ailing institution. It also may be the result of regional or national economic weakness that has left its mark on the bank's loan portfolio.

The burden of carrying the impaired loans often includes costly workout efforts within the bank that can distract loan officers from servicing good loans or developing new business. Moreover, a high proportion of subpar loans likely encourages stricter scrutiny from bank examiners, thereby imposing additional regulatory costs on the bank. Finally, the announcement of large loan losses often leads to a market reassessment of the viability of the bank, possibly depressing equity share prices.

Traditionally banks deal with this situation by establishing or expanding a separate internal group to handle the problem credits, thus concentrating their most appropriate personnel and other resources on working out the problem loans. Some institutions, however, have determined that it is more cost effective to establish a separate corporation, to pool questionable assets and transfer them to that corporation, and to concentrate workout efforts outside the primary bank. In many cases, the sole purpose of the new entity is to dispose of delinquent assets and, eventually, liquidate itself. For this reason, the bad bank is sometimes referred to as a self-liquidating trust.

At first glance, there appears to be little to distinguish the traditional method of dealing with problem assets from the bad bank approach. This is especially true if the holding company does not sell off a portion of the bad bank to outside investors. Under these circumstances, the nonperforming assets are still held by the holding company, the problem loans continue to command resources from one or another of the parent's subsidiaries, and losses arising from the nonperforming loans affect the consolidated holding company's income statement and balance sheet. However, in order for the holding company to adopt the apparently costly approach of establishing a separate subsidiary, there must be some value to segregating the bank's problem loans outside the primary bank. The source of this value is not immediately apparent.

Origins of the bad bank approach
Interestingly, the good bank/bad bank spinoff has its origins in the resolution policies of banking and thrift regulatory agencies. When these agencies take control of an insolvent institution, the most frequently used resolution technique is the so-called "purchase and assumption" transaction. In this transaction, regulators arrange for a

solvent institution to purchase the failed bank's assets and assume its deposit liabilities.

In many cases, the failed bank or thrift has very little in the way of performing assets, so the regulatory agencies must provide some inducement to the purchaser to consummate the transaction. This inducement typically involves purging the asset portfolio of most or all of the problem credits, leaving a relatively "clean" bank for the acquirer. Of course, the government is left holding the bad assets, and must dispose of them in the open market. Such disposal is often difficult, as is apparent from the huge expenses incurred by the FDIC in recent years.

When an operating financial institution adopts a good bank/bad bank format, it usually does not have the option of selling the bad assets to the government. Instead, the good bank sells the problem loans to the bad bank at a price that may be substantially below book value. As a result, this sale typically involves substantial losses for the good bank. Some of this loss is absorbed by the bank's loan loss reserve. If the reserve is insufficient to absorb all of the losses, however, bank capital may be depleted. Depending on the bank's capital position, it may need to obtain additional funding to replenish bank capital and restore the loan loss reserve to a level acceptable to bank regulators.

Funding the bad bank

In principle, the holding company has a variety of options available for financing the transaction. Typically, it will choose some combination of equity and debt to fund the bad bank spinoff. For example, the holding company can issue new equity, and spin off ownership of the bad bank to (new and old) shareholders through a stock dividend in the form of shares in the bad bank. It also can sell various forms of senior and subordinated debt to investors. The proceeds of this funding pay for the purchase of the assets by the bad bank, the capitalization of the bad bank, and rebuilding the capital position of the good bank.

Of course, alternative methods of financing the bad bank spinoff may have different effects on the holding company and its investors. At one extreme, the holding company could choose a financing strategy that leaves it or one of its subsidiaries as the only shareholder or creditor of the bad bank. This would occur, for example, if the holding company issued new debt, and subsequently "lent" it to the bad bank. In this case, the holding company has done nothing to rid itself of the bad bank's substandard assets. Consequently, its consolidated earnings and capital will directly reflect over time the performance of the bad bank's liquidation efforts.

At the other extreme, the holding company could choose a complete divestiture of the bad bank by selling it entirely to outside investors. Here, the bad assets are completely removed from the holding company's books, leaving a clean institution. In practice, a funding approach between these two extremes is typically used, with the holding company maintaining a diluted interest in the bad bank. In this way, it is able to share the risk of the bad bank's activities with outside investors while still maintaining some control over the liquidation process. This dilutive funding also reduces the impact of the bad bank's impaired assets on the holding company's financial position.

Is the bad bank a good idea?

Proponents of the good bank/bad bank spinoff argue that segregating good from bad assets enables the banking firm to manage the bad assets more efficiently. By concentrating workout efforts in the bad bank, they claim, the company can take advantage of economies of "management specialization" that would not be available under alternative corporate structures.

Another argument in favor of the bad bank approach relates to investors' demands for bank assets. According to this argument, the assets held by the good bank may appeal to one type of investor while the problem assets of the bad bank may appeal to another type. Bad bank assets may require considerable time before a settlement can be negotiated between borrowers and lenders. Investors in the bad bank also may need patience to ride out temporarily depressed conditions in real estate and other markets. As a result, these investors must have a longer investment horizon and be willing to hold riskier assets than more traditional bank investors. By segregating the assets, it is claimed, the bank holding company may be able to attract investors whose demands are more in line with the specific asset characteristics of the good and bad banks. If this is true, then with the same portfolio the good bank/bad bank may command a better price in the market than the original bank.

Of course, the good bank/bad bank approach has not received universal support in financial markets. Detractors argue that there is little or no advantage to the expensive process of creating and funding a separate holding company subsidiary. Any efficiencies that a specialized workout group can accomplish in a bad bank, they argue, also can be realized by a similar effort within the original bank. Moreover, transferring workout personnel to the bad bank can rob the good bank of its best credit evaluation staff.

The response of investors also has not been uniformly positive. Most notably, some of the earlier spinoffs in the late 1980s were greeted by significant declines in holding company share prices. Part of this negative impact probably was due to announcements that funding for the bad bank (say, by the issuance of new holding company stock) would significantly dilute the holdings of existing shareholders. Additional negative response may have been the result of the bank's recognition of loan losses with immediate charge-offs once the problem credits were transferred to the bad bank.

Additional considerations

As the preceding discussion indicates, differences of opinion persist regarding the desirability of the good bank/bad bank spinoff. However, several additional considerations generally weigh in favor of the spinoff approach. The first of these relates to the treatment of the bank by regulators. A bank with a large portfolio of nonperforming assets likely will receive particularly close scrutiny by bank examiners. Such scrutiny involves substantial costs to the bank, both in terms of more frequent examinations and, perhaps, stricter application of examination standards. These costs likely will become more important in the future, as recent bank legislation has mandated progressive discipline for banks with lower capital levels. If a bank can alleviate some of this regulatory pressure by cleaning up its loan portfolio, selling problem assets to a subsidiary, and replenishing bank capital, then the good bank/bad bank approach may be worth the costs of creating and funding the new entity.

Moreover, spinoffs often are accompanied by demands from regulators that the holding company dilute its holdings in the bad bank by selling a portion of it to outside investors. By sharing the risks involved with restructuring or liquidating the bad bank's assets, the holding company can reduce its overall financial risk. In fact, if the holding company is no longer a majority shareholder in the bad bank, it may not be required to include the activities of the bad bank in its consolidated balance sheets and income statements.

Finally, the spinoff of the bad bank may actually help to overcome problems related to information asymmetries in financial markets. When the good and bad assets are combined in the same institution, it may be difficult for outside investors to value the bank accurately. This problem may be particularly acute in the bidding for failed banks. Unsure about the extent of problem loans in the banks' portfolio, investors may assume the worst and require a premium before they will invest. By spinning off the bad assets, and leaving a clean portfolio,the good bank/bad bank split may reveal important information about the condition of the two institutions and enable investors to make more accurate assessments of risk and expected return.

Will the process continue?

With the expected continuation of consolidation in the banking industry, it is likely that the good bank/bad bank spinoff will become more common in the future. Financial markets have gotten used to the spinoff idea and seem more willing to accept this type of transaction as a reasonable form of corporate reorganization. Moreover, if such a transaction can alleviate regulatory pressures, then the costs of the spinoff are mitigated. And if regulators want to encourage the purchase of weak institutions by healthier ones, the good bank/bad bank approach may actually deepen the market for bank assets and bring needed capital to the banking industry.

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