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Good bank, Bad bank

Last week, financial stocks rallied on news that the Obama administration is considering the creation of a bad bank to absorb all the toxic assets. The market viewed this development positively since it will not only address the toxic asset overhang, but at the same time, this move will prevent further fire sales and preserve asset values.

So far, the so-called Troubled Assets Recovery Program (TARP) which was supposed to stabilize the banking system is not working. The terrible performance of the banking index (down more than 50 percent) since the TARP was implemented obviously points to the fact.

Dealing with capitalization issues

Originally proposed by the US Treasury to buy the toxic assets of banks, TARP was then redirected to follow the UK model of recapitalizing the banking system first, before directly addressing the toxic asset problem. However, the problem is that there was no guarantee that the banks would resume lending even after receiving half of the TARP money or $350 billion. Instead, the banks sat on the money to consolidate their balance sheets and preserve capital.

Dealing with toxic assets

Now the US Treasury and the Fed is proposing the next step, which is to deal with the toxic assets thru the creation of a "bad bank."

In order to understand this, consider the balance sheet of a typical financial company:

Good Assets	$80.00	Liabilities to Customers	$80.00
Bad Assets	$20.00	Debt to Bondholders	$10.00
Total Assets	**$100.00**	Shareholder Equity	$10.00
		Total Liabilities	**$100.00**

The simplest way to do implement this next step is to split a bank into two: one to hold the good assets, the other to hold the bad assets. With regard to the liabilities side, both debt and equity will be divided on a proportional basis.

Here's the result:

Good Bank			
Good Assets	$80.00	Liabilities to Customers	$64.00
Bad Assets	$0.00	Debt to Bondholders	$8.00
Total Assets	$80.00	Shareholder Equity	$8.00
		Total Liabilities	**$80.00**
Bad Bank			
Good Assets	$0.00	Liabilities to Customers	$16.00
Bad Assets	$20.00	Debt to Bondholders	$2.00
Total Assets	**$20.00**	Shareholder Equity	$2.00
		Total Liabilities	**$20.00**

After the split, the "bad bank" will simply be a special purpose vehicle (SPV) holding the bad assets. Meanwhile, the "good bank" will be rid off the bad assets and could resume lending. So, instead of one sick bank with $100 in assets that isn't doing any lending, there is now a healthy bank with $80 assets that is lending.

Furthermore, the clean balance sheet of the “good bank” would allow it to raise private capital more easily. This should lure back the sovereign wealth funds who were willing to invest before but had stayed away due to early bad experiences. By eliminating the risk of further impairment to capital brought by the bad assets, it would now be more appealing for private capital to invest in these “good banks”.

Problems with good bank, bad bank

While the solution appears to be simple, the implementation is not all that easy. The problem with this scenario is that no bank would be willing to spinoff its bad assets if it hopes to receive extra TARP money. Spinning off would mean that the bank will now fully recognize the losses from these assets.

In addition, doing a split would likely face legal problems because it tends to favour the equity shareholders at the expense of the debt holders. If the bad assets are large enough, equity shareholders of the whole entity would be wiped out. But if the bank was split, equity shareholders would still be holding a share of the good bank at the cost of a lower recovery for the debt holders. Even if Congress passes a bill to legalize it, there would still be lawsuits challenging its constitutionality.

Swiss solution

UBS circumvented this problem with the support of the Swiss government. In November 2008, UBS unloaded $60 billion of bad assets in a bad bank. The funding came from $6 billion from UBS which it raised by selling shares to the Swiss government. Then the Swiss government loaned the bad bank $54 billion. In effect, UBS would lose their equity in the bad bank first, before the government bears any further losses. In the end, UBS had their shareholders diluted (thru the new shares sold to the Swiss government), had a $6 billion investment in a bad bank it is likely to lose, but it freed its balance sheet of $60 billion worth of bad assets.

The Aggregator bank

The other option (instead of splitting a sick bank into a good bank and a bad bank) is to create an “aggregator bank” that will become the reservoir of all the toxic assets in the system. This is the solution proposed by Bernanke. The plan is for the US Treasury to fund the “aggregator bank” (possibly from the 2nd tranche of TARP) and the FED to provide loans. The “aggregator bank” would then buy all the toxic assets from regular banks, so that these banks start lending again.

The success of this proposal ultimately rests on the pricing of these toxic assets. If the assets are priced at what they are currently worth, banks will refuse to participate. If the assets are priced high, it would help the banks but would be politically contentious.

The Asian Bad Bank solution

The US should also learn from the 1997 Asian crisis. Back then, Korea, Malaysia, Indonesia, Thailand and the Philippines faced similar problems like that of the US. These countries had fragile banking systems due to high non-performing loans (our own version of toxic assets) that were illiquid and hard to sell.

One central strategy for the resolution of the problem was the establishment of centralized asset management companies (AMCs) which are basically aggregator banks. Indonesia established the Indonesia Bank Restructuring Agency (IBRA); Malaysia, Danaharta; Korea, the Korean Asset Management Company (KAMCO); and Thailand, the Thail Asset Management Company (TAMC). The Philippines, due to fiscal constraints, was not in a position to institute a centralized AMC. Instead fiscal incentives were provided for the establishment of private AMCs, a.k.a. SPAVs. These AMCs helped clean out the bad loans problem, and in time, credit growth regained momentum.

The experience of these Asian countries also showed that the purchases of the AMCs helped arrest the freefall of loan prices in a buyers' market, and consequently, helped prevent further bank losses. In the selling side, centralized AMCs also helped other sectors in the economy, particularly the real estate sector, in ensuring price stability.

A strategy is what is needed

While the creation of a "bad bank" has its pros and cons, what is important is something definite is being done. Whether it is good for the bank or bad for the bank, what is important is that there is a strategy, there is clarity and direction.

In the end, we believe the equity shareholders, the debt holders, and ultimately, the taxpayers, will have to share the pain (in one form or another) if that's what it takes to stabilize the system and get the banks lending again.