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Good Bank/Bad Bank

Introduction

In recent weeks, the idea of the creation of a government aggregator bank, or “Bad Bank” (“Bad Bank”), has been gathering support within the Obama administration. On January 21, 2009, Treasury Secretary Timothy Geithner stated during his Senate confirmation hearing that the Obama administration is considering whether the government should establish a Bad Bank which would purchase certain troubled assets from banks to remove those toxic assets from the banks’ balance sheets to restore liquidity to the capital markets. Congressional interest in the proposal has been tepid due to the projected cost of a full-fledged Bad Bank program of between \$3 and \$4 trillion. During Secretary Geithner’s Senate confirmation hearing, Sen. Charles E. Schumer (D-NY) said the idea is attractive but the price tag is so large it would “shake our financial system” and “create great worries for the dollar.”

As of today, the mechanics of the Bad Bank remain shrouded in mystery with rumors and speculation floating about as to how the Bad Bank program will work. President Obama and his finance team had planned to unveil preliminary details of a financial rescue program as early as next week but both unresolved issues and the time necessary to vet the plan with key members of Congress have delayed the unveiling.

Mechanics of a Good Bank/Bad Bank System

As proposed, a government-created Bad Bank would be comprised of a fund that would purchase a certain amount of the most toxic assets currently held on bank balance sheets, such as devalued mortgages and derivatives, and keep them “ring-fenced.” This would permit banks to cleanse their balance sheets of problem assets and permit those banks to begin lending again.

Ideally, by shedding their problem assets, the banks are left with healthy balance sheets. Bank management can focus on new lending. The banks will have improved earnings by disposing of non-earning assets and freeing up liquidity. At the same time, the market can begin to price the problem assets once the Bad Bank com-

mences the sale of the problem assets in the open market.

A Brief History of “Good Bank/Bad Bank”

Recent calls for a “Good Bank/Bad Bank” solution to the current banking crisis have included a call for an updated version of The Resolution Trust Corporation (the “RTC”) to liquidate the toxic assets. Under the Financial Institutions Reform Recovery and Enforcement Act of 1989, RTC was created as a United States Government-owned asset management company charged with liquidating assets (primarily real estate-related assets, including mortgage loans) of insolvent savings and loan associations (“S&Ls”) during the S&L crisis of the 1980s.

Initially, the RTC had engaged in “bulk sales” of asset portfolios. However, because purchasers discounted heavily for “unknowns” regarding the assets and general uncertainty at the time regarding the real estate market, the pricing on certain types of assets often proved to be disappointing to the government.

Accordingly, the RTC introduced the “equity partnership” program to help liquidate real estate and financial assets which it inherited from insolvent thrift institutions. The RTC’s equity partnerships had various structures but all were characterized by a private sector partner who (i) acquired a partial interest in a pool of assets, (ii) controlled the management and sale of the assets in the pool, and (iii) made distributions to the RTC in accordance with RTC’s retained interest.

By introducing equity partnerships, the RTC retained an interest in asset portfolios which enabled it to participate in the strong returns being realized by portfolio investors. Additionally, the RTC’s equity partnerships benefited from the management and liquidation efforts of their private sector partners. Between 1989 and mid-1995, the RTC closed or otherwise resolved 747 S&Ls with total assets of \$394 billion.

In the private sector and on a smaller scale, the Good Bank/Bad Bank concept has produced notable success stories such as the Mellon Bank/Grant Street National Bank transaction

("Mellon;" now part of Bank of New York Mellon). Due to falling real estate values and the collapse of oil prices, in 1988, Mellon Bank spun off a subsidiary, Grant Street National Bank ("Grant Street") to house 191 of Mellon's troubled commercial and industrial loans and leases and real estate interests. The assets were worth \$1.4 billion but were sold to Grant Street at a 47 percent discount (roughly \$640 million). Mellon's shareholders kept their shares in Mellon and received shares in Grant Street as a dividend on a one-for-one basis. Following the Mellon/Grant Street split, shares in Mellon rallied rewarding shareholders. Two years after the Mellon/Grant Street split, Mellon was again a healthy institution making acquisitions. Conversely, a non-bank unit of Mellon managed Grant Street's assets and quickly liquidated them. By 1995, Grant Street's debts were paid and Grant Street was wound down.

In October 2008, UBS AG ("UBS") used a Good Bank/Bad Bank structure when the Swiss government stepped in to rescue the bank. UBS set up a special purpose vehicle ("SPV") to purchase \$60 billion of UBS' troubled assets. UBS injected \$6 billion into the pool to cover losses. The Swiss government invested \$6 billion in return for a 9 percent stake in UBS. The Swiss National Bank also guaranteed loans of up to \$54 billion to the SPV to pay for the toxic assets.

On January 16, 2009, Citigroup announced it had begun a modified version of the Good Bank/Bad Bank plan by splitting the bank in two to shed its troubled assets. Although the details are not final, Citigroup's Good Bank, Citicorp, would be compromised of its core commercial, retail and investment banking businesses worldwide. The Bad Bank, Citi Holdings, will encompass the bank's retail asset management, consumer finance and a pool of risky assets. This transaction was facilitated by a \$300 billion Treasury loan guarantee. The fate of Citi Holdings' assets is yet to be determined as Citigroup is considering selling off the assets or letting them mature.

Good Bank/Bad Bank Under TARP

Initially the Troubled Asset Relief Program ("TARP") was designed to act essentially like a Bad Bank purchasing and aggregating toxic assets from participating banks. Using an initial \$350 billion, TARP would operate as a revolving purchase facility to buy troubled mortgage-related assets and other problem holdings from financial institutions. The government would then either (i) sell those troubled assets at auction to private investors and/or companies or (ii) hold the assets and collect the "coupons." Funds received from such sales and from the held coupons would go back into the pool to facilitate the purchase of additional troubled assets.

When it became clear that the economy was slowing much more rapidly than experts had initially thought, the original structure of TARP, as a Bad Bank set up, was discarded. In its place, Treasury established a plan that provided for an infusion of cash to certain financial institutions, holding companies and insurance companies in the form of preferred stock and subordinated debt purchases. Today, it appears that the Bad Bank idea under TARP has come full-circle based on the Obama administration's economic team's recent statements.

Issues With the Good Bank/Bad Bank Proposal

As evidenced by Sen. Chuck Schumer's statement above, the total cost of the Bad Bank program remains speculative with some estimates running as high as between \$3 and \$4 trillion. As of September 2008, Federal Deposit Insurance Corporation ("FDIC") insured banks held approximately \$13.8 trillion in assets, with \$7.7 trillion in loans, with \$1.3 trillion in equity. Clearly, the \$350 billion of remaining TARP funds would not support the amount of bad assets in the system. The Treasury and the current administration must invent creative solutions to achieve the goals of removing the bad assets from the bank's balance sheets, provide borrower relief and recoup some of the money expended on the purchase of

the toxic assets. All of this is driven by the need to minimize the impact on the budget and the deficit.

Key questions that remain unanswered are: how will the Bad Bank be structured; who will operate and manage it; which financial institutions would be permitted to sell their assets to the Bad Bank; how will those toxic assets be chosen; how will those assets be valued, either at current market valuation or at par; and, most importantly, how much will the Bad Bank program cost the taxpayers.

A current report on the proposed structure of the Bad Bank suggests that the FDIC may manage the Bad Bank. FDIC Chairman Sheila Bair avers that the FDIC is in the best position to run and finance the Bad Bank program because it could issue bonds backed by the FDIC. It remains to be seen what competing arguments are presented to the Obama administration by either Treasury, the "OCC" or the Federal Reserve in a turf-battle over management of the Bad Bank. It is entirely possible that Treasury will insist on an independent agency staffed with Treasury-recommended appointees with the power to outsource many of the asset management and disposal functions to other government agencies such as the FDIC, FannieMae and FreddieMac.

The Bad Bank would most likely take the shape of, and operate along the lines of the RTC, which was the instrument used to clean up the S&L crisis of the 1980s and early 1990s. While equity partnerships could be re-introduced to maximize and recoup the taxpayers' investments, a key difference is that the Bad Bank would not oversee failing financial institutions with the intent to liquidate bad assets and wind up the bank. Rather, the goal is to absorb the toxic assets from the banks' balance sheets while the banks nurse themselves back to health.

Another key issue is what sort of regulatory scheme would be introduced to clean up the management practices of those banks selling their bad assets to the Bad Bank. In the 1980s, the Phoenix program was utilized by the Federal

Savings and Loan Insurance Corporation ("FSLIC") to combine one or more distressed S&Ls into a single operating unit which could then be rehabilitated or merged, with FSLIC then infusing capital in the Phoenix institution. As part of a S&L's reorganization under the Phoenix program, the S&L's board was removed and new management was appointed to run the improved Phoenix institution. The Phoenix institutions were established only after all other options to find other merging institutions were exhausted and liquidation was the only alternative. The result of forming a Phoenix Bank was that it was cheaper and less politically volatile for the FSLIC than paying out insurance to accountholders and liquidating the S&L.

The Bad Bank initiative is intended, in part, to open the door for regulators to modify troubled mortgages, which are the root of the banking crisis and rising home foreclosures. At issue is how the bank bailout and the Bad Bank regime would help troubled homeowners. Presumably, the Bad Bank's purchase of troubled assets would include troubled mortgages. As such, many troubled homeowners could be dealing with the federal government in an attempt to save their homes from foreclosures. A nationwide temporary moratorium on foreclosures could result, with borrowers given options to modify their loans and reduce their payments.

The IndyMac bank failure and the FDIC's response may provide precedent for a nationwide temporary moratorium on foreclosures by the government. As part of the Indy Mac seizure, FDIC Chairman Bair introduced a 38 percent solution, which puts a cap at 38 percent of a borrower's income that can be applied to mortgage, tax and insurance payments. It included a step-by-step process of evaluating mortgages and reducing payments below the 38 percent threshold and thereby avoiding foreclosures. The IndyMac model essentially lowered homeowners' payments to thirty-eight percent (38 percent) of their income by lowering the interest rate to a set fixed amount (around 6.5 percent). Concomitantly, the terms of the loan could also be

extended by as much as 10 additional years. Also, the IndyMac model provided for forbearance on the principal that would be repaid when the home is eventually sold or refinanced.

However, questions remain as to whether the FDIC, FannieMae or FreddieMac could do better than other loan servicers at modifying troubled mortgages. In November 2008, FDIC Chairman Bair, while lobbying for another FDIC-sponsored borrower relief program, cited the fact that more than 5,000 of the 40,000 or so eligible troubled borrowers had received loan modifications under the IndyMac borrower relief plan; a number many industry experts find dubious. In general, the track record of loan modifications market-wide is not particularly great. A study released in the fall of 2008 by analysts at Keefe, Bruyette & Woods, using data provided by a prominent loan servicer, showed that, in general, 25 percent of recent loan modifications went delinquent after just one post-modification payment and more than half had become delinquent after multiple payments.

Recent statements by key members of the Obama administration's economic team suggest that a reverse auction would be employed to purchase the toxic assets of the banks. Generally in a reverse auction transaction, a buyer announces an amount it intends to buy and a maximum price it will pay. Interested sellers then offer the quantities that they are willing to sell at the buyer's named price. If the quantity for purchase exceeds the quantity the buyer intends to purchase (i.e., if supply exceeds demand), the price will be lowered and a new offer will be generated. This practice continues until supply equals demand.

By way of example, here, the buyer is the Bad Bank and the quantity to be bought is a certain amount of mortgage-backed securities ("MBS") with a face value of \$100 million. At this point potential sellers, holding these MBS in their portfolio, announce what amount they want to sell at that price. If supply exceeds demand, i.e., the MBS being offered exceed the face value of \$100 million, their price will

be lowered. Presumably at the lower price, the seller will reduce the amount of MBS it is willing to sell. If the seller's reduction is sufficient to match supply and demand, the auction will be over and the MBS are sold at the last price announced. Otherwise the price will be lowered yet again, until supply and demand are matched.

As mentioned above, a key issue which would affect any reverse auction is how to value certain toxic assets that the banks are holding to sell. One type of toxic asset, MBS, presents unique issues in that they are financial assets whose cash flow is tied to the repayment of the mortgages on which they are based. Two seemingly identical MBS, having the same maturity date and interest rate, can be valued very differently depending on the solvency of the underlying mortgages. Only the bank holding the MBS in its portfolio can truly value the MBS as only it knows the status of the borrower and therefore the cash flow likely to be generated by underlying mortgages. It is likely that the banks would choose to sell those MBS assets that they know have a lesser chance of being repaid, typically those that are worth less than 50 percent. The result is either a significant loss for the seller or the buyer depending on what pricing methodology is employed. That is, if the program is intended to be a subsidy, then the purchase price will be at some level above current market price. If not, the banks would be unable to suffer the loss without causing insolvency.

Another issue that complicates the valuation of MBS is that, currently, there is no market for this debt; otherwise the banks would have already sold them. Therefore, it is difficult to set the value based on what the market will pay. Most likely, the Bad Bank will pay significantly over current market value for these MBS assets. Arguably, the unprecedented financial situation has eliminated any reliable market indicators. In effect, the function of the Bad Bank is to make the market.

Without recapitalization of the banks, the Bad Bank's purchase of these assets only makes sense if the Bad Bank purchases the assets at a premium to cur-

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Good Bank/Bad Bank cont'.d

rent market prices. If the banks' toxic assets are sold at the value at which they are carried on the selling banks' balance sheets, then the Bad Bank would be overpaying for securities it expects to decline in value and, at the same time, will be making a huge gift to the banks' shareholders. A potential solution would be to force participating banks to take equity in the Bad Bank so as to bear some of the losses due to the overpayment. As mentioned above, the Swiss government forced UBS to inject \$6 billion in capital to capitalize its bad bank so as to suffer at least some of the loss that UBS's bad bank was expected to incur.

Another alternative being considered is to leave a significant amount of assets on the balance sheets so long as they are performing but provide a Bad Bank guarantee for a fee. The guarantee would also be provided for other classes of assets provided those assets were written down to within some valuation range. This would be coupled with borrower relief. All of these components borrow concepts from existing Government relief plans.

Whatever the final form that this plan takes, it is clear that it will be pursued vigorously once a consensus is reached on Capitol Hill. It will dwarf in size any government program ever taken on, including the RFC of the Depression era. It will afford numerous opportunities for both buyers and sellers of residential and commercial loans and will influence the pricing and structure of lending for the indefinite future.

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