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Good Bank-Bad Bank: A Clean Break and a Fresh Start

With global financial markets in varying states of disarray, financial institutions and government officials are seeking to stabilize the banking industry and restore the flow of credit. Financial institutions have been plagued by continuing losses from troubled assets on their balance sheets. The application of mark-to-market accounting results in the announcement of new write-downs each quarter. These write-down announcements sap investor confidence in financial institutions and lead to stock price declines and increased volatility. This chain of events continues to overshadow efforts to refocus attention on business prospects. Over the course of 2008, the scope of troubled assets broadened—from subprime mortgage-related assets, to auction rate securities, to derivatives, to commercial real estate related assets. Uncertainty regarding future losses and a market and asset value "bottom" inhibit private investment in financial institutions.

Initially, the U.S. government plan, proposed by former Treasury Secretary Paulson, contemplated purchasing troubled assets from financial institutions. However, for a variety of reasons, including concerns regarding the appropriate valuation of those assets to be purchased, this plan was abandoned. Instead, the government proceeded with direct capital injections into financial institutions, through the Capital Purchase Program. In recent months, market participants and regulators both in the U.S. and in Europe have debated alternative measures to restore financial stability and investor confidence. There are two principal alternatives (and many permutations of these) that have been put forth: an asset guarantee model and a good bank-bad bank model. Both of these alternatives are intended to mitigate or ring fence troubled assets and limit the detrimental effect on financial institutions of subsequent losses from portfolios of troubled assets.

Along these lines, after much anticipation, on February 10, 2009, Treasury Secretary Geithner announced a plan to establish a Public-Private Investment Fund to remove troubled assets from financial institutions' balance sheets. Although the details of Geithner's new Financial Stability Plan are still not public, removing "bad" or troubled assets from core financial institutions appears to be part of the solution.

Although federal assistance may be forthcoming, financial institutions may wish to consider independently implementing the "good bank-bad bank" model, whereby the core financial institution, or good bank, separates off troubled assets into a newly formed bad bank. Below, we discuss some of the structuring considerations for good bank-bad bank models and compare and contrast these to asset guarantee models.

For general information on private investment in financial institutions, please see our Client Alert "Federal Reserve Board Liberalizes Rules for Investments in Banks" and for information on the government intervention efforts in response to the financial crisis, including the U.S. Treasury Department's Capital Purchase Program to inject capital into healthy financial institutions and its subsequent efforts to guarantee large pools of troubled assets, please see our Client Alerts and resources at Financial Crisis Legal Updates and News.

Overview of the Good Bank-Bad Bank Structure

In a good bank-bad bank structure, a financial institution establishes a separate entity for its "bad" assets, as shown in Table 1 below. Free of troubled assets, the resulting "good" bank can expect restored investor and market confidence, allowing it to raise capital more easily and at more affordable rates, and resume normalized lending. In structuring a bad bank, consideration must be given to the ultimate goal of the bad bank, whether its purpose is solely to liquidate bad assets or whether it will also house business operations. That decision influences others, including ownership of the bad bank, the legal and regulatory structure, capital and liquidity requirements, management, composition of the asset pool to be transferred and valuation of those assets.

If the bad bank is left to focus entirely on loan recovery and self-liquidation, then funds recovered from the troubled assets in the bad bank are paid to shareholders of the bad bank in the form of a dividend or interest payment after any repayment of debt raised by the bad bank to fund the purchase of the troubled assets.

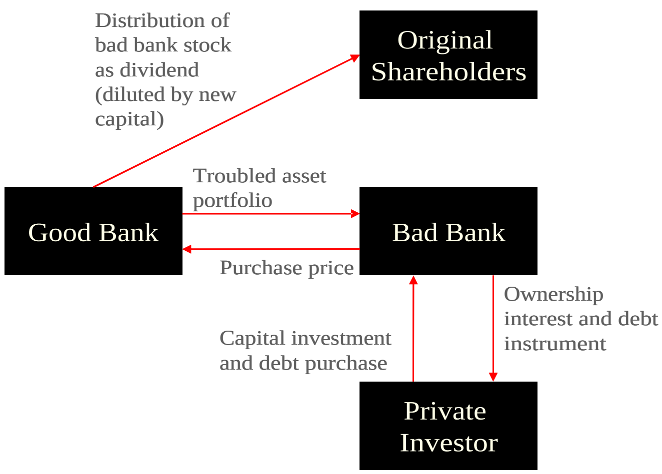

Table 1

Structure

The goal of the good bank-bad bank structure is to "clean up" the balance sheet of the good bank by transferring to the bad bank assets that are illiquid, non-performing or otherwise resulting in write-downs and depleting capital. In order to separate the problem assets, care must be taken to ensure the newly formed bad bank is not under common control with the good bank such that for accounting or regulatory purposes the balance sheets are consolidated. Accordingly, although a bad bank may be initially established as a subsidiary of a good bank, sufficient external capital is required to deconsolidate the bad bank subsidiary. At most, the good bank may maintain a non-controlling minority interest in the bad bank.

In forming a bad bank, consideration must be given to corporate, banking and securities laws. Assuming the bad bank's sole purpose is to liquidate troubled assets, limited regulatory oversight is required. Although the new entity is referred to as a "bad bank," whether the new entity needs to be chartered as a bank depends on the assets transferred to it and the business activities of the new entity. Transfer of ongoing business operations, in addition to troubled assets, is more likely to require a banking charter or satisfaction of relevant regulatory requirements.

Funding the Bad Bank

The bad bank must be capitalized. It will obtain a limited amount of capital from reserves allocated to the acquired assets. After that, a bad bank is typically funded primarily by selling equity or debt securities. In 2008, private investors experienced significant losses as a result of sizable investments in financial institutions, inhibiting their willingness to step forward now and invest in troubled institutions. However, investment in discrete pools of assets may attract private investors interested in targeted and concentrated ownership with significant control over the new entity. Private investors specializing in work-out situations or distressed assets will be more interested in a bad bank investment opportunity over which they can exercise asset management control, than an investment in a global financial services enterprise. Depending on the needs of the financial institution and the size of the portfolio of bad assets, among other factors, a bad bank may be established through a negotiated transaction with a private investor or private investor group.

The level of capital required by the bad bank will be based on the anticipated losses on the pool of transferred assets. Independent analysis of potential losses will be important for private investors evaluating investments in bad bank structures. As we note below, the required capitalization will depend on the asset mix, valuation of the assets, the anticipated loss levels on the assets and a number of other related factors.

In a liquidation model, a bad bank's funding needs will be limited to include, for example, ongoing management costs and debt service. A bad bank established with a model other than the liquidation model must consider additional costs, including ongoing financing for an unknown or perhaps indefinite period and more variable management, legal and regulatory costs. Given the current widespread, sustained and unprecedented dislocation in the markets, the bad bank plan should include sources of ongoing funding and liquidity that do not rely exclusively on the capital market and new investors. Private investors will need to consider carefully their ongoing funding commitment and the commitment of any other partners in a bad bank enterprise.

Ratings Impact

Transferring troubled assets to a bad bank is likely to improve the credit ratings of the good bank, reducing borrowing and financing costs for the good bank and ultimately increasing earnings potential. Coordination with rating agencies is essential in order to ensure that the desired benefits of the good bank-bad bank structure can be obtained. As a good bank evaluates the composition of the assets to be transferred to the bad bank, consideration should be given to the impact on credit ratings.

Valuing Assets

A challenge in establishing a bad bank is the valuation of troubled assets. Financial institutions have reported significant concerns with the current interpretations of mark-to-market accounting requirements for assets in illiquid markets.[1] In illiquid markets, such as the markets for most troubled assets, assets required to be marked-to-market may be held at a valuation based on the institution's internal model. Internal models are based on management's assessments of various factors that may include limited market price information, credit expectations, whether payments are current or delinquent, as well as anticipated losses. These models will vary by institution, resulting in different carrying values for similar assets and asset classes.

Financial institutions, and their financing partners, will need to determine the transfer prices of troubled assets, including whether to transfer at book value or at recent trading prices, if different. Assets transferred at less than carrying value will require an additional write-down by the good, transferring bank. Current investors and regulators can be expected to raise questions regarding any asset write-downs in connection with establishing a bad bank. The financial institution's book value for an asset, however, may not reflect the price at which a private investor is interested in acquiring the asset. Balancing these independent interests requires detailed negotiation with private investors, and flexibility in determining the appropriate composition of the asset portfolio to be transferred.

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[1] Please see our Client Alerts "SEC Study Recommends Keeping Mark-to-Market Accounting" and "Wall Street in Crisis: Fair Value and the Recent Market Turmoil".

The German government recently announced a plan under consideration to establish a middle ground between valuing the transferred assets at carrying value and at an illiquid market value. German banks would value their troubled assets at carrying value and above current illiquid market prices, preventing further write-downs by the transferring institution. If, in the future, the bad bank recovered less than the transfer value of the troubled asset, the good bank would be required to make the bad bank whole. For such a solution to be implemented in the United States, new accounting guidance would be required permitting such a transfer, notwithstanding the retained interest in the performance of the asset by the good bank, to be considered a "sale" of the asset by the good bank.

Asset Selection

Selection of the asset portfolio is a critical factor in the ultimate success of a good bank-bad bank transaction. Financial institutions must transfer a significant portion of their bad assets in order to achieve the benefits of a bad bank model, without stripping their balance sheets of performing assets. An institution also should consider the overall size of the resulting good bank. There are regulatory, market, ratings and counterparty benefits to maintaining a large size good bank.

Portfolio mix will be important to the bad bank's ability to achieve its goals. Given the limited market for troubled assets, it is unlikely a bad bank will achieve a short-term goal of liquidation. An institution must structure the bad bank to align the goals of the private investor with the capital structure of the new entity and the asset pool characteristics. For example, a bad bank funded with interest-bearing debt needs to hold a portfolio of assets generating current returns sufficient to satisfy the debt obligations.

As the recession continues, financial institutions are challenged to identify all of their bad assets. The benefit of relieving management from the burden of managing troubled assets and focusing on write-downs rather than business operations will not be achieved if the retained assets continue to negatively impact the balance sheet. Institutions will need to be confident that they can transfer sufficient bad assets to prevent additional announcements of significant write-downs following the creation of a bad bank.

Care should also be taken to define the optimal balance sheet for the resulting good bank. Asset transfer decisions should be consistent with business plans and strategies for the retained businesses. The benefits of establishing a bad bank, including increased investor, rating agency and counterparty confidence, could be diminished if the retained assets do not align sufficiently with the ongoing businesses and meaningful management resources are still required to manage or liquidate a portfolio of troubled assets.

Asset Management

The good bank must consider the ongoing management of the transferred assets. Options include having the good bank transfer management resources to the bad bank, providing management services on a contract basis, or having the private investors manage, or hire asset managers for, the portfolio.

Managing assets through the new bad bank entity should simplify and target decision-making with respect to the troubled assets. An independent bad bank established to liquidate or obtain the best current price for an asset will not face the conflicting goal of maintaining long-term lending and banking relationships with borrowers. As a result, decisions focused on the goals of the bad bank – such as liquidation or obtaining current value for an asset – will take priority over borrower-focused goals or longer-term asset performance goals. A bad bank with more diverse or long-term operating goals may face ongoing conflicts in managing troubled assets. If a bad bank is concerned with its long-term business prospects, care should be taken to align the entity's interests with those of its investors to ensure management of troubled assets is conducted in a manner consistent with all parties' objectives.

Benefits of the Good Bank–Bad Bank Structure

Benefits of the good bank-bad bank structure include a renewed focus on the long-term core operations of the good bank without the ongoing distraction of the troubled assets. Management's focus can return to building or rebuilding the financial institution and reporting on results of operations rather than performance of the troubled assets. Removing troubled assets from the balance sheet should have a positive impact on the view of credit rating agencies, investors and potential investors, lenders, depositors and borrowers. Additionally, removing troubled assets will relieve pressure on capital, enabling the institution to engage in more profitable and growth-oriented business activities, including lending.

As we note above, many factors need to work together to achieve the benefits of a good bank–bad bank structure. A financial institution should develop its views on the optimal portfolio of bad assets to structure a transaction that reflects the institution's long-term goals. At the same time, the institution must retain the flexibility necessary to identify and work with the best private partner available to finance and structure the bad bank.

Models of Good Bank-Bad Banks

The good bank-bad bank model has been used in the US and internationally with some success, as we describe briefly below.

Resolution Trust Corporation

The federal government continues to develop a new program to remove troubled assets from the balance sheets of financial institutions. Many expect that the ultimate structure of this plan will closely resemble the Resolution Trust Corporation (RTC), established to manage and dispose of assets acquired by the government during the savings and loan crisis of the 1980s. The RTC both sold assets and, when faced with illiquid markets and depressed asset prices, partnered with private investors to manage and transfer ownership of assets. The private-public partnerships used by the RTC are seen as a model for the government plan currently under development.

Mellon Bank Corp.

In 1987, although not insolvent, Mellon Bank Corporation (a predecessor of The Bank of New York Mellon) faced significant liquidity and other issues as a result of a decline in real estate values and the price of oil. Mellon Bank Corporation (Mellon) created a new institution, Grant Street National Bank (GSNB), which purchased Mellon's bad loans, valued at $1.4 billion when originated, and written down 53% when sold to GSNB. GSNB was capitalized with $123 million from Mellon and with $513 million in short-term bonds sold by Drexel Burnham Lambert. GSNB hired a non-bank subsidiary of Mellon to manage the troubled assets with a goal of liquidation. Mellon's earnings increased following the sale of the bad loans to GSNB. GSNB liquidated all of the loans and wound down in 1995.

UBS AG (UBS)

In October 2008, UBS sold $60 billion of its troubled assets to a special purpose vehicle acting as a bad bank for UBS. To capitalize the bad bank, UBS raised $6 billion through share sales to the Swiss government, giving the government a nine percent ownership stake in UBS. In addition, the Swiss National Bank loaned the bad bank $54 billion to help pay for the troubled assets. In the transaction, UBS diluted its shareholders by nine percent (as a result the government ownership stake), invested $6 billion in a bad bank, and removed $60 billion of troubled assets from its balance sheet.

Citigroup

In January 2009, Citigroup issued a press release announcing its decision to divide itself into two banks: Citicorp and Citi Holdings. The bank's "core" assets will be held in Citicorp and Citicorp will focus on future growth opportunities. Citigroup's non-core assets will be transferred to Citi Holdings, including Citigroup's brokerage and retail asset management, local consumer finance and special asset pool. The management of Citi Holdings will focus on obtaining value from the non-core assets and managing risks and losses. Citigroup noted in the press release that it is still looking for managers for Citi Holdings. At the time of the announcement, Citigroup was seeking necessary regulatory approvals, resolving tax issues and working to address the interests of all stakeholders. The Citigroup proposal includes a transfer of substantive operations into the "bad" bank, Citi Holdings, a more complex model than the liquidation bad bank. As discussed, impact on credit ratings, funding and liquidity needs and regulatory requirements will be important considerations as Citigroup structures its two entities.

Government Good Bank-Bad Bank: The Aggregator Bank

The structure to use public funds to remove troubled or bad assets from financial institutions is referred to as an "aggregator bank." In this model, as shown in Table 2 below, the government establishes an entity to purchase troubled assets from numerous financial institutions, aggregating the bad assets into one entity. Using its "exigent circumstances" authority under Section 13(3) of the Federal Reserve Act, the Federal Reserve Board (Federal Reserve) may loan the aggregator bank funds to purchase troubled assets. Government capital for the aggregator bank would likely require Congressional approval, such as that obtained by the Secretary of the Treasury (Treasury) under the Emergency Economic Stabilization Act of 2008 (Stabilization Act).

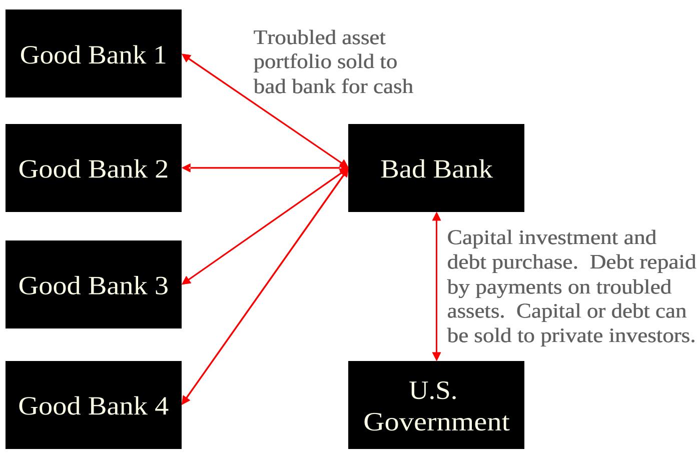

Table 2

Under Secretary Geithner's Financial Stability Plan (Plan), Treasury, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), together with private investors, will establish a Public-Private Investment Fund (Fund) to remove troubled assets from the balance sheets of financial institutions. Treasury, the Federal Reserve and the FDIC previously collaborated on the asset pool guarantees for Citigroup and Bank of America in separately negotiated transactions announced in November 2008 and January 2009, respectively. Each of their roles in those transactions may serve as a model for how they will work together to structure the Fund. The role of private investors has not been detailed, and we expect specific terms and roles will develop as the Fund's terms are announced and as private investors are identified and provide proposals to Treasury.

Including private investors resolves many of the challenges facing Treasury in establishing the Fund and avoids some of the criticisms it faced in early financial crisis programs and transactions. Questions have been raised from the Congressional Oversight Panel, Congress and the media about the prices Treasury paid for securities received in connection with its Capital Purchase Program; specifically how those valuations compared with recent private equity investments in the same or similar institutions. Private investors in the Fund will be able to provide independent pricing and market information for the asset purchases, relieving Treasury of that responsibility.

Another concern has been the lack of a clear exit strategy for Treasury's investments under the Capital Purchase Program. Treasury currently holds a significant portfolio of securities in the country's financial institutions. The program's transaction terms include features that will encourage participating institutions to replace government capital with independent capital. However, Treasury has been criticized for not developing and articulating a clear exit strategy. Including private investor participation in the Fund from inception prevents sole ownership of the troubled asset portfolio by government sponsors, and facilitates an exit strategy for government involvement.

Details of the Plan and the Fund are expected in the coming weeks, with an anticipated initial investment of $500 billion and an ultimate investment of up to $1 trillion.

Numerous reports have highlighted the challenges facing the government as it establishes an aggregator bank. As with a private good bank-bad bank structure, determining the value of troubled assets to be transferred to the bad bank is complex. In a government-sponsored, large-scale program, these valuation issues can have industry-wide impact. Many believe the purchase price established by a government fund creates a public, "objective" floor for the price of the transferred asset. If so, other holders, whether or not participating in the Fund, may be obligated under mark-to-market accounting standards to use the Fund purchase price as the current value of the troubled asset, rather than assigning alternative valuations based on independent assessments and models. In addition to these practical issues, the valuation decisions raise public policy considerations. The Fund's purchase of assets at above market prices rewards the selling institutions at the cost of the U.S. taxpayer. The Fund's purchase of assets at reduced or discount prices may require that financial institutions holding similar assets mark those assets down to the government purchase price, resulting in further industry wide write-downs, which will prolong the crisis.

The Asset Guarantee Model

As we note above, in November 2008, Citigroup announced an agreement whereby Treasury, the Federal Reserve and the FDIC will guarantee and provide funding for a pool of troubled assets. Bank of America entered into a similar agreement several weeks later. Each of the Citigroup and Bank of America transactions fall under Treasury's Asset Guarantee Program, used in coordination with significant capital investments by Treasury under its companion Targeted Investment Program. For a detailed description of Treasury's Asset Guarantee Program, please see our Client Alert "Treasury's Asset Guarantee Program."

The key difference between asset guarantees and a good bank-bad bank model is the retention, in the asset guarantee model, of the troubled assets on the institution's balance sheet. The financial institution identifies a pool of troubled assets using a process similar to that used in the good bank-bad bank model, but without the same limitations. Because the assets are be retained, the institution will not need to align the characteristics of the asset pool with the funding requirements for the bad bank. A pool of assets that might not be appropriate to transfer to a bad bank, for example, because they are not generating reliable cash flow, would be appropriate to retain in the asset guarantee pool. These assets are then segregated or "ring fenced" from other assets, as shown in Table 3 below. The most straightforward method of segregating assets is to annotate in the institution's records that the assets are subject to the guarantee. Alternative approaches are possible, including transferring the assets to a newly formed, wholly owned subsidiary.

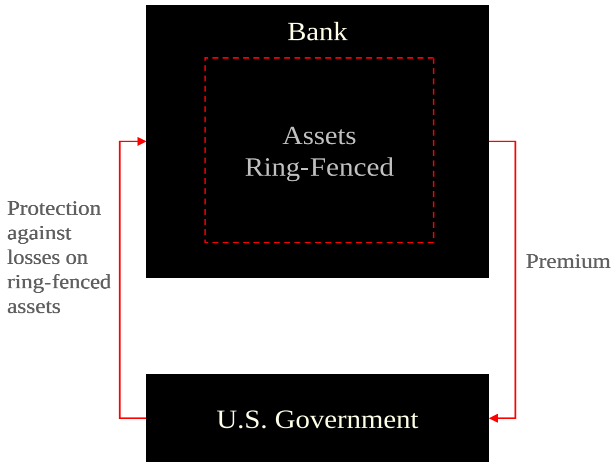

Table 3

Valuation considerations are not eliminated in the guarantee approach, but will not result in additional write-downs. The guarantor provides the guarantee for defined losses, which may be all losses up to book value or another agreed upon value, or may be losses after a first loss is absorbed by the financial institution. Under Treasury's Asset Guarantee Program, the financial institutions retain losses up to a threshold and Treasury and the FDIC share 90% of losses up to a second threshold. Thereafter, the Federal Reserve will loan the institution funds for any further losses on the asset pool. Determining the point at which the guarantee coverage attaches and terminates, and the premium for the coverage, can be as complex as determining the valuation for transferring assets to a bad bank, but the impact to the balance sheet is less transparent. An additional benefit of the government guarantee may be a lower risk-weighting assigned to the asset pool. In each of the Citigroup and Bank of America programs, the risk-weighting for the troubled assets in the pool is 20%.

There are some disadvantages to the government guarantee approach, most notably the executive compensation and corporate governance requirements imposed on the participating institutions. Participation in the Targeted Investment Program and the Asset Guarantee Program requires compliance with the executive compensation and governance requirements of the Stabilization Act, as interpreted through Treasury's evolving rulemaking. In addition, each of the participating institutions must comply with corporate governance agreements limiting corporate dividends and certain corporate spending. Notwithstanding the unique benefits of a government guarantee, serious consideration must be given to the longer-term impact of the accompanying restrictions.

Asset guarantee models are also being considered outside the United States. The approach requires limited initial government expenditure, providing policymakers with a more politically acceptable solution in light of the extensive spending and rescue programs already announced. Additionally, independently negotiating attachment points for the guarantee with each institution provides more flexibility than purchasing whole assets under an aggregator bank model.

Alternative and Hybrid Proposals

Government "Good" Bank

The aggregator bank discussed above is a public bad bank, funded with government capital, or a combination of private and public capital. An alternative government good bank-bad bank model has been proposed by George Soros.[2] Under the proposal, financial institutions would establish a bad bank into which they would transfer their

[2] The February 4, 2009 Wall Street Journal opinion article "*We Can Do Better than a 'Bad Bank'*" by George Soros is available at http://online.wsj.com/article/SB123371182830346215.html.

troubled assets, funded with a transfer of existing capital and debt. Rather than finance the bad bank, Mr. Soros proposes that government capital would be better spent re-capitalizing the remaining, and capital depleted, good bank. Existing shareholders would be given interests in the new bad bank, as well as rights to subscribe for new shares of the good bank. Government resources would be used to capitalize the good bank—a more appealing investment for U.S. taxpayers and their policymakers. It would be easier to attract private capital to the good bank than to the bad bank, limiting the cost to the government, a key consideration given the scope of the current crisis.

Losses on the bad bank assets would be borne first by pre-existing shareholders, rather than by new investors. Mr. Soros notes that any risk of loss to bad bank debtholders may reduce the ability of financial institutions to borrow in the future, an outcome he finds acceptable given his belief that financial institutions should not be as highly leveraged in the future.

The proposal supports a public policy goal of preventing moral hazard arising from government intervention. Widespread concerns are being discussed that once financial institutions are bailed out by the government, the resulting implied safety net will continuously impede an appropriate level of risk management. This will result in a nationalized banking system in practice, if not in name. In contrast, Mr. Soros notes, if financial institutions, and their shareholders, are made to pay the price of past decisions, they will be more prudent in future corporate and capital allocation decision-making.

Hybrid Proposal

The proposal of Max Holmes[3] offers a hybrid approach, including both government intervention and private restructuring.[4] The plan requires that financial institutions establish separate, government owned bad banks, rather than using a government sponsored aggregator bank. Government support would come in the form of long-term funding for the separately formed bad banks. Each financial institution would transfer its selection of troubled assets to its new bad bank at most recent quarter-end or year-end valuations, eliminating many of the valuation concerns discussed above with a single aggregator bank. The government would finance the bad banks by assuming outstanding debt of the financial institutions, rather than issuing new Treasury debt. The specific debt instruments would be selected by the government, in an aggregate amount equal to the troubled assets transferred to the good bank. Cash flow from the troubled assets would be used by the government to repay the outstanding debt, with the government absorbing any losses. The portfolio of assumed debt could be structured to match, as closely as possible, the expected cash flows from the bad bank.

Mr. Holmes' proposal focuses on the largest financial institutions "and perhaps some others." The proposal requires mandatory participation by four major financial institutions, but doesn't provide details on the criteria for including others. If such a proposal were to be adopted, the financial institution stress tests to be performed under Treasury's Plan could potentially be used to identify additional financial institutions.

The structure of the program provides some funding advantages. First, funding with long-term debt would permit management of the assets absent pressure to attempt immediate liquidation at current fire sale prices. Additionally, assumption of debt, rather than printing new money resolves a frequent criticism and concern expressed over the growing size of the government's stimulus and stabilization programs. Mr. Holmes recommends that participating institutions grant transferable warrants to the government, so that the expected upside potential from clean, strong balance sheets could be shared by the U.S. taxpayer.

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[3] Max Holmes is an adjunct professor of finance at the Stern Graduate School of Business at New York University and the chief investment officer of an asset management firm.

[4] The January 31, 2009 New York Times opinion article "Good Bank, Bad Bank; Good Plan, Better Plan" by Max Holmes is available at http://www.nytimes.com/2009/02/01/opinion/01holmes.html.

Summary

Each of the structures we discussed and their numerous variations have advantages and disadvantages. No structure is ideal for all institutions, which is a continuing challenge for the government as it tries to balance the unique situation and nature of each institution with the goal of creating a program that can be implemented consistently across the industry.

Below we summarize the pros and cons of some of the basic structuring alternatives.

Structure	Pros	Cons
Private Good Bank-Bad Bank	• Removal of bad assets from balance sheet • Institution can structure an ideal solution tailored to a specific portfolio of troubled assets • Bad bank can be established to manage or liquidate a discrete pool of assets or can include operations, either business lines to be phased out or to continue • Bad bank will not face conflicts of interest with troubled asset counterparties and will have time to manage assets • Depending on structure, shareholders may receive interest in bad bank, retaining some potential upside • Permits management to focus on good bank businesses and assets • Separate good bank improves rating agency, shareholder, investor and market perception of institution • Private structure will not subject institution to executive compensation and corporate governance requirements	• Limited current availability of private investors • Must be highly structured to meet the needs of private investors • Valuation of assets challenging and highly negotiated; likely to result in either short-term additional write-downs or longer-term opportunity costs • May require ongoing management of assets, for example on a contract basis, depending on investors • Requires management of shareholder expectations, which may be ongoing, particularly if private investor profits from transaction • Establishment of new legal entity may raise regulatory compliance and charter issues
Repackage Troubled Assets for Private Sale	• Flexibility in selecting portfolio • No further involvement with assets	• No current market
Asset Guarantee Program	• Retention of upside • Out-of-pocket costs limited to price of premium; potential to issue securities to satisfy premium obligation • Ease of transaction execution—no need to establish separate legal entity; valuation questions simpler • Asset risk-weighting adjusted to reflect benefit of government guarantee • Ability to prepay Federal Reserve loans and terminate guarantee • Does not eliminate future option of bad bank • No upfront funding requirement for any	• Institution will be subject to government executive compensation and corporate governance requirements • Long-term nature of guarantee results in longer-term imposition of government rules • Asset management decisions subject to government rules • Assets retained on balance sheet: additional losses to be absorbed; management costs; ongoing management distraction • Does not achieve public separation from bad assets, no good bank boost • Does not provide funding, bank must

	guarantor • Guarantee can be restructured and assets can be restructured	continue to finance the assets
Government Aggregator Bank (Bad Bank)	• See "Private Good Bank-Bad Bank" above • No further involvement with assets, which are removed from balance sheet and managed by government asset managers • Unlike Private Good Bank-Bad Bank, government will establish legal entity and structure transaction • Unlike Private Good Bank-Bad Bank, government more likely to accept broader scope of troubled asset classes	• Institution will be subject to government executive compensation and corporate governance requirements • Unable to participate in upside • Unlike Private Good Bank-Bad Bank alternative, bad bank must be limited to troubled assets to be liquidated, no operating businesses • Unlike Private Good Bank-Bad Bank, negotiations on price will be more transparent and public • Valuation of assets challenging and because they will need to be consistent across all institutions, likely to result in either short-term additional write-downs or longer-term opportunity costs • Requires management of shareholder expectations, which may be ongoing, particularly if the government profits from the transaction
Government Sponsored Good Bank	• Removal of bad assets from balance sheet • Institution can structure an ideal solution tailored to specific portfolio of troubled assets and funding needs for bad bank • No further involvement with assets, which are removed from balance sheet and managed by government asset managers • Permits management to focus on good bank businesses and assets • Separate good bank improves rating agency, shareholder, investor and market perception of institution • Good bank will be well capitalized • Assets will be transferred at book value with no additional write-downs • Achieves public policy objectives of charging current shareholders for the impact of acquiring troubled assets	• Institution will be subject to government executive compensation and corporate governance requirements • Requires management of shareholder expectations, which may be ongoing, particularly if the government profits from the transaction • Establishment of new legal entity will be more complex than using a government aggregator bank (but less complex than Private Good Bank-Bad Bank as structure would have government approval) • Current shareholders will be diluted • Depending on the size of the portfolio transferred to the bad bank, may create effective nationalization of good bank • Will increase cost of debt financing (risk of transfer of debt to new entity, risk of loss from bad assets) • Unlike Private Good Bank-Bad Bank alternative, bad bank must be limited to troubled assets to be liquidated, no operating businesses • Unlike Private Good Bank-Bad Bank, valuation of assets will be more transparent and public
Hybrid: Multiple Government Funded Bad	• Removal of bad assets from balance sheet	• Institution will be subject to government executive compensation and corporate

Banks	• No further involvement with assets, which are removed from balance sheet and managed by government asset managers • Assets will be transferred at book value with no additional write-downs • Permits management to focus on good bank businesses and assets • Separate good bank improves rating agency, shareholder, investor and market perception of institution • Achieves public policy goal of funding structure through assumption of existing debt, rather than "printing money"	governance requirements • Requires management of shareholder expectations, which may be ongoing, particularly if the government profits from the transaction • Establishment of new legal entity will be more complex than using a government aggregator bank (but less complex than Private Good Bank-Bad Bank as structure would have government approval) • Unlike Private Good Bank-Bad Bank alternative, bad bank must be limited to troubled assets to be liquidated, no operating businesses • Ability to raise future debt may be impeded by risk that government can assume debt at any time • Unlike Private Good Bank-Bad Bank, valuation of assets will be more transparent and public

Conclusion

As the financial crisis continues, the need to remove troubled assets from financial institutions' balance sheets has become critical. Confidence in our banking and financial system requires confidence in our financial institutions and the ongoing reporting of losses and write-downs continuously hampers progress. The SEC has rejected suspending mark to market accounting, which would have helped. Segregation of troubled assets would alleviate the pressures they create on the individual institutions, and on the financial system. Private investors working with individual institutions have the opportunity to structure bad banks that meet individualized investment needs. Whether a good bank–bad bank structure duplicates past precedent or brings something novel to the table, regulators are highly motivated to approve plans that transfer troubled assets and restore stability.

A government program will inevitably be shaped by policy considerations, politics and practical considerations. Whatever its final form, the creation of the government's Fund may serve as a model and springboard from which creative private investors may partner with financial institutions interested in structures that can be tailored to individual circumstances.

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