

The 'Bad Bank' Experience: Lessons From Mellon-Grant Street

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The past year has shown that when banks are good (Goldman Sachs Group), they can be very good; when bad (Countrywide Financial), they can be horrid. Then there are those straddling the line: institutions that believe if only they could rid themselves of some very bad assets they could unleash the good bank inside. Think Lehman Brothers Holdings or American International Group, each of which is kicking around the idea of creating a "bad bank" to house its troubled, mostly mortgage assets.

Curious about how the process works and how successful it can be, Deal Journal talked with Michael Bleier, a partner with Reed Smith LLP and former general counsel of Mellon Financial who worked on the watershed "bad bank" event: Mellon's late '80s spinoff of Grant Street National Bank. Here is an edited version of our conversation.

Deal Journal: *Why is the "bad bank" structure so popular right now with financial institutions?*

Michael Bleier: Banks want to be more successful, so they want to separate the good assets from the bad. Whether they put it into a true "bank" structure we don't yet know. It makes sense to separate good assets from bad assets and leave a stronger good bank than before the separation. For one, you allow management to focus on the future, not having to deal with the problem assets. The good remaining piece is in a stronger financial position, therefore its funding is cheaper and you get a direct impact on your earnings. And in the lending context, bankers always wanted to keep the client relationship. So by separating the collection officers, you allow them to focus on collecting on the bad assets and not worry about the effect of that in an ongoing client relationship. Then you get to tackle the general banker approach to depreciating assets: "If he owes me 10 dollars, I will get 10 dollars and I will not take \$9.50." So you get away from that thinking as well.

Deal Journal: *What do shareholders get out of owning part of a bad bank?*

Bleier: The way we did it at Mellon, the bad bank was divided up to shareholders on a one-for-one basis: one share in a good bank, one share for the bad bank. It was a dividend, so it didn't cost you any money. The good stock would be worth more because it didn't have bad assets and the bank's position was strengthened because it eliminated all those problem assets from its books. The post-sale bank was stronger than the pre-sale bank, and all of its ratios were stronger. The bad bank traded the counter-like any other stock. If it went bad, it went bad. But the kick to the good bank would be much more positive than if something were to happen to the bad bank.

Deal Journal: *What lessons did you learn during the Grant Street situation that would be applicable to banks today?*

Bleier: I think it requires a lot of advance planning. It requires the support of the regulators. It allows management to focus on the future, it allows them to feel that their organization or their company is immediately stronger. It also improves many of the ratios that the markets use.

We had an administration agreement between a Mellon subsidiary and Grant Street, partly to collect on the assets. The employees were Mellon employees, and they knew that after the assets were collected and Grant Street was closed, they could come back to Mellon. There was also an immediate positive impact in the debt that Mellon had outstanding, which reduced the cost of funding, and that would have an immediate impact on earnings. Two years after Mellon did the good bank/bad bank, it was back in the business of making acquisitions. It could do many of the same things. But some holders did not want their assets transferred to a bad bank.

Deal Journal: *So what did Mellon do with those holders?*

Bleier: They just paid them off, very quickly.