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IBC16's Bad Bank Bulletin

Grand Street National Bank

The First Ever Bad Bank

BACKGROUND

The Troubled Asset Relief Program ("TARP") and the National Asset Management Agency were established in the United States and Ireland respectively, as a repercussion of the global financial crisis of 2008. The practice of creating bad banks became a sought-for panacea during this era.

The pioneer of this practice was Mellon Bank, who first segregated its stressed assets into a subsidiary in the late 80s. The new subsidiary created came to be known as Grand Street National Bank, and it marked the official advent of 'Bad Banks'.

TOTAL ASSETS UNDER MANAGEMENT

In late 1986, Mellon Bank's credit portfolio started to grow in the strained areas of the economy. A year later it reported its first quarterly loss. Rapid expansion programs caused an unprecedented loss of $65 million along with a $175 million provisions made for future loan losses. In June 1987, the bank was about to announce a second-quarter loss of roughly $566 million, with a loan loss provision of $533 million. At this point, the bank's market capitalization was approximately $750 million and it appeared to have reached the edge of the fall. After the GSNB establishment, Mellon managed to do a considerable amount of new business. Its extent was to facilitate the disposal of Mellon Bank's non-performing energy and real estate loans worth almost a billion dollars, in order to allow Mellon to raise fresh capital and revive operations. It comprised Mellon's own board of directors along with $130 million capital.

WAY OF FUNCTIONING

Frank V. Cahouet, Chairman Emeritus of Mellon Financial Corporation, led the successful restructuring of the company through the creation of a bad bank, in addition to other innovative decisions. He described his strategy as fairly straight-forward with infusion of capital for growth at its core.

The non-straight-forward part of it was to make the strategy resonate with stakeholders, as a new fiat was to be invested for the continuance of Mellon Bank. Consequently, the bad assets were differentiated from the good and a dedicated team initiated the liquidation of the loan. Although GSNB had a legitimate national license, it did not engage in accepting deposits or making loans, adhering to its scope.

The most immediate task was to stabilize the bank, stop the credit losses, and preserve its cash flow. The new team immediately identified several problems – destabilizing credit losses, excessive operating expenses with inadequate controls, a basic lack of focus on profitability, and misunderstanding what the numbers actually meant. A stabilization plan was set in place to stop the hemorrhage, which consisted of cost reduction executed through layoffs to control operating expenses, renewal of retirement incentives, and closing the bank's foreign operations.

A key highlight was how attention was paid to minute details. There was two-way communication at all levels, sync between the senior management and the board of directors and regulators, and a strong audit committee. This helped in winning over stakeholders while the plan was set in motion. Recapitalization within the right time period was deemed imperative for Mellon to have the market convinced that it had long-term viability, and to save them from regulatory intervention. $500 million were required in fresh equity capital on an immediate basis.

$1 billion worth of Mellon's non-performing assets were transferred to GSNB using proceeds of common stock offerings worth $525 million, to offset the loss in the transfer of loans and other bad assets at market value while ensuring that the required new capital was injected in Mellon.

Bad loans of Mellon were sold on a non-recourse basis in one lump-sum while the bank focused on its core business strategy, to maintain and grow profitability. The bad bank mechanism was also used as a magnet to pull all the strain that demotivated employees, to set them on an optimistic path. What sets Mellon's strategy apart from similar ventures, is the harmony amongst its structure and incentives. Calculated investments, apt legal assistance, and efficient accounting were executed to perfection while the novel plan turned to reality. The entire assignment was completed before the time period initially estimated, with all debt paid off and common equity invested in GSNB returned to the shareholders. The bonds and preferred stock used by GSNB yielded as much as 17%, which gave Mellon the incentive to pay investors back rapidly. Mellon's stock went up almost immediately after GSNB was disclosed, and it played a huge role in leading Mellon's total return to shareholders to be compounded at an annual rate of 21.3% across its growth period.

ONE THING NARCL CAN LEARN FROM GSNB

NARCL can learn numerous lessons from GSNB — most importantly, recognising its responsibility to strike a balance between lending support to state-owned ventures, and justified application of strict lending regulations. Maintaining a sense of realism regarding their conduct might just be the biggest take-away here for NARCL. Further, NARCL can take the inspiration to strive for a specific mandate which is straight-forward and rigid, to determine an efficient strategy which can ensure greater efficiency and stability. Lastly, NARCL could also extend its support in raising more awareness about its objectives and capacities among its clients, since relying entirely on NARCL can seem convenient but would never lead to optimum results. Great effort on part of Mellon helped catalyse the execution of the bank bank strategy and its consequent growth; a lesson which should keep both NARCL and its clients grounded through the process of bouncing back.