

# BAD BANKS: HISTORICAL GENESIS AND ITS CRITICAL ANALYSIS

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## Abstract

A bad bank is created for the purpose of transferring the toxic assets of a regular bank to it so that the balance sheet of the regular bank can be cleaned up. The bad bank then services the transferred assets and liquidates them. During this process the bad bank incurs costs. While creating a bad bank several essential factors have to be kept in mind. Bad banks evolved out of several historical examples and have numerous advantages and disadvantages.

**Keywords: Good bank-bad bank, Stressed assets, Toxic assets, Asset Reconstruction Company, Fire Sale Externality, Contagion risks.**

## 1. INTRODUCTION

The banks in India have in the recent past accumulated a large number of stressed assets arising from the default in repayment of loans by both corporate and individual borrowers. As per Reserve Bank of India's Annual Report of 2017-18 the stressed assets account for 12.1% of gross advances by banks at the end of March, 2018. The definition of stressed assets in this report includes both gross non-performing assets as well as restructured standard advances. If the gross non-performing assets are taken separately then it will account for about 11.2% of advances at the end of March, 2018. This will amount to about 10.3 lakh crore in monetary terms (CRISIL, 2018). This increased burden of stressed assets gets reflected in the balance sheet of the banks resulting in lower investor confidence and other associated problems. A large number of solutions have been suggested by economists to tide over this crisis and recapitalize the banks. The most prominent among the said suggestions is that of the good bank-bad bank scheme. The Economic Survey of the Government of India for the year 2016-17 suggested the creation of bad banks.

This article attempts to critically analyse the concept of bad banks in the background of different historical examples. It also analyses the essential factors to be considered while establishing a bad bank. The pros and cons of bad banks are also discussed.

## 2. WHAT IS A BAD BANK?

A bad bank is an entity established for the purpose of separating the stressed assets held by a regular bank from its performing assets (Öncü, 2017). The said separation is achieved by transferring the stressed assets from the regular bank to the bad bank. When that is done, the stressed assets go out of the balance sheet of the regular bank and it gets recapitalised. Thereafter the regular bank can focus on its normal business activity without worrying about the stressed assets. The task of managing and/or liquidating the stressed assets is left to the bad bank. Since the toxic/stressed assets get removed from the balance sheet of the regular bank, it is often called as the good bank.

### 3. HISTORICAL EXAMPLES OF BAD BANKS

More than in theory, bad banks evolved in the late 1980's out of the crisis in the banking sector of the United States of America. At that time due to the steep fall in real estate and oil prices, a number of banks were on the verge of collapse and bankruptcy (Bleier, 2008). The most badly hit was Mellon Bank based at Pittsburg, Pennsylvania. That bank was steadily making loss and had to be recapitalized. For this purpose, Mellon Bank created another bank called the Grant Street National Bank (GSNB). GSNB was not a normal bank which would collect deposits and lend the same. The purpose of creating GSNB was to transfer Mellon Bank's toxic assets to it (McKinsey & Company, 2003). The GSNB would then liquidate those toxic assets and thereafter liquidate itself. The toxic assets of Mellon Bank having an original worth of \$ 1.4 billion was transferred to GSNB at a discounted book value of \$ 640 million. This purchase was primarily funded by a public issue of extendable pay-through notes and Mellon Bank's shareholder's dividends. (The shareholders of Mellon Bank received GSNB's shares for their dividend value). GSNB which was created in 1988, liquidated all the toxic assets transferred to it and went out of existence in July, 1995 (Bleier, 2008). Mellon Bank on its part began to make profits within about one year of the creation of GSNB (McKinsey & Company, 2003).

The success of the Mellon Bank's case has resulted in the good bank-bad bank approach being adopted both in the USA as well as other countries. The success of GSNB promoted the US government to establish an asset management company called the Resolution Trust Corporation. This corporation took over the task of liquidating those stressed assets of banks declared as insolvent by the Office of Thrift Supervision. The early 1990's saw this corporation liquidating stressed assets worth \$394 billion which arose as a result of the saving and loan crisis of the 1980's (Schäfer & Zimmermann, 2009). However this bad bank resolution process cost the US tax payer a total of \$ 124 billion (Curry & Shibut, 2000).

Japanese banks have employed the good bank-bad bank technique to restructure their bad debts. In 1992, the Banker's Association of Japan created a bad bank by the name Credit Co-operative Purchasing Company (CCPC). This company purchased the stressed assets of Japanese banks and serviced them (Bleier, 2008). The banks which sold the stressed assets at a discounted value to CCPC itself financed the said sale by extending a loan for the sale value. The CCPC then sold the real estate property and other assets given as security for the stressed assets and used that money to repay the loan extended to it by the bank which had sold the stressed assets to it (Taniuchi, 1997).

Many countries in Europe have successfully used varying shades of the good bank – bad bank solution to deal with the bad loan crisis in their respective banking sectors. The earliest bad banks in Europe were set up in Sweden. The Swedish government set up two bad banks by the name Securum and Retriva (Schäfer & Zimmermann, 2009). Securum was established in 1992 to take over the stressed assets of Nordbanken, a commercial bank. Securum financed this purchase partly with a loan from Nordbanken and partly with a government equity infusion (Repousis, 2017). At about the same time, Retriva was established for taking over the stressed assets of Gota Bank (Ingves & Lind, 1996). The remaining good assets of Gota Bank were auctioned off and purchased by Nordbanken (Repousis, 2017). Even though that bailout package cost the tax payer a considerable amount, the same was offset by the end of 2007 due to revenues from dividends, selling of stock etc. (Schäfer & Zimmermann, 2009). The two bad banks on their part successfully liquidated the stressed assets taken over by them (Repousis, 2017).

In Germany a bad bank called Berliner Immobilien Holding (BIH) was created in 2006 to separate the stressed assets of a bank called Berliner Bankgesellschaft (Schäfer & Zimmermann, 2009). However, when a bigger financial crisis hit Germany in 2008-09, the German Federal Legislature enacted a law in July 2009 for providing a good bank-bad bank solution which put very little burden on the tax payer. The said law created two separate bad bank models for the private and public banks. For the private banks the German law created a special purpose entity model. Under the said model, private banks transferred their stressed assets at the book value to these special purpose entities. As consideration for such transfer, these special purpose entities issued bonds at 90% of the book value of the stressed assets to the transferring bank. These bonds were guaranteed by a government funded institution called Special Fund Financial Market Stabilisation (SoFFin). The

said guarantee is only for redemption at par value. For such guarantee SoFFin charged the bank a one-time fee as well as a fixed annual sum. For the public banks, the German law created a 'Consolidation Model'. Under the said model the public banks could transfer not just stressed assets but also other type of assets including business divisions which had lost their profit making ability. The fundamental feature of the consolidation model was that certain types of liabilities that were incurred prior to the coming into force of the legislation would be borne by the German Federal and State Governments (Ulrich & Ilgmann, 2013).

In Ireland, a bad bank by the name National Asset Management Agency (NAMA) was established through legislation in 2009 to deal with the crisis in its banking sector arising from the global meltdown in the real estate sector (Honohan, 2009). Under this scheme all toxic assets of a participating bank were transferred to NAMA at a discounted value. Payment to the transferring bank was in the form of Irish government bonds. Once this transfer took place, NAMA was statutorily mandated to liquidate those assets within a time frame of seven to ten years in such a manner as to obtain the optimum financial return. Banks transferred a total of € 74 billion at a discounted value of 57% to NAMA. By mid-2015, NAMA had liquidated more than 70% of its major obligations and is eventually expected to bring profit to the Irish Government by the time it would be wound up (Schoenmaker, 2015).

Spain in the year 2012 created a bad bank by the name SAREB (an acronym short form for a Spanish name which when translated to English reads as 'Company for the Management of Assets proceeding from Restructuring of the Banking System'). The toxic assets of many Spanish banks were transferred to SAREB. As of mid-2016, SAREB held assets worth more than € 50 billion and is expected to profitably liquidate those assets within 15 years of its creation (Blazsek, 2016).

The above brief analysis of important historical examples of bad banks very clearly shows that there is no standard or uniform structure of bad banks. Different countries have created different bad bank schemes to suit their national requirements. However, the basic purpose of the bad banks is same, i.e. to separate (and eventually liquidate) the toxic assets from the balance sheets of the regular banks so as to save the latter from collapse.

#### 4. TYPES OF BAD BANK SCHEMES

As discussed above, the fundamental principle of good bank-bad bank technique is in the separation of the stressed assets of a regular bank from its performing assets (Mínguez, 2016). The purpose of this separation is for enabling a specialized management team to liquidate the stressed assets. For achieving the said separation of assets it is not always necessary that the bad bank and the good bank be separate legal entities. Bad banks can also be created as a separate business entity within the regular bank. Keeping this in mind, it is possible to identify four basic types of bad bank schemes (Martini, et al., 2009). The first type of bad bank scheme is called the on-balance sheet guarantee. Under this scheme certain stressed assets of a bank are protected from further loss under a guarantee agreement whereby the government or some public institution guarantees that the book value of those stressed assets will not go below a certain value. Those stressed assets however, remain in the balance sheet of the regular bank. The second type of scheme is the internal restructuring unit scheme. Here, instead of creating a bad bank as a separate legal entity, an internal bad bank or restructuring unit is created. All the stressed assets of the bank are transferred to the internal restructuring unit which manages the same. In this case also the stressed assets remain in the balance sheet of the regular bank. The third type of bad bank scheme is referred to as the off-balance sheet special purpose entity. In this type of scheme the regular bank transfers the stressed assets to a special purpose entity which is usually public funded. It results in the stressed assets being taken off the balance sheet of the regular bank. The fourth type of bad bank scheme is called as the bad bank spin off. In this type of scheme a separate legal entity called the bad bank is established and the stressed assets of the regular bank are off loaded to the bad bank. The bad bank is a separate legal entity and it usually has a banking license. This results in the stressed assets being taken out of the balance sheet of the regular bank. It is this fourth type of scheme that is normally referred to as the good bank-bad bank scheme.

It may be noted that when a separate bad bank is established, it could be used to service the toxic assets of one bank or several banks. Also the bad bank may be established by a single bank or a consortium of banks.

## 5. ESSENTIAL FACTORS TO BE TAKEN INTO CONSIDERATION BEFORE ESTABLISHING A BAD BANK

A number of factors have to be taken into consideration before a particular good bank-bad bank scheme is chosen. Some of the most important factors are:

- i. **Structure:** The type of good bank-bad bank scheme that will be adopted for servicing the toxic assets of regular banks will depend upon the nature and extent of the crisis in the banking sector. If the problem is with a few stressed assets of a single bank then the on-balance sheet guarantee scheme will serve the purpose. When the percentage of stressed assets held by a regular bank exceeds 20% of its total assets, then the regular bank would normally opt for an internal restructuring unit. All the stressed assets of the regular bank are transferred to this unit for liquidation (Martini, et al., 2009). However if the problem becomes more severe and chronic, banks will opt for special purpose entity scheme or the bad bank scheme itself.

As long as the crisis is limited to a bank and the said crisis does not affect the entire banking system, the individual banks are normally permitted to deal with the problem on their own with the help of the financial market regulator/central bank. However, if the problem magnifies and begins to affect the entire financial system, the concerned government will step in and aid the process of creation of bad banks. In such situations, it is possible that the government creates a single centralized bad bank with some amount of public financing instead of creating several bad banks (Medina Cas & Peresa, 2016).

- ii. **Specific purpose:** The purpose for which a bad bank is established influences the type of scheme chosen. If the sole purpose of creating a bad bank is to liquidate the toxic assets then the structure of the bad bank would be simple and it requires very little regulatory monitoring (Pinedo, 2009). However, if in addition to liquidating toxic assets, if any on-going business activity is transferred to the bad bank, then the bad bank would require a banking license and its structure would become more complex.
- iii. **Ownership:** When regular bank(s) themselves create the bad bank for transferring their toxic assets, then the regular bank(s) creating the bad bank will own it. Here the regular bank(s) still retains the risk of losses from the transferred assets with themselves (Medina Cas & Peresa, 2016). At times, the government establishes a bad bank for a single or a group of banks. In such situations, the bad bank will be either fully or partly owned by the government or related public institutions. In such situations the government takes the risk of possible losses from the stressed assets. Hence the risk is now passed on from the bank to the tax payers. Such bad banks may enjoy special legal status/privilege, but are prone to political interference (Gandrud & Mark, 2013). The bad banks can also be jointly owned by the government and the private sector and in such a situation; the risk is jointly shared by the tax payer and the bank.
- iv. **Funding:** In order to purchase the stressed assets the bad bank requires to be capitalized and the owners of the bad bank will have to find financial resources for the same. Acquisition costs and operation costs are the two main costs that determine the extent of capitalization that a bad bank requires (Schäfer & Zimmermann, 2009). If the costs of acquiring the toxic assets are low, then the initial capital required is also low. The extent of liquid funds required by the bad bank depends on how the acquisition costs are paid. Quite often acquisition costs are paid in the form of equity or debt security. In such situations the requirement of liquid fund is comparatively less and is required only to meet operational costs. The number of toxic assets required to be acquired and the anticipated losses will also influence the extent of capital that is required to finance the bad bank (Pinedo, 2009). A large share of the funds required to capitalize the bad banks are often provided by the government or its agencies. The regular banks may also contribute funds. Once capitalized, the bad bank can borrow money from different agencies to finance its purchase of toxic assets (Elliott, 2009).



- v. Toxic Asset Transfer Pricing: The transfer price that a bad bank will have to pay the regular bank for purchasing the toxic asset is also a very crucial factor that has to be taken into consideration before establishing the bad bank. This calls for a proper valuation of the toxic assets. This is a very difficult task because the toxic assets are very complex structures (Elliott, 2009). The transfer price offered by the bad bank must be high enough to induce the regular banks to transfer the toxic assets to the bad bank (Hauck, Neyer, & Vieten, 2011). However if the transfer price is too high, then the burden on the bad bank and its owners/promoters will be heavy. One option for the bad bank will be to buy the toxic assets at the market value. However determining the market value is a very cumbersome process. The second option will be to purchase the toxic assets at the book value (or at a fraction of the book value) (Elliott, 2009). However the difficulty here is that banks quite often hold the toxic assets in their books at a higher value than the actual market value.
- vi. Nature of transfer: Another factor that influences the creation of the bad bank is the nature of the transfer of toxic assets from the regular bank to the bad bank. The said transfer can be either permanent or temporary. In case of permanent transfer, an outright sale of the toxic assets takes place and the risk of the toxic assets is thereafter fully borne by the bad bank. In case of temporary transfer, there will be a repurchase agreement between the regular bank and the bad bank. Under the repurchase agreement, the regular bank agrees to repurchase the toxic assets after a fixed period of time. The idea behind such repurchase scheme is to give the regular bank some time to generate profits after which it can repurchase the toxic assets. In such a situation the risk of the toxic assets remains with the regular bank (Hauck, Neyer, & Vieten, 2011).
- vii. Types of assets to be transferred: Asset selection is a crucial factor in determining the success of any good bank-bad bank scheme. The bad bank should acquire only those assets which it can manage more effectively than the regular bank (Woo, 2000). For example bad banks should acquire only large toxic assets and leave the smaller ones with the regular bank itself (Medina Cas & Peresa, 2016). Further while acquiring toxic assets, the bad bank must ensure that the portfolio mix is such that, its own viability is secure. For example, if a bad bank is funded with interest bearing debts or bonds, then it should take over only such stressed assets which will generate sufficient current returns in order to meet the interest obligations. From the perspective of a regular bank, it should transfer a substantial portion of its toxic assets to the bad bank while retaining only the performing assets. Only then will the regular bank be able to reap the benefits of the good bad-bad bank scheme (Pinedo, 2009).
- viii. Asset management and its disposal: How the toxic assets acquired by the bad bank will be managed and/or liquidated is another crucial question that has to be addressed at the time of establishing a bad bank. The owners of the bad bank will be able to recover their investments only if this aspect is properly addressed. The first issue to be decided is whether the toxic assets should be liquidated quickly or held till its maturity. Holding the toxic assets for longer periods involves the risk of further deterioration of those assets and the consequent probable need of higher funding (Medina Cas & Peresa, 2016). The highly capital intensive assets should be restructured and sold as quickly as possible (Aggarwal, Aritomo, Brena, Clark, Guse, & Harle, 2012). On the other hand, medium-performing assets, assets which are less capital consuming, illiquid long dated assets and assets whose restructuring and sale would be costly should be held on for a longer time (Medina Cas & Peresa, 2016). Such assets could be sold after some time, when the markets have stabilised enough to secure reasonable price from their sale. This would take different amounts of time for different assets (Elliott, 2009).

The toxic assets taken over by the bad bank must be properly categorised and entrusted to specialised management teams. Some toxic assets taken over will require active management, i.e. some form of restructuring or hedging. This process includes conducting negotiations with debtors, debt rescheduling, debt reductions to avoid default etc. (Schäfer & Zimmermann, 2009). The legal issues like existing laws suits have to be also dealt with (Elliott, 2009). Managing some toxic assets may also involve much more efforts like completing unfinished

buildings, and other infrastructures, so as to increase the market value of those assets. Such a form of active management of toxic assets is called factory approach. On the other hand some toxic assets may not require any form of active management. In case of such assets one has to wait and expect that the value of those assets will recover with time. Such a form of passive management of toxic assets is termed as warehouse approach (Medina Cas & Peresa, 2016).

- ix. Governance of bad bank: The organisational structure of the bad banks should be such that there is transparency, independence and efficiency (Medina Cas & Peresa, 2016). The organisational structure should ensure that there is no political interference (Ingves, Seelig, , & Dong, 2004). Even if the bad bank is owned by the regular bank, it is highly advisable that an independent team of staff be hired. If necessary the active management of the stressed assets should be outsourced to specialised asset managers (Pinedo, 2009). The bad banks must however be made accountable for its actions through regular reports, audit, etc. Such accountability is required particularly if the bad bank has no banking licence and is outside the regulatory control of the central bank (Medina Cas & Peresa, 2016).
- x. Legal Framework: For the proper functioning of a bad bank, necessary legal framework must be created by the government. This is because the stressed assets more often than not, involve a number of disputed claims and associated litigations. The legal framework must also ensure a hassle free transfer of toxic assets including title from the regular bank to the bad bank (Parker, 2010). If a proper legal framework is not established, it could result in the under performance of the bad bank and the consequent failure to resolve the crisis (Klingebiel, 2000).

Sometimes countries enact specific legislations creating a bad bank and providing necessary legal framework for the functioning of the bad bank so created. For example the National Asset Management Agency Act, 2009 enacted by Irish Parliament created the National Asset Management Agency (NAMA) as a bad bank for managing the bad assets of certain banks in Ireland. The said Act laid down an elaborate framework for the smooth functioning of NAMA. On the other hand, countries may enact general legislations which would facilitate the smooth functioning of bad banks which get themselves registered under the legislation. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 enacted by the Indian Parliament is an example of such legislation. Chapter II of that Act lays down the general legal framework for the efficient functioning of bad banks registered under that legislation.

## 6. PROS AND CONS OF BAD BANKS

The good bank-bad bank schemes have been utilised by a number of countries for resolving the crisis in their banking sectors due its obvious advantages. Some of the advantages of using good bank - bad bank schemes are outlined below:

- i. The regular bank after transferring its toxic assets to the bad bank can focus on its long term core operations without worrying about those toxic assets (Pinedo, 2009).
- ii. Cleaning up of the balance sheet of the regular bank by transferring the toxic assets to the bad bank will have a positive impact about the regular bank in the eyes of the credit rating agencies, investors, lenders, borrowers and depositors (Pinedo, 2009).
- iii. The transfer of toxic assets to the bad bank will relieve pressure over the capital of the regular bank. This would enable it to involve itself in profitable/growth oriented business activities (Pinedo, 2009).
- iv. The bad bank, which is created as a specialised agency to deal with toxic assets, can hire specialised personnel to manage those assets. This will help the speedy disposal of those assets with minimum loss in the most efficient manner.
- v. The bad bank can be given special powers to expedite loan recovery and toxic asset disposal (Klingebiel, 2000).
- vi. The ownership of the toxic assets and its collaterals are centralized in the bad bank thereby facilitating better management of those assets (Klingebiel, 2000).
- vii. The good bank-good bank scheme minimizes contagion risks. Since the toxic assets of the regular bank are removed from its balance sheet and transferred to a new entity, the

performing assets of the regular bank are less exposed to risks of failure (Bolzico, Mascaro, & Granata, 2007).

The good bank-bad bank schemes are not without disadvantages. Some of them are enlisted below.

- i. Prior to the creation of a bad bank, certain key operational decisions are taken regarding many issues including how the associated risks will be managed. If these decisions go wrong, the bad bank and its owners will suffer huge losses (Elliott, 2009).
- ii. The regular bank usually transfers the toxic assets to the bad bank at a discounted value. This lowers the market value of similar assets held by other banks. This forces the other banks to liquidate similar assets at lower prices thereby starting a vicious cycle which pushes prices below their fundamentals. This is known as fire sale externality (Ulrich & Ilgmann, 2013).
- iii. If banks become aware that there will always be a bad bank to takeover and manage their toxic assets, then banks will tend to be less careful while granting loans.
- iv. Since toxic assets are held by bad banks, these bad banks are prone to political interferences by politicians supporting the chronic debtors (Gandrud & Mark, 2013). Unless the legislations creating the bad banks enact provisions to prevent such interferences, the functioning of the bad banks will be seriously jeopardized.
- v. A strong legal system that facilitates the creation and functioning of bad banks is a pre-requisite. Hence a regular bank would be able adopt a viable and reliable good bank-bad bank scheme only if the legislature has enacted necessary laws.
- vi. Huge costs are involved in the creation and running of bad banks, transfer of toxic assets from the regular bank to the bad bank, restructuring the toxic assets, eventual disposal of the toxic assets etc. Many of these costs can be avoided, if the toxic assets are left with the regular bank itself.
- vii. Sufficient number of skilled and specialized staff that is necessary to actively manage these stressed assets may not readily available. Even if available, engaging them would be a very costly affair.

## 7. CONCLUSION

The above analysis will clearly show that the basic task of the bad bank is to mop up the mess created by the regular banks in relation to the management of their toxic assets. The toxic assets of a regular bank are transferred to the bad bank not just for the purpose of better management of the transferred assets but also for the purpose of cleaning up the balance sheet of the regular bank. This process however involves some costs. As long as these costs are borne by the concerned banks or private players, the impact on the economy will be limited and the government need to have only a regulatory control over the entire process. However, if these costs are financed with tax payer's money, a mere regulatory control by the government agencies will not be sufficient and a more strict and watchful control of the bad banks by the government will be necessary.

In India, as of now a large number of bad banks (called as asset reconstruction companies) registered under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 are functioning. These banks are primarily financed by those regular banks whose toxic assets they service and liquidate. The said legislation provides the Reserve Bank of India with sufficient powers to exercise regulatory control over those bad banks. However, it is highly doubtful, whether the said regulatory powers conferred on the Reserve Bank would be sufficient to ensure the efficient functioning of any public funded bad bank that may be established in pursuance of the suggestions made in the Economic Survey of the Government of India for the year 2016-17. More stringent legislation will be necessary.

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