

# *Kiel* Policy Brief

## Bad Banks – The German Scheme

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## Elements of the scheme

In May, the German government has decided on the draft of a law for establishing so-called “Bad Banks” (Bundesregierung 2009). The draft has the following core elements:

1. Banks (or financial holdings or their subsidiaries) may establish a special purpose vehicle (SPV) to which they can transfer structured assets – such as asset backed securities (ABS), collateral debt obligations (CDO) or collateralized loan obligations (CLO). These assets must have been acquired before Jan.1, 2009.
2. In exchange, the transferring bank (from now on just “bank”) receives securities of the SPV which are guaranteed by the German state through the Financial Market Stabilisation Fund (“SoFFin”). The bank pays a guarantee fee to SoFFin.
3. As a rule, the transfer of assets is made on the basis of 90 per cent of the book value in the bank’s balance sheet.
4. The bank has to supply information on the current time value of the asset, which has to be confirmed by an independent expert and by the banking supervisory authority. On the basis of this information and additional risk considerations, SoFFin determines a fundamental value for the asset.
5. If the transfer value of an asset is higher than its fundamental value, the bank pays an annual compensation amount to the SPV which is calculated as the difference of the two values, divided by the number of years of the guarantee. The amount has to be at least 5 per cent of the difference<sup>1</sup>.
6. When the SPV is dissolved, a remaining surplus goes to the shareholders of the bank. In case of a loss, SoFFin is compensated by the shareholders: SoFFin has a claim to future dividend payments, or can be compensated by receiving new shares<sup>2</sup>.

## Differences compared to Geithner plan

The German scheme differs substantially from the Geithner plan for the US. The Geithner plan seeks to help banks getting rid of their troubled assets in order to improve their chances to attract fresh private capital; it involves, however, large risks for the taxpayers (Sachs 2009b, 2009c; Stiglitz 2009; Snower 2009a). The German scheme, in contrast, seeks to avoid benefitting shareholders at the expense of taxpayers. It contains core ele-

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<sup>1</sup> The annual compensation, however, does not exceed the amount which is available for dividend payments. If a payment of the full compensation amount is not possible due to this constraint, it has to be made up for in the subsequent years.

<sup>2</sup> Several details of the scheme are left open in the draft, e.g. the determination of the interest rates on the guaranteed securities, the determination of the guarantee fee and the payment of interest on potential deficits of the SPV which are financed by SoFFin (van Suntum 2009).

ments of the bad bank proposal that has been made by Jeffrey Sachs (2009a): bank shareholders have to stand in fully for eventual losses resulting from the holdings of troubled assets; the extent of the losses depends on the final disbursement value of the assets; and by replacing prime assets for troubled assets in the bank's balance sheet, large short-run losses resulting from a strict application of the "mark-to-market" rule are avoided.

### Coverage of losses

The procedure for the coverage of losses under the German scheme deserves some closer consideration. There are two elements. First, the transferred assets enter the balance sheet of the SPV at only 90 per cent of their previous book value in the bank's balance sheet. The idea behind this rule (the inclusion of which was demanded by the EU-commission) is that, in general, book values in German banks' balance sheets are considerably higher than their fair value<sup>3</sup>. An upfront depreciation of structured assets in case of a transfer to the SPV, however, tends to conflict with the aim of stretching the recovery of losses over a longer period. An initial 10 per cent balance sheet loss on transferred assets could imply a substantial worsening of the bank's capital position. The draft of the law considers this problem insofar as it rules that the 10 per cent depreciation does not apply if this would reduce the bank's core capital ratio below 7 per cent. But the incentive for a bank with a core capital ratio well above 7 per cent to set up its own SPV may be substantially lowered by the entailed initial depreciation.

The second loss-recovery element consists of the bank's annual compensation payment to the SPV on the basis of the difference between the value at which the asset entered the books of the SPV, and its fundamental value. The main problem here concerns the determination of the fundamental value. First, there may be substantial administrative problems. There are four institutions involved: the bank, the independent expert, the banking supervisors and SoFFin. To determine, first, the time value and, subsequently, the fundamental value of hundreds of different structured assets may be a cumbersome process. As banks have only six months to transfer assets to an SPV after the passing of the law, it may be that fundamental values will not be available in time for all of the assets that banks wish to transfer.

In addition, the scheme includes a substantial discretionary element. Experts and banking supervisors are likely to revise a bank's estimate of the time value downward in order to avoid later accusations that they have been too lenient. SoFFin, in addition, is likely to set the fundamental value at a relatively large discount to the time value, in order to reduce the probability that the SPV will suffer a loss and SoFFin will have to honour its guarantee. Thus, while the scheme makes it possible to distribute losses over time, it tends to have the

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<sup>3</sup> The draft for the law allows for exemptions from the rule in case that the time value of an asset is above 90 per cent of the book value; in this case the transfer to the SPV occurs on the basis of the time value.

property of charging exaggerated loss provisions and thereby weaken the capital position of a bank that uses the scheme.

In this case there could also be major side-effects for banks that do not participate in the transfer of structured assets to an SPV. If the banking supervisors apply the values for structured assets which have been determined in the evaluation process (and which tend to be distorted downward) to other banks which also hold these assets, this may lead to substantial asset losses by the other banks and a worsening of their capital position.

### **“Buying time” at substantial cost**

The scheme which is described here, allows a bank to “buy time” by transferring troubled assets to an SPV<sup>4</sup>. “Buying time” under the German bad bank scheme involves the payment of a guarantee fee to SoFFin which the bank could avoid by keeping the assets in its own books. This reduces the incentive of banks to use the scheme. It is important to recall that banks already have the opportunity to “buy time” at no cost by using the regulatory flexibility that has been created in autumn 2008 and which allows banks to deviate from the “mark-to-market” principle in case of structured assets with longer holding horizons. This may explain why several German banks have already signalled that they do not plan to participate in the bad bank scheme.

### **Loophole to escape Basle rules**

In this context it is remarkable that the head of the German banking supervisory institution (BaFin) has recently encouraged banks to use the scheme and transfer their structured assets to an SPV (Handelsblatt, May 20, 2009). His main argument is that in this way banks can avoid the additional short-run capital requirements which would be associated with the ongoing downgrading of structured assets by the rating agencies. In fact, while the regulatory flexibility that was created last year exempts banks from the mark-to-market principle it does not exempt them from the capital requirements of Basle I and Basle II.

Changes in the ratings may have a very substantial impact on minimum capital requirements. This can be illustrated by referring to the total amount of about 200 bill euro that has been mentioned as the potential volume of structured assets in Germany that could be transferred to bad banks (FAZ 2009). If these were AAA/AA assets, the total minimum capital requirement for the assets under the Basle rules would be 3.2 bill. Euro; if ratings fall to A, required capital would rise to 8 bill. Euro; if ratings fall to BBB/BB, required capital would

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<sup>4</sup> “Buying time” through the transfer of assets to an SPV does, however, not necessarily mean that insolvency is prevented (Snower 2009b). “Buying time” only prevents insolvency, when the bank would become insolvent on the basis of current mark-to-market values, and when asset prices recover sufficiently over time (or when the assets generate a sufficiently high net income stream) to restore solvency.

rise to 16 bill. Euro<sup>5</sup>. By transferring structured assets to a SPV – which is not subject to the Basle rules – banks could escape the additional capital requirement that is associated with a downgrading of present ratings<sup>6</sup>.

Establishing SPVs to circumvent the Basle rules is a dubious procedure. There are two major reasons. First: there is widespread agreement that the Basle rules have to be changed in order to remove their current pro-cyclical effects. Rising minimum capital requirements in recession times as a result of lower ratings need to be prevented. This should, however, be achieved through a global regulatory reform, not through creating national loopholes. In case of urgency, preliminary exceptions from the Basle rules could be agreed upon at the international level (or EU level) to prevent destabilizing effect of lower ratings on the financial system. Second: whereas the specific property of structured assets, in particular the difficulty to establish market prices, could justify an exception from the mark-to-market principle, there is no obvious reason for a preferential protection of structured assets from changes in the rating classification. If an SPV-loophole is created to avoid the additional capital requirements of a lower rating, this immediately raises the question, why the loophole should be available only for structured assets and not for other assets, like corporate bonds, which are also affected by changes in rating classification.

### **Weak incentives for recapitalisation**

A main task of bad bank schemes is to support the recapitalisation of banks. In contrast to the Geithner plan which amounts to strengthening bank shareholders at the expense of high risks for the taxpayer, the German scheme with its relatively high taxpayer protection does not leave much room for increasing the attractiveness of bank shares. Bank shareholders have to stand in fully for eventual losses resulting from the troubled assets which are held by the SPV, so there is no reduction of shareholder risk in comparison with keeping the assets on the bank's own books. To support recapitalisation, the German scheme entails an additional provision that allows exempting new shareholders from part of the risk that other shareholders carry. The provision looks as follows: The bank can issue new preferred shares up to 50 per cent of its initial capital. These shares may have voting rights. They are not subject to cuts in dividend payments in case that the SPV makes a loss; on the other hand, they also do not participate in eventual surpluses of the SPV.

Holders of preferred shares are not exempted from the burden of the guarantee payments to SoFFin and the compensation payments to the SPV. Their only advantage against the

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<sup>5</sup> See Kurowski (2009) for the minimum capital requirements for banks issued by the Basle Committee under the Standardized Approach. At the present stage it is difficult to quantify the actual additional capital requirement, as this depends both on the degree of the changes in the ratings and on the extent of the risk provisions which banks have already made.

<sup>6</sup> In fact, banks do not only avoid the additional capital requirement, but reduce the capital requirement for the transferred assets to zero (as there is no capital requirement for the government guaranteed assets which the bank receives in exchange). This is clearly inappropriate since the bank is fully liable for eventual losses on the transferred assets and should have a capital backing for this – potentially very risky – asset position.

other shareholders is that they do not suffer losses in case that the final disbursement value of the transferred assets falls below their initially-set fundamental value. If the fundamental value were set at a relatively low level (as one may expect) the probability of such losses would be rather low and not provide a strong incentive for private investors to provide fresh capital in form of preferred shares rather than regular shares. This consideration is reinforced by the fact that preferred shares do not participate in an eventual surplus of the SPV while regular shares do<sup>7</sup>.

## Conclusion

The German scheme of creating national SPV-loopholes for structured assets is a relatively expensive way to “buy time” for troubled banks and runs counter to the task of a more uniform and transparent international regulatory framework. It also does not provide a major incentive for a recapitalisation of banks, as the expected advantage of the envisaged new class of preferential shares over existing regular shares tends to be at best small.

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<sup>7</sup> To illustrate this, consider the following extreme example. Suppose the fundamental value of all transferred assets were set to be zero. In this case the SPV cannot make a loss but only a gain, so that holders of regular shares would be obviously better off than holders of the new preferred shares.