Editorial

Do We need a Bad Bank?

The pressure to create a bad bank becomes stronger every day. For many bankers, a government sponsored bad bank seems to be the ultimate solution to the crisis. After selling (at book value) the loss making "toxic" securities to the bad bank, the selling bank would be relieved from further losses stemming from these assets and it is thus expected that both credit worthiness and share prices of banks could resume to pre-crisis levels. The transaction also prevents – to some extent – the stigma of using public support as there is no obligation to publicly disclose transactions with the bad bank. It is not surprising that even sound banks find this solution attractive as it promises public subsidies to every bank with toxic securities – and that is virtually every bank.

Unfortunately, government has good reasons not to follow these arguments:

- The capital market does not know the amount of toxic securities on a bank's balance sheet – neither before nor after selling the securities to the bad bank. Thus intransparency and distrust in the capital markets would remain.
- Scarce public money is not used where it is most urgently needed: on those banks that would collapse without help and that may cause systemic risks.
- Government does not have the necessary organizational capabilities to refinance, manage and hedge a complex portfolio of structured credit products held by the bad bank.

Banks would receive cash or government securities in return, but they do not get what they need most urgently: equity capital. The federal finance ministry is currently working on a revised scheme called **"bad bank light"**, where the state takes over future losses from toxic securities and in return receives a share of future profits over

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the next 40 to 50 years ("Ausgleichsforderung"). Nice idea, but it can be easily improved by changing the terms slightly. Why not increase the maturity from 40 or 50 years to infinity? In this case the "Ausgleichsforderung" becomes a capital increase and gives banks what they need most urgently: a strong capital base. **This solution could become the silver bullet to resolve the crisis:** Government takes over (a large fraction of) the downside risk from "toxic" securities portfolios and is paid for this by new equity. The fair price of a guarantee could be determined in market auctions and government should improve the auction price in a transparent way in order to provide real support to the banks. The auction could work as follows: First a bank specifies a "toxic" securities portfolio and the type and level of protection it desires. In a next step, market participants like large international banks and private equity houses are asked to submit binding bids for selling a fraction of the desired protection. The protection seeking bank would then select the best bids and acquires e.g. 20% of the protection from the bidding group. The remaining 80% of protection would be provided by government in return for new shares whose value should be (100-X)% of the auction value of its own protection stake. X denotes the price improvement provided by government and might be set to 50%.

This scheme strengthens the banks by curbing out the toxic risks and at the same time by improving their deteriorated capital position – and it does not violate one basic principle of government subsidies: if taxpayers' money is spent for saving banks, this should not happen behind curtains but needs to be made transparent to the public.