With banking sectors worldwide still suffering from the effects of the financial crisis, public discussion of plans to place toxic assets in one or more bad banks has gained steam in recent weeks. The following paper presents a plan how governments can efficiently relieve ailing banks from toxic assets by transferring these assets into a publicly sponsored workout unit, a so-called bad bank. This plan effectively addresses three key challenges. It provides for the transparent removal of toxic assets and gives the banks a fresh start. At the same time, it offers the chance to keep the cost to taxpayers low. In addition, the risk of moral hazard is curtailed.

Public discussion concerning the structural dislocation of the global financial system continues unabated. With the escalation of the financial crisis in the autumn of 2008, many economists advocated internationally coordinated steps to recapitalise the banking sector. The recapitalisation of distressed banks via public funds as well as the creation of bad banks for toxic assets were both proposed early on, yet the international community continues to debate potential solutions. While a general consensus on the principles for the reorganisation of global financial markets was reached at the G20 conference in Washington D.C. on 15 November 2008, the implementation of concrete measures was not addressed until the G20 conference in London on 2 April 2009.

Efforts to master the crisis have fallen short so far. Measures have been implemented primarily at a national level, if they have been implemented at all. As in many other countries, the bank rescue package in Germany has only been partially successful. The package’s provisions for the sale of toxic assets have hardly been taken advantage of to date. The debate in Germany concerning the structural reforms necessary as a result of the crisis has drawn renewed attention to existing weaknesses such as the question of whether Germany needs public funds as well as the creation of bad banks for toxic assets were both proposed early on, yet the international community continues to debate potential solutions. While a general consensus on the principles for the reorganisation of global financial markets was reached at the G20 conference in Washington D.C. on 15 November 2008, the implementation of concrete measures was not addressed until the G20 conference in London on 2 April 2009.

In this paper, we analyse how a bad bank plan can be designed efficiently and evaluate existing proposals, in particular the bad bank plan of the German government.

Against this backdrop, it seems advisable to maintain a clear separation between the plans for the removal of toxic assets and the plans to address other structural issues. The creation of bad banks is becoming ever more necessary. The government must confront the problems at hand with a proactive industrial policy so that it can retreat from interventionist measures as quickly as possible. At the same time, the necessary structural adjustments must soon be implemented at private and public banks; German banks must quickly regain their function as sources of credit and as institutes which serve the real economy, in order to counteract the cyclical downturn.

In order to be efficient, a bad bank plan has to address three key challenges. It has to provide for the transparent removal of toxic assets and give the remaining good banks a fresh start. At the same time, the cost to taxpayers has to be kept to a minimum. Finally, the risk of future moral hazard has to be curtailed. The key element of the plan is the valuation of troubled assets at their current market value – assets with no market would thus be valued at zero. The current shareholders will cover the resulting losses. Under the plan, the government would bear responsibility for the management and future resale of toxic assets at its own expense and recapitalise the good bank by taking an equity stake in it. The risk to taxpayers from this investment would be acceptable, however, once the banks are freed of their toxic assets. A

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*Dorothea Schäfer* and Klaus F. Zimmermann**

BAD BANKS

**DIW Berlin, IZA, CEPR, University of Bonn, Germany.**

* DIW Berlin and Free University of Berlin, Germany.

** DIW Berlin, IZA, CEPR, University of Bonn, Germany.

Intereconomics, July/August 2009
clear emphasis that the government stake is temporary would also be necessary. The government would cover the bad bank’s losses, while profits would be distributed to the distressed bank’s current shareholders. Either a separate bad bank can be created for each systemically relevant banking institute, or one central bad bank with a separate account for each institute. Under the terms of our proposed plan, bad banks and nationalisation are not alternatives but rather two sides of the same coin. Although we refer mainly to the German situation, the elements of the plan will work in other countries as well.

The rest of the paper is organised as follows. First, we evaluate the situation of German banks in terms of capitalisation, then bad bank solutions of the past are studied and prerequisites for success examined. We then develop a classification scheme for existing and planned bad bank solutions and present an efficient design for a public bad bank. Finally, we evaluate the German Government’s bad bank proposal. Two simple numeric examples illustrating the working of both bad bank plans are presented in Boxes 1 and 2.

**Weak Capital Basis of German Banks**

The capital bases of German banks are seriously endangered by the high quarterly write-down of asset values. A lasting return of confidence cannot be expected without the removal of the troubled securitised assets plaguing the system, which largely have their origin in the US mortgage markets. Figure 1 displays equity capital to assets and core capital ratios (in per cent) for a selection of large banks. Figure 2 displays this data for a selection of German federal state banks (Landesbanken). Some of these banks have already accepted government assistance in order to stay above the minimum core capital ratio of 4%.2

According to the Bundesbank, the total capital including reserves held by all German banks is approximately 415 billion euros.3 Estimates of the total incurred losses from toxic assets vary at present between 200 and 300 billion euros – in other words, between 8 and 12% of German GDP. The president of the Federal Financial Supervisory Authority (BaFin) recently estimated toxic assets in German banks’ balance sheets at 180 to 200 billion euros.4 During the Swedish bank crisis in the ear-

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2 Following the intensification of the financial crisis, many have advocated that a bank’s core capital should comprise at least 10% of its risk-adjusted assets. Financial experts view an equity capital to assets ratio of 4 to 5%, and thus a leverage ratio of 25:1 and 20:1, as acceptable for a credit institute. In recent years, leverage ratios of 30:1 for hedge funds have been normal. Nine months before it was shut down by the government in January 1998, the US hedge fund Long Term Capital Management had a leverage ratio of 25:1 (see https://treas.gov/press/releases/reports/hedgdfund.pdf, p.12).

3 Consolidated balance sheet for German monetary financial institutions (MFIs) from the German central bank’s European System of Accounts (cf. http://www.bundesbank.de/download/statistik/bankenstatistik/S101ATIB01013.PDF).