

The German government's "bad bank" model

Additional element in the government's financial market stabilisation framework

The severe financial market crisis and the resulting high degree of uncertainty continue to endanger overall economic activity. The Financial Market Stabilisation Act (*Finanzmarktstabilisierungsgesetz*),¹ which was passed in October 2008, has undeniably made an important contribution to stabilising the situation through the measures the Financial Market Stabilisation Fund (Special Fund Financial Market Stabilisation (*Sonderfonds Finanzmarktstabilisierung* or SoFFin)) has undertaken to date. However, the developments of the past few months have shown that these measures have not been sufficient to eliminate the uncertainty regarding the financial system and the real economy arising from questions concerning the underlying value of problematic assets, especially on banks' balance sheets. The German government therefore passed the Draft Act to Develop Financial Market Stability (*Gesetzentwurf zur Fortentwicklung der Finanzmarktstabilisierung*) on 13 May 2009, based not least on the lessons learned from previous financial crises which indicate that the "detoxification" of balance sheets is a key condition for restoring confidence in the financial sector. The draft act focuses on freeing up balance sheets by hiving off financial assets subject to a severe impairment risk to special purpose vehicles ("bad banks"). The legislation is currently going through the parliamentary process.

Objectives and key criteria

The underlying objective of the government initiative is to stabilise the banking system and the financial market. As with any government assistance, however, fundamental principles of a market economy should be observed, and the financial risk to the general pub-

lic should be minimised. A "bad bank" solution must therefore meet certain key criteria.

Freeing up balance sheets and restoring confidence in financial sector enterprises

Financial sector enterprises that are relevant to financial market stability should be freed of high uncertainty and risk by ensuring that risky assets are effectively removed from banks' balance sheets. Providers of new equity and debt capital should be shielded from risks arising from the revaluation of problematic assets.

Ensuring losses are borne by those who caused them: relief for enterprises, but not for risk capital providers

In a market economy, the providers of equity and risk capital bear the risks arising from entrepreneurial activities and benefit from the opportunities. On the other hand, the government must, in the public interest, provide protection especially for systemically relevant enterprises where their existence is threatened in order to maintain the stability of the financial system. However, this does not apply to the net worth of the shareholders who provided the risk capital.

Subordinated liability of government and minimised burden on government coffers

It is one of the government's tasks to ensure the ongoing functional viability of the financial system in a crisis. However, where possible the government's legal responsibility should be subordinated to that of the risk capital providers. The risks and opportunities arising from enterprises' transactions should, therefore, remain with the old owners wherever possible – as would, incidentally, also be the case if the "bad bank" model were not deployed.

¹ See Deutsche Bundesbank, Monthly Report, November 2008, pp 30-31 for an outline of the Financial Market Stabilisation Act as at 17 October 2008. — ² Below we provide a rough outline of the "bad bank" model according to the government's draft legislation. The details will, in some cases, need to be clarified, and further changes and adjustments are possible during the legislative process. Alongside the model presented here, the German government is also working on a more comprehensive model for transferring further risk positions and business units. — ³ These include, in particular, far-reaching disclos-

ure requirements in terms of the impaired assets, adequate capital levels, a sound business policy and solid business model. In addition, the transferring enterprises must comply with the same management remuneration requirements as for the recapitalisation instrument. — ⁴ Cut-off date 31 March 2009 or later; otherwise, the book value as at 31 March 2009 shall apply as determined according to the applicable rules for the annual accounts. — ⁵ According to the European Commission, the real economic value is the transfer value reflecting the underlying long-term economic value of the assets on the basis of

Risk offload conditional on a sustainable business concept and sufficient capital levels

Financial sector enterprises that benefit from offloading their risks should have both a sustainable business concept and sufficient capital levels, both at the present juncture and going forward. The government initiative is intended neither to compensate enterprises for currently foreseeable losses nor to keep unprofitable institutions or business units afloat. Rather the intention is to dispel the uncertainty surrounding the future development of the underlying value of illiquid and complex bank assets that is aggravating the crisis.

Limiting impact of valuation problems on distribution of losses

It is currently very difficult to reliably determine the real economic value of the problem assets. Nevertheless, the decision on large-scale financial risks for the state will have to be delegated to (expert) third parties. The consequences of misvaluations should therefore be minimised when it comes to the final distribution of losses between the government and the equity capital providers.

The "bad bank" model – an outline²

Voluntary participation of systemically relevant banks, in particular

The Financial Market Stabilisation Agency (*Finanzmarktstabilisierungsanstalt*) decides on institutions' application to participate in the government "bad bank" model, giving special consideration to their systemic relevance, the urgency of their situation and the principle of the most effective and economical de-

underlying cash flows and broader time horizons. See also European Commission, Communication from the Commission on the treatment of impaired assets in the Community banking sector of 25 February 2009. — ⁶ Including the associated hedging transactions. Examples are asset backed securities (ABS), residential or commercial mortgage backed securities (RMBS, CMBS) and collateralised debt obligations (CDO). — ⁷ The haircut will be determined by SoFFin on a case-by-case basis. — ⁸ The constant percentage is calculated by dividing the difference (reduced book value minus fundamental value) by the

ployment of resources. In comparison with the other stabilisation instruments according to the Financial Market Stabilisation Act, the range of potential applicants is more narrowly defined and includes only credit institutions, financial holding companies and their subsidiaries (hereinafter referred to as transferring enterprises) domiciled in Germany as at 31 December 2008. An application to participate must be made within six months of the Act to Develop Financial Market Stability being promulgated and is conditional on various requirements³ being met. There is no legal entitlement to participate; however, neither can enterprises be obliged to participate.

Offloading of problem financial assets to a special purpose vehicle at reduced book value

To offload impaired financial assets, a special purpose vehicle (SPV) is set up, which does not require authorisation to conduct banking business. The problematic financial assets are then transferred to the SPV at the reduced book value. This is the higher of 90% of the book value as stated in the last audited annual accounts⁴ or the real economic value.⁵ The latter must be calculated by the transferring enterprise, and this valuation must be checked by an expert third party nominated by SoFFin and confirmed by the banking supervision authorities. The flat-rate haircut on the book value is subject to the proviso that the transferring enterprise retains a core capital ratio of at least 7%.

The range of impaired financial assets that can be transferred to the SPV includes structured securities.⁶ Plain vanilla loans, for instance, are not included. In addition, the SPV may only take over impaired financial assets that the transferring enterprise acquired prior to 31 December 2008.

number of full years in the term of the guarantee. As compensation payments are limited to a maximum of 20 years, the annual percentage is at least a twentieth of the difference. — ⁹ In the original draft of the Act, problematic assets were to have been transferred to the SPV at book value, with a compensation payment equal to the difference between the book value and the fundamental value to be paid in instalments. The 10% flat-rate haircut on the book value now envisaged in the legislation means that the transfer of assets to an SPV results in an immediate write-down on equity and consequently to a

The German government's "bad bank" model (con'd)

Funding through government-guaranteed debt securities issued by the SPV

The transfer of the impaired financial assets at the reduced book value is financed through the issue of a corresponding volume of interest-paying debt securities by the SPV to the transferring enterprise. The debt securities issued by the SPV are guaranteed by SoFFin in return for remuneration at market rates. This remuneration is based, *inter alia*, on an institution-specific percentage of the maximum guarantee provided to cover default risk plus a margin. The guarantee may not run for longer than the contractual maturity of the longest-dated structured security.

Balance sheet relief for transferring enterprise

From the perspective of the transferring enterprise, exchanging impaired risky financial assets for safe, interest-paying bonds guaranteed by SoFFin gives effective balance sheet relief. These guaranteed bonds may be used as collateral in refinancing transactions within the Eurosystem and may reduce capital requirements as they have a lower risk weight. Both factors should encourage lending.

Repayment of the difference between the reduced book value and the fundamental value over a period of up to 20 years, capped at amount of income distributable to shareholders

To ensure that the SPV does not end up with a loss from today's perspective and therefore that the guarantee does not mean the government has to intervene, the transferring enterprise must pay a compensation sum spread over a specific period. To set the compensation payment, the fundamental value of the paper must first be determined. This is calculated as the real economic value minus a risk haircut.⁷ The dif-

reduction in the bank's lending base. Moreover, the additional haircut to be applied by SoFFin when calculating the fundamental value remains in place. Furthermore, institutions would be subject to greater uncertainty if the European Commission were to monitor not only the legislation and its proper implementation, but also each individual case for compliance with state-aid regulations. — 10 While this payment is deferred, interest-bearing debt securities in the amount of the reduced book value are transferred immediately for the entire term of the guarantee. Consequently, the transferring enterprises re-

ference between the reduced book value and the fundamental value determines the expected loss and therefore the compensation payment, which the transferring enterprise must pay to the SPV in equal annual instalments⁸ spread over the life of the guarantee, although at most 20 years. This annual instalment is capped by the amount that would otherwise be paid out to shareholders in the respective business year.⁹ The interest rate advantage arising from the deferred payment of the difference between the reduced book value and the fundamental value must be remunerated in the form of a market-based fee for SoFFin's guarantee (the guarantee fee).¹⁰ If, in any one business year, the sum to be disbursed to the shareholders is lower than the annual compensation payment to be made to the SPV, the latter will be increased in subsequent years until it reaches the sum to be disbursed to the shareholders.

Transferring enterprises shielded from further risks

The transferring enterprises therefore incur no more risks from the problematic securities once they have been written down to the reduced book value. They are protected against any additional write-downs on the impaired assets and thus from any further deterioration in their solvency situation this could entail.

Old owners continue to participate in all opportunities and, to a large extent, in all risks, government has only a subordinated liability, new investors shielded from risks

To ensure that the government's liability for any losses is, at most, subordinated and that the current providers of risk capital remain responsible to as great an extent as possible for the opportunities and risks arising from the problematic assets, as is appropriate under a market-based regulatory policy (and as would

ceive interest payments on a loss that has yet to be repaid amounting to the difference between the reduced book value and the fundamental value. To prevent this subsidy, the guarantee fee should take due account of this interest-rate advantage. — 11 In this case, the losses exceed the difference between the reduced book value and the fundamental value. — 12 Where transferring enterprises do not operate as public limited companies, SoFFin must stipulate this extended liability in the terms of the guarantee. — 13 A more consist-

be the case if the “bad bank” model were not deployed), both extended liability and extended profit participation are envisaged. This perceptibly eases the valuation problem, as potential errors have only a limited impact on the ultimate distribution of profits and/or losses.

In terms of the distribution of potential profits, the SPV’s profits are, in the event of a positive balance for the SPV after full disposal of the impaired financial assets, to be given to the transferring enterprise for distribution to its shareholders. Consequently, SoFFin would receive compensation for the assumption of the risk of a loss in the form of the guarantee fee, but would not participate in any further profits.

If the compensation payments paid over the term of the guarantee do not cover losses compared to the reduced book value,¹¹ the shareholders in the transferring enterprise must make up the shortfall from the income distributable to them (the dividends) after disposal of the relevant structured securities. Their liability therefore extends beyond the term of the guarantee. This additional loss compensation may also be effected by issuing shares to SoFFin. There is no time bar on SoFFin’s claims.¹² However, risk capital providers’ liability is perceptibly limited under the current plans in that the final disposal of the structured paper and thus the final calculation of losses are, in some cases, far off in the future, and any dividends paid out in the meantime are not included in the liability.¹³

In order to render the transferring enterprises attractive for new capital and shield this new capital from the risks associated with the problematic securities, preferential shares can be issued (which may also have voting rights).¹⁴ Unlike the stock of other shareholders, these are given preferential treatment over SoFFin’s claims in the event of extended liability. The

ent implementation of subordinated liability on the part of the government as part of the “bad bank” model could, for instance, be to have all dividends (with the exception of those paid to new preferential shareholders) flow into the SPV and to issue the shareholders with tradable participation certificates on the SPV’s profits in return. That would indeed mean that all opportunities and risks remain with the current risk capital providers. The tradable participation certificates would allow the anticipated profits (including the dividends

transferring enterprise is therefore attractive for new investors, as they are not burdened with incalculable risks from problematic assets (although they do not benefit from potential profits from the realisation of the problematic assets either). It should, however, be ensured that the preferential shareholders’ claims on distributable profits are no greater than their percentage share in the equity capital to prevent the government’s claim to senior liability of the current equity capital from being diluted.

All in all, the government consequently does not benefit from potential profits from the realisation of problematic assets, but at the same time only has subordinated liability after the risk capital providers. Nevertheless, it does assume the risk that future dividends will not cover losses (and the interest payments incurred thereafter).¹⁵ This should constitute the government’s only contribution to stabilisation. Assumption of this risk is inevitable if the government wishes to rule out the possibility of a systemic bank becoming insolvent and if providers of debt capital and future providers of equity capital are to be shielded from risk. Nevertheless, it must be ensured that the old owners cannot escape their liability by carrying out dividend payments, capital reductions or the like ahead of the liability event.¹⁶

However, by taking part in the “bad bank” model, the current shareholders continue to participate in the opportunities and risks of the relevant financial securities – just as they would if the securities were to remain with the transferring enterprise. Credit institutions are shielded from future risks arising from problematic securities by participating in the “bad bank” scheme, rendering them attractive for new investors. This may mitigate the uncertainty in the financial markets.

“saved up” in the SPV) to be realised at any time. — **14** Up to a maximum of 50% of the equity capital as at the day the Act enters into force. — **15** In other words (to simplify), if the present value of the losses incurred on problematic securities exceeds the present value of the current equity capital of the transferring enterprise. — **16** If the accruing loss looks likely to exceed the return on capital (dividends), measures should be put in place to prevent the transferring enterprise from attempting to compensate for this by incurring large risks.