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Book Part — Published Version

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Suggested Citation: Snower, Dennis J. (2009) : Redistribution through the Geithner Plan, In: Klodt, Henning Lehment, Harmen (Ed.): The crisis and beyond, Kiel Institute for the World Economy, Kiel, pp. 19-23

This Version is available at:

<https://hdl.handle.net/10419/32968>

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Redistribution Through the Geithner Plan

Dennis Snower

Abstract

Appropriate policies to address the problem of toxic assets should act as automatic stabilizers, so that institutions whose toxic assets turn out to be worthless receive more public support than institutions whose toxic assets have value. Furthermore, such policies should be frugal in their demands on the taxpayer. In the context of a simple illustrative toxic asset, the paper shows that the Geithner Plan fulfills neither of these desiderata. The plan is extremely wasteful when banks need only modest bailouts; when they need large bailouts, the plan is ineffective.

Under the threat of the present economic crisis, U.S. financial institutions have received huge bailouts and guarantees. This support is leading to large increases in the national debt, which will need to be financed through taxes in the future. In the process, a massive redistribution of income is under way (Sachs 2009).

The public is vaguely aware of this redistribution and is angry about it. Why, people are asking, are we giving such generous payouts to the financiers who got us into this mess? How large might this redistribution turn out to be? Is this redistribution necessary to restore the financial industry to health?

These questions are tough to answer since the banks' toxic assets, along with the resulting bailouts and guarantees, are fiendishly complicated and intransparent. Not surprisingly, strategies that are complicated and misguided receive far less public scrutiny than those that are uncomplicated and misguided. This is one reason why the financial crisis was permitted to occur: the financial instruments were too complicated for their buyers and sellers, or regulators, to understand what was being bought or sold. By the same token, the complexity of Geithner Plan also contributes greatly to its chances of political success, for now most voters don't understand the terms of the bailout. (This, I will argue, is the strongest point in its favor.)

To grasp what is going on, let's start with a simple question: What sort of policy do we need when the underlying problem is bailing out financial institutions with toxic assets? The distinguishing feature of toxic assets is that we don't know how to value them. This lack of knowledge is what makes them "toxic." This means that we don't know in advance how large a bailout the institutions with toxic assets will need to enable them to survive.

To deal with this sort of a problem, needless to say, we need a policy that acts as an "automatic stabilizer:" institutions whose toxic assets turn out to be worthless will need larger bailouts than institutions whose toxic assets turn out to be valuable. Take an analogy. We don't know the external temperature will be when we install a heating system in our house. And we don't need to know, provided that we have a thermostat, so that the internal temperature adjusts automatically to whatever the external temperature happens to be.

Along the same lines, we now need a financial rescue package that automatically adjusts to the problem at hand.

The Geithner Plan pretends to be an automatic stabilizer. The official line, after all, is that the plan permits the free market system to price the toxic assets, and thereby enables the government to provide the appropriate amount of bailout. As we will see in a moment, the truth looks different. The Geithner Plan is more like a thermostat that is stuck at one temperature, so that we might freeze in the winter, but boil in the summer. Specifically, I will show that the plan can be fabulously wasteful when the banks need only modest bailouts. Then far too much money may be redistributed from the taxpayer to the financial sector. And when the banks need big bailouts, the plan may turn out to be completely ineffective. In short, this is precisely the sort of policy we want to avoid when we are faced with toxic assets.

A Frightening Scenario

To see why this is so, let's take a simple example (for more, see Krugman 2009, Stiglitz 2009, and Young 2009). Consider an asset that has a 50 per cent chance of being worth \$ 100 and a 50 per cent chance of being worthless. So the asset's value is \$ 50, the average of \$ 100 and \$ 0. (I leave you to add enough zeros to each dollar figure so that the example looks realistic to you.) Suppose that the asset is toxic, which means that we don't yet know how to value it, since we aren't yet aware that the asset has a 50–50 chance of yielding \$ 100 or \$ 0.

Now let's work out how U.S. Treasury Secretary Geithner's plan would deal with this asset, and how much income would be redistributed in the process. Although arithmetic is boring, I assure you that the outcome of our calculations won't be. Because they will show that there is something fundamentally wrong with the Geithner Plan: It generates a potentially gigantic amount of redistribution and, furthermore, the redistribution is completely unnecessary, since it is completely irrelevant to the job of bailing out the banks.

To keep my explanation simple, I will assume, in agreement with the Geithner Plan, that the right way to deal with the financial institutions that are too large to fail is to bail them out with taxpayers' money. Then all I will ask with whether the plan gives them the bailouts they need. (As a matter of fact, however, I think this assumption is wrong. In my opinion, (i) the burden of bailout out these institutions should be shared among the taxpayer, the bondholders and the stockholders of these institutions and (ii) the appropriate instrument to bring such sharing about are debt-for-equity swaps. They, incidentally, could be made to work as an automatic stabilizer, but that is a different story.)

Since the asset is toxic, its current valuation is inevitably somewhat arbitrary. So suppose that the bank currently values the asset at \$ 55 – which is \$ 5 more than the asset is actually worth – and if the bank were to receive \$ 55, it would return to financial health. Moreover, suppose that a private-sector bidder indeed offers \$ 55.

Under the Geithner plan, the government finances 92 per cent of the asset, the private bidder finances the remaining 8 per cent, and the private bidder and government each receive the same amount of equity. If the asset costs \$ 55, then the private bidder contributes

\$ 4.4 in equity (8 per cent of \$ 55). The government also contributes \$ 4.4 in equity. So the government loan is \$ 46.2 (which is \$ 55 minus the \$ 4.4 private equity, minus the \$ 4.4 government equity).

Recall that the asset has a 50 per cent chance of being worth \$ 100. If that happens, then the government loan can be repaid. The remaining profit is \$ 53.8 (which is \$ 100 minus the loan of \$ 46.2). Since the private bidder and government have the same amount of equity, this profit gets shared equally between them. So each gets \$ 26.9 (half of \$ 53.8). The private bidder's yield is \$ 22.5 (which is \$ 26.9 minus the \$ 4.4 that the private bidder paid for the asset).

The asset also has a 50 per cent chance of being worth \$ 0, and if that happens, then the government loan can't be repaid. So the private sector loses \$ 4.4 (its equity stake) and government loses \$ 50.6 (its loan of \$ 46.2 plus its equity stake of \$ 4.4).

Let's take stock. On average, the private sector's gain is \$ 9.05 (which is the average of its \$ 22.5 gain in good times and the \$ 4.4 loss in bad times). So the private bidder winds up with the fabulous rate of return of 205.68 per cent (namely, its \$ 22.5 average gain relative to its initial investment of \$ 4.4)!

But the government, on average, makes a loss of \$ 14.05 (which is its \$ 22.5 gain in good times and its \$ 50.6 loss in bad times). This means that the government is left with a horrifying rate of return of -319.32 per cent (namely, its average loss of \$ 14.05 relative to its initial investment of \$ 4.4)!

Observe that the government's average loss (\$ 14.05) is higher than the private sector's average gain (\$ 9.05): the government and private sector together make a loss of \$ 5. This is the amount they overpaid for the asset.

It's now easy to see what redistribution has taken place:

- \$ 5 gets redistributed from the private bidder to the bank (since the bidder paid \$ 55 for an asset worth \$ 50) and
- \$ 9.05 gets redistributed from the taxpayer to the private bidder.

The really sad thing is that only the first payment is necessary if we wish to return the bank to health through a bailout. But under the Geithner plan, the taxpayer winds up paying \$ 14.05. That is 181 per cent more than was needed to save the bank!

But that, unfortunately, is not the end of the story. Since the private-sector bidder made a rate of return of 205.68 per cent on his equity investment, the other bidders may be expected to bid up the price of the asset. The following table shows what will happen:

Price Offer	Average Private-Sector Gain	Average Government Gain	Private Rate of Return (per cent)	Government Rate of Return (per cent)	Excess Redistribution (per cent)
55	9.05	-14.05	205.68	-319.32	181
60	7.6	-17.6	158.33	-366.67	252
65	6.15	-21.15	118.27	-406.74	323
70	4.7	-24.7	83.93	-441.07	394
75	3.25	-28.25	54.17	-470.83	465
80	1.8	-31.8	28.13	-496.88	536
85	0.35	-35.35	5.15	-519.85	607

As the price of the asset is bid up (from \$ 55 to \$ 60 to \$ 70), the private-sector rate of return gradually falls (from \$ 205.68 to \$ 158.33 to \$ 118.27 ...). Eventually, once the offer price has reached \$ 85, this rate of return has declined to 5.15 per cent. At this point, there is little to be gained from bidding the price up further and so the price of the asset may be expected stabilize at around \$ 85.

At this price, as you can see, the government's rate of return is an eye-popping -519.85 per cent. Now the redistribution scheme is this:

- \$ 35 gets redistributed from the taxpayer to the bankers (since \$ 85 was paid for an asset worth \$ 50) and
- \$ 0.35 gets redistributed from the taxpayer to the private-sector bidder.

But since the bank just needed \$ 5 to be restored to health, the taxpayer is paying in excess of 600 per cent more than is required.

Other Frightening Scenarios

The exercise above is just one of many possible frightening possibilities. So far our calculations were based on the premise that only \$ 5 – the equivalent of 10 per cent of the true value of the bank's toxic assets – is required to save the bank. But suppose that more money were required, say 20 per cent or more of the value of the toxic assets. How would the Geithner Plan perform then?

The next table shows the amounts of excess redistribution corresponding to different amounts of bailout.

		Excess Redistribution for Different Bailouts						
		5	10	15	20	25	30	35
55	181							
60	252	76.00						
65	323	111.50	41.00					
70	394	147.00	64.67	23.50				
75	465	182.50	88.33	41.25	13.00			
80	536	218.00	112.00	59.00	27.20	6.00		
85	607	253.50	135.67	76.75	41.40	17.83	1.00	

The numbers in the first row are the size of the bailout. So if a bailout of \$ 10 is required (which is 20 per cent of the true value of the toxic asset), then the bank will accept at least \$ 60 for the asset and thus the excess redistribution is 76 per cent. But, as we saw in the previous table, the private rate of return is high and so the price of the asset will get bid up to \$ 85, corresponding to excess redistribution of about 135 per cent.

In this way, the table shows clearly that as the size of the required bailout rises, so the amount of excess redistribution falls. If it should turn out – by coincidence – that the required size of the bailout (\$ 35) is about equal to the amount by which the Geithner Plan induces the private bidders to overpay for the asset ($\$ 85 - \$ 50 = \$ 35$), then there will be virtually no excess redistribution. But this, as noted, could only happen by accident.

But what happens if even an overpayment of \$ 35 – corresponding to 70 per cent of the true value of the toxic asset – is insufficient to return the bank to health? Specifically, suppose that \$ 40 (amounting to 80 per cent of the value of the toxic asset) is required. What then? The first table gives the answer. At \$ 40 overpayment, the asset must be valued at \$ 90, and then the private rate of return would be about –15 per cent, that is, the private bidders would be making a loss. So clearly no private bidders would be willing to offer \$ 90. This means that the Geithner Plan would not work, since the banks would require an overpayment in excess of what the bidders would be willing to offer. There would be no takers, and the government's offered loan would remain unused. Then, in the absence of any further rescue package, the bank would have to default.

What is the upshot of this woeful portfolio of frightening scenarios? Which one is likely to apply? The answer is as simple as it is important: *We don't know*. It's the essence of a toxic asset that we don't know. If we knew what the asset was worth, it wouldn't be toxic. If we knew how large a bailout each financial institutions needs, the policy response would hardly be a challenge.

It is for this reason that we need a rescue plan that acts as an automatic stabilizer, providing large bailouts to those institutions toxic assets turn out to be worth little and smaller bailouts to those whose toxic assets are worth more. But that is precisely what the Geithner Plan doesn't do. As the exercise above show, far too much money is transferred from the taxpayer to the banks when these banks need only modest bailouts, whereas none might be transferred when they need large bailouts. Only through a massive coincidence could it happen that the plan transfers the right amount of equity to the banks.

In short, this is a hopeless plan. Of course, it's true that some of the redistributed money will probably make its way back to the taxpayer through pension funds, mutual funds, and other institutions that invest in the financial sector. But is this redistribution sensible? Do we want to take potentially huge amounts of money from the taxpayer and give them to the financiers, just as the economy slides deeper and deeper into recession? Do we want to rely on a policy that we know will become ineffective as soon as the banks are in really big trouble?

I find it hard to believe that the American public would have accepted the Geithner plan, if these possibilities had been presented to them. No, I think that the main appeal of the plan lies in its complexity, enabling voters to retain the hope – for the time being – that the banks will get the funds they need through the capitalist system, free of government control.

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The German Bad Bank Scheme

Harmen Lehment

Abstract

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.

Elements of the Scheme

In July 2009, the German parliament passed a law for establishing so-called “Bad Banks” (Deutscher Bundestag 2009). The law 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, 2009.¹
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.²

¹ As an alternative to the establishment of a special purpose vehicle, banks may establish a so-called “Abwicklungsanstalt” to which they can transfer not only structured assets, but also other risk positions and activities (see SoFFin 2009 for details).

² The annual compensation, however, may 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.

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.³

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 elements 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 to 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.⁴ 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 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.⁵

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

³ Several details of the scheme are left open, e.g. the determination of the interest rates on the guaranteed securities, and the payment of interest on potential deficits of the SPV which are financed by SoFFin (van Suntum 2009).

⁴ 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.

⁵ Moreover, according to the law, banks can transfer assets at more than 90 per cent of the book value on March 31, 2009, if book values have been adjusted downward by the banks during the period July 2008 – March 2009 (see SoFFin 2009 for details).

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 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 depreciations 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.⁶ “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.⁷ 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.

⁶ “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.

⁷ In the standard case the guarantee fee amounts to an annual 7 per cent rate on the difference between the transfer value and the fundamental value (SoFFin 2009).

Loophole to Escape Basle Rules

In this context it is remarkable that the head of the German banking supervisory institution (BaFin) 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. With a total amount of about 200 bill euro that has been mentioned as the potential volume of structured assets in Germany (FAZ 2009), required capital could rise by several billion Euro. 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.⁸

Establishing SPVs to circumvent the Basle rules is, however, 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. The creation of an SPV-loophole to avoid the additional capital requirements of a lower rating 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

⁸ 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.

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 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.⁹

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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