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Retrieved Tuesday 11th of July 2017 07:41:51 PM

Bad Banks and Naughty Secrets

Written on July 11, 2017 by *Simone Wapler* | *Central Banks*, *Simone Wapler*

Finance ministers from EU countries meet to discuss Bad banks *And find a solution to technically bankrupt banks.*

The so-called Eurofin group is now examining the case of many banks in Greece, Italy, Spain and Germany which are practically insolvent. Agency Fitch has loudly sounded the alarm on this subject; Equity does not cover provisions for impaired loans that should be made. We are talking about € 1,092 billion at the end of 2016

These banks survive only because their state supports them and the ECB turns a blind eye to their books of account. For the Italian banking system, € 200 billion to € 360 billion is at stake.

Among the solutions mentioned by Eurofin, the *Bad banks* Which we are likely to hear more and more.

It is surprising that this *Bad banks* Or - in policious and technocratic French - "defeasance structures".

These are companies that take back non-performing loans from banks either to manage them "in extinction" or to resell them to others, usually specialized funds, sometimes called "vulture funds".

Why not rather put these assets into losses once and for all and no longer talk about them? Why do you want to *Bad banks*?

The lemons market and information asymmetry

The distressed lending market is a market with a high degree of "information asymmetry". The buyer has much less information than the seller who is very reluctant to give them. Obtaining the information represents a cost to the potential buyer.

This is what the Anglo-Saxons call a "market of *lemons*" According to the pictorial expression of the economist George Akerlof *. The *lemons* Used cars. In this type of market, the introduction of a guarantee by the seller or an intermediary assuming costs to collect and certify information can restore confidence to the buyer.

The role of *Bad bank* Can therefore be compared to that of the mechanic who takes back a second-hand car and returns it to the market with a guarantee.

Obviously, in the case of loans, the situation is a little more complicated. If the loans are "non-performing" it is because the borrower is in trouble. National legislation on debt collection plays a very important role.

The other strategy is securitization - which suffers from the same disadvantage of opacity. Without going into details, the ECB would like to develop a standard of information on each loan available to all market participants.

So to sum up and retaining the analogy with the automobile, the *Bad bank* (Or securitization) makes it possible to avoid putting all cars to scrap and to return to the market the healthiest.

Germany is also on the hot seat in this case. Bremer Landesbank and HSH Nordbank are in extreme difficulty. Wolfgang Schauble therefore looked with a benign (and interested) eye on the recent Italian rescue.

Eurofin is discussing the possibility that national bad banks can take non-performing loans back to an "economic value" and not to a "market value". This makes it possible to clean up the balance sheets without the banks having to recognize too heavy losses and to dismiss the vultures funds.

In short, the*Bad banks*Will overpay the portfolios of doubtful debts ...

As you can see, dear reader, the strategy "*Extend %26 pretend*- which is to pretend that the breakage is limited - still has good days a. As for the guarantee, it is not the*Bad bank*(The mechanic) who brings it but the taxpayers.

The Market for "Lemons": Quality Uncertainty and the Maket Mechanism, Published in 1970 in the*Quarterly Journal of Economics*