

Banking: visibility needed

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Wiped clean? A Dusseldorf branch of the only regional German lender to funnel loans into a 'bad bank'. Berlin injected €3bn into WestLB but that is at risk if the bank is split up as proposed

Angela Merkel was firm with her audience of **German bankers**: taxpayers must never again be asked to fund a bail-out. "Market economy rules also apply to financial institutions," the chancellor told them in Berlin last week. "Banks, like everyone else, have to show responsibility."

As the financial crisis spread in 2008, Germany offered up to €500bn (\$710bn) in liquidity guarantees and capital to its teetering institutions. But has the money offered brought an increase in their ability to withstand future crises? Speaking a week earlier in Frankfurt, Ms Merkel admitted that the banks had "still not comprehensively proved their competitiveness".

It would be unthinkable for her to say the same of her country's thriving carmakers or machine tool manufacturers. But while the stock of German industry has rarely been higher, its banks remain the Achilles' heel of Europe's largest economy and – thanks to their cross-border exposure – a big obstacle to cleaning up the eurozone's financial and fiscal crisis.

"The German economy has a remarkable asymmetry. On the one hand, many companies that are ... world leaders. On the other side, only one globally successful German bank," says Josef Ackermann in a reference to Deutsche Bank, the country's biggest banking group, which he heads – and which the chancellor exempted from her criticism.

The **€24bn in extra capital requirements** revealed last week at Irish banks, and the latest pressure on Portugal's borrowing costs, emphasise how a round of sovereign defaults and European bank failures would have dismal consequences for German banks. They are among the biggest holders of eurozone sovereign debt – with €46.5bn of bonds from the governments of Greece, Ireland, Portugal and Spain combined, according to the **most recent data** from the Bundesbank, the country's central bank. The banks have another €91bn of exposure to those countries' banking sectors.

German banks also have an unusual reliance on hybrid capital: the oddly named "silent participations" (*stille Einlagen*), which global regulators will no longer consider as up to scratch. If the London-based European Banking Authority does decide to disqualify much of this capital from imminent stress tests that it is to conduct, the result promises to be damning for some German banks, which are fighting any such plan.

Just as problematically, Germany has made little progress on a task that should have been a consequence of the financial crisis: to massage viable banks quickly back to life while taking failing institutions from the market. None of the four banks that received a direct injection of federal capital is yet free of it. Of some €30bn provided, only a tiny fraction has been repaid, although Commerzbank was expected on Wednesday to announce plans to repay some of its €18.2bn of government capital. Another €40bn of liquidity guarantees remain in use. Only two took advantage of a window to offload toxic assets into "bad banks" last year.

Critics say Germany is allowing lame institutions to stagger along, wagering that time will either restore the eurozone to balance or at least allow banks to avert collapse. "We have not seen so far that Germany really wants to get the banking system back on a sound track through adequate triage or restructuring," says Nicolas Verón of the Bruegel think-tank in Brussels.

Altogether, €7,600bn of German banking assets are supported by less than €350bn of equity and reserves,

according to DIW, a Berlin think-tank. Franz-Christof Zeitler, deputy president of the Bundesbank, on Tuesday confirmed a November estimate that the sector needed an extra €50bn in core tier one capital by 2018 to meet forthcoming international regulations known as Basel III. "At the moment there is nothing to suggest the new quotas cannot be met," he added.

German officials often perceive a hostile "Anglo-Saxon" strain in criticism. Many individual institutions – from Deutsche to small savings banks and mutual lenders – survived the crisis well. The government is confident that a tougher regulatory environment will strengthen the system and that stricter requirements of Basel III will bring owners of troubled banks – the regionally owned Landesbanken in particular – to sell, consolidate or pump in more capital. Pressure from European Union competition authorities on banks that received state aid may also help to revamp the sector.

"The German banking market is better than its reputation in some foreign countries," says Steffen Kampeter, a deputy finance minister. "There may be a need for capital in some cases, for example. But I think we're moving in the right direction on those issues. Remember that we don't feel that the state needs to intervene everywhere. We believe much can and should indeed come from normal market processes."

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What Berlin has done is to develop one of Europe's first **bank restructuring acts**, approved in recent months along lines proposed for all of Europe by the European Commission. The law is intended to create the conditions for failing banks to be reorganised without spooking markets, "bailing in" creditors by enforcing debt-to-equity swaps if needed, and winding down the businesses.

Ralph Brinkhaus, an MP from Ms Merkel's Christian Democrats, says: "We've created a mechanism which will allow us to take banks that fail from the market as smoothly as possible. That's a big advantage today over 2008 and 2009."

Yet normal market processes are what many critics believe are most lacking in Germany's banking system, which is thick with public sector institutions. The main problem are the Landesbanken, which lack stable funding streams such as retail deposits, and which tried to compensate for low profits with a sally into the structured securities that turned out to be at the heart of the financial crisis.

Berlin is prodding one bank, **WestLB** – which over two decades has gone from international rival to Deutsche to byword for German banking mishaps – towards a break-up and partial market exit. But Joaquín Almunia, EU competition commissioner, has lambasted the **lack of a comprehensive action plan**, while the government has not engineered a consensus for reform of WestLB's peers.

The other set of banks badly hit were property and public sector lenders such as Hypo Real Estate and Eurohypo, a **Commerzbank** offshoot: they were big financiers of foreign property and eurozone debt. Daniel Zimmer of the University of Bonn – who headed a commission convened by the government to examine its bank "exit strategy" – says: "Particularly in property finance and public sector finance, you have too much capital and too much competition. Of course competition is desirable but here it is a structural problem."

In the case of HRE, which has been nationalised, Ms Merkel's government has signalled it will ignore the advice of Prof Zimmer's group, which suggested winding down the property lender, and work towards a reprivatisation. Carsten Schneider, budget spokesman from the opposition Social Democrats, says: "Chances have not been taken simply to take some banks out of the market."

Germany's financial strength and credibility with investors has allowed a wait-and-see approach. With Berlin behind them, banks have had better access to liquidity than Ireland's banks, which are backed by a much more fiscally stretched government. Spain has also begun the reform of its caja public savings banks after pressure from financial markets.

But it is equally clear that Berlin is praying its financial support is repaid so it avoids a loss for taxpayers. The €3bn of capital put into WestLB is at risk if the bank is largely split up. Alexander Bonde, the Green party's budget spokesman in parliament, says: "There is still billions of euros of risk for taxpayers bound up with the state's support for banks."

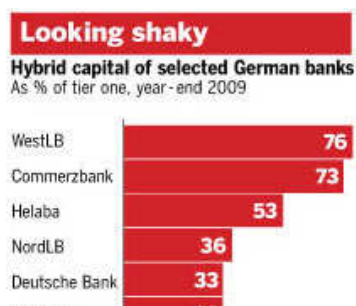
The government has also taken €250bn of assets spun off by HRE and WestLB into "bad banks" on the government's balance sheet. Mr Schneider says: "We are still probably going to need 20 or 30 years, and have to absorb €20bn or €30bn of losses, to wind down the bad banks."

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The crisis has brought a **degree of change**, with Dresdner Bank, Postbank and SachsenLB taken over. Among Landesbanken, risk-weighted assets have fallen by one-third since mid-2008. Tier one ratios have improved.

However, even with some assets parked in bad banks, there are huge remaining risks from lending. The banks have €2,240bn in foreign exposure, according to the Bundesbank, including some €895bn to eurozone states, of which €136bn is to Spain – illustrating why Madrid is "too big to fail". Commercial property loans are another concern. The Bundesbank's latest estimate is that banks have €325bn of such loans – more than three times their tier one capital.

Moreover, while ratios may be improving, they still include substantial slugs of hybrid capital. Some will be ineligible as core tier one when Basel III comes into force, although some public sector bankers are confident that hybrid instruments can be tweaked to meet the new criteria.



European leaders have said banks failing the stress tests will receive more capital, though how this would happen in Germany is unclear. Critics say more state exits would help to create a sounder system. But as Mr Verón says: "Banking reform in Germany, more than in any other European country, is inseparable from the political discussion. It makes everything much more intractable."

One push may come from Brussels. WestLB's mooted break-up – reducing it to a rump service provider for savings banks – would cut its ties to the North Rhine-Westphalia government, a significant break. Prof Zimmer says: "This should be a signal for other regional governments that this period of 30 or 40 years during which they were big participants in the banking system has come to an end."

Brussels is also set to issue verdicts in the coming months on what BayernLB, HSH Nordbank and HRE must do to compensate for their receipt of state help. Their owners want to privatise them but the chances of doing so soon are slim, even though all three are back in profit.

While federal and regional governments mull their options – and Ms Merkel lauds the restructuring law as a guarantee that failing banks will not be propped up by taxpayers – Prof Zimmer fears a longer-term risk: that Berlin's continued role will increase the distortions that have caused so many problems in the first place.

"If the government tries to wait until ... the banks where it is invested [are] fit and healthy, there is a danger that they will give an advantage to those banks for several more years. It will simply perpetuate competition problems, weaken and marginalise competitors, and risk causing more failures further down the line," he says. "I think the government has a strategy to deal with the banks – but it is a strategy that is based very much on hope."

Savings banks

'It will take imagination and political will to overcome these hurdles'

In the soap opera that is German banking, the savings banks or **Sparkassen** are like the friendly neighbour who has a skeleton tucked away in the wardrobe.

According to the slogan of the association binding the 430 locally owned banks into a network with 250,000 employees, assets of almost €1,100bn (\$1,400bn) and pre-tax profits of €4.5bn last year, the Sparkassen are "Good for Germany".

They trade on customer relationships and concern for their districts, where they provide substantial backing for sports and the arts. For supporters, their bread-and-butter lending and deposit-taking make them a model of responsible, reliable banking.

Savings banks "were very important in financing the German recovery with their loans", says **Steffen Kampeter**, deputy finance minister. "We never experienced the credit crunch that some people feared we'd get."

A more doubtful picture emerges when one considers their relationships to the Landesbanken, the other main group of public sector banks and Germany's most troubled institutions. Historically, savings banks have owned about half of the Landesbanken alongside regional governments, using them as central banks for services they were too small to support themselves.

Post crisis, the **Landesbanken model** of funding themselves by borrowing cheaply on capital markets and lending at competitive rates looks broken. They would love access to retail deposits as a source of funds. But, aside from a few isolated cases, they have been kept away from this by the savings banks.

Savings banks are "taking responsibility" for events at many Landesbanken, says Heinrich Haasis, president of DGSV, the savings banks association – whether by injecting capital or shouldering risks.

A recent policy paper from Frankfurt's Goethe university, co-authored by two former Landesbank chief executives, puts it differently. The writers say: "The savings banks seem to be intent on losing no time in retreating from all responsibility for financial burdens associated with their commitment as owners and creditors vis a vis Landesbanken."

Aside from the problem of exposure to Landesbanken, the report says savings banks are too reliant on trying to boost margins by using cheaper short-term funds to finance long-term lending – a claim rejected by Mr Haasis – and face growing competition from the likes of Deutsche Bank and from foreign competitors.

The solution, the authors say, is reform of public-sector banking. They propose moulding Landesbanken and some bigger metropolitan savings banks into regional institutions that offer a wider, and more stable, range of banking activities.

But they admit that "it will take no little imagination and a strong political will to tackle and overcome these hurdles in a structured manner". Loosely translated, that probably means the plan has no chance in a country where many savings banks have close ties to important local politicians.

Mr Haasis sees massive legal obstacles. In addition, he says: "It would totally change the system that has been so stable in the crisis – why should we?"

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