

Germany's path into the financial crisis and resolution activities

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German financial crisis has historic domestic roots

- Sparkassen / Landesbanken system
 - Permanent mandate conflicts, partly failure of vertical integration lead to role of Landesbanken in cross-border banking, global capital markets
 - Governance problems in most institutions due to political interference
 - Seriously undercapitalized by public owners (hence role of silent participations)
- Pfandbrief system
 - Jumbo-Bond success in the 1990s (stimulated also Fannie/Freddie) masked ongoing stability problems
 - 5 de-facto insolvencies between 1995 and 2008: Rheinboden (credit risk), Berliner Hypothekenbank (credit risk), HypoVereinsbank (credit risk), AHBR (interest rate risk), Dusseldorfer Hypo (credit/interest rate risk), Hypo Real Estate (interest rate risk).

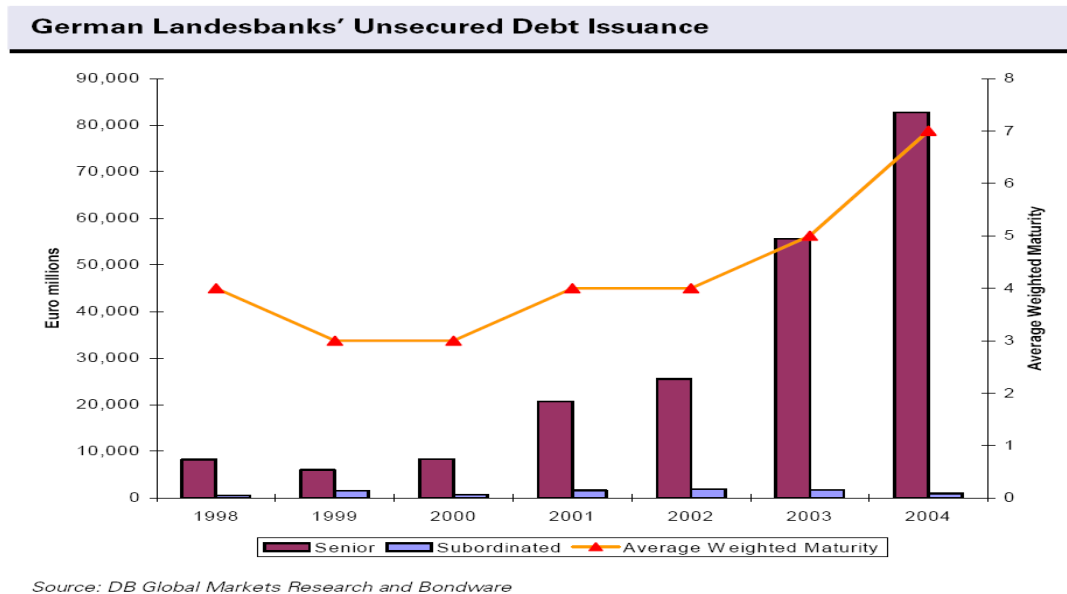
..historic roots

- Private commercial banks
 - In permanent search of valid business model: Deutsche successful, Dresdner unsuccessful (governance)
 - Strong foreign entry and public banking cut down retail margins
→ wholesale, 'successful' means still high risk-taking (Deutsche)
- Regulators
 - Partly successful on the micro level: Depfa left to Dublin because of German tightening (interest rate risk), AHBR insolvency case. But huge outsourcing, understaffing etc.
 - Massive political capture: BAFIN politically gagged by BMF (treasury), Bundesbank is governed by Laender who own the Landesbanken, Landesbanken and many local banks are de-facto no-go areas for supervisors.
 - No broader financial sector strategy, policy dominated by lobbyism, legalism and a canon of unproven self-assurances ('Sparkassen are social', 'Pfandbrief never defaulted', 'stability culture' etc..).

Reverse CARE: the pump-priming of America by Germany

- German current account surplus (07: 7% GDP) flows out mostly via banks. 2 types of portfolio investment: autonomous and 'natural' surplus recycling.
- Autonomous capital exports: key role of Landesbanken in inflating the US price bubble
 - 'Brussels declaration' left 4 years (7/01-7/05) to issue gov-guaranteed bonds and guarantees – lobbyism by key German politicians including Steinbrueck.
 - Landesbanken 'parked' this liquidity on balance sheet, in other banks (via IOUs, sub debt), in off-balance sheet vehicles.
 - One WestLB vehicle alone held 23 billion Euros in US assets. Some figures overleaf.
- Surplus recycling:
 - Examples DZ Bank, Apothekerbank; but such banks issued a lot of non-deposits to be part of the game (Landesbanken as investors?); data picture still unclear.
- SIV/ABCP conduit sponsorship under Basel I arbitrage:
 - All banks with unviable wholesale business strategies (Landesbanken, Dresdner Bank)
 - Some permutations (e.g. IKB, a Mittelstandsbank, investing in global conduit market post KfW-takeover).

Landesbanken issues for gov guaranteed debt parking purposes



01-05 was grandfathering period..

Bundesbank reports some 100 billion extra issuance in term debt 01-05 – likely underestimated (see Deutsche); also ignores guarantees, huge conduit sponsorship.

Note the duration increase, as grandfathering arrangement allowed for maturities up to 2015. → 2004-2000 8 times multiple means in reality some 15 multiple in duration!!

By 08 still some E 440 billion of state-guaranteed debt, duration in the 1-2 trillion range. 5

4 Landesbanken had at least E 400 billion in securitisation & non-strategic exposures

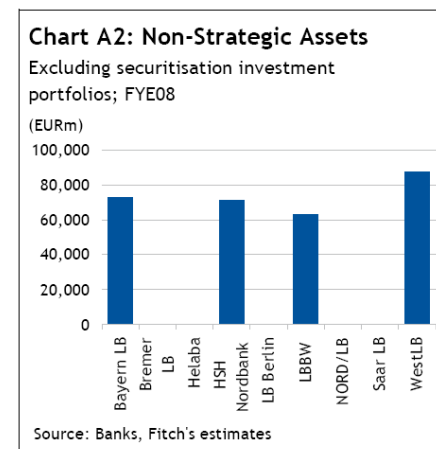
Securitisation exposures of four Landesbanken per 12-07 to 12-08

in million Euros per 07 / 08	Total	RMBS Prime agency	& Non-prime & unspecified	CDO / CLO	CMBS	ABS	Single-name CDS	Other
BayernLB 12/31/07	26,302	8,307	7,832	4,953	3,078	2,133	-	-
LBBW 12/31/2008	29,736		11,456	9,339	3,749	5,192	-	-
WestLB 6/30/2008	29,760	220	3,220	11,620	7,350	3,900		3,450
HSH Nordbank 6/30/2008	29,968		1,312	2,590		9,734	13,994	2,338
TOTAL	115,766	8,527	23,820	28,502	14,177	20,959	13,994	5,788
% of German GDP 2007	4.78%							

Source: Financial stability forum reports (dates varying from 12/07 – 12/08)

Political wall of silence ('Berlin syndrome') → patchy official evidence:

- No details on US ABS exposure, no details on writedowns, stress tests in public (e.g. Bundesbank, BIS, IMF).
- Semi-official BAFIN figure for entire German system: 850 billion dubious assets, of which 230 billion toxic, no further breakdowns are given.
- FSF submissions suggest >> E 120 billion exposure by top 4 Landesbanken eo 07, see table, as of eo 08 down to ~ E 80 billion due to write-offs (esp. Bayern), sales.
- Fitch reports other non-strategic assets for the same 4 banks of some E 290 billion per eo 08, see chart.
- Minimal Landesbanken recaps (except Bayern), but large 'risk shields'. 4 banks ~ 18 billion recaps vs. 35 billion risk shields (Fitch).



E 400 billion = 16.5% of 07 German GDP

German ABCP exposure

<i>Banks by Country</i>			
	<i>Not sponsoring ABCP programs</i>	<i>Sponsoring ABCP programs</i>	<i>Total</i>
Austria	6	0	6
Belgium	2	2	4
Denmark	1	1	2
Finland	2	0	2
France	14	2	16
Germany	15	13	28
Greece	5	0	5
Ireland	4	0	4
Italy	14	2	16
Luxembourg	1	0	1
Netherlands	5	3	8
Norway	1	0	1
Portugal	3	0	3
Spain	6	1	7
Sweden	4	0	4
Switzerland	7	0	7
United Kingdom	4	6	10
United States	29	7	36
Total	123	37	160

Original title of NY Fed PPT:

„Why are almost all ABCP vehicles sponsored by non-U.S. banks?“

Findings:

„European banks (and Citi) set up fixed-income arb hedge funds to invest in U.S. ABS“

Note: analysis excludes US investment banks.

German SIV exposure

Global SIV market (February 2007)

SIV	Manager/Advisor	Date senior debt rated	Senior debt (USD m)	Total assets (USD m)	Growth since Q1 06	Par value of capital	Leverage	Rating of income notes (Moody's/S&P/Fitch)	Date income notes / capital publicly rated
Sigma Finance Corp.	Gordian Knot Ltd.	02-Feb-95	47,789	n/a	10%	n/a	n/a		
Cullinan Finance Ltd. *	HSBC Bank PLC	18-Jul-05	27,819	30,157	223%	1,668	15.2	Baa2 / BBB	27-Apr-2006
K2 Corp.	Dresdner Kleinwort Wasserstein	01-Feb-99	24,000	n/a	27%	n/a	n/a	A	29-Sep-2006
Links Finance Corp.	Bank of Montreal	18-Jun-99	21,496	23,203	39%	1,707	12.0	Aa2/A3	14-Jul-2006
Centauri Corp.	Citibank International PLC	09-Sep-96	21,091	n/a	21%	n/a	n/a	Baa1	17-Mar-2006
Beta Finance Corp.	Citibank International PLC	08-Sep-89	20,415	n/a	17%	n/a	n/a	Baa1	17-Mar-2006
Stanfield Victoria Finance Ltd.	Stanfield Global Strategies LLC	10-Jul-02	12,502	13,477	43%	975	12.7	Baa2 / BBB-	09-May-2005
Harrier Finance Funding Ltd.	Brightwater - WestLB AM (US) LLC	11-Jan-02	12,356	13,226	24%	870	13.4		
Tango Finance Corp.	Rabobank International	05-Dec-02	11,297	n/a	53%	n/a	n/a	Baa1	12-Sep-2006
Dorada Corp.	Citibank International PLC	17-Sep-98	10,441	n/a	4%	n/a	n/a	Baa1	17-Mar-2006
Cheyne Finance PLC	Cheyne / QSR	03-Aug-05	9,512	10,166	74%	654	13.9	Baa2 / A3 - A/BBB	02-Aug-2005
Sedna Finance Corp.	Citibank International PLC	22-Jun-04	9,249	n/a	74%	n/a	n/a	A	21-Sep-2004
Five Finance Corp.	Citibank International PLC	15-Nov-99	8,831	n/a	54%	n/a	n/a	BBB+	05-Jan-2006
Whistlejacket Capital Ltd.	Standard Chartered Bank	24-Jul-02	8,526	9,083	31%	557	14.0	BBB+	11-Dec-2006
White Pine Corp. Ltd.	Standard Chartered Bank	04-Feb-02	7,677	8,178	1%	501	15.0	BBB+	11-Dec-2006
PACE	Société Générale	10-Jul-02	4,214	4,504	51%	290	14.6	Baa2 / BBB-	06-Apr-2006
Kestrel Funding PLC	Brightwater - WestLB AM (US) LLC	02-Aug-06	3,234	3,474	8%	240	12.6	Baa2 / BBB	02-Aug-2006
Carrera Capital Finance	HSH Nordbank Securities S.A.	06-Jun-06	3,118	3,402	n/a	284	11.0	Baa2	06-Jun-2006
Parkland Finance Corp.	Bank of Montreal	07-Sep-01	3,003	3,224	85%	221	12.8		
Orion Finance Corp.	Eiger Capital Management	31-May-96	2,442	2,620	15%	178	13.8	Baa3 / BBB	09-Mar-2006
Zela	Citibank International PLC	13-Oct-06	1,801	n/a	n/a	n/a	n/a		
Vetra Finance	Citibank International PLC	15-Nov-06	1,099	n/a	n/a	n/a	target 18x		
Abacas Investments Ltd.	Bank of New York	08-Dec-99	916	n/a	-6%	n/a	n/a	- / A / A	08-Dec-1999
Hudson-Thames Capital Ltd.	MBIA	05-Dec-06	850	n/a	n/a	n/a	n/a		
Cortland Capital	IXIS Securities North America Inc.	17-Oct-06	n/a	n/a	n/a	n/a	n/a		
SIV Sector Total			273,678	292,835	38%	19,157	14.3		

Note: This is an updated version of the originally published table (*Conduits to SIVs*, 28 March 2007), which was incomplete with some of the ratings missing
Source: HSBC, Moody's, Standard & Poor's, SIVs

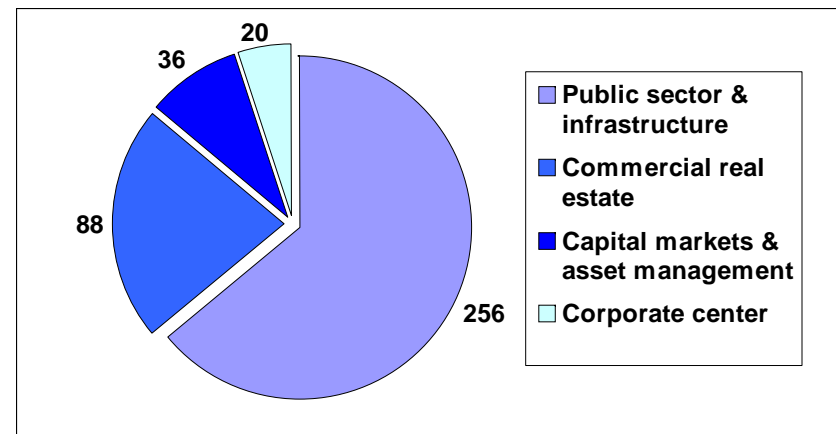
SIV / ABCP managers provided liquidity facilities to investors, which under Basel I were not subject to capital requirements.

However, under agreed Basel II plans they were and German supervisors did not act as long as Basel II was not formally implemented.

HRE-Depfa – failed covered bond issuer

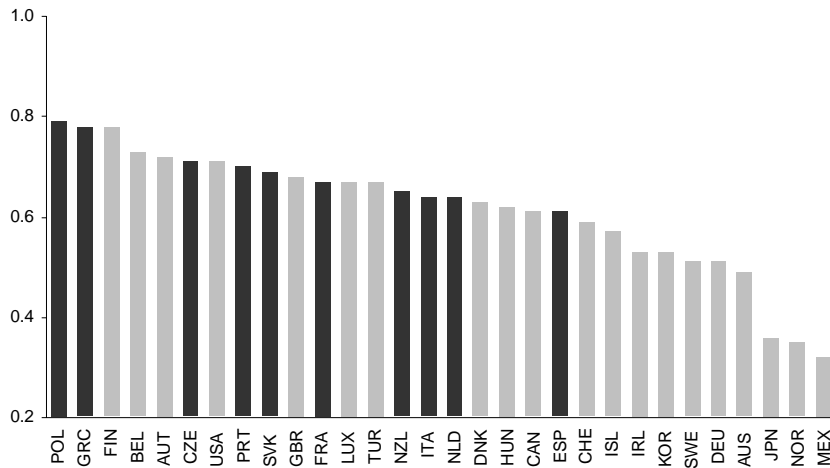
HRE balance sheet per 30.9.08					
Position	Billion Euros	%	%	Billion Euros	Position
Interbank	45.8	11.7%	37.0%	144.5	Covered bonds (secured)
Claims on clients	217.3	55.4%	28.0%	109.4	Repo and central bank (secured)
Financial investments	105.2	26.8%	27.0%	105.5	Unsecured / IOUs
Trading	11.2	2.9%	8.0%	31.2	Reconciliation with balance sheet
Other assets	12.9	3.3%	0.5%	1.9	Capital
Assets	392.5			392.5	Liabilities

- Depfa move to Ireland for regulatory / tax arbitrage reasons → open interest rate positions
- HRE 'bad bank' of HypoVereinsbank, 02-05 massive refocus from German to international markets → credit risk
- Large CMBS, other securitization portfolio → credit risk
- High run risk through ~10-20% nominal overcollateralization of Pfandbrief

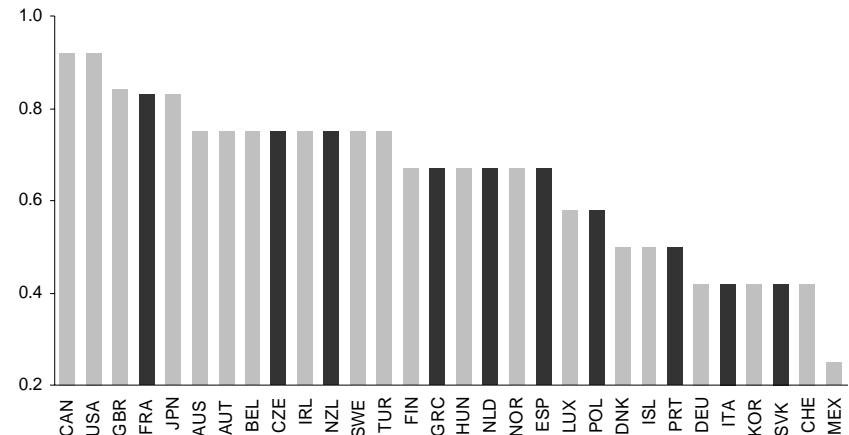


Political and industry capture of German bank supervision

Political dependency index



Industry dependency index



BAFIN extremely politically and industry dependent (e.g. conflicts with FSA over Deutsche Bank)

Transfer to Bundesbank may decrease political dependency somewhat, but risks further deepening of industry dependency (Landesbanken)

When the storm hit the house of cards ..

- Crisis management is a function of political and industry dependency
 - Strong interference into both strategy and specific resolution cases by industry lobby, examples (motivations)
 - Landesbanken (to mask massive waste of taxpayer money)
 - Deutsche (to mask private bank deposit insurance fund insolvency),
 - Allianz (to mask huge risk exposure of insurers in subordinated debt and silent participations)
 - Deutsche de-facto advised finance ministry on SoFFIN setup.
- Results
 - BAFIN was forced to reverse past successful resolution strategies
 - Not a single formal German bank insolvency during crisis (compare to FDIC count).
 - Bankruptcy law was set out of force (agreement even on G20 level)
 - Massive public risk exposure via guarantees and ownership
 - E 400 billion guarantee max by SoFFin, of which ~143 billion used per 7/09 plus 24.5 billion in capital injection; in addition >>18 billion recap by state bank owners and >>35 billion state risk shields

AHBR 06 (pre-crisis)

Cause:

- Misspeculation with interest rate derivatives,
- Excessive size, growth of liabilities due to earlier specialist Pfandbrief issuer mergers

Cure:

- Old stock owners were coerced to provide large old asset guarantees,
- De-facto loss of capital of old stock owners after squeeze-out
- Haircuts imposed on upper tier-2 (Genussscheine) and tier-1 participations (stille Einlagen)
- Pfandbriefe transferred partly to other issuers.
- These restructuring steps taken by BAFIN allowed sale to new private owner (Lone Star).
- During fin crisis additional federal guarantees.

Issues:

- Genussscheine and participation holder lawsuits against BAFIN

IKB 07

Cause:

- Post partial nationalization (KfW, strategic) large on- and off-balance securitisation engagements
- SME lender's balance sheet pumped up by IOU investors (likely including Landesbanken)

Cure:

- Dilution of Tier 1 capital via capital increase by KfW.
- Haircuts imposed on upper tier 2 (Genussscheine) and tier-1 participations (stille Einlagen).
- Public-private old asset guarantee shield – with public guarantee ratio far in excess of public pre-insolvency capital ratio. Private counterpart was the private deposit insurance fund.
- Sale to new owner – as in AHBR case Lone Star.

Issues:

- Bailout of private deposit insurance fund, or bailout of Landesbanken?
- IKB was a third smaller than AHBR, nevertheless BAFIN publicly cited systemic risk fears for the public guarantee operation. This came after federal finance minister Steinbrueck had excluded direct support for Laender re Landesbanken losses.
- Lone Star is accused by competitor to have misled KfW/federal gov on additional bond guarantee needs (E 5 billion).

Landesbanken 07

Cause:

- Parking of publicly guaranteed debt in the wrong corners of the capital markets
- Absent of vertical integration with Sparkassen (apart from Helaba, LBBW)
- Excessive large corporate exposure, adverse selection on international markets

Cure:

- Recapitalizations by states, partial withdrawal of Sparkassen (and private co-owner at HSH) by not participating in recaps
- State protection shields for old assets (asymmetric, Sparkassen exposure capped).
- Tier-1 and tier-2 bondholders (stille Einlagen and Genussscheine) capital-protected, isolated non-payment of interest (HSH, SachsenLB).
- 1 bad bank (WestLB), separate bad bank model in federal bank rescue program (AIDA – Anstalt in der Anstalt or consolidation model)
- SoFFIN guarantees for new bonds issued.

Landesbanken II

Issues:

- Likely large additional write-off needs with some banks (LBBW, HSH Nordbank, WestLB).
 - Savings banks/local governments cannot afford to write down their tier-1 holdings → another capital hole to plug (in NRW alone some E 5 billion)
 - Loss distribution between federal and state level is subject to political power play, as many states cannot fiscally afford full support.
- Instruments of write-off delaying tactics:
 - German bad bank law focus de-facto accounting arbitrage vehicle (20 year-write-offs, from dividends only)
 - Pre-emption of public stress testing, full exposure transparency.
 - 'Rating shopping' to reduce write-down pressure (WestLB & Fitch, BayernLB & S&P).
- Debate about mergers ~ likely some 3-4 Landesbanken to survive (currently 8, up from 7 after SaarLB), specialist business to be privatized (aircraft finance, ship finance)

Commerzbank 08

Cause:

- Takeover of Dresdner Bank with remaining securitisation portfolio risks (despite write-downs taken by Allianz who incurred ca E20 billion loss through its Dresdner engagement)
- Eurohypo with similar investment/funding profile, scale as Hypo Real Estate and large roll-over needs. As AHBR and Hypo Real Estate, Eurohypo was the result of merger of several specialist Pfandbrief issuers.

Cure:

- SoFFIN tier-1 investment (silent participation), moderate dilution of tier-1 stock holders.
- Haircuts imposed on upper tier-2 (Genussscheine) and tier-1 participations (stille Einlagen). Temporary discontinuation of Genussscheine interest payments.
- SoFFIN bond guarantees.

Issues:

- Arguably preferential treatment of tier-1 capital owners by choosing silent participation instrument, e.g. compared to Hypo Real Estate and IKB
- Eurohypo appears like a less publicized version of Hypo Real Estate, is likely the indirect beneficiary of public bond guarantees for Commerz.
- Eurohypo may be a tough sell re liquidity risk, commercial exposure → raises perspective of national Pfandbrief bank (merger with Hypo Real Estate)

Hypo Real Estate 08

Cause:

- @ Depfa: Interest rate risk speculation in the middle of the financial crisis (eo 07 ca 20% of long-term assets funded via money market), Depfa Ireland public sector entity more speculative than German mortgage entity due to regulatory arbitrage.
- @ HRE core: some E5 billion toxic assets, conduit sponsorship & other on-balance sheet investment, legacy issues of HypoVereinsbank in commercial real estate (Unicredit guarantee expiring just at time of insolvency)

Cure:

- Complete nationalization of tier-1 capital base in 3 steps
 - 47.3% 3/09 via authorized capital increase (subsidy of E 60 million via inflated share price)
 - 90% 6/09, 6/09 via ordinary capital increase, possible via change of majority rules in voting for capital increases (1/2 rather than 2/3),
 - 100% 10/09 via squeeze-out
- Public bond guarantees with minimal private deposit insurance fund exposure (E 7.5 billion against 102 billion support).

HRE II

Issues:

- Failure of supervisors to act on a simple open position problem, BAFIN as of 09 still maintaining the IR risk is core business for banks (??)
- No willingness to test Pfandbrief law due to CRE legacy problems
- Massive exposure esp. of Bavarian finance and public sector community in IOUs (Unicredit, BayernLB > E 2 billion each) → huge political pressure post BayernLB bailout.
- Deutsche Bank and Commerzbank as key sponsors of private deposit insurance system unwilling to foot bill for domestic key competitors.
- Result: “Bigger-than-Lehman” fearmongering; however limited systemic risk if private deposit insurance fund would have taken over (likely resulting in cash to bond guarantee swap).

Summary – who pays (so far)?

Status as of 10_09

Technical insolvency date	2006	2007		2008			
Case	AHBR	IKB	Landesbanken	Dresdner	Commerzbank	Duesseldorfer Hyp	HRE
Total assets eo 07*	75 (06)	50	1600***	500	616	27	400
Impaired asset ratio	Moderate	High	High	High	Moderate	Low	Moderate
Write-offs / impairment	High	High	Low	Moderate	Moderate	Moderate	High
OLD CAPITAL							
Senior secured	Unimpaired	n.a.	Unimpaired	n.a.	Unimpaired	Unimpaired	Unimpaired
Pfandbriefe							
Senior unsecured	Unimpaired	Unimpaired	Unimpaired	Unimpaired	Unimpaired	Unimpaired	Unimpaired
Ungesicherte Schuldverschreibungen							
Lower tier 2	Unimpaired	Unimpaired	Unimpaired	Unimpaired	Unimpaired	Unimpaired	Unimpaired
Nachrangkapital							
Upper tier 2	Reduced capital	Reduced capital	Partially no interest	Reduced capital	Unimpaired	40% reduced capital	2/3 reduced capital
Genussscheine	No interest	No interest	(HSH, Sachsen)	No interest		No interest	No interest
Participations/preferred stock	Reduced capital	Reduced capital	Unimpaired	Reduced capital	Unimpaired	n.a.	n.a.
Stille Einlagen/Vorzugsaktien							
Common shareholder fds	Squeeze out,	Highly	Highly	Stock swap	Moderately	"temporary" transfer	Squeeze out,
Aktienkapital, Reserven	almost wiped out	diluted	diluted	ca 2/3 loss	diluted	to private DIF	almost wiped out
NEW CAPITAL							
Recaps	New private shareh	New private shareh	States	Old private shareh	Federal gov	Private DIF	Federal gov
Rekapitalisierungen				New private shareh	(participation)		(common shares)
Old asset guarantees	Old private shareh	Federal gov	States/Sparkassen	Old private shareh	n.a.	n.a.	n.a.
Abschirmungen		some private DIF**	(1 bad bank)				
New bond guarantees	n.a.	Federal gov	Federal gov	n.a.	Federal gov	Private DIF	Federal gov &
Garantien f. neue Schuldverschreibungen							some private DIF**

* E billion, after incorporation of conduits, **deposit insurance fund, ***total Landesbanken, insolvencies: HSH, WestLB, SachsenLB, LBBW, BayernLB

Bad bank law

SPV model:

- Transfer of toxic assets to SPV at book value minus deduction, in exchange for SoFFIN-guaranteed bonds (max maturity 20 years). Transfer value is highest of:
 - 90% of book value per 3/30/09
 - 90% of book value per 6/30/08
 - 'actual economic value'
 - Not exceeding book value of 3/30/09
- Total deductions must allow institution to preserve 7% core capital ratio
- SoFFIN then calculates 'fundamental value' = 'actual economic value' minus allowance for risk 'in accordance with EU rules'
- Bank pays depreciation to SoFFIN out of dividends according to difference of 'transfer value' and 'fundamental value', divided by maturity of SoFIN bonds. In addition guarantee fees.
- Excess loss is paid out of future dividends or by offering of shares.

Issues

- Gambling for resurrection almost guaranteed as no immediate recapitalization.
- No credit by rating agencies for SPV model as no material recapitalization.

Federal or state resolution model:

- Creation of sub-agencies of SoFFIN (AidA) or state agencies that absorb entire business segments of banks (esp. Landesbanken non-strategic assets).
- Spin-off or hive-down (new company creation) as asset transfer.
- Owner retains unlimited, proportional and direct obligation for transferred assets.

Issues

- Special liability solution protects savings banks.

German insolvency reform – competing proposals

SPD proposal

- 2 stages
 - Insolvency plan process ‘far before insolvency’
 - Managed insolvency
- Insolvency plan process
 - Application by bank to court or regulator
 - Private administrator
 - Negotiates with creditors
 - Arranges debt-equity swaps
 - Arranges share sales/new ownership
 - Separate voting by creditor groups
- Managed insolvency - good bank solution
 - Horizontal balance sheet split to create good bank
 - Equity position of good bank and doubtful assets remain with bad bank
 - Creates incentives against acceleration of claims (bankruptcy triggers), which can be shifted back to bad bank, where they face lower recovery expectation.

CDU proposal

- Sovereign act, ‘close to insolvency’
- Ordinance by regulator
- Public administrator (regulator)
 - May take over bank management or exchange managers
 - May assume administrative rights from owners
 - May limit payments to subordinated debt and equity holders

Missing pieces

- Cross-border aspects (asset/subsidiary ring-fencing & resolution strategy)
- Treatment of holding structures, cross-guarantees
- Watering down vs. replacement of tier 1 capital?
- Excessive use of contractual instruments in Germany → standardization, clarification of ranking
- Lack of structuring of liability side (too much pari passu) → enforce more granular structuring
- How to address Pfandbrief segregation rights pre-insolvency, Pfandbrief subordination
- Criteria for good bank asset allocation.

The long todo list

- Insolvency reform
 - Fierce resistance by insurers→conservative party proposes greater state interventionism than social-democratic party
- Deposit insurance reform, other bank debt instrument reform
 - Complete conceptual unclarity about public role: which instruments, which coverage, which fee levels?
 - Dito on whether there should be, or not, a private mezzanine deposit insurance fund going forward. De-facto insolvency was never addressed.
- Bank equity instrument reform
 - Landesbanken still lobbying for silent participations (not clearly defined by commercial code)
 - Will 'Lex HRE' squeeze-out rules be constitutional?
- Who should be the regulator/supervisor?
 - FDIC model or Fed model? Conservative party lives in good old Bundesbank times, faulty analysis of regulatory failures.
 - Current EU initiatives seen as French-British power grab.
- General: 'stability is a state of mind'
 - Reduction of political and industry capture
 - Reduce government ownership and guarantees, credibly reprivatize system
 - Change of lethargic approach to insolvency, i.e. allow banks to fail rather than problems to fester