Research Handbook on State Aid in the Banking Sector

Chapter 8. Crisis aid to banks in Germany

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The financial crisis hit Germany's banking sector early[1] and severely.[2] By August 2008, 12 German banks had suffered write-downs totaling €51.3 billion.[3] In 2009, the IMF announced that German banks accounted for around a quarter of write-downs in Europe.[4] Four German banks, including the country's third largest, all but collapsed in the process. Commentators argued that the financial crisis was leaving the German banking sector among 'the most battered […] in Europe'[5].

The severity of Germany's first systemic banking crisis since WWII[6] required public intervention of unprecedented scale and scope, prompting Chancellor Merkel to say that 'extraordinary times call for extraordinary measures'.[7] As a spokesperson for Germany's Federal Agency for Financial Market Stabilization explained, '[t]he order of the day was to act as fast as possible because the survival of the German banking sector was at stake'.[8] To keep its banking system afloat, and to gradually restore confidence in it, Germany resorted to a wide array of State aid measures, ranging from capital injections (€114.6 billion) and liquidity assistance (€9.5 billion) to guarantees (€447.8 billion) through impaired asset relief measures

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1 OECD, 'Economic Surveys: Germany 2010', March 2010 (OECD 2010), 88: 'German banks were among the first to suffer from the crisis on financial markets that reached Europe in mid-2007'.

2 See, e.g., Felix Hüfner, 'The German Banking System: Lessons from the Financial Crisis', OECD Economics Department Working Paper No. 788, 2010, 4 (Hüfner 2010): 'The banking sector was hit hard during the crisis'; IMF, 'Germany: Technical Note on Banking Sector Structure,' IMF Country Report No. 11/370, December 2011 (IMF 2011a): 'Large parts of the German banking sector were hit hard during the crisis.'

3 Data extracted from Yalman Onaran, 'Banks' Subprime Losses Top $500 Billion on Writedowns (Update1)', *Bloomberg* (August 12, 2008) (on file with author).

4 IMF, 'Germany: 2008 Article IV Consultation', January 2009, 12.

5 Jack Ewing, 'In Germany, Little Appetite to Change Troubled Banks' *The New York Times* (9 August 2013) <http://www.nytimes.com/2013/08/10/business/global/in-germany-little-appetite-to-change-troubled-banking-system.html?_r=0.> accessed 12 August 2016.

6 Hüfner 2010, 12: 'in the post-war period Germany has not had a wide spread banking crisis, in contrast to many other countries'.

7 '*Bankenkrise: Merkel will Staatsmehrheit an Hypo Real Estate*', *Spiegel Online* (15 February 2009) <http://www.spiegel.de/wirtschaft/bankenkrise-merkel-will-staatsmehrheit-an-hypo-real-estate-a-607752.html> accessed 12 August 2016: '*Außergewöhnliche Zeiten erfordern außergewöhnliche Maßnahmen*'. Stéphanie Marie Stolz and Michael Wedow, 'Extraordinary Measures in Extraordinary Times – Public Measures in Support of the Financial Sector in the EU and the United States', Bundesbank Discussion Paper No 13/2010.

8 Christopher Pleister, 'The Federal Agency for Financial Market Stabilisation in Germany: From Rescuing to restructuring', OECD Journal, 2011, 4.

(€82.8 billion).[9] Total recapitalization and asset relief measures amounted to approximately 7% of German GDP, while the nominal amounts of the guarantees reached around 17% of the country's national income.[10]

Closer analysis reveals the fundamentally asymmetric nature of Germany's banking crisis and of the German government's response thereto, as certain segments of the industry came to the brink of collapse while others remained largely unscathed. The five largest commercial banks and the 12 regional public banks (*Landesbanken*) suffered the bulk of German bank losses. *Kreditanstalt für Wiederaufbau* (KfW) – a public development bank involved in rescuing other distressed banks – and specialized commercial banks such as real estate giant Hypo Real Estate (HRE) and industry financing specialist *Deutsche Industriebank* (IKB) accounted for the remainder of the losses and aid. By contrast, other commercial banks such as Deutsche Bank and, most strikingly, Germany's savings banks and credit cooperative institutions barely required any public support.

This chapter argues that the financial crisis' asymmetric impact on Germany's banking industry was largely a function of the German banking industry's highly segregated three-pillar structure and of the differentiated business models, degrees of exposure to international financial markets, and dependence on interbank borrowing, that this structure entailed (Section 1). These peculiarities largely shaped the three phases of Germany's rescue and restructuring efforts.

Before the global financial crisis unfolded in the wake of Lehman Brothers' bankruptcy in September 2008, Germany resorted to a myriad of *ad hoc* aid measures designed to shore up the banks that were the most exposed to toxic subprime-loaded asset-backed securities, namely SachsenLB and IKB (Section 2). The collapse of HRE in late September 2008 set the stage for a more comprehensive approach to tackling Germany's banking crisis, with the creation of a €480 billion financial stabilization fund designed to help ailing banks bridge liquidity gaps and strengthen their equity capital (Section 3). Once the threat of bank runs had receded, Germany's strategy entered a third phase beginning in July 2009, as the priority shifted from short-term rescue measures to the removal of toxic assets to tackle German banks' pervasive balance sheet problems. To that effect, Germany set up a bad bank scheme that allowed for the liquidation of WestLB and HRE (Section 4).

1. The German banking system – a giant with feet of clay

Germany is notorious for having one of the world's 'most bank-based' financial systems,[11] with a ratio of bank assets to GDP higher, and a ratio of stock market capitalization to GDP

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9 These figures represent aid approved by the Commission between 2008 and 2014. Data extracted from DG Competition, State Aid Scoreboard 2015 – Aid in the Context of the Financial and Economic Crisis <http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html> accessed 22 August 2016.

10 *Ibid*.

11 Sigurt Vitols, 'Changes in Germany's Bank-Based Financial System: Implications for Corporate Governance', in Gregory Jackson and Andreas Moerkes (eds.) [2005] 13 Corporate Governance: An International Review 2.

lower, than most developing countries.[12] As the IMF has noted, '[t]he banking sector accounts for the majority of total financial sector assets, serving as a backbone to the German industry',[13] which has traditionally favored bank funding from a stable relationship with a house bank (*Hausbank*)[14] over access to capital markets.

Yet, as a prominent German business leader explained on the eve of the Lehman Brothers bankruptcy, 'the credit sector in Germany is one of the weakest areas of the national economy'.[15] While this may be an overstatement, international institutions such as the IMF, ECB, and OECD had by then already on several occasions highlighted the high degree of fragmentation (1) and the prevalence of unsustainable business models (2) in the German banking sector.

a) A highly fragmented market: Germany's three-pillar banking model

The IMF has dubbed the German banking sector 'complex and dispersed'[16] while rating agency Moody's has described it as 'overbanked, fragmented and fiercely competitive'.[17] On the eve of the financial crisis, Germany's ratio of credit institutions per 100,000 inhabitants was 2.46, compared to 1.73 in the rest of the Eurozone.[18] Its Herfindahl-Hirschman Index reached only 183, compared to an average of 1,102 in the Eurozone and 2,079 in neighboring Belgium.[19]

By and large, this is a consequence of the German banking industry's relatively rigid three-pillar structure. The German banking sector comprises three types of banks that differ in terms of ownership, legal form, and objectives: private commercial banks (*Kreditbanken*), public banks (*Öffentlich-rechtliche Kreditinstitute*), and cooperatives (*Genossenschaftsbanken*). These are overwhelmingly universal banks, although specialist mortgage banks (*Bausparkassen*), credit and loan societies (*Realkreditinstitute*) and a host of smaller specialized institutions operate in all three pillars.

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12 See, e.g., Hüfner 2010, 7.

13 IMF, 'Germany: Financial Sector Stability Assessment', 2011 (IMF 2011b), 8.

14 A *Hausbank* is the bank that acts as the primary relationship banker to a company, typically providing or arranging the full range of banking services.

15 Frank Mattern, '*Finanzmarktkrise forciert Veränderungen im deutschen Bankensektor*', Address to the Union International Club Frankfurt, 30 January 2008 <http://www.wmd-brokerchannel.de/bc/itemshowone.php4?id=67807&return=> accessed 18 August 2016.

16 IMF 2011b, 8. See, too, Hüfner 2010, highlighting the 'very fragmented' structure of Germany's banking sector.

17 James Wilson, 'Moody's Warns on German Banks' *Financial Times* (19 October 2012) <http://www.ft.com/intl/cms/s/0/094c10d8-1915-11e2-af88-00144feabdc0.html#axzz3iAAujqOw> accessed 12 August 2016.

18 Banking Structures Report, European Central Bank, October 2014, 61.

19 *Ibid.*

Other EU Member States such as Sweden have similar banking systems, but none are as rigidly segregated as Germany's.[20] Legal restrictions on cross-pillar mergers, notably regarding the takeover of public banks by private institutions, have made industry-wide restructuring and consolidation all but impossible. As can be seen from Table 1 below, the crisis has done little to change this.

Table 1. The structure of the German banking sector[21]

Type of bank	Institutions		Branches		Share of banking assets (%)		Goals
	2007	2014	2007	2014	2007	2014	
Commercial banks	**373**	**391**	**11,322**	**9,978**	**29**	**38**	Profit maximization
Public banks	**458**	**425**	**14,109**	**12,359**	**34**	**28**	Public interest
Savings banks	*446*	*416*	*13,624*	*11,951*	*14*	*14*	
Landesbanken	*12*	*9*	*485*	*408*	*21*	*14*	
Cooperatives	**1,236**	**1,052**	**12,488**	**11,280**	**12**	**14**	Members' welfare and business success
Local cooperatives	*1,234*	*1,050*	*12,477*	*11,269*	*8*	*10*	
Central cooperatives	*2*	*2*	*11*	*11*	*4*	*4*	
Specialist banks	**210**	**122**	**1,914**	**1,685**	**25**	***20***	Miscellaneous

Source*: Bundesbank*

i) Commercial banks

Commercial banks are privately owned and typically incorporated as public limited companies (*Aktiengesellschaft*) or private limited partnerships (GmbH). The commercial banking pillar comprises a wide array of profit-maximizing institutions, including large banks, smaller private and regional banks, and foreign bank branches.

Large commercial banks are archetypically universal, combining retail wholesale banking services with investment banking activities. Prior to the financial crisis, commercial banks accounted for only 16% of German credit institutions but 29% of banking assets. At the time, the commercial banking pillar was dominated by five of these large banks which together accounted for around two thirds of total private sector banking assets in Germany:

[20] IMF, 'Germany's Three-Pillar Banking System: Cross-Country Perspectives in Europe', 2004, 1: 'Banking systems in several other European countries have a similar structure but have recently introduced more flexibility for cross-pillar restructuring.'

[21] Table 1 largely draws from a similar table in Patrick Brämer *et al*., '*Le système bancaire allemande et la crise financière*', *Regards sur l'économie allemande*, 2011, 6.

Deutsche Bank, Commerzbank, Dresdner Bank, Hypo Vereinsbank, and Postbank.[22] The financial crisis, however, brought about a wave of consolidation within this segment of the commercial banking pillar, with Commerzbank acquiring Dresdner Bank in August 2008 and Deutsche Bank taking control of Deutsche Postbank AG one month later.

These large institutions coexist with smaller commercial banks, which tend to be 'regionally and functionally confined in their activities',[23] with a 'strong local presence'[24] or a focus on specific or even niche activities such as housing finance, industry financing, or wealth management. As for foreign banks, they have barely made inroads into the German market.

ii) Public banks

Prior to the financial crisis, the non-profit-maximizing public banking sector accounted for around 34% of total banking assets in Germany, the largest share in the OECD.[25] Germany's public banking sector is organized territorially and vertically, mirroring the administrative structure of the German state:

- *Savings banks.* Before the crisis, there were 446 local savings banks (*Sparkassen*) in Germany. These banks are owned by municipalities, unions of municipalities, and regional districts. They are subject to a public service mandate (*öffentlicher Auftrag*), which requires them to provide (out of their own profits) local households and SMEs with credit facilities and safe interest-bearing investment opportunities.[26]
- Landesbanken. Before the crisis, the Landesbanken segment comprised 12 regional institutions. These regional banks are generally owned by the *Länder* as majority shareholders together with local savings banks and other Landesbanken. Their core mission is to centralize clearing-house and refinancing functions within the public banking sector. As payment system centers (*Girozentralen*), they provide savings banks with cash management services, refundable advances, and other commercial and investment banking services. The Landesbanken also promote regional development, supporting local businesses and servicing the financial needs of the public sector.
- *DekaBank.* The public banking system is topped by DekaBank, a centralized provider of asset management and capital market solutions jointly owned by the Landesbanken and the savings banks through the savings banks association (*Deutscher Sparkassen- und Giroverband*).

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22 IMF 2011a, 25.

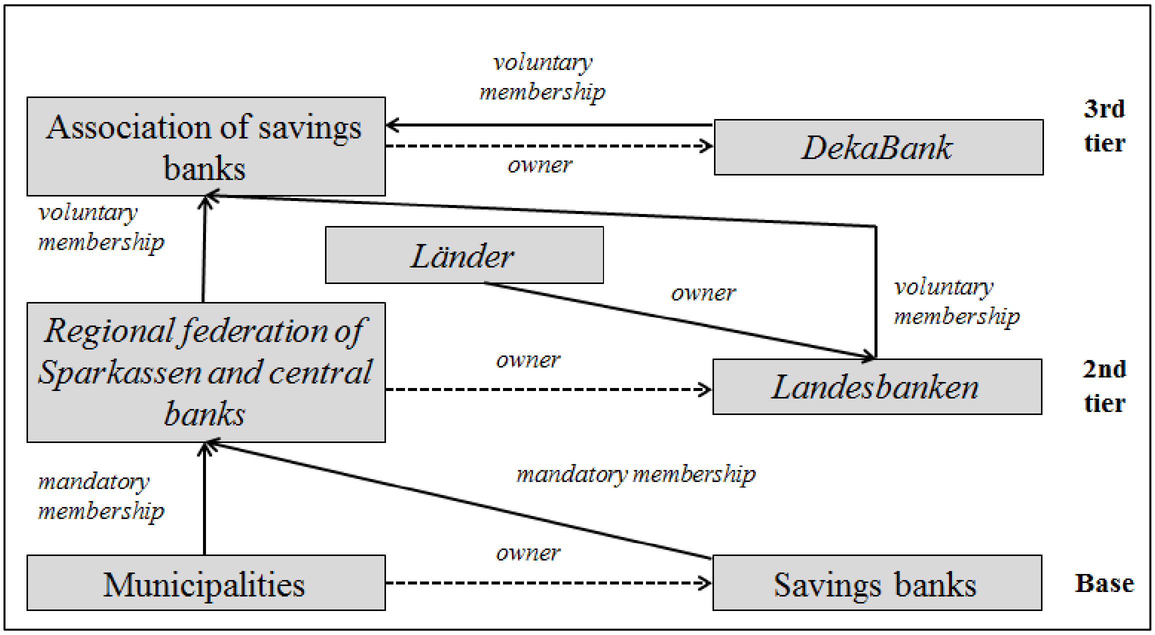
23 German Council of Economic Experts, 'Market Structure and Competition in German Banking', Working Paper 06/2013, November 2013, 7.

24 OECD 2010, 91.

25 Hüfner 2010, 8.

26 Certain *Länder* impose broader public service mandates on their savings banks. For example, the *Land* of Rhineland-Palatinate's Savings Banks Act's public mandate includes the improvement of the equity resources of start-up companies.

Figure 1. Structure of the German public banking pillar



Source*:* P. Brämer *et al*.

As such, the public banking sector is governed by two core organizational (*Ordnungsprinzipien*) principles derived from federalist thought:

- *Regional principle.* The regional principle (*Regionalprinzip*) traditionally restricts each savings bank's business area to the geographical area of its owner.
- *Subsidiarity principle.* The subsidiarity principle governs the division of labor between the various entities that compose the public banking sector. This principle requires the public banking sector to address customers' banking needs in a decentralized fashion, at the most immediate (or local) level possible. This means that the local savings banks are required to carry out all tasks that they can handle fully and autonomously. Only when that is no longer the case do the Landesbanken step in. Accordingly, the Landesbanken serve as a link between the savings banks and their customers when it would be less efficient for the savings banks to provide certain specific services. This includes sophisticated services (e.g., capital markets products, private banking) or services that only a small number of customers request.

The public banks' mandate and public ownership traditionally went hand in hand with unlimited public guarantees (*Anstaltslast*[27] and *Gewährträgerhaftung*[28]). But more than a decade before the first tremors of the financial crisis, the European Commission began to investigate these guarantees under EU State aid rules and obtained their abolition following the expiry of a transitional period designed to accommodate the legitimate expectations of third parties.[29] This allowed for liabilities existing on July 18, 2001 to continue to be covered by the *Gewährträgerhaftung* until their maturity ran out and for liabilities incurred between 18 July 2001 and 18 July 2005 to be covered if their maturity ran out no later than 2015. Germany definitively abolished the unlimited guarantees on 18 July 2005.

iii) Credit cooperative banks

The credit cooperative sector accounted for around 12% of total banking assets in Germany in 2007. The structure of the cooperative pillar mirrors that of the public banking sector. At the base of this two-tiered system, primary cooperative institutions operate pursuant to the regional principle, providing retail banking services to local households and SMEs. Unlike public banks, however, credit cooperative banks such as the Raiffeisenbank are mutually owned by their member-depositors who have one vote regardless of the size of their investment and are entitled to a yearly dividend. Their articles of associations typically require a broad ownership structure and prohibit share transfers, thus effectively sheltering credit cooperative banks from corporate takeovers. This reflects the cooperative banking sector's distinctive purpose, which is to promote member-depositors' economic welfare and business success.

At the top of the cooperative pillar, two central institutions (DZ-Bank and WGZ-Bank) perform functions comparable to those of the Landesbanken within the public banking sector. In particular, they provide cash management services and other commercial and banking services to the primary cooperatives, and enable deposits and credits within the credit cooperative group.

b) Vulnerable business models

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27 The *Anstaltslast* is a maintenance obligation that requires a public bank's owners to secure its economic basis and functioning for the entire duration of the bank's existence. The *Anstaltslast* does not confer any right to third parties (e.g., creditors). See Commission Press Release IP/02/634 of 26 April 2002.

28 The *Gewährträgerhaftung* is a guarantee obligation. It stipulates that the guarantor (i.e., the bank's public owner) will meet the bank's liabilities which cannot be satisfied by its assets. As such, the *Gewährträgerhaftung* confers rights upon the bank's creditors. See *ibid.*

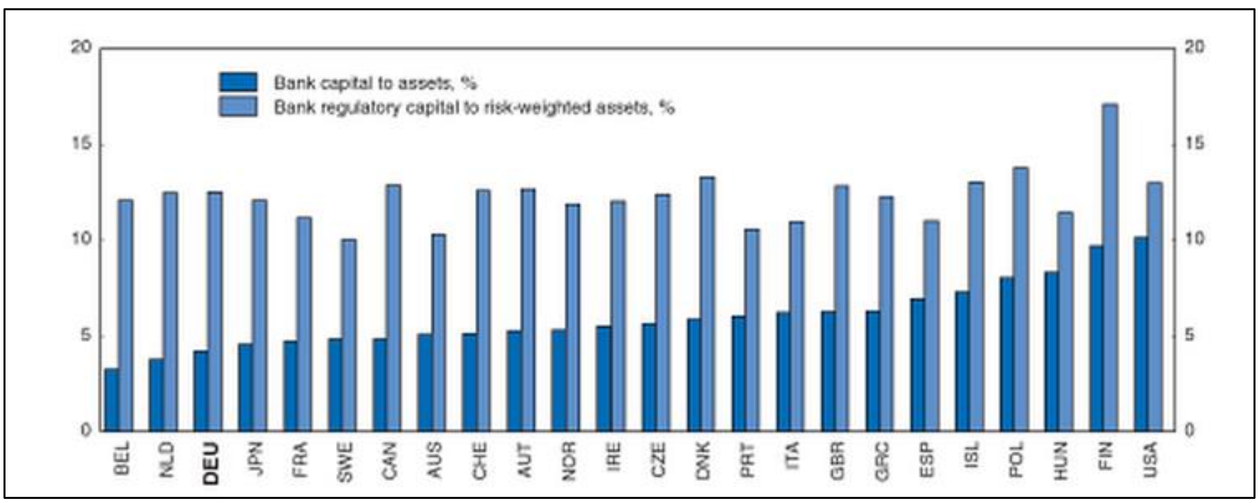
29 For an overview of the case, see Stefan Moser *et al.* 'State Guarantees to German Public Banks: A New Step in the Enforcement of State Aid Discipline to Financial Services in the Community', Competition Policy Newsletter, June 2002.

Prior to the crisis, German banks across all three pillars displayed structural weaknesses (a). But those banks that were the most heavily exposed to international markets had the greatest difficulties withstanding the collapse of the US subprime mortgage market (b).

i) Fragile fundamentals

In the run-up to the financial crisis, German banks across all three pillars quite paradoxically combined high leverage with low profitability. While their average capital-to-asset ratio was lower than that of their European peers, German banks displayed one of the highest regulatory capital-to-risk weighted asset ratios in the developed world. This was especially true for the country's largest commercial banks, Landesbanken, and mortgage lenders. This meant that German banks carried high volumes of assets to which they attached low risk.[30] For a number of these assets (e.g., derivatives portfolios), that risk was likely significantly underpriced, which exposed the German banking system to external shocks.[31]

Figure 2. Average bank capital to assets ratios (2003-7)



Source*:* F. Hüfner

Yet, contrary to the predictions of standard financial theory,[32] German banks also ranked among the least profitable in the OECD in the years leading up to the financial crisis. Between 2000 and 2007, German banks displayed an average return on assets of merely

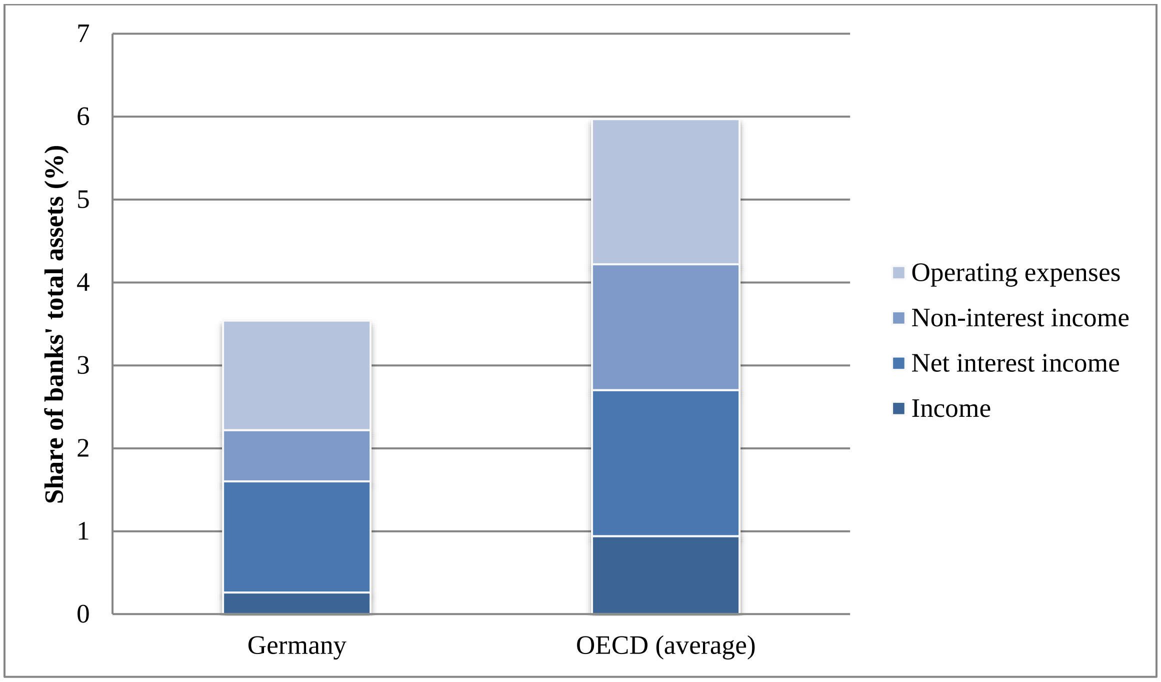
30 IMF 2011b, 14-5.

31 Hüfner 2010.

32 The standard trade-off theory of capital structure predicts that more profitable firms ought to borrow more and have higher leverage. For a critical assessment of the literature and evidence, see Murray Z. Frank and Vidhan K. Goyal, 'The Profits–Leverage Puzzle Revisited', Review of Finance, 2014.

0.26%, compared to an average of 0.94% in the OECD.[33] This trend was attributable neither to economic cycles, nor to the prominence of non-profit-maximizing banks within the German banking sector, as commercial banks (0.2%) fared even more poorly than savings banks (0.4%) and cooperatives (0.5%).[34]

Figure 3. Profitability of the German banking sector



Source: OECD bank profitability database

Rather, as is evident from Figure 3 above, the German banking sector's low profitability reflected significantly lower non-interest income than in other developed economies. Econometric analysis attributes this to inadequate pricing of risk, lower revenue from sources other than interest margins, and, to a lesser extent, the intense competition that tends to come with a lesser degree of market concentration.[35]

ii) Exposure to international financial markets

When financial markets began to collapse, this paradoxical combination of high leverage and low profitability left those German banks that were the most heavily exposed to international financial markets far more vulnerable to external shocks than many of their European peers. While savings banks and cooperatives emerged from the crisis largely unscathed due to their

33 Hüfner 2010, 13-4.

34 *Ibid.*

35 *Ibid.*

primarily local focus,[36] the Landesbanken and, to a lesser extent, commercial banks and specialist banks were severely hit by the financial crisis. As the table below shows, 13 of the 15 German banks with the greatest pre-crisis exposure to conduits and special investment vehicles had to resort to State support to weather the crisis.

Table 2. Ranking of German banks by pre-crisis exposure to conduits and SIVs

Bank	Pillar	Conduit- and SIV-financed assets: Share of capital (%)	Conduit- and SIV-financed assets: Share of assets (%)	Received State aid?
Sachsen Finanzgruppe	Public (Landesbank)	1,126	30.3	✓
WestLB	Public (Landesbank)	542	12.7	✓
IKB	Commercial	494	20.5	✓
Dresdner Bank	Commercial	364	9.9	✓
Landesbank Berlin	Public (Landesbank)	179	2.2	✓
BayernLB	Public (Landesbank)	170	5.1	✓
HSH Nordbank	Public (Landesbank)	126	4	✓
Deutsche Bank	Commercial	114	3.3	✓
HVB (incl. HRE)	Commercial	105	6.6	✓
NORD LB	Public (Landesbank)	89	2.9	✓
Commerzbank	Commercial	85	2.2	✓
Helaba	Public (Landesbank)	68	1.1	✗
DZ-Bank	Cooperative	61	1.3	✗
LBBW	Public (Landesbank)	59	1.7	✓
KfW	Public	58	2.6	✓

Source*: Bundesbank*

In search of a viable business model: the Landesbanken's "Flucht nach vorn"

Over the past few decades, the Landesbanken's business model has undergone dramatic change. As the proportion of their revenues coming from central banking activities dropped

36 Only one German savings bank received State aid. See Commission Decision of 29 September 2010 on State aid C 32/09 (ex NN 50/09) implemented by Germany for the restructuring of Sparkasse KölnBonn.

steadily, they sought to diversify and became commercial banks in their own right. Yet, the segregation of the German public banking sector between savings banks and Landesbanken prevented the latter from meaningfully expanding into the former's private turf, i.e., retail and small business banking.[37] As a result, the Landesbanken were left with wholesale and investment banking.[38] They also sought to take advantage of their access to cheap funding to service companies at home and abroad, engaging in 'funding arbitrage',[39] that is, borrowing at cheap rates under the guarantee of their AAA or AA+-rated public owners, lending at slightly higher rates, and pocketing the difference.

The 2001 compromise between the Commission and Germany to gradually phase out the Landesbanken's unlimited State guarantees destabilized this business model. Without State guarantees, the Landesbanken would no longer be able to count on the cheap funding that came with their owners' AAA or AA+ credit rating.

Thus left without a viable business model, the Landesbanken took advantage of the 'generous' three-year phasing-out period negotiated with the Commission to expand their balance sheets and establish an international presence before the curtain fell.[40] In anticipation of the sharp increase in refinancing costs that was expected to come with the definitive end of the guarantees in 2005, the Landesbanken sharply increased the volume of their capital market refinancing and accumulated large funding reserves.

Once the guarantees had been completely phased out, the Landesbanken used these funds to generously grant loans to foreign financial institutions and to invest in foreign securities, including complex subprime-loaded securitization portfolios. So much so that by 2006, the Landesbanken had come to sponsor 8.4% of the global supply of asset-backed commercial paper. It is thus no surprise that eight Landesbanken featured in the ranking of 15 German banks according to their pre-crisis exposure to conduits and special investment vehicles (see Table 2 above). As former Enterprise and Industry Commissioner Verheugen noted: '[n]owhere in the world, not even in America, were banks so ready to take incalculable risks, first and foremost the Landesbanken'.[41]

Unlike their commercial peers, however, the Landesbanken largely lacked the necessary expertise to engage in, and managerial skills to control, such a strategy.[42] In 2008, for example, BayernLB's 10-member supervisory board included three Bavarian State ministers, one deputy minister, a high-ranking State civil servant, one mayor, and four

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37 Max Lienemeyer and Marcel Magnus, 'WestLB Liquidation – The End of the Saga', Competition Policy Newsletter, 2011.

38 *Ibid.*

39 'The Landesbanken: Inside Germany's Trillion Euro Banking Blind Spot' *Reuters* (17 September 2013) <http://www.reuters.com/article/2013/09/17/banking-germany-landesbanken-idUSL6N0H211D20130917> accessed 12 August 2016.

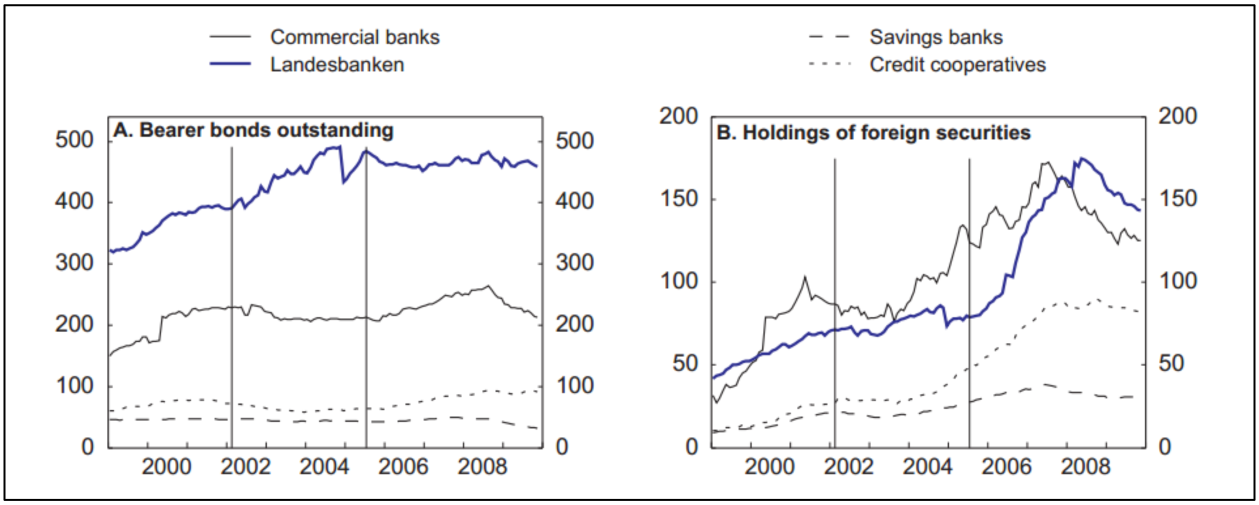
40 OECD 2010, 92.

41 Quoted in '*Weltmeister in riskanten Geschäften*', *Süddeutsche Zeitung* (17 May 2010) <http://www.sueddeutsche.de/wirtschaft/eu-kommissar-verheugen-weltmeister-in-riskanten-bankgeschaeften-1.458276> accessed 22 August 2016: *'Nirgendwo auf der Welt, auch nicht in Amerika, haben sich Banken mit größerer Bereitschaft in unkalkulierbare Risiken gestürzt, allen voran die Landesbanken'*.

42 See, e.g., Harald Hau and Marcel Thum, 'Subprime Crisis and Board (In-)Competence: Private vs. Public Banks in Germany' [2009] Economic Policy 701-52.

representatives of the Bavarian savings banks. As a result, the Landesbanken continued to increase their foreign securities holdings until well after the financial crisis had begun.

Figure 4. Refinancing and investments across banking pillars in Germany



Source: F. Hüfner

Commercial banks: between liquidity shortage and mismanaged internationalization

The picture is somewhat more nuanced in the commercial banking pillar. One German commercial bank, Commerzbank, primarily fell victim to the liquidity crisis in late 2007. As the interbank lending market dried up, Commerzbank had to resort to State support to raise capital. The bank displayed capital ratios that were in line with regulatory requirements as late as 2008, but the recessionary forecasts for 2009 and 2010 and the market's increased capital expectations made raising capital from State sources a practical necessity.

Other commercial banks, however, mirrored the Landesbanken in how they mismanaged their international expansion. For example, IKB had become heavily involved in the US subprime mortgage market through off-balance-sheet special investment vehicles (SIVs), accumulating more than €12 billion in subprime-loaded asset-backed securities in the run-up to the crisis. Real estate specialist HRE was afflicted by a similar malady. In 2007, HRE took over Dublin-based DEPFA Bank. HRE's balance sheet more than doubled from €161.6 billion in 2006 to €400.2 billion in 2007 as a result. The acquisition exacerbated the maturity mismatch in HRE's portfolio. Given that the bank had insufficient liquidity reserves, the collapse of the interbank lending markets meant that it could no longer bridge the funding gap and had no choice but to turn to the State for assistance.

2. The *ad hoc* rescue phase: the 2008 IKB decision

Before the financial crisis turned into a fully-fledged systemic crisis with the fall of Lehman Brothers in autumn 2008, the Commission continued to apply its usual State aid policy to failing banks such as Northern Rock in the UK, Roskilde in Denmark, and IKB and SachsenLB in Germany. The Commission took the view that these were individual bank failures stemming from firm-specific – rather than systemic – difficulties and accordingly assessed them under the generally applicable Rescue and Restructuring Guidelines. As Competition Commissioner Kroes explained:

> Banks, like companies in other sectors, need to implement substantial changes to the way they do business when they receive restructuring aid – there are no free lunches. In all sectors, the conditions for the Commission to approve restructuring aid are the same – long term viability, aid limited to the minimum and limited distortions of competition.[43]

The rescue of IKB is particularly illustrative of the Commission's approach to bank failures during these initial stages of the financial crisis. IKB was a commercial bank specialized in industry financing. Beginning in 2002, the Düsseldorf-based institution had invested heavily in US subprime mortgages through an off-balance sheet and offshore SIV named "Rhineland Funding Capital". Over the years, the SIV accumulated a €12.7 billion portfolio of asset-backed investments, many of which were bundled into collateralized debt obligations (CDOs). When IKB eventually restated its 2006/2007 financial statements to reflect this portfolio, its total assets accordingly increased from €49.1 to €63.5 billion.[44]

As credit-market worries spread, IKB's "Rhineland" portfolio sustained one of the heaviest investment losses in German banking history since 1945. Faced with losses totaling €7 billion, the SIV became unable to secure new short-term funding and thus called on a €12 billion credit line promised by KfW and a handful of other banks. One such lender, Deutsche Bank, thereupon exercised its option to cancel the commitment and alerted German banking regulator BaFin.

To prevent the bank's imminent collapse, Germany granted IKB State aid in the form of liquidity facilities and of a risk shield of both €8.1 billion against losses in "Rhineland" and €1 billion against losses in other on-balance-sheet subprime portfolio investments. The German banking association would cover 30% of the losses, limited to €1 billion, while the State-owned KfW would bear 70%, with no upper limit. Germany initially estimated the total expected losses from the risk shield at €4.5 billion, but did not exclude the possibility that the liability might eventually increase to the full amount. Concurrently, KfW increased its stake in IKB from 33.2% pre-crisis to 43.3% in June 2008 and 90.8% in August 2008 via a series of capital injections, at least one of which was mandated by the German government. KfW eventually sold that stake to US private equity fund Lone Star for a reported purchase price of €137 million.

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43 Commission Press Release IP/08/1557 of 21 October 2008.

44 Commission decision of 21 October 2008 on State aid measure C 10/08 (ex NN 7/08) implemented by Germany for the restructuring of IKB Deutsche Industriebank AG, para. 9.

The Commission concluded that all these measures failed to meet the private investor test and therefore involved elements of aid. Regarding the risk shield in particular, the Commission held that in such unpredictable circumstances, a private investor would have considered the €8.2 billion worst-case scenario of expected losses rather than a mid-range estimate. Moreover, the fact that the privately-held German banking association's participation was limited to €1 billion whereas State-owned KfW's was unlimited suggested that a private investor would not have acted as KfW did.

In assessing the measures' compatibility, the Commission likewise rejected the application of Article 107(3)(b) TFEU out of hand:

> The investigation has confirmed the Commission's observation that IKB's problems are due to company-specific events. Moreover, the information provided by the German authorities has not convinced the Commission that the systemic effects that might have resulted from a IKB's insolvency could have reached a size constituting 'a serious disturbance in the economy' of Germany within the meaning of Article [107](3)(b).[45]

The Commission therefore assessed the measures under Article 107(3)(c) TFEU and found that they met the cumulative criteria of the Rescue and Restructuring Guidelines, subject to a number of conditions. In particular, the Commission required that the restructuring plan be implemented by September 2011. That plan was based on two main propositions. First, the plan was designed to ensure IKB's return to long-term viability by enabling the bank to re-focus on its core business (*i.e.,* medium-sized corporate clients), increasing its cost- and risk-efficiency, and reducing its exposure by ceasing portfolio investments and divesting or liquidating its real estate financing business as well as a number of loss-making assets and subsidiaries. In addition, IKB's annual net turnover was capped at €33.5 billion.

Second, the Commission found that the sale of IKB to Lone Star would be instrumental in supporting IKB's positive economic development and restoring long-term viability. This, along with the funding provided by the German Banking Association, meant that the Rescue and Restructuring Guidelines' burden-sharing requirements were also met.

3. From *ad hoc* rescue to restructuring: the Financial Market Stabilization Act

After the *ad hoc* rescue of IKB and SachsenLB,[46] the fall of Lehman Brothers forced the German authorities to shift to a more comprehensive and forward-looking approach to tackling the financial crisis. As such, the emergency Eurozone summit of October 12, 2008, the German government adopted a major State aid scheme to shore up the banking sector.

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45 *Ibid.*

46 WestLB also received guarantees from its owner, Land North Rhine-Westphalia, in March 2008, but the bulk of WestLB's rescue took place in 2009-2011.

a) The Financial Market Stabilization Act

i) Background

On October 17, 2008, the German government enacted the Financial Market Stabilization Act (FMSA) to not only stabilize, but also initiate the process of restructuring, Germany's battered financial system. As the *Handelsblatt* reported, there was talk in government circles of the rescue scheme 'becoming the nucleus of a new banking order. Not only the provision of liquidity and capital support w[ould] constitute the main focus of attention, but rather the future sustainability of business models'.[47]

The FMSA, together with the October 18, 2008 Act Creating a Financial Stabilization Fund (*Finanzmarktstabilisierungsfondsgesetz*), set up the €480 billion Special Financial Market Stabilization Fund (*Sonderfonds Finanzmarktstabilisierung*) (SoFFin). An agency of the *Bundesbank* placed under the supervision of the Federal Ministry of Finance (and later the newly minted Federal Agency for Financial Market Stabilization), SoFFin was designed to help ailing banks bridge liquidity gaps and strengthen their equity capital. Any such assistance was subject to SoFFin's approval of the prospective beneficiary's business plan.[48] The purpose was to allow the government to examine the soundness of the applicants' business strategy and to prevent them from engaging in high-risk activities. Notably, the FMSA empowered SoFFin to make State support conditional on the beneficiary reducing its exposure to, or even ceasing to engage in, certain risky activities.

SoFFin was equipped with three core instruments:

- *Guarantees.* To support banks with a sound capital base that were unable to access interbank funding, the rescue scheme included a €400 billion guarantee scheme covering new issuances of short- and medium-term debt at a market-oriented rate of 0.5 to 2% per year. The €400 billion scheme was never fully utilized, reaching a peak of €174 billion in October 2011.[49]
- *Asset swaps.* The FMSA also allowed distressed bank to temporarily transfer risk positions (e.g., securities, receivables) of up to €5 billion per institution to SoFFin under a 36-months asset swap scheme.[50] SoFFin, in turn, could hold these risk positions for a risk-based interest rate. In return, financial institutions were entitled to a secure debt title against the State. Only WestLB made use of this instrument.

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47 '*Regierung mischt Bankenlandschaft auf*', *Handelsblatt* (9 April 2009) <http://www.handelsblatt.com/unternehmen/banken-versicherungen/finanzkrise-regierung-mischt-bankenlandschaft-auf/3153022.html> accessed 12 August 2016.

48 See, e.g., Peer Steinbrück, Governmental Declaration concerning the FMSA, Federal Government Wesbite (15 October 2008) <http://www.bundesregierung.de/Content/DE/Bulletin/2008/10/109-2-bmf-bt.html> accessed 12 August 2016 ('*Von unserem Paket profitieren alle Geldinstitute und Versicherungen in Deutschland, die sich unter den Schutzschirm der neuen staatlichen Garantien stellen wollen. Aber dies erfolgt unter sehr strengen Bedingungen. Leistung – Gegenleistung, wie die Kanzlerin gesagt hat, ist das Prinzip, nach dem wir handeln*').

49 IMF 2011a, 9.

50 The duration later increased to 84 months for covered bonds and 60 months for other liabilities.

- *Recapitalizations.* The recapitalization scheme was designed to make available fresh capital (of up to €10 billion per institution) to financial institutions in exchange for new preference shares, silent participations, or other equity instruments. In return, SoFFin was supposed to receive adequate compensation. In total, as set out in the table below, four banks benefitted from recapitalizations totaling €29.3 billion.[51]

Table 3. SoFFin bank recapitalizations

Bank	Amount (€)
Aareal Bank	380,000,000
Commerzbank	18,200,000,000
HRE	7,700,000,000
WestLB	3,000,000,000
Total	**29,280,000,000**

Source*:* SoFFin

ii) The Commission’s approval

On October 27, 2008, the Commission conditionally approved the FMSA.[52] Germany and the Commission agreed that the FMSA involved elements of State aid, as SoFFin’s recapitalization and guarantee measures would allow beneficiary banks to source capital on much more favorable terms than under normal market conditions. The Commission also agreed with Germany that the FMSA was necessary and suitable to tackle a serious disturbance in the economy and was therefore compatible with the internal market pursuant to Article 107(3)(b) TFEU. Competition Commissioner Kroes even went so far as to describe the statute as a blueprint for future bank bailout schemes: ‘Thanks to extensive and fruitful cooperation between the German authorities and the Commission, the German rescue package is an efficient tool to boost market confidence, but at the same time is ring-fenced against abuses. I hope that other Member States will soon follow course.’[53]

Specifically, the Commission found the recapitalization scheme to be necessary because it was aimed not only at distressed banks, but also purported to help healthy banks overcome temporary financial difficulties and thus restore confidence in the crisis-stricken

[51] IMF 2011b, 4.

[52] Commission decision of 12 December 2008 in Case N 625/2008, ‘Rescue package for financial institutions in Germany’.

[53] Commission Press Release IP/08/1589, 28 October 2008.

financial sector. The measures were well-suited to achieving this objective, because Germany would recoup its investments through appropriate minimum returns for the preference shares to which it was entitled to, in exchange for the capital injections. The recapitalizations' suitability was further compounded by their limited duration of six months and the strict conditions for beneficiary banks, such as dividend bans and commitments to maintain high solvency ratios, refocus on core markets, and cap executive compensation.

The Commission likewise found that the guarantees would provide a much-needed safety net to investors and thus contributed to revitalizing the interbank market. The guarantees were suitable to the extent that they were available only to solvent banks, limited in duration, and subject to strict conditions designed to limit beneficiaries' ability to use State aid for advertising and expansion purposes.

The temporary risk transfer scheme was also deemed necessary to help fundamentally healthy banks overcome liquidity bottlenecks. The Commission also highlighted that the bank would remain liable, as the assets needed to be bought back at essentially the same price after a maximum of 36 months. In addition, the banks would have to pay adequate compensation in the form of a minimum premium similar to that under the guarantee scheme.

Finally, Germany had to commit to re-notifying the measures after six months and subsequently report on their implementation to enable the Commission to verify that they were not maintained any longer than necessary.

b) The Commerzbank case

Germany soon had to make use of (almost) the full range of FMSA instruments to rescue the ailing Commerzbank.

With a balance sheet of €1,100 billion in 2009, Commerzbank was Germany's second largest commercial bank and the largest financial institution to receive State aid from the German authorities. Commerzbank's troubles primarily arose from the deterioration of its asset-backed securities portfolio and from the need to increase risk-provisioning as the real economy collapsed. Commerzbank's ill-fated 2009 acquisition of fellow commercial bank Dresdner Bank exacerbated these difficulties, as Dresdner Bank's large investment banking portfolio was replete with toxic assets.

In response to the bank's difficulties, SoFFin took a silent €8.2 billion participation in Commerzbank in December 2008. However, deteriorating market conditions dramatically shrank the bank's capital basis whilst markets and regulators began to increase their capital requirements. As a result, the initial capital injection ended up being insufficient to appease market concerns and to comply with regulatory capital requirements in the medium-term. On January 2009, SoFFin injected an additional €10 billion into Commerzbank in exchange for a further silent participation (€8.2 billion) and a 25% stake in the bank (€1.8 billion). In parallel to this, SoFFin provided Commerzbank with a €15 billion bond issuance guarantee.

Germany notified the measures to the Commission in early 2009, ostensibly for 'legal certainty' purposes. According to the German authorities, the Commission's October 2008 approval of the FMSA indeed made an individual notification unnecessary. But

Commerzbank's €18.2 billion recapitalization exceeded the FMSA's threshold of €10 billion per financial institution.

The restructuring plan submitted by Germany allowed the Commission to approve the aid without a formal investigation, thus illustrating the Commission's crisis-time flexibility and readiness to impose stringent behavioral safeguards on beneficiary banks.[54] Further to a particularly detailed assessment of Commerzbank's internal risk management and controlling reports, as well as regulatory risk reviews performed by the competent supervisory authority, the Commission concluded that the restructuring plan would enable Commerzbank to withstand another severe recession and emerge from the crisis with a Tier I ratio meeting market expectations. In particular, the Commission found that the restructuring plan would facilitate Commerzbank's return to long-term viability by allowing it to re-focus on its core retail and corporate banking businesses while curtailing its more volatile and riskier investment banking, commercial real estate, and public sector financing activities.

The Commission further conditioned its approval on a series of measures designed to ensure that the aid was limited to the minimum necessary and that the bank and its shareholders would adequately contribute to the restructuring effort. In particular, Commerzbank committed to divesting around 45% of its current balance sheet while agreeing to a ban on dividend and coupon payments.

The Commission also took steps to ensure that the aid would not unduly distort competition, obtaining a series of structural and behavioral commitments from Commerzbank. On the behavioral side, Commerzbank committed to not use the aid for advertising purposes and was subjected to a three-year acquisition ban. Commerzbank also agreed to a price leadership ban, undertaking not to do business on more favorable conditions than its top three competitors in markets where it held a market share above 5%.

On the structural side, Commerzbank committed to divesting further subsidiaries, including its real estate arm Eurohypo. When this proved impossible due to market conditions, the Commission took the flexible approach of approving amendments to Commerzbank's restructuring plan to allow Eurohypo to be written down rather than sold.[55]

4. Between nationalizations and bad banks: the HRE and WestLB cases

In response to HRE's and WestLB's continued difficulties (despite a series of guarantees and liquidity support measures), Germany undertook to reinforce its legislative framework and expand its anti-crisis toolbox by enacting the Rescue Takeover Act (*Rettungsübernahmegesetz*) (a) and the Bad Bank Act (*Gesetz zur Fortentwicklung der*

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[54] Commission decision of 7 May 2009 in Case N 244/2009 – Commerzbank – Germany; and Neelie Kroes, 'State Aid Decisions on Commerzbank, Hypo Real Estate and Northern Rock', Opening Remarks at Press Conference of 9 May 2009: 'This case illustrates how the state aid framework is an important part of the solution to the current crisis, by asking the right questions and helping banks to have the right answers for their future. This will support a process of transformation for the banking sector, where financial stability and effective competition are reinforced.'

[55] Commission decision of 30 March 2012 in Case SA.34539, 'Germany – Amendment to the restructuring plan of Commerzbank'.

Finanzmarktstabilisierung) (b). These instruments proved significant in the complex processes of addressing the failure of HRE (c) and WestLB (d).

a) The Rescue Takeover Act

In April 2009, the German government enacted the Rescue Takeover Act to facilitate the acquisition of shares by the German State in systemically relevant banks that had previously been subject to stabilization measures. In particular, the Rescue Takeover Act made capital decisions (*Kapitalbeschlüsse*) in systemically relevant banks subject to a simple (rather than qualified) majority vote, with a 50% quorum requirement. The statute also lowered the threshold for squeezing out minority shareholders from 95% to 90%, while exposing shareholders who opposed or jeopardized the adoption of necessary capital measures to potential claims in tort. Although the legislature had initially only contemplated this as '*ultima ratio*',[56] HRE's private shareholders were eventually expropriated and squeezed out.

b) The Bad Bank Act

The Bad Bank Act (*Gesetz zur Fortentwicklung der Finanzmarktstabilisierung*) was enacted on July 17 2009, and further strengthened Germany's financial stability framework by allowing banks to establish their own resolution agencies under the umbrella of the Federal Agency for Financial Market Stabilization. The Bad Bank Act provided for two types of bad bank models:

- *SPV model.* Under the SPV model, banks can transfer structured credit products to an SPV in exchange for SoFFin-guaranteed securities equal to the real economic value of the transferred assets or their book value minus a 10% discount. The SPV's expected losses[57] are spread over a 20-year period. The transferring bank has to cover these losses in equal installments from its future distributed earnings. Its shareholders remain liable for any loss in excess of those estimated at the time of transfer. The SPV model, however, has failed to gain traction. As of July 2015, no bank has resorted to it.
- *Consolidation model.* Under the consolidation model, distressed banks can transfer both structured credit products and other debt securities, loans, and receivables to an organizationally and economically independent public sector resolution agency (*Abwicklungsanstalt*). This scheme was designed to get rid of whole business units or portfolios of non-core assets to reduce ailing banks' balance sheets and facilitate their restructuring. As such, it was especially well-suited to address the restructuring needs of banks such as HRE and WestLB.

[56] Legislative Materials, Drucksache 16/12100, 3 March 2009.

[57] The SPV's expected losses equal the difference between the transferred assets' transfer value and estimated true value minus a discount.

c) The Hypo Real Estate Holding AG case

i) Background

In October 2003, Hypovereinsbank spun off its real estate financing activities to its newly created subsidiary HRE. When interbank markets dried up, HRE's once profitable business model of resorting to short-term interbank funding to finance long-term wholesale investments became unsustainable. HRE's 2007 acquisition of Dublin-based DEPFA Bank, which was primarily active in loans to local public authorities and funded through the covered bonds market, and its concurrent expansion into public sector and infrastructure financing, exacerbated this maturity mismatch. HRE's significant exposure to the US subprime mortgage market made the bank even more vulnerable. The persistent lack of risk system consolidation and coordination between HRE's and DEPFA's IT systems did little to improve the situation.

Initially, federal and regional authorities provided a number of loans and guarantees to HRE. In the night of September 28 to 29, 2008, the *Bundesbank* and BaFin announced that the German banking association would extend a €35 billion credit line to HRE, subject to a public guarantee. At that stage, the *Bundesbank* and BaFin still assumed that 'HRE's commercial viability [was] ensured'.[58] The Commission approved the measure subject to the submission of a restructuring or liquidation plan within six months, which Germany provided in April 2009. But these initial measures failed to stem the HRE's losses and Germany had to extend further guarantees and other support measures to the real estate giant.

By April 2009, HRE had received more than €100 billion in State aid. Its situation had nonetheless become so dire that its CEO declared that there was 'no realistic alternative' to nationalization.[59] Shortly thereafter, the German State nationalized HRE under the newly enacted Rescue Takeover Act. After acquiring a 47% shareholding in the bank by May 2009, SoFFin increased its stake to 90% via a capital injection on June 2, 2009 and eventually squeezed out the remaining shareholders on October 5, 2010. All in all, the capital injections and other relief measures represented more than 20% of HRE's pre-crisis risk weighted assets, making it one of the biggest State aid cases of the financial crisis.

Having nationalized HRE, Germany proceeded to clean up its balance sheet. Germany transferred the bulk of HRE's assets to the newly established bad bank FMS Wertmanagement (FMS-WM) in October 2010. The transferred asset portfolio was composed of assets that lacked further strategic value, were too capital-intensive or risky, or were unsuitable as collateral for obtaining future long-term funding. Over time, FMS-WM accumulated €280 billion in derivatives as well as €210 billion[60] in real estate assets, structured credit products,

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[58] Commission decision of 2 October 2008 in Case NN 44/2008, 'Rescue aid for Hypo Real Estate', para. 8.

[59] '*Kapitalerhöhung abgesegnet. Bund kann HRE verstaatlichen*', *Handesblatt* (3 June 2009) <http://www.handelsblatt.com/unternehmen/banken-versicherungen/kapitalerhoehung-abgesegnet-bund-kann-hre-verstaatlichen/3190472.html> accessed 12 August 2016: '*Es gibt für die Hypo Real Estate keine realistische Alternative zur Beteiligung des Bundes*'.

[60] Nominal value.

and public sector and infrastructure bonds,[61] with considerable exposure to Southern Europe and Ireland.

ii) The Commission's approval

Between October 2008 and July 2011, the Commission issued seven decisions relating to State aid measures in favor of HRE.[62] After Germany notified the first draft of HRE's restructuring plan on May 7, 2009, the Commission initiated an in-depth investigation. At the time, the Commission expressed serious doubts as to whether the restructuring plan would restore HRE's long-term viability and included sufficient measures to limit distortions of competition. The Commission subsequently extended the investigation as HRE benefited from additional State aid measures, each of which was subject to the Commission's approval. The focus of this sub-section is on the case's most noteworthy overarching features, rather than on any of these decisions in particular.

The Commission concluded that the measures in issue all involved elements of aid, with the exception of the squeeze-out of minority shareholders. According to the Commission, this squeeze-out did not in itself contain State aid elements because it did not provide the bank with an advantage stemming from State resources. Although it involved a payment from the State to the minority shareholders, it had no economic effect on HRE. From HRE's perspective, the Commission found, it merely involved a change in ownership structure.

The case thus primarily turned on the other measures' compatibility with the internal market. The Commission conceded that the measures were necessary to remedy a serious disturbance in the German economy within the meaning of Article 107(3)(b) TFEU. HRE was indeed a systemically relevant bank given the size of its original balance sheet and the amount of derivatives it held.

However, due to the sheer amount of State aid involved and the practical impossibility of recovery, the Commission made the clearance conditional on there being 'a very far-reaching restructuring plan'.[63] The purpose of the restructuring plan was not only to ensure the bank's long-term viability, but also to mitigate against significant distortions of competition arising from the decision to allow HRE (through its subsidiary PBB) to stay in business rather than be liquidated.

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61 IMF 2011b, 12.

62 Commission decision of 2 October 2008 in Case NN 44/2008, 'Rescue Aid for Hypo Real Estate'; Commission decision of 7 May 2009, replaced by decision of 24 July 2009 in Case 15/2009 (ex N 196/2009); Commission decision of 13 November 2009 in Case C 15/2009 (ex N 196/2009), N 333/2009 & N 557/2009, 'Hypo Real Estate – Extension of formal investigation procedure, and temporary find capital injections compatible'; Commission decision of 21 December 2009 in Case N 694/2009, 'Emergency Guarantees for Hypo Real Estate'; Commission decision of 19 May 2010 in Case N161/2010, 'Further recapitalization of Hypo Real Estate'; Commission decision of 24 September 2010 in Case C 15/2009 (ex N 196/2009) & N 380/2010, 'Extension of scope of formal investigation procedure, winding-up institution, additional SoFFin guarantees for HRE'; Commission decision of 18 July 2011 in SA.28264, 'State aid which Germany is planning to implement for Hypo Real Estate'.

63 Matthäus Buder *et al.*, 'The Rescue and Restructuring of Hypo Real Estate', Competition Policy Newsletter, 2011.

As PBB was only allowed to have an adjusted strategic balance sheet total of €67 billion at the end of 2011 (i.e., 15% of HRE's total balance sheet at the end of 2008), the restructuring plan targeted 'one of the most significant downsizings of aided banks in Europe in the financial crisis, in both absolute and relative terms'.[64] The core bank subsidiary PBB would be the only one to remain active, with its business lines limited to real estate and public investment finance. PBB was to be re-privatized by the end of 2015. On the other hand, DEPFA, the other subsidiary, and the impaired assets transferred to the HRE's winding-up institution FMS-WM would be wound down.

The restructuring plan required PBB to adopt a more stable and conservative commercial strategy, by refocusing on real estate and public infrastructure finance and shifting to a covered bonds-based funding business model to reduce its dependence on interbank funding. HRE also pledged to integrate its IT systems and drastically reduce its geographic scope, branch network and the absolute size of the business. Terminating other activities and treating them as a run-down portfolio was the logical complement to that concept. The plan also imposed lending caps and acquisition bans on HRE, while organic growth was subject to stringent restrictions.

The Commission also found that HRE and its former shareholders adequately shared the burden of the restructuring plan. While HRE's overall economic situation meant that it 'was simply not in a position to make any further own contribution to the restructuring costs' and could therefore not bear the usual 50% of the overall restructuring costs, the 'particularly far-reaching measures in the restructuring plan' were 'an adequate substitute for the lack of own contribution'.[65] Likewise, the fact that HRE's former shareholders were expropriated on the basis of a share price reflecting the value of the bank without State support meant that 'the former shareholders ha[d] been wiped out and thus c[ould] be considered as having sufficiently contributed to the costs of the restructuring of HRE'.[66]

d) The WestLB case

i) Background

WestLB, a German Landesbank owned by the Land of North Rhine-Westphalia together with two local savings bank associations, namely the *Rheinische Sparkassen- und Giroverband* (RSGV) and the *Westfälisch-Lippischer Sparkassen- und Giroverband* (WLSGV), suffered a similar fate. With assets totaling €285.3 billion as of December 2006, WestLB was one of the ten largest German banks and the third largest Landesbank. Much like the other Landesbanken, WestLB had sought to expand into investment banking after Germany agreed to abolish their unlimited guarantees in 2001. Yet, WestLB proved even less successful at this endeavor than its peers, as short term profits from investment banking activities were regularly followed by massive losses in 2002, 2003, 2004 and 2007.

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64 *Ibid.*

65 Commission decision of 18 July 2011, 'State aid which Germany is planning to implement for Hypo Real Estate', para. 120.

66 *Ibid.*, para. 121.

ii) The first restructuring plan

Even before the fall of Lehman Brothers, WestLB had suffered such heavy losses from the collapse of the subprime mortgage market that the bank's co-owners had to step in. They set up a €5 billion risk shield to protect WestLB against the volatility of its €23 billion structured investment portfolio. These measures were supplemented by a restructuring plan. However, in May 2009, the Commission concluded that WestLB would not be in a position to significantly reduce its activities whilst also restoring viability. It therefore made the approval of the restructuring measures conditional on the total or partial sale or liquidation of WestLB by the end of 2011, or otherwise the cessation of its business activities. The Commission also required WestLB to reduce its balance by 50% and curtail the volume of risky activities (e.g., proprietary trading).[67]

Although all shareholders initially agreed to the proposal, it was eventually imposed as a conditional decision, because a binding commitment by the statutory bodies of all of WestLB's owners to support the amended restructuring plan was not forthcoming at the time of the decision, which WLSGV challenged before the General Court.[68] In what was the only challenge against a Commission decision concerning State aid to German banks in the financial crisis, the two savings banks notably argued that the requirement to sell WestLB amounted to a forced privatization and thus violated Article 345 TFEU, which provides that 'the Treaties shall in no way prejudice the rules in Member States governing the system of property ownership'. The General Court disagreed, noting that while Member States may organize their systems of ownership as they please, they are still bound by the fundamental principles of the Treaty. Since the competition rules qualify as such, Article 345 cannot restrict the concept of State aid. The General Court therefore held that 'Article [345 TFEU] cannot limit the discretion conferred on the Commission to decide whether or not a measure covered by the general prohibition of State aid referred to in Article [107(1) TFEU] may be authorised under one of the derogations from that provision provided for by Article [107(3) TFEU]'.[69] Neither did the sale of publicly-held shares in WestLB affect the general system of ownership in Germany

iii) Interim measures

In its May 2009 decision, the Commission had said that the bank would be capable of returning to viability.[70] Commissioner Kroes had even described the Commission's decision as 'a turning point in a longer journey (started in 1997), a journey where the Commission has done it's [*sic*] utmost to address the chronic disease of a Landesbank that seemed addicted to

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67 Commission decision of 12 May 2009 in Case C 43/2008 (ex N 390/2008), 'The restructuring of WestLB AG'.

68 Case T-457/09, Westfälisch-Lippischer Sparkassen- und Giroverband [2011] ECR I-00819.

69 *Ibid*., para. 390.

70 Commission decision of 12 May 2009 in Case C 43/2008, para. 77.

periodical state aid'.[71] However, mere months later, WestLB informed the Commission that it needed significantly more State aid to avoid liquidation. WestLB's capital ratio was falling short of regulatory requirements due to the continuing deterioration of the underlying securities in one of the bank's portfolios. In September 2009 Germany notified the Commission of an additional €6.4 billion risk shield for certain tranches of WestLB's derivatives portfolio. The Commission temporarily authorized this measure in an October 2009 interim decision, for reasons of financial stability, while the stakeholders came up with a more systematic and stable solution.[72]

iv) Bad bank

In late 2009, Germany dropped the previously approved risk shield, as WestLB's shareholders agreed to significantly reduce the bank's balance sheet. To that effect, WestLB transferred €77 billion in toxic and non-strategic assets to the newly established bad bank *Erste Abwicklungsanstalt* (EEA). Carrying out the asset transfer required an additional €3 billion capital injection and a €1 billion guarantee.

In its decision of December 22, 2009, the Commission decided to temporarily allow the asset transfer for financial stability reasons, but at the same time opened an in-depth state aid investigation because it doubted that the measures were in line with the Impaired Asset Communication's transparency, valuation, and burden-sharing requirements. As Competition Commissioner Kroes put it: 'The setting up of the bad bank shows that WestLB's restructuring process is underway. However, I am surprised about the level of the additional aid required and will make sure that the new aid is fully compatible with EU state aid rules.'

The Commission's in-depth investigation primarily focused on the issue of the real economic value of the assets transferred to EEA. In November 2010, the Commission estimated that these assets were transferred to EEA at €3.41 billion above their market value and decided to extend the investigation opened in December 2009 to this matter.

Since WestLB would have been unable to generate the necessary funds to reimburse €3.41 billion in incompatible aid in the event of a recovery order,[73] its only hope was to find an acquirer. In fact, the December 2009 restructuring plan had already been devised under this assumption. Yet, the public tender initiated in September 2010 proved futile, as all potential buyers (e.g., BayernLB) concluded that a merger would make no economic sense. At this point it became clear that even the most far-reaching modification to WestLB's restructuring plan would fall short of addressing the issues facing WestLB. Germany and the bank's co-owners therefore took a more radical approach.

v) Liquidation

[71] Neelie Kroes, 'State aid decisions on Landesbanken', Opening remarks at press conference (12 October 2009).

[72] Commission decision of 7 October 2009 in Case N531/2009, 'Assumption of risk for WestLB'.

[73] Commission decision of 5 November 2010 in Case C 40/2009, 'WestLB AG – Decision to extend proceedings'.

In June 2011, Germany submitted a liquidation plan and concurrently withdrew all previous restructuring plans. According to the newly minted plan, WestLB would carve out its core business unit Verbundbank, a 400-employee entity focused on cooperation with regional savings banks and representing less than 20% of WestLB's original balance sheet. To alleviate the Commission's concerns that the Verbundbank would not be profitable on a stand-alone basis, Germany pledged that the entity would be taken over by Frankfurt-based Landesbank Helaba. Conversely, WestLB would transfer to EEA all assets and liabilities not sold or transferred to Verbundbank by June 30, 2012. After that date, WestLB would cease to engage in banking activities and take up the role of an asset manager.

The liquidation plan was also designed to minimize distortions of competition. With the exception of the assets carved out and transferred to Helaba, the bulk of WestLB would be sold or liquidated within the shortest possible period. Only the bank's servicing platform was allowed to continue providing asset management services, both for resolution purposes and, in limited proportions, to third parties at a fair market price. It did so with 10% of WestLB's original employee pool. By the end of 2016, after a short reorganization period, the servicing platform would have to be sold or liquidated.

Whereas the Commission had expressed concerns that the 2010 restructuring plan lacked 'sufficient measures for an adequate burden-sharing'[74] the June 2011 liquidation plan would cause WestLB's shareholders to lose their entire capital in the bank and thus ensured adequate burden-sharing. Moreover, the State of North Rhine-Westphalia committed to bearing the costs associated with liquidating WestLB (e.g., pension liabilities), while the savings banks agreed to inject €1 billion in further capital to facilitate the carve-out of Verbundbank.

5. Conclusion and postscript

Starting in 2007, Germany suffered a peculiarly asymmetric banking crisis. I have argued that this largely reflected the German banking industry's highly segregated three-pillar structure and the differentiated business models, degrees of exposure to international financial markets, and dependence on interbank borrowing, that it entailed. While savings banks and cooperatives emerged from the crisis largely unscathed due to their primarily local focus, the Landesbanken and, to a lesser extent, commercial and specialist banks were severely hit by the financial crisis due to their significant exposure to international financial markets and toxic asset-backed securities. These idiosyncrasies played a significant role in shaping the three phases of Germany's rescue and restructuring efforts.

Before the collapse of Lehman Brothers in September 2008, Germany resorted to a range of *ad hoc* aid measures designed to rescue the financial institutions that were the most heavily exposed to subprime-loaded securities, namely regional bank SachsenLB and industry financing specialist IKB. In both cases, the Commission rejected the application of Article 107(3)(b) TFEU, which provides for the authorization of aid designed to remedy serious disturbances in the economy of a Member State. Instead, the Commission viewed these cases as individual bank failures stemming from company-specific difficulties and accordingly

74 Commission decision of 20 December 2011 in Case C 40/2009, 'Approval of split-up of WestLB'.

assessed – and approved – the rescue packages under the ordinarily applicable 2004 Rescue and Restructuring Guidelines.

The collapse of HRE in late September 2008 paved the way for a more comprehensive and forward-looking approach to tackling the banking crisis. The German authorities' goal was no longer just to stabilize the sector, but also to set in motion the process of restructuring it. The October 17 Financial Market Stabilization Act and the October 18 Act Creating a Financial Stabilization Fund set up the €480 billion Special Financial Market Stabilization Fund to make available fresh capital, issue guarantees, and hold risk positions to the benefit of struggling banks, subject to the approval of their business plan. This time around, the Commission approved the scheme under Article 107(3)(b) TFEU, deeming it necessary to remedy a serious disturbance in the German economy.

No sooner had the Commission authorized the scheme than the German authorities had to use (almost) the full range of FMSA instruments to rescue the faltering Commerzbank. In May 2009, the Commission approved a package of measures in favor of Commerzbank, along with a restructuring plan designed to facilitate the bank's return to long-term viability by allowing it to re-focus on its core retail and corporate banking businesses while curtailing its more volatile and riskier activities. The Commission conditioned its approval on a series of far-reaching behavioral and structural commitments, ranging from sizeable divestitures to price leadership and coupon and dividend payment bans.

By the second half of 2009, the threat of bank runs had receded and Germany's rescue and restructuring efforts entered a third phase. To tackle its banking sector's pervasive balance sheet problems, Germany expanded its anti-crisis toolbox by enacting the Rescue Takeover Act and the Bad Bank Act, both of which proved instrumental in addressing HRE's and WestLB's difficulties.

After initial efforts to stabilize HRE proved insufficient, Germany had to nationalize the bank and to transfer the bulk of its assets to a bad bank. The German authorities' decision to keep in business rather than to liquidate the bank's core subsidiary PBB meant that they had to agree to one of the most substantial bank downsizings of the crisis. In particular, the Commission's approval was subject to a significant reduction in the bank's geographic scope, branch network and the absolute size, as well as stringent behavioral remedies.

The German government and the Commission also encountered significant difficulties in solving WestLB's persistent troubles. So much so that, when it became apparent that, contrary to the Commission's initial expectations, the bank's initial restructuring plan fell short of restoring its long-term viability, Germany took the radical step of liquidating the bank.

Yet, this did not mark the end of the German banking sector's troubles. When I drafted this chapter in mid-2015, the saga of what may have been the last of Germany's troubled Landesbanken, HSH Nordbank, had yet to come to a close.[75] The Commission had opened an in-depth investigation into the matter in June 2013, when Germany notified the Commission of a €3 billion increase in a second-loss guarantee that the Commission had originally approved together with a capital increase in September 2011.[76] On May 2, 2016,

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75 Commission decision of 2 May 2016 on the State aid and measures SA.29338 (2013/C-30) and SA.44910 (2016/N) in favor of HSH Nordbank.

76 Commission decision of 20 September 2011 on State aid C 29/2009 (ex N 264/2009) in favour of HSH Nordbank. At the time, Commissioner Almunia had 'commend[ed] the bank for acknowledging its weaknesses

the Commission approved the measure under the rules applicable at the time of notification (i.e., the 2008 Banking Communication and the 2009 Restructuring Communication), based on Germany's commitment to split the bank into a bad bank and an operating subsidiary and to sell that subsidiary without additional aid in an open tender by February 2018.

Nevertheless, it remains to be seen whether Germany's banking sector has truly emerged from the financial crisis more resilient. The sector's three-pillar structure remains intact and new research suggests that German banks may still suffer from large capital shortfalls that could call for additional State support.[77] The European Banking Authority's July 2016 stress tests have done little to allay these concerns.[78]

Still, as the IMF has recognized, 'a transformation of the [German] financial sector is clearly underway'.[79] The Landesbanken are reconsidering their business models and have experienced significant consolidation in recent years. Much like their commercial peers, they have endeavored to shed the toxic assets they had accumulated before the crisis. At the same time, the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) has strengthened the regulatory and institutional framework and could help avoid a repeat of the HRE, WestLB, and HSH Nordbank sagas.

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and structural deficits and engaging with the German authorities and the Commission's services to address them in a convincing way'.

77 Viral Acharya *et al.*, 'Capital Shortfalls of European Banks since the Start of the Banking Union', Working Paper (27 July 2016) <http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/pdfs/shortfalls_v27July2016%20(1).pdf> accessed 22 August 2016.

78 See, e.g., 'Stress Tests Do Little to Restore Faith in European Banks', *Financial Times* (30 July 2016) <http://www.ft.com/cms/s/0/b5c21178-557f-11e6-befd-2fc0c26b3c60.html> accessed 22 August 2016: 'Other Italian, Irish and German banks were also among the weakest'.

79 Michaela Erbenová, 'Globally Important German Financial System is Resilient', *IMF Survey* (29 June 2016) <https://www.imf.org/en/News/Articles/2016/07/06/21/55/Globally%20Important%20German%20Financial%20System%20is%20Resilient> accessed 22 August 2016.