No time to waste in reforming German banking

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Back in November 2008, Rahm Emanuel, then the White House chief of staff-designate, laid down a useful measuring rod for what lay ahead: "Never allow a crisis to go to waste." In the wake of the financial crisis, that dictum has direct application not just for the US, but the entire world.

Alas, in the middle of 2009, it is not just American policymakers who are letting a great crisis go to waste. Things are not much better in Germany, where this crisis ought to have led to the long-overdue reform of the banking sector – the consolidation of the **Landesbanken**.

Germany has seven independent state banks, or Landesbanken, which are jointly owned by the state governments and the savings banks. Established to provide state guarantees for regional business development, this practice was essentially outlawed by the European Commission back in 2002. Since then, Landesbanken have faced corporate governance problems. For example, the advisory boards of Landesbanken are supposed to control the top management but professional expertise plays no role in the allocation of seats. In some Landesbanken, neither the management nor the board had reliable information about their holdings of subprime mortgage products when the crisis hit.

Worse, the already doubtful sustainability of their business model – international wholesale banking – has been shattered by the financial crisis.

To compensate for their low rates of return compared to private banks of equal size, many Landesbanken before the crisis created structures to hold assets outside their balance sheets. Protected by state guarantees, they borrowed large sums of money in capital markets, which they invested in supposedly high-yielding subprime products with good credit ratings. When the products were subsequently downgraded, two state banks were forced to merge immediately. Four of the remaining seven state banks lost much of their equity and had to be bailed out by various state governments with tens of billions of euros.

This situation could get much worse: If the Landesbanken fail to clean up their balance sheets, the next decline in equity capital could prove lethal. To avert such an outcome, it is imperative to establish a **"bad bank"** to receive their toxic assets – and then continue the clean-up by reducing the number of Landesbanken through mergers.

The total assets of Germany's state banks exceed €1,900bn ($2,695bn, £1,640bn). All Landesbanken rank among the 15 biggest German banks – with four of them in the top 10. These four account for about 23 per cent of total assets of the top 10. They are so big and interconnected with the entire banking sector that bankruptcy is not an option.

Due to the unsolved problem of **toxic assets** and the shortage of equity capital, **Standard and Poor's** recently downgraded most of the Landesbanken to a rather mediocre level of around BBB+. This has turned the crisis in German banking to a large extent into a crisis specific to the Landesbanken. Against this backdrop, the federal government and the savings banks, as the biggest shareholders, have called for the Landesbanken to merge, to a maximum of three. State governments oppose this strategy because the continued existence of the Landesbanken makes it easier for them to manage their cash flow and to implement industrial policy decisions without much publicity.

One way for the federal government to restructure the system would be to take the toxic assets at zero value from the four ailing Landesbanken and transfer them into the bad bank, with the losses covered by the shareholders – state governments and savings banks. The federal government could then recapitalise the good state banks, possibly in co-operation with the savings banks. Pressured by the new shareholders – federal government and savings banks – the remaining Landesbanken could hardly resist merging into a single good bank.

Reform is both needed and possible. While this process will evolve in stages, one can envision a world in which even the two state banks that are considered relatively stable – Helaba and Nord LB – would be privatised. That would be the logical conclusion of a process which has seen the idea of an explicit public purpose of the Landesbanken fall by the wayside.

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