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**Citation**: Deo, S., Franz, C., Gandrud, C. and Hallerberg, M. (2015). Preventing German bank failures: Federalism and decisions to save troubled banks. Politische Vierteljahresschrift, 56(2), pp. 159-181. doi: 10.5771/0032-3470-2015-2-159

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**Link to published version**: http://dx.doi.org/10.5771/0032-3470-2015-2-159

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**Preventing German Bank Failures: Federalism and decisions to save troubled banks**

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**Abstract:** We examine government decisions to support troubled banks. Our contribution is the examination of how federalism can affect decisions to classify banks as systemically important. Whether a bank is viewed by politicians as 'systemically important' varies based on how its failure would affect supporters of the government. How a federation is designed has a strong influence on which banks are given public assistance. Where the top level of government is solely responsible for banks, there will be fewer systemically important institutions and so more banks will be allowed to fail. Where lower levels are responsible, governments will allow fewer failures. We use this approach to understand government support for failing banks in Germany. Our findings are relevant for the European Banking Union.

**Keywords:** Federalism, financial crisis, bailouts, systemically important financial institutions, Landesbanken

**Schlagwörter:** Föderalismus, Finanzkrise, Bail-outs, systemrelevante Finanzinstitute, Landesbanken

## 1. Introduction[1]

Why do some jurisdictions have relatively few bank failures as the result of a financial crisis, while others have relatively many, even if the crises start with similar levels of severity? To answer this question, we start with the assertion that banks do not naturally fail in some process that is separate from the state and politics. In a simple sense, a bank becomes insolvent when it is unable to meet its liabilities in a timely manner, including holding regulatory capital. A bank having trouble meeting its obligations or even one that is outright insolvent is well on its way to closing its doors. But this does not mean that it will necessarily fail.

[1] Thank you to the Deutsche Forschungsgemeinschaft for generous financial support.

Instead, letting a bank fail is a government decision. If politicians wanted to prevent a failure, they have numerous tools at their disposal to help failing banks limp along and even rebuild. They could choose forbearance, recapitalization, liquidity support, and purchasing troubled assets with publicly guaranteed funds through a 'bad bank', to name only a few options. These policies can be very expensive. Laeven and Valencia (2012) find that from 1997 through 2011 the median public cost of responding to financial crises was estimated to be about 6.8 percent of GDP. If letting banks fail is a potentially expensive political decision, why do politicians choose to prevent banks from failing?

Previous research has posited a number of factors that may shape public decisions to close or alternatively prop-up troubled banks. These include industry capture and crony capitalism (Rosas 2006), regulators' reputations and post-public service employment prospects (Kane 1989), bureaucratic capacity (Satyanath 2006, p. 18), veto players (Alesina and Drazen 1991; MacIntyre 2001; Satyanath 2006), information games played between regulators and politicians (Gandrud and O'Keeffe 2013), how bargaining is structured between banks and governments (Grossman and Woll 2014; Woll 2014), and political institutions such as democracy and electoral competitiveness (Keefer 2007; Rosas 2006, 2009) along with their interaction with interest group-state coalitions (Calomiris and Haber 2014). However, none of these approaches explain which and what types of banks are saved.

One of the most prevalent reasons given in the finance literature for why some banks receive public assistance to prevent their failure is that they are too big to fail or, more broadly, that they are systemically important (Thomson 2010, p 2). However, defining and measuring whether or not a given bank is systemically important is not easy (Segoviano and Goodhart 2009), especially before a troubled bank actually does fail, when politicians are deciding whether or not to save it. This raises the question: how do politicians decide if a bank is important enough to need saving?

In this paper, we seek to improve our understanding of why politicians choose to save a bank (or not). We argue that politicians are more likely to prevent the failure of banks that are *systemically important to them*. Our novel contribution is to define more clearly what systemic importance means to policy-makers. Rather than assume that politicians use a purely objective

financial definition of systemic importance, we argue that what policy-makers view as their financial system varies based on the overlap between banks' activities and who politicians rely on for electoral support. A key political institution shaping the group that politicians rely on for electoral support is federalism. Federalism influences both: which politicians have the power and means to prevent bank failures (national or sub-national), as well as which constituencies are important for politicians to remain in office. Federalism also shapes how policies evolve over time, especially when there are conflicts between different government levels that share banking competencies.

Not all federations are designed equally. Some federations endow only the top-level jurisdiction with banking policy competencies, while in other federations these competencies are shared between the top and provincial levels. So, it is inappropriate to use a one size fits all understanding of the effect federalism has on bank assistance. A simple dichotomous federalism variable will not be illuminating and will likely produce null findings. We need to look at how each federation is designed, particularly at what levels have exclusive or shared banking policy competencies, as well as how disputes between the levels are adjudicated.

We begin the paper with a review of the political economy literature on bank bailouts and, in particular, the proposition that systemically important financial institutions (SIFI) are more likely to be aided with public rescues. We build on this literature to develop a novel theory of how vesting different levels of a federation with banking competencies influences which banks politicians decide to save. We then examine our theory in light of decisions made in Germany during the early stages of the 2008–09 financial crisis. This case is initially anomalous. Despite a popular perception of Germany being an adamant opponent of bank bailouts during the Eurozone crisis, considerable public support was given to German banks and only three very small banks were allowed to fail during the height of the crisis. We argue that the structure of German federalism and banking sector competencies explains this apparent contradiction. Sub-national German Länder (provincial) governments have considerable power over, and are deeply intertwined with, regional banks. This *Verflechtung* (or intertwining), when added to the more general *Politikverflechtung* of the German federal system, means that multiple levels of government have influence over policy (Scharpf 1985) with an important policy affect: many

banks that were not systemically important from a national perspective were nonetheless prevented from failing at the onset of the recent crisis because they were important to Länder-level politicians. Our research has important implications for predicting the sort of support that is likely to be extended to banks in federations, a topic that is particularly important for the nascent European Banking Union.

## 2. Public responses to failing banks – Review

In this section we discuss previous work in the political economy and finance literatures to understand support to troubled banks. This literature provides a good base for studying public assistance to troubled banks, but has important shortcomings.

### 2.1 Previous political economy literature

There is a growing political economy literature on public responses to failing banks and financial crises. A portion of this research focuses on trying to explain the overall type or level of public responses to failing banks in terms of broad policy choices and ultimate fiscal costs. Keefer (2007) examines how electorally competitive countries are more likely to have lower crisis response costs. He also finds that less electorally competitive countries are more likely to use forbearance with troubled banks. Similarly, Rosas (2006, 2009) finds that democracies are more likely to use what he calls "bagehot" policies, such as providing short-term liquidity support backed by good collateral, to aid sound banks while imposing costs on and closing troubled banks. Autocracies are more likely to use costly bailouts that favor narrow banking interests. Grossman and Woll (2014) argue that governments with close one-to-one relationships with banks tend to have larger public bailouts than governments that deal with the banking sector collectively.

Others examine why policy-makers may delay troubled bank failures through some form of regulatory forbearance. Kane (1989) argues that regulators may choose to delay publicising the poor health of a bank in order to maintain their reputation until they can move on to other employment. Gandrud and O'Keeffe (2013) argue that information games between banks, regulators, and policy-makers can lead politicians to provide more support to troubled banks

during crises than they ultimately prefer.

A strain of the political economy literature examines how veto players may change the pace with which public policy responses to crises are created and enacted. It may be that when there are more policy-makers whose agreement is needed for new policies to pass, the slower the policy response will be (Alesina and Drazen 1991). Rodrik (1999) argues that how the veto players are organized is important for determining the speed of the public response. MacIntyre (2001) provides some evidence that there is a "U-shaped" relationship between the number of veto players and crisis outcomes, with a middle level of veto players resulting in the best outcomes.

In a related strain of literature mostly written before the 2008–09 crisis, political economy scholars examined the possibility that financial regulatory policies were converging as a result of globalising financial markets. Countries were anticipated to adjust their regulatory regime to a global standard. However, Lütz (1997, 2003) and Busch (2003, 2009) recognized that, as with banking resolution choices, there is not a clear trend towards such convergence in financial market regulation.

Despite this diversity of work, the political economy literature has not directly addressed the issue of which particular troubled institutions are likely to receive public support, nor developed a good way of predicting the aggregate number of bank rescues. It has also not considered the role that federalism may play in these processes.

## 2.2 Defining the system in systemic importance

There has been a vibrant discussion, especially after the start of the 2008–09 financial crisis, about how to define and measure a financial institution's systemic importance (e.g., Billio et al. 2012; Laeven et al. 2014; Segoviano and Goodhart 2009; Thomson 2010; Zhou 2010).

An unaddressed question is: what is the geographic scope of the financial system? There are two financial system levels most often discussed in the literature: national and global. For example, Thomson (2010, pp. 2–3) lays out a number of different methods for determining if a bank is systemically important. Similarly, Segoviano and Goodhart (2009) focus on nations (the United States), international regions (e. g. Europe), or the global financial system. Formal models, such as Zhou (2010), typically treat the financial system as given and do not define its geographic

scope. French et al. (2010) make a policy suggestion that countries should establish national systemic risk regulators based within their central banks.

The terms 'systemically important' and 'too big to fail' nonetheless implicitly rely on a correspondence between the financial system and governments' jurisdictions. The literature on too big to fail in particular has developed the theory that banks have incentives to change their behaviour based on the size of the jurisdiction that oversees them. Banks want to become bigger (Acharya and Yorulmazer 2007) *within their regulators' and politicians' jurisdiction* in order to receive bailouts if they run into trouble. The underlying assumption is that policy-makers want to prevent a systemic banking crisis. If one does occur, they will attempt to contain it in order to prevent the crisis' negative externalities from severely damaging the real economy (Rosas 2009, p. 6) and hurting those whose support politicians need to stay in office. Bankers recognize that policy-makers have this preference. To maximise their chances of receiving public bailouts, and therefore also minimize their borrowing costs, as their debts receive an implicit "too big to fail subsidy", bankers try to become systemically important. They can do this by growing in size and becoming more interconnected (Kane 2000). Brewer and Jagtiani (2013) find evidence for this behaviour by looking at the premiums banks pay for mergers that would turn them into too big to fail banks, compared to mergers that would not have done this.

The SIFI literature provides evidence that policy-makers have an awareness of what their banking system is and that bankers also understand policy-makers' perspective. However, most of the research again has been on national financial systems. Almost no attention has been given to understanding why regulators and policy-makers would view the national level as *the* financial system that they care about.

## 3. Our argument: federalism and systemic importance

In this section, we lay out our argument for how federalism, and specifically which level of the federation has control over banking policy, conditions which banks are regarded as systemically important and so are likely to be assisted. This also allows us to predict the overall proportion of banks that are likely to be assisted if they are in trouble.

To understand how politicians determine the relevant financial system unit that they are

concerned with, we first make the standard assumption that politicians are office-seeking. Incumbents act in order to stay in office. They will therefore be primarily concerned with mitigating the negative externalities of bank failures to those whose support they need to remain in office. In democracies supporters generally means voters.[2] The maximum pool of voters that an incumbent can draw supporters from–what Bueno de Mesquita et al. (2003) refer to as the selectorate–is generally defined by the boundaries of the area they have jurisdiction over and, in democracies, electoral system rules. For example, the selectorate for the president of the United States is clearly the voters of the United States. The incumbent president does not require the support of every member of the US electorate. Instead, the support of some *winning coalition* of voters is needed, who in turn elect delegates on a state-by-state basis, to remain in office through the next election.

Regardless of what exactly constrains the winning coalitions that politicians can form, in the banking realm they will be concerned with saving banks whose failure would have negative consequences for these supporters. Incumbents are strategic in how they target goods to voters to create winning coalitions. Their strategies are shaped by the prevailing political institutions (Persson and Tabellini 2004).

Incumbents focus on aiding banks that are important for a banking system that corresponds to their jurisdiction, and specifically to their electoral supporters. National-level politicians typically assist banks that are systemically important on a national scale, because national systemic banking crises will hurt their electoral supporters. They will also aid banks that are important to the government's electoral winning coalition specifically, even if they are not nationally systemically important. This motivation could push them to extend support to banks that are based beyond their borders if the banks threaten the stability of their own national banking system and their supporters. A good example of this is the intervention in 2011 by European Union Member States to aid Spanish banks in order to avoid bank failure contagion from spreading to their banking systems.

Negative externalities from bank failures are often in the form of credit contractions to the private economy that lead to contractions of the real economy (for a detailed account see

[2] Our argument could easily be extended to autocracies. However, our regional focus in this paper is on Europe, so we limit ourselves to a discussion of policy-making in democracies.

Reinhart and Rogoff 2009). Public finances and public policy-making more generally can also be directly and intimately tied to the banking sector. The very existence of modern banking is the result of political imperatives, especially the need to finance public policy projects (Neal 2000) that generally please incumbent supporters (Calomiris and Haber 2014). The recent increased importance of banks–or the financial sector as a whole–through a process of "Financialization" (Epstein 2005)[3] may further heighten the negative externalities of bank failures. As a result of this process not only have financial elites and financial institutions become more powerful, but capital ownership in general became more popular among middle class households. These new "financialized masses" (Erturk et al. 2007) have an intrinsic interest in preventing bank failures. They may well be a highly relevant voter group for politicians who want to get reelected.

If the federal division of competencies does not give national policy-makers exclusive jurisdiction over banking policy, but instead there is shared responsibility, the question then becomes, how do the relevant sub-national policy-makers define systemic importance? They may care about the national levels because of possible spill-overs to their region, but if sub-national voters decide their fate directly they will care most about sub-national banks in their constituency. One would expect them to be concerned with avoiding the pain that bank failures would inflict on their supporters, that is, banks that are important to their *sub-national banking system*.

This conclusion has important novel implications for predicting the number of banks that are likely to receive public support when sub-national, as opposed to national-level policy-makers, are responsible for banks. We predict that:

*In federations where sub-national governments have partial or sole responsibility for banking, over time more banks will receive public assistance, and these banks given aid will be on average smaller than those that are given aid in federations where the national government has sole responsibility for banking.*

[3] "Financialization refers to the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international level" (Epstein 2005).

One important banking sector competency that national and sub-national governments may have is direct ownership stakes in banks that enable them to direct bank lending to supporters. Failures of banks with significant public ownership stakes mean that governments may lose this tool. These failures also clearly have a direct impact on governments' financial positions, thus hampering their ability to please supporters with fiscal expenditures. *We would expect that as governments have larger ownership stakes in banks and/or rely more on financing from banks in their jurisdictions for projects to please their supporters they will be even more unwilling to simply let 'their' banks fail*. Allowing sub-national governments to have ownership stakes in banks will shape which institutions receive public assistance when they run into trouble.

A good example of this is the recent case of the Austrian lender Hypo Alpe Adria. The Austrian Land of Carinthia partially owned the lender, provided it with generous guarantees, and "found it a useful source of funds for prestige projects and [governing political] party coffers" (The Economist 2014). When it got into trouble during the 2008–09 financial crisis, Hypo Alpe Adria received considerable public financial support from the Land and national governments and was ultimately nationalized in 2009. Both the Carinthia and national governments viewed Hypo Alpe Adria as systemically important and therefore in need of assistance (The Economist 2014).

Swiss cantonal banks are another apt example. These institutions are often guaranteed and at least partially owned by regional canton governments. The banks are important providers of credit to their local economies. During the 1990s Swiss banking crisis many small regional banks were closed or merged without direct public assistance, but the cantonal banks received public assistance from their cantons to maintain their operations (Basel Committee 2004, pp. 46–47).

Finally, though a given level of government may initially assist a bank that is systemically important to it, *the specific federal structure will also shape how this assistance evolves over time*. This is particularly important in jurisdictions where banking and related powers are shared between multiple levels of government with different views of systemic importance. For example, in the Austrian case cited above, the Austrian national government later decided to assert increased control over banking policy by annulling Carinthia's guarantees to Hypo Alpe Adria (Reuters 2014). Governments can use competencies in non-banking policy areas to influence banking policy decisions at other federal levels. For example, a sub-national

government may assist a regionally important bank, but become fiscally constrained by this decision. It may then need fiscal support from a higher level of government. Politicians at the higher level may not view helping the regional bank as important to its supporters. It may then make fiscal assistance conditional on the sub-national government removing its support for the bank, possibly leading to the bank's failure.

## 4. Failures and federalism in Germany

In this section we find empirical support for our argument with a detailed case study of the decision-making processes behind German policy-makers' choices to provide public assistance to financial institutions during the recent 2008–09 financial crisis. The facts of the German case do not fit with the popular image of the anti-bailout state that many of its actions during the Eurozone crisis fostered and it is difficult for previous political economy and finance theories to explain. Despite having a severe banking crisis, only three banks failed during the early stages of the crisis, and very few banks would eventually fail after receiving considerable public support. Many of the banks that were actively aided by governments were not nationally systemically important. Furthermore, Germany had competitive elections that previous theories have posited would minimize bailouts.

In one of the most recent examinations of the 2008–09 German banking crisis, Woll (2014) argues that German bailouts were so large overall because the government was unable to get the banking industry to coordinate on contributing to its own salvation. Instead, the government had to deal with troubled banks individually. This is in contrast to Denmark, which also has a traditionally coordinated economy and pillared banking system, but which was able to find a collective solution to its very severe banking crisis. The solution involved considerable private sector participation and a dozen bank failures, including some of the country's largest banks (Woll 2014, Ch 7). Given the traditionally coordinated nature of German capitalism and its similarities with Denmark, why was a German collective solution so hard to find?

Germany's close correspondence between federal layers of government and the banking system is the major contrast between Germany and Denmark. In Denmark the national government controls banking policy. Unlike in Germany, Danish banks cannot expect local government

support and are therefore more likely to coordinate on a national solution to banking difficulties.

### 4.1 Overview of the German banking system

Banks traditionally dominate the German financial system. They compose the largest share of external corporate financing through loans (Krahnen and Schmidt 2004; Hackethal et al. 2006). Federal governments did promote the development of German securities markets (*Initiative Finanzplatz Deutschland*) in the 1990s, which led the corporate world to rely more on capital markets for financing than before (Enderlein 2011), but banks continue to play an important role in corporate financing (Deutsche Bundesbank 2012).

The banking system in Germany comprises three types of banks: Private commercial banks, cooperative banks, and public banks. The geographical scope and ownership structures of banks in these three pillars create tiered webs of national and regional stakeholders. In many ways, the structures of German banks mirror the structures of German federalism. Private banks have focussed on national and international business and have traditionally financed large industrial firms. Regionally based public and cooperative banks are focussed on retail banking and provision of loans to consumers, as well as small and medium-sized companies within their regions. The group of public banks consists of 426 local savings banks and ten regional Landesbanken which act as house banks for the German Länder and as wholesale banks for the local savings banks (Detzer et al. 2013). In the 1960s the Landesbanken, such as WestLB, were supported by regional policy-makers to expand and, in so doing, break the traditional monopoly of the big private banks in the syndicate business (Seikel 2013; Dieckmann 2012, p. 34).

The Landesbanken have been considerably transformed in the last 20 years as the state-bank link has been weakened, often due to European Commission competition rulings. Nonetheless, these banks continue to be relevant for provincial and local governments. It is important to highlight the mechanisms linking these banks to provincial politicians. These mechanisms play a pivotal role in the decision-making process behind choices to let a bank fail or not.

1. **Legal provision to serve the public interest:** The justification for the existence of public banks, i. e. the savings banks and the Landesbanken, within a market-based

economy is founded on the obligation to serve the public interest. The goal of these banks should not be just profit maximization, but rather fulfill a public task on the provincial level.

2. **Government-Savings banks-Landesbanken nexus**: The governance structure of the public banks creates extensive ties among provincial governments, local savings banks, and the regional Landesbanken. The savings banks and the respective German Land often have significant ownership shares in Landesbanken.[4]
3. **Economic policy tool**: The Landesbanken have traditionally played an important role in provincial-level politics, because governments use them to pursue policy goals, such as supporting new industries.[5] A case in point is HSH Nordbank, which in 2013 granted 40 percent of its total financial volume to clients in the region of Hamburg and Schleswig-Holstein (HSH Nordbank 2013). Another prominent example is the role WestLB played in the economic transformation of North Rhine-Westphalia from an economy based on steel and coal to one based on services. Between the 1980s and 1990s the bank bought shares in regional industries. This strategy was supported by–or at least tolerated by–the province's premier (Dieckmann 2012).

Having Landesbanken available to fund public policy initiatives is particularly important within the institutional design of German federalism. They are one of the few policy instruments that are at the discretion of the Länder. Sub-national level policy-makers need to cater primarily to their electorate in their respective area. The support of the electorate is dependent on the success of the regional economy and employment situation. However, German "cooperative federalism" (Kisker 1971) limits policy-making competencies at the sub-national level. While the implementation of Federal and Länder laws lies almost entirely with the Länder, core policy-making competencies for pleasing supporters such as taxation, labour market policies, and

[4] See European Commission reports on state aid procedure (European Commission 2008a-e; European Commission 2009a).
[5] In one of our interviews, a senior official of the German Federal Agency for Financial Market Stabilisation (FMSA) explained the mechanism as follows: While every one euro of the state budget results in one euro public spending, the possibility to use leverage means that one euro in the Landesbank translates into ten euros of public spending.

social policies are concentrated at the national level. As Scharpf (2001, 2007) highlighted, if state governments want to have a competitive advantage over other states inside of Germany or towards their European neighbours, the competencies that they have at their discretion are industry, infrastructure, and education policies. Being able to influence a Landesbank's lending is a powerful additional tool Länder governments can use to please their supporters.

4.2 The German banking crisis and political responses

Amidst the German institutional setting, the financial crisis of 2008–09 led to public support for many banks. The federal government alone supported eleven banks with either guarantees or recapitalization. Some banks were even nationalised to prevent their failure. These choices were always justified with the argument that a failure of one of these banks would lead to the failure of the others (German Council of Economic Experts 2012). As we will see, German Länder were also very active in providing assistance to regionally important banks. This is in sharp contrast to determinations of systemic importance in other contexts. In the United States, for example, very large and highly interconnected banks, such as Citigroup, were viewed as systemically important and received considerable public support. However, many smaller troubled regional banks were not viewed as systemically important by the Federal government–which had almost sole jurisdiction over banks–and were instead allowed to fail. The United States Federal Deposit Insurance Corporation (FDIC) reports that 494 banks failed in the US between 2008 and July 2013 (Sapir and Wolff 2013, p. 5). In contrast, only three German domestic banks did not receive public support and failed during the height of the crisis. All of them had tiny balance sheets. The largest was Noa bank, with about €180 million in assets. None of them had public owners.[6] Some larger banks that did receive public assistance, such as Hypo Real Estate and WestLB, were eventually wound down. However, this was after a restructuring process mandated by the most distant federal institution: the European Commission.

There is some debate over whether the Landesbanken *sector* is systemically relevant from a national perspective. Schrooten (2010) argues that the Landesbanken are systemically relevant, because the combined balance sheet of Landesbanken and savings banks who are important

[6] Weserbank failed in April 2008, Noa bank failed in August 2010, and the much smaller FXdirekt Bank AG failed in December 2012. Information based on BaFin press releases on "Moratoria".

Landesbanken shareholders contribute a large share to the total assets of the banking sector (30 percent in 2012). Conversely, Hellwig and Weder di Mauro (2009) questioned German policy-makers' interpretation of systemic importance. They see the lack of a restructuring framework for banks that would allow an orderly liquidation as leading governments to rescue too many banks. They argue that systemic importance becomes in such an environment a term that can be claimed by any bank. In particular, Hellwig and Weder di Mauro mention the example of the Hypo Real Estate (HRE)–a Munich-based real estate bank–that was considered to be systemically important because of its relevance for the *Pfandbrief*-covered bond-markets.[7]
We examine different cases of German banks receiving public support during the 2008–09 financial crisis. We capture the full range of types of troubled banks that received public assistance. Tables 1 and 2 summarise the support provided the German banking institutions we look at in detail. On the one hand, we argue that there were banks that received assistance because national policy-makers considered them to be systemically important at the national level. Among those is Commerzbank, which was viewed as systemically important by the Federal government because of its size (it is the second largest bank in Germany). Also included in this group is Hypo Real Estate. It was a major issuer of *Pfandbriefe* and thus highly interconnected. On the other hand, there are banks that were systemically important to sub-national governments. These were the Landesbanken WestLB and HSH Nordbank.

**Table 1:** Selection of Nationally Systemically Important Banks

| | **Commerzbank** | **HRE** |
|---|---|---|
| Employees & Total assets | 43,169; €625 billion (2008) | Approx. 1,900; Approx. €400 billion (2008) |
| Scope/Size of rescue measures | Recapitalization (€8.2 billion) and guarantee framework for securities (€15 billion) ('SoFFin I') | Guarantee framework (reached up to €124 billion) Recapitalization (€9.8 billion) |

[7] *Pfandbriefe* are fixed income bonds that are considered to be almost as safe as public bonds and are subject of particular legislation, the German *Pfandbrief* Act.

| | | |
|---|---|---|
| | Subsequently, additional equity capital provided (€10 billion) (‘SoFFin II’) | Subsequent nationalization and the creation of a bad bank |
| Who rescued? | Special Market Stabilisation Funds (SoFFin) | SoFFin |

*Source:* Commerzbank: European Commission 2009b; HRE: European Commission 2008c.

## 5. Saving Nationally Relevant Banks

### 5.1 Commerzbank

In general, Commerzbank “was affected less than average by the financial market crisis owing to the bank’s focus on retail and commercial banking and its low-key proprietary trading and investment activities” (European Commission 2009b). Nonetheless, the failure of Lehman Brothers and continuing troubles in the subprime markets hit its trading and investment portfolios hard. At that time, Commerzbank had around 43,000 employees and total assets of €625 billion in 2008 which would become about €1,100 billion once its merger with Dresdner Bank was completed (European Commission 2009b; Commerzbank 2008).

#### 5.1.1 Crisis unfolds and result

Revaluations of its public sector portfolio and the bankruptcies of Lehman Brothers and a number of Icelandic banks greatly diminished Commerzbank’s capital reserves and the additional capital increase implemented in fall 2008 to assist the recent purchase of Dresdner Bank proved insufficient. To avoid imminent insolvency, public assistance was provided to Commerzbank in two-steps, SoFFin I and SoFFin II. In total, capital measures of €18.2 billion were provided, alongside a €15 billion guarantee (European Commission 2009b).

#### 5.1.2 Systemic importance?

It is clear from Germany’s position in the European Commission’s hearing that Commerzbank was viewed as a “systemically important credit institution”, which should not come as a surprise

as it was the second largest bank in Germany in terms of credit provision (European Commission 2009b).

### 5.2 Hypo Real Estate

While Commerzbank may be a fairly straightforward case of systemic importance on the national level due to its size, it is important to look at another major German bank rescue to capture another mechanism that can trigger national systemic importance: interconnectedness. Interconnectedness is especially important in the German *Pfandbriefe* market. These covered interest-bearing bonds are issued on the capital market by licensed credit institutions and represent one of the largest fixed income markets in the world (Prokopczuk et al. 2013).

We will focus here on the most prominent case of a troubled private bank issuing *Pfandbriefe*–Hypo Real Estate. The Munich-based HRE focussed on commercial real estate finance. HRE's business model was extremely successful in the years prior to the crisis. While in 2003, HRE ranked fourteenth among German banks in terms of total assets (€152.9 billion), it rose to seventh in 2008, with total assets of €419.7 billion.

#### 5.2.1 Crisis unfolds and result

Supported by a favourable pre-crisis business environment, HRE was working on a high-risk investment strategy as well as acquiring other institutions. The most prominent bank that HRE took over–and probably the most problematic–was the Dublin-based DEPFA Bank. The acquisition, completed in October 2007, almost doubled HRE's balance sheet (Handelsblatt 2007). DEPFA refinanced long-term credits for public sector projects with short- or medium-term credit lines (European Commission 2008c). This business model was highly reliant on the inter-banking market, which came to a sudden halt after the Lehman Brothers collapse. DEPFA and HRE quickly faced a liquidity shortage that threatened their solvency.

From this moment on, HRE became dependent on public support to prevent it from failing. Between fall 2008 and the end of 2010, HRE received government guarantees of €124 billion. Between March 2009 and November 2009, SoFFin recapitalized and eventually nationalized HRE. In September 2010, HRE established a publicly owned asset management company and

transferred a portfolio worth €173 billion to the new entity (European Commission 2011). Due to these massive state aid measures, the European Commission's Directorate General for Competition (DG Comp) demanded that the bank be significantly restructured (Buder et al. 2011).

### 5.2.2 Systemic importance?

The question of whether HRE was really systemically important has been heatedly discussed (Hellwig and Weder di Mauro 2009) among policy-makers and researchers. In February 2009, finance minister Peer Steinbrück said in an interview to the Kieler Nachrichten newspaper that HRE had to be stabilized in order to stabilize the *Pfandbrief* market.[8] The German government argued that it was not only HRE's size that was the largest threat of a failure, but HRE's massive stock of outstanding *Pfandbrief* bonds. According to a reply by the German government to a parliamentary inquiry, HRE and its subsidiaries constituted the second largest issuer of *Pfandbriefe*.[9] Therefore, a failure of HRE had to be avoided in order to prevent any damage to the good reputation of the German *Pfandbrief* (Bundestag 2009).

**Table 2:** Selection of Banks Important to Sub-National Banking Systems

| | **WestLB** | **HSH Nordbank** |
|---|---|---|
| Employees & Total assets | 5,663; €281.1 billion (2008) | 5,070; €208.9 billion (2008) |
| Scope/Size of rescue measures | Risk shield (€5 billion) and subsequent creation of a bad bank (which included recapitalization by | Recapitalisation (€3 billion) and a "risk shield" (€10 billion) |

[8] In the German original, Peer Steinbrück said: "Sie [HRE] muss stabilisiert werden – damit auch der deutsche Pfandbriefmarkt" (Bundestag 2009).

[9] It is important to note that other troubled banks had a high stock of outstanding *Pfandbriefe* in 2008, but were not rescued on the base of their risk to the *Pfandbrief* market. This is because of the different crises banks experienced. While *Pfandbriefe* are resilient towards an insolvency of the issuer, because the cover pool is not part of the insolvency procedure, a liquidity crisis of a bank is problematic for the performance of *Pfandbriefe*, because then the issuer cannot provide timely payment to the bondholder. The example of LBBW illustrates this difference: The bank held *Pfandbriefe* worth €74 billion on its balance sheet, roughly 10 percent of all outstanding *Pfandbriefe* at the time. However, LBBW's liquidity was never in doubt, rather the bank needed further capital to fulfill the regulatory requirements. The differences between these cases were also confirmed by the revaluation of the *Pfandbriefe* by the rating agency S&P which links the rating for the *Pfandbrief* also to the liquidity risk of the issuer (Cünnen 2009).

| | SoFFin) | Additional guarantees by SoFFin (up to €30 billion) |
|---|---|---|
| Who rescued? | Shareholders, the vast majority of which are controlled by NRW and local savings banks. | Länder of Freie- und Hansestadt Hamburg and Land Schleswig-Holstein |

*Source:* WestLB: European Commission 2008e; HSH Nordbank: European Commission 2009a.

**6. Saving Sub-Nationally Relevant Banks**

In the next section, we analyse public assistance to Landesbanken WestLB and HSH Nordbank to demonstrate that regional policy-makers with responsibility for banking provided similar assistance as their national counterparts when their constituents' interests were at risk.

6.1 WestLB

"In the current discussion, we speak about the future of WestLB, the financial center Düsseldorf, 6,000 employees, and the future of the Landesbanken,"[10] said the premier of North Rhine-Westphalia (NRW), Jürgen Rüttgers, during an interview on the potential acquisition of WestLB by another Landesbank (Landesbank of Baden-Württemberg, LBBW) in August 2007. In doing so, he highlighted several important aspects of regional policy-makers views' about Landesbanken in general and WestLB in particular.

The Düsseldorf-based WestLB had the tenth largest balance sheet in Germany. In 2007, the state of North Rhine-Westphalia owned about 37.7 percent of WestLB's shares, the local savings banks together owned about 50.3 percent, and local municipalities owned the remaining 12 percent. The bank had struggled for some years already and had failed to find a functioning business model after the removal of the Landesbanken's state guarantees. This led to a disastrous track record for the bank. It had an accumulated loss before tax from 2001–07 of about €5.08 billion (European Commission 2010).

6.1.1 Crisis unfolds and result

[10] Original: "In der aktuellen Diskussion geht es um die Zukunft der WestLB, den Finanzplatz Düsseldorf, es geht um 6000 Arbeitsplätze und um die Zukunft der Landesbanken." (Ludwig 2007).

Following the removal of public guarantees, WestLB moved into new investment markets including the U.S. subprime market. As a result, the financial market crisis hit WestLB's portfolio hard and resulted in significant write-downs and difficulties refinancing its business.
On January 20, 2008, the owners of WestLB–the state of North Rhine-Westphalia and the savings banks–gathered for an emergency meeting to find a solution for an expected 2007 loss of €1billion and further expected write-downs of €1billion from the deteriorating value of assets on WestLB's balance sheet. The first plan of providing capital injections worth €2billion to WestLB was rapidly replaced by a more far reaching "risk shield" of €5billion when the German regulator's stress test revealed more significant threats (European Commission 2008e).[11]
This first attempt to stabilize WestLB, however, proved to be insufficient. On November 24, 2009, the German government and WestLB's shareholders agreed to establish a bad bank winding-down agency–the Erste Abwicklungsanstalt (EAA)–to which the bank could transfer its impaired assets and relieve its balance sheet from the constant pressure of having to keep more capital to account for these assets.
The European Commission's Directorate General for Competition was again crucial in the decision to ultimately wind down the bank. DG Comp demanded significant restructuring of WestLB due to the high level of state aid it received. Initially the plan was to restructure WestLB. However, over the course of the following year it became clear that restructuring WestLB was impossible within the Commission's rules. First, attempted mergers between the WestLB and other Landesbanken (such as the BayernLB) failed largely for political reasons, then the negotiation with other investors did not deliver any further results and eventually the bank came to the understanding that a reduction of the total assets to 20 percent of WestLB's former size–one condition laid out by the European Commission–would not leave a viable business. As a result, the Federal government and the owners of WestLB decided to liquidate WestLB and split it into three parts of which one was sold to Helaba, a second part was transferred to the bad bank and a third part continues to exist to assist the winding-down of the bad bank's assets.

[11] The agreement between the owners determined that the first €2billion of these guarantees would be covered by all shareholders according to their share in the WestLB. If the loss would exceed these €2billion NRW would bear the remaining €3billion on its own.

### 6.1.2 Systemic importance?

The abolition of the *Gewährträgerhaftung* guarantees resulted not only in the Landesbanken's expansion into new business areas, but also increased pressure to consolidate. The politically charged nature of the mergers indicate how important regional politicians viewed their banks to be. A key example is the failed acquisition of WestLB by LBBW in August 2007. The Premier of NRW at the time, Jürgen Rüttgers, rejected the plans, because he feared they would reduce the significance of Düsseldorf, a key city in his Land, as a leading financial centre (Handelsblatt 2010). In the spring of 2008 it was already too late to find a buyer for WestLB and the negotiations with Helaba (the Landesbank of Hesse and Thuringia) failed because Helaba's shareholders feared the risks in WestLB assets (Köhler 2008).

Despite WestLB's huge losses and the widespread opinion among observers that the bank has no functioning business model (e. g. von Hiller 2007), the government of NRW and the savings banks provided extensive guarantees. The support was strongest among the savings banks that owned parts of WestLB and resisted until the very end the plans to break up the bank. Without the influence of the European Commission, public support for the bank likely would have continued.

## 6.2 HSH Nordbank

"We want a bank, which can support the export oriented North German mid-sized industry abroad" was the way Premier Heide Simonis of Schleswig-Holstein justified the merger between the Landesbanken of Hamburg and Schleswig-Holstein, which led to the creation of HSH Nordbank in 2003 (Deutsche Welle 2013). HSH Nordbank was a recipient of state guarantees that other Landesbanken enjoyed as well, the end of which necessitated changing the core business model. Nonetheless, the bank remained largely publicly owned. Prior to the crisis, majority shareholders of HSH Nordbank were public.

### 6.2.1 Crisis unfolds and result

Being headquartered in Hamburg, a major port, HSH Nordbank is heavily involved in shipping

finance. As the financial crisis hit, overcapacity in the shipping container industry along with historically low charter prices strained HSH Nordbank's business model (Brautlecht 2014). HSH Nordbank suffered a €2.8 billion loss in 2008. It received a bailout of €13 billion from two German states in February 2009 (Spiegel 2009). Nonetheless, HSH Nordbank's losses continued to mount with a reported loss of €124 million in 2012 and €814 million in 2014 (Brautlecht 2014).

### 6.2.2 Systemic importance?

There are clear parallels between this case and WestLB's in terms of HSH Norbank's importance to regional politicians. A large percentage of loans made by HSH Nordbank go to clients in Hamburg and Schleswig-Holstein.[12] HSH Norbank's market penetration among potential regional clients is more than 50 percent. In 2008, HSH Nordbank had approximately 5,000 employees, most of whom were situated in Hamburg and Kiel, the principal city in Schleswig-Holstein. HSH Nordbank actively remains engaged with the local community, organizing events for entrepreneurs and managers along with a charity run. Furthermore, in an interview, a senior official from the Federal Ministry for Financial Market Stabilisation stressed that politicians' role on the bank's board is extremely important for both the bank and the politicians, helping them achieve their respective goals. This supports the argument that banks are systemically important for regional politics, while explaining HSH Nordbank's influence at the local level, both financially and politically.

### 6.2.3 Result

Though the German government argued for systemic relevance of HSH Nordbank at the European Commission's Competition commission hearing, especially its systemic importance to Hamburg and Schleswig-Holstein (European Commission 2009a), separate interviews with three members of the Bundestag who worked on financial matters at the time suggest a tension between regional views and national views of systemic importance. The interviewees argued that the government's position at the Commission was strongly influenced by Hamburg and

[12] In 2013, 40 percent of its lending was to clients in Hamburg and Schleswig-Holstein (HSH Nordbank 2013).

Schleswig-Holstein, along with the local savings banks associations. The interviewed members of the national parliament went on to highlight the suboptimal nature of the existing business model of HSH Nordbank, stating that it would have been better to allow the bank to fail than to continue operations.

## 7. Conclusion

In this paper we show how federalism can play a crucial and previously unnoticed role in determining which and how many banks politicians are likely to support when on the brink of insolvency. In doing so, we make a novel contribution to understanding how politicians view whether or not a bank is systemically important. In contrast to the previous literature on systemically important financial institutions, we do not take the financial system's geographic scope for granted. Instead, we argue that what politicians view as the financial system and therefore which banks are systemically important is strongly influenced by the institutions of federalism. From this novel proposition, we argue that federations which give banking policy responsibility to sub-national politicians are likely to see public assistance given to relatively more and smaller banks than federations where national politicians exclusively control banking policy.

Indeed, in Germany where both the Federal and provincial governments have banking system powers, a very few small banks were allowed to fail outright during the height of the 2008–09 financial crisis. Our approach allows us to understand bank rescue decisions in Germany that previous work has been unable to explain. Federalism also shapes how governments interact after initial support has been provided. The European Commission's Directorate General of Competition–which does not rely on German banks for support–was especially important in ultimately forcing the restructuring and winding down of failed banks that were being assisted by provincial and national politicians.

Our approach has clear distributive implications for banks and therefore should help us understand their behaviour as well. If it is true that sub-national politicians are more likely to save smaller banks, smaller banks should be motivated to lobby for supervision by sub-national governments. We actually have seen this type of activity in the recent negotiations regarding the

establishment of the new European Banking Union.

German savings banks have lobbied strenuously to be excluded from supervision by the European Central Bank under the Single Supervisory Mechanism and resolution under the Single Resolution Mechanism. This lobbying has been successful. The new Single Supervisory Mechanism is mostly limited to the 120 or so largest banks, excluding smaller regional banks such as Germany's savings banks (Steinhauser and Stevens 2013). Based on our work here we can predict that a crucial reason for this lobbying is not that the savings banks are worried about preventing bank bailouts in other EU Member States, but instead that they were trying to preserve the high likelihood of local government support they would receive in difficult times.

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