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On a Fundamental Reorganisation of the Landesbanks and Savings Banks Sector in Germany

Institute for Monetary and Financial Stability
Johann Wolfgang Goethe-Universität Frankfurt am Main

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Table of Contents

1. Motivation and background 2

1.1 Motivation 2

1.2 Background 3

2. The interconnectedness of savings banks and Landesbanks... 5

3. Basic considerations for the reorganisation of savings banks and Landesbanks 8

3.1 Business model 8

3.2 Governance / Owners 10

3.3 Competition 10

4. Proposed model 11

4.1. Sparkassenregionalinstitute (SRIs) 12

4.2. Sparkassenzentralinstitut (SZI) 14

4.3. Landesförderbanken (LFBs) 15

4.4. Overview of the proposed model 16

4.5. Open organisational issues 16

5. Recommended course of action.................................... 18

1. Motivation and background

1.1 Motivation

The robust economic trend in Germany and positive labour market data have diverted attention from the fact that fundamental structural problems in the financial sector have still to be addressed, not least owing to the current financial crisis. Indeed, first steps have already been taken towards improving the regulation of the financial sector – capital and liquidity requirements are becoming more stringent, the incorporation of systemic risks is in preparation under Basel III and the first statutory regulations have been laid down to abolish the de facto survival guarantee for financial institutions ("too-big to fail") and to ensure bank creditor participation in the event of an imminent insolvency.

However, these initial steps focus on crisis prevention in the financial sector – yet the fundamental issue of a reorganisation and strengthening of the public-sector segment[1] of the German financial industry continues to be unaddressed. This white paper aims to promt a discussion of one of the most important segments in our country's financial infrastructure, namely the Landesbanks and savings banks. The real shortcoming is not so much the problematic situation of some segments in this sector but rather the absence of a broad debate on the desirable structure of this key component of the financial sector in Germany. We assume that a topic of such relevance for general discussion is not taking place because well-reasoned alternative approaches worth openly disputing are simply lacking. Without tangible, coherent alternatives, the subject matter is often too complex for many who take an active interest to participate meaningfully in the debate.

The structural model presented here fulfils a range of conditions that we presume as given and which can be derived from three main goals, namely economic earnings power, a broad offering of financial services and overall economic sustainability. In this way, it is possible to ensure that a discussion take place on the presented model as a realistic, albeit ambitious, alternative to today's situation – while leaving the details of the design to the political process. At the same time, however, it also affords the public a basis of assessment for actual policy decisions

[1] More precisely, of the financial institutions in federal or municipal ownership. In some cases they are currently organised as legal persons under private law.

enacted during this historically decisive phase for the further development of the German financial sector.

Given the partly grave state of political disarray surrounding the bail-out and future structure of Landesbanks and the widespread conflicts of interest between municipal, state, association, federal policies and European competition policy, an open and critical public debate is of particular relevance. Taken as a whole, Landesbanks and savings banks currently pose a considerable financial risk to the Federal Republic of Germany and the public budgets – if, overall, a targeted reform of the sector proves unsuccessful. At the same time, however, it offers the chance to permanently strengthen the role of the German financial industry in an integrated European financial market – provided that the necessary measures have been taken in a decisive manner. We discuss some versions further below. Based on the foregoing, the authors convened for "workshop talks" with the goal of prompting a forward-looking reform (debate) for the overall "Landesbanks and savings banks" sector in a bid to move away from the currently rather haphazard and piecemeal consolidation efforts in behalf of German Landesbanks[2].

1.2 Background

The sector's current situation is highly worrisome, not least because fundamental structural changes affecting Landesbanks impacted by the state aid investigation have been dictated by Brussels but have yet to be implemented. Moreover, savings banks and the Federal States are still planning to retreat from their ownership in most of the Landesbanks.

Also looming large are substantial burdens arising from the implementation of a number of regulatory changes, above all Basel III, the bank levy and a deposit guarantee scheme reform.

At present, major segments of the Landesbanks sector have neither a sustainable business model nor economically viable income or balance sheet structures. The burden on Landesbanks stemming from financial assistance and from costs for government guarantees is very high. In so far as the Federal States have injected equity capital, this may be considered a form of economic subsidisation of the current profit and loss account, as distributions cannot be anticipated in the foreseeable future. Roughly 10% interest must be paid on any silent participation.

[2] The discussion surrounding the merger of West LB and Bayern LB in early autumn 2010 serves here as a case in point.

The likelihood of reducing the resulting charges is remote. If the silent participations were converted into equity or share capital, the risk position of the owners would increase as it would then be treated as core capital.

Several Landesbanks have been kept afloat – in some cases for years – by substantial government support predicated on the “too big to fail” argument. Such a situation – as in the case where assistance was provided for a number of heavily indebted privately organised banks – has resulted in a distortion of the competitive environment in the German banking landscape. This is exacerbated by the burden that directly results from the extensive use of tax money to bail out public and private banks.

At first glance, the municipal savings banks appear stable and seem to be unscathed by the crisis at large Landesbanks. However, this is true only to a certain degree. On the one hand, they – and hence their municipal owners – are indirectly owners[3] of the Landesbanks via the regional savings banks associations and are thus proportionately liable for their losses to the extent that any liability (still) exists. On the other hand, savings banks hold, to a large extent, claims against Landesbanks, with figures cited in the three-digit billion range. Should further write-downs on the values assigned to their ownership interests be required, the stability of numerous savings banks would be at risk. Against the backdrop of this problematic and complex situation, it is possible for a confidence crisis to develop rapidly. Thus, there is considerable pressure to take action, which is further exacerbated by the restrictions imposed by the EU. Now is the time to take suitable precautions in order to protect the public owners (Federal States and municipalities), the German economy and the German consumers, too. The current economic upswing affords the opportunity to undertake the necessary fundamental structural reforms. A reform of the Landesbanks and savings banks in Germany – as well as the streamlining of distressed private banks – will be decisive for the question whether Germany is able to eliminate the prevailing structural risks in the

[3] For historical reasons their ownership interest (as of mid-2009) is typically 50%, with the remaining 50% held by the relevant Federal States. A similar ownership interest has been essentially maintained at Nord LB, LB Bremen (as subsidiary of Nord LB) and West LB. By contrast, the ownership interest of savings bank associations in LBBW has been reduced to 40.5%, and likewise reduced to a 15% interest in Saar LB, 6% in Bayern LB and 5.3% in HSH. Only Helaba and LB Berlin present a different picture. Whereas the association’s ownership share in Helaba increased to 85%, LBB was 98% taken over by means of a complex arrangement by the German Savings Banks Association.

financial sector and thus also stave off a repeat of the current financial crisis.

2. The interconnectedness of savings banks and Landesbanks

It is a matter of public record that key segments of the German Landesbanks lack a stable and self-sustaining business model and have neither a sustainable, robust income structure nor a resilient balance sheet. In particular, the refinancing of Landesbanks following the abolition of state guarantees ("Anstaltslast und und Gewähr-trägerhaftung")is still unresolved, as neither the interbank market nor the capital market makes funds available on reasonable terms. This has resulted in a significant shrinkage of the balance sheet for individual Landesbanks - a process which is far from being complete. The final outcome of the state aid investigation and resulting restructuring requirements is still to a large extent open for the Landesbanks concerned. Fact remains that the balance sheet total needs to be roughly halved, while the balance sheet has to be adjusted for non-performing loans and securities as well as non-strategic business units.

An isolated examination of the Landesbanks falls decidedly short of the mark, however, as the problematic situation of the Landesbanks as a whole cannot be properly appreciated without taking into account its specific environment, close economic interconnectedness and cross-liabilities. In addition to the ownership structures – savings banks today still contribute to the liable capital to a significant degree – the role of savings banks as creditors and ultimate economic providers of the guarantee scheme of the savings banks and Landesbanks is central to the further examination. The following facts are relevant for the discussion of a new Landesbanks and savings banks structure that is geared towards system stability.

Although the savings banks' business model has weathered the financial crisis decidedly better than that of Landesbanks, it is not altogether free from weaknesses. The operating result is highly dependent on the maturity transformation and on the net result from own funds. The withdrawal of the ECB's crisis-related expansionary money market and liquidity policies, coupled with the associated flattening of the yield curve, will presumably have significant negative repercussions on net operating interest income of the Landesbanks and savings banks.

Savings banks have material excess funds, leading to considerable investment pressure on the asset side, which used to be resolved via deposits at Landesbanks. Following the abolition of state guarantees for Landesbanks, major solvency problems have arisen in a number of cases that particularly impact savings banks in their position as creditors vis-à-vis Landesbanks. The continued existence of substantial financial risks resulting from the state guarantees, although abolished as of 2005, puts an additional strain on the situation. The state guarantee expires in 2015 and at present is still expected to represent a three-digit billion figure. In addition, a major portion of the subordinated capital of Landesbanks was subscribed by the savings banks.

The high reliance of savings banks on interest income is evidence that risk diversification of revenue sources is widely absent. Commission income continues to consist by and large of commissions on payment transactions and account management; in both of these areas competition (free account management) and EU legal requirements will permanently reduce revenue.

There will be increased competitive pressure in savings bank-dominated market segments (private banking and SMEs). The private banking sector is largely consolidated through the merger of Unicredit and HVB, Commerzbank and Dresdner Bank and Deutsche Bank and Postbank. There are also formidable competitors from other countries (ING, Santander/SEB, and Credit Mutuel/Targobank) whose private-client-focussed business models in their respective home markets have clearly demonstrated their ability to succeed in these market segments.

The strategic capacity of savings banks and savings banks associations has been significantly impacted in recent years.

Alongside the noted burden arising from their role as creditors for the Landesbanks, legacies from past consolidation efforts severely limit the flexibility of the organisation as a whole. The acquisition of LBB not only leads to a considerable volume of additional write-downs at the savings banks but also makes it more difficult to effect any meaningful structural change that includes LBB as long as the write-downs have not been recognised. In this setting, the step towards a full takeover of DekaBank, which is a strategically desirable move for the savings banks, in and of itself becomes a severe test for the entire savings banks organisation.

At the savings banks there is no conceptually unified, sustainable concept discernible for the structure of the Landesbanks. For the most part, the savings banks seem to be intent on losing no time in retreating from all responsibility for financial burdens associated with their commitment as owners and creditors vis-à-vis Landesbanks. The willingness and capacity of savings banks to use financial resources for such a dissociation process is objectively limited. This will have repercussions on the alternative courses of action to be pursued.

Savings banks, Landesbanks and regional building societies are integrated via various support funds into a joint liability scheme that guarantees the existence of the financial institutions and hence their clients' deposits. In a crisis situation, a multi-tiered liability cascade regulates financial support. According to the current system, savings banks and Landesbanks are liable to one another. Following the abolition of state guarantees, the quality and economic performance of such an institutional protection scheme no longer meets the requirements.[4] Neither the funding of guarantee schemes nor the guarantee pool is likely to be sufficient to bail out even a single larger Landesbank.

Based on experience from the financial crisis, the EU plans to reorganise deposit guarantee schemes across Europe.[5] The savings banks would like to be exempt from this regulation by virtue of the existing institutional protection scheme. If the preservation of the savings banks' institutional protection scheme and exemption from inclusion in a newly created deposit guarantee scheme become subject to the condition that the Landesbanks exit the joint liability scheme of the savings banks, this would have far-reaching consequences for their credit rating. Independently of this, the question arises whether today's institutional protection scheme is still applicable to Landesbanks, which are almost exclusively owned by Federal States. Moreover, those savings banks, which balance their books in accordance with GAAP accounting rules, have an accounting advantage over Landesbanks, which report according to IFRS. The comparatively solid financial performance of savings banks from 2007 to 2009 is mainly, albeit not exclusively, driven by write-downs on fixed assets that were either not at all or only partly required under GAAP. In the end, the burden resulting from a fair value assessment is borne by the Landesbanks but not – or at least not to the same extent – by the savings banks.

The foregoing considerations lead to the conclusion that a one-dimensional approach to a future-oriented reorganisation of the

[4] The same of course applies to deposit guarantee schemes of private and co-operative banks.

[5] EU Commission draft directive dated 12/7/2010 KOM(2010) 368/2.

Landesbanks in Germany is simply not practicable. First, the need for a fundamental structural change also holds true for the savings bank sector. Second, due to the interconnectedness of Landesbanks and savings banks, only a collective, future-oriented reorganisation is meaningful. The debate on reform must therefore be extended to encompass the entire “Landesbanks and savings banks” sector.

3. Basic considerations for the reorganisation of savings banks and Landesbanks

Irrespective of the concrete legal organisational structure, a restructuring of the Landesbanks and savings banks in Germany will need to satisfy a number of basic “objective” requirements in order to be economically viable, legally feasible and politically acceptable. The last-mentioned criterion pertains to the ownership structure of the Landesbanks and savings banks, without whose positive – if not to say enthusiastic – co-operation a concrete reform proposal has no chance to succeed. We identify three such basic requirements: the development of a sustainable, future-oriented business model, the creation of permanent ownership structures and the promotion of competitive structures in the banking market.

3.1 Business model

As noted in the introductory section, the majority of the Landesbanks currently have neither a sustainable business model nor economically viable income or balance sheet structures. Failing access to the broad retail market, the Landesbanks have frequently focussed on specific market segments, for which a network of branch offices is not a prerequisite, or else they have expanded abroad. The previous competitive edge in wholesale banking derived from the comparatively very favourable refinancing terms via the state guarantees, the abolition of which resulted in margins no longer comfortable compared to private national and international competitors. A straightforward expansion of the business model that would open access to the retail business has proved barely sustainable to date given the competition with savings banks, which are (indirectly) owners of the Landesbanks. There have been some notable exceptions to date, mainly in the operating area of the Federal State of Berlin, in Frankfurt am Main, in Baden-Württemberg and in Braunschweig.

Accordingly, the restructuring of the Landesbanks sector is anything but an inherently solvable task. Redistributing and/or shrinking volumes and/or functions alone will not lead to the emergence of new competitive units. Only when a sustainable business model for Landesbanks has been devised will there be renewed interest in taking over an entrepreneurial role for these banks.

The wholesale business of the Landesbanks is generally regarded as tending to be opportunistic and highly capital market-dependent, seizing upon individual opportunities but falling short of systematically covering or developing a market. For this reason as well, the business is particularly prone to volatility. A restructuring of the sector therefore must lead above all to the development of a business portfolio that is sufficiently diversified, with corresponding profitability and a reasonable risk profile.

The integration of savings banks may be accomplished in a different way, as set out further below. Savings banks provide a natural extension to Landesbanks through their private and corporate client business (notably in the retail but also SME sector); they offer stable and competitive refinancing, by means of which liquidity and profitability may be improved. Direct or indirect access to the retail banking market and SME credit business results in improved diversification and more stable revenues while minimising the reliance on money and capital markets. Conversely, the ties with Landesbanks enable savings banks to systematically expand in the upper medium-sized business sector and support companies through a growth and internationalisation process.

This invites the conclusion that a form of *verticalisation* is necessary for the restructuring of the Landesbanks. The goal of tying the business models of Landesbanks and savings banks in this way, however, is not to subsidise the weaknesses of one side with the strengths of the other. The tie-up is aimed rather at securing – by means of balanced business and balance sheet structures – a structural contribution to the microeconomic compensation of risk and hence to financial market stability. It is therefore probable for the whole to be more stable than the sum of its parts. For the moment, the issue of which legal organisational form this verticalisation should take remains open. At this juncture it suffices to elucidate the conceivable alternatives, ranging from stable contractually agreed cooperations through to a legal merger.

3.2 Governance / Owners

Past experience has shown that savings banks and the Federal States have pursued a variety of business strategy interests in their capacity as owners of the Landesbanks. Since the financial crisis, however, both owner groups have been equally intent on retreating from their responsibility vis-à-vis Landesbanks. Nevertheless, a further development of the Landesbanks is conceivable only if their owners are in the position and willing to abide by their entrepreneurial responsibilities and provide the Landesbanks with the equity capital they need in order to ensure their risk bearing capacity and growth. This holds particularly true against the backdrop of the increased capital requirements under Basel III.

The foregoing considerations evince a second requirement: A separation of both owner groups should take place if the conflicts of interest that were clearly apparent in the past are to be avoided. The goal should be that financial institutions emerge from a structural reform with a clear strategic orientation that aligns with that of their owners, i.e. financial institutions that are owned either by the municipalities and/or savings banks associations, on the one hand, or by the Federal States on the other. Therefore, the separation of responsibilities within the savings banks and Landesbank sector must be radically rethought. In the interest of financial stability – but also of the owners and taxpayers – an improvement in risk management, as well as in the internal and external control of public banks, is indispensible.

3.3 Competition

As competitors, Landesbanks fulfil an important function for the German economy. They hold market shares of between 20% and 40% in the mid- and large cap, commercial real estate and project financing, as well as municipal and state credit business. Accordingly, they are important partners for companies, commercial real estate and institutional clients, not to mention municipalities, states and the federal government. Compared to other market participants, they are also prepared to carry risks on their balance sheet and not transfer these to other players. Were it not for the Landesbanks, competition in key market areas would be severely hampered in the wake of the consolidation of commercial banks that has already taken place. This being so, it simply cannot be the goal, from a competitive point of view, to abolish the Landesbanks.

A consolidation of the Landesbanks‘ and savings banks‘ activities under a single roof would create a bank with a balance sheet ranking among the largest in Europe, surpassing even that of Deutsche Bank. Such a concentration of banks in Europe's largest and most important economy would not be desirable in terms of competition policy, is hardly likely to be authorised by the European anti-trust authorities and would not be possible to finance. In light of the foregoing, it likewise cannot be the objective from a competition point of view to simply merge the Landesbanks into a single bank.

In keeping with this, a politically viable reform of the Landesbanks and savings banks in our view entails a consolidation that does nothing to reduce competition in the financial market but everything to strengthen it instead. This involves the notion that the desired financial institutions of the future are large enough and sufficiently diversified to assume at some point an active role in the European market as well. Competitiveness defined in this way opens up growth opportunities for the financial institution not only in its regional market as it exists today but also reaching beyond to encompass the national and international market.[6]

4. Proposed model

The general requirements outlined in Section 3 may in principle be combined with a large diversity of reform concepts. From among a multitude of conceivable models, we would like to present – on the basis of the stated basic requirements – a new structural model that features a clear division of labour while at the same time providing for a bundling of forces. For the sake of simplicity, the proposed model shall be referred to as the *tripartite model* in that it gives rise to three new types of financial institutions alongside which the traditional (municipal) savings banks will continue to exist.

In addition to the savings banks, the basic components of the tripartite model consist of the following: several *Sparkassenregionalinstitute* (SRIs) [regionally integrated public banks], a *Sparkassenzentralinstitut* (SZI) [national financial service institution] and a number of *Landesförderbanken* (LFBs) [state development banks]. DekaBank and Landesbanks are either wholly or partly assimilated by the three stated

[6] Comparable financial institutions in other countries have successfully entered the competition in Europe for some time now and have seen gains in market share as a result. Examples include the competitors of other countries, such as financial institutions in Italy, Spain and France.

components. Thanks to the redistribution of responsibilities, existing overlap is eliminated.

For example, currently existing Landesbanks will be split into three parts and assigned to the newly established financial institutions (cf. Chart 1). This means that the retail business of a Landesbank will be integrated into one of the newly created *Sparkassenregionalinstitute* [regionally integrated public banks]. At the same time, any existing Verbund business (joint business) within a Landesbank will be incorporated into the *Sparkassenzentralinstitut*. Thirdly, and lastly, all unsustainable business segments will be either phased out or transferred to a bad bank. This is based on the assumption that a sale or initial public offering is not practicable for Landesbanks with their traditional business model as wholesale banks and that only a divestment of Landesbank segments is feasible, as a number of examples have already demonstrated.

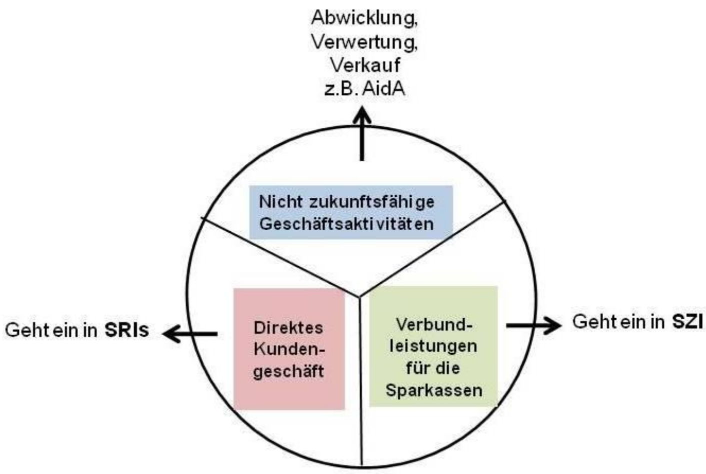

Chart 1: Split of Landesbanks

4.1. Sparkassenregionalinstitute (SRIs)

The integration of savings banks and Landesbanks[7] within a single metropolitan area gives rise to a small number of *Sparkassenregionalinstitute* [regionally integrated public banks]. On a supra-regional level, these financial institutions conduct their retail banking, mid- and large cap, project finance, capital market, municipal and real estate financing business, as well as special funds business for institutional investors. Their retail banking, as well as business with

[7] Strictly speaking, this refers only to the Landesbank’s direct client business, i.e. in particular the mid- and large cap business.

smaller and medium-sized enterprises, on the other hand, is performed on a regional level within the operating area of the integrated savings banks. By contrast, the SRIs transfer the Verbund business services, including building society, mutual fund and leasing activities, to the SZI.

These financial institutions will be characterised by a better risk diversification vis-à-vis the status quo. Above all, they provide for a more balanced asset/liability management. The vertical structure allows for a broader range of products, including internationally operating medium-sized businesses (wholesale) while at the same time promoting broad-based access to client business (retail).

The new regional banks are formed from the tie-up of Landesbanks and savings banks, preferably on a regional level. This can be achieved by exploiting Germany's distinct economic structure with its metropolitan areas of Hamburg/Bremen, Berlin, Cologne/Dusseldorf, Hanover, Frankfurt/Rhein-Main, Stuttgart/Rhein-Neckar and Munich. As regards the Landesbanks, activities with development potential in the mid- and large-cap segment, including other segments, will be transferred to the new SRIs.

Regional banks will play a pivotal role in the further development of these metropolitan areas. In contrast to the current situation, the savings banks and Landesbank sector will initially operate as a regional savings finance group, as it were, and later as a supra-regional *S-Finanzgruppe* [S-financial group]. The integrated business model of a *Sparkassenregionalinstitut* [regionally integrated public bank] is strongly focussed on the direct client business and is able to dispense with speculative investments. A balanced relationship between the client and capital market business goes a long way to ensure the earnings power and hence the growth of these financial institutions over the long term. This also secures a high rating.

For the Landesbanks such a solution would necessitate spinning off the legacies and non-strategic activities, as well surplus in personnel, into a bad bank, the risk of which remains with the previous owner. However, another possibility would be a sale or reduction on the part of Landesbanks in their own right. The existing integrated business models at LBBW, LBB, Helaba and NordLB lend themselves to further development with the possibility of creating new SRIs in the other metropolitan areas. However, the emergence of such regional cluster is also conceivable through the merger of savings banks (even without the participation of one of today’s Landesbanks). The SRIs essentially belong to the municipalities and municipal associations. Alternatively to a metropolitan area based business model or as a long-term development model, supra-regional business models are as in other European countries (e.g. Italy, Spain, Austria) also possible in the event of an abolition of the regional principle.

The creation of integrated business models leads to competitive units for the private and corporate client business that are able to hold their own in intra-European competition with access to the capital market. Several such regional clusters should be created in order to fulfil the second basic requirement, namely competition. These could constitute an effective competitive corrective to the private commercial banking sector.

Chart 2: Functions and components of SRIs

4.2. Sparkassenzentralinstitut (SZI)

The underlying premise is the creation of a *Sparkassenzentralinstitut* (SZI) [national financial service institution] centrally providing the Verbund business (joint business) for the savings banks and newly created SRIs. This business includes proprietary and client securities business, syndicated lending, payment transactions, mutual fund offerings, closed funds and certificates, leasing and consumer loans as well as building society and insurance business. Within the framework of a holding solution, regional building societies are thus integrated into the SZI in the same way as DekaBank and other banks with Verbund business, such as insurance companies under state or municipal ownership that are already assigned to the savings banks group at present. In these business segments there will be only one product provider within the savings banks organisation, allowing economies of scale to be fully exploited.

Chart 3: Functions and components of the SZI

Therefore, it is necessary, among other things, to adjust the ownership structures at DekaBank and transfer DekaBank to the sole ownership of the savings banks. DekaBank and other banks of the *S-Finanzgruppe* [savings banks financial group] that are owned by the savings banks may represent the nucleus of the *Sparkassenzentralinstitut* [national financial service institution].

The business model of the *Sparkassenzentralinstitut* is sustainable, as it encompasses the Verbund business with the savings banks and regional banks, as well as the associated indirect access to the retail market. This provides for a balanced business portfolio. As a holding company, the *Sparkassenzentralinstitut* is the exclusive responsibility of the savings banks and savings banks associations.

4.3. Landesförderbanken (LFBs)

For the Landesbanks, for which integration into a regional savings or Sparkassenzentralinstitut [national financial service institution] is not a viable option, the only remaining possibility is an orderly winding down, as purely wholesale banks may not be sold or listed on the stock exchange. A conceivable alternative to directly winding down the banks is perhaps to streamline them down to activities approved under the Agreement II ("Verständigung II") or a merger with the public sector development banks of the Federal States. The "competitive business" may be sold off, and the legacies – in keeping with the previous ownership structures – may be transferred to a bad bank, which implements the orderly winding down as agency within an agency (publicly owned special purpose vehicle). In this way the main problems of an orderly winding down, namely the reduction of personnel and safeguarding public employee pension benefits, are thereby resolved.

The newly formed *Landesförderbanken* [state development banks] have a clear development mandate under the Agreement II ("Verständigung II") and are under the sole ownership of the Federal States. On the basis of the public legal framework and under the ownership of the Federal States, they have good access to the money and capital markets and are able to fulfil the development tasks of the Federal States. However, they need to be subject to effective monitoring by their state sponsor. Liability for the wind-down facility ("bad bank") of the Landesbanks (e.g. agency within an agency) must be taken over by the legacy owners of the (former) Landesbanks on a pro rata basis and cannot rest solely with the Federal States.

4.4. Overview of the proposed model

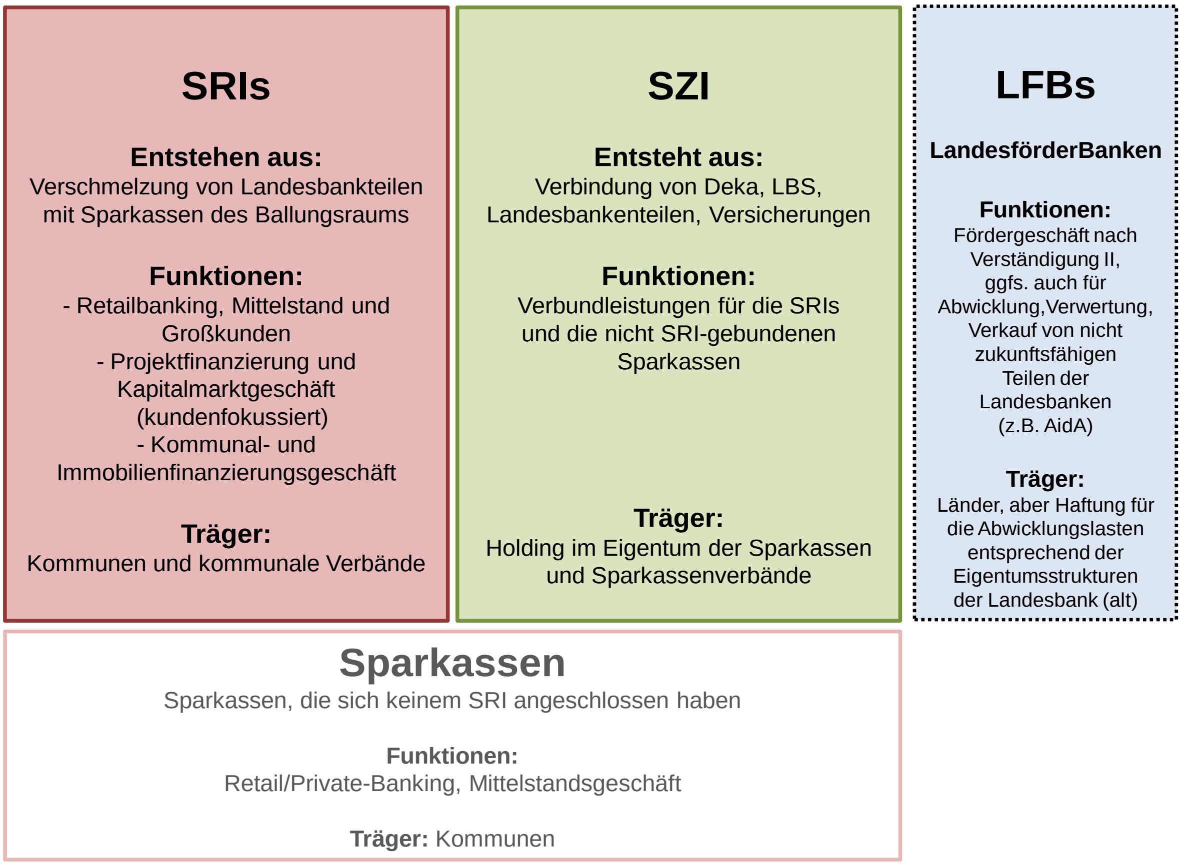

Chart 4: Tripartite model consisting of SRIs, SZI and LFBs

4.5. Open organisational issues

The three reform components – SZI, SRIs, LFBs – complement one another; their implementation would constitute a 'big bang' for the

German financial industry. In our view, positive growth impetus is a realistic possibility not only for the overall economy but for the financial industry as well. On the longer term, we expect the proposed reform model to provide a strong boost to financial competition in Germany. This is particularly so if, following the formation of competitive regional banks, the regional principle, which continues to enjoy public law guarantees to this day, should be restricted or entirely eliminated.

However, there are formidable obstacles standing in the way of the implementation of our reform model some of which are addressed in the following section. It will take no little imagination and a strong political will to tackle and overcome these hurdles in a structured manner. We believe these challenges can be overcome within a reasonable period of time if such political will is at hand.

One major obstacle consists in the complex **ownership structures** of financial institutions under federal or municipal ownership. This is further exacerbated by the fact that the interests of the savings banks are bundled in regional associations, which in turn have their own legal personality and in particular undertake special functions while pursuing their own interests. If the restructuring proposal presented in this paper is to have a chance, all parties concerned must be convinced that it is to their advantage to participate in the restructuring process. This applies to the owners of Landesbanks, i.e. in particular to the Federal States and associations, including their owners, as well as the savings banks themselves. Consequently, for each of the parties concerned it is important to examine the degree to which the relevant situation stands to improve as the result of a 'big bang' – be it that individual expected losses are reduced or that positive courses of action may result.

However, a system of **compensation payments** should make it fundamentally possible for all parties concerned to improve their position and thus prevent a veto posture on the part of individual parties involved. Since the overall solution strengthens the competitive performance of the financial sector as a whole while stabilising it at the same time, there also exists at least in principle a net capital gain calculated across all parties concerned to be distributed more or less equitably by means of the system of compensation payments. For example, a way must be found for municipalities as owners of the savings banks to integrate the latter into an SRI. There are various solutions to choose from, including those already implemented in other

European countries in comparable situations and whose results can be relied upon for an assessment of alternatives[8].

The compensation payments required for the formation of the SRIs and SZI need to be **financed**. For example, the question arises as to how the savings banks and associations will finance the missing shares in the banks that are integrated into the SZI. Solutions need to be found that do not necessarily entail raising additional capital on the part of the owners. Intelligent participation models may be a conceivable solution, too. In our view the elaboration of a corresponding financing and participation strategy is a challenging – albeit manageable – task.

We have not given due consideration to two other challenges so as not to find ourselves mired in a maze of topics and as a result put off the development of a proposed solution to the Landesbank problem. First, we have not examined **legal issues**, in particular the question of the public mandate of savings banks and Landesbanks, as well as rules and regulations from the Federal State-specific rights of savings banks. These topics merit deeper investigation as they could have a considerable impact on the above-mentioned requirements. Second, we have not looked into the issue of a meaningful, i.e. lastingly viable and at the same time credible **guarantee scheme** for savings banks and Landesbanks.

All of the topics addressed in this section – ownership structures and compensation payments, their financing and related legal issues, as well as the reform of guarantee schemes – are indeed relevant; even so, they are secondary in importance to the fundamental structural issue that is the focus of interest in this white paper.

5. Recommended course of action

In the previous sections of this white paper we outlined in brief a possible structure for the entire savings banks and Landesbank sector, leaving aside a few relevant issues. This draft fulfils the basic requirements, set forth at the outset, for a desirable reform of this segment of the public law financial system. Given today's prevailing banking structure, these requirements cover 1) the verticalisation of the banking sector, 2) the clear allocation of ownership rights to a (public)

[8] Alongside a wide variety of approaches adopted in Italy, Spain and France, other different innovative options are also conceivable. We shall not pursue these considerations further in this study.

body and 3) the protection or improvement of competition in the market for financial services.

As to the course of action going forward – and in order to put the discussion on a socio-political legitimate track – we recommend the establishment of a **government commission** with a corresponding mandate to develop a proposal ready for implementation with regard to the restructuring of the entire public law financial sector, or at least the savings banks and Landesbanks. This proposal is to be submitted within a clearly established timeframe and on the basis of a clearly defined government agenda.

We regard the reform proposal presented in this paper as a contribution to the formulation of the objectives and agenda for this government commission. If it should be decided to set up an **enquête commission** instead of a government commission, the report is to be presented to the parliament. In either case the members of the commission are to be appointed by the mandating authority – i.e. government or parliament – and authorised with a mandate for their task. Stakeholders, such as representatives of the associations, savings banks or Landesbanks, should be consulted by the commission but should not be members of it.

The results of this commission’s work will serve as a conspicuous and pro-active strategy in response to the long-standing reproaches on the part of the European Commission. The implementation of this strategy will permanently preserve the savings banks and Landesbanks sector as a formidable force within Germany while laying the foundations for such a position within Europe. Accordingly, we are convinced that keeping the discussion initiated here alive should rank high on the political agenda, particularly in the light of imminent burdens on state budgets in the absence of fundamental reforms.

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