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Germany: Technical Note on Crisis Management Arrangements

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

GERMANY

CRISIS MANAGEMENT ARRANGEMENTS

TECHNICAL NOTE

JULY 2011

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS AND LEGAL DEPARTMENTS

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GLOSSARY

BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
BCBS	Basel Committee on Banking Supervision
BMF	Bundesministerium der Finanzen (Federal Ministry of Finance)
EAA	Erste Abwicklungsanstalt
ECB	European Central Bank
EFC	Economic and Financial Committee
ELA	Emergency liquidity assistance
EU	European Union
FMS	FMS Wertmanagement
FMSA	Federal Agency for Financial Market Stabilization
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
HRE	Hypo Real Estate Group
IADI	International Association of Deposit Insurers
IMF	International Monetary Fund
KfW	Kreditanstalt für Wiederaufbau
MOU	Memorandum of understanding
SoFFin	Special Fund for Financial Market Stabilization

EXECUTIVE SUMMARY

Following the global financial crisis, a new financial stability framework was introduced in October 2008. The authorities set up the Special Fund for Financial Market Stabilization (SoFFin) to be administered by the Federal Agency for Financial Market Stabilization (FMSA). Financial stability support measures comprised guarantees, recapitalizations, asset purchases, and subsequently, the establishment of winding-up institutions. The authorities also strengthened the mandate of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

The authorities provided sizeable financial sector support measures during the crisis. The volume of guarantees peaked at €174 billion, with only €64 billion remaining at end-2010. Recapitalizations amounted to €29.4 billion, of which €150 million has been repaid as of end-April 2011. The FMSA also oversees the winding-up institutions created for WestLB and Hypo Real Estate Group (with portfolios of €63 billion and €174 billion at end-2010, respectively). Some banks received additional assistance from the federal states.

The financial support has contributed to overall financial stability, and a more detailed exit strategy will need to be defined soon. The authorities' support contributed to overall financial stability, benefiting also institutions that did not seek assistance. With a view to promoting a viable financial sector going forward, concrete action plans need to be established with regard to the remaining capital injections and the winding-up institutions. Strategic plans should aim at reducing the likely future need for assistance, either by raising private capital or by adjusting banks' balance sheets. The process will take considerable time to complete, with uncertainty as to the overall losses. It is understood that the authorities are deliberating on their strategy.

The new bank restructuring law significantly strengthens the crisis management framework in Germany, although interagency coordination needs to be clarified. The new law, which reflects many aspects for a stronger bank resolution framework as currently discussed at the European Union (EU) level, grants broad powers to the authorities to facilitate more timely and effective resolution of problem banks that are deemed systemically relevant. It empowers BaFin to transfer the banking business to another institution, including to a bridge bank, with coordination with the FMSA in case resources are needed to facilitate the transfer. In this regard, the process for interagency coordination between BaFin and the FMSA should be set out more clearly. The law should be enhanced by introducing provisions regarding resolution plans. The regime could be further complemented by a tool for the transfer of assets and liabilities suitable for all banks (not systemically relevant) to facilitate efficient resolution upon entering corporate insolvency proceedings (as a cost-efficient alternative to the reimbursement of depositors in bank liquidation). While the law applies to financial groups that comprise banks, consideration could be given in the future to establishing a special resolution regime for other nonbank systemically-important financial institutions.

The new restructuring fund is crucial to facilitate bank resolution, but additional coordination with the private deposit insurance schemes and mutual protection schemes is needed. With limited resources initially built up by means of the bank levy, existing contingency funding arrangements remain important. Under the current arrangements, resources from the private deposit insurance schemes and mutual protection schemes may be committed to finance the restructuring of banks on a going-concern basis (rather than to reimburse the depositors). In this regard, clarification is needed as to the interaction between the restructuring fund and the private deposit insurance schemes and mutual protection schemes in the restructuring of banks deemed systemically-relevant whose deposits are protected by one of the schemes. A deposit insurance scheme or mutual protection schemes have mandates and fiduciary responsibilities distinct from that of the restructuring fund, but they will inevitably interact; coordination is therefore all the more important.

With a stronger bank resolution framework in place, the shortcomings of the deposit insurance regime should be addressed. The deposit insurance regime is fragmented, pre-funding is very limited, and its features lack transparency. However, confidence among depositors was maintained during the crisis, also because of the authorities' public commitment to fully protect household deposits. Yet, limitations became apparent in the commercial bank's private scheme in connection with the failure of Lehman Brothers, and in the mutual protection scheme run by the savings banks association in the case of some *Landesbanken*. The current coverage level of €100,000 under the statutory schemes appears broadly appropriate in that it is estimated to cover more than 90 percent of retail deposit accounts. In order to make this coverage applicable for all three pillars of the banking system, the two mutual protection schemes run by the savings banks association and cooperative banks, respectively, should be modified to ensure that depositors have a legal claim for the reimbursement of €100,000 (including changes to the legal framework as needed). Key information on the actual financial strength of the various schemes should be made public. To reduce pro-cyclicality, any pillar scheme should build up adequate pre-funding.

The Bundesbank has procedures in place for emergency liquidity assistance (ELA) that take account of the Eurosystem provisions regarding the information exchange in this area and the principle of constructive ambiguity. The Bundesbank made use of its ELA framework during a short period of time in 2008–09. The Eurosystem has a range of monetary policy instruments to ensure the appropriate supply of liquidity to the financial sector as a whole.

Institutional arrangements for cross-border crisis management are in place, but concrete procedures and tools need to be further developed. The Federal Ministry of Finance (BMF), BaFin, and the Bundesbank have established a standing committee to coordinate and facilitate regular discussions on financial stability and crisis management issues. This committee acts also as a "single point of contact" for foreign authorities in cross-border crises. Crisis management groups were set up to discuss institution specific cross-

border crisis management issues. It is encouraging that the German authorities are actively involved at the international fora to deal with cross-border crisis management. They are aware of the importance of an appropriate legal framework and developing procedures and tools ex ante for handling the major distress at a German global bank, including how to deal with burden sharing arrangements and conflict of laws when defining resolution strategies.

Table 1. Key Recommendations

Topic	Recommendation
Restructuring Fund	Ensure the financial strength of the new bank restructuring fund, and clarify the interaction between the restructuring fund and the various deposit insurance schemes and mutual protection schemes that allow the commitment of resources for bank restructuring.
Crisis Management Framework/Bank Resolution	Strengthen the framework for crisis management by: a) including provisions on resolution plans; and b) specifying more clearly the process of coordination between BaFin and the FMSA in bank resolution.
	Consider introducing a complementary tool for the transfer of assets and liabilities suitable for all banks (not systemically relevant) to facilitate efficient resolution upon entering corporate insolvency proceedings (as a cost-efficient alternative to the reimbursement of depositors in bank liquidation).
	Finalize specific strategies for exiting from the government support to banks, and require the affected banks to formulate strategic plans aimed at reducing the likely need for such assistance.
Deposit Insurance	Reform the deposit insurance regime by: a) extending the legal claim for the reimbursement of EUR 100,000 to the savings banks' and cooperative banks' mutual protection schemes; b) introducing an appropriate and harmonized limit to the currently very high level of coverage under the private deposit insurance schemes; c) ensuring adequate ex ante funding for both the statutory and private schemes; and d) providing key information on the actual financial strength of the various schemes to the public.
Cross-Border Coordination	Develop further concrete procedures and tools ex ante for handling financial distress of German global banks, including burden sharing arrangements and how to deal with conflict of laws when defining resolution plans.

I. Introduction

1. **As part of the German Financial Sector Assessment Program (FSAP) Update for Germany, January 19–February 4, 2011, this note seeks to identify challenges and measures to strengthen crisis management arrangements.** This note was prepared on the basis of discussions with counterparts at the various ministries, agencies, banking associations, and other relevant stakeholders, including a review of materials published and provided prior and during the mission. We very much appreciate the many productive discussions and would like to thank our counterparts for their cooperation and the provision of relevant materials for the preparation of this note.[1]

2. **Crisis management frameworks aim at handling distress in financial institutions, while minimizing risks to financial stability.** This note covers several fields, including crisis coordination, liquidity assistance, bank resolution, and deposit insurance, also drawing on recent developments at the EU level. It also analyses the coordination between different agencies with differing institutional mandates and responsibilities. It further explores whether the crisis management arrangements are ex ante defined and well embedded in a regulatory framework. Further, it discusses the cross-border crisis arrangements.

II. Crisis Management Process and Coordination

3. **Adequate coordination among the various agencies tasked with different elements of the crisis management framework, and regular testing of arrangements, are essential.** Several authorities and agencies are involved, such as the BMF, BaFin, the Bundesbank, and the FMSA, and good coordination is crucial to act timely and effectively. High-level interagency coordination in crisis management takes place within the Standing Committee for Financial Market Stability of the BMF (Ständiger Ausschuss). It comprises the BMF, Bundesbank, and BaFin, and meets twice a year or on an ad-hoc basis when needed. Another forum for coordination of financial sector support measures is the FMSA's steering committee (Lenkungsausschuss), comprising representatives from the Chancellery, various ministries, the federal states, the Bundesbank (in consultative capacity), but excluding BaFin. In late 2010, a working group dealing with specific bank resolution issues was formed including representatives of BMF, BaFin, the FMSA, and the Bundesbank. The banking associations representing the three pillars of the banking system play an important role by administering the various private deposit insurance schemes and mutual protection schemes.

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[1] This note has been prepared by Elias Kazarian (Monetary and Capital Markets Department) and Maike Luedersen (Legal Department), and is reflecting developments as of end-April 2011.

4. **Given the high confidentiality of bank specific information, sharing of information among the various agencies during the crisis was at times constrained by the boundaries of the legal framework, though an appropriate solution was found.** Going forward, the framework (including modifications to legal provisions as needed) should be applied in a manner that allows for an expedient exchange of information within and between relevant agencies during a crisis situation.

5. **BaFin is tasked with banking supervision and the formulation of bank resolution strategy, though close interaction with the Bundesbank on the former and the FMSA on the latter is essential.** BaFin maintains three internal risk committees that focus on possible vulnerabilities in each financial sector (banking, insurance, and securities), including cross-sectoral issues. BaFin and the Bundesbank closely coordinate in the interagency risk committee on banking matters, which also encompasses BaFin representatives for all three financial sectors. If Bundesbank is tasked with macro-prudential oversight, the role of the interagency risk committee could be further broadened. For bank resolution, because BaFin is not represented on the FMSA's steering committee, a mechanism for close collaboration between BaFin and the FMSA would appear useful, for example, by developing further the working group on bank resolution issues.

6. **The Bundesbank maintains an internal crisis committee and a steering committee.** The crisis committee is chaired by a board member and combines expertise from various departments such as banking, financial stability, markets, and payment issues. The steering committee is at the staff level mainly focusing on operational issues.

III. Financial Stability Measures

7. **Parts of Germany's banking system were hit hard during the financial crisis, but with exceptional support measures, the financial sector has stabilized.** Early signs of financial stress in individual institutions (e.g., IKB, SachsenLB) emerged during the summer of 2007 and were addressed by the authorities with ad hoc solutions. The authorities provided substantial support to IKB, channeled through the development bank Kreditanstalt für Wiederaufbau (KfW). SachsenLB required support by a state guarantee and was later taken over by another *Landesbank*.[2] Following the failure of Lehman Brothers, the liquidity rollover needs at Hypo Real Estate Group (HRE) (a major issuer of covered bonds) in early October 2008 required substantial financial support and led to subsequent nationalization in 2009. These ad hoc measures demonstrated the limitations of the then-existing framework.

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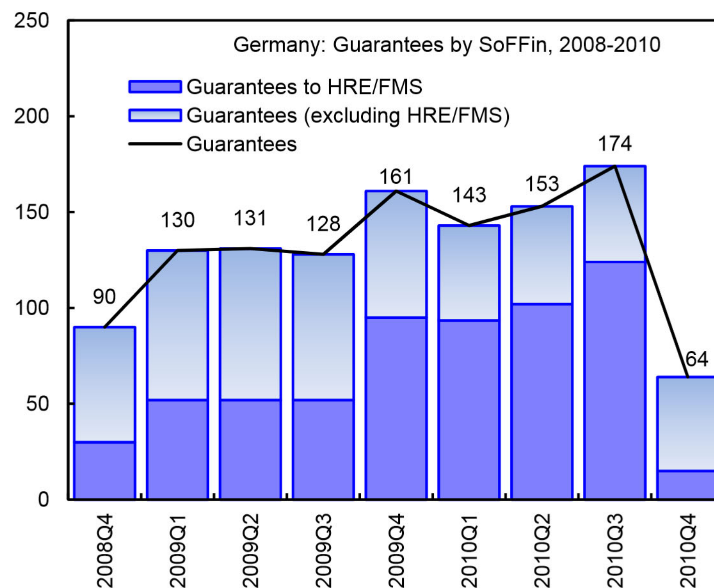
[2] Guarantees of €2.75 billion were provided by the federal state of Sachsen (with a line of credit extended by the savings bank group). SachsenLB was later taken over by Landesbank Baden-Württemberg.

8. **The German authorities moved to a more comprehensive approach in addressing the financial crisis.** A new financial stability framework was introduced in October 2008, including the establishment of the FMSA to administer the SoFFin fund.

9. **Although the FMSA is a federal agency with its own management structure, decisions on important matters ultimately involve the BMF.** The FMSA's management team is guided by a steering committee composed of representatives from the Chancellery, BMF, Ministry of Justice, Ministry of Economics and Technology, the federal states (*Länder*), and the Bundesbank (the latter in consultative capacity only). The BMF reports on the FMSA's activities to a special parliamentary committee.

10. **Under the new framework public resources were provided for (a) guarantees; (b) recapitalizations; and (c) in support of the winding-up institutions.** Financial stability measures comprised guarantees, recapitalizations, asset purchases, and subsequently, the establishment of winding-up institutions. The total volume of support available through SoFFin was capped at €400 billion for guarantees and €80 billion in capital support/asset purchases. The uptake of financial sector support administered by the FMSA has been significant.[3] At its peak, the volume of guarantees reached €174 billion (see chart below), with only €64 billion remaining at end-2010.[4] The availability of these guarantees for interbank loans and bank-issued debt alleviated funding constraints. Recapitalizations amounted to €29.4 billion total, of which €150 million has been repaid so far.[5] However, the modality for direct asset purchases remained unused. The financial support provided by the authorities has contributed to overall



Source: FMSA

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[3] Some support measures involved conditions such as the review of the banks' business plan and compensation limits.

[4] Further reduced to €35.2 billion outstanding by end-April 2011. None of the SoFFin liquidity guarantees have been called yet. In case of state guarantees provided for capital support, it is anticipated that at least in some instances the guarantees may eventually be called (e.g., SachsenLB).

[5] Taking note of substantial repayments made after end-April 2011, €11.7 billion has been repaid already.

financial stability, benefiting also institutions that did not seek assistance. The window for granting new SoFFin support closed at end-2010, with the exception of any ancillary measures that may be needed to support the existing winding-up institutions and the exit from the capital positions.

Table 2. Germany—Key Measures in Response to the Financial Crisis (as of April 2011)	
2007	
Aug.	IKB received €3.5 billion from public and private banks. Sachsen LB receives credit line of €17 billion from savings bank group and €2.75 billion in guarantees from the state of Saxony.
Dec.	Landesbank Baden-Württemberg takes over Sachsen LB.
2008	
Mar./Apr.	WestLB receives €5 billion first loss guarantee from its owners.
August	KfW agrees to sell its 90 percent share of IKB to investor Lone Star.
Sept.	BaFin prohibits naked short-selling of selected instruments.
Oct.	Hypo Real Estate receives liquidity support with package worth €35 billion from the Federal government, banks, and financial sector firms to prevent collapse, subsequently increased to €50 billion. Government announces public commitment to fully protect household deposits. *Finanzmarktstabilisierungsgesetz* is passed creating SoFFin and providing framework for €480 billion in guarantees, recapitalizations, and asset purchases.
Nov.	Commerzbank is granted €15 billion in guarantees (of which €5 billion are taken) and receives €8.2 billion in the form of a silent participation from SoFFin (at end-2008). Bayern LB is granted €15 billion in guarantees (of which €5 billion are taken, subsequently reduced to €2.8 billion) and receives €10 billion in capital from state of Bavaria.
2009	
Jan	Commerzbank to receive additional €10 billion from SoFFin, made up of a silent participation amounting to €8.2 billion and a capital increase of 25 percent of ordinary shares plus one share held by the Federal government against payment of €1.8 billion.
Feb.	HSH Nordbank receives €3 billion in capital and €10 billion in guarantees from states Hamburg and Schleswig-Holstein. Hypo Real Estate support reaches total of €52 billion in guarantees from SoFFin.
March	HSH Nordbank is granted €30 billion in guarantees from SoFFin (of which €17 billion are taken and €13 billion are subject to conditions). SoFFin buys shares in Hypo Real Estate worth €60 million.
April	*Finanzmarktstabilisierungsergänzungsgesetz* is passed, including an option for public takeover of banks as a last resort. SoFFin buys shares in Hypo Real Estate worth €124 million. Landesbank Baden-Württemberg receives €5 billion in capital and €12.7 billion in guarantees from state Baden-Württemberg.
May	BaFin extends prohibition of naked short-selling.
June	SoFFin to provide €2.96 billion in capital to Hypo Real Estate.
July	"Bad-Bank"-Act is passed allowing the establishment of winding-up institutions.
Oct./Nov.	Hypo Real Estate is nationalized after squeezing out shareholders with compensation of €158 million and receives additional €3 billion in capital from SoFFin, with guarantees extended until end-June 2010.
Dec.	Winding-up institution created for WestLB to take on up to €85 billion portfolio of assets and liabilities. WestLB core bank to receive €3 billion in capital support from SoFFin.
2010	
April	WestLB split into core bank and a residual €77 billion portfolio is transferred to the winding-up institution EAA.
July	Winding-up institution created for Hypo Real Estate to take on up to €210 billion portfolio of assets and liabilities.
Oct.	Hypo Real Estate is split and a €176 billion portfolio is transferred to the winding-up institution FMS.
Dec.	Availability of new financial stability measures supported by SoFFin expires at end-2010.
2011	
Jan.	New bank restructuring law in force that allows for special resolution measures and establishes a restructuring fund.
Feb.	Revised restructuring plan for WestLB with different options, including possibility to increase the size of the portfolio transferred to the winding-up institution EAA.
April	Further details of restructuring plan for WestLB submitted to the European Commission.

Sources: Authorities and IMF staff. Status: April 2011.

11. **Two winding-up institutions have been set up as public bodies with their own governance structure under the general oversight of the FMSA.** The portfolios of the winding-up institutions are legally characterized as spin-offs where assets and liabilities of the transferring entity are split and normally transferred at book value to the winding-up institution. As the transferring entity's owners (but not the transferring entity) remain responsible for any losses in the winding-up institution, this approach appears suitable for a limited range of institutions only. For example, in practice it would normally not be feasible to impose additional financial responsibility on shareholders in a commercial bank in excess of the value of their shares.[6]

Box 1. Germany—Winding-Up Institutions

The first winding-up institution was established for WestLB (Erste Abwicklungsanstalt (EAA)) in late 2009. By April 2010, a portfolio of about €77 billion in assets and liabilities had been transferred priced at book values. The assets mainly consisted of lending operations, tradable securities, and structured loans. The ownership structure of the EAA reflects the ownership of WestLB that includes the state of North-Rhine Westphalia and two regional savings banks associations. Due to progress in the disposal of assets, the current volume of the EAA portfolio was reduced to about €68 billion by August 2010, and €63 billion by end-2010. Losses amounting to €1 billion have been realized so far, though less than projected. At the outset, provisions were made to cover expected losses of about €4 billion, with an additional €5 billion set aside for losses incurred in the "Phoenix" portfolio. Further loss-sharing arrangements are in place for unexpected losses, though limitations apply benefiting the regional savings banks associations. The transfer to the EAA is currently being reviewed by the European Commission under its state-aid rules with a specific focus on the transfer pricing (the valuation differences are estimated at €3.4 billion), and a revised restructuring strategy with different options was submitted to the European Commission in mid-February 2011, with further details submitted in April 2011. As part of such revised strategy, it is possible that additional business parts may be transferred to the winding-up institution.

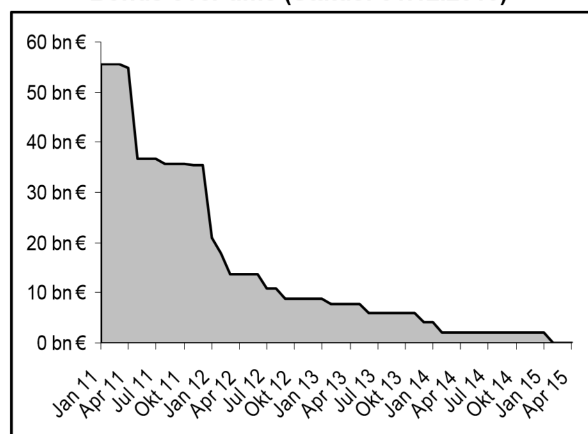
Another winding-up institution was established for publicly-owned HRE in mid-2010. As HRE was taken into public ownership in 2009, this winding-up institution (FMS Wertmanagement (FMS)) is owned entirely by the Federal Republic. The asset side of the €176 billion portfolio transferred to FMS in October 2010 comprised mainly commercial real estate assets, public sector bonds and loans, infrastructure bonds and loans, financial institution bonds, and structured credit products. The transfer was supported by SoFFin guarantees of €124 billion. The two main HRE banking operations, pbb Deutsche Pfandbriefbank and Depfa Bank (Ireland), no longer benefit from SoFFin guarantees and are to be sold off. The size of the FMS portfolio was reduced to about €174 billion by end-2010. Remaining SoFFin guarantees of €15 billion for the FMS were replaced with other funding in March 2011.

12. **A more detailed exit strategy will need to be defined in the near term.** The financial support provided by the authorities has contributed to overall financial stability, including for institutions that did not seek assistance. With a view to promoting a viable financial sector going forward, concrete action plans need to be established with regard to the remaining capital injections and the winding-up institutions, taking into account applicable EU rules. One element could be the conversion into common equity of (part of) the

[6] Exceptions may apply where shareholders actively engaged in conduct directly leading to the bank failure.

government capital injected into banks, with a view to selling these shares to the private sector when market circumstances permit; this process has already started. Strategic plans should aim at reducing the likely future need for such assistance, in part by raising private capital or by adjusting banks' balance sheets. The process of asset disposal in the winding-up institutions will take considerable time to complete, with uncertainty as to the overall losses. It is understood that the authorities are deliberating on their strategy.

Outstanding Volumes of SoFFin Guaranteed Bonds over time (Status: 31.12.2010)



Source: FMSA

Outstanding Financial Support by SoFFin at End-April 2011 (in € billion)

Guarantees	**35.2**
Aareal Bank AG	2.0
BayernLB	2.8
Commerzbank AG	5.0
Düsseldorfer Hypothekenbank AG	2.4
HSH Nordbank AG	9.0
IKB Deutsche Industriebank AG	8.6
Sicherungseinrichtungsgesellschaft deutscher Banken mbH	5.4
Recapitalizations	**29.2**
Aareal Bank AG	0.3
Commerzbank AG	18.2
Hypo Real Estate Holding AG (incl. share purchases)	7.7
WestLB AG	3.0

Source: FMSA

IV. Bank Resolution

13. **The new bank restructuring law, in force since 2011, significantly strengthens the crisis management framework.** It grants broad powers and effective instruments to the authorities to facilitate more timely and efficient resolution of problem banks that are deemed systemically relevant. A particularly powerful new instrument is the ability to transfer the banking business to another institution, including to a bridge bank. Other new instruments comprise stronger remedial powers, reorganization procedures involving the courts, the appointment of a special administrator to take over the management of a bank, and measures to improve own funds adequacy and liquidity. The law also provides the basis for the restructuring fund, administered by the FMSA.

14. **The transfer order is a powerful tool that authorizes BaFin to transfer some or all of a bank's business to another bank in an administrative proceeding.** The exercise of this power is discretionary when the bank's capital adequacy or liquidity position has fallen below 90 percent of the applicable regulatory minimum (or this is expected) and this going-concern risk places the stability of the financial system at risk (and the latter cannot be mitigated in any other manner). BaFin may exercise this power only in the absence of other suitable measures for stabilizing the bank (or such measures have been unsuccessful), and it

is exercised in agreement with the FMSA's steering committee in case resources are needed to facilitate the transfer. BaFin shall assess, after consulting the Bundesbank, whether going-concern risk and systemic risk exists, and shall document their joint assessment in writing.

15. **Since the failure of several small banks may well constitute a systemic event and thus may be addressed under the bank restructuring law, a complementary tool for the transfer of assets and liabilities could also be useful for the efficient resolution of individual small banks that are currently subject to corporate insolvency proceedings (i.e., bank liquidation).** The transfer order applies only to banks with systemic relevance; consideration should therefore be given to introducing a complementary tool for the transfer of assets and liabilities suitable for all banks (not systemically relevant) to facilitate efficient resolution upon entering corporate insolvency proceedings (as a cost-efficient alternative to the reimbursement of depositors in bank liquidation).[7] In this regard, the new special resolution powers may have a preventative effect as these powers together with prompt access to deposits will mitigate the contagion effect.

16. **Considerable flexibility exists with respect to what portion of the banking business should be transferred by means of a transfer order.** The transfer order is a statutory measure that may be taken vis-à-vis a bank in the event of risks to the stability of the financial system. The purpose of the transfer order is to support financial stability.[8] Depending on which portions of the business are to be transferred to another bank (or bridge bank), some creditors may be better off than others. In this regard, it is important to note the safeguards in the law that creditors left behind in the residual entity (that is likely to be liquidated) should not be worse off than if the bank had been placed into corporate insolvency/ liquidation proceedings. The possibility for a retransfer of certain liabilities from the receiving institution to the residual entity left behind may create legal uncertainty and should be utilized with care. There is, however, a time limit on initiating such retransfer. To enhance legal certainty, the new framework provides for access to the courts while curtailing the ability to undo resolution measures already implemented.

17. **Requiring the establishment of resolution plans would strengthen the legal framework.** As part of its enforcement powers, BaFin may require banks to submit recovery plans on how to restore the bank to financial soundness. In a few cases, BaFin has requested the preparation of resolution plans as part of the banks' general information requirements under the law. However, there is no specific requirement in the law for establishing resolution plans ("living wills") that could serve as the basis for deciding the resolution

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[7] This tool would facilitate the liquidation process, though no public resources should be committed in non-systemic cases (other than deposit insurance funds not to exceed the insured amount otherwise paid out in case of liquidation).

[8] The law does not establish depositor preference. Depositor preference can be useful, in part by reducing legal uncertainty, but is not present in all systems. Discussions on the merits of depositor preference are ongoing in various international fora.

strategy where the bank needs to be resolved in an orderly manner in the event of its failure.[9] In the absence of this information (e.g., concerning group structure, intra-group transactions, service level agreements, counterparties, and IT infrastructure), preparing the resolution strategy in a prompt manner may be challenging for BaFin in practice.

18. **While BaFin is granted the lead in the formulation of the resolution strategy, several agencies will be involved, and it is crucial to promote efficient interagency collaboration.** The FMSA is tasked with providing resources to facilitate the resolution process and therefore becomes a key player. The Bundesbank will need to assess implications on overall financial stability, especially when granted a stronger role in macro-prudential supervision. Finally, the BMF is understood to have a central role in systemic cases even though no direct responsibility is assigned in bank resolution (the BMF is represented on the FMSA's steering committee and oversees the operations of BaFin). With different roles for a number of agencies, an appropriate coordination framework should be considered to limit possible delays. Given the authorities' decision that the agency tasked with banking supervision is also in charge of designing and implementing the bank resolution strategy, it is important to note that combining both functions in one agency may give rise to conflict of interest. This could be mitigated by a strong rules-based remedial action regime. Also, it may be possible to draw on the expertise available in other agencies, for example, the FMSA has been established during the crisis and gained expertise in bank resolution. If the current division of functions is maintained, an efficient mechanism for interagency collaboration, especially between BaFin and the FMSA, should be put in place, perhaps by building on the existing working group.

19. **The voluntary reorganization procedure, with some court involvement, (Sanierungsverfahren) seems to be of little practical value as it may only be initiated by the bank and not the banking authorities.** While it opens up the option of a private sector solution to resolve the bank's difficulties, the procedure does not allow for any additional restructuring options that could not be pursued privately by bank management (with the exception of granting preferred status to any "fresh money" provided in the restructuring). Another option would be for BaFin to order the bank to draw up and implement the recovery plan. However, the initiation of a voluntary reorganization procedure may become known among market participants, which could deepen the bank's difficulties due to liquidity outflows. Moreover, for a listed entity, an ongoing voluntary reorganization might be perceived as market-sensitive, necessitating disclosure.

20. **The court-supervised reorganization procedure (Reorganisationsverfahren) is a well-balanced but relatively time consuming legal proceeding (including possible debt write-down and debt-to-equity conversion) that seeks to promote legal certainty.** This

[9] See Part 2 (D) of the Commission Staff Working Document on "Technical Details of a Possible EU Framework for Bank Recovery and Resolution" (January 2011).

procedure may be initiated by the bank, and in certain circumstances, following an application to the court by the banking authorities. The court-supervised reorganization procedure is modeled after an existing corporate insolvency proceeding, and the minimum time needed for completion is estimated at two to three months, with a somewhat longer period deemed more likely in the view of experienced legal practitioners. The reorganization procedure is applicable where the bank's capital adequacy or liquidity position has fallen below 90 percent of the applicable regulatory minimum (or this is expected) and this going-concern risk places the stability of the financial system at risk. The reorganization plan is of particular importance. In the reorganization process, a write down of creditor claims may facilitate the restructuring, though the law stipulates that claims that are protected under a deposit insurance scheme may not be reduced.[10] This is understood to include mutual protection schemes that protect all liabilities of the institution. The exception should be more narrowly worded by focusing on excluding deposits only. A debt-to-equity conversion may be carried out only on a voluntary basis.[11] In this context, it is also necessary to consider that not all holders of debt may be suitable as bank shareholders under the applicable "fit and proper" regime, which might require the involvement of a trustee to exercise voting rights. The reorganization plan will be voted on by creditors in corresponding creditor groups and the shareholders, if needed, with some override mechanisms in place. Finally, the reorganization plan will be approved by the designated court.

21. **If this court-supervised reorganization procedure is to be successful in an open bank, financial support must be available to the bank while the reorganization is underway to avoid a run on the bank.** There are differing views among various agencies as to whether such financial support could be granted by the FMSA under the provisions of the new law given that financial support is intended for supporting the new healthy banking entity after implementation of a spin off. It is understood that one of the motivations for the new law was to promote prompt resolution efforts and to avoid drawn-out financial support outside the immediate restructuring process. Another possibility, perhaps in exceptional cases, could be to make available guarantees issued under the general authority of the Federal government. Without such financial support, given the significant time needed to implement the procedural requirements in practice, the reorganization procedure may be of limited practical significance for resolving an open bank.

22. **The powers for BaFin to appoint a special administrator to take over bank management could support the restructuring process.** This provides a mechanism for the prompt replacement of management in cases where a bank is weakening. The special administrator manages the institution, oversees the implementation of corrective measures imposed by BaFin, and provides information to BaFin. The special administrator may also be

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[10] In this context, consideration should be given to a more pronounced regime that provides for depositor preference as this could help reduce the need for financial support in bank resolution.

[11] Under the constitutional framework, creditors may not be forced by law to take on a shareholder position.

tasked with the preparation of the restructuring plan. However, it is important that the period under special administration be kept as brief as possible to limit expectations of sustained financial support.

23. **The new restructuring fund provides additional resources for bank resolution, though contingency funding mechanisms are essential for its credibility.** The restructuring fund has a target size of €70 billion and is administered by the FMSA under the general oversight of the BMF. The restructuring fund is meant to facilitate the resolution of systemically relevant banks through the establishment of bridge banks, providing guarantees (up to €100 billion or 20 times the size of the restructuring fund), capital injections, and other support measures.[12] The restructuring fund is financed ex ante by a bank levy, but expected receipts in the range of €650 million to €1.3 billion per year (estimating expected receipts over time is difficult) are low relative to the target size and the potential costs of the failure of a systemically relevant bank. As a contingency funding mechanism, special assessments may be imposed on banks and residual borrowing authority originally granted to SoFFin may be utilized (€20 billion for recapitalizations complemented by up to €100 billion for guarantees) for purposes of the restructuring fund. With limited resources initially built up and despite the contingency arrangements in place, the implicit government backing for major interventions may remain. Nor is it is addressed in the law how the restructuring fund will be linked with the various private deposit insurance schemes and mutual protection schemes that allow the commitment of resources for bank restructuring,[13] and to what extent resources will be drawn under these schemes. There appear to be differing views as to whether resources from these schemes would form a first line of defense in instances involving a bank that is deemed systemically relevant. This should be clarified to maximize available resources.

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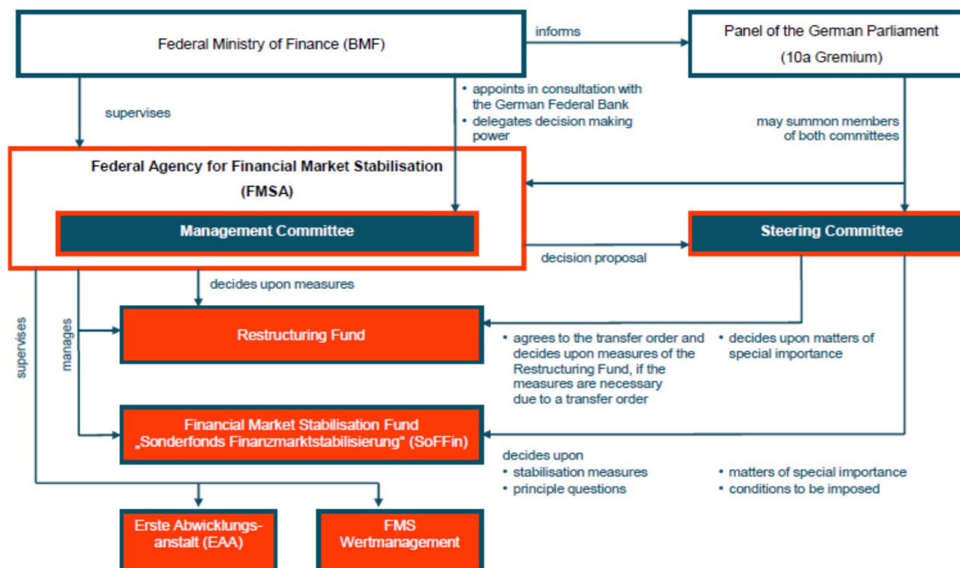
[12] Capital positions should only be taken to the extent that there is an important public interest.

[13] The statutory schemes are "pay-box" mechanisms and solely provide for the reimbursement of depositors.



Source: FMSA

24. **The bank levy, applied to all banks holding a German banking license, will be higher for banks that engage in activities creating systemic risk (based on size and interconnectedness).** The levy is meant to cover the costs of operating the restructuring fund and financing the support measures calculated according to government regulations. Subject to an overall ceiling linked to the banks' annual profit (over a multi-year period), the proposals for the levy considered 2 basis points (bps) of bank liabilities (excluding deposits and capital) up to €10 billion, 3 bps from €10 billion up to €100 billion, and 4 bps in excess of €100 billion.[14] Small banks (e.g., cooperative banks) will benefit from this staggered structure of the levy. An additional element of the levy based on the nominal value of off-balance sheet derivatives covers interconnectedness. For measuring interconnectedness, network analysis could also be useful. As the bank levy will be collected in addition to contributions to the various deposit insurance schemes, an assessment of the impact of the overall contributions on bank profitability would seem a valuable tool before finalizing the regulations.

[14] The regulations issued in July 2011 set the levy at 2 bps of bank liabilities (excluding deposits and capital) up to €10 billion, 3 bps from €10 billion up to €100 billion, 4 bps from €100 billion up to €200 billion, 5bps from €200 billion up to €300 billion, and 6 bps in excess of €600 billion. An additional 0.03 bps (earlier proposal: 0.015 bps) applies to the nominal value of off-balance sheet derivatives.

25. **The new bank restructuring law reflects many aspects for stronger bank resolution frameworks currently under discussion at the European level.**[15] The authorities decided to move forward with legislative reform (with the U.K. authorities taking the lead in Europe with the introduction of a special resolution regime in 2009) and are aware that some adjustments to the law might be needed once agreement has been reached at the European level. For example, incorporating provisions on recovery and resolution plans would seem appropriate. In parallel to this work, the cross-border aspects of the bank resolution framework should be advanced further. Moreover, while powers under the new law may be applied to financial groups that comprise banks, consideration could be given in future to establishing a special resolution regime for other non-bank systemically-important financial institutions.

V. Deposit Insurance

26. **With a stronger bank resolution framework in place, the shortcomings of the German deposit insurance regime should be addressed.** A well-designed deposit insurance framework can play an important role in crisis management by strengthening confidence in the banking sector. The German deposit insurance regime is fragmented in nature and lacks transparency. However, confidence among depositors was maintained during the crisis in part because of the authorities' public commitment to fully protect household deposits. In particular, limitations became apparent in the commercial banks' private scheme in connection with the failure of Lehman Brothers, and in the mutual protection scheme run by the savings banks association in the case of a large *Landesbank*.

27. **During the financial crisis, Germany, like many European countries, enhanced the existing deposit insurance arrangements.** The main objective was to safeguard the confidence of mainly small depositors in the stability of the financial system by protecting them from incurring losses due to bank failures. In Germany, the minimum coverage limit under the statutory schemes was €20,000 (10 percent coinsurance element) at the outset of the crisis, subsequently increased to €50,000 with coinsurance eliminated in 2009, and to €100,000 since 2011. The current coverage level appears broadly appropriate in that it is estimated to cover more than 90 percent of retail deposit accounts at commercial banks.[16]

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[15] See, in particular, Commission Staff Working Document on "Technical Details of a Possible EU Framework for Bank Recovery and Resolution" (January 2011); and EC Communication on Bank Resolution Funds (26.4.2010).

[16] The ratio is higher when including retail deposit accounts at savings banks and cooperative banks protected under their respective mutual protection schemes.

Box 2. Germany: Complex Deposit Insurance Regime

Commercial banks: statutory scheme—The coverage provided for deposits in private commercial banks under the statutory scheme is €100,000 and the claim for reimbursement is legally enforceable. Reimbursement of deposits is initiated by a declaration by BaFin and should be completed within 20 business days thereafter (an extension of 10 business days is possible). Banks' contribution rates have recently been doubled to 0.016 percent of the banks' balance sheet item "liabilities to customers."

Commercial banks: private scheme—The Bankers' Association offers for its member banks additional coverage amounting to 30 percent of the bank's capital per depositor, constituting a de facto full compensation scheme (for new member banks, limits of €250,000 per depositor are in place for the first three years). However, claims are not legally enforceable by depositors, an approach recently confirmed in a court ruling (see 2010 decision by the Berlin district court). The scheme came under significant pressure when faced with the successive failures of Düsseldorfer Hypothekenbank and Lehman Brothers Bankhaus in 2008. For the latter, substantial support by the FMSA in the form of a €6.7 billion guarantee was needed to ensure sufficient liquidity in a specially formed entity for the reimbursement of depositors, including large deposits held by insurance companies and municipalities. Contribution rates have recently been doubled to 0.06 percent of the liabilities to customers. The parameters for ex post burden sharing arrangements among banks in times of financial turmoil and heavy claims are not clear and require ad hoc solutions.

Savings banks (Sparkassen) and *Landesbanken*—Partial ex ante funding (risk-based) is built up under regional arrangements and coupled with additional ex post burden-sharing provisions (in addition to any contributions from the local authorities as sponsors/owners of the institution) to protect the institutions in their entirety (mutual protection scheme). Further support is provided under the inter-regional arrangement among the 11 regional arrangements and a master arrangement (that includes the *Landesbanken* arrangement and the state building societies arrangement), if needed (without legal obligation). Financial support may be used to facilitate mergers but there are limits under the arrangements as to the amount of support that could be made available for each support case. When a large *Landesbank* experienced financial strain in 2009, given the voluntary nature of the arrangements, only a small amount was made available under the mutual protection scheme of the *Landesbanken*, essentially representing its own paid-in contribution.

Public banks (other than savings banks and *Landesbanken*) have their own statutory and private schemes administered by the Association of German Public Sector Banks.

Cooperative banks (Volks- und Raiffeisenbanken)—The protection scheme run by the National Association of German Cooperative Banks is intended to protect cooperative banks in their entirety (mutual protection scheme). Ex ante funding (risk-based) is complemented by limited guarantees. When called upon, resources may be committed for broad purposes but there is no legal obligation to provide assistance. During the crisis, the Association provided guarantees to back several member banks. The Association takes the lead in resolving failed member banks, typically through purchase-and-assumption transactions or mergers and operates a dedicated "bad bank" to facilitate resolution.

28. **The public commitment to fully protect household deposits built confidence during the financial crisis.** The Chancellor announced a public commitment to fully protect household deposits in October 2008. While the exact features of such commitment have not been specified, it was understood that the authorities would provide the necessary backing of household deposits after application of the statutory scheme and the relevant private

schemes. This public commitment remained untested until a recent failure of a small commercial bank (not member of the commercial banks' private scheme). In this case, the authorities rejected depositors' compensation claims for amounts exceeding the coverage limits under the statutory scheme on the basis that the failure was the result of poor bank management rather than the financial crisis, but stopped short of generally rescinding the commitment. This position, while protecting public resources, may have consequences for future public assurance, as depositors may not be able to distinguish the reasons for a bank failure.

29. **Further efforts are needed to reduce complexity and to enhance resilience and transparency by establishing a legally enforceable harmonized coverage limit of €100,000.** Awareness of the importance of deposit insurance has grown greatly during the financial crisis, but it appears that the specific features of the various schemes in Germany are still not well understood by the general public. This is no surprise given the diversity and complexity of the different arrangements (see Box 2). In order to promote depositor confidence, the regime should be clear and transparent and contain the right incentives to discourage moral hazard. International best practice emphasizes a limited but credible coverage level where depositors have a legal claim to reimbursement.[17] Several measures have been taken to strengthen the statutory schemes in Germany (e.g., higher coverage limit, reduction of the payout period, increased ex ante funding), and some enhancements have also been made to the commercial banks' private scheme (increased ex ante funding and lower coverage limits for new member banks). Irrespective of the outcome of the ongoing discussions at the European level regarding the exemptions under the 1994 Directive in place for the two mutual protection schemes run by the savings banks association (including the *Landesbanken*) and the cooperative banks, respectively, the mutual protection schemes should be modified to ensure that depositors have a legal claim for the reimbursement of €100,000 (including changes to the legal framework as needed). This change would enhance transparency and legal certainty in all three pillars of the banking system, and promote appropriate provisioning for these contingent liabilities.

30. **Key information on the actual financial strength of the various schemes should be made public.**[18] While financial statements are regularly submitted to BaFin and the Bundesbank, almost no information on the financial condition of the various schemes is made publicly available in an accessible format.[19] In the absence of specific data, based on

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[17] See Basel Committee on Banking Supervision (BCBS)-International Association of Deposit Insurers (IADI) Core Principles for Effective Deposit Insurance Systems - A Methodology for Compliance Assessment (BCBS-IADI Methodology), December 2010, Core Principles 9 (EC 3) and 17. In the European context, the 1994 Directive, as amended, provides a set of minimum harmonized rules for deposit insurance regimes, such as regards the scope, coverage levels, legal enforceability, and payout mechanisms.

[18] See BCBS-IADI Methodology, Core Principle 5 (EC 5).

[19] For the statutory schemes only, the total annual contributions are published in the annual federal budget.

the crisis experience it appears that the ex ante funding level under the commercial banks' private scheme is insufficient, and the resilience of the mutual protection scheme of the savings banks association is not assured when under pressure.

31. **A more uniform approach to deposit insurance by eliminating the high coverage promised under the pillar schemes would enhance overall credibility of the regime.** Work is underway in international fora[20] and at the European level[21] to emphasize the need for adequate ex ante funding of deposit insurance schemes. For example, the European Commission has proposed that ex ante funding levels should reach a minimum of 1.5 percent of eligible deposits over 10 years, but discussions are ongoing. While there is little transparency on the financial condition of the various schemes in Germany, the coverage levels of the commercial banks' private deposit insurance scheme[22] and both mutual protection schemes are very high by international comparison (unlimited under the mutual protection schemes), and coverage is also very broad (encompassing all liabilities of the institutions under the mutual protection schemes[23]). Such arrangements for protecting wholesale depositors and other claimants weaken market discipline, especially since the schemes—due to their private legal nature—are not subject to close oversight by the authorities. Further, in a crisis situation, the ability of the pillar schemes to meet these expectations will either require massive public financial support or potentially destabilize the other member banks that need to make good the payouts. Therefore, coverage (or at least, legally binding coverage) should be capped at a level that can be readily funded so as to enhance the credibility of the regime and reduce moral hazard of implicit public support. To reduce pro-cyclicality, any pillar scheme should build up adequate pre-funding. Going forward, a move towards a more uniform statutory deposit insurance regime should be considered.

VI. Liquidity Support Issues

32. **The financial crisis exposed particular vulnerabilities in German banks relying on short-term wholesale funding, though effective measures to provide liquidity were in place.** In the euro area, liquidity is regularly provided by the national central banks of the

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[20] See IADI, Funding of Deposit Insurance Systems, May 2009.

[21] Discussions at the European level on the reform of the 1994 Directive (see proposals published on July 12, 2010) underpin the need for reform by emphasizing adequate funding and transparency of schemes, providing a legal claim to depositors, and envisaging a European network of schemes with a common borrowing facility, with less reliance on mutual protection schemes.

[22] Since the time of writing, the private banks have announced the attention to phase in a reduction in coverage levels.

[23] Due to the broad coverage afforded under the mutual protection schemes, the resolution strategy for a failed institution typically involves a merger rather than liquidation, avoiding the need for reimbursement of depositors.

Eurosystem (including the Bundesbank) to solvent banks against eligible collateral through open market operations and the marginal lending facility. During the crisis, the European Central Bank (ECB) introduced several changes to the monetary policy operational framework to enhance credit support in the euro area, including liquidity provision through "fixed rate tenders with full allotment," enlargement of the list of securities accepted as collateral, clarifications regarding counterparties, and provision of liquidity in foreign currencies.

33. **The Bundesbank has comprehensive procedures in place for ELA.** In a crisis situation, the national central banks of the Eurosystem are competent to provide ELA to individual domestic banks. This tool should be used only in exceptional circumstances and on a case-by-case basis to assist temporarily illiquid but solvent institutions. Liquidity assistance was provided against collateral and without putting in question the independence of the central bank. To this end, the ELA framework was developed exclusively within the Bundesbank without the involvement of other authorities. The Bundesbank has made use of its ELA framework during a short period of time in 2008-2009.

VII. Cross-Border Issues

34. **Important interconnections exist between the German financial system and the global system.** The failures of IKB, SachsenLB, and subsequently Lehman Brothers, and the financial distress of HRE with subsidiaries in other European countries, demonstrate the importance of interconnections between the German financial system and the global system. Consequently, the failure of a German or of a foreign bank operating in Germany requires close coordination with other countries' banking authorities in order to smooth any adverse cross-border impact on the financial sector.

35. **From the outset of the financial crisis, coordination among central banks in responding to the problems in money markets was swift and effective.** After the crisis broke out, the scale of the reliance of European banks on dollar funding from U.S. markets quickly became apparent. The Bundesbank, as a part of the Eurosystem, coordinated an effective response to these problems by taking a concerted action to ease liquidity conditions in dollars and other currencies with the Federal Reserve System announcing the introduction of the Term Auction Facility (heavily used by a few German banks) and swap lines with the ECB.

36. **The German authorities coordinated with foreign regulators during the crisis, but cross-border coordination arrangements need to be enhanced.** After the failure of Lehman Brothers, the U.S. banking authorities established the Senior Supervisors Group in September 2008 consisting of representatives from BaFin and the banking authorities from various important financial centers. This group quickly became a focal point for exchanging information on specific problems, and also tried to address some gaps that existed in available information. However, as demonstrated by the experience in the case of HRE (with

sizeable European operations outside Germany), steps are needed to further strengthen international coordination processes among the relevant counterparties.

37. **Looking forward, the authorities recognize the international dimension of German global banks in developing crisis management strategies, but a concrete cross-border resolution framework needs to be worked out.** Drawing on the Financial Stability Board (FSB) Principles for Cross-border Cooperation on Crisis Management and the EU MOU on this topic, BaFin, Bundesbank and the BMF have established a crisis management group for a large commercial bank. A first meeting took place in April 2010, involving relevant authorities. The discussion focused on the role and tasks of the authorities involved as well as on the preliminary recovery and resolution planning of the institutions. At the European level, the Economic and Financial Committee (EFC), which is a preparatory committee of the ECOFIN Council of the EU, regularly discussed financial crisis resolution. Recently, the discussions focused on coordinating crisis resolution, phasing out of the exceptional rescue schemes, and the level of the minimum fee for state guarantees. It is encouraging that the German authorities have implemented international principles to deal with cross-border crisis management. Nevertheless, the authorities are aware of the importance of an appropriate legal framework and developing procedures and tools ex ante for handling the failure of global German banks guided by the work of the Financial Stability Board, the BCBS, and at EU level (e.g., crisis management framework, Cross-Border Stability Groups) currently underway, including how to deal with burden sharing arrangements and conflict of laws when defining resolution strategies.[24]

[24] This work could also draw on the elements set out in the IMF staff paper on "Resolution of Cross-Border Banks—A Proposed Framework for Enhanced Coordination," June 2010.