

The WestLB restructuring decision

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Introduction

On 12 May 2009, the European Commission took a final decision⁽²⁾ on State aid given to German bank WestLB AG, by approving a €5 billion risk shield. This conditional decision followed an in-depth investigation⁽³⁾ opened in October 2008, and was the first step on the way to a final solution of a long story which started many years ago. WestLB is one of Germany's seven, regionally organized public Landesbanks, which not only act as a central giro institution for local saving banks (Sparkassen), but also offer retail, wholesale, special project finance and corporate banking services. Investment banking services, in particular, have over time gained more importance in the balance sheet structure of Landesbanks.

Landesbanks have long been the subject of careful investigation by the Commission, as they have benefited in the past from two complementary forms of unlimited State guarantee, namely the so-called *Gewährträgerhaftung* and *Anstaltslast*⁽⁴⁾. Due to these guarantees, Landesbanks were better rated by credit rating agencies, giving them a competitive advantage through lower refinancing costs. In 2001, the

Commission reached a number of understandings with Germany⁽⁵⁾ regarding the abolition of *Gewährträgerhaftung* and *Anstaltslast* which, after a transitional period, became effective as of 18 July 2005. Thereafter, public mission activities were transferred to separate, newly created banks⁽⁶⁾. Since then, Landesbanks have actively expanded their business activities, turning to new groups of customers in their quest for additional sources of revenue⁽⁷⁾.

The expansion of business activities was one of the reasons why Landesbanks strove towards an increase of their equity capital base. From August 2002 until October 2005, in particular, the owners of WestLB agreed to five re-capitalisation measures, amounting to approximately €6.2 billion. On 18 July 2007 the Commission took a decision clearing the five re-capitalisation measures as being in conformity with the market economy investor principle⁽⁸⁾.

Rescue aid for WestLB

The expansion of WestLB's business activities was accompanied by a noticeable increase in more risky business activities, especially the trading of securities for the bank's own account (so-called 'proprietary trading') and investment management activities that comprised structured portfolios. In short, these activities led to a higher risk exposure.

In February 2008, before the collapse of *Bear Stearns* and of *Lehman*, the bank announced⁽⁹⁾ that its owners had reached an agreement to provide a risk shield for risks in the bank's structured portfolios.

⁽¹⁾ The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the authors.

⁽²⁾ Commission decision of 12 May 2009 in state aid case No C 43/2008 (ex N 390/2008) implemented by Germany for the restructuring of WestLB AG, OJ L 345, 23.12.2009, p. 1

⁽³⁾ OJ C 322, 17.12.2008, p. 16.

⁽⁴⁾ *Gewährträgerhaftung* (guarantee obligation) is a public law development of the conventional commercial guarantee, under which the bank's guarantors (usually, but not necessarily, the owners) have an unlimited, joint and several liability to the creditors of the bank to meet any obligations that the bank cannot meet out of its own assets. *Anstaltslast* (institutional obligation) dictates that the owners of a public law institution (in this case a Landesbank or Sparkasse) have a legal obligation to keep that institution financially viable, i.e. in a position where it can at all times pay its debts as they fall due. Under *Anstaltslast*, the owners of the bank have no direct obligation to the creditors of the bank. *Anstaltslast* ensures the solvency of the institution.

⁽⁵⁾ Following the first of the Understandings dated 17 July 2001, between a transitional period between 19 July 2001 and 18 July 2005 new liabilities could still be covered by *Gewährträgerhaftung* - so-called "Grandfathering" -, provided their maturity did not go beyond 31 December 2015. See for details case State aid E 10/2000, OJ C 146, 19.6.2002, p. 6 and C 150, 22.6.2002, p.7. See also the press release IP/02/343.

⁽⁶⁾ WestLB AG, for example, emerged from the former Westdeutsche Landesbank Girozentrale on 1 September 2002 after the public mission activities of the latter were integrated into Landesbank NRW, a company under public law, which was established on 1 August 2002.

⁽⁷⁾ See, for instance, Klaus Berge, Ralf Berger, Hermann Locarek-Junge, *Deutsche Landesbanken: Status Quo und Strategien vor dem Hintergrund des Wegfalls der Staatsgarantien*, Vierteljahrshefte zur Wirtschaftsforschung, vol. 75, no. 4, DIW Berlin, 2006, p. 73–92.

⁽⁸⁾ OJ C 4, 9.1.2008, p. 1.

⁽⁹⁾ See, for instance, WestLB's press release dated 21 January 2008 *Eigentümer stärken Kapitalbasis der WestLB AG*

The intended effects of this measure were to protect against the volatility of the markets. As a result of the subprime crisis, there was a significant reduction in its market value, which should have been reflected in the balance sheet. Securities with a nominal volume of roughly € 23 billion were therefore taken off WestLB's balance sheet and transferred to a special purpose vehicle. In turn, the financing of the special purpose vehicle was secured by a risk shield from the public owners of up to € 5 billion, to cover any payment defaults. Under the terms of the arrangements between the owners, the majority stakeholder, i.e. the federal State of North Rhine-Westphalia, would have to bear a disproportionately large part of the financial burden of the measure, while the other public owners – mainly savings banks associations – would only participate to a lesser extent.

On 27 March 2008, the Germany authorities officially notified the €5 billion risk shield to the Commission, pointing out that, from their perspective, the measure was deemed to be in line with the market economy investor principle, since the measure would protect the investment previously made.

Considering WestLB's overall financial situation at that time, the Commission concluded that the bank was in difficulties. On 30 April 2008⁽¹⁰⁾, the Commission approved the risk shield in favour of WestLB, concluding that the announcement of the risk shield committed state resources because it signified an undertaking by the owners to prevent a downgrading of the bank by the rating agencies, which would have posed a serious threat to the bank's refinancing capacity. This gave the bank an advantage, as it could not really be justified from the perspective of a hypothetical market economy investor. Hence, the risk shield constituted State aid. However, it was found to fulfil the conditions for rescue aid, because the measure was limited in time and was reversible. The latter was accepted despite the fact that the risk shield was covering the asset side, because it was the least structural measure possible that met the requirement of prudent management. Furthermore, the approval was conditional on the submission of a restructuring plan outlining how the bank could restore its long-term viability within a reasonable timescale. In line with this requirement, WestLB submitted a restructuring plan on 8 August 2008.

WestLB's restructuring plan

The restructuring plan that was initially submitted included a number of action points aiming at cost cutting, downsizing and refocusing of WestLB's business model. One of the objectives was to

strengthen the less volatile business with savings banks, private-banking customers, and midsize corporates. The plan aimed at a 36% reduction of the risk weighted assets (RWA), and a 27% reduction of total assets. There were plans for a withdrawal from the investment management business, as well as the sale of shareholdings and the closure of several locations. The plan furthermore included a commitment by the bank's owners to change the ownership structure by 31 December 2008.

In its opening decision on 1 October 2008⁽¹¹⁾, the Commission raised doubts about whether the measures were sufficient to mitigate the adverse effects of the aid on competition, and whether the restructuring plan would be sufficient to achieve the restoration of the bank's long-term viability. Thus, in a series of meetings, the owners of WestLB and the Commission reached an agreement that an amended restructuring plan would need to provide for additional measures both to restore long-term viability and to limit undue distortions of competition.

Additional measures restoring long-term viability

When the merits of the initial restructuring plan were assessed, one of the main concerns was the issue of whether WestLB would sufficiently address the root causes of its problems and significantly adapt its previous business model, which had proved to be non-viable. The Commission's view was shared by a number of experts⁽¹²⁾ who recommended more structural changes.

During the discussions it appeared that, due to a conflict of interests between the bank's owners, significant changes to the business model could only be expected if there was a concomitant change of the ownership structure, i.e. after a sale of WestLB to a new owner. The change of the ownership structure commitment was therefore a central element of the restructuring plan. The owners initially undertook to put the first steps in place by the end of 2008 subsequently, the deadline for an ownership change had to be extended. WestLB preferred to merge with another German Landesbank based in Hesse, namely Helaba. In the end, WestLB did not succeed in finding a potential new owner or merger partner.

In order to avoid such difficulties with the ownership change in the future, the amended restructuring plan had to include more intermediate steps which would facilitate the future sale of WestLB. It was therefore agreed that the organisational allocation of

⁽¹¹⁾ OJ C 322, 17.12.2008, p. 16.

⁽¹²⁾ See, for instance, S&P report "WestLB AG?" dated 14 August 2008; S&P report "Ratings affirmed on four Landesbanks due to owner support, but how long can it last?" dated 5 August 2008.

⁽¹⁰⁾ Press release IP/08/665.

core business activities should be incorporated into the amended restructuring plan, so as to separate well-defined business areas ('unbundling'). WestLB defined three core business areas: so-called 'transaction banking' (i.e. the treatment of payments), loan financing for medium-sized companies, and corporate banking activities (e.g. financing of large projects). The organisational unbundling enables the current owners to offer WestLB in form of a public tender in which interested parties may bid not only for the whole bank but also for just one of the core business areas. This splitting of the bank increases the number of potential buyers, making the achievement of a commitment to ownership change more likely.

Additional measures limiting distortive effects

Following the in-depth assessment of the initial restructuring plan, the Commission called for additional measures to mitigate as far as possible any adverse effects of the aid on competition. This condition usually involves limiting or reducing the company's presence on the relevant product markets by selling production capacity or subsidiaries, or by reducing activities. In line with decisions taken in comparable cases⁽¹³⁾, WestLB was therefore asked to reduce its balance sheet by more than 27% (balance sheet reduction proposed in the initial restructuring plan of 8 August 2008). Likewise, the amount of RWA had to be reduced by more than 36% (restructuring plan of 8 August 2008).

The whole package of measures offered by the bank in its amended restructuring plan was submitted in May 2009. In addition to the reduction of the balance sheet and the RWAs, it entailed restrictions to the growth of new business, further downsizing of the network of branches inside and outside Germany, a more comprehensive list of subsidiaries available for sale, and a withdrawal from proprietary trading. In sum, these measures were considered to

be suitable to limit the distortive effects of the State aid received.

Conditional decision

The amended restructuring plan, including the sale of the bank, has to be fully implemented, in line with a three-year timetable. A binding commitment by WestLB's current owners to support the amended restructuring plan – subject to the approval given by the general meeting of its shareholders – was not forthcoming at the time the decision was taken. The approval of the risk shield was therefore made conditional upon the adoption and implementation of the amended restructuring plan.

Conclusion

The handling of the WestLB story by the Commission is interesting for several reasons. First, the case sets a clear precedent by the application of the private investor test (2007 decision) and its limits (2008 decision). Second, in the rescue aid decision, the Commission indicated how much of a structural measure is allowed in a banking rescue case (before the crisis). Third, the restructuring decision illustrates that a long-lasting conflict of interests between the bank's owners can justify an ownership change. In the meantime it has emerged that additional aid⁽¹⁴⁾ is needed in order to implement the restructuring decision and transfer the impaired and non-core assets into a "bad bank". The setting-up of a "bad bank" is necessary in order to ensure that the viable parts of the bank will be sold.

Recently, other German Landesbanks also got into financial difficulties and have received State aid that qualifies as rescue aid. It is debatable whether the conditions set by the Commission in the WestLB case, and reflected in the details of the amended restructuring plan, may serve as a blueprint for these Landesbanks too. In any case, the decision does not prevent the core bank from being sold to or merged with other Landesbanks.

⁽¹³⁾ Commission Decision in case C 327/2004 of 18 February 2004, *Bankgesellschaft Berlin*, OJ 2005 L 116, p.1, Commission decision in case C 10/2008 of 21 October 2008 *IKB*, Commission Decision in case C 9/2008 of 4 June 2008 *SachsenLB*, OJ L 104, 24.4.2009, p. 8 (http://ec.europa.eu/competition/state_aid/register/ii/doc/C-9-2008-WLWL-en-04.06.2008.pdf).

⁽¹⁴⁾ Commission Decision in case N 531/2009 of 7 October 2009, Assumption of risk shield for WestLB, OJ C 305, 16.12.2009. p. 4.