The Commerzbank recapitalisation decision: providing legal certainty in times of crisis and guidance for future restructuring

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On 7 May 2009 the Commission approved the EUR 18 billion recapitalisation of Commerzbank AG (“Commerzbank”). It was one of the first decisions the Commission has taken on a restructuring case originating from the financial crisis. In view of the large amount of the aid, legal certainty regarding the compatibility of the measure with the internal market was required. Following lengthy discussions with the Commission, (2) Germany filed a formal notification which included a plan of measures for the restructuring of the bank. This allowed the Commission to take a position on the compatibility of the aid in the context of Article 87(3)(b) of the EC Treaty. In the following we describe briefly the situation of the bank (1), the measures involved (2), the procedural context of the decision (3) and the assessment of the restructuring measures (4), before drawing some brief conclusions (5).

1. Commerzbank and the need for State aid

Commerzbank is a credit institution with a total group balance sheet of approximately EUR 1 100 billion. It is the second biggest private credit institution in Germany since its acquisition of Dresdner Bank AG (“Dresdner Bank”) in 2008.

Commerzbank is a universal bank with an extensive branch network in Germany and abroad. It has various subsidiaries in Germany and elsewhere. Commerzbank has positioned itself as a provider of services to retail and commercial customers and to SMEs, but it also looks after numerous large, multinational commercial customers. Although Commerzbank had been steadily cutting down investment banking, with the purchase of Dresdner Bank it acquired the latter’s significant investment banking activities.

Up until Lehman Brothers insolvency on 15 September 2008, Commerzbank was less affected by the financial market crisis than some other banks owing to its focus on retail and commercial banking and its low-key proprietary trading and investment activities. As a result of the worsening of the financial market crisis, its ABS portfolio started to deteriorate. On top of this came the need for higher risk provisioning for its loan book as a result of the worsening conditions of the real economy.

The situation was further aggravated by the acquisition of Dresdner Bank. Initially, Dresdner Bank’s retail and commercial banking business had proven to be relatively stable too. However, as a result of its larger investment banking portfolio with a high proportion of investment and trading positions, it was hit harder by the effects of the financial market crisis.

2. Description of the State aid measures

In December 2008, Commerzbank received a first silent partnership (perpetual hybrid tier-1 capital instrument) of EUR 8.2 billion from SoFFin (3) under the German bank rescue scheme. The remuneration for the silent partnership is 9% p.a., plus a dividend related step up of 0.5% per 0.25 EUR dividend.

However, after conditions continued to deteriorate further, the capital basis shrank and capital requirements rose. The amount of capital received was thus no longer sufficient to calm market concerns and to comply with regulatory capital requirements in the medium term.

Therefore, on 9 January 2009, Germany agreed to make additional core capital totalling EUR 10 billion available to Commerzbank. This additional measure is made up of a further silent participation of EUR 8.2 billion and an acquisition of 25% plus one ordinary shares against payment of EUR 1.8 billion. In addition, SoFFin provided a guarantee for bond issuances worth EUR 15 billion.

3. Procedural issues

Before the agreed capital injections could be made, it was necessary to ensure compliance with the State aid rules. The question arose as to whether the aid measures could be authorised under the existing German bank rescue scheme, which the Commission had authorised in December 2008 (State aid

(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) For evidence of the high stakes in the discussions see “Steinbrueck urges EU to give ground on Commerzbank aid”, Reuters, 4 April 2009

(3) The Sonderfonds Finanzmarktstabilisierung, created by the German government for dealing with the banking aid measures.
No. N 625/2008), or whether they required a notification to obtain an individual approval by the Commission.

The German bank rescue scheme allows, amongst others, recapitalisations for a market-oriented remuneration in line with the Commission’s Recapitalisation Communication of 5 December 2008. However, the scheme provides for a limit of EUR 10 billion of recapitalisation per bank “in principle”. Furthermore, unless the soundness of the bank can be demonstrated, a restructuring plan is required.

Given that the above limit had been exceeded, and in order to avoid a discussion on the soundness of the bank, Germany decided to file a formal notification to the Commission to create legal certainty. Germany agreed to present a restructuring plan for the bank, which should allow the Commission to approve the aid for the recapitalisation in a single final decision. Given that the restructuring plan did not raise doubts as regards compatibility of the recapitalisation with State aid rules, the Commission was able to approve the aid without the formal investigation which is normally required in cases of such magnitude and complexity.

4. Description and assessment of the restructuring

Under State aid rules, the assessment of a restructuring aid requires a restructuring plan which demonstrates inter alia (i) how the beneficiary will restore long-term viability, (ii) how to ensure that aid is kept to the minimum necessary, including a significant contribution of the beneficiary and its owners and (iii) how to mitigate undue distortions of competition caused by the measure.

Return to long-term viability

The main element of Commerzbank’s plan to return to viability is to focus on its core businesses, namely retail and corporate banking, including in Central and Eastern Europe, which generated stable returns in the past. In contrast, the more volatile investment banking will be reduced over time, as well as commercial real estate activities and public finance.

On the basis of this revised business model, the bank needed to carry out a viability analysis on the basis of its short- and medium-term planning. The difficulty to be faced was that such planning is extremely difficult under the current circumstances. It is impossible to project exactly to what extent banks’ results will continue to suffer as a consequence of the continuing and deepening crisis. In any case, planning depends to a large extent on assumptions about future developments. In the Commerzbank case, the analysis became even more challenging due to the significant effects of the recent merger. Thus, checking the plausibility of the bank’s assumptions, including ensuring that forecasts had not already been reversed by the reality, was a crucial element of the Commission’s viability assessment.

In this context, the Commission focused on the potential impact that different economic scenarios would have on the future performance of Commerzbank and its capital ratios. In particular, the Commission concentrated on determining whether the bank would be able to withstand the pressure resulting from higher risk provisioning and increasing capital requirements. In this regard, Commerzbank utilised two differing complex approaches. First, a ‘top down’ estimate is made of risk trends. This estimate is largely automated and is an important point of reference in the ordinary monitoring of the portfolio. But it can represent only general stress on the portfolio, and it is not possible to estimate and account in detail for more specific effects, such as a running down of the portfolio or changes in provisioning. Therefore, where necessary, additional ‘bottom up’ analyses are carried out, which incorporate expert judgement. The effects of the stress calculation are simulated for homogeneous sub portfolios and often are made at the level of individual customers. Thus, they offer a clear advantage in terms of detailed results.

Commerzbank also reviewed its practices regarding risk management and corporate governance in order to reduce its vulnerability to risk in the future. Commerzbank also demonstrated that it can meet its liquidity needs, as the bank continues to enjoy market access to both secured and unsecured refinancing. Besides this, Commerzbank has sufficient assets which are eligible for central bank refinancing to obtain liquidity if this were to become necessary.

In order to carry out its assessment, the Commission not only analysed publicly available information but also had access to Commerzbank’s internal risk management and controlling reports. Furthermore, the Commission made sure that risk reviews and assessments performed by the competent supervisory authority were also taken into account.

The Commission’s assessment concluded that the aid granted will put Commerzbank in a position to withstand further substantial effects of a severe recession, and to emerge from the crisis with a Tier I ratio which meets market expectations.

Minimum necessary/own contribution

Commerzbank will sell a significant amount of ownership stakes and other assets, amounting to roughly 45% of its current balance sheet total. In this way, it provides a contribution to its restructuring and at the same time limits the aid to the minimum necessary.
Although the existing shareholders and holders of hybrid capital instruments - with the exception of Allianz - have not taken part in the capital increases, they shoulder part of the burden through a ban on dividend payments and a ban on coupon payments on hybrid instruments.

The Commission found that the large-scale divestments and the suspension of payments of dividends and interest provided for in the plan limit the aid to the minimum necessary and ensure an adequate contribution of the bank and its owners to the restructuring.

Mitigation of distortions of competition

As stated above, the plan includes a number of measures which are aimed at keeping the aid to the minimum necessary and which, at the same time, limit its potential to distort competition. These measures include divestments by Commerzbank of activities and the sale of subsidiaries (including the sale of Eurohypo) to address the Commission’s concerns regarding possible distortions of competition due to the large size of the aid granted. The Commission has granted an extended time line for divestitures in view of the current crisis environment.

In addition, to allay further concerns related to potential distortions of competition, the bank will be subject to a general three-year ban on acquisitions of financial institutions or other businesses which potentially compete with it. Furthermore, the bank will not be allowed to do business (including deposit taking) under more favourable price conditions than its top three competitors in markets/products where it has a market share above 5%. On this basis, the Commission found that Commerzbank had sufficiently mitigated the potential distortions of competition.

5. Conclusion

The decision gave a first illustration of how the Commission is dealing with large scale structural measures in the current crisis. It anticipated what was subsequently set out in the Commission Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (“the Restructuring Communication”). Two elements stand out:

First, the Commission has again demonstrated that it is contributing to overcoming the financial crisis by not blocking large rescue measures by Member States that are apt to maintain financial stability. The Commission needs however to ensure that they take place in an adequate framework aiming at the long term viability of a bank and propose safeguards against undue distortions of competition and trade in the single market. The present decision is also an example of the pragmatic approach the Commission has taken in the crisis in order to provide legal certainty to Member States and beneficiaries of State aid.

Second, this decision shows that the key principles of the rescue and restructuring guidelines still provide an adequate framework for the assessment of such State aid, whilst a number of refinements were introduced in order to deal with issues specific to banking. For example, the decision illustrates for the first time in the financial crises how a bank’s long term viability can be demonstrated on the basis of a number of simulations, including stress test scenarios. This approach is set out in more detail in the Restructuring Communication.

Moreover, in the context of the minimum necessary, the Commission showed a high degree of flexibility regarding own contributions through divestments. For the sake of financial stability and to avoid fire sales, the Commission largely renounced the compulsory selling of businesses and granted reasonably long time frames. Furthermore, it indicated that instead of insisting on static, fixed thresholds for own contribution, as indicated in the rescue and restructuring guidelines. Instead, in the banking sector the Commission is now more interested in the quality and appropriate burden sharing, and, therefore, in the suspension of payments of dividends and interests in order to ensure an adequate contribution to the restructuring from the owners of the bank (as set out in the Restructuring Communication).

Finally, the Commission has clarified that, in order to mitigate potential distortions of competition, a ban on acquisitions and a price leadership prohibition are suitable means to avoid State aid being abused for both organic and non-organic growth at the expense of competitors who have not received State aid. Additionally a ban on acquisitions and a price leadership prohibition maybe an acceptable substitute - at least in part - for divestitures which are required under the rescue and restructuring guidelines, but which may be difficult to implement in the current market environment. Again, these behavioural commitments introduced in the Commerzbank decision have since become a standard instrument under the Restructuring Communication.

(4) This is the leitmotif of all previous communications of the Commission with respect to the financial crisis. See, for example, the banking communication of 13 October 2008.