The rescue and restructuring of Hypo Real Estate

Matthäus Buder, Max Lienemeyer, Marcel Magnus, Bert Smits, Karl Soukup (1)

1. Introduction

In this article, we briefly describe the case of State aid for Hypo Real Estate (HRE). HRE is a German banking group that got into difficulties in 2008 and was subsequently rescued and nationalised by Germany. In July 2011, the Commission approved the aid to HRE on the basis of an in-depth restructuring plan, which is currently being implemented.

2. Description of HRE and its difficulties

2.1. The history of HRE

In the autumn of 2002, the German HVB bank group decided, as part of a major reorganisation plan, to spin off its international commercial real estate finance business and the domestic mortgage bank participations, establishing HRE in 2003 as a specialised commercial real estate finance bank. In the beginning, HRE seemed to operate quite successfully, and between 2005 and 2008 HRE managed to be listed in the German DAX index, which is composed of the top 30 German companies. In 2007, HRE took over Dublin-based DEPFA Bank plc (Depfa) and extended its business to public sector and infrastructure finance. That transaction more than doubled HRE group's balance sheet, which by the end of 2008 grew to approximately EUR 420 billion.

2.2. HRE's difficulties in the context of the financial crisis

HRE's business model, i.e. financing long-term wholesale investments by short-term interbank funding, was at the root of its difficulties. In particular, the Depfa takeover exacerbated the asset and liability maturity mismatch in the group's portfolio. As long as there was an excess supply of liquidity available in the markets this appeared to be a profitable strategy, mainly because the inherent transformation risk was not appropriately priced in. At the end of September 2008, after Lehman Brothers applied for creditor protection, HRE faced a liquidity shortage which put the bank on the brink of insolvency. HRE was no longer able to obtain short-term financing on the markets and it did not have sufficient liquidity reserves to bridge the funding gap.

In addition, HRE faced possible capitalisation difficulties attributable to legacy assets that did not show an appropriate return on investment when considering their actual risk profile. Finally, a lack of IT and risk system consolidation between divisions made efficient management more difficult.

2.3. The bail-out of HRE

In order to alleviate HRE's liquidity constraints and to prevent its collapse, the German banking association tried at the end of September 2008 to set up a rescue system by providing about EUR 35 billion of liquidity to HRE. This was based on a guarantee by Germany which was approved by the Commission, on 2 October 2008, only under the condition that Germany submitted, within six months, a restructuring or liquidation plan for HRE, or proved that the guarantees were entirely redeemed. HRE continued to report heavy losses, so Germany not only had to provide further liquidity support but needed to inject capital as well. Finally, HRE was nationalised by Germany; this was achieved through a squeeze-out of the remaining shareholders.

In autumn 2010, a public winding-up institution (FMS Wertmanagement AöR - FMS-WM) was established for HRE. It manages a large portfolio of assets and derivatives taken over from the HRE group. The criteria that guided HRE in the selection process for the portfolio were that assets were either considered to be of no further strategic value, that they contained risks considered to be no longer acceptable, that they were too capital-intensive or that they were unsuitable as collateral to obtain future long term funding. FMS-WM has over the course of time taken over HRE assets with a nominal value of about EUR 210 billion, i.e. half the 2008 balance sheet total.

2.4. HRE now

The HRE group currently consists of Hypo Real Estate Holding AG (HRE Holding) and its subsidiaries pbb Deutsche Pfandbriefbank AG (PBB) and Dublin-based Depfa. PBB is the renamed core

(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.

banking entity of the group, the only part of the business that continues to operate as such in the market, focussing on real estate finance and public investment finance ([2]). Depfa is in run-down mode, no longer contracting new business.

By the end of 2011, HRE's core bank PBB was allowed to have an "adjusted strategic balance sheet" ([3]) total not exceeding EUR 67 billion. That means that its portfolio of real estate finance assets and interest bearing assets in the area of public investment finance was capped and could not exceed that threshold. As a result, although the HRE group's balance sheet is still relatively large, the core going concern of the institution has been severely cut down in size.

3. The in-depth investigation

In light of HRE's unfortunate former business strategy, the initial restructuring approach of April 2009 and the related refinancing needs, the Commission opened an in-depth investigation into State aid measures for HRE on 7 May 2009 ([4]), based on doubts regarding HRE's long-term viability. At that stage, the Commission also had doubts that sufficient measures to limit distortions of competition and to achieve adequate burden-sharing were included in the plan. The in-depth investigation was extended on 13 November 2009 and on 24 September 2010 because additional State aid measures for HRE had become necessary in the meantime.

4. Main features of the restructuring plan

On 1 April 2009, Germany notified the first draft of a restructuring plan for HRE and, after several modifications, submitted the final version of the plan on 14 June 2011. In view of the considerable state support which HRE had received, a deep restructuring of HRE was necessary not only to restore viability but also to minimise distortions of competition and to ensure adequate burden-sharing.

According to the restructuring plan, HRE – freed from its legacy of impaired assets with a nominal value of EUR 210 billion – will redesign its business activities in such a way that its core bank PBB can carry out its activities based on stable funding and improved internal control systems. Its future activities will be on a considerably smaller scale than HRE's activities before the crisis, whether measured in terms of balance sheet size, volume of new business, workforce, branch network or geographical scope.

PBB's adjusted strategic balance sheet total at the end of 2011 accounts for approximately 15 % of HRE's balance sheet size at the end of 2008. That reduction in size was accompanied by a substantial reduction of the workforce. More than 30 participations, one third of which are outside Europe, have already been divested or liquidated, or are in the process of liquidation. Twenty-six out of 32 branches have been closed. In addition, a multi-year group-wide transformation with a budget of approximately EUR 180 million has been launched to improve and integrate the IT systems.

PBB is the only subsidiary of HRE Holding which is continuing to generate new business; it pursues two strategic business lines, real estate finance and public investment finance. Both business lines target assets that are eligible for German covered bonds, either in the form of German mortgage bonds (*Hypothekenpfandbriefe*) or German public sector bonds (*öffentliche Pfandbriefe*). Refocusing HRE's business model in such a way that the bank will in future only acquire assets that are eligible for German covered bonds is a crucial element of the restructuring plan in order to achieve de-risking of its activities. The eligibility criteria set out in the German law for covered bonds (*Pfandbriefgesetz*) in essence only allow for a bond cover pool of good quality. Accordingly, PBB will no longer pursue other activities, in particular not budget finance business, infrastructure finance, capital markets and asset management activities.

In order to ensure that the business model set out in the restructuring plan is actually implemented, and to ensure that adequate burden-sharing is achieved and distortions of competition are limited to the minimum, Germany submitted a number of commitments. The following are key:

– the growth rates of PBB have to remain within defined limits, measured in terms of balance sheet size as well as volume of new business,

– the bank can acquire new business only on certain geographic markets,

– the bank must not acquire other businesses during the restructuring period,

– Germany will re-privatise PBB as soon as possible.

The Commission's investigation confirmed that HRE has a significant list of tasks to fulfil in order to restore long-term viability. The most important

([2]) Public investment finance means those public finance activities that relate to specific projects and investments, as opposed to general purpose lending or the holding of (quasi-)government bonds.

([3]) PBB's adjusted strategic balance sheet total is defined as the balance sheet total corrected for items that are in run-down mode or have been synthetically transferred to FMS-WM – accounts.

([4]) OJ C 240, 7.10.2009, p. 11.

ones are the ongoing restructuring and cost cutting efforts; the further development of an adequate stable revenue generating business from the strategic pillars, independent from the revenues it is currently generating from the asset management mandate of FMS-WM; and further fine tuning and improving of risk management systems to allow strict monitoring and planning of risk positions.

5. The State aid approved for Hypo Real Estate

Based on the above business strategy, the Commission decided on 18 July 2011 (5) that Germany's State aid to HRE, consisting of capital injections of approximately EUR 9.95 billion (FMS-WM is the recipient of part of that capital), guarantees of EUR 145 billion and an asset transfer to FMS-WM with an aid element of about EUR 20 billion, was compatible with the internal market on the basis of Article 107(3)(b) of the Treaty on the Functioning of the European Union (TFEU) in the light of the commitments submitted by Germany.

Before reaching that final decision, the Commission took six decisions authorising a series of aid measures temporarily, respectively opening and extending the in-depth investigation:

– Decision of 2 October 2008; State aid NN44/2008 - Germany, Rescue aid for Hypo Real Estate (6);

– Decision of 7 May 2009 (Corrigendum of 24 July 2009); Staatliche Beihilfe C 15/2009 (ex N 196/2009) - Hypo Real Estate, Deutschland;

– Decision of 13 November 2009; State aids n° C 15/2009 (ex N 196/2009), N 333/2009 & N 557/2009 – Germany, Hypo Real Estate – Extension of formal investigation procedure, and temporary find capital injections compatible (7);

– Decision of 21 December 2009; State aid n° N 694/2009 – Germany, Emergency guarantees for Hypo Real Estate (8);

– Decision of 19 May 2010; State aid N 161/2010 – Germany, Further recapitalisation of Hypo Real Estate (9);

– Decision of 24 September 2010; State aids n° C 15/2009 (ex N 196/2009) & N 380/2010; Extension of scope of formal investigation procedure, winding-up institution, additional SoFFin guarantees for HRE; Hypo Real Estate, Germany (10).

According to the Commission decision of 18 July 2011, a monitoring trustee keeps the implementation of HRE's restructuring plan and the fulfilment of the commitments submitted by Germany under close surveillance, reporting to the Commission on a regular basis.

6. Interesting features of the HRE case

The HRE case is characterised by several interesting features. The most important ones are the following.

6.1. Procedurally long and complex case involving substantial aid amounts

The first rescue decision for HRE was adopted on 2 October 2008. This was the first decision adopted under the accelerated procedure (11) introduced during the financial crisis.

The final restructuring decision for HRE was adopted on 18 July 2011, i.e. nearly three years after the first rescue decision, which so far is one of the longest periods for a banking State aid case in the financial crisis. One of the reasons for the length was that it took some time to establish the actual portfolio of assets to be hived off, not least because the bank's IT and risk reporting systems at the time were inadequate.

The HRE case entailed seven Commission decisions. Hence, it is one of the banking State aid cases with the most decisions. On 7 May 2009, the Commission opened the in-depth investigation regarding State aid for HRE. After the opening of the investigation, HRE required further State aid from Germany. Each of these further State aid measures were individually approved by the Commission.

The German State aid package for HRE makes the HRE case one of the biggest State aid cases of the financial crisis, whether measured in absolute or relative terms. The amount of capital injection and the amount of State aid resulting from the relief measure together represent more than 20% of HRE's pre-crisis risk weighted assets. As regards state guarantees, HRE has so far received the highest amount of state guarantees compared to other State aided banks in Europe during the financial crisis.

(5) http://ec.europa.eu/competition/state_aid/cases/231241/231241_1279613_551_2.pdf
(6) OJ C 293, 15.11.2008, p. 1.
(7) OJ C 13, 20.1.2010, p. 58.
(8) OJ C 25, 2.2.2010, p. 14.
(9) OJ C 190, 14.7.2010, p. 7.
(10) OJ C 300, 6.11.2010, p. 6.
(11) See recital 53 of the Commission communication on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270, 25.10.2008, p. 8.

6.2. Involvement of impaired assets measures through large bad bank

HRE´s bad bank, FMS-WM, was established in the autumn of 2010. FMS-WM acts independently of HRE and benefits from an obligation of SoFFin (Sonderfonds Finanzmarktstabilisierung – a public German Fund) to compensate losses. FMS-WM does not have a banking licence and hence does not have to fulfil the regulatory capital requirements of a bank.

FMS-WM holds a portfolio of securities, loans and derivatives. The loans portfolio consists of three main areas, namely commercial real estate/workout, value management (public sector linked structured products) and infrastructure. It has considerable exposure to PIIGS governments and quasi government entities.

FMS-WM has in the course of time taken over assets of HRE with a nominal value of about EUR 210 billion. This makes FMS-WM the biggest bad bank in Europe in the context of the current financial crisis. In the context of the transfer of assets from HRE to the bad bank, HRE needed additional short term guarantees from the state to bridge liquidity gaps caused by transfer counterparties demanding controlled settlement.

An assessment of the bad bank transfer revealed an *a priori* incompatible aid amount of more than EUR 15 billion, which according to the Impaired Asset Communication ([12]) ought to be recovered or clawed back over time. Although certain clauses allowing for contingent payments and profit skimming have been introduced, PBB was not able to provide for full recovery.

6.3. Considerable down-sizing of the business but no liquidation

Given the above features, in particular the inability to claw back the *a priori* incompatible aid amount involved in the asset transfer to FMS-WM and the other considerable aid amounts, a very far reaching restructuring plan including significant downsizing was necessary, not only from a long-term viability perspective, but also to mitigate the distortions of competition caused by allowing the undertaking to continue to be in business. On that basis, as explained above, PBB is only allowed to have an adjusted strategic balance sheet total of EUR 67 billion at the end of 2011. That threshold is equal to approximately 15% of HRE group's balance sheet at the end of 2008; the restructuring plan therefore targets a downsizing of approximately 85%, one of the most significant downsizings of aided banks in Europe in the financial crisis, in both absolute and relative terms.

The Commission carefully considered whether such massive State aid could still be found compatible with the internal market without liquidating the bank. First of all, after careful in-depth assessment on the basis of information provided by Germany, the Commission was able to conclude positively on the prospects of PBB, i.e. the core bank of the "new" HRE, to restore long-term viability, subject to full implementation of the restructuring plan. It noted the significant downsizing in terms of balance sheet size and scope of activities as well as the other limitations offered by Germany as measures limiting distortions of competition. The Commission considered that the nationalisation implied important burden-sharing by the former stakeholders, addressing moral hazard issues. It noted that although PBB contributes as much as possible to the restructuring costs and the claw back, this would not reach the level of own contribution normally required. However, the overall amount of downsizing was considered to be an adequate substitute for this lack of sufficient own contribution.

Overall, the conditions for finding the aid compatible with the internal market were considered to be met, allowing the Commission to take a positive conditional decision.

([12]) Communication from the Commission on the treatment of impaired assets in the Community banking sector OJ C 72, 26.3.2009, p. 1.