WestLB liquidation – the end of the saga

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1. Introduction

On 20 December 2011, the European Commission approved the liquidation plan submitted by the German government for the commercial bank WestLB, majority-owned by the two savings banks associations in North Rhine-Westphalia and the federal state of North Rhine-Westphalia. After 30 June 2012, WestLB stopped new banking business. The plan aims at a sale and eventual winding down of its banking activities. In the medium term, the bank will be transformed into a run-down vehicle for servicing legacy positions that were transferred to a bad bank named EAA, while the brand name WestLB will finally disappear from the market.

That liquidation brings an end to the WestLB saga. The bank has not only often hit the headlines but has also been subject of several State aid investigations over the last decade (2). To put the decision taken in December 2011 into context, we briefly outline some common problems faced by most German Landesbanks and the specific situation of WestLB which led to the liquidation plan.

1.1. The wider context: German Landesbanks

The German public banking sector is made up of a large number of smaller savings banks on the one hand and a small number of very large Landesbanks – among those WestLB – on the other hand. For a long time Landesbanks benefitted from a competitive advantage in the form of State guarantees called Gewährträgerhaftung, which gave them access to cheap funding. In 2001, the European Commission and the German government agreed to bring the Gewährträgerhaftung to an end, albeit with a transitional period until the end of 2005. In general Landesbanks struggled to find a sustainable business model once they were deprived of the privilege of access to cheap financing. While banks in Germany in general tend to be less profitable than banks in other countries, as can be seen in the OECD Bank Profitability Database, Landesbanks performed even worse than the average German bank, and consequently were even more affected by the financial crisis. The poor profitability and inglorious track record of several Landesbanks in Germany led over time to difficulties, and the broad consensus in Germany was that the Landesbank sector needed to be reformed (3). That necessity was also highlighted in assessments made by external experts such as research institutes, regulators, the OECD and the IMF.

A detailed analysis of the underlying reasons for the Landesbanks’ insufficient performance would go beyond the scope of this article. Still, one core aspect should be mentioned: the segregation of the German public banking sector (4) prevented Landesbanks from expanding into retail or small business banking, a business area which is in the hands of the savings banks. Landesbanks were hence left with wholesale and investment banking. So they expanded into business areas that they perceived to be profitable, and made large investments in foreign markets, buying for example structured credit products and bonds whose inherent risks they apparently underestimated. Those investments and similar exposures made them specifically vulnerable to the impact of the financial crisis. In consequence, first SachsenLB, then WestLB, and later on also BayernLB, HSH and LBBW had to be bailed out by the German taxpayer, who provided them with substantial State aid to weather the crisis. If it had not been for those substantial capital injections, guarantees and asset relief measures, losses related

(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) Already in July 1999 the Commission took a negative final decision regarding capital transfers in favour of WestLB which occurred during the 1990s. That decision was annulled by the Court due to lack of motivation, and replaced by a new decision in October 2004. The total recovery including interest amounted to about EUR 1 billion. On 18 July 2007, the Commission took a decision to endorse five capital contributions as being eligible under State aid rules. Those capital contributions to WestLB were made between 2002 and 2005 and added up to approximately EUR 6 billion.


(4) In fact, the extent to which Landesbanks are vertically integrated with the savings banks branch network varies, with Helaba being a prominent example of a Landesbank that is rather well integrated and that was hardly affected by the financial crisis. Likewise it is true that, although Landesbanks share common features, notably their shareholder structures, their business models and respective risk appetites differ.
to these activities would have absorbed a major part or all of those banks’ equity.

1.2. WestLB’s specific situation

WestLB’s quest for a sustainable business model goes back to 2001 when activities carried out in the public interest were separated from its economic activities. From the very beginning the bank’s restructuring efforts focused on investment banking activities.

These efforts did not, however, lead to the desired results. Short term profits stemming from opportunistic, volatile and costly investment banking activities were followed by huge losses in 2002, 2003, 2004, and 2007 (1).

2. The May 2009 decision

At the beginning of 2008, remarkably even before the collapse of Lehman Brothers, which is often considered as the starting point of the financial crisis, WestLB was once again in desperate need of support. Its public shareholders had to shield a portfolio of toxic assets by a guarantee of EUR 5 billion. After notification of that aid, a restructuring plan was submitted for WestLB, outlining the measures intended to minimize the distortion of competition. In the assessment the Commission concluded that the bank was not in a position to reduce its activities significantly and to restore viability at the same time. The aid to WestLB was therefore authorized in May 2009 only under the condition that the bank would be sold as a whole or in parts by the end of 2011, or would otherwise need to cease its business activities. The decision provided that WestLB had to reduce its overall assets by 50%, cease risky activities like proprietary trading, and had to implement a reporting structure that would facilitate a sale in parts. Although all shareholders initially agreed to the proposal, it was eventually imposed as a conditional decision which was attacked in Court.

3. New aid – and a new final decision

3.1. The interim guarantee

Within only a few weeks after the decision of May 2009, WestLB informed the Commission that it needed considerably more State aid in order to escape bank resolution procedures. Due to the continuing deterioration of underlying securities in one of the bank’s portfolios, the capital requirement increased sharply, resulting in a situation where WestLB’s capital ratio fell significantly short of the regulatory minimum capital requirements. Hence, for reasons of financial stability the Commission authorized on 7 October 2009 a temporary asset guarantee of EUR 6.4 billion that enabled deconsolidation of the toxic portfolio. That measure was approved for two months until it was to be replaced by a permanent solution.

3.2. In-depth investigation of the bad bank

In late 2009 WestLB’s shareholders agreed on a bad bank to free WestLB of its toxic and non-strategic assets and to significantly reduce its balance sheet. That bad bank, named Erste Abwicklungsanstalt (EAA), was the first bad bank set up under the umbrella of an agency (SoFFin) that Germany had established in the financial crisis to stabilize and restore confidence in its financial system.

EAA’s task was to take over and wind up WestLB’s toxic and non-strategic assets with a total initial nominal amount of approximately EUR 85 billion. In order to provide EAA with sufficient capital for the transfer, WestLB needed more State aid, namely a capital injection of EUR 3 billion. That capital was provided by SoFFin in the form of silent participation, as well as a further guarantee of EUR 1 billion by WestLB’s public shareholders.

On 22 December 2009, the Commission opened an in-depth investigation, based on doubts that the measure was in line with the requirements of the impaired asset communication, as regards transparency, valuation and burden sharing. At the same time, the Commission’s temporary approval was based on Germany’s commitment to adjust both the remuneration and measures to limit distortion of competition, and to submit a new restructuring plan that adequately reflected the additional amount of State aid granted to WestLB. One of the main purposes of the in-depth investigation was to assess the real economic value of the toxic and non-strategic assets that had been transferred to EAA. The Commission hired external experts for that assessment.

The assessment has taken considerable time due to the sheer volume of the portfolio, the number of transactions involved, discussions, and the existence and impact of mitigating factors. To cut a long story short, the in-depth investigation finally came to the conclusion that the transfer of the portfolio of toxic and non-strategic assets to the bad bank happened at EUR 3.414 billion above the real economic value.

The aid amount was calculated as the difference between the market value of the portfolio and the

price at which the portfolio was transferred to the bad bank. According to the Commission’s communication (6) such State aid is compatible as long as the price paid for the assets only exceeds (temporarily distorted) market prices but not the real values of the assets. In the case of WestLB, however, the in-depth investigation established that the transfer price exceeded the real economic value of the assets by EUR 3.414 billion. That amount, which is a priori incompatible with State aid rules, either had to be paid back by WestLB or be regained in another suitable form, for example by more in-depth restructuring or the sale of WestLB.

3.3. Consequences

The bad bank transfer involved an amount of State aid that by far exceeded the EUR 5 billion in aid that was subject to the May 2009 decision. For that reason Germany submitted a new restructuring plan, the assessment of which was the second phase of the in-depth investigation.

The new restructuring plan needed to take into account all the aid that was provided to WestLB, which required more in-depth restructuring, even in the context of the envisaged sale of WestLB.

A summary of related efforts reads as follows: in June 2010 SoFFin mandated the lawyer Friedrich Merz, formerly a politician and chairman of the CDU/CSU parliamentary party, to pursue the sale of WestLB, assisted by Morgan Stanley investment bank. A public tender for WestLB was launched in September 2010. A few weeks later BayernLB, another large German Landesbank, stepped forward and publically announced its interest in a merger with WestLB. In November 2010, however, BayernLB stopped those negotiations, indicating that due diligence had shown that a merger with WestLB would not lead to acceptable economic results.

Although later on some other well-known names of strategic investors, as well as a few exotic names, popped up in the financial newspapers and were supposedly interested in acquiring WestLB, in the end, after weighing all the risks none of them made a bid with terms and conditions acceptable to WestLB’s shareholders. Consequently, in May 2011 the mandate of the divestiture trustee Merz was not prolonged.

From the Commission’s point of view the failure of the sale efforts was a marked judgement on the credibility of WestLB’s business model, as evidently no market investor was willing to “buy” the story that this bank would generate economically sufficient returns on investment.

Also the implementation of the old restructuring plan was lagging behind schedule. In particular, WestLB did not succeed in selling its most important subsidiary, WestImmo, a bank specialised in real estate financing. Therefore, the intended reduction of WestLB’s balance sheet as stipulated in the decision did not materialize.

The bank then finally stated in its updated restructuring plan that adequate remuneration as well as more in-depth measures would jeopardize WestLB’s prospects of returning to viability. Shrinking the bank’s balance sheet size to less than 20% of its former size, a proposal made by WestLB in February 2011, clearly proved impossible since that exercise had stronger effects on revenues than on costs, making the business less and less profitable.

Not only did the question of how WestLB might build a sustainable business model on a much smaller scale than before remain unsolved; the same was true for the question of how the EUR 3.414 billion of incompatible aid could be repaid. Considering that WestLB was not able to generate the required funds internally, and that the intention to sell WestLB failed as well, there were no realistic alternatives left.

Once it had become clear that modifications of WestLB’s restructuring plan would definitely not lead to a sustainable business model and State aid-compatible results, a more radical plan was worked out by Germany, the federal state of North Rhine-Westphalia, and the savings banks, which in essence suggested carving out a small part of WestLB’s business, transferring that part to the savings banks, and liquidating the remainder.

4. The liquidation plan

That liquidation plan was submitted to the Commission on 30 June 2011. It said that WestLB would carve out the so-called Verbundbank, an entity which focuses on cooperation with savings banks and will employ about 400 employees, and that the remainder of assets would either be sold or liquidated. To this end, WestLB intended to transfer on 30 June 2012 all assets and liabilities to EAA, the bad bank that had already taken over its portfolio of toxic and non-strategic assets. After 30 June 2012, WestLB would no longer engage in banking business on its own account, no longer use its brand name, and be transformed into an asset manager. Banking licences not needed for the provision of asset management services would be withdrawn. Thus, significant and irreversible steps were laid out in the liquidation plan, which marked
an irrevocable exit from the market for the majority of WestLB’s former activities within 12 months. In the decision taken on 20 December 2011 the Commission concluded that the liquidation plan fulfilled all relevant criteria of the Restructuring Communication and the Banking Communication and thus approved all aid measures. Consequently, the May 2009 decision had lost its object and was repealed.

As regards Verbundbank, the carved out entity will actually proceed with some of WestLB’s former business activities. The 20 December 2011 decision says that the entity will not be run on a stand-alone basis – alleviating our concerns whether the entity would be sufficiently profitable to do so – but will be taken over by Helaba which is a viable bank. The carved out activities represent in terms of balance sheet size less than 20% of WestLB’s former balance sheet and in terms of personnel less than 10% of WestLB’s former staff.

In order to minimise distortions of competition, the winding-down of WestLB had to be limited to the shortest period possible, even if the process takes several years. The bank itself may only continue with asset management services that are a rather insignificant part of WestLB’s bank activities. These services are nevertheless required by EAA in order to run down the assets. They will be provided by the rump of WestLB, the servicing platform. Third parties may contract those services as well, but only to a limited amount, offered at fair market prices, and under the condition that the servicing platform be sold before 31 December 2016 or will otherwise be liquidated. A transformation period is required simply to allow management to reorganize the structures, to carve out the servicing company and to establish at least a short track record in order to attract potential investors.

As regards burden-sharing, the liquidation plan is based on the concept that WestLB’s shareholders will lose all their capital in WestLB. The savings banks have furthermore committed to provide EUR 1 billion of additional capital to enable the carve out of Verbundbank, while the federal state of North Rhine-Westphalia agreed to take the major part of the burden and committed to bear the costs associated with the liquidation of WestLB, a considerable part of which stems from pension liabilities. The overall agreement sufficiently takes into account both the respective burden-sharing capacities of the parties as well as the degree to which they were formerly involved in setting the bank’s strategy and their degree of influence on the bank’s corporate governance.

Since North Rhine-Westphalia has taken the largest burden of the WestLB shareholders, the concession to allow the servicing company to offer a limited range of services to third parties, which reduces the overall costs of the liquidation, was well justified.

5. Concluding remarks

The WestLB case demonstrates that ordinary winding down can be a realistic possibility for ailing banks. In fact, WestLB was not able to generate sufficient, permanent and risk-adequate profits in view of its high cost basis after having lost its cheap funding from Gewährträgerhaftung. After the attempt to sell the bank failed, liquidation, although costly in the short term, seemed inevitable and was in the long term preferable to repeated rescue operations. Nevertheless, the owners would probably not have agreed to a costly liquidation if they had not been faced with a credible alternative, a resolution under the new restructuring law passed by the Bund. Application of the restructuring law would in fact have implied that neither the owners nor the entire German public banking sector had been able to find a solution. The German federal savings banks association therefore decided to get involved and to take half the losses while the other half was shouldered by the Land of North Rhine Westphalia. In spite of the potential costs of redundancies, the parties managed to reduce costs by limiting the bank’s activities to that of an asset manager on a going concern basis, while all assets were transferred to a bad bank. That provision reduced costs, as the bank does not have to report based on liquidation values and assets do not have to be sold in a fire sale. For the Commission that scenario was acceptable because the bank clearly stopped any new business and transferred economic responsibility for asset management services to another entity. Furthermore, the systemic risk of the bank’s failure is now clearly contained. WestLB is so far the only major banking case where failed attempts at restructuring ended in liquidation. Assuming that other Landesbanks do not want to go the same route as WestLB, they will certainly want to make sure that they can provide and implement sound and achievable restructuring plans.