Denial, Coverup, *and the* Blaming *of* Others

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Germany's performance after the subprime collapse.

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For some it may be an eye-opener: European banks have now suffered more losses because of the credit crunch than their U.S. rivals—even though the turmoil was first triggered by problems in the U.S. subprime mortgage market—but raised less capital.

These are the findings of a survey that the Institute of International Finance, the Washington-based association of leading financial institutions, recently published in their "Capital Markets Monitor." Of the $387 billion in credit losses that global banks have reported since the start of 2007, close to $200 billion were suffered by European banking groups and $165.7 billion by U.S. financial institutions. Credit turmoil bank losses in Asia in the survey amounted to $21.4 billion. Capital raised by banks since the beginning of 2007 was $276.4 billion with $141.3 billion by financial institutions in the Americas, $125.5 billion in Europe, and $9.9 billion in Asia. Of the $387 billion in reported losses, about 13 percent represents credit losses, the remainder mark-to-market losses.

In terms of fallout from the U.S. subprime crisis, Germany may claim—after the United States and Great Britain—third place in announced losses, write-downs, and recapitalizations. Here some numbers. To use the May 13, 2008, damage estimates of the German TV magazine "Frontal21," German taxpayers may be faced with an added fiscal burden in the form of public guarantees and recapitalization costs of €36.5 billion. Such are the consequences of importing "toxic waste

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German President **Horst Köhler** *is making his contribution to solving the financial crisis by starting a "monster hunt."*

made in the U.S.A." by institutions such as IKB Deutsche Industriebank of Düsseldorf and several Landesbanks investing in high-yield structured financial products related to the U.S. subprime mortgage sector. IKB might need €8 billion, Sachsen LB €17.5 billion, BayernLB €6 billion, and WestLB €5 billion. Last year the Landesbanks payed taxes of only €137 million. A year earlier, in 2006, it was €1.4 billion.

But some observers see "a mixture of denial, cover-up, and blaming others" in the way the German public sector and a large part of the banking community are dealing with the damage. Although top managers of IKB and the problem-ridden Landesbanks had to go, Germany is still waiting to see an in-depth critical internal report similar to that published by the British Financial Services Agency on March 26, 2008. (Because state bank KfW is a major shareholder of IKB, its rescue with largely public funds underlines its role as a quasi-public-sector bank that the German government could not let fail.)

German taxpayers have also not seen a report into the failures of any particular bank, published as a summary on the Internet, as was done by the Swiss financial watchdog EBK in the case of UBS. Instead, German officials responsible for financial market supervision—such as finance minister Peer Steinbrück, BaFin head Jochen Sanio, or Bundesbank president Axel Weber—are mostly addressing two themes in their speeches and statements. First, they mention all the important things that Germany is doing in international bodies such the G7, the Financial Stability Forum, the International Monetary Fund, and Ecofin to repair the international financial architecture. And second, they point fingers at those responsible for the hundreds of billions of dollars in losses: the greedy, reckless packagers and distributors of toxic waste products in Wall Street, and the principal villains, the international rating agencies making billions of dollars issuing Triple-A ratings for what turned out to be junk mortgage securities.

Such are the consequences of importing "toxic waste made in the U.S.A."

It's an eye-opener to look at the headlines in the German press reporting on BaFin's presentation of its 2007 annual report: "BaFin sees itself as victim of rating agencies" (*Frankfurter Allgemeine*), "Sanio critical of risk systems" (*Handelsblatt*), and "BaFin sees no own fault in the crisis" (*Kölner Stadt-Anzeiger*).

The official German way of coping with the worst financial crisis in living memory—that is mostly hitting the bloated public Landesbanks—now has reached the highest office in the land. German President Horst Köhler, notes Gerd Langguth, author of a bestselling biography on Köhler, is making his contribution to solving the financial crisis by starting a "monster hunt."

On May 14, Köhler in an interview accused banks of taking on risky investments without adequate risk provisions, turning markets into "monsters that must be tamed." Köhler, who previously served as managing director of the International Monetary Fund, told the weekly magazine *Stern:* "We need stricter and more efficient rules, more capital set aside to cover financial investments, more transparency, and an independent global institution that monitors the stability of the international system—the IMF."

After four years running the IMF and stints as junior finance minister, president of the Association of German Savings Banks, and president of the European Bank for Reconstruction and Development, Köhler knows how financial markets tick. "Capitalism is not just about pulling profits but above all about being able to handle risk, and the financial markets crisis shows that too many players in banking houses did not understand precisely that," he told *Stern,* and continued: "The over-complexity of financial products and the possibility of undertaking huge leverage operations with the smallest of capital as security allowed the monster to grow. We have to hold up a mirror to the finance world. They have deeply embarrassed themselves. And I still have not heard a clearly audible *mea culpa.*"

But things may change.

Opposition parties have now taken the first concerted steps to press the German government for a full accounting of huge public sector bank losses to be picked up by German taxpayers. "The German government and its ruling parties are so far refusing to carry out a systematic investigation into those aspects of the financial crisis that are solely related to Germany," begins the May 14 statement of three leading opposition members of the German parliament's influential Finance Committee. Frank Schäffler (Free Democrats), Gerhard Schick (Greens) and Axel Troost (Left) are *de facto* speakers on banking and financial market matters for the three opposition parties.

A Tale of Mass Conflict of Interest

Although some top managers of problem banks like IKB, WestLB, Sachsen LB and Bayerische LB had to go, the weaknesses of Germany's financial market supervision and corporate governance systems became again apparent in the fallout from the subprime crisis. When legions of politicians at all levels, flanked by representatives of labor unions under the German co-determination laws, dominate a public banking sector that represents almost half of total banking assets, the diseases of politization and conflict of interest make investigations by independent experts almost impossible. There is broad consensus among the country's political class on the desire to shift—under an opaque smokescreen—the huge losses of the banks to German taxpayers without coming up with *mea culpas* in order to rebuild confidence and credibility.

Consider those responsible in Germany for financial market supervision, the BaFin and the Deutsche Bundesbank. So far, they have not presented any internal investigation into their examination failures. The German central bank, which shares banking supervision duties with BaFin, traditionally has used its independent status to ward off any meaningful investigation into its failures. As for BaFin, a look at the composition of its supervisory board makes clear that the agency, funded by contributions from the industry it supervises, is controlled by all major players. Its chairman is deputy finance minister Thomas Mirow and his deputy Jörg Asmussen, while public servants from the ministry of finance, the economic ministry, and justice ministry sit on the BaFin board. Five BaFin board members come from parliament. Finally, the different banking groups have five members, the insurance industry four, and the investment funds industry one representative on the BaFin board.

Consider finance minister Peer Steinbrück. He has been blocking any meaningful independent investigations for sound personal reasons. As a former minister of economy, minister of finance, and prime minister of the state of Nordrhein-Westfalen, he belonged to those ruling state politicians watching over the state's major investment, WestLB. According to the old banking wisdom that "bad loans are made in good times," Steinbrück was more part of the problem than part of the solution with respect to WestLB at the time when this public sector bank started to invest into toxic waste products from the U.S subprime mortgage market in a major way.

Peer Steinbrück

Consider Steinbrück's key aid, Jörg Asmussen. Steinbrück wants to put Asmussen in the deputy finance ministry position when the present office holder, Thomas Mirow, heads to London this summer as the new president of the European Bank for Reconstruction and Development.

Asmussen was caught asleep on his watch not only as a member of the supervisory board of the near-failing IKB, but also—together with Mirow—as member of the BaFin board. With so many CDU/CSU top politicians damaged by the Landesbank disaster, the party of Angela Merkel is keeping a low profile in the financial crisis. Therefore, Steinbrück (SPD) won't face any serious opposition in the grand coalition partner if he elevates Asmussen to deputy finance minister.

Consider the political opposition. In spite of huge fiscal burdens to German taxpayers because of the subprime-fallout, as yet the three opposition parties in the German parliament have been unable to get their act together and push for a special investigation committee of the Bundestag. There are good reasons. First, the opposition parties also have their man on the BaFin board, Carl-Ludwig Thiele, a member of the FDP. Second, all three opposition parties are represented on the supervisory board of the state bank KfW with party leaders. Germany's maverick Oskar Lafontaine, head of the German Left party, is a member of KfW's board of directors as are Christine Scheel, a former finance committee chairwoman from the Greens, and FDP parliamentary whip Jürgen Koppelin.

Consider the major banking associations. They also have reasons to block any independent inquiry into the huge fiscal burdens. The Association of German Banks, representing the private banks, has to take into account that Deutsche Bank AG, its main financial contributor, was a big seller of "toxic waste made in the USA." Deutsche Bank may receive greater attention because it sold huge quantities of subprime paper on to IKB and some Landesbanks at a time when the bank knew that it was dumping toxic waste. The German Savings Bank Association and the Landesbanks' Association of German Public Sector Banks are fearful of what might come out through an independent investigation. It could expose embarrassing management and supervisory failures in the public banking sector and increase the political pressures for radical reforms and consolidations of the Landesbanks to save German taxpayers from the next public sector banking meltdown.

—*K. Engelen*

All three complain that so far, the government's written or verbal answers to questions by the opposition about the subprime fall-out "amount to nothing but generalities and evasions." This, in spite of the fact "that major questions have to be raised and answered concerning future policies with respect to Germany's financial sector."

There was also a call by leading experts that appeared in *Handelsblatt,* Germany's leading economic and financial daily, for an independent investigation into the causes and consequences of the fallout from U.S. subprime crisis.

Some argue that the politicians and political parties still in control of the huge public banking sector so far have blocked such an independent investigation into what actually went wrong at the level of bank management, supervisory boards, and bank supervision. They warn that without convincing answers as to what happened, who was responsible, and what lessons should be drawn, confidence will not return to the markets. They warn that the international competitive position of Germany's financial sector will be damaged if the present "policy of cover-up" continues.

"Making a clean slate in terms of the causes and consequences of the banking crisis will not be easy, since many potential actors are sharing responsibility and thus are not objective in their views," says Hans-Peter Burghof, who teaches banking and financial markets at the University of Hohenheim. "A retrospective analysis may be tainted by shortsighted interests of a political or economic nature. Therefore it is crucial to establish a neutral body mindful of the public interest to shed light into how the crisis came about and who was responsible. Such an investigation will bring facts to light that might be damaging so some, but that's what is needed now, and that's the risk of such an exercise."

Werner Michael Waldeck, a former official in the German finance ministry, points to historical precedents. Waldeck was charged with managing an eleven-person commission established in 1974 to cope with the aftermath of the Herstatt Bank failure. The commission published its final report in 1978. "Today we are coping with a financial crisis of much larger domestic and international dimensions than we had after the Herstatt Bank failure," says Waldeck. "Today's need is more urgent for a group of independent experts to get to the roots of the present financial crisis as it affects Germany's financial sector.

Also supporting such a demand is Stephan Paul, who teaches finance and supervision at Ruhr-Universität Bochum, and who led a team of professors charged with developing recommendations for reforming German banking supervision structures. "In order to avoid too much or not enough regulation with its consequences, we need a 'High Level Expert Group' excluding politicians to analyze the effect of the subprime fallout on Germany's financial sector." Such an expert group should have its own budget and should particularly focus on the specific problems of good governance that plague Germany's public sector banks, says Paul. "Unfortunately, there have already been a great many proposals for change presented to the public despite the fact that the crisis has not been analyzed—like a medical doctor prescribing medicine without diagnosing the patient."

Marcus Geschwandtner, who specializes in banking law at the firm of DHPG in Bonn, argues: "Whether supervisory authorities like BaFin and the Bundesbank have made mistakes or, considering the high risk exposures of the examined banks, are even guilty of negligence, can only be uncovered by an independent investigation. In view of the dimensions of what went wrong, the indications are that negligence by supervisory authorities has occurred. Banking supervisors have a duty to defend against dangers inside the parameters circumscribed by law and regulation. There are broad parameters in which BaFin is in a position—very early and forcefully—to fend off systemic risks or to counter other risky or unacceptable banking practices."

For Geschwandtner, it is crucial that the failures in corporate governance for all banking groups are a central target of investigation. For example, are seats on supervisory boards awarded on the basis of professional qualifications, not political party affiliations? Another focal point, says Geschwandtner, should be "how far public-sector banks have moved away from a regional public-sector mandate into international commercial business areas like investment banking that were not intended when the banks were founded by regional and local communities and state governments, because the originally established business model was designed as an effective preventative risk management device."

For Jan Pieter Krahnen of Goethe University in Frankfurt and the Centre for Financial Studies, "The key question for the coming weeks and months is what reform or repair proposals will be based on academically researched analysis of the causes of the failures in management and market supervision. Only that will repair the market machinery and help market confidence return. For realistic observers, it is clear that market repair actions can only succeed if they are based on a no-holds-barred investigation of all the facts." Krahnen has extensively written on the implications of the structured products crisis in global financial markets. Together with colleague Reinhard H. Schmidt he authored the international benchmark publication, *The German Financial System* (Oxford, 2004).

Some experts argue that from a German perspective, a major lesson from the subprime crisis is that the Landesbanks showed themselves as the weak link in the German financial system because they lack a viable business model. That is, they have no sustainable earnings base in their respective

regions. Germany's Landesbanks are public sector banks controlled by the states along with the regional and local communities and their savings banks.

Achim Dübel, a World Bank financial sector consultant who has been working on savings bank reform in Europe, argues that in the case of the Landesbanks the old banking rule applies: "Bad loans are made in good times." According to Dübel, the good times for the Landesbanks came in 2001–2005 when, to soften the blow of losing the state guarantees after the European Commission ruled against such treatment, the banks were granted an additional period of four years before the guarantees were ended. During that period they used their top ratings to raise cheap funds used to buy staggering amounts of high-yielding structured securities including, as it turned out, a sizable amount of U.S. subprime mortgage paper.

Behind the drive to extend the guarantees were still-serving ranking politicians such as German finance minister Steinbrück. The state governments and the politically influential lobby of the Landesbanks and the German Savings Bank Association were all aware how the Landesbanks became soaked with liquidity and put it to work in high-yielding—but also risky—top-rated investments. "Also this explains," says Dübel, "why there is so much resistance in Germany to getting at the real causes for the huge losses of public sector banks in the subprime disaster."

But reform-minded leaders of the savings banks and Landesbank sector are chained to deep entrenched powerful political structures. Since throughout Germany legions of political party officials on the federal, state and local level use the supervisory positions in the savings banking system and the Landesbanks to supplement their regular incomes, they defend the "status quo" tooth and nail, disregarding the many billions of euros in public-sector wealth that have been squandered by bad management and politically weakened corporate governance. No German government dares to deny their party functionaries the considerable financial benefits gained from being part of the public-sector banking system. This explains why Germany's political elite is able to stick to a strategy of "denial, cover-up, and the blaming of others."

A final note: As savings bankers all over Germany are up in arms these days over the hefty contributions they have to raise in order to rescue the Landesbanks, the savings bank system is still carrying the financial burden of an earlier rescue operation, the politically driven investment in Landesbank Berlin Holding. ◆

Frank Schäffler

Gerhard Schick

Axel Troost

Tough Questioners

The "Three Musketeers" from the opposition benches—Frank Schäffler (Free Democrats), Gerhard Schick (Greens) and Axel Troost (Left)—offer a series of questions that puts Germany's chief cover-up strategist—finance minister Peer Steinbrück—in the hot seat:

■ First, regarding the KfW/IKB situation, they want to make clear the role of the state-owned development bank KfW as dominant shareholder of IKB. What is the IKB's financial position, they ask, along with its total risk exposure, the sales procedure, the impact on the federal budget, the failures of IKB's managers and supervisory board members, and the economic and financial rationale for state support for IKB?

■ Second, they ask whether the financial supervisors, BaFin and the Bundesbank, made mistakes. Under what directives and norms were they working? Could they have intervened in the examined banks' management much earlier to fend off the huge losses? Why was German government not able to use the international bodies to prod U.S. authorities into reining in the rating agencies and hedge funds by demanding more transparency and securing a faster implementation of the capital rules under Basel II?

■ Third, they raise the issue of political management. Is the present banking structure viable? Are the shared responsibilities among the two major supervisors, BaFin and Bundesbank, working adequately? Do financial market supervisors have the qualified staff that can handle the complex structured financial products in the age of globalization? And what will be the total burden to German taxpayers?

—K. Engelen