IKB: A Sad German Story

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Ten days ago, one of the sorriest and most revealing episodes of the financial crisis came to a close. KfW, the German state-owned financial institution, on 21 August sold its 91% equity stake in IKB, a bank specialised in lending to small- and medium-sized enterprises, to private equity fund Lone Star for €137 million.

IKB traces its roots back to 1924 and to the need to help German industry bear the burden of first-world-war damage. It later became part of the financial infrastructure which sustained the post-war German economic miracle, alongside KfW itself which was created at the time of the Marshall Plan.

During the last decade, squeezed lending margins drove IKB, together with several regional banks (Landesbanken), to diversify into risky international investments, including ill-fated subprime securities.

In IKB's case these were held by Rhineland Funding, an off balance-sheet conduit registered in the quasi-tax haven of the Dublin docklands. The size of this conduit exceeded €10 billion in the spring of 2007, more than one fifth of the entire IKB balance sheet at the time.

At the end of 2007 the abrupt drop in the value of subprime assets started to bring Rhineland down and, by contamination, IKB itself.

Part of IKB's junior debt belonged to local savings banks - the lifeblood of the German banking system, both as the main takers of deposits and also as financers of the economy – as well as to Landesbanken and other public institutions. This fact certainly explains the panic which seems to have gripped the federal authorities, leading the president of federal financial regulator BaFin to speak on 2 August 2007 of 'the worst banking crisis since 1931'.

The government undertook a bail-out in spite of IKB's mostly private ownership (KfW held only 38% of its equity at the time). It thus set in train a year-long nightmare sequence of repeated equity injections and failures to find a private buyer.

According to the *Frankfurter Allgemeine Zeitung*, the price tag to taxpayers exceeds €9 million, or €125 for every German citizen, not including residual risks. This amount is of a similar order to France's Crédit Lyonnais debacle of the 1990s, in spite of IKB's much smaller size.

Moreover uncertainty will remain until October, when the European Commission decides whether the massive injection of public money is compatible with rules governing state aid.

This spectacular disaster, simultaneous with others affecting Landesbanken such as Sachsen LB and WestLB, is a devastating blow to the credibility of German financial supervision.

The authorities chose to bury their heads in the sand, even when they were fully aware of the outsized risks parked in off balance-sheet conduits. The supervisory board likewise failed to exercise its duty.

Then, when the crisis came in 2007, the government could still have abandoned IKB to its bankrupt fate; but it stepped in without gauging the whole extent of its financial commitment, in a climate of mistrust and poor coordination between the central bank, BaFin, and the ministry of finance.

The government's assessment of the situation has been inadequate throughout the developments. Even recently the ministry of finance was still giving assurances that the sale of IKB would yield at least €800 million.

At no point did the German authorities explain these repeated failures, in contrast to the UK Financial Services Authority, which in March published a scathing self-critical report on the Northern Rock collapse.

Several respected experts, such as Stephan Paul at Bochum University, Jan Pieter Krahnen at Frankfurt University and consultant Hans-Joachim Dübel in Berlin, have called for an independent inquiry into the malfunctions in the supervisory system. This would be essential to re-establish trust. But nothing of the sort is planned yet.

The IKB saga also sheds a sobering light on the whole German financial system, one of the most politicised in the developed world.

The tangle of public financial institutions; savings banks, whose governance is closely linked to local authorities; and private players often put in the position of insiders or free-riders or both, has become dysfunctional as a result of blurred responsibilities and interests.

Beyond Germany, IKB also illustrates the difficulty which many European countries face in making the regulation of the financial sector into a tool of economic competitiveness.

This would imply ensuring equal treatment of all players; and no longer granting preferential status to public, semi-public or freshly privatised banks handled as sacred cows. Another example of the same problem was the assurance given earlier this year by France's prime minister Fillon that Société Générale would remain 'a major French bank'.

This attitude has a price, which is unequal competition in the financial sector. One of the consequences is an inadequate capacity to foster the growth of the most promising companies.

One last revealing lesson from IKB is the identity of the buyer. Private equity funds are likely to play a key role in restructuring the banking sector.

Lone Star is a case in point. It purchased a huge portfolio of securities from Merrill Lynch in July. In 2003 it had acquired Korea Exchange Bank, one of the biggest cross-border banking deals ever carried out in Asia.

In the current phase of the crisis, injecting cash into ailing banks is no longer sufficient. They also must be sorted out in order to optimise their value and risk exposure, based on a deep understanding of market dynamics.

Private equity funds seem to be better equipped to do this than most of the sovereign wealth funds which have held centre stage in the recent past.

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