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FINANCIAL TIMES

November 23, 2007 2:00 am

Saxon klaxon

By Gerrit Wiesmann and Ivar Simensen

It was late August in Leipzig and, for German banking, one of the most humiliating moments in recent times.

Jochen Sanio, the country's top bank regulator, had journeyed to the east German city to deal with an urgent problem that was threatening the rest of the sector with crisis. In the midst of the global credit squeeze, Sachsen LB, a provincial bank set up 15 years ago, had run out of ready money. A bankruptcy could create chaos throughout the sector.

Mr Sanio was there to give the bank's shareholders a stark choice. They could sell the business immediately for whatever they could get - or he would close it down.

Waiting for him in Sachsen LB's glass-and-stone tower at the northern tip of Leipzig's city centre were representatives of its shareholders - the Saxon state government and municipal Sparkassen savings banks. When he made clear the problem, they were shocked. One complained: "We've got our backs against the wall." An official briefed about the meeting recalls that, frustrated that his audience was failing to grasp the consequences of the bank's liquidity shortage, Mr Sanio shot back: "There's no wall behind you - only an abyss."

Talk of a chasm helped to focus minds. Before dawn lit the patchwork of old streets below, once home to Bach and birthplace of Wagner, the politicians and savings bank bosses agreed to sell the bank to Landesbank Baden-Württemberg from south-western Germany for an initial €300m ($445m, £216m).

The credit squeeze has routed the world's biggest banks - from Citigroup and Merrill Lynch down. Northern Rock, the most prominent UK casualty, is preparing for life under new management and probably new owners. Shareholders in Natixis of France said yesterday they would bail out its bond insurance unit. But the only European bank so far saved from collapse by a take-over is Sachsen LB. Its implosion was one of the first signs of the debt market shake-out.

Now an investigation by the FT reveals the political motivation, mismanagement and failed supervision that contributed to Sachsen LB's failure. The demise of east Germany's first and last Landesbank is an indictment of state-owned banking in the country, a structure that has underpinned Europe's biggest economy since the second world war.

Sachsen LB is one of just seven Landesbanken, based in regional cities and pillars of a big public banking sector. The need for the rescue of August 26-27 calls into question the ability of those who own, supervise and manage public banks in Europe to comprehend and monitor the activities of specialist offshoots that can come to provide much of a group's business but operate far beyond their usual gaze.

The FT investigation highlights how much forewarning there was of the Sachsen LB mishap - and how an Irish unit had come to generate much of the bank's income without clear disclosure of the means by which it did so. It also points to a problematic split in banking supervision between Mr Sanio's Bafin and the Bundesbank, which signs off banks' annual accounts.

Barely in the top 300 global banks by capital, Sachsen LB became one of Europe's biggest operators of off-balance-sheet funds. It was suddenly in a league with global players such as HBOS of the UK, which had about 25 times the equity. "The disaster we have seen in the past weeks is not a natural phenomenon," says Karl Nolle, a member of the Saxon parliament who has spearheaded a two-year inquiry into Sachsen LB's affairs. "It was the result of disastrous strategic decisions by the bank and the state government."

The disposal to the Stuttgart-based LBBW was a dismal outcome to a lone initiative by the Dresden-based Saxon state government, which after German reunification embraced the idea of founding a Landesbank to help the region bordering the Czech Republic rekindle its old commercial glory. The sooty industrial combines gathered there had collapsed after the communists left power and other staples, such as publishing and a venerable trade fair, were not enough to feed the region.

While other east German states beckoned existing western Landesbanken to set up there, in 1992 Saxony established its own bank to help lure western companies with credit on special terms. Some, including the carmakers Porsche and BMW, were soon persuaded to build plants.

But just like longer established Landesbanken, Sachsen LB was barred by its savings bank co-owners from entering high-street banking and beset by rivals in corporate lending. All had to reassess their future after the European Commission in 2001 backed complaints from commercial banks that state guarantees gave the Landesbanken unfair advantages. The banks used the states' top-flight credit ratings to borrow money and lend it to clients more cheaply than rivals could. That was to end in mid2005. They had four years to find new business, merge or close.

The Landesbanken already had a reputation for being troublesome. German state and federal governments in past years had to deal with a string of neardisasters that threatened not only those banking groups but also the reputation, and with that the business, of other banks. Josef Ackermann, Deutsche Bank chief executive, thus felt obliged to make an unusual number of appearances in September to reassure the public that the nation's banks were holding up amid the latest problems.

Sachsen LB had found itself in scrapes involving Russian government bonds in the late 1990s

and property and leasing a few years later. But the scuppering of the public banks' old business model lured it once more to try to punch beyond its weight.

Transcripts from the Saxon parliamentary hearings, many confidential but seen by the FT, show that decisions that led to the August crisis were taken years ago. "We had to raise more capital or we had to steer bank business a different way," Eckhard Laible, head of loans until 2001, told MPs last year. Staying in lending was stymied by the state government's refusal to provide more capital. In August 2001, Michael Weiss, who served as chief executive until 2004, withdrew the bank from lending in favour of the markets unit.

As a result, the Landesbank mutated from a tool to support regional companies into a low-maintenance cash cow for its state and municipal owners. (The Saxon finance ministry and a lawyer representing Mr Weiss declined to comment.) "This innovative strategy has proved to be worthwhile, as [Sachsen LB's] continuing profitability shows," Georg Milbradt, state governor, told parliament in 2005.

Mr Weiss's tenure started shortly after the bank was founded. The man with the wiry white moustache had gone to Leipzig after working for Landesbanken in Cologne and then Berlin. An economist by training, he is credited by former colleagues with both intelligence and warmth but also an increasingly authoritarian manner.

One main lieutenant was Rainer Fuchs, who had recently landed a board seat. Mr Fuchs, about 20 years younger than his boss and a lawyer by training, had cut his teeth at DGZ Bank in Frankfurt, which later became Deka Bank. Light-haired and bespectacled, his benign appearance hid what some describe as a genius for advancement. A former executive says Mr Fuchs was friendly with important non-executive directors through his work at local sports clubs.

He rose to the top of the corporate lending department, which started to take an interest in the market for selling on loans in the form of asset-backed securities. On the board, he was responsible for Sachsen LB's markets unit.

A colleague from DGZ bank joined Sachsen LB in the late 1990s. Claus Wilsing expanded the asset-backed securities business and moved to Dublin in 1999 to head the new markets operation there. A former superior says Mr Wilsing, tall and lean with a stylish brown coiffe, was likeable and pleasant. Another ex-colleague agrees but also says he was happy to let it be known he had the best connections to board executives in Leipzig.

In 2001, as Sachsen LB's new markets strategy was gestating, Mr Fuchs and Mr Wilsing drafted in Adrian Fitzgibbon, another colleague from the DGZ bank days. Round-faced with a hint of jowls, the Irishman was the creative genius in Dublin. He came from a job in London brimming with knowledge about the latest financial instruments. With Mr Wilsing looking after relations with Leipzig, Mr Fitzgibbon was free to let his contacts play.

Sachsen LB became a ready buyer of products sold by big lenders keen to shift loans off their

books: asset-backed securities, a type of bond whose annual pay-out came from the interest owed, say, by a pool of US homeowners on their mortgages. To be able to buy more of this safe-seeming paper than its lowly capitalisation allowed, Sachsen LB used off-balance-sheet funds, often called conduits. These borrowed money by issuing short-term bonds, or commercial paper.

Executives bet that the difference between the cost of borrowing by issuing the commercial paper and the interest flowing from the home loans would bring a reliable profit. But investors this summer, worried about the number of US homeowners unable to service their loans, stopped lending to the funds that owned the bonds. Within days, Sachsen LB had to assume billions of dollars in assets it had never been able to afford.

Sachsen LB had chosen Dublin as home to its conduit operations in order to profit from low taxes and a well of financial market talent. Its base on the river Liffey, in a squat complex cloaked in emerald-coloured glass, came to symbolise Sachsen LB's ascendance as much as Ireland's.

A corporate finance unit already there was bringing in some €10m in annual profits. But a big expansion pushed the contribution of the Irish entity, called Sachsen LB Europe, to €29m in 2003. By last year it was providing €47m - or 90 per cent of group earnings.

Sachsen LB accorded Dublin and its 50-odd employees an eight-page spread in its 2002 annual report. Mr Wilsing and Mr Fitzgibbon, installed as managing directors, "rightfully [took] pride" in the fruits of their labours, it said. But the bank remained coy about the source of - and risks to - its new-found wealth. The German parent revealed merely that the unit focused on investing in corporate bonds, buying asset-backed bonds and issuing debt instruments, which included commercial paper. Mr Wilsing and Mr Fitzgibbon were cited as saying: "It is not only a question of buying but one of management."

Sachsen LB Europe's debt experts sold short-term bonds to investors and passed the money raised to asset specialists, who bought long-term bonds. The difference between the cost of borrowing and interest earned on assets was booked as fee income. This doubled to €9.2m in 2002, approached €30m a year later and eventually produced three-quarters of the unit's profits.

Bafin asked accountants at KPMG to look at Sachsen LB's markets business in late 2004. Behind the fee bonanza, KPMG ultimately identified €30.7bn in off-balance-sheet assets.

There is no suggestion that this was illegal. These funds were off the books, so Sachsen LB Europe had no reason to report them to regulators. The Dublin board, including Mr Weiss and Mr Fuchs, markets director, approved them all - and, as the unit regularly asked Leipzig to provide small direct credit lines for new funds, Sachsen LB's credit committee (which included many members of the supervisory board) was kept in the picture about individual off-the-books projects.

But KPMG observed in its report, parts of which have been seen by the FT, that the bankers at first seemed to make no effort to provide either the Dublin board or the credit committee with an overview of Sachsen LB's total exposure. The bank says it reacted in 2006 by including off-balance-sheet overviews in risk reports to non-executive directors. But it remains an open question whether those board members saw the risks any more clearly after that. Some, after all, failed to see the August abyss.

When he testified to the state parliament last November, Mr Fuchs himself said he could "not judge" how well placed non-executive directors, mostly savings bank directors and politicians, would have been to weigh up the risk position of the bank. But hesaid Sachsen LB's funds were not prone to the risks of the loans business. Only small amounts of bank equity were at play; nominal volumes did not equal real risk. "We invested almost exclusively . . . in triple-A rated asset-backed securities that have a default risk of under 1 per cent," he said. "That is why people shouldn't be scared of [the] large volumes involved. We are not blindly putting anything at risk."

Jörg Wille, Sachsen LB's chief internal auditor from 2005, told MPs last year the bank had given credit lines to cover only about one-tenth of each fund. Liabilities stood at €2.7bn, not €30.7bn, in late 2004. "There are no further risks," Mr Wille said.

KPMG in 2005 cautioned presciently that the Dublin strategy was "based on the premise that markets never malfunction". It warned that the bank could be forced to sell assets if investors stopped buying the bonds that were being used to finance the various funds. (Mr Fitzgibbon, Mr Wilsing, a lawyer for Mr Fuchs and a Sachsen LB spokeswoman all declined to comment on that view.)

The market for the bonds the funds were issuing was one of the most liquid. It was not unreasonable to think there would always be buyers. But it was no certainty. "You have to assume that one day . . . commercial paper may not be a source of funding," says Deutsche Bank's Mr Ackermann. Though 20 times the size, his bank managed funds only as big as Sachsen LB's.

A chastened Horst Metz, who as Saxon finance minister was also Sachsen LB's supervisory board chairman, told the Dresden parliament in August: "The question is justified whether the risks of this model were assessed correctly and seen quickly enough." Mr Metz later quit both posts.

Why was there such an apparent reluctance to examine the risks? Certainly, the bank's profitability had become increasingly dependent on the off-balance-sheet funds - and on the people in charge of them. Once Dublin had proved its recipe for success, Leipzig was happy to let it scale up the operation. Off-the-books funds grew to €45bn by late 2005.

With the fees these earned providing the bulk of group profit, the bank had the previous year assented to an unusual arrangement. Mr Wilsing and Mr Fitzgibbon, along with two other colleagues, were allowed to set up a fund of their own, AC Capital, while retaining their jobs at Sachsen LB. The Leipzig bank also gave them €400m to manage.

Hans-Jürgen Klumpp, a Sachsen LB director until late 2005, told Saxon MPs the deal was struck to keep the Dublin executives aboard. They had received offers to go to London, through which they could have sextupled their annual salaries of €500,000. "You can say everyone is replaceable, there's something to that," Mr Klumpp said. "But to have lost the most important people in Dublin in that phase would basically have set it all back. The profits made in Dublin were vital for our institution."

But if the relaxed, even generous, attitude Sachsen LB took towards AC Capital was intended to strengthen links with its founders, the arrangement was not to last long. At the end of 2005 Mr Wilsing left his job at Sachsen LB Europe, although remaining a non-executive director. The following summer he and Mr Fitzgibbon cut all ties with the bank. (They also sold 51 per cent of AC Capital to Germany's ApoBank.)

Indeed, they were not the only architects of Sachsen's success to depart. In Leipzig, Mr Weiss and Mr Fuchs were gone by early 2005, after the state government's support wavered in the wake of the property and leasing scandals. The other notable event of that year was KPMG's review, which - as well as questioning the size of the off-books funds - lambasted shoddy controls and risk profiling at the Irish unit.

Speaking for his AC Capital colleagues, Mr Fitzgibbon says there has never been any accusation of wrongdoing. During the time of their parallel involvement with Sachsen LB and AC, a code of conduct "dealt with both parties acting on an arm's-length basis and in a commercially reasonable manner".

Neither the KPMG findings nor the spate of departures meanwhile appeared to have a great impact on strategy. The bank's new chief executive - Herbert Suess, a savings bank veteran - stuck to the path taken by Mr Weiss. Indeed, Dublin launched another fund, Sachsen Funding I, this spring.

But by late July, funds were having trouble finding buyers for their commercial paper. IKB, another German bank, was bailed out by rivals after financing for one if its funds dried up. On August 9, the European Central Bank pumped cash into the money markets as banks, distrustful of each other's exposure to the US subprime mortgage problems, turned hoarders.

A day later, Sachsen LB said it had no problems financing its funds. But by August 14, it was in danger of not being able to refinance one of them, called Ormond Quay. The peril that executives had always seemed to block out came to pass: the commercial paper market dried up. The bank was too small to replace unwilling investors as the fund's key financier and was saved by its Sparkassen owners, which pledged to bridge any shortfall at Ormond Quay. But money was so tight that, on August 21, Sachsen LB could not handle a call for extra cash from another fund. Less than a week later the bank was sold to LBBW.

In recent weeks at Sachsen LB, the distinctive Saxon dialect has mingled with the singsong Swabian inflection of LBBW managers from Stuttgart as they comb through the books, says one

person who knows the bank.LBBW is taking a very thorough look at every decision and position, the person adds, before it agrees a final takeover price with Saxony's state government and the municipal savings banks.

That regulators pointed to the dangers more than two years ago, and proved powerless to force changes, raised eyebrows following the collapse. Bafin has said it informed Sachsen LB of the risks it was taking but had no legal basis to stop it, while Franz-Christoph Zeitler, vice-president of the Bundesbank with responsibility for banking supervision, this week acknowledged imperfections in the system. The supervisory structure "has proved itself, but that does not mean there is no room for improvement", he told a conference in Frankfurt.

A recent study showed German financial institutions wanted "higher transparency and efficiency in the sharing of responsibilities between Bafin and the Bundesbank, to avoid duplication and overlaps".

A plan to give Bafin power over the Bundesbank experts who approve banks' accounts is on the cards. Peer Steinbrück, federal finance minister, has meanwhile called on states to create Landesbanken big enough to endure financial shocks. Tie-ups being discussed between LBBW and two others could go some way to meeting his call.

But the creation of bigger wholesale banks does not itself address the main problems of the Landesbanken. Most would still have no retail business and limited corporate lending clout.

That leaves intact the temptation to gamble on the markets. The solemn August trip to Leipzig by Bafin's Mr Sanio may not be the last of that nature that a German regulator makes to a historic but questionably run regional financial centre.

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