

FINANCE/BUSINESS

German State Banks to Repay 3 Billion in Illegal Subsidies

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BRUSSELS:

The **European Commission** on Wednesday ordered seven German regional public banks to repay more than 3 billion in illegal subsidies they received from their regional governments in the 1990s, ending a chapter in the longest and most bitter state aid dispute between Germany and the European Union's executive arm.

The decade-long battle is seen as a major front in the commission's campaign to stamp out protectionism and build a single EU-wide market based on liberal economic values.

Germany's cosseted public banks, known as the Landesbanken, play a huge role in the domestic German banking market. Forcing them to compete on the same terms as private banks which led the fight against the subsidies will open up one of the most protected markets in the EU, the commission argued. "These decisions close a very long and painful dispute between private and public banks in Germany thereby creating a level playing field in the sector," said the competition commissioner, Mario Monti.

In the early 1990s, new EU-wide bank solvency laws required German public banks to increase their capital in order to continue their banking activities. The regional governments, or Lander, injected the required capital by transferring ownership of public assets, including housing, to their banks.

Private banks complained that they were under the same obligations to increase their capital, but they had no public benefactor to help them.

Their complaint to the commission sparked the state aid inquiry. Last month, the private banks reached an agreement with the regional governments, the public banks and the commission on how to end the dispute. But the commission may begin separate state-aid investigations if the regional governments decide to reinject money into the banks.

WestLB, the state bank of North Rhine-Westphalia region and the Landesbank that benefited most from the subsidies during 1990s, was ordered to repay 979 million, or \$1.2 billion, plus interest. The others must pay between 6 million and 810 million plus interest.

Ratings agencies have played down the likelihood of a heavy blow to the Landesbanken from the financial settlement announced Wednesday, although the banks might incur one-time losses.

But the ruling does mark the beginning of a new phase for the Landesbanken. The major disputes with Brussels have now been wrapped up, and beginning in July, under a previous agreement with Brussels, the banks would no longer enjoy state guarantees for their refinancing.

In anticipation of these changes, the Landesbanken have already begun revamping their businesses to compete against Germany's private banks without subsidies, principally by tightening their relationship with the Sparkassen, Germany's local savings banks, which are also part of the state-owned sector. The savings banks, most of which own direct stakes in the nearest Landesbanken, have tight links to retail customers whom they serve through over 15,000 branches in Germany, while the Landesbanken have the Continental or even global reach to offer products that the savings banks cannot.

"The Landesbanken have immense potential because they have specialized financial services and the Sparkassen can pay close attention to retail customers," said Cenap Kuloglu, a consultant who has advised Berlin savings banks about their business models.

Helaba, the bank in Hesse and Thuringia that is based in Frankfurt, has embraced this approach more clearly than any other Landesbank. The local savings banks own 85 percent of Helaba, have a common deposit insurance plan, and planned to offer joint accounts.

"No other Landesbank has such close ties with its savings banks," Morgan Stanley wrote in an August report.

With this ruling behind them, the Landesbanken will increasingly abandon arbitrage trading in **securities** with very low profit margins, analysts and investment bankers said. High-volume dealing in, for example, sovereign debt or derivatives, was only possible because the Landesbanken could raise money much more cheaply than private banks.

"The banks have to get away from businesses that relied on cheap, state-guaranteed funding," said Thomas von Lupke, an analyst with Fitch Ratings.

From a purely financial point of view, the Landesbank Baden- Wurttemberg is "the largest and best in class," according to Morgan Stanley. This bank is profitable, has a strong consumer banking base and operates in a highly affluent part of Germany, around the city of Stuttgart, that has above-average growth rates.

Other Landesbanken will compete with a unique geographic reach, analysts said. HSH Nordbank the product of a **merger** of two Landesbanken already has extensive operations in Scandinavia and the Baltic states, from its base in Hamburg and Kiel, both in northern Germany. BayernLB in the southern state of Bavaria, by contrast, has scaled back its presence outside Germany over the past year, but still has international operations in eastern Europe, Switzerland and Luxembourg that contributed a quarter of its profit last year.

WestLB, the Landesbank that will pay the most to Brussels, stands out as the most international of the lot, even in the face of heavy losses over the past two years, analysts said. The bank, based in Dusseldorf, has roughly 500 employees in New York and 1,000 in London, and could work in a wider range of businesses than other Landesbanken.

"WestLB has an international presence that few others can match," said one investment banker who advises several Landesbanken. Banking industry officials said that they expected consolidation, which could improve the banking system's efficiency, but only in the long term.

The head of BayernLB, for example, has ruled out a **merger** because the Bavarian government, which still owns 50 percent of the bank, and other politicians, could not tolerate the layoffs, or the loss of a bank headquarters, that would come with a **takeover**.

"The political reality of **mergers** is very difficult," a German investment banker said. "Every Lander would like to have its own Landesbank."

Within "two to three years," consolidation might began as the political atmosphere changes, the banker said. In the long term, many analysts expect to have at least two very strong Landesbanken, grouped around Landesbank Baden-Wurttemberg in the south, and WestLB in the north.

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Paul Meller reported from Brussels and Carter Dougherty reported from Frankfurt.