Financial Bubble Bursts in Germany

by Rainer Apel

For at least three weeks in June, Germany's leading news dailies ran semi-alarming reports on the the U.S. mortgage bubble crisis, repeating the soporific nostrum, "It may happen here, but the experts say it will not happen."

Then, on July 30, it did happen: Hints that Industriekreditbank (IKB) had severe problems on the U.S. subprime mortgage market, sent the stocks of the bank down like a stone in the first minutes of trading on the Frankfurt stock exchange. By 10 a.m., trading of IKB stocks, which had lost 15.7% in value, was halted. News made the rounds that IKB was exposed on a good part of the 12.7 billion euros ($17.3 billion) of highly leveraged loans organized through its Delaware-based operation, Rhineland Funding. When trading of IKB stocks resumed, the bank lost another 8% in Frankfurt in the early afternoon.

But a full default was prevented, at least for the moment, when Kreditanstalt made public that it had, in close consultation with the German financial market watchdog agency BAFIN, provided an emergency credit-line for IKB in the range of 8.1 billion euros. Not a minor sum, and not a minor crisis, apparently.

A particular aspect that is said to have prompted the instant intervention of the Kreditanstalt, is that IKB handles 33% of all Kreditanstalt loans to German *Mittelstand* (small and medium-sized) firms, and that IKB provides 14% of *all* loans in Germany to that crucial sector of productive industry, nearly as much as all the biggest private banks put together. And in the category of bigger *Mittelstand* firms, IKB provides 30% of all loans.

IKB and the Bubble

IKB's prominent position tells a story about how the bubble came to Germany. During the 1980s, but increasingly during the 1990s, the big private banks walked out of industrial financing, especially of *Mittelstand* loans, so that around the beginning of the millennium, the smaller industrial firms, notably the highly productive machine-building ones, were provided with loans primarily from the savings and loans banks, Kreditanstalt, and IKB. Kreditanstalt functions as a substitute for a national bank, by arranging longer-term credit-lines at low interest, which are transferred to IKB for project-oriented loans to *Mittelstand* firms. Whereas Kreditanstalt and IKB (of which Kreditanstalt took over 38% in 2001) act on a national level, the savings and loans banks have similar credit policies on the regional level.

The problem today is, that the creditt-crunching policies of the private banking sector have forced the public banks and semi-public banks (like IKB) to seek capital on the free market, because, with the exception of a few billion euros annually, the state has opted out of issuing loans for productive industry, under the budgeting strictures of the European Union. This has lured banks like IKB into the seemingly profitable mortgage markets of the United States, and for several years, the refinanciang of loans and bonds through asset-backed commercial papers worked well. But now, the previously profitable situation has turned into a disaster, as also some of the big private banks, such as Deutsche Bank, were forced to recognize, when two hedge funds of Bear Stearns, with a high exposure on the standard and subprime mortgage market, went under a few weeks ago. Whereas Deutsche Bank is playing down the affair, analysts at Morgan Stanley speak of up to 500 million euros in losses at Bear Stearns for the Germans.

In reality, Deutsche Bank must be considered the first German casualty of the bubble, because it got hit earlier than IKB; but the latter is viewed as the first de facto casualty, because the sudden withdrawal of several leading creditors, including a yet-unnamed "big German private bank," drove IKB into a situation where it would have to come up with up to 1 billion euros in emergency credit guarantees—money which it simply did not have. The aforementioned Kreditanstalt intervention averted the disaster for the time being.

Tip of the Iceberg

IKB is only a minuscule portion of the German exposure to the bubble's acute problems. Apparently in a concerted move on the European level, BAFIN, at the end of June, began interviewing 20 German banks and funds about their engagements on the volatile U.S. markets. The results of those interviews have not been made public, but insiders speak of a situation that is out of control. A market analyst based in Frankfurt told this author on June 30, that all banks that have offered a return above 7-8% to their shareholders, have gone to the subprime and other such markets, because there has been no other source of fresh capital in recent years. Revenues that high cannot be yielded by the classic banking operations, and the subprime operation is only a minor aspect of the whole system, because "who knows who owns what to whom, in the end," in a market that keeps bundling subprime and other liabilities in multi-leveraged constructs to rally fresh capital on the yen-carry-trade market in Tokyo.

That is how it has been done, at least until recently; but now, there are grave problems with the former Tokyo money-machine, the analyst said. The 12.7 billion euro exposure of IKB appears comparatively mild, as "much larger sums" are rumored in connection with some of the largest private sector banks, the analyst hinted. All the more reason to begin discussion about a New Bretton Woods financial reorganization!