BUSINESS CASE

CAPITAL BANKING

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Staying silent

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CAPITAL BANKING – BANKGESELLSCHAFT BERLIN

In January 1994, the state-owned Landesbank Berlin (LBB), the partly state-owned Berliner Bank (BB), and the real-estate bank Berlin Hyp (BH) were integrated into the newly created Bankgesellschaft Berlin (BGB). The new bank was a publicly listed company, with the state of Berlin being the major shareholder. In terms of assets, BGB was among the top 10 banks in Germany.

Immobilien- und Baumanagement der Bankgesellschaft Berlin GmbH (IBG) was a 1996 spinoff of LBB. It was jointly owned by BGB, BB, LBB, and BH. Its main purpose was to buy, sell, and develop property, as well as set up closed property funds.

The new banking conglomerate was supposed to finance Berlin's ambitious growth plans in Germany's post-reunification years and establish Berlin as a regional German banking center. Initially, BGB operated primarily as a coordinating body, having little impact on business decisions, which were still made at the level of the three main subsidiaries.

In 1997, the BGB CEO, Wolfgang Rupf, introduced a new management structure: BGB would be responsible for the strategic direction of the group, whereas the subsidiaries would act as business units. By the end of 1998, BGB was becoming a real bank and achieved a group operating profit of €1.3 billion before risk provisions. However, after loan loss provisions, it showed a marginal profit of €35 million.

IBG greatly expanded its closed property fund business in 1997 and 1998, even though a change in German tax law abolished the privileged tax treatment of property investments, and thus reduced their attractiveness to investors.

In 1999, all divisions achieved a pre-tax profit. The capital market, private banking, and real estate divisions were the major contributors to this profit. The bank benefited in particular from proprietary trading on the booming German stock market. BGB was able to report a group profit of €157 million; the management board suggested cashing out a dividend of €0.60 per share. This was in part to satisfy the needs of the deficit-plagued

Berlin state government, although, according to a McKinsey report commissioned for the BGB management board in the summer of 1999, BGB had potential loan risks of 26 percent of its loan portfolio, and its management was giving clear indications of severe problems. By early November 2000, this situation had not improved. Interest income continued to decline (–16%), and profit was expected to be significantly lower than before. Still, the management board maintained a calm face for the public. Behind the scenes, things looked different. A report resulting from a special review of the loan portfolios of BGB, LBB, and BH – ordered by the regulator Bundesaufsichtsamt für das Kreditwesen – highlighted the risks of guarantees that were provided to the property funds. According to the report, these risks had not been addressed at the level of BGB and would need to be reported on in the future. The management board therefore was forced to anticipate additional risk provisions on its property fund business, which amounted to more than €10 billion.

By that time, Thomas Kurze, member of the BGB management board and a supervisory board member of IBG, became more closely involved in IBG's closed property fund business and realized the mounting problems at this institution. However, the major supervisory function of IBG remained with Wolfgang Rupf.

As the 2000 third-quarter results of BGB's division continued on a downward trend, the bank was faced with additional loan loss provisions. The biggest problems were at IBG, which expected a net loss of €780 million. This far outweighed its nominal capital of €40 million and reserves of €215 million; in fact, it exceeded BGB's capacity to absorb IBG's losses. BGB's management board therefore was presented with a proposal to sell large parts of IBG. Consequently, the bank looked for a financial investor.

To facilitate the process, a new real estate holding called IBAG was set up. It was planned that IBAG would buy most of IBG's assets from BGB, which would, in turn, acquire a 40 percent share in IBAG. Based on IBG's cost structure, IBAG needed to generate an annual property fund placement volume of approximately €1.5 billion in order to achieve a balanced result. Since IBAG was not majority-owned by BGB, it could use additional credit facilities from BGB, thereby increasing its funding pool. All transactions would have to be completed before year's end to ensure compensation for IBG's 2000 losses. Accordingly, it was suggested that the 60 percent share of IBAG should be sold to a special purpose vehicle located on the Cayman Islands until a financial investor could be found. JP Morgan was to arrange the deal.

Questions for case discussion: What should Kurze have done to change the course of BGB? What could he have done, given the possible reactions of his CEO, Wolfgang Rupf, and BGB stakeholders?