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Threat of fallout from crisis hangs over city

Optimism remains, despite uncertainties over the future of the eurozone, reports **James Wilson**

Germany's companies are thriving and its consumers have money in their pockets, so these should be exciting times in Frankfurt.

Instead, the eurozone crisis is a black cloud hanging over Germany's financial capital, which would suffer more than perhaps any other city from the nightmare scenario of the disintegration of the single currency.

The twin towers of the European Central Bank, under construction on the banks of the Main river, are just the most visible symbol of how much Frankfurt has staked on the eurozone – the break-up of which is now openly contemplated by politicians and policy makers who have spoken of a possible Greek exit.

Germany's biggest banks – one of which, Commerzbank, is still dependent on government aid – would in all probability be massively shaken by losses through contagion from a eurozone break-up. Frankfurt's march to become a centre of cross-border equities and derivatives trading, led by Deutsche Börse, would be jeopardised and perhaps sent into reverse as the prospect of an ever more integrated European financial market vanished.

Substantial liabilities in peripheral countries that have accumulated on the balance sheet of the Bundesbank, the German central bank, during the eurozone crisis could also crystallise into huge real costs in the event of an end to currency union.

For German policy makers, who no one doubts will have a leading role in deciding the outcome of the eurozone crisis, these challenges to domestic financial stability are inevitable considerations as they contemplate the plight of peripheral countries.

German banks have already played their part in trying to stabilise the eurozone, contributing to a voluntary write-off of Greek debt this year. But they remain some of the biggest creditors of weaker eurozone nations, having enthusiastically recycled German deposits into loans to Spanish property developers or purchases of Italian bonds. Moody's, the rating agency, downgraded six German banks this month because of the risk of further shocks from the eurozone crisis.

Resolution of the crisis is likely to take months if not years, meaning Frankfurt's long-term future remains shrouded in doubt. But the paradoxical effect of the crisis has been to accentuate Germany's financial strength in the short term, to the benefit of its banks and other financial institutions.

German banks are capturing capital inflows from other parts of the eurozone, reflecting its haven status, and its government borrowing costs are being driven to record lows. Credit is generally available and KfW, Germany's national development bank based in Frankfurt, says its latest business survey shows small businesses are finding loans as easy to come by as at the height of the banking boom in 2007. Even property prices in Germany, stagnant for much of the past decade, have started to rise as investors seek shelter in "real" assets.

German companies are pumping out exports for the rest of the world and corporate failure rates declined last year, according to Creditreform, a risk management group.

German companies have become vastly more competitive over the euro's first decade, aided by labour market reforms. Rene Döring, a lawyer at Freshfields, says: "Many of the clichés about the inflexibility of the German market are not relevant any more. If you look at what has been done in the past decade in respect of temporary employment, there is now enormous flexibility. Germany is ahead of many other countries in some of these areas."

In the latest iteration of the Global Financial Sectors Index, published by the Z/Yen group, Frankfurt's ranking improved three places, the best leap of any top 20 financial centre, and a contrast with what the report calls "centres in the weaker eurozone economies". Confirming Frankfurt as the eurozone's leading financial centre, the report says the euro crisis "has changed the balance of interest within the eurozone".

Some of the interest reflects a defensive instinct from investors – a desire to minimise the downside if the worst happens and the eurozone breaks apart. "Germany is always going to be core Europe," says one investment banker who is based in the city. "So people think: 'If I am to invest in Europe I will invest in Germany, then I am fully hedged from the currency point of view'."

Even so, interest in Germany has obvious limits in the current turbulent climate. There has not been a significant initial public offering of a German company in the past two years, and a top dealmaker in the city says the investment banking community is "deeply anxious and concerned" by the crisis. Investment in many financial instruments is at very subdued levels. "All sorts of investors in Germany are behaving very conservatively ... the big money is on the sidelines," says Thomas Timmermann, Commerzbank's head of equity markets and commodities in Frankfurt.

Sentiment would hardly improve if the government were to introduce some sort of financial transaction tax, which remains under discussion. One proposal is to limit such a tax to stock market transactions, akin to stamp duty in the UK.

Meanwhile Josef Ackermann, on his last day as chief executive of Deutsche Bank last month, sounded a warning about Germany's corporate strength, saying companies were "lowering their expectations" as the crisis continued.

Elke König, head of BaFin, Germany's financial supervisor, this month said: "The German banking system is comparatively robust but it cannot completely seal itself off from developments around it."

Over the longer term German banks, while not as under pressure as some in the eurozone, still have to prepare themselves for a world of higher capital requirements. They must shake off their hangovers from the crisis, with Commerzbank facing the particularly daunting task of winding down most of the operations of Eurohypo, its property lending subsidiary based just outside Frankfurt, under EU pressure.

At a time when Frankfurt's banking sector has just lost its long-time international figurehead in Mr Ackermann, the city is also seeing rare political change at the top. Peter Feldmann, of the centre-left Social Democrats, will assume the role of mayor on July 1 after surprisingly winning the race to succeed Petra Roth, an ally of Chancellor Angela Merkel and Frankfurt's mayor since 1995. Mr Feldmann has said little since his election about his economic policies, but has previously said Frankfurt must develop as an industrial, not just service-oriented, city.

Lutz Raettig, chairman of Morgan Stanley in Germany and spokesman of the executive board at Frankfurt Main Finance, an organisation representing the city's financial sector, says cost pressures on banks will grow, leading to further consolidation among Germany's 2,000 or so banks.

Banks will also have to find ways of serving their customers with fee-based advice as more corporate borrowing is conducted through capital markets rather than traditional bank lending, Mr Raettig says.

But he believes that most aspects of the German universal banking model are successful and will remain intact.

"Banks still have to be capable of supporting the international success of German companies and directing capital from emerging markets to Germany," he says.

Changing scenery: Peter Feldmann, incoming mayor, has said Frankfurt must develop as an industrial city, not just a service-oriented one Getty

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Germany walks fine line in euro crisis

Bundesbank

The central bank is proving hard to ignore, writes **Ralph Atkins**

The Bundesbank is back. Germany's central bank – headquartered in an austere concrete building on the city's edge – is playing a crucial role in the eurozone crisis. Fiercely conservative, it is helping define limits to the European Central Bank's actions and the German government's response. Its stance is criticised fiercely by US and UK economists, but the Bundesbank is proving an institution that cannot be ignored.

Only a few years ago that was not necessarily so. The independent Bundesbank was one of Germany's most successful postwar institutions. It carved a reputation as among the most hawkish central banks in the battle against inflation, especially after the collapse of the Bretton Woods fixed exchange rate system in 1973.

"Not all Germans believe in God, but they all believe in the Bundesbank," quipped Jacques Delors, president of the European Commission, in 1992.

With the launch of the euro in 1999, however, the Bundesbank's most important weapon – the power to set interest rates – was transferred to the ECB. The Bundesbank president became just one voice on the ECB's governing council, currently 22-strong. Interest rates were set at a level deemed appropriate for the entire eurozone.

The Bundesbank remained the ECB's conservative conscience. But it returned to prominence in dramatic fashion in May 2010. To counter the escalating eurozone crisis triggered by Greece's debt woes, Jean-Claude Trichet, then ECB president, had launched a government bond buying programme to calm nervous markets. It was a step too far for Axel Weber, the then Bundesbank president. His public criticism of the programme, which he saw as a dangerous intrusion by a monetary authority into fiscal policy, was an important warning shot.

> 'The Bundesbank is much less isolated than the impression given sometimes in newspapers'

Mr Weber was anxious that the ECB should not be dragged into actions that it would later regret or that would, over time, undermine its control over inflation. With his conservative credentials clear, Mr Weber was Berlin's choice to succeed Mr Trichet as head of the ECB.

His problem was in securing allies on the ECB council. In February 2011, Mr Weber unexpectedly resigned as Bundesbank president. One main reason was that he felt constantly at odds with other ECB policy makers.

Mr Weber's departure cleared the way for Italy's Mario Draghi to become ECB president when Mr Trichet's term expired last November. German influence in the ECB appeared to be weakened further by September's resignation from the executive board of Jürgen Stark, a former Bundesbank vice-president, who was also unhappy with the ECB's increasingly active crisis management policies. But if anyone thought the Bundesbank had been marginalised they were soon proved wrong.

Mr Weber's successor was Jens Weidmann, former economics adviser to the chancellor. Aged just 44, and an effective communicator, he has stuck to the Bundesbank's conservative positions but cultivated allies within the ECB council. As the eurozone crisis re-escalated in late 2011 it became clear the Bundesbank was often voicing the thoughts of a significant minority within the council. "The Bundesbank is much less isolated than the impression given sometimes in newspapers," Luc Coene, Belgium's central bank governor, told the Financial Times recently.

Mr Draghi, meanwhile, arrived in Frankfurt determined to learn from the bruising

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Failed NYSE/Euronext merger haunts exchange

Deutsche Börse

Moves by regulators still dog the company, reports **Philip Stafford**

Deutsche Börse's anger and disappointment was palpable after the European Commission blocked its bid to merge with NYSE Euronext in February.

"This is a black day for Europe and its future competitiveness on global financial markets," the bourse said as antitrust officials ruled against a deal that would have created one of the world's largest operators of exchanges.

The basis of the merger was the growing derivatives market. In the modern market, equities trading is regarded as a high-volume, low-profit business. In defining that the scope of market it studied was European, the commission dismissed arguments derivatives trading was also global and frequently conducted off-exchange.

The merger would have created a powerhouse, representing more than 95 per cent of Europe's trading and clearing in benchmark exchange-traded derivatives. The companies were loath to compromise by giving access to the clearing houses, or spin one off.

Thus no deal. That verdict was the death of a dream. The companies had talked about creating a rival to CME Group of the US, the world's largest futures exchange, in 2008 but this went no further after the financial crisis.

The anger has abated, although Europe's largest exchange by market capitalisation plans to challenge the commission over its market definition as a matter of principle. But it is looking ahead.

Reto Francioni, chief executive, noted Deutsche Börse's integrated business model in cash equities and derivatives, made it "outstandingly positioned". That model – the so-called "vertical silo" in which an exchange owns its own clearing house – allows bourses to lock in clearing revenue that otherwise would go to a third party. Such structures underpin the relatively high market valuation of exchanges such as Deutsche Börse, CME and BM&FBovespa of Brazil.

While this was the merger's main stumbling block, it is also likely to be key to Deutsche Börse's future as incoming regulation in the wake of the crisis threatens to reshape trading.

Regulators want to push more of the vast but opaque over-the-counter (OTC) derivatives market on to electronic trading venues such as exchanges, and process trades through a clearing house. A clearing house stands between two parties in a deal, guaranteeing a trade in the event of a default. At the same time, rules from Basel III require banks to hold more capital, leaving less to lubricate the markets.

Taken together, the two trends are taking the group into new markets, in part as the tighter capital rules may penalise banks who clear trades on behalf of hedge funds, asset managers and smaller banks through a clearing house. This emphasis on clearing should benefit Eurex, Deutsche Börse's clearing house.

Reto Francioni, Deutsche Börse's chief executive, says its integrated business model makes it 'outstandingly positioned'

Last month Deutsche Börse said it would begin clearing OTC interest rate swaps through Eurex. The goal is to be able to clear both exchange-traded derivatives and OTC derivatives at the same clearing house.

Positions in each can be offset against each other in a process known as "portfolio margining", reducing the amount of collateral, or insurance, investors have to place for trading.

Deutsche Börse also has a thriving business in other post-trade services. Clearstream, its settlement and securities custody arm, has won deals to upgrade other countries' central securities depositories.

Together, Eurex and Clearstream generate three-quarters of total operating income for the group, compared with 30 per cent a decade ago. The group also wants to generate more revenues from its markets data and indices businesses. Neither is well known but each forms a vital component in modern-day trading.

Through purchases such as Need to Know News and Market News International, the group feeds market-sensitive economic data to the automated high-speed trading systems. The service, AlphaFlash, quickly delivers to investors some of the world's most closely watched statistics, such as US employment figures and the Chicago Purchasing Manager Index, which measures business activity in the region. Earlier this year it made AlphaFlash available inside the new CME data centre in Chicago, almost as close to the global futures trading market as it can be.

It also owns Stoxx, the index compiler and owner of some of the most actively traded derivatives contracts, including the Euro Stoxx 50. Ownership of an index allows an exchange to develop products, stimulating trade flow, and so revenues, while locking out rivals.

But moves by European authorities still stalk the company. Brussels wants open access to exchanges' derivatives clearing services as part of a review of its Markets in Financial Instruments Directive (Mifid). Critics say the vertical silo is a barrier to competition as it makes it hard to offer trading in the same derivatives offered by the silo.

Deutsche Börse has said the move could increase financial instability and help fight off plans to insert a similar clause in another key piece of legislation on clearing, the European Markets Infrastructure Regulation (Emir).

A related European proposal, "Mifir", is also aiming to force exchanges that own stock index businesses to allow rivals to license those indices so they can spin rival products off them. That would strike at the Stoxx business.

Neither proposal is guaranteed to be in the final texts, although politicians have indicated they will take a hard line stance for their inclusion. Nor have the technical details emerged from Emir, which will determine what OTC products should be traded on an exchange. These are due by the end of the summer.

City demonstrates its leftwing credentials

Protests

Ralph Atkins finds the tradition for political radicalism is alive and well

Signs of discontent: the Occupy Frankfurt camp outside the ECB headquarters was closed down by the authorities last month but returned to life Bloomberg

Throughout the eurozone debt crisis, the European Central Bank has sought to exude self-confidence. But last month, top ECB policy makers had to pack their bags and leave town.

The cause was not political turmoil in Greece or worries about banks elsewhere in the eurozone. Protests by German radicals on the doorstep of its Frankfurt headquarters threatened to take a violent turn and the police had sealed off the city centre. A conference marking the departure of José Manuel González-Páramo as ECB executive board member was moved to a hotel at the airport, safely on the city's borders.

As the ECB has learnt, Frankfurt has a – perhaps surprising – tradition for political radicalism and demonstrations. When the Occupy Wall Street demonstrations spread, Frankfurt was a natural focus within Germany, and the Occupy Frankfurt camp outside the ECB building became a much-photographed emblem of the eurozone debt crisis.

As the crisis has escalated, Frankfurt has become a stronghold for movements such as Attac, which campaigns against "neoliberal" globalisation and for the regulation of financial markets and for a financial transaction tax.

Both history and geography have played a role. In the 1960s and 1970s, Frankfurt was a leftwing bastion of the Social Democratic Party (SPD) and the German socialist students union, the student movement that was ejected from the SPD in 1961 because of its radicalism, which led anti-authoritarian protests. That provided a contrast to the many US troops stationed in the region.

Frankfurt was also home to IG Metall, the powerful engineering sector trade union. Providing brain power was the so-called "Frankfurt school" of critical, left-orientated thought at Frankfurt university's institute of social research.

As a result, Frankfurt ranked second only to Berlin as a German centre for the global protests of 1968. "Berlin was the wild, impulsive centre, Frankfurt was more the intellectual centre," says Gerd Koenen, then a Frankfurt student and today a historian.

Frankfurt's small size actually helped. With protests along just a few streets, Frankfurt radicals could cause widespread disruption. "Whenever there was a demonstration, half of the city was paralysed. It was a relatively simple method," recalls Mr Koenen.

German radicalism had a dark side in the 1970s – a time when Frankfurt was going through a development spurt, with a boom in high-rise office block construction. Frankfurt provided the backdrop to some of the tensest scenes in the country's battle with the Red Army Faction, the leftwing terror group.

From the mid-1970s, house sit-in protests developed into an alternative movement, with its own newspapers, publishers and printers, which addressed increasingly environmental themes and gained ground within the newly emerging Green party.

"The goal was to give up the extra-parliamentary protests and advance parliamentary representation," says Wolfgang Kraushaar, historian at Hamburg's Institute for Social Research.

In the 1980s, Joschka Fischer, a prominent Frankfurter who became German foreign minister in the late 1990s, was among the Green party's "realos" – or realists – who led the struggle against the Green party's hard-left "fundis" or fundamentalists. In much of the city, the Greens remain strong and are almost the political mainstream rather than a fringe grouping.

With the rise of the Occupy Frankfurt movement, the city is regaining its radical edge – although for different reasons. "It is easy to say that today's protest generation are standing on the shoulders of their predecessors," says Mr Kraushaar.

"That is not completely wrong, especially as within the Occupy Frankfurt scene there are people who were counted among the activists 40 years ago. But this is superficial. You cannot draw a direct line between the Occupy movement and the 1968s. There are significant differences in regard to their form and goals."

Whereas the 1968-ers were ambitious and idealistic in their radicalism, movements such as Attac are arguably more pragmatic, and focused on seemingly technical issues such as bank capital ratios or financial supervision. "You don't really win many people over with 'smash the system'," explains Sybille von Foelkersamb, a member of Attac Frankfurt's co-ordinating committee.

> 'You don't really win many people over with [the slogan] "smash the system"'

The most recent demonstrations attracted participants of all ages rather than being essentially student led. They were also focused on attacking the banking system – hardly a feature of protests in the 1960s – which explains why Frankfurt, as Germany's financial centre, was the focus of demonstrations. The city's mid-German location makes it a natural choice for protesters as the country's high-speed train network means it can be reached within a few hours from most parts of Germany.

Frankfurt's authorities were lenient for some time. The Occupy Frankfurt camp in a small park next to the ECB headquarters building – a 1970s high-rise in the centre of the financial district – remained throughout the bitter winter months. But in May the city's authorities worried it would be used as a refuge by violent demonstrators and closed it down. A series of demonstrations intended to "Blockupy" the city centre were banned.

The result was a nervous stand off in May. For four days, the banking quarter of Frankfurt, where the ECB is located, was sealed off and some 5,000 police were deployed to stop any attempt to flout the bans. The result was an eerie calm, which led to criticism of the police for their apparent overreaction.

Organisers concluded they had made their point. "The police did the job for us – the banks were more or less blocked," says Ms von Foelkersamb. On the final day some 25,000 demonstrators took part in a mostly peaceful – and authorised – march through the town.

The demonstrations are far from over. The next battles could be about the future of the camp outside the ECB building, which returned to life after the protests. The debates about the future of banking remain as animated as ever, which will also keep the city on edge. "OK, Frankfurt is sleepy, but it is where things are happening," says Ms von Foelkersamb.

'Mittelstand' bonds prove attractive

Corporate finance

The lending crisis has prompted companies to revise their financing, says **James Wilson**

Big kicker: FC Schalke is making use of innovative financing techniques to raise €50m Getty

Schalke 04, one of Germany's most popular football clubs, has no problem attracting thousands of fans to each home game. But this month the "Royal Blues" were trying to find supporters among another group that can be hard to please, German investors.

Schalke was due to issue a corporate bond to be listed on the Frankfurt stock exchange to raise an expected €50m. It makes the club one of a growing number of borrowers that is making use of innovative financing techniques during the financial crisis.

In Germany, as in much of Europe, great attention is being paid to the subject of corporate finance and particularly to the risk that hard-pressed banks, desperate to husband scarce capital, will no longer be willing or able to provide sufficient finance to companies of the real economy – potentially exacerbating the region's economic problems.

Some of these worries seem overblown in Frankfurt given that the German economy has been among Europe's best performing during the crisis.

Furthermore, many German companies remain amply supplied with credit by small savings banks and mutual lenders, which prize their longstanding relationships with local customers.

Commerzbank, which as Germany's second-largest bank by assets is one of the biggest lenders to the German corporate sector, is having to cut back many parts of its international business after the financial crisis but still says it has plenty of capacity for domestic corporate loans, with unused credit lines.

Markus Beumer, the bank's management board member responsible for its "Mittelstand" – small and medium-sized enterprises – business, says: "We could give 10 per cent more lending. There is enough there for the Mittelstand to grow. But we can only give out as much as is requested."

Mr Beumer says the crisis has made corporate bosses think long and hard about their banking relationships and sources of funding.

"Companies are revising every aspect of their financing – maturities, structures and so on," he says.

Particular concerns arise from a forthcoming banking rule book known as Basel III, which will require banks to recalibrate the amount of capital they must hold against their corporate lending. Four out of five companies in a recent Commerzbank survey thought Basel III would make it more onerous for them to get loans.

At a time of such concerns, the promotion by Germany's stock exchanges and corporate financiers of the use of capital markets instruments by smaller companies is a natural development. So-called "Mittelstand" bonds such as that planned by Schalke 04 have attracted growing investor attention since the segment was pioneered by Stuttgart stock exchange two years ago for smaller companies to get access to capital markets. Deutsche Börse launched a similar "entry standard" bond segment in Frankfurt last year.

Frankfurt's target is Mittelstand companies with turnovers from €50m to €1bn. It is attractive both for issuers, who can issue bonds with listing requirements that are more relaxed than for blue-chip companies, and for retail investors, who can buy into corporate bonds at yields well above the rates they can earn on bank deposits.

"After the financial crisis it is more difficult for banks to give credit – it is going to get more important for companies to look for alternatives," says Alexander von Preysing, senior vice-president of Deutsche Börse. "Markets were not open for this kind of company before. The fact that there has been interest from private investors has also encouraged institutional investors who wouldn't have looked [at investing in these companies] before."

Still, the sector is small and the risks higher than for blue-chip issuers. After two years, Stuttgart's Mittelstand bond issuance has reached €1.5bn while Deutsche Börse says the first year of its "entry standard" bonds produced 13 issues, raising €530m. The median issue volume was €23m, and the average coupon on the bonds was 7.1 per cent. One issuer in Frankfurt has already been delisted after insolvency.

Arne Laarveld, of Equinet, adviser to a number of Mittelstand bond issuers, told a recent conference that some criticism of the segment – including scarce liquidity, lack of transparency and incomplete ratings coverage – was partly justified. But he said there was a demand for its services. "This sector will get more professional," he said.

Regular bank loans remain a far more important part of the financial armoury of most German companies. A study of the 4,400 largest family companies by Deutsche Bank and the BDI, Germany's industrial lobby organisation, found more than 86 per cent still made limited use of capital markets. Bank loans were the favoured means of finance for half of these companies.

Mr Beumer points out that, in trying to ensure their finance is secure, many companies have decided to become much more self-reliant – squirrelling away profits and increasing their own equity to become much less exposed to the vagaries of either banks or capital markets. "Forty per cent of companies have equity of more than 30 per cent. Ten years ago it was only 10 per cent," he says.

The Deutsche/BDI study also found one in four companies thought their own capital would become more important, compared with one in 10 that saw a similar increase in importance for capital market finance.

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Lenders make effort to cash in on German roots

Banks

Acquisitions have boosted the region's institutions, reports **James Wilson**

Frankfurt's banks have the backing of a fiscally sound government and a base in Europe's strongest economy, but they have not been spared the pains of the financial crisis and the need for substantial fresh capital.

In some cases, big adjustments have been needed to business models.

Deutsche Bank, Europe's largest by assets, strode into the elite league of global investment banks under Josef Ackermann, who stepped down as chief executive on May 31 after a decade. His joint successors, Anshu Jain and Jürgen Fitschen, must negotiate a less confident period of tougher regulation, lower returns and increased public and political hostility.

Part of Deutsche's response is a renewed focus on its home country. It remains the most important bank in Germany and wins the lion's share of corporate finance mandates from blue-chip industrial companies. Yet until recently some aspects of the bank's domestic role were surprisingly limited, with only a small share of German retail deposits or loans, because of Germany's fragmented banking landscape.

Over the past couple of years this has changed, thanks mainly to Deutsche's acquisition of Postbank, the former post office bank, which had more retail customers than any other in the country.

"Deutsche is today the undisputed market leader in its home market," said Mr Ackermann as he left. "We have established a strong retail bank as a second pillar to match our strong investment bank."

The Postbank takeover has also dispelled some concerns that Deutsche's commitment to Germany was somewhat halfhearted – and that the bank may move to London. These days Mr Jain, Deutsche's most prominent London-based investment banker, who is slowly trying to learn German, acknowledges the benefits of the bank's German roots.

The task for Mr Jain and Mr Fitschen is how to use the bank's "German-ness" to cement its place in the global superleague of banks while meeting regulators' demands it hold more capital and takes fewer risks.

Commerzbank, Frankfurt's next most prominent bank, is in a more challenging position. It has also strengthened its role within Germany following its takeover of Dresdner in 2008. But the deal saddled Commerzbank with burdens that almost sank it at the peak of the crisis, and the bank is still heavily dependent upon support from the German government, which maintains a blocking minority stake of 25 per cent.

> Each phase of the crisis has cast a spotlight on some of Commerzbank's more troubled exposures

Each phase of the financial crisis has cast a spotlight on some of Commerzbank's more contentious exposures.

Its Dresdner inheritance of off-balance sheet vehicles, its vast book of loans to hard-hit sectors such as shipping or property, and its billions invested in the bonds of Greece and other troubled eurozone countries, for example.

Commerzbank was assessed by the European Banking Authority last year as having to close a €5.3bn shortfall in its capital – more than any other German bank. Deutsche's gap was put at €3.2bn.

To the surprise of many, Commerzbank looks to have managed to meet the target early without the need for more government help, but it has had to retreat from many businesses and its balance sheet has been cut by almost 40 per cent since the Dresdner takeover, with a self-imposed moratorium on most international lending. Its Eurohypo subsidiary, once one of Europe's biggest commercial property financiers and bond buyers, is to be dismantled.

The bank's immediate future is likely to much be less global than its top managers, or the German government that championed the creation of a strong rival to Deutsch, anticipated.

Commerzbank is fortunate Germany has weathered the economic storm well. It has made the most of the strong domestic position it secured with the Dresdner takeover, especially among Germany's Mittelstand, family-owned industrial companies. "Our Mittelstand bank remains by some distance our strongest leg," Martin Blessing, chief executive, told shareholders last month.

Two other Frankfurt banks also showed a lack of capital, according to the EBA.

Helaba, the regional Landesbank, weathered the crisis in far better shape than most of its peers, and has agreed a €1.9bn capital injection from its public sector owner. It is now looking to grow by absorbing some of the assets of WestLB, the stricken Düsseldorf Landesbank, which is being wound down.

DZ Bank, Germany's largest co-operative bank, was considered by the EBA to be short of €353m in capital, which is an easily surmountable sum given the bank's close links to 1,200 small cash-rich mutuals.

Complexity of retail products in spotlight

Investments

The revelation of issuer risks has turned sentiment, says **James Wilson**

Among Europe's markets for retail investment products, Germany's stands out for the sheer volume of offers it makes to customers.

Each month Frankfurt's banks produce tens of thousands of tailored retail derivatives known as certificates (*Zertifikate* in German), which bear descriptions such as "discount", "express" or "knockout" to categorise the way they are structured and their level of risk. Certificates are based on underlying assets such as market indices or individual stocks, and offer investors a range of ways to expose themselves to – and hopefully profit from – market movements.

Volumes are astonishing – almost 520,000 issued in Germany in the first quarter of the year alone. This is 95 per cent of the issuance logged by the European Structured Investment Products Association, which covers Germany and five other countries. There is also a steady stream of certificates maturing.

The DDV, the association representing 17 of Germany's leading certificate issuers, counts more than 930,000 different certificates available to investors. The variety is vast. For example, the share of carmaker BMW is the underlying for 15,000 different certificates.

Christian Reuss, chief executive of Scoach, Deutsche Börse's Frankfurt-based exchange for certificates, says: "It is probably a valid question whether you need so many products, and less could be more. Look at Hong Kong, which has the highest turnover of structured retail products with just 5,000 products. Choice is generally a good thing but the truth probably lies somewhere in the middle."

Scoach is one of two German exchanges where certificates can be traded: each month exchange volumes are some €4bn-€6bn.

The appeal of certificates took a knock in the financial crisis when owners of certificates issued by the German arm of Lehman Brothers, many distributed by other banks, became grimly aware of the hitherto little-acknowledged risk of issuer default. Many small investors waged court battles against banks that had sold Lehman products that became worthless.

Christian Vollmuth, a managing director of the DDV, says the structured products industry was "wrongly associated" with problems from the Lehman bankruptcy. He says: "It was perceived that the 'complexity' of certain structured products was the source of the trouble and that investors had been duped because of this. In reality, the relevant issues were exclusively about issuer counterparty risk and had nothing to do with the particularities of structured products."

The size of the German certificates market was put at €135bn at the end of 2007, then shrank to €80bn a year later. It is now about €100bn.

In the same period, the popularity of passive investment products such as exchange-traded funds has grown. Frankfurt is one of the leading European locations for trade in ETFs. Deutsche Börse's Xetra platform claims a market share of about 37 per cent in European ETF trading.

> 'It is probably a valid question whether you need so many products. Less could be more'

Deutsche Börse now lists some 900 funds and €165bn of assets under management in ETFs. The number of funds and trading turnover has more than doubled in the past five years.

ETFs are transparent, democratic and competitive in terms of cost, says Rainer Riess, managing director of Xetra market development at Deutsche Börse.

ETFs are used mainly by institutional investors but retail investors drive 40 per cent of trades, according to Deutsche Börse.

At Commerzbank, Germany's second-largest bank by assets, Thomas Timmermann, head of equity markets and commodities in Frankfurt, says: "Certificates can be a cheaper product than ETFs. But ETFs have become more appealing for many retail investors since the crisis, because investors have become more aware of the counterparty risk attached to issuers of certificates."

ETFs have critics. Regulators on the international Financial Stability Board last year expressed concern at the pace of innovation in ETFs, pointing to risks in "some corners of the market" and some "disquieting developments". Xetra's Mr Riess says: "the industry has suffered a little bit from the boom times". Providers need to "work a bit more on helping investors to understand" what distinguishes different types of ETFs, he says.

The DDV has stepped up efforts to bring more transparency to the certificates sector, while trying to stop German structured products being drawn into what it argues could be an overly zealous regulatory response to the financial crisis. Last year Belgium's regulators and issuers of structured products agreed a moratorium on the sale of "overly complex" products. That concerns the DDV, which defends the German approach based on transparency by making product information available.

"It is simply not true that 'complexity' is the source of increased risk. On the contrary, complex features are usually used to reduce the inherent risk of the underlying," Mr Vollmuth says.

Mr Reuss agrees it is "difficult" to regulate complexity. "It would be better to focus on transparency," he says. "Regulation is a sword of Damocles over financial products but I am still positive because structured products have lots to offer investors. We will see how far the pendulum swings but I fear that some overshooting is likely."

Flag waver: Deutsche Börse lists €165bn of assets under management in ETFs Getty

Funds sector Products restructure as citizens lose trust

It is not just Frankfurt's banks that are suffering in the financial crisis. Its asset managers, the bedrock of Germany's €1.9tn funds sector, are having to deal with the obvious financial effects of nervous savers' reluctance to invest, as well as with the more uncertain outcome of planned regulation for the sector.

"Many citizens have lost trust – in the stability of our currency, in the financial system, and especially in the capacity of European politicians to solve the debt crisis," said Thomas Neisse, the president of Germany's investment and asset management association, the BVI, as he reported on the €16bn of withdrawals from retail mutual funds last year. "Private investors' sales can be blamed on the search for security."

Some money flowed back in to mutual funds in the first quarter of the year, and Germany's funds sector remains substantial – with assets under management equivalent to twice the market capitalisation of the German stock market. Investment from institutional investors rose last year, with Mr Neisse, also chief executive of Deka Investment, speaking of a "market with two faces". Indeed Germany's funds are becoming increasingly the province of institutional investors, whose share of total assets has risen almost twice as rapidly as that of retail investors since 2003.

The BVI, which represents more than 80 asset managers, says the government should do more to give funds a level playing field to compete with the life insurance sector as a long-term way for retail investors to build retirement savings.

Another challenge for the funds sector comes from the review of the EU's Markets in Financial Instruments Directive (Mifid II). The European Commission wants to prohibit independent financial advisers from receiving fees from product providers. The BVI says it welcomes Mifid II if it promotes fair competition between independent and tied advisers. But it is concerned the review will also put a number of types of mutual funds into the category of "complex" products, which would limit their availability to retail investors.

Specific problems surround a sub-sector of Germany's funds landscape, namely its open-ended property funds, many of which are struggling for their future. Paradoxically, this is happening at a time when German investors have seldom had so much interest in investing in property, seeking shelter from the eurozone crisis in bricks and mortar assets.

The problems for the property funds, where €85bn is invested, arose in large measure because they traditionally allowed investors to make virtually on-sight withdrawals in spite of the obviously illiquid nature of their property assets. This was more or less sustainable until the financial crisis, when many funds had to block access and freeze redemptions when a large number of investors ran for the doors.

Such pressures led in 2010 to the first announced liquidation of an open-ended property fund in the 50-year history of the sector. Others were suspended.

Remaining funds must introduce rules that should, in effect, redefine them squarely as retail products by requiring long notice periods for all but the smallest withdrawals.

> German investors have seldom had so much interest in investing in property as they seek shelter from the eurozone crisis

When two of the biggest suspended funds – run by SEB, the Swedish bank, and Credit Suisse – tried to reopen under these rules last month, they were overwhelmed by demand for redemptions. They now plan to liquidate their assets completely instead.

"Liquidating the fund is the right thing to do, even if we regret taking this path," said Credit Suisse's CS Euroreal property fund.

"Many investors understand that the long-term stabilisation and continuation of the fund is only possible on the basis of amended conditions. Nonetheless, some of these investors only wish to make investments which they can access at short notice," the company added.

Eight of 20 German funds primarily aimed at retail investors are now in the process of liquidation, according to Credit Suisse. But analysts say a consolidated property fund sector still has a role to play, with the winners likely to be the big Frankfurt banks and asset managers, such as Deka and Union Investment, which have strong nationwide sales networks.

BVI president Thomas Neisse

James Wilson

Desirable homes seen as haven against feared inflation rises

Property

A buoyant jobs market reflected in house prices, says **James Wilson**

An advert on a lamppost in Frankfurt's highly sought-after Westend district offers a fairly chunky financial reward to anyone who can help a family to find a flat to buy in the neighbourhood.

Such tactics would probably be irrelevant in most of Europe, where property prices are falling and demand is lacklustre. But Germany's market has been at odds with wider international trends for years. Prices flatlined even as bubbles inflated in countries such as Ireland, Spain and the UK.

Now, however, they are rising strongly in many parts of the country, propelled by low interest rates, a healthy jobs market and the faith of German nationals in bricks and mortar as a store of value if inflation takes off, which many believe it surely will.

The price rises were put at an average of about 5.5 per cent last year in Germany's 125 largest towns and cities. But the Bundesbank, Germany's central bank, has cast doubt on the sustainability of some of the increases.

The headline national rise masks stark regional differences. In some less economically successful areas of the country, including many towns in the one-time communist east, prices for property are expected to fall, exacerbated by Germany's population decline. By contrast places such as Frankfurt are expected to see growth and continued demand for homes.

A recent report by Savill's, the property consultancy, which considered investment risk in more than 120 German cities based on economic and socio-demographic factors, gave Frankfurt a favourable score. The city was ranked fourth as a low-risk investment location, behind three southern cities – Munich, Regensburg and Stuttgart – and scored best marks in some categories measuring economic performance, such as the city's tax revenues and number of companies being formed.

Stefan Niedermeier, managing partner of the Frankfurt office of Engel & Völkers, an estate agency, says the city's rental market is one of the most robust in Germany, with prices above €20 per square metre for flats in the best locations.

"Frankfurt is so small and the top areas are small in number, and yet there is a whole lot of purchasing power," he explains.

Another explanation is that the city, arguably Germany's most cosmopolitan and international, has a relatively large transient population that helps to drive demand in the rental market. "There are always people coming and going, more than anywhere else in Germany," Mr Niedermeier says.

F+B, a property consultancy, says Frankfurt has the 13th highest average sale price per square metre in Germany, and the fourth-highest average rents.

Tobias Just, professor at the International Real Estate Business School at Regensburg university, says price rises in some of Frankfurt's most sought-after areas are eye-catching.

"They have not been echoed across the board in the city, in spite of the fact that all market segments should be benefiting from economic conditions including low interest rates and a strong labour market," says Mr Just. "What seems to be happening is that investors are nervous and want to put their money into areas where they are taking as little risk as possible. That means properties in core areas at the top end of the market."

> 'Investors want to put their money into ... as little risk as possible'

Westend, where high-ceilinged old buildings stand on tree-lined streets within a short walk of the city's banking district, as well near as its largest green spaces, remains a much sought-after location. Houses near here can fetch €8,500 per sq m, says Mr Niedermeier, while flats of a desirable size and with the right amenities, such as a parking space, can cost more than €6,000 per sq m.

Another popular area, Westhafen, has a very different feel, with modern apartments overlooking the river Main and a lively nightlife. Flats costing €4,000 per sq metre a few years ago are now sold for more than €7,000 per sq m, Mr Niedermeier says.

An indication of how things can change for the worse, however, is given by the developments in Frankfurt's once popular Sachsenhausen neighbourhood, south of the river Main. It is on the flight path of aircraft using Frankfurt's expanding airport and prices have suffered accordingly.

What of the damage that might be caused by less tangible factors? Mr Just acknowledges that tougher regulation looms over the banking and asset management industries, which drive much of Frankfurt's economy and hence demand for property.

"But there are many other facets of the city's financial and professional services that continue to be in high demand, while the city also has a broader industrial base than many people realise," he says. "So I think the long-term future for the city's housing market is positive."

Mr Niedermeier of Engel & Völkers says: "It stayed stable during the financial crisis. There was always demand for property in good areas. There is not so much of a bubble effect here."

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Frankfurt as a Financial Centre

Night flight ban threatens airport expansion

Infrastructure

Court ruling raises fears for viability of aviation hub, writes **Daniel Schäfer**

If one were to make a list of public bones of contention, airports would presumably come close to the top of it.

Frankfurt and London, two of the three largest aviation hubs in Europe, are currently mired in political and popular debates over the scope, merits and, above all, disadvantages that another round of expansion would bring.

Flughafen Frankfurt am Main, one of Europe's busiest international airports, has long been an important selling point for the city, but disquiet over its fourth runway has re-emerged recently, raising the prospect this could threaten the region's economy and financial centre.

Bumpy landing: residents' protests over excessive noise after the launch of the fourth runway at Frankfurt airport led to a court ruling endorsing a ban on night flights AFP/Getty

Compared to London, the debate over this vital piece of infrastructure at Germany's financial heart looks rather modest. In the UK, the discussion is about how to add capacity to a system of five airports that is bursting at the seams. Under consideration are a third runway for Heathrow, a fast train service linking the latter with Gatwick in an alliance dubbed "Heathwick", or to build a wholly new airport in the Thames estuary.

By comparison, in Frankfurt, the long sought-after and hotly debated fourth runway has already been built and opened last year, extending Europe's third-busiest passenger and second-biggest freight airport's capacity from more than 460,000 take-offs and landings annually to 700,000 by the end of this decade.

But the launch of the fourth runway has sparked vociferous protests by residents complaining about excessive noise, and has ultimately triggered a German court ruling endorsing a ban on night flights at the aviation hub.

In April, a Leipzig court upheld a lower court ban on flights landing at Frankfurt between 11pm and 5am, reversing the state government's move to allow 17 flights during the night.

The ruling was a blow for both Fraport, the airport's listed operator, and Lufthansa, the country's largest airline. Both fear the restrictions could leave Frankfurt at a disadvantage as competition intensifies with rival air traffic hubs, including fast-growing airports in the Gulf.

Christoph Franz, Lufthansa's chief executive, warned in April that there would be long-term negative consequences for Frankfurt's airport. "This is a big blow for Germany as a place to do business and there is no doubt that one of Europe's biggest hubs will slip in international competitiveness," he said.

Lufthansa's cargo unit estimates it will lose €40m in annual earnings because of the ban on night flights but said it would wait until the end of the third quarter before taking a decision on future investments at Frankfurt.

"For Frankfurt airport the night flights ruling is a further step that limits the ability of German airlines and airports to compete with foreign rivals," Klaus-Peter Siegloch, president of the BDL, the German air industry body, said at the time.

The airport is not only an important hub for Europe and the economically bustling Rhine-Main region where it is based. It is also an economic force in itself, employing more than 70,000 people at more than 500 companies and institutions, making it the largest local employer in Germany.

However, there have been some encouraging signs for the future of this aviation hub as well. Last year, Fraport's managers not only opened the fourth runway in the north-west but they also proudly inaugurated The Squaire, Germany's largest office building. Sitting atop the airport's long-distance train station, the shiny 660 metre office and hotel building is home to accountancy firm KPMG, Lufthansa, Hilton hotels and various retailers in 140,000 square metres.

Still under construction is a cavernous maintenance hall for Lufthansa's fleet of Airbus A380 aircraft, due for completion by 2015.

Another upcoming project is the building of a third passenger terminal at the former US Rhine-Main air base in a move to prepare the airport for the 88m expected annual passengers at the end of the decade. In the past year, Flughafen Frankfurt handled 56.4m passengers.

The terminal, which will have a spider-like form based on a concept by British architects Foster + Partners, is due to open in 2016 with capacity for about 25m passengers annually.

With plans for yet another runway remaining unlikely thanks to the public conflict such a move would trigger, Fraport is looking abroad for further expansion. The group is currently scouting around for deals to buy and operate airports in developing countries in Africa, Asia and Latin America.

At the moment, Fraport's international portfolio consists of controlling stakes in airports in Bulgaria, Peru and Turkey. It also has minority stakes in Chinese, Indian and Russian airports, where Fraport operates the assets.

With further such international expansion, Europe's largest airport by revenues could follow in the footsteps of the Rhine-Main region's industrial companies, many of which are well-known for their export success.

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Germany walks line in euro crisis

Continued from Page 1

experiences of his predecessor. He realised that, without the Bundesbank on his side, the effectiveness of any steps he took would be undermined – financial markets bet against an equivocating central bank.

Under Mr Draghi, the ECB's government bond purchase programme has been shelved. Instead he masterminded a plan by which the ECB offered eurozone banks unlimited three-year loan offers, which averted a eurozone disaster at the end of 2011.

Crucially, the Bundesbank did not object. Providing sufficient liquidity to solvent banks was a core responsibility of central banks, it accepted.

The Bundesbank shadow hangs over the ECB. Despite supporting the idea in principle, Mr Weidmann has expressed concern about the generous terms of the three-year liquidity offers, and would probably oppose further such proposals. He disliked the ECB's deal with eurozone national central banks that allowed them to broaden the range of collateral lenders could use to obtain ECB liquidity.

Mr Weidmann has also put pressure on Mr Draghi to play hardball with Greece, insisting the ECB should not take any more risks on to its balance sheet to help the country's battered financial system.

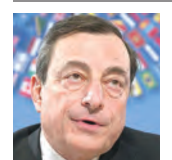
The Bundesbank's overriding concern has been to respect the ban on "monetary financing" – central bank funding of governments – written into EU treaties. The ban is seen by Germans as guarding against a repeat of the hyper inflation of the 1920s and prevents the ECB acting as "lender of last resort" to governments.

"I cannot see how you can ensure the stability of a monetary union by violating its legal provisions," Mr Weidmann argued in an interview with the Financial Times in November.

He has a difficult balancing act. The Bundesbank represents a strong strand of German thinking. He knows he has a certain role to play. But he has to remain part of the team if he is to win arguments.

A premature resignation along the lines of Mr Weber or Mr Stark would bring little long-term benefit.

Germany's media and many of its politicians believe the Bundesbank should never compromise.



Mario Draghi, ECB chief, realised he needed the Bundesbank on his side

But the Bundesbank's thinking is more flexible than commonly supposed in London or New York. The Bundesbank has signalled, for instance, that it could tolerate a German inflation rate above the eurozone average as part of a "rebalancing" that boosted the relative competitiveness of southern European economies. Even that concession raised anxiety levels in Germany. "Inflation alarm!" screamed a headline in Bild, the mass market newspaper.

Mr Weidmann and his press team had to work fast to reassure Germans that the Bundesbank's postwar achievements were not about to be unwound.