»Open Forum on Germany's Banking System«

Conference organized jointly by
Elena Carletti (Center for Financial Studies)
Jörg Decressin (International Monetary Fund)
Jan Pieter Krahnen (University of Frankfurt and Center for Financial Studies)
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Introduction to an "Open Forum on Germany's Banking System"

In the fall of 2003, the International Monetary Funds published the results of its latest Financial Sector Assessment Study, focusing this time on Germany. This report contained some important conclusions concerning the future of Germany's three-pillars banking system.

The public debate that ensued after the report's release in November quickly made it clear that our knowledge concerning the basic performance characteristics of Germany's banking system was actually quite limited – and has remained so to date. For example, there is little factual information, let alone comparative analysis, on product market competition, pricing, service level characteristics, or on corporate governance with respect to specific market segments or regions.

This lack of hard data is all the more disturbing as, from an international perspective, Germany's banking system is seen as the prototype of a bank-based system, and is frequently referred to in many discussions among academics and policymakers on comparative issues. The apparent financial system stability in terms of institutional structure makes an understanding of its prerequisites particularly relevant.

The report by the IMF was written while some of us were involved in editing a handbook on the German financial system (which has since been published with Oxford University Press). Its international reception made clear that there is a strong interest in how the German financial system is evolving.

Having discussed these issues with the IMF team visiting Frankfurt in 2003, we expanded on this theme of common interest and decided to hold a joint conference in early 2005. The idea was to bring together representatives of Germany's three banking pillars, policymakers, and academics in order to discuss the following issues:

- What are the responses to the conclusions and suggestions contained in the original IMF report?
- What has changed since the authors of the report collected their information in 2003?

- And what do outside observers, i.e., government officials, investment bankers, or academics have to say on the performance and stability of this bank-based financial system?

The conference was held on March 7, 2005 in Frankfurt/Main. The opening session comprised two thought-provoking talks, one by **Franklin Allen**, the leading international scholar on financial system analysis and a long-time proponent of the strengths of bank-based financial architecture. The other talk was delivered by **Mario Monti**, formerly the Commissioner at the European Union responsible for the competitive structure of European markets, including financial markets, and now the President of Italy's prestigious Bocconi University.

A special session was devoted to the key findings of the IMF's *Financial Sector Assessment Program* study on Germany. The results and conclusions were presented by two of its authors, **Jörg Decression** and **Daniel Hardy**, both from the IMF.

The morning session continued with what some observers labeled the "key panel", an encounter between high-ranking spokesmen of the three banking pillars in Germany. It consisted of **Christopher Pleister**, President of the Association of German Cooperative Banks, **Karl-Peter Schackmann-Fallis**, Executive Member of the Board of the Association of German Savings Banks, and **Manfred Weber**, Chief Executive Officer of the Association of German Banks.

The afternoon session saw two further panels that grouped industry and policy-maker responses. First, in a panel entitled "Reorganization and Consolidation of Public Sector Banks" three prominent bankers discussed their experiences with public sector banking, from both an internal and external perspective. The panelists were **Norbert Bräuer**, Member of the Board of Managing Directors of the Landesbank Hesse-Thuringia, **Lutz Raettig**, Chairman of the Supervisory Board of Morgan Stanley Bank, and **Andrea Moneta**, Head of New Europe Division at UniCredito Italiano.

The concluding panel brought together leading policymakers, all with a public finance background. **Tommaso Padoa-Schioppa**, Member of the Executive Board of the European Central Bank, opened the session with an introductory speech on Germany and European financial integration. The panel further consisted of **Jörg Asmussen**, Head of the National and International Fiscal and Monetary Policy Department at the German Ministry of Finance, **Stefan Ingves**, Director of the Monetary and Financial Systems Department at the International Monetary Fund, **Hans-Helmut Kotz**, Member of the Executive Board of the Deutsche Bundesbank, and **Karlheinz Weimar**, Minister of Finance for the State of Hesse.

Overall, the conference made clear that a definite assessment of the welfare implications of the three-pillars system is less evident than most observers from within Germany seem to believe. We take this lesson to imply a need for additional research focused on performance, competition and governance of Germany's financial system.

This is also the starting signal for a fresh attempt to find answers to the many questions that remained open during the conference, using the research network established under the auspices of the CFS program "Financial Intermediation and Risk Management".

To conclude, we would like to thank all speakers and guests for their active participation in the forum; and the IMF and CFS for their financial and logistical support that allowed the conference to be so successful. Our thanks also go to **Isabelle Panther**, who provided the administrative support and is responsible for the smooth running and enjoyable atmosphere that prevailed throughout the event.

On the following pages you will find excerpts from all the contributions to the conference – they deserve your attention because they not only show where we stand, but they also have a lot to say about where we are expecting to go in the near future. We hope that you will enjoy reading these excerpts – and we shall look forward to seeing you at the next conference on the role of public and private ownership of financial institutions in Frankfurt (November 17-18, 2006).

The Organizers

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Open Forum on Germany's Banking System

March 7, 2005 in Frankfurt/Main, Germany

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Jörg Decressin *(International Monetary Fund)*
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Karlheinz Weimar *(Minister of Finance, State of Hesse)*

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Presentations on Structural Implications of the German Banking System

Moderator

Günter Franke
(Professor of International Finance,
University of Konstanz)

The Role of Public Ownership in Banking

Franklin Allen *(Nippon Life Professor of Finance and Economics, University of Pennsylvania and Co-Director, Wharton Financial Institutions Center)*

Allen started his speech describing the advantages of Germany's three-pillar banking system. He argued this system has been very successful in many ways. It has done a good job allocating funds to industry. Until reunification the German economy was one of the best performing in the world and many attributed this to its banking system. Finally, Germany has not had a widespread banking crisis in the post-war period.

He then summarized the major points of the IMF Report on the German banking system. The report starts by comparing the performance of German banks with the performance of banks in other countries. German banks turn out to be less profitable than banks elsewhere because of low revenues rather than cost inefficiencies. The report suggests that the ending of public sector guarantees will put further pressure on the profitability of public sector banks. Furthermore, it suggests that efficiency does not differ markedly between public and private sector banks, but also that market failures are not sufficient to justify public ownership of half of the banking system and that public sector banks should be restructured. Privatizations of public sector banking systems in Austria, France, Italy, Spain, and Sweden provide examples of the benefits that can be obtained from doing this.

In Allen's view the report is a careful piece of work and a good starting point for the debate about how the German banking system should be reformed. However, he stressed the report is only a start and much more research is needed. Given the success of the current system it is not immediately clear that a radical reform is needed. Allen commented then in detail on the report dividing his comments into empirical and theoretical issues.

The first empirical issue he discussed concerns the report's finding that profitability as measured by return on assets has trended downward in the last five years and is less than in other countries. Accounting data across countries is difficult to compare because of differences in regulatory features of national banking systems, accounting rules and practices, and reporting methods. As a result, it is not clear exactly how to interpret this finding concerning Germany's banks. A second issue with regard to the cross-country comparisons of asset returns is that the risk of banking assets may vary across countries and this will lead to differences in expected returns. No adjustment for risk is made in the study. Including such an adjustment may lead to a quite different picture. Once it is recognized that asset returns are risky, focusing on figures for only a few years may also be misleading.

The report makes adjustments for countries being at different stages of the business cycle by using macro variables such as the output gap and interest rates. Allen suggested that another important variable that could perhaps be used is the state of the real estate market since it is so important for the health of banking industry. In recent years real estate returns have been much worse in Germany than in other countries. For example, BIS data shows that if real house prices at the start of 1995 are normalized to 100%, then by the end of 2001 German house values had fallen to 91% of their initial value. In contrast, in Italy they were 104%, France 128%, Spain 151%, and the UK 178%.

As last empirical issue, Allen stressed that there is no analysis in the report of the effects of public ownership on financial stability. Unlike many other countries Germany has been exceptionally stable. Upper and Worms' (2002)[1] study on bilateral exposure and risk of contagion in Germany suggests that this stability is likely to continue.

Turning next to theoretical issues, Allen argued that the IMF report correctly emphasizes the importance of identifying the market failures in Germany that would provide a rationale for public ownership of half the banking system. One possibility is that public banks can undertake projects with higher public than private rates of return but the report argues that this task is already performed by the development banks. A second possible market failure is that banking has increasing returns to scale but increasing returns run out well below the scale that is relevant for German banks. A third is that public banks may be the only way to ensure broad access to financial services but the Postbank

[1] C. Upper and A. Worms (2002). "Estimating Bilateral Exposures in the German Interbank Market: Is there a Danger of Contagion?" Deutsche Bundesbank Discussion Paper 09/02.

and privatized Sparkassen can achieve this objective. A final justification for public banks is that they can operate with a long-run perspective and so can overcome asymmetric information through relationships better. However, the report argues that cooperative banks can do this.

After commenting on the report, Allen argued that there are other market failures that provide a justification for public ownership. One is incomplete intertemporal risk sharing opportunities. German households hold much more in bank accounts and much less in equity than US households. As a result German households bear significantly less financial risk than their US counterparts despite the US having a much more developed set of financial markets. How can this paradox be explained? Citing previous work coauthored with Gale[2], he argued that when risk sharing opportunities are incomplete public sector banks that do not maximize profits allow better intertemporal smoothing than financial markets.

[2] F. Allen and D. Gale (1997). "Financial Markets, Intermediaries, and Intertemporal Smoothing," *Journal of Political Economy* 105, 523-546.

A second market failure identified by Allen results from incomplete contracting possibilities that make it very costly for the private sector to create AAA assets and AAA counterparty risk. Governments can provide AAA guarantees at low cost because they can tax, which the private sector cannot.

The possibility of contagion and financial fragility represent a third market failure. Contagion through the interbank market (Allen and Gale 2000) and through asset prices (Allen and Gale 2004) potentially poses a serious threat to financial stability. Publicly guaranteed assets and positions as counterparties by publicly owned banks can act as "firewalls" and prevent contagion. Thus financial stability provides a good justification for public ownership of banks.

Starting from the discussion of market failures, Allen suggested a number of research issues. How important quantitatively is intertemporal smoothing? What is the public cost to local and state governments of providing guarantees? How does this compare with the private sector's cost of providing guarantees? If the public sector's cost of guarantees is less than the private sector's cost, then the Sparkassen and Landesbanken may be efficient institutions that generate revenue through these cost savings. As an empirical matter, if one takes account of the activities funded by these institutions, their increase in value, and any rebates to the governments are the Sparkassen and Landesbanken subsidized or net contributors to local and state budgets? What are the financial stability effects of abolishing state guarantees of securities issued in the interbank market and counterparty risk in terms of contagion and financial fragility?

In his conclusion, Allen stressed again that more research is needed to definitively establish the desirability of changing the German banking sector. Financial stability and efficiency potentially provide strong arguments for public ownership. Finally, rather than eliminate public ownership a better way to restructure the German banking system might be to allow Citigroup or HSBC to acquire Deutsche Bank.

[3] F. Allen and D. Gale (2000). "Financial Contagion," *Journal of Political Economy* 108, 1-33.
[4] F. Allen and D. Gale (2004). "Financial Fragility, Liquidity and Asset Prices," *Journal of the European Economic Association*, 2, 1015-1048.

Germany's Banking System and European Competition Policy

MARIO MONTI *(President, Università Bocconi and Former Member, European Commission)*

Monti started his speech with a remark about the German attitude to the issue of competition policy. While on the one hand Germany is the European country from which competition culture first originated before spreading across other European countries, on the other hand it is also Germany that has shown the strongest resistance to the fully-fledged consequences and implications of the competition policy it created.

Turning to the intervention of the European Commission on the issue of German banking, Monti stressed that beyond the macroeconomic and political implications of the phasing out of state guarantees, the political economy approach – specifically the mixture of economic, political, legal and psychological intricacies concerning this time-honored piece of German structures and societies – seems of particular interest with regard to obtaining a more comprehensive understanding of the issue. Already the first dialogue between the Commission and Germany's authorities in 1996 resulted in a deep concern on the part of the German authorities about the possible impact European Competition Policy might have on the German banking system. In fact in June 1997 the German authorities insisted that guarantees to the German public banks should remain outside the scope of application of European competition rules on state-aid control.

Hence the dialogue between the European Commission and Germany's authorities was marked by strong tension from its very beginning in 1996. The Commission was particularly concerned about the inconsistency between the state guarantees to German public banks and the European rules on state aid. As the guarantees were without limitations as regards time and amount and without compensation, they were considered by the Commission to be a hidden form of state-aid and were therefore critically addressed in the communication of 1999. This communication included a number of inferences about how either to eliminate these guarantees or to make them compatible with the European competition rules.

The earlier debates and the communication's requirements triggered substantial resistance on the German side. Under pressure from the 'Länder', the federal government, first under Chancellor Kohl and then later under Chancellor Schröder, had threatened to block the ratification of certain treaties (Amsterdam and Nice) should the Commission continue to force Germany to apply European competition rules to its public banks. Two aspects of this resistance, both legal and political, are of particular interest.

Firstly, the German side was invoking the article of the treaty about neutrality with respect to public and private ownership in order to justify the principle of 'Anstaltslast' (the so-called maintenance obligation which refers to the liability assumed by a public sector body for the debts of an enterprise incorporated under public law). The position of the Commission was that member states are indeed free to choose the legal form of undertakings and to decide in favor of public or private ownership, but they must nevertheless respect the rules relating to competition.

Secondly, strong and rather aggressively voiced political resistance was expressed in the accusation that the Commission wanted to destroy the German three-pillar system and public ownership, with the ultimate objective of enforcing the privatization of Landesbanks, Sparkassen and Special Banks.

Monti gave both economic and political reasons for this strong line of resistance. It is well known that the state guarantees enable the Landesbanks to secure advantages in refinancing costs and to expand aggressively internationally, but this provides little insight into explaining why this system is so strongly supported. In this respect Monti identified a rather close and privileged relationship between the political world, especially at the regional (Länder) level, and the public banks.

Monti underlined that the Commission certainly did not try to eliminate public ownership, but had the duty to eliminate distortions to competition. To achieve this, it set out an approach that was open to negotiations but was combined with the threat of legal enforcement, in order to make sure that the negotiations would be ultimately productive and bring about a satisfactory solution. In this context the Commission did, of course, respect the rights of the member states to choose the legal form of undertakings and to decide whether to have private or public ownership, but it did make clear that if the legal form gives companies advantages that produce distortions in competition, which are prohibited by the state-aid rules, then this legal form must be subjected to the discipline of these rules. Looking back it was a very difficult problem to tackle, which required extensive and multilevel negotiations. At different stages, negotiations involved the Federal government (Minister of Finance Hans Eichel and particularly State Secretary Caio Koch-Weser, but in certain moments also Chancellor Gerhard Schröder himself), the governments of the Länder, the Association of the Public Banks. The final agreement between Germany and the Commission was reached in July 2001.

Monti underlined the importance of the bilateral understanding that was eventually reached. Without a consensual solution Germany would have gone to the European Court of Justice, with the hope of getting the Court to pronounce against the Commission, and that would have created great uncertainty about the nature and timing of the final outcome. He highlighted the interesting fact that Germany rejected the offer made by the Commission to allow the saving banks, with the exception of very few, very large savings banks, to continue to operate with guarantees. By comparison to the Landesbanks, the Sparkassen do not have significant impact on cross-border trade both in terms of lending, which is largely local, and in terms of funding, which depends on a predominantly local deposit base without much access to international capital markets. However, the German side decided not to accept the offer made because keeping the public banking sector unified took priority over economic advantages. Monti interpreted this as a clear indication of the importance that political considerations had during the entire process.

Monti finished his speech by summarizing the broader implications from the German case, which are of great

importance. The dialogue about how to deal with state guarantees brought about a series of positive "externalities", both substantive and political, for competition policy. The German example has become a sort of a blueprint for other intervention cases with regard to European competition policy, such as the Austrian banking industry, the financial services in Italy, and Electricité de France in France. Furthermore, regarding "political externalities", the German case was an unequivocal response to criticisms concerning unequal treatment among member states, since it made clear that the same competition policy applies to all EU member states irrespective of their size. In fact, it was a clear example that the Commission is prepared to intervene with respect to the large EU member states in order to enforce the rules of the Treaty.

Presentation of the IMF Report

Moderator

Beatrice Weder di Mauro
(Professor of International Macroeconomics,
Johannes-Gutenberg-University of Mainz and
Member, German Council of Economic Experts)

Financial Sector Assessment Program (FSAP) for Germany

Jörg Decressin *(Deputy Division Chief, European Department, International Monetary Fund)*
Daniel Hardy *(Deputy Division Chief, Monetary and Financial Systems Department, International Monetary Fund)*

Decressin and **Hardy** presented their paper "Germany's Three Pillar Banking System: Cross Country Perspectives in Europe" (IMF Occasional Paper 233). This paper had been prepared as part of the IMF's Financial Sector Assessment Program with Germany, undertaken in 2003. In their presentation Decressin and Hardy compared the performance of banks in Germany with that in other countries (France, Italy, Spain, United Kingdom); explained the repercussions of the phase out of government guarantees for public sector banks and the required restructuring; discussed the rationale for public sector involvement in banking in Germany; and presented experiences with public sector banks in other countries.

Decressin and Hardy observed that the structure of the German banking system was unusual in various respects when compared with the systems in the other EU countries reviewed. First, it included a large number of banks – over 2000 – or about twice the number of banks in France and more than eight times the number in Spain. Second, the share of public sector banks in total banking system assets was very high, reaching about 45 percent. That said, aside from the United Kingdom, the other countries reviewed also had several banking system pillars, including private banks, public sector banks, and cooperative banks, just as Germany did. But none came close to Germany with respect to the size of the public sector. Nor had the structure in the other countries been as stable as in Germany; they had generally witnessed major and fairly recent shifts in the composition of the various pillars.

One important issue was the decline in the profitability of the German banking system, which had fallen to disconcertingly low levels, according to Decressin and Hardy. The return on assets (ROA) before tax in the banking system was essentially zero in 2003, down from 0.15 percent in 2002. For the EU excluding

Germany, the ratio was about 0.6 percent for both 2002 and 2003. The situation in Germany had deteriorated to a point where it had prompted discussion about a credit crunch, although the existence or intensity of such a crunch could be debated. Over the longer term, capital would leave the German banking system unless it was better rewarded. It was therefore imprudent to proceed on the assumption that all was well with the system.

According to Decressin and Hardy, the profit weaknesses in Germany was largely structural rather than cyclical and the structural weakness did not reflect higher competition among banks. For example, purging indicators of profitability of cyclical effects (proxied by the output gap and interest rate) revealed that German banks' profitability was at only about one third of the level of that in the other countries reviewed. Regarding competition, savings banks did not really compete with one another and the same was true among cooperative banks, as they operated along the "regional" principle. Thus, the large number of banks in Germany could not be taken to point to strong competition. Decressin and Hardy therefore explored the relation between revenues and costs to gauge competition, using the Panzar-Rosse (1987) H-statistic. Overall, this relation did not differ much in Germany from that in the other EU countries reviewed, suggesting a broadly similar degree of competition, notwithstanding lower profitability and a larger number of institutions.

Decressin and Hardy presented estimates of revenue and cost functions suggesting that the German banks' profit weakness was rooted mainly in low revenue rather than high cost. Specifically, German banks had lagged in the development of nontraditional revenues, doing little to offset the erosion of interest revenue driven by rising competition from new intermediaries. Evidence from revenue functions – using microeconomic data on thousands of EU banks – suggested that German banks generated some 10-15 percent less revenue than other EU banks, holding constant for differences in scale, factor inputs, and asset structure. Since these estimates also considered differences in the degree of capitalization across banks, they indirectly (although imperfectly) adjusted for asset risk. The reason was that banks with riskier balance sheets were required to hold more capital to meet EU capital adequacy standards.

Decressin and Hardy argued that the structural strains on profitability could be expected to increase, requiring significant restructuring in the German banking system, some of which was underway already. Specifically, the public guarantees for Landesbanken and savings banks would be phased out in mid-2005. The Landesbanken would lose their AAA rating, with downgradings to around the single A range, with a few BBB. These downgradings would gradually raise the average cost of funding, significantly cutting Landesbanken profitability over time. While the situation of individual Landesbanken differed, restructurings would be needed to maintain the initial ratings. Decressin and Hardy presented estimates according to which Landesbanken would have to increase income by 20-40 percent to maintain their new ratings over the long run or risk further downgradings. Alternatively, estimates, for the cost side suggested that personnel expenses would need to be cut by 30-80 percent. These estimates were not forecasts, but rather illustrated the size of the needed adjustment. Work to adjust was underway and encompassed all players in the public sector: the Landesbanken, who were directly concerned; Sparkassen because they stood behind the Landesbanken either as owners or through the institutional guarantee scheme; and the regional governments as ultimate owners of the public sector banks.

How should the restructuring in the German banking system proceed? Decressin and Hardy argued that there was no single business model or blueprint for restructuring. Restructuring had to be guided by market forces to successfully improve banks' operations. This required the removal of various barriers to restructuring, notably the "public law" ownership structure of public sector banks. Specifically, transforming public sector banks into joint stock corporations would enhance their ability to attract new capital, including in periods of stress; merge or expand both within and across pillars, which under the "public law" form involved a laborious political process; and harness market signals (beyond ratings, which had all too often had played catch-up with markets) to guide the restructuring efforts, by placing some stock in markets.

Furthermore, the restructuring had to be supported with reforms to the

governance of public sector banks, including greater transparency, which would also foster an open debate about the future of public sector involvement. Decressin and Hardy found it hard to identify a market failure that justified a 45 percent asset share of public sector banks in Germany. The German public sector was already divesting from many other activities: the formerly public telecommunications, energy, post, and railways companies were all joint stock corporations by now. Similar steps should be considered for Landesbanken and savings banks because: (i) the remaining development banks (Landesstrukturbanken/KfW) could take care of projects that were in the interest of the public; (ii) financial services for disadvantaged people could be subsidized rather than allocated to public sector banks; (iii) public bank ownership entailed substantial fiscal risks; and (iv) public ownership structures distorted competition among banks – public sector banks would continue to get a bonus for their rating even after the phase out of guarantees, as acknowledged by rating agencies.

Decressin and Hardy then compared Germany's experience with public sector banks with that in other EU

countries. They observed that many other countries, including Austria, France, Italy, and Spain, had larger public sector involvement in mid-1980s than Germany but no longer did so now, and that all had a stronger banking system. These countries had sold publicly owned banks; transformed savings banks in joint stock corporations and divested; turned savings banks into cooperatives; reformed the governance of public sector banks; and abolished the regional principle applying to public banks so as to maintain competition in the face of consolidation.

The bankings systems resulting from these restructurings and others such as in Austria and Sweden were not monolithic. Rather, banks were heterogeneous in ownership form, specialization, and size.

Decressin and Hardy concluded that Germany's banking system had to adapt through reform or it would have to do so under stress. They summed up the FSAP view that bank restructuring was required, notably to develop new sources of business/revenues; that there was a need to strengthen the resiliency of the system to shocks, else the complaints about access to credit would be much louder during the next economic downswing; that there was no blueprint for how restructuring should proceed but that it had to be a market-driven process, with freedom to explore all possible options within and across pillars; and that this process had to unfold on a level-playing field, which meant that legal privileges had to be dismantled.

Panel on Industry Responses to the IMF (FSAP) Report

Moderator

Jan Pieter Krahnen
(Professor of Finance, University of Frankfurt and Director, Center for Financial Studies)

Panelists

Christopher Pleister *(President, Association of German Cooperative Banks)*
Karl-Peter Schackmann-Fallis *(Executive Member of the Board, Association of German Savings Banks)*
Manfred Weber *(Chief Executive Officer, Association of German Banks)*

The first panel of the Open Forum, chaired by **Krahnen**, concentrated on industry responses to the IMF FSAP report and brought together representatives of each of the three pillars of the German banking system. Krahnen asked the panelists to give their view on the IMF report and comment on the reasons why they regarded a change of the German banking system as being either necessary or unnecessary.

As a representative of the savings bank sector, **Schackmann-Fallis** spoke first, and began his statement by thanking the IMF for directing attention to the German banking system, even though much of the attention has been given to its perceived weaknesses. He made clear, however, that not all of the problems mentioned in the IMF report are to be blamed on the savings bank sector, but are also attributable to the commercial banks. Citing Horst Köhler, the current German President and former Managing Director of the IMF, he stated that "savings banks are good for Germany". In particular, he associated this statement with the advantages of the German banking system, such as the system's resilience under extreme stress and the ensuing financial stability, the increased access to finance and the high level of financial services.

With regard to the disadvantages put forward, i.e., the low and declining profitability of the German banking sector, Schackmann-Fallis remarked that high returns are not an end in themselves. Rather, the German banking system should be very careful in trying to reverse the decreasing development of profitability in order not to reduce its efficiency in satisfying customers' needs. He criticized the IMF report for promoting the creation of few large, stock-listed and, to his mind, monotonous banks. He argued that such a concept would weaken the current strengths of the German banking system and would no longer foster systemic stability, competition and access to finance. In particular, the savings banks' highly efficient way of gathering information about their customers and their needs, which give rise to the high level of customer satisfaction, would suffer by weakening their position in the banking system. In contrast to commercial banks, Schackmann-Fallis said, savings banks foster a long-term financial culture that is particularly beneficial for small and medium-sized enterprises, which account for a large part of the German business sector. With regard to retail banking, that has been criticized as not being competitive enough owing to the continuing existence of state guarantees to publicly owned banks, he stressed that a level-playing field is already in place. In particular, the observed small margins and low bank profits should be seen as a sign of favorably high competitiveness.

Schackmann-Fallis concluded his speech by asking for an explicit discussion of the economic rationale and political view behind the IMF suggestions for Germany. He said that as long as the proposed reform process simply imposes the Anglo-Saxon view of economics on German banks, the German banking system would be weakened rather than strengthened.

The second speaker **Pleister** commented on the situation of cooperative banks as the second pillar of the German banking system. He responded to Alan Greenspan's verdict at the end of the 1990s, characterizing the German banking system as medieval. Even though some cooperative banks in the German countryside may be housed in very old buildings, he said, the banking system as such is up-to-date and very well suited to serve customers' needs. The cooperative banking sector, in particular, tries to achieve the highest possible level of customer satisfaction via tailored banking services through its wide-spread net of branches, while at the same time desiring recognition of the group of cooperatives as "one bank". By doing so, the cooperative banking sector aims at receiving attention as a single entity both for rating, regulatory and monitoring means.

Pleister claimed to be very confident with regard to the sector's further development. In his opinion, the future of cooperative banks is based both on the proximity to its 15 million members and 30 million clients and to a further unification of the group, for instance via the creation of a "credit factory", in order to remain a strong nationwide provider of high-quality services and products.

Weber, representing the commercial banks, gave the final panel statement and started by stating that almost everything had already been said on the IMF report and its reform suggestions. He said he was rather disillusioned since, despite all the discussions in recent months, hardly anything had as yet changed. In particular, he blamed the defensive attitude towards changes on the ideological stance taken when it comes to reforming the German banking system. In his opinion, the IMF report clearly showed that profitability had to be improved by reducing structural inefficiencies in the banking system. The private banks were not proposing privatization of public banks with the aim of buying them and restricting competition. On the contrary, a market based banking system would increase competition.

However, he continued, the need for restructuring should not only be seen from a research perspective but also from a political viewpoint. In this respect, he claimed that future European consolidation would force German banks into an active role and impose structural changes. In his view, the phase-out of state guarantees to public banks would not be enough to

create a level-playing field among the different German banks. As an example he mentioned that the shadow rating of Landesbanks, taking into account the future lack of state guarantees, was remarkably high with an average of A, compared to the former AAA rating. In his view, this still represented an implicit guarantee of the state and as such unfair treatment of public banks compared to commercial banks. As long as this situation continued, the German banking sector would not make use of its real potential but, simply for the sake of conserving outdated structures, continue to squander the positive effects that an optimal banking sector would have for the German population and the German economy. With regard to the restructuring process, he suggested looking at other European countries that had already undergone major changes in their banking systems. He pointed out that in several of these reform processes the savings banks sector had come out in better shape than before – an example that should give some encouragement to restructuring the German banking system in keeping with the IMF suggestions.

In the final discussion, members of the audience put forward the view that further European consolidation not only imposes changes on the banking system but on all other firms as well. Their need to do business internationally gives rise to the quest for truly global German banks, providing services not only within Germany but also internationally. Referring to one of the statements of Allen's earlier talk, commercial banks were also asked to look for opportunities to merge among themselves rather than waiting for the cooperative and savings bank sectors to open up. In this respect, panelists agreed on the fact that a further discussion of the reform process has to focus less on ideology and more on the position of the banks' customers and their needs.

March 7, 2005

Panel on Reorganization and Consolidation of Public Sector Banks

Moderator

Reinhard H. Schmidt

(Professor of International Banking and Finance, University of Frankfurt)

Schmidt
Bräuer
Moneta
Raettig

Panelists

Norbert Bräuer *(Member of the Board of Managing Directors, Landesbank Hesse-Thuringia)*
Andrea Moneta *(Head of New Europe Division, UniCredito Italiano)*
Lutz Raettig *(Chairman of the Supervisory Board, Morgan Stanley Bank)*

The second panel was chaired by **Schmidt** and focused on the reorganization and consolidation of public sector banks. In contrast to the first panel, which consisted of representatives from associations of each of the three pillars, the second panel brought together experts bearing executive responsibilities within the banking industry. The composition of the panel guaranteed a national as well as an international perspective. The panel started with brief statements by each speaker on their thoughts about the need and the proposed procedure for reorganizing and consolidating public sector banks.

Bräuer started out by stressing the benefits of Germany's three-pillar banking system. In his view, such system guarantees i) that banking services are offered to everyone anywhere in the country, ii) that there is competition to the benefit of customers, and iii) that the banking system is stable. Given these benefits, he argued, there is a compulsion to act in the interest of stability when consolidating the German banking sector. As an example, he referred to the British banking sector, as being highly consolidated and representing an oligopoly of only a few large banks. While these banks have a high return on equity, both supply and prices are bad for customers. He referred to a statement of Ralf Dahrendorf that Britain needs savings banks. In Germany, prices for banking services are low owing to high competition stemming from the three-pillar system. Bräuer argued that "fragmentation" is the wrong word for Germany's banking landscape, and pointed out that Germany, in addition to global players also needs regional players. Pointing to ways to success in the future, he recommended that savings banks and his own organization (Helaba) should discover their own strength. With respect to consolidation, he recommended both horizontal and in specific situations vertical integration. A closer cooperation among savings banks, e.g., in the areas of task and fund allocation, could lead, quoting Dietrich Hoppenstedt (president of DSGV, the Association of German Savings Banks), to a "decentralized network" of savings banks.

In the remaining part of his statement, Bräuer discussed the pros and cons of privatizing public banks. While he agreed that this would facilitate the access to private capital, he put forth several reasons against privatizing savings banks. First, there is resistance in the population towards privatization. Second, in contrast to private banks, public banks are by construction acting in public interest. Third, German savings banks do not need additional capital, as they already are well endowed with this factor. Fourth, companies do not exist for the sake of stock markets only.

Starting from a more international perspective, the second speaker **Moneta** compared the banking systems in Italy and Germany in terms of both micro- and macro-environment. He argued that, given a similar macro-environment in both countries, differences exist with respect to profitability and efficiency, with Italian banks showing a far better performance record than German banks since the middle of the 1990s. Various business ratios (return on assets, return on equity, and cost-income ratio) indicate a widening gap. Moreover, the market capitalization of the largest three Italian banks grew faster than that of their German counterparts.

Moneta identified three structural reasons for the superior performance of Italian banks. First, from 1990 to 1996, the ratio of public sector ownership dramatically decreased in Italy (from 75% to 36%), while it only decreased slightly in Germany (from 62% to 52%). Second, a comparison between banks from various countries reveals that there is an inverse relation between the return on assets and bank density, with Germany having one of the highest bank densities and one of the lowest return on assets among the countries investigated. Similarly, there is a positive relationship between the average return on assets of banks in each country and the market share of the five largest banks in each country. Again, Germany is positioned at the low end of the range. Third, the share of income generated by new services for the banks differ between Italy and Germany. In particular, the share of new sources of income, proxied by non-interest income as a percentage of operational income, increased faster in Italy than in Germany after starting from a similar level.

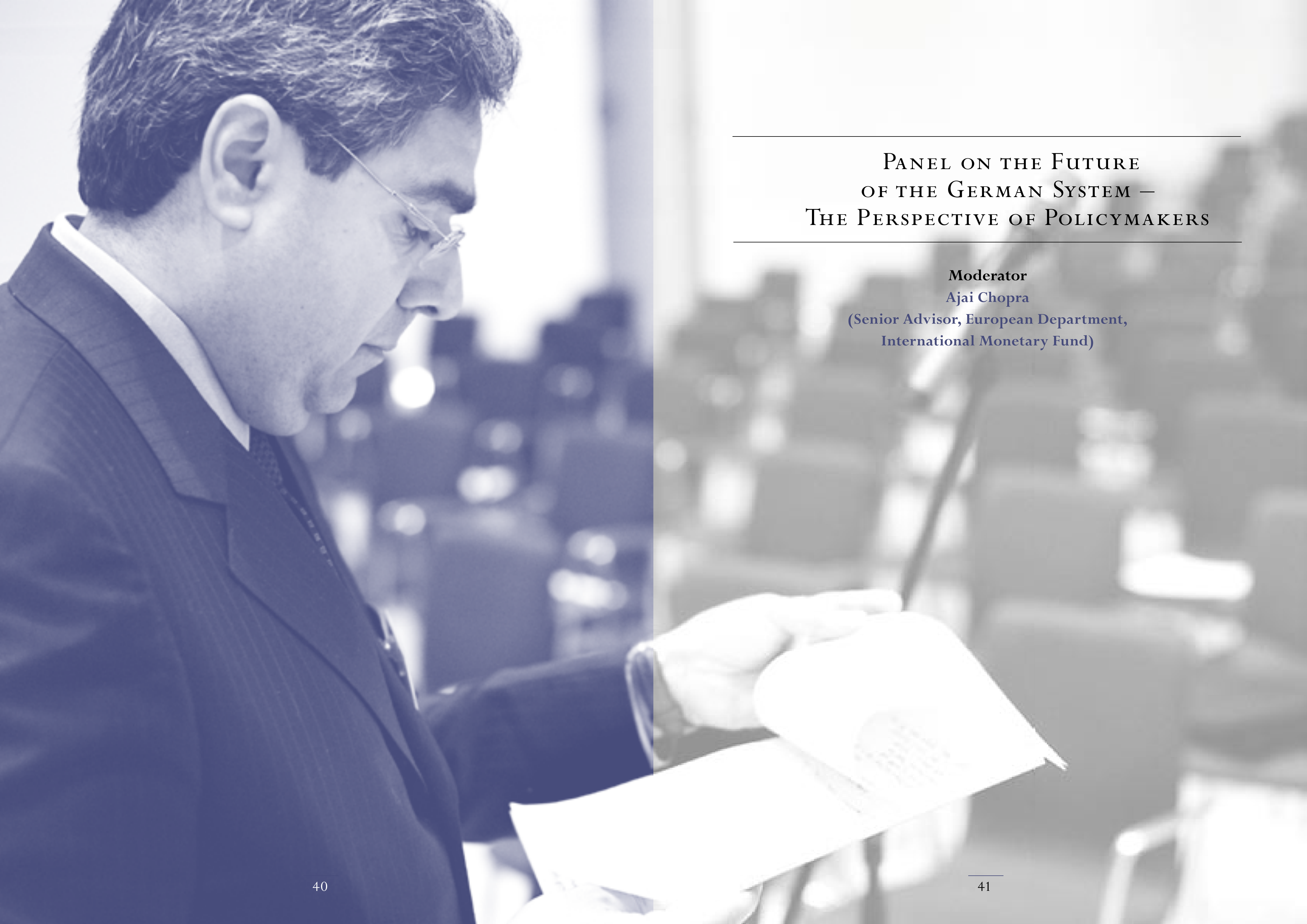
After the cross-country comparison, Moneta turned to the micro-perspective and outlined the reasons behind UniCredito Italiano's success. As determinants, he identified both the own strategies of the group and the general structural process, which resulted in good performance, e.g., decreasing cost-income ratio as well as increasing market capitalization and return on assets. He stressed that UniCredito Italiano is a clear example of a successful privatization and consolidation process. Starting from the privatization of Credito Italiano and the acquisition of several saving banks,

in only ten years Unicredito Italiano undertook a deep process of internal reorganization, and it is now a three-segment bank (retail, corporate and private), has a strong foothold in the investment banking business (through UBM) and in the asset management industry (through Pioneer).

Raettig started his comments by stressing that it is not clear whether a bank or a market-based economy is better. Furthermore, there is no indication of a credit squeeze in Germany. He mentioned three possible reasons for the low profits of German banks: high competition, lack of consolidation, and bad management. In his view, there is no need or added value to be derived from having national champions, and banks should rather focus on operating performance, providing new products, services, funding, and growth. He referred to both the present and the past when he noted that there were no homogeneous groups in the three pillars. In all pillars, there are big regional banks as well as small local banks. As an example, he mentioned the pillar of cooperative banks, with a highly integrated and consolidated DZ bank coexisting with a multitude of local cooperative banks. Commenting on the topic of consolidation, he stated that tendencies towards de-consolidation can also be observed, e.g., the re-emerged Postbank, the auto-banks, special retail banks, and mortgage banks. This is to be seen with some skepticism, as no bank is able to do everything well everywhere and for everyone. With respect to concentration, it is not the three pillars in Germany's banking system that are important, but other dimensions instead. Once again, he stressed that banks should concentrate on performance, and consolidation should happen with the aim of improving it.

In the subsequent discussion, the audience linked the statements of Bräuer and Moneta, by asking Bräuer to comment on his hypothesis about the three advantages of the German banking system (general access to banking services, competition, and stability) in view of the Italian example as outlined by Moneta. The reply implied that there is no structural problem. The German banking system and the services offered would not improve by changing the three-pillar system. Bräuer referred to the problems of German private banks that occurred when they changed their strategy to give more weight to investment banking rather than to retail banking. Today's problems lie in the main focus on investment banking in the past of these banks with the consequence of a strong strategic disadvantage in domestic retail- and corporate banking.

Subsequently, it was asked whether public banks offer their services more cheaply than is appropriate when they underprice their competitors. Bräuer responded by denying that underpricing exists, and stressed that the low price level results from competition, and public banks generally offer the same price level as their competitors. Raettig added some points to his earlier statements on the need of increasing bank profitability. He observed that the new standards elaborated by the Bank of International Settlement (Basel II) may reduce banks' profitability; and that in the loan market for small and medium-sized enterprises there is no evidence of a credit squeeze resulting from the new banking rules. There is enough money available for entities that deserve funding. Instead, there is a communication problem between banks and bank customers. Banks can tackle this by asking the right questions, demanding transparency (business plans, profits), and by applying the new banking rules (Basel II). If these criteria are met and transparency is achieved, then there is enough money available. Raettig confirmed that German banks are not profitable enough, but he only partly attributed this to the structure of the German banking system. The main reasons lie elsewhere and the individual banks themselves have to improve in every respect (resource allocation, product development, and risk management).



Panel on the Future of the German System – The Perspective of Policymakers

Moderator

Ajai Chopra
(Senior Advisor, European Department, International Monetary Fund)

Panelists

Tommaso Padoa-Schioppa *(Member of the Executive Board, European Central Bank)*
Introductory Speech: Germany and European Financial Integration

Jörg Asmussen *(Head of the National and International Fiscal and Monetary Policy Department, German Ministry of Finance)*
Stefan Ingves *(Director of the Monetary and Financial Systems Department, International Monetary Fund)*
Hans-Helmut Kotz *(Member of the Executive Board, Deutsche Bundesbank)*
Karlheinz Weimar *(Minister of Finance, State of Hesse)*

The third panel was chaired by **Chopra** and concentrated on the future of public sector banks. The panel itself combined a mix of policymakers at the regional, national and international level. Chopra first gave all speakers the opportunity to present their thoughts on the perspective of the future of the German banking system in an opening statement.

Padoa-Schioppa, as a representative of the European Bank, started out by describing the background of the European perspective. Key elements of this European perspective are the level of consolidation and integration, the ownership of banks and corporate governance in the different European countries. Padoa-Schioppa started his talk by taking a closer look at the notions banking system and integration. In his opinion, we can speak about a banking system because there is a link between all banks, namely the central bank. This link is currency and not country specific.

He then raised the question as to the degree of financial integration in Europe and linked this question with a description of two different approaches to integration, one determined by the single currency and the other determined by the single market which seeks to provide a framework for free provision of banking services and full capital mobility in Europe. He remarked that both types of integration are still in progress, that the level of integration today is significantly higher than a few years ago, but that further integration is hard to measure. He noted that in retail banking, an area, which is the most visible banking activity for customers, integration seems less advanced than in other banking market segments such as wholesale and investment banking. In line with this he expressed that European banks have too many branches and stated his expectation that in the future we will see at the top of the system a few big banks worldwide and some banks, which operate only in the European area.

Finally, Padoa-Schioppa turned to the question of remaining barriers to financial integration. He noted that political and regulatory bodies have to create the framework for financial integration but that it is up to market forces to exploit this potential. In this regard he noted that some of the potential created for financial integration by policy makers, namely the creation of a single currency, may not have been fully exploited yet. In addition he acknowledged that there are a number of challenges remaining to achieve a truly integrated European financial market. By way of example, Padoa-Schioppa mentioned the mortgage market or financial reporting standards.

Asmussen commented on the situation and the future of the banking system in Germany. He started his appraisal of the IMF report with the remark that the report provides a good picture of the

German banking system. The report correctly points out the high level of stability of the German banking system. This feature has been confirmed by the stress tests of the German banking system. Moreover he declared himself to be very confident about the role of the German Financial Supervisory Authority (BaFin). BaFin has performed very well since its establishment in the year 2002 and has been widely acknowledged since then. Besides many German banks have successfully managed to reduce their costs on a permanent basis and lowered their credit risk significantly. The three-pillar structure of the German banking system has shown a high degree of flexibility. It has allowed good progress and will make further improvements possible. Mainly for business reasons further consolidation could be expected. Speaking of the credit institutions under public law a clear distinction should be made between the so-called Landesbanken on the one side and the savings banks on the other side. Consolidation across the three sectors might gain importance on a long-term basis, however not in the near future because of the hurdles still existing. Apart from this the rating-based approach under the new prudential capital adequacy standards will set more incentives for risk-adjusted lending. Appropriate lending is very important for the stability of the financial system and the economic constitution of the banks. Asmussen pointed out the need of further developing the legal framework of financial markets und financial instruments because the financial system and financial products are very innovative requiring a legal system that is up-to-date. As an example, he referred to new investment laws for Hedge Funds and covered bonds.

Ingves commented on the challenges facing the banking sector in Germany from the perspectives of banking system restructuring in other countries. Ingves pointed out that key determinants of the equilibrium structure of a banking system include ownership restriction, market segmentation and the legal framework. He saw a trend towards the public sector moving out of the banking system and reducing its impact on a new equilibrium. When this happens, it is easier to move money into the banking system and from one part of the system to another to adapt to changes in demand for bank services, competition, and technology. The structure, and its flexibility, is intimately linked to its stability. Ingves mentioned that stability in one period does not guarantee stability forever because stability is time-dependent; events occur within and outside the

banking system, so that a structure that is stable for a long time may accumulate strains. Hence, changes in a banking system may be necessary to preserve stability and should not be seen as a threat to stability. One important determinant of the scope for changes in a banking system is the regulatory framework, which is easier to reform in a healthy economic environment and when the banks subject to regulation are generally strong. Ingves argued that transformation must be possible within any and across all three sectors of the German three- pillar banking system, and ownership of the banks must be transparent to all stakeholders. To this end, it will be necessary to construct the legal framework to allow for the potential restructuring of the German banking system and for experimentation.

Kotz began his remarks with reference to a most remarkable reversal of perceptions: Until the early 1990s, German (Universal-) banking was conventionally rendered as the model to pursue. Providing for a low user-cost of capital, as shown in numerous empirical studies in

particular in the U.S., and allowing for a longer horizon it was deemed as most appropriate in underwriting a productive economy. Barely a decade later, perceptions – or as Kotz observed: fashions – have completely changed. Meanwhile, capital-market oriented systems are invariably deemed to be more effective in fostering growth, in particular in innovative sectors of the (new) economy. The decisive reason for the very much declining attractiveness of German-style banking was its comparatively lackluster performance in terms of profitability. And the standard diagnosis held, as Kotz observed, that this was essentially for structural reasons, thereby alluding to the German financial system's in the meantime most idiosyncratic feature: the three-pillar structure of private banks, cooperative sector credit institutions and public sector – nota bene: not state-owned – banks.

Historically, Kotz remarked, societally acknowledged market imperfections (problems of market access, credit rationing as a result of information asymmetries and/or price discrimination) frequently gave rise to public sector intervention. While the modes of intervention – public provision or regulation – differed, they, according to Kotz, essentially responded to the same perceived market failures. Thus, what matters ultimately is performance in two dimensions: efficiency as well as stability. As concerns the latter criterion, Kotz observed that, as a system, German finance had shown for more than half a century a remarkable robustness. He admitted that there exists a certain tension between competition, exposing individual banks to fragility, and concentration, redistributing consumers' surplus to producers. And he underlined that in this dimension the three-pillar system, to be more precise: its provision of effective competition (contestedness) is in some way causal for lower but, possibly more normal or fundamentally justifiable/sustainable, returns on equity. At the same time, as the IMF study showed again, German banking has been comparatively cost-efficient. From a client's perspective, Kotz held, all of this might be rather laudable. And, indeed, in mundane reality banking consolidation has usually not been driven by purported economies of scale (being fairly rapidly exhausted) but by the economics of market concentration or power and, hence, influence on price. Moreover, in order to understand German banks' comparative profitability performance, in confirming Franklin Allen's previous diagnosis, Kotz pointed out that, if one tried to understand developments in an aggregate dimension, one should quite obviously account for differences in activity levels (relative to potential output). For almost half a decade the mediocre macroeconomic performance with its logical corollary, a higher number of corporate failures as well as the consequential amount of bank provisioning, has, according to Kotz, not been adequately acknowledged. Hence, as Kotz argues, the frequently drawn conclusion, that a reorientation towards a system closer to the U.S. blueprint would be called for, would need a significantly more solid footing. To begin with, it is, as Kotz observed, interesting to note that the substantially higher degree of interventionist regulation as applied in the U.S. frequently is simply not known. Numerous U.S. regulations, however, from the Truth in Lending Act to the Community Reinvestment, try to deal with perceived market imperfections. The same holds true for housing finance (Fannie Mae and Freddi Mac) or pension funding (ERISA, the Employment Retirement Income Security Act or the Pension Benefit Guarantee Corporation). Following Kotz, a typical fallacy committed hence is to compare the ideal capital-market oriented approach with the real model of bank-based finance: the prototypical grass-is-always-greener solipsism. Given such weak foundations, showing up in perceptions cycles, humbleness on the part of social engineers would be well advised. In finance as well, variety could be viable and in the interest of the general public, the demand side. Kotz therefore finished by reiterating Allen's point that what ain't broke doesn't need fixing. Or, if deemed to be in need of repair, do it most carefully.

Finally, **Weimar** commented on different questions about the role of the State of Hesse. First he answered the question why the State of Hesse increased its stake in the Landesbank. Weimar pointed out that Helaba is very important for Hesse, and the provincial government wants to have a significant stake in the Helaba because it is possible for all provincial governments to invest in a Landesbank. Second, he explained that the long-term interest of the State of Hesse is the affirmation of the three-pillar banking

system and the public sector. In addition public sector banks are vital for small and medium-sized companies and that it is essential to have regional banks. The savings banks' and Landesbanks' finances are crucial for SME financing and for providing seed capital. Thirdly, Weimar confirmed that the state government does not appreciate private investors in the saving banks and Landesbanks. According to the Hessian Banks Act, private firms cannot be shareholders in saving banks and Landesbanks.

In the final discussion, Asmussen explained that additional reforms of the banking system should be regarded as an effective means of preventing a banking crisis as well. Further improvements, which closely match to the European financial markets, would be worth striving for.