

Changes in the German Banking Sector

Savings Banks and Cooperative Banks in Relatively Good Position¹

For years the German banking sector has been in a difficult situation, evident in low returns by international comparison. Banks have responded in the past by cutting down personnel, merging and closing branches. Earnings problems emerge with particular clarity in times of economic slowdown. In Germany credit institutions incorporated under public law account for a large share of the sector's balance sheet total, at around 40%. Mergers are not possible between banks of the different pillars of the German banking system, that is, commercial banks, public law banks and cooperative banks. An analysis of the three-pillar system shows that on average the savings banks and cooperative banks have been able to achieve relatively high returns for the last ten years.

Most of the German commercial banks operate as universal banks, offering every type of banking service; in addition there are specialised banks which concentrate on specific fields of business. Both the universal banks and the specialised banks can have various legal forms. Within the universal sector there are three different types of banks – commercial, cooperative and public law banks, all of which have different objectives and tasks. The commercial banks' avowed objective is to maximise profits, while the cooperative banks aim 'to promote their members' earnings'; the public law banks, finally, also perform tasks in the public sector (cf. table 1).

The three groups of banks differ not only in their objectives, but also in their liabilities. In the past the state guarantee for the public law banks, under which the Federal Government bears an institutional liability, has frequently been seen in connection with their specific objectives. The European Commission has now insisted on changes to the guarantee system for the public law banks, and the state guarantees in force hitherto will end on 18 July 2005.² After the changes the banks

¹ The main statements in this article are taken from the report 'Untersuchung der Grundlagen und Entwicklungsperspektiven des Bankensektors in Deutschland (Dreisäulensystem)' for the Federal Ministry of Finance, cf. www.diw.de/deutsch/produkte/publikationen/gutachten/aktuell/index.html.

² The consequences of the changes to the state guarantees are analysed in detail in Wochenbericht no. 25/2004.

will be operating under the same rules but mergers across segments will still not be allowed.

Public law banks account for a big share

On principle a distinction is drawn between economies with a bank-based financial system and those with a market-based system. The German system is regarded as bank-based, as external corporate financing is largely in the form of bank loans. In the United States, on the other hand, corporate financing is largely transacted through the financial market (a market-based system). Empirically the importance of the banking system in an economy is reflected in the ratio of bank loans to gross domestic product. In economies with a bank-based financial system, e.g. Germany, this ratio is generally much higher than in economies with a market-based system (cf. figure 1). The development of this indicator over time also reflects the economic situation. In times of strong macroeconomic dynamic the share generally grows markedly, while in weaker phases it often stagnates or even may decline.

Within the German banking system the three pillars have different weights, and this is often measured by their share in the balance sheet total for the banking sector as a whole. In 2002 the savings banks and Landesbanken (state-owned regional banks) together had a balance sheet total of more than 2.3 trillion euros, giving them a market share of about 36% (cf. figure 2). The Landesbanken accounted for the greater part of this (20 percentage points). The commercial banks had a share of about 28%, while the cooperative banks and the central banks accounted for just under 12%.³

Growth in private sector lending only hesitant

In fact, lending is a major activity of German banks. At the end of 2002, loans and advances accounted for about 75% of their balance sheet total. In recent years the differences in the structure of the lending business between the groups of banks have widened:

- For the commercial banks the share of lending to non-banks has fallen from 62% of the balance sheet total (1992) to 41% (2002).⁴ However, their commitments in interbank business have increased, with loans and advances to banks reaching a share of

³ The remaining shares were those of the mortgage banks, building and loan associations and banks with special tasks.

⁴ In the 1980s the commercial banks accounted for a major part of the expansion in lending to non-banks but this dynamic slowed markedly in the first half of the 1990s.

Table 1
Objectives and Liabilities of Banks by Type of Ownership

	Commercial banks	Public Law Banks	Cooperative Banks
Objective	Profit maximisation	Public commissions, also (e.g.) to promote savings and asset formation, SMEs and new businesses and to finance public works	To promote the incomes and businesses of their members
Liabilities	Liable to customers	State guarantee: Federal Government's institutional liability (Gewährträgerhaftung und Anstaltslast) until 2005	Solidarity, members obliged to make further contributions

Source: DIW Berlin.

28% of the balance sheet total (1992: 19%).⁵ The percentage of shares and equity investments rose markedly, reaching about 8% of the balance sheet total in 2002 (1992: 3%). The importance of securities business also rose slightly (1992: 10%; 2002: 13%). The structural change reflects the withdrawal of many commercial banks from business with private customers, which often involved small transactions, and their expansion at the same time of investment banking.

- The importance of loans and advances to non-banks has tended to decline for the public law banks as well; nevertheless, that area of business still accounted for 47% of their balance sheet total in 2002 (1992: 52%). The savings banks are particularly active in the traditional lending business and – contrary to the general trend – have actually expanded this (1992: 58%; 2002: 60%). The Landesbanken, on the other hand, have clearly reduced their business with non-banks (1992: 44%; 2002: 36%) and have stepped up their business in the interbank market (1992: 34%; 2002: 41%). Another difference between the savings banks and the Landesbanken is evident in fixed-interest securities. While their share in the savings banks' balance sheet total has declined (1992: 21%; 2002: 18%), that of the Landesbanken has increased (1992: 12%; 2002: 15%). Both groups, the savings banks and the Landesbanken, have increased their percentage of shares and equity investments noticeably in the last eleven years.
- The share of lending to non-banks in the balance sheet total has declined for the cooperative banks (1992: 57%; 2002: 51%). Loans and advances to banks have also declined slightly (1992: 15%; 2002: 12%), as has the percentage of fixed-interest securities (1992: 18%; 2002: 16%), while the importance of

⁵ However, the commercial banks are not a homogeneous group, there are particular differences between the big German banks and the branches of foreign banks. Lending to non-banks, which include smaller and medium-sized companies, has clearly declined in importance for the big commercial banks, while it has gained importance for foreign banks' branches.

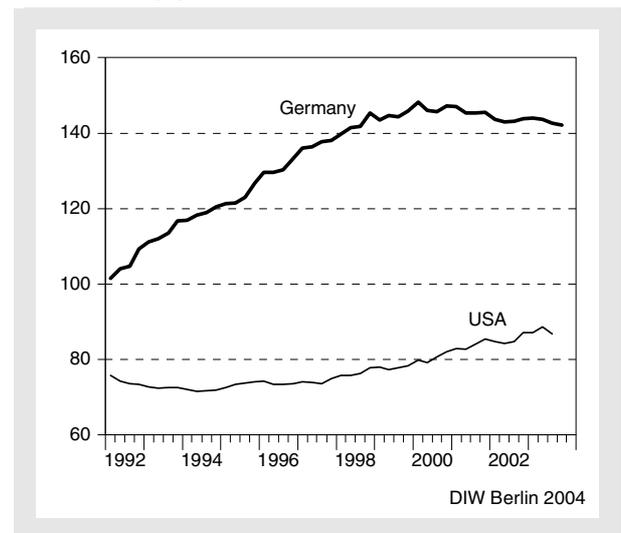
shares and equity investments has risen markedly (1992: 0.5%; 2002: 5%).

Basically, it is evident that the savings banks in particular, and also the cooperative banks, have concentrated on business with private customers, while the Landesbanken, and especially the larger commercial banks, are moving more towards financial market activities.

Adjustment processes in the German banking sector – progress with consolidation

Independently of the changes that will be made to the legal conditions under which the public law banks operate, the German banking sector has for years been undergoing a process of adjustment. First, banks are

Figure 1
Lending in Germany and the USA¹
1992 to 2003
Share of GDP (%)



¹ USA until 3rd quarter 2003.

Sources: IMF; International Financial Statistics on CD-ROM, May 2004; DIW Berlin calculations.

responding to the earnings problems that are particularly evident in weak phases of economic activity by reducing staff and closing banks and branches, and secondly, they are changing their business strategies in an attempt to increase their returns, which are low by international comparison. At the same time they are preparing to meet the challenges of the future, including the Basel II regulations.

For years the numbers of banks, branches and staff in the banking sector have been declining. However, there are differences between the three pillars of the system in the degree of consolidation:

- In the commercial banking sector the number of banks dropped markedly from 1992 to 2001, from 334 to 304. However, after that the trend changed and in 2002 the number rose to 354. This increase was due first to increased activities by foreign banks in Germany, and secondly, probably also to the expansion of direct banks.⁶ Despite the higher number of commercial banks the decline in employment has continued. In 2002 the sector was employing 203 650, 6% fewer than five years previously.
- The number of savings banks has fallen by just 28% in the last ten years (1992: 717 banks; 2002: 519).⁷ In 2002, despite efforts to merge the number employed was 278 800, only slightly below the corresponding figure for five years before. In contrast, between 1997 and 2002 the Landesbanken actually increased their staff by 7% to 41 850.
- Consolidation has progressed furthest within the cooperative segment of the banking sector. In the last ten years the number of cooperative banks fell by about 50%.⁸ At the same time a reduction in the number employed – albeit moderate – has been observable for years in this segment. In 2002 the cooperative banks were employing 176 200, about 3% fewer than five years previously.

As consolidation in the German banking sector progresses branch density is falling (1997: about one branch per 1300 inhabitants; 2002: 1600). However, it is still high in Germany by comparison with other European countries.⁹ Against this background gaps in sup-

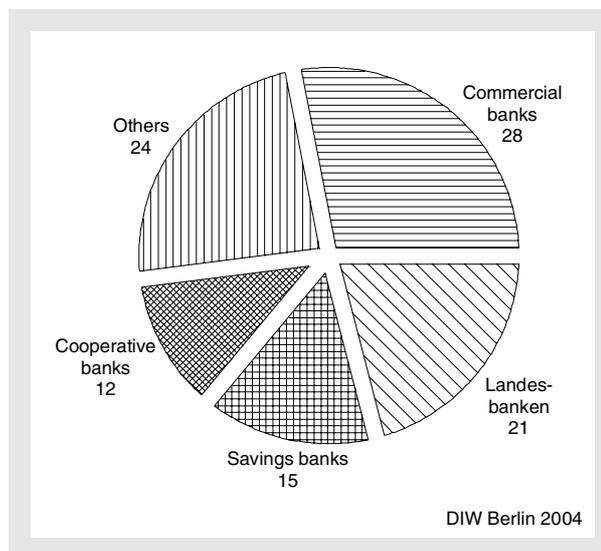
⁶ Direct banks do not have a branch network and transact their business mainly through the electronic media. The Bundesbank does not show the activities of direct banks separately in its statistics.

⁷ The number of savings bank branches fell by about 4000 from 1992 to 2002 (-20%). Arithmetically, therefore, there are more branches to one savings bank now than ten years ago.

⁸ From 1992 to 2002 the number of branches operated by cooperative banks fell much more slowly, at around 23%. Hence there are more branches to one cooperative bank now than ten years ago.

⁹ According to information from the ECB, in 2002, for example, there was one bank branch to 2325 inhabitants in France and one to 3225 in the Netherlands. Cf. European Central Bank: 'Structural Analysis of the EU Banking Sector, Year 2002', Frankfurt a.M. 2003.

Figure 2
Balance Sheet Total of Banks 2002
Shares as %



Sources: German Bundesbank, Bankenstatistik January 2004; DIW Berlin calculations.

ply that would justify the existence of public law banks are hard to find, especially as the growing spread of cash machines and the increase in electronic on-line banking are reducing the need for branch banking.

Big differences in earnings between the three groups of banks

Owing to their different legal forms the individual pillars of the banking sector have different means of acquiring equity capital. While the commercial banks can increase their subscribed capital by issuing shares on the financial market, the public law banks are dependent on allocations of funds by their authorities. The cooperative banks can increase their subscribed capital by issuing more cooperative shares. All three types can increase their capital by retaining earnings.

In the last ten years nominal equity capital in the entire banking sector has risen strongly, amounting to 291.7 billion euros at the end of 2002 (1992: 125.4 billion euros). Arithmetically that was an average annual rise of about 13%. Most recently, however, the annual growth rate has been far below that average, at about 6.5%.¹⁰ The development in the individual groups of banks has been uneven. The commercial banks roughly doubled their nominal equity capital between 1992 and 2002, while the public law banks increased theirs by a factor of 2.8 in the same period. That was mainly due to the fact that the Landesbanken's equity quadrupled.

Table 2

Return on Equity Capital Before Tax in Germany 1994 to 2002

As %

	1994	1995	1996	1997	1998	1999	2000	2001	2002	Average 1994 to 2002	Standard deviation
All groups of banks	12.9	14.1	13.3	12.8	19.3	11.2	9.3	6.4	4.4	11.5	4.4
Commercial banks	.	.	.	.	27.4	9.7	8.2	4.7	1.0	10.2	10.2
Big banks	12.5	10.2	11.8	7.4	39.5	6.2	6.3	5.0	-3.1	10.6	11.8
Regional banks and others	10.1	10.7	10.2	11.1	16.8	16.5	11.6	4.1	9.1	11.2	3.8
Landesbanken	7.8	8.9	8.7	10.9	11.7	10.6	8.1	4.8	2.4	8.2	3.0
Savings banks	19.2	22.6	21.4	19.4	17.8	15.2	13.4	9.2	8.2	16.3	5.1
Cooperative central banks	15.2	13.0	14.8	12.0	28.6	5.7	13.0	4.4	4.5	12.4	7.5
Credit cooperatives	17.4	19.5	17.7	14.9	12.8	10.7	8.6	7.5	9.2	13.1	4.0
Mortgage banks	13.4	16.5	16.4	15.9	17.8	15.6	5.9	12.2	9.1	13.7	4.0

Sources: German Bundesbank; DIW Berlin calculations.

The cooperative banks doubled their equity capital from 1992 to 2002; most recently the figure was 38.4 billion euros.

The return on equity capital (before tax) in the German banking sector has been declining for years (1997: 12.8%; 2002: 4.4%). Table 2 shows the return on equity capital by group of banks in recent years.

- For the big banks in particular, losses have pushed the return on equity capital into negative figures (2002: -3.1%). By contrast, the other commercial banks have been able to increase their return strongly and counter the general trend.
- In the public law segment the decline in equity capital return slowed down markedly in 2002, and despite the generally difficult environment the savings banks were able to achieve a clearly above-average return (8.2%), while the Landesbanken fell to far below the average (2.4%) of 2002.
- The return on equity capital for the cooperative banks was most recently 9.2%, i.e. far above the average for 2002. The cooperative central banks achieved about average returns.

Comparison of the return on equity capital between the public law segment and the commercial banks shows that in the past it has been above average in the public law segment as a whole (the sum of the return for the savings banks and the Landesbanken). Moreover, the volatility was relatively slight. It is also clear that on average the savings banks had a much higher return on capital for several years (1994 to 2002) than the other

banks. By contrast, the average profitability of the Landesbanken for the years 1994 to 2002 was clearly below that of the savings bank sector and the commercial sector. The return on equity capital for the Landesbanken has been relatively low for many years and deteriorated again in 2002; this is indicative of fundamental problems in their business.

Conclusion

This analysis of the German banking sector shows that in recent years all the groups have undergone consolidation. In this process it is mainly the rather small savings banks and cooperative banks that have continued the traditional banking business, while the big commercial banks and the Landesbanken have concentrated more on market transactions.

There are clear differences between the three pillars of the German banking sector with regard to return on equity capital. In the commercial sector the big banks in particular have suffered losses in recent years, while the other commercial banks have been able to increase their returns on capital strongly. The cooperative and savings banks segment has also had relatively high profitability, while the return on equity capital in the Landesbank sector is relatively low. The aggregate consideration of the public law segment does not permit statements on the prospects for individual banks.

In mid-2005 the conditions of the guarantees for the public law sector will be modified. This will involve higher costs for these banks. It is clear that the savings banks and Landesbanken are not prepared for this to the same extent. The savings banks are in a relatively good position.

Hella Engerer and Mechthild Schrooten

¹⁰ In the consolidated banking sector the share of subscribed equity capital in total equity was about 28% at the end of 2002. Published reserves have for years been far above subscribed equity capital. In its statistics the German Bundesbank shows subscribed equity capital and reserves separately, but only for the German banking sector as a whole, while in its data on the individual pillars of the system it aggregates the two figures, showing capital and reserves together.