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German Banks in the Global Economy: Global Pressures and Public Sector Banking

Jason A. Gorn

German banking is distinguished from neighboring European banking systems by the influence of its public sector banks. Nearly 50% of German banking is carried out by government owned state banks (*ländesbanken*) and regional savings banks (*sparkassen*) whose roots date from the 18th century. German banks play a particularly important role in the economy and exert more control over firms and corporations than do their American counterparts. German banks tend to be less profitable than foreign counterparts. German public banks were originally founded to foster local and regional business. However, the operations of German public sector banks now extend into all forms of international investment. German public banks are currently seeking new business models to increase profits as they are being forced to compete in the global financial market under liberal market practices dictated by the European Union. Turbulence in the global financial market precipitated by the U.S. sub-prime mortgage meltdown has severely impacted German public sector banks, precipitating a banking crisis that leaves German taxpayers exposed to staggering losses. These global financial pressures dictate the restructuring of the German financial system. This restructuring has forced a breaking point in the traditional German corporatist banking model and is associated with significant risks to the stability of the German banking system.

Preface

The increasing pressure of globalization on domestic economies has given rise to theories of economic convergence based on liberal market financial practices. Since the United States and its allies first approached global financial markets under the practices of Breton Woods, the die was cast toward a convergence of economic policies. Beginning with the establishment of the European Coal and Steel Community in 1951, which later evolved into the European Union, Europe has also pressed for increased free trade. Two main foundations, or models, of economic policy formed within the Western capitalist system. The first economic foundation, or model, is the liberal free market model defined by open markets and unguided prices. These markets are exemplified by the American and British models and are characterized by an emphasis on capital markets. The second economic model is the “coordinated” or “communitarian” model that is characterized by higher levels of bank participation in firms and more domestically oriented financial policies. Germany follows this model of a coordinated market economy, particularly as it relates to its banking system. Today, Germany finds itself at a crossroads in economic policy. As global pressures knock at the door of the German market, what are the needs and possibilities for German economic readjustment?

The German economic system is sometimes referred to as brittle or ailing. However, the German system has adapted in the past to the changes and pressures presented by the international economy. The German economy recently absorbed some serious blows stemming from the U.S. sub-prime mortgage meltdown that cracked the foundations of its three pillar banking structure. The resulting financial crisis caused the

insolvency of several publically controlled state “landebanks” (*landesbanken*) and a cooperative bank. These threats to German banks have resulted in increased calls to reform the German banking system. However, the question as to how much Germany stands to gain or lose by reforming its financial and banking system is complex.

I have employed a multi-level institutionalist approach in attempting to understand the many structural and institutional problems currently facing the German financial system. This approach includes some assessment of the German domestic socio-economic environment in which the German banks operate, as well as the evolving European socio-economic environment, and the international (or global) economic environment. The global financial environment is increasingly affecting all components of the German financial system, despite the regional or at least national focus that much of the German banking system has historically maintained.

The German financial system is based on a multi-tiered banking structure, referred to as a three pillared banking system or structure. In order to assess Germany’s place within the international financial system and to allow for an understanding based on a comparison to other national financial systems, it is necessary to describe the components of the German three pillared banking system. An understanding of the likely evolution and future direction of German banking is enhanced by an historical understanding of how this system evolved, along with some relevant examples of this process and an explanation of the banking structure itself. Recent stresses on the German banking system created by the presently evolving international financial crisis precipitated by the U.S. sub-prime mortgage investment bubble will be examined for

insight into how the German banking system is faring under this latest strain, which was brought on by the convergence of financial markets in a global economy.

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Chapter One: Introduction

Since the dawn of the 20th century, with the exception of the years immediately after Word Wars I and II, the German economy has maintained a central position in the international market as the most vibrant economy in Europe. Germany is the third largest economy in the world. Thirty-five and a half percent of Germany's GDP came from exports in 2002.¹ Germany was second in world trade to the U.S. in 2000, accounting for 9.5 % of world exports.² Statistics such as these that indicate the economic might of the present German export machine appear incongruent with the analyses of some academics and business pundits who ruminate over the perceived long-term competitive weaknesses of Germany in the global economy. The concern for Germany's competitiveness relates to the presence of subsidies in some sectors of the German economy with a degree of protectionism inherent in Germany's coordinated market economy. Subsidies and pseudo-protectionist practices persist in Germany's coordinated market economy despite an apparent economic openness that relates to the free trade needed for exports.

Protectionism and subsidies are significant factors in the German banking industry that distort competition in banking. German savings banks (*sparkassen*) and their allied head institutions, the state banks (*landesbanken*), are semi-public institutions that "can compete with commercial banks under privileged conditions, thereby driving down the rates of return. If these...institutions fail, the

¹ Siebert H, p 5

² Siebert H, p 2

municipalities and the länder [states] will pick up the bill.”³ As semi-public institutions, these banks are also protected against corporate takeovers since they are not for sale. This protectionism limits consolidation in the German banking industry and distorts competition. “This means that, in an international comparison, German banks are not efficient.”⁴ Furthermore, this market distortion in the banking sector pervades into virtually all sectors of the German economy due to the capacity of banks to uniquely influence industry and to coordinate the activities of industries within the German economy to a much greater degree than in most other countries. The influence of banks on firms in Germany occurs because of German corporatist financial policy. The German corporatist structure relies much more on banks for financing rather than the securities markets that dominate the U.S. and British systems. These policies also give the banks considerable influence in the governance of German firms and banks often have a voice in the strategic plans of these firms as well. Ironically, this German financial strategy was not so much the result of reform in response to domestic pressures in Germany, but resulted from changes in response to the international economy and was for years perceived as providing a competitive advantage with some protectionist features.

German corporatist practices are centered on the German mentality of shareholders as company stakeholders rather than outsider investors. The shares of German companies, particularly the voting shares, are not widely distributed compared to the broad distribution of company stocks held by mutual funds,

³ Siebert H, p 223

⁴ Siebert H, p 223

pension funds, insurance companies, private institutions, and individuals in the United States or in the United Kingdom.⁵ German shareholder voting blocks and company board seats are much more tightly held and include very strong representation by the banks allied with the company, in addition to the possible holdings of the company's founding families, other German companies, and in some cases the state. These German shareholders typically have a long-term stake in the company whose shares they hold. These German investor-stakeholders are generally seen as risk adverse investors that are interested in the long-term stability of the corporation. These investors are, to a considerable degree, also concerned with the social implications of risky organizational change.⁶

The classic role of the banks under German “corporatist” structure can be seen in the example of Daimler-Benz (prior to its acquisition, and subsequent divestment, of the U.S. Chrysler Corporation). Daimler-Benz, like most German corporations, had a “lesser reliance on capital markets and outside investors and a stronger reliance on large inside investors and financial institutions to achieve efficiency...”⁷ Instead of stock market investors, German firms like Daimler receive strong support and investment from banks. German banks are very influential in the running of German companies. The German banking system has an “extraordinarily intimate relationship with the big industrial groups....[that] allows the banks to act

⁵ Brecht M and Mayer C, p 29

⁶ Luo Y, p 38

⁷ Luo Y, p 42

as brokers, investment analysts, dealers and much else besides.”⁸ Representatives of the banks sit on the boards and commissions of the German companies in which they invest. The corporate influence of the banks is further enhanced by the fact that the banks are able to vote by proxy on behalf of shares deposited with them by clients. Ernst-Jürgen Horn analyzed a sampling of German corporations and found that the banks themselves owned on average more than 25% of shares in the sampled companies. The banks also controlled through proxy votes more than 25% of the shareholder votes in 41 of the sampled corporations and over 50% of the votes in 30 of the corporations sampled.⁹ For example, in the late 1980s and the 1990s banks were the top 5 shareholders in Daimler-Benz and controlled 78.39% of the company’s voting stock.¹⁰ Deutsche Bank in particular had deep and historic ties to Daimler-Benz. Deutsche Bank’s investment consisted of approximately 28% of Daimler’s stock in 1993 and this bank wielded incredible power in managing Daimler-Benz.¹¹

This dominant role of banks is a central part of traditional German corporatist policy. The role of banks means that external capital markets exert relatively little influence on German corporations. Purported advantages to this corporatist system include less pressure for corporations to pursue short term outlooks aimed at maximizing share price, thereby allowing a greater emphasis on a corporation’s long-term strategic interests. These advantages occur because

⁸ Horn E-J, p 55

⁹ Horn E-J, p 56

¹⁰Logue DE and Seward JK, p 90

¹¹Logue DE and Seward JK, p 90

German banks see themselves as long-term stakeholders in the company rather than speculators in the company's stock. The fact that the shares of German companies are concentrated in fewer hands than the shares of typical U.S. or U.K. companies also discourages corporate takeovers.¹²

Germany's strong corporatist policies have more recently come under pressure in an increasingly global economy. While the pressures of an international economy have been prevalent since the end of the Second World War, the 21st century presents a new mix of problems and an enlarging cast of competitors. Globalization pressures beyond product competition have permeated into German economic structures. Even existing protectionist practices in the German financial market did not prevent the current financial crisis caused by U.S. sub-prime mortgage securities from wreaking havoc on some German banks, resulting in the financial failure of two German *landesbanks* and a cooperative bank, as well as forcing other German banks to write down billions of dollars in losses. Four German *landesbanken* are estimated to have a combined exposure to risky assets of 80 billion euros (117.2 billion dollars), placing German taxpayers in the states that own these banks at considerable financial risk.¹³ The effects of the American sub-prime mortgage crisis and other economic pressures, such as the international competition for financial services, provide case studies that are useful in assessing whether or not Germany can compete and thrive by continuing to employ domestically centered corporatist practices that decrease the efficiency of the

¹² Gorn JA, p 41-42

¹³ "Landesbanks' subprime exposure 80 bln eur-report", *Reuters UK*, 1/26/2008

German financial sector. The sub-prime mortgage crisis certainly shows that German corporatist banking practices are impacted by the tide of global financial forces.

Some might argue that instead of indicating a need for change, perhaps these global financial pressures indicate a continued need for Germany's coordinated market economy, which has the advantage of fostering collective business action in order to assure social and economic stability, even if this advantage occurs at the cost of ongoing subsidy and protectionism in the financial system. Answering this question requires an analysis of the structure and history of the German banking system and the different functions that each of its three main types (or "pillars") of banks were meant to serve. This background on the German banking system will facilitate an examination of some of the pressures that the globalized economy is exerting on the German financial system.

The German financial system has not been as static as one might think. Historically, Germany has made changes through incremental adjustments to its financial system and economic policies as the result of economic pressures. The line between American free market practices and German corporatist policy was more defined forty years ago. The convergence of international markets has already pushed the two systems closer together. German financial institutions and corporations have had an increased presence in the Anglo-American securities sector in recent years. Some in Germany point to this as a source of trouble, and this argument has increased in credibility as the result of the present crisis caused by

securitized sub-prime U.S. mortgages. There has also been a relative weakening in the role of banks in dictating policy to German industry. These changes are the observable results of market convergence.

The existing convergence of German financial practices toward the Anglo-American model occurred because of the need to conform to global practices in order to compete in a global market. This has, to a degree, changed how German institutions operate. The once “cozy” and orderly state and national banking structures that acted as universal banks in Germany now find that, “Ever more efficient capital markets and specialized non-bank financial institutions have allegedly eroded the once strong role of traditional universal banks. Apparently, German banks are suffering from the same fate as their peers around the world.”¹⁴ The landscape of the international financial market has changed; Germany stands to lose if it fails to change with the times. The old German market that could seemingly allow the world to change around it with little impact on the economic policies of Germany is gone. While global competition is one thing, Andreas Hackethal describes the other side of the coin, namely the susceptibility of Germany and other world economies to an international economic recession and financial crises. Such international crises will “show whether the majority of German banks will eventually be able to cope with the growing challenges by concentrating on core competencies, improving efficiency and possibly by inter-group cooperation and

¹⁴Hackethal A, p 71

consolidation, or whether the German banking industry is indeed in a state of terminal decline.”¹⁵

The old phrase, “When the United States sneezes, the whole world catches cold” threatens to prove true again with the American sub-prime mortgage crisis and resulting U.S. recession wrecking havoc on the world’s financial system, including the German banks. According to Mark Lander in the *New York Times*, “This is not the first housing downturn to cross borders, but its reverberations have been amplified by the integration of financial markets. When faulty American mortgages end up on the books of European banks, the problems of the United States aggravate the world’s problems.”¹⁶ At present, despite some changes, Germany still maintains many of its corporatist business and financial practices and its distinct three pillar banking system. This banking structure remains at the center of the German economy and differs from the banking systems found in common free market models.¹⁷ The following chapters describe the landscape of Germany’s banking system, as well as the clouds that hang over these German institutions.

¹⁵ Hackethal A, p 101

¹⁶ Lander M, *New York Times*, 4/14/2008

¹⁷ Deeg R, p xi

Chapter Two: The Structure of the German Banking System

The Three Pillar System

The German banking system is allocated into three pillars. Each pillar is comprised of many individual credit institutions. The three pillars consist of: 1) public sector banks, 2) cooperative banks, and 3) the commercial banks. The banks that make up each of these three pillars differ in their goals and ownership.

The First Pillar: Public Sector Banks

The first pillar is largely based on public sector savings banks (*sparkassen* and their regional big brothers, the *landesbanken*). This pillar has its origins in the 18th century. The German Johann Joachim Becher, along with the Englishman Daniel Defoe and the Frenchman Hugues Delestre, called on the government to supply a banking system that would allow everyone, including the poorer classes, to deposit their money in a bank in hopes of acquiring interest. The poorer classes were the targets of this effort since the existing private banks were not interested in dealing with the poor, working class. These people were forced to save their cash under floorboards and in mattresses, which kept their money out of the investment market

where their saving could be put to work for the benefit of the economy. The first savings banks of the time “...were simple, usually private institutions that collected savings deposits and invested them, primarily in state bonds and, to a lesser extent, in loans to local governments and individuals. After the post-Napoleonic political reconstruction of the German states, local governments began to use their recently expanded authority to bring existing private savings banks under their administration, or to create new ones.”¹⁸ This practice began as early as 1778 with the founding of the first public savings bank in Hamburg.¹⁹ Rapid and widespread growth followed as several German states promoted similar banks, supposedly “to prevent the growth of an urban, industrial proletariat through support for production in agriculture and small craft firms.”²⁰

Through government support, the number of these savings banks grew, and merchants and craftsmen of all sorts benefited as they began to receive more local lending from these banks. “By 1836, 280 savings banks had already been founded, the vast majority of which belonged to the municipalities either directly, or indirectly through the local government groups.”²¹ State regulation influenced the savings banks to invest in sectors such as low-risk mortgage loans or state securities and this left little for small-business investment. This regulation caused a “vacuum” in small-business lending that eventually brought about the rise of the cooperative banks, the second pillar of the German banking system, to facilitate loans to

¹⁸ Deeg R, p 34

¹⁹ Sinn H-W, p 17

²⁰ Deeg R, p 34

²¹ Sinn, H-W, p 17

tradesmen and small businessmen. The restrictive lending policies of the savings banks, which required collateral in exchange for credit, initially blunted their role in facilitating German industrialization.²² Savings banks did not take on the role of *hausbanken*, in which the banks build a long-term financial relationship with firms by acting as the premier lender and stakeholder for a business (or firm), until Germany was unified under Bismarck in 1871. Berlin based savings banks pioneered the role of German banks as *hausbanken* for industry. The resulting economic and entrepreneurial boom brought a new transformation in joint stock bank foundings.²³ As savings banks took on the role of *hausbanken*, banking and industry became tied together, with banks providing “continuous financial relations with large firms, providing short- and long-term capital to industry, primarily through current account credits....From the 1880s onward, the Berlin banks continued to expand their dominant position in industrial finance.”²⁴ Thus, German capitalism was driven by its banks as much as it was driven by its industry.

German savings banks became increasingly influential in the following decades. By the turn of the 20th century, the German savings bank sector had slowly transformed itself into a universal banking system; but, this advance required the savings banks to overcome challenges that threatened their long-term survival during the last two decades of the 19th century. First, the savings banks were limited in creating additional lending methods through the lending of capital by float

²² Deeg R, p 34

²³ Deeg R, p 35

²⁴ Deeg R, p 35

mechanisms, which limited their expansion at the time. Float mechanisms are cashless transfer payments that allow easier transfer of funds. Because banks in Germany could not do this at the time, they could not expand into larger markets. The second challenge for the German savings banks in the last two decades of the 19th century was that German industry was outgrowing the capacity of the savings banks to finance and invest in German firms. The cooperative banks faced this challenge as well. The expanding capital needs of German middle and large-scale industry put pressures on the banks to become bigger. To further counter these pressures, the German savings banks consolidated by forming regional associations in order to provide some liquidity equalization among themselves. In 1884, several regional associations joined together to form the *Deutscher Sparkassenverband*. Through this association, the banks lobbied the government on the needs of the savings banks, furthering the ties between the savings banks and the states.²⁵ Through the remainder of the 19th century and into the 20th century, the German savings banks remedied the competitive demands placed on them by organizing.

From 1907 until the Depression and the banking crisis of 1931, the savings bank associations expanded their role into typical commercial banking activities. After a severe shortage of capital plagued the German economy in 1907, the savings banks were able to secure Imperial legislation in 1908 that finally allowed them to offer checking accounts and cashless transfers, activities that previously were only

²⁵ Deeg R, p 35-36

allowed to the commercial banks.²⁶ The liberalization of restrictions on the savings banks by the state was in part due to the extremely difficult banking circumstances of the time. Worse times lay ahead for the banks. Hyperinflation in the 1920's, followed by the banking crisis of 1931, increased the stresses on the bank sector. During this time there was a dramatic consolidation of the traditional commercial banks, the third pillar of the German banking system. These large commercial banks expanded their operations into the provinces, threatening the locally oriented business of the savings and cooperative banks. The savings banks responded by increasing the strength of their associations and by lobbying the *länder* (states) to allow them to further expand into areas of commercial banking. The commercial and cooperative banks joined together to try to block the savings banks from expanding their banking activities through a political campaign. With the help of their state (*länder*) benefactors, the public savings banks again prevailed in their effort to liberalize governmental restrictions on their commercial banking activities. The *länder* granted the savings banks further entry into the commercial banking market by allowing the savings banks to make larger industrial investments in German middle-sized firms (the *middlestand*).²⁷

The savings banks were granted independent legal and organizational status in 1931 to separate them politically from their local governments and give them more control over their own business practices. This policy protected the savings banks from abuse by their local governments, as defaults on extensive loans made

²⁶ Deeg R, p 37, 39

²⁷ Deeg R, p 40-42

by savings banks to their local governments had played a big role in the insolvency of savings banks in the bank crisis of 1931.²⁸ At the same time, however, local public ownership and liability for deposits was maintained. An “obligation guarantee” (*Gewährträgerhaftung*) was enacted whereby the public entity that founded a savings bank (a municipality or state) was made liable in the event of a default by their savings bank. This guarantee protected third party lenders to the savings banks and, in effect, served as a sort of subsidy that allowed these banks to obtain third party capital at lower rates than other banks because the capital was guaranteed by a government entity. Subsequently, a “maintenance obligation” (*Anstaltslast*) was also placed on the public entity that founded the savings bank as well. This required the state entity to infuse capital into the savings bank if the bank was threatened with insolvency.²⁹ In practice, over the years, local governments have not often had to make good on this maintenance obligation. Given the constraints of government budgets and a desire to minimize the stigma that an insolvent bank would have on its region, banks threatened with failure are typically pushed into mergers with healthy institutions to avoid government bailouts.³⁰ By the 1930s, the German savings banks had matured into their “traditional role” as universal banks.³¹

Following World War II, bank competition between the three German banking groups (pillars) continued with the commercial banks competing for the

²⁸ Deeg R, p 43

²⁹ Hackethal A, p 78

³⁰ Hackethal A, p 78

³¹ Deeg R, p 37

business of consumers and mittelstand firms, becoming more like the regional and local savings banks, while the savings banks continued to compete in broad areas of commercial banking. Today this intergroup competition continues, with the *landesbanken* (regional state banks) increasingly providing commercial and investment banking services to larger domestic and foreign clients. The public *landesbanken* and local savings banks (*sparkassen*) continue to serve as hausbanks for their respective states and municipalities. They do not compete for consumer services outside of their regions. Nevertheless, they remain universal banks and increasingly provide all banking services, with extensive international investments as well. Landesbank investments also include securities, as is evidenced by the U.S. sub-prime mortgage securities held by *landesbanken* that resulted in multi-billion euro losses in the present international financial crisis. German banking system adjustments have been incremental; the platform and design of this system has been intact since the savings banks were reconstructed after the Second World War.

Today, the German public sector banking pillar is divided into two tiers. The first tier of the public sector banks is divided into 13 State banks (*landesbanken*) and 534 Savings banks (*sparkassen*). The second tier is comprised of the development banks (*landesbausparkassen*). These two tiers comprise one pillar because they both operate on a regional level. The two tiers combined comprise nearly half of the banking market in Germany.³² The *sparkassen* are organized by their respective state (*land*) and are “essentially the base of the *landesbanks*. It [the *sparkassen*]

³² Brunner A et al, p 2

collects the savings which the ländesbanks can then use to finance international risk.”³³. However, the state governments (länder) are the major stakeholders in their regional ländesbanks and the “mandate of the sparkassen and ländesbanken is to foster the economic development of their regions by following viable business plans. As part of this mandate, the sparkassen and ländesbanken are expected to subsidize local public goods....While the sparkassen and ländesbanken need not maximize profits, retained earnings are intended as their main source for funding new business.”³⁴ Although the ländesbanken are public entities of the state governments, the ländesbanken operate much like private banks in the sense that they operate in the same financial sectors as private banks. Legally, ländesbanken are stock companies that are owned by the regional savings banks (sparkassen) and the state in which they are located. For example, the ländesbank West LB, which has been ranked as the 5th largest German bank, is 42% owned by the State of North Rhine-Westphalia, 17% by the Rhenish savings bank (sparkasse) and 17% by the Westphalian savings bank (sparkasse), with additional ownership held by regional authorities.³⁵

Until recently, the liabilities from a landesbank’s investments were backed and guaranteed by the state in which they are located according to the specific statutes mentioned above (the *Gewährträgerhaftung* and *Anstaltslast* statutes). This

³³ Sinn H-W, P 17

³⁴ Brunner A et al, p 3

³⁵ Siebert H, p 221

insured that they were “endowed with an unlimited public warranty for survival.”³⁶ Because they are given state support, these ländesbanken investments are given AAA ratings. While most of the services are geared toward financing, ländesbanken provide several services to the state, acting as hausbanks for their state and local government authorities. This involves providing loans to the state. Ländesbanken are also clearing banks that process the cashless payment transactions between the savings banks (sparkassen).³⁷ The advantages that ländesbanken enjoyed as public banks with unlimited state guarantees helped them to extend their investments beyond their respective states and helped them to expand into global investments.

The European Commission challenged the German public sector bank guarantees enjoyed by the sparkassen and ländesbanken after the European Banking Federation filed a formal complaint in 1999 claiming that these guarantees constituted anti-competitive state aid.³⁸ In 2001, the European Commission and the German authorities agreed that the public sector guarantees for the sparkassen and ländesbanken would be abolished after a transition period that allowed guarantees for investment obligations made up until July 18, 2005 and maturing before the end of 2015. No public guarantees apply for obligations entered into after July 18, 2005. This does not mean that the German public sector banks no longer enjoy any benefits from public support, however. The public remains the ultimate owner of the ländesbanken and sparkassen and public support would be forthcoming in the

³⁶ Sinn H-W, p 1

³⁷ Sinn H-W, p 10-11

³⁸ Grossman E, *JCMS*, v 44(2), p 338

event of a bank crisis. This implicit public backing has proved to be true in the current crisis precipitated by the U.S. sub-prime mortgage securities meltdown, as demonstrated by a publically underwritten bailout of the SachsenLB ländesbank by the state of Saxony together with aid from the region's other public banks (i.e. sparkassen).³⁹ The sparkassen have to stand behind the ländesbanken due to a joint institutional protection scheme. Also, the agreement to eliminate direct guarantees on the investments of public banks still allows public guarantees if they are remunerated at market rates.⁴⁰ The remaining state-backed protections afforded to the German public banks will continue to provide a security safety net to boost the debt ratings on their investments. Higher debt ratings resulting from these *de facto* guarantees will likely continue to provide public banks with access to the cheaper capital that provides them with a continued competitive advantage over private banks. This advantage is only partially eliminated by the phasing out of the direct public guarantees.

The second tier of the first pillar consists of the “development banks” or ländesbausparkassen, which are specialized public banks on the federal level, as opposed to the municipal or state level. These banks complement the regional ländesbanken and sparkassen. The original purpose of these development banks was to fund the reconstruction of the German economy following the Second World War. The most important of these development banks is the Kreditanstalt für Wiederaufbau (KfW), whose early tasks included the distribution of funds provided

³⁹ Dougherty C, *New York Times*, 2/28/08

⁴⁰ Brunner A et al, p 24

by the Marshall Plan.⁴¹ Subsequently, this sector dealt with sustainable growth policy and helped finance German reunification. These are not typical banks, as “they do not accept deposits from retail clients.”⁴² The largest institutions were the KfW and the *Deutsche Ausgleichsbank* (DA) that merged in 2003.⁴³ The new KfW, like the predecessor KfW development bank, is owned by the German Federal Government, which uses it to help implement government policy. For example, the KfW is charged with organizing Germany’s international development aid program and has worked on securitization with other banks. These development banks are highly specialized and rarely step out of their assigned roles. In 2003, for example, “Germany’s five biggest banks ... confirmed plans to pool their loans in an attempt to tidy up their battered balance sheets....In an unusual deal, Deutsche Bank, HypoVereinsbank, Dresdner Bank, Commerzbank and DZ Bank are forming a joint venture with state-owned Kreditanstalt für Wiederaufbau [KfW].....the venture will hold a fund....this fund will then be chopped into pieces and sold on to investors as bonds, a process known as securitisation.”⁴⁴ These banks directly link the Federal Government to the banking system. In total there are “11 Länder building societies (*Ländesbausparkassen*), 21 public insurance companies, and various leasing and factoring companies.”⁴⁵

⁴¹ Sinn H-W, p 19

⁴² Brunner A et al, p 4

⁴³ Brunner A et al, p 4

⁴⁴ “German Banks Pool their Loans”, *BBC News*, 4/23/2003.

⁴⁵ Brunner A et al, p 4

The Second Pillar: The Cooperative Bank Sector

The second pillar of the German banking system is the cooperative sector (*Volksbanken* or *Raiffeisenbanken* and *Spar- und Dahrlehenskassen*). This second pillar is also comprised of two tiers. Although the cooperative banks usually operate on a regional basis, they are not compelled to do so and they are often the main competitors of the sparkassen in certain small towns or rural areas.⁴⁶ They do not receive guarantees from the government; nor are the cooperative banks split amongst the German states. The cooperative banks were founded in the 19th century as “self help organizations for craftsmen, workers, and farmers....most cooperative banks concentrate (voluntarily) on their respective local markets and do not compete with one another, but some...are now offering services to everyone across the country.”⁴⁷ These banks were developed because, “In the early nineteenth century German craftsmen and farmers suffered from dire financial constraints because the existing private bankers were largely focusing on trade finance, private commercial banks were mainly granting loans to the manufacturing and transportation industry, and savings banks had to request collateral in exchange for

⁴⁶ Brunner A et al, p 4

⁴⁷ Brunner A et al, p 5

credit.”⁴⁸ The founder of the cooperative banking system was Herman Schulze-Delitzsch, who wanted to promote a banking system that could assist the craft sector of the economy without adopting socialist practices or resorting to state protection, while at the same time protecting the craft sector from extinction at the hands of large scale capitalism.⁴⁹ Schulze-Delitzsch created the first credit cooperative in 1852. The idea spread quickly around Germany and by 1859 there were 80 commercial credit cooperatives consisting of 18,000 members in total.⁵⁰ The first banks that formed were local banks whose capital was generated by members who pooled their money together and borrowed from the bank when necessary. The banks were at first often operated on a part-time, honorary basis.⁵¹

The cooperative banking system evolved over the next few decades. Like the *ländesbanken*, the cooperative banks also suffered from the credit crisis that occurred around the turn of the 20th century and had difficulty supplying their members with the credit that they needed. Two factors transformed and institutionalized the cooperative banking system. The first factor was the passing of the Imperial Cooperative Law in 1889, which expanded the roles of the cooperative banks by allowing them to offer short-term current account and acceptance credits to their members, like the commercial banks offered to large firms. This allowed the cooperative banks to operate on the level of formally organized universal banks rather than simple lending institutions. The second boost that these banks received

⁴⁸ Hackethal A, p 83

⁴⁹ Deeg R, p 34

⁵⁰ Deeg R, p 34

⁵¹ Deeg R, p 34

came from the Prussian state government. In 1895, the Prussian government sought to protect its farming and craft industry by forming an independent bank organization to act as a central bank for the cooperative banks. This bank structure was known as the *Preussenkasse*. It was capitalized by the Prussian government and operated under public law.⁵² However, many of the cooperative banks refused to work with the *Preussenkasse* believing that this amounted to accepting state aid and compromised the principle of self-reliance on which these cooperatives were founded.⁵³ The German cooperative banks grew throughout the beginning of the 20th century until the hyperinflation of the early 1920s and the bank collapses of 1931. The hyperinflation period turned out to have a silver lining for the cooperative banks that survived. When the hyperinflation wiped out the equity of the cooperatives, the state acted through the *Preussenkasse* to stabilize the still surviving cooperatives with an infusion of state supplied capital. The cooperatives were given a financial position in the *Preussenkasse*. Giving the cooperatives an interest in the *Preussenkasse* allowed cooperatives that had previously been opposed to accepting state aid to compromise by accepting aid through the *Preussenkasse*.⁵⁴ The acceptance of the *Preussenkasse* as a central bank for the cooperatives strengthened the status of the cooperatives as banking institutions. With the help of the *Preussenkasse*, the cooperative banks fared reasonably well during the 1931 banking crisis. Subsequently, the *Preussenkasse* was reorganized with the national government taking over the major portion of governmental

⁵² Deeg R, p 36

⁵³ Deeg R, p 36

⁵⁴ Deeg R, p 40

ownership in the Preussenkasse from the Prussian state government and renaming it the *Deutschlandkasse*.⁵⁵ In the years that followed the banking crisis, the cooperatives were able to regain their equity capital due in large part to their role as intermediaries in war finance.⁵⁶

Following World War II, Germany began to promote market mechanisms in the banking sector as part of the post-war German social economy policy. The resulting expansion of market mechanisms in the banking sector changed some of the traditional banking practices. More recently, EU involvement has also expedited this process. Two big factors changed the entire banking system. “First, in 1957 the new central bank—the Bundesbank—was established. Second, the deutschmark was made freely convertible and capital controls were eliminated, thereby opening the door for the gradual integration of domestic and international capital markets.”⁵⁷ These reforms transformed the system and the role that the cooperative banks played. The noticeable shift in German banking toward a more Keynesian policy shifted further in 1967 with the adoption of the Stability and Growth Promotion Law (*Stabilitätsgesetz*)⁵⁸. The Social Democrats that came into power around this time followed this law with other measures to ensure competitiveness in German industry and the banking sector.

⁵⁵ Deeg R, p 44

⁵⁶ Deeg R, p 44

⁵⁷ Deeg R, p 47

⁵⁸ Deeg R, p 49

These changes benefited the cooperative banks the most. “With their vast network of banks and branches, the cooperatives were well positioned to capture the fast growing consumer banking business.”⁵⁹ Internally, a shift was taking place; the nature of the cooperative banks was transforming in the midst of all the competitive reforms. Georg Draheim, the President of the Deutsche Grenossenschaftskasse, or DG Kass, (the successor of the Deutschlandkasse) argued that the cooperative banks served dual purposes. The first purpose was as “business enterprises,” but the second purpose was as “member communities”⁶⁰ whereby the goal was to provide mutual aid to its members. This system meant that the cooperatives conformed to market-oriented management, but that profit maximization was not essential since this might run contrary to their second goal as cooperatives working to aid their members. Thus, the cooperative banks fit well with the political philosophy of the social economy that prevailed in Germany in the late 1960s. As the result, “the cooperative banks were the success story of the post-1967 era. In less than two decades, they doubled their market share of total bank business, while their membership grew almost exponentially.”⁶¹ Following the 1960’s reforms, the 1970’s brought further change. Until the 1970’s, only members who qualified could receive loans from cooperatives. In 1972, however, the German credit cooperatives organized into the German Association of Volks- and Raiffeisenbanks. This reorganization of the cooperatives represented a partial emulation of the German Association of Savings Banks. After this reorganization, the

⁵⁹ Deeg R, p 54

⁶⁰ Deeg R, p 54

⁶¹ Deeg R, p 64

cooperative banks allowed non-members to receive loans from their institutions. During the 1970s, the role of cooperatives as viable market-oriented businesses, as well as mutual aid societies, was reflected in the mergers of hundreds of cooperatives as competition with the other banking pillars forced the cooperatives to improve cost-efficiency through greater size.⁶² In 2003 there were approximately 1,500 cooperative banks servicing 15 million members⁶³ While the roles of the cooperative bank pillar have greatly expanded, along with its growing market share that includes 13% of total domestic banking assets⁶⁴, the 15 million member-owners of the cooperatives who are also the depositors of these banks can no longer closely monitor the performance of this pillar. The elected representatives of bank members select a supervisory board; however, this board may have little discipline over management.⁶⁵ This is because of many factors, one being that because shares in ownership of a cooperative bank are limited, an outsider group cannot amass enough shares to mount a takeover attempt of a poorly run cooperative bank. Thus, cooperatives are frequently plagued by slow growth. Smaller local banks are particularly susceptible to this problem because of the lack of diversification in their investment portfolios. This problem is somewhat balanced by the presence of a cooperative bank association that can perform some supervisory functions and

⁶² Deeg R, p 54

⁶³ Brunner A et al, p 5

⁶⁴ Hackethal A, p 85

⁶⁵ Brunner A et al, p 5

exert pressure on the management of a poorly performing bank to accept a takeover or merger.⁶⁶

The Third Pillar: The Commercial Banks

The third and final pillar consists of the commercial banks. These banks were first established in the middle of the 19th Century. Their establishment was in response to the limited ability of private bankers at the time to satisfying the investment needs of the rapidly expanding industrial sector. Before the establishment of the German commerce banks, “Industrial finance came largely through personal and familial relations.”⁶⁷ Investment was further complicated because of the political fragmentation of Germany in the first half of the 19th century that also fragmented German capital markets. To meet the capital demands of industry, the big private bankers began to form consortia in the form of joint-stock credit banks. The great banks of Berlin, in particular, fostered the development of industry by forming relationships with industrial firms, typical of the German bank-firm relationships that have continued to be the hallmark of German capitalism. The big three German commercial banks, the Dresdner Bank (1872), Deutsche Bank (1870) and Commerzbank (1870) all emerged in the 1870’s. By 1931, there were

⁶⁶ Brunner A et al, p 5

⁶⁷ Deeg R, p 33

eight major German joint stock commercial banks, based in Berlin. Only the “big three” commercial banks emerged from the German banking crisis of 1931. The bank crisis of 1931 started with a run on the 4th largest commercial bank at the time, the Danatbank, which failed. During the 1931 bank crisis, the state bailed out and merged numerous other banks. Following the crisis, only three major commercial banks remained, the Deutsche Bank, Commerzbank and Dresdner Bank, and only the Deutsche bank escaped rescue through majority state ownership.⁶⁸

The second interruption in the commercial banking sector was the disbanding of the commercial banks into 30 independent regional banks by the Allies after Second World War in order to prevent a concentration of German economic power. As the Allies became preoccupied with Russia during the cold war, and an economically strong Germany became an important bulwark in the Cold War, the banks were gradually allowed to reconsolidate. The reconsolidation of the three German commercial banks was completed by 1957.⁶⁹ Today’s commercial banks function in a similar fashion to the way they did after their founding, “they still act as *Hausbanks* to Germany’s large industrial corporations and form the core of Germany’s private commercial banking group.”⁷⁰ This sector continues to be dominated by its largest banks, now known as the “big four,” after the addition of the HypoVereinsbank to the “big three.” The “big four” consists of Deutsche Bank, HypoVereinsbank, Dresdner Bank, and Commerzbank. These four large commercial

⁶⁸ Deeg R, p 43

⁶⁹ Deeg R, p 46

⁷⁰ Hackethal A, p 75

banks control around two thirds of the sector's business.⁷¹ "Although all four banks belong among the largest commercial banking institutions in the world, their combined market share in German non-bank deposits was less than 14 percent at the end of 2000. They operate 2,973 branches compared to the 16,892 branches of the savings bank group and the 15,332 branches of the cooperative banking group."⁷² Deutsche Bank, for example, is an internationally known global investor; however, Deutsche Bank has a total market share in Germany of only 5.4 percent.⁷³ The Commercial banks are at a competitive disadvantage with the ländesbanken due to their lack of public sector guarantees. This difference potentially leads to a higher cost for commercial banks when they have to raise capital in the capital markets or attract depositors since investors in the commercial banks do not enjoy the state guarantees on their commercial bank investments and deposits that the ländesbanken receive. While at a potential competitive disadvantage with their ländesbank rivals, commercial banks manage risk by operating a voluntary deposit protection system administered by the commercial bankers association. This "safety net" helps the commercial banks to compete with the German public banks and cooperatives for deposits.⁷⁴ German commercial banks are highly dependant on retail customers. To compete for customers, the four large commercial banks in Germany provide incentives to customers, such as allowing common ATM withdrawals, whereby a member of one commercial bank can withdrawn funds

⁷¹ Brunner A et al, p 5

⁷² Hackethal A, p 76

⁷³ Siebert H, p 219

⁷⁴ Brunner A et al, p 5

from the ATMs of the other commercial banks. Although this example may show collective action to counter the ländesbanken and cooperative banks, it should be added that, “Commercial banks are defined as a group primarily by their common legal foundation, not because of interbank cooperation as is found in the savings or cooperative banking groups. Commercial banks compete individually against other commercial banks and the two other banking groups.”⁷⁵ While competitive, the German commercial banking pillar pales in its relative importance to the German market, as compared to the domestic market roles of the major Anglo and American commercial banking giants. While commercial banks play a significant role in German banking, the larger ländesbanken dominate the contemporary German banking market.

⁷⁵ Deeg R, p 240

Chapter Three: German Banks and their Role in the German Economy

Many analysts emphasize the power that banks wield to influence corporate policy and governance in the German corporatist economy. German universal banks are often seen by these analysts as benevolent stakeholders in German firms that provide long-term debt financing while maintaining direct shareholdings, board representation, and proxy voting rights. This makes the banks of paramount importance in corporate governance. At the same time, other analysts describe this type of universal banking relationship as malignant to the efficiency of the market. These analysts point to the potential for banks to abuse their influence on firms in order to sustain their entrenched positions in corporate governance. This relationship can potentially allow banks to exploit firms for their own advantage, for example, by blocking transfers of firm control that would otherwise increase a firm's efficiency, corporate profits, or market advantage.

Ralf Elsas and Jan Pieter Krahnen point out that these extreme positions about the dominance of German bank power, for good or for evil, are somewhat overstated myths.⁷⁶ While banks may wield significant influence on large publically traded German corporations, the vast majority of German firms, as assessed by either the number of firms or by sales, have no public equity. Banks play no role in these firms as shareholders, board members, or proxy voters. The only role of banks in these smaller firms is as lenders. Since banks are by far the largest source of

⁷⁶ Elsas R. and Krahnen JP, p 197

capital for these firms, one can still argue that banks play a major role in the success of these firms. The long-term role of banks as *hausbanken* for large and small German corporations must be considered separately for each sized firm to be understood. It is the role of banks as *hausbanken* that is typically evoked as a relatively unique and meritorious function of the German bank-firm relationship. For some, however, these merits are controversial, particularly in a globalized economy that is supposed to favor a form of Darwinian efficiency.

This section will first address the role of banks in smaller German firms and, second, the role of banks in large German corporations. While German banks traditionally exercise considerable influence over firms, a larger policy question concerns the degree to which the German states and federal government can exert control over the banks to steer economic and corporate policy and influence the market. This consideration becomes an obvious issue in a country with a large state owned banking sector. German banks can and are used to exert state direction at various levels. First, the development banks, or *landesbausparkassen*, are tools used by the federal government to enact and bolster policy. Second, savings banks (*sparkassen*) and the *landesbanken* can be used to bolster regional and state interests. The roles of banks as mediators of economic policy reflect the great importance of the bank in the German economy.

The possibility that the failure of German banks could lead to failures of businesses and the economy as a whole is a reasonable concern, particularly because of the exposure of German states (and taxpayers) in the event of a public

sector bank crisis. Post-World War II Germany has avoided large-scale bank failures. In recent years, Germany has had to deal with only an occasional insolvent bank, typically coping with these problem banks through mergers and consolidations. The present global financial crisis gives some reason to consider the risks of a possible bank crisis in a German banking environment in which publically held banks are making international investments, particularly in poorly regulated securities, leaving the domestic taxpayer at risk.

Before embarking on an analysis of bank-firm relationships, some traditional institutional practices in German banking practice must first be addressed. Typically, the investment strategies employed by banks to fund the activities of firms is not encouraged solely by profitability. As a result, the profitability of the German banking system as a whole is relatively low compared to other countries. For example, the Organization for Economic Co-operation and Development (OECD) states that German bank's pre-tax return on assets (ROA) was only around $\frac{1}{4}$ percent in 2000-2001.⁷⁷ Profitability is substituted for other factors, such as long term strategic planning and competencies based on close networking and relationships between the banks and firms. There are also networks between the managers and technical personnel of a firm and their counterparts in the firms of major suppliers and corporate clients, as well as networks through industry associations. German companies have seats on the supervisory boards of other companies and are often involved in joint development of technologies or

⁷⁷ Brunner A et al, p 8

products.⁷⁸ Banks typically have multiple, even incestuous “insider” views of an industry and a company through their relationships with multiple companies.

As a result of these extensive bank-corporate networks, banks in the German corporatist economy “typically provide companies with access to finance that is not entirely dependent on publicly available financial data or current returns. Access to this kind of ‘patient capital’ makes it possible for firms to retain a skilled workforce through economic downturns and to invest in projects generating returns only in the long run.”⁷⁹ Furthermore, “The prevalence of long-term investment has the consequence that firms from [such] stakeholder systems often pursue growth in market share at the cost of lower rates of return on equity investment.”⁸⁰ While firms in typical shareholder economies have a greater capacity to exercise more flexibility in markets and to undertake “big leaps”, firms in the typical German stakeholder model typically make “small steps.” This is due to the coordinated relationships between the actors, primarily the investors (the banks) and the firms themselves. “Changing a strategy involves bargaining, is information intensive, and requires patience on [the] part of the stake holders.”⁸¹ While this may result in precisely targeted end results, the deliberative nature of this process between the banks and firms beleaguers the process, often times making companies and banks slow to compensate for losses or changes in the market. While small fluctuations in the market do not sink the ship, large dips make the vessel cumbersome in a storm.

⁷⁸ Hall, A and Soltice, D, p 23

⁷⁹ Hall, A and Soltice D, p 22

⁸⁰ Börsch, A, p 17-18

⁸¹ Börsch, A, p 18

The Role of Banks in Small to Mid-Size German Firms

An analysis limited to only the large corporate sector would result in a failed understanding of the German banking and enterprise sector relationship. The goal of this section will be to highlight the great importance of small and medium-sized firms, the *mittelstand*, to the German economy and the role of the banks in these firms. These firms can be defined based on their annual revenue or by the number of employees. Typically, small firms earn annual revenues of 50 million euro or less and consist of fewer than 500 employees. These firms may seem insignificant when compared to multinational corporations such as Siemens or Allianz; however, of the 2.9 million enterprises in Germany, 2.6 million (89.4 percent) have annual revenues of less than 1 million euro.⁸² These smaller firms have a cumulatively large impact on the German economy. An analysis of these firms provides one of the best indicators of the Germany economy.

These mittelstand firms are frequently called the backbone of the German economy.⁸³ These firms remain semi-autonomous in decision-making. "Instead of having hired managers, as in the incorporated large enterprises, entrepreneurial effort of the owner-entrepreneur plays a decisive role."⁸⁴ Such companies may be most affected by fluctuating markets, taxation, regulation, and credit squeezes. This has to do with the fact that a predominant number of these small firms are built around niche markets, most being in machine construction and specialty technology

⁸² Siebert H, p 8-9

⁸³ Siebert H, p 10

⁸⁴ Seibert H, p 10

that was often developed or advanced by the owner-entrepreneur. These firms provide Germany with the ability to produce a diversity of high quality products, often producing more customized goods for their clients in comparatively smaller batches than the mass-produced products of large corporations. Development of such high quality specialized products often requires considerable research and development, making the success of such companies potentially very dependent on obtaining long-term capital.

The markets for the products of these companies products can be drastically affected by changes in the economy. The ability of these smaller firms to weather economic down turns requires being able to obtain credit based on the future potential of the company in times of economic distress. These smaller and middle-sized German firms are primarily or entirely dependent on banks for their financing since these private firms lack public equity. The survival of these collectively important firms is highly dependent on the German construct of the *hausbank*. The *hausbank* serves as the primary lender to a firm and maintains a close relationship to the firm. This relationship includes the sharing of timely information with the bank that allows the bank to develop and maintain a close, long-term relationship with a firm. The bank-firm interaction is based on a trusting relationship, as compared to lending that typically takes place at an arm's length in other Western countries. Because the *hausbank* has access to confidential business information about a firm over time and through repeated interactions, the bank can better assess its risk when making a loan under this privileged relationship. This may potentially lower the cost of a loan if the bank feels confident that its loan will be a good long-

term investment based on the prospects of the company. The close ties of a bank to a firm may also make a bank more likely to subsidize a company in times of distress based on perceived long-term success potential and the prospect of obtaining further investment returns (interest) on loans to the firm in the future. This hausbank relationship therefore depends on the existence of a two-way street in which the firm typically remains mutually committed to its hausbank. The commitment of the firm to its hausbank naturally occurs because the firm is so dependent on the bank for its survival given the time that it takes to develop this relationship. Both the bank and the firm feel a “special responsibility” toward each other in this relationship.

This relationship may enable banks to subsidize a firm’s development at times. Loans made for the relative long term based on relationship lending fosters long term planning by firms and helps firms get through financially stressful times by keeping the cost of borrowing down due to a higher level of trust on the part of the bank. Because of mutual long-term interest in maintaining the relationship between the bank and the firm, this relationship based lending may at times also work in favor of the bank and drive up the cost of lending to the firm in good times, when the bank may set a higher rate of interest on its loans to a firm. However, the long-term relationship between the bank and the firm also provides for contractual flexibility through renegotiation of the lending terms if the situation of the company changes.⁸⁵ However, the reliance of small and middle sized firms on one or at most a

⁸⁵ Elsas R and Krahnan JP, p 208-9

few bank lenders for all their capital needs presents a potential challenge to the German system in times of a credit crunch, such as the now widespread sub-prime mortgage crisis.

The Role of Banks in Large Firms and Multi-National German Corporations

Large German firms include the large multinationals such as Volkswagen, Daimler, Bayer, Allianz, and Siemens, which generate a large portion of their value abroad. Although large German corporations are publically traded, unlike their little brothers in the mittlestand, banks still dominate corporate governance of large firms in the German system. German universal banks hold direct equity stakes in publically traded German companies and are usually represented on the supervisory boards of large firms. The voting power of the banks extends well beyond the shares that they directly hold because the banks also hold proxy voting rights on shares that bank customers buy through the banks. The influence of banks on large corporations has therefore more to do with direct corporate control than with the provision of credit alone.

As noted, German commercial banks traditionally own substantial shares in large German companies. The 1990's saw an actual increase in the level of bank share holdings. In the beginning of the 1990's, German banks owned 10.3 percent of shares in German companies, by the end of the 1990's the percentage of bank owned shares in German companies rose to 13.5. By comparison, only 3.4% of

shares in American companies were bank owned at the end of the 1990s.⁸⁶ German banks hold stock in many companies, even in companies within the same industry (“cross holdings” of shares). The position of banks on the supervisory boards of multiple large publically traded corporations often allows banks to have contact networks with, and to exercise active influence on, the corporate customers and suppliers of a given company, and *vice versa*. “This system of corporate governance is an insider control system.”⁸⁷ The by-product of this is that banks can mitigate and control their own credit risk. However, in practice, the bank members of these corporate supervisory boards often “end up with many broad mandates and usually a major day job as well, often resulting in a lax ‘duty of care’ and conflicts of interest in the ‘duty of loyalty,’ [which is] the essence of board responsibility.”⁸⁸ In fact, even when a bank’s holdings do not include proportionally strong share holdings in a company that would otherwise warrant a board seat, “Bankers tend to be elected to the supervisory board because of their comprehensive information on other firms, corporate trends, the political scene, and international developments.”⁸⁹

It is important to note that German banking practices regarding cross-holdings are changing, particularly since 2002. These practices historically enabled German businesses to keep foreign competitors and potential take-over bidders at bay. As financial markets have grown closer together, the German financial market has also become less isolated and protected. “The shareholder structure is becoming

⁸⁶ Siebert H, p 234

⁸⁷ Siebert H, p 235

⁸⁸ Siebert H, p 235

⁸⁹ Siebert H, p 235-6

more international; several major German companies are now listed at the New York Stock exchange...and have to satisfy the transparency demands that listing entails.”⁹⁰ Tax reforms enacted in 2002 relieved the seller of cross-holding shares of tax liability on the sale of these holdings. This removed an incentive for banks, corporations and insurance companies to continue to hold on to these shares and the banks and companies responded by selling off some of their cross-holdings, typically reinvesting the proceeds back into their core business.⁹¹ This process continued apace. In 2005, Eric Pohl, Chairman of Dresdner Kleinwort Wasserstein, was quoted in *The Banker* as saying, “Germany Inc. no longer exists. While many...have failed to notice, German corporate restructuring is pretty much complete. The cross-holdings [that German Companies and banks traditionally hold in each other] have been disentangled.”⁹² Although this statement likely represents a degree of hyperbole, the German banking and corporate system is clearly evolving and not static.

⁹⁰ Siebert H, p 242

⁹¹ Seibert H, p 242

⁹² “Germany experiences a silent revolution,” *The Banker*, 4/4/2005

The Role of Banks in Transmitting and Influencing German Government Economic Policy in the German Coordinated Market Economy

As the above analysis of the role of the banks in both smaller and larger German firms reveals, the financial system in the German coordinated market economy has the ability to provide access to long-term, or “patient”, capital. This patient capital can, for example, help maintain the employment of skilled workers in the event of an economic downturn or provide capital for projects that will generate returns only in the longer term. This kind of financial investment requires banks to have “insider” knowledge of a firm’s business that may not be reflected by the firm’s current balance sheet and is typically not public knowledge. This information on a firm’s business, acquired through the business and political networks described above, is necessary in order for banks to monitor the performances of companies and ensure the value of their investments.⁹³ The availability of long-term investment that helps stabilize the economy and maintain employment is in the public interest and, therefore, in the policy interests of the state in the context of the German coordinated market economy. The availability of patient capital requires a high degree of stability in the banking sector. Such investment strategies require a lowering of risk because they can result in lower profit margins than those achieved by banks in comparator countries with more competitive banking systems.⁹⁴

⁹³ Hall PA and Soskice D, p 22-3

⁹⁴ Brunner A et al, p 8

Maintaining such stability has been a major goal of German banking policy through public bank ownership and government regulation of the financial system.

Bank regulation has an important impact on the function of a financial system and on the economy as a whole. Historically, bank regulation in Germany has focused on bank stability to protect depositors while maintaining the flow of capital to the firms that employ the workers and contribute to the Gross Domestic Product. This policy has succeeded in achieving a very high degree of bank stability in the post-war period, at least until recently. This stability was fostered by regulations that often restricted competition with foreign banks and non-bank suppliers of financial services. Bank regulators have used this anti-competitive regulation to promote banking in Germany as an economic “... ‘safe haven’ [that is] not vulnerable to excessive risk taking.”⁹⁵ These regulations include laws that foster the close networks of ties among the banks, firms and trade associations that allow for “imperfect competition” in the German coordinated market economy. Such insider networks would likely be considered illegal anti-competitive practices in a liberal market economy such as the U.S. Although more recent European Union regulations have forced a retrenchment in the “anti-competitive” regulations affecting German banks, the effects of coordinated market practices linger.

Public ownership of German banks must, of course, be considered in assessing the role of the banks in government economic policy. The close tie of public banks to their municipalities and states provides an obvious conduit for these

⁹⁵ Fischer K-H and Pfeil C, p 292

banks to lobby the government. Conversely, by cooperating with government objectives, the banks might hope to escape government regulations that threaten their position, creating a mutual interest in cooperation between the banks and government. For their part, “politicians like to exercise control of banks because the banking business provides...[the] opportunity to...fund projects that serve the politicians’ own purposes.”⁹⁶ These conflicting interests touch on a significant regulatory need in a system in which the government owns banks; the need to regulate the interactions between public banks and their municipal and state governments.

As noted in the first chapter, municipalities that defaulted on loans made to them by their savings banks worsened the bank crisis of 1931. Even today, according to Fischer and Pfeil, “state governments use the Landesbanks as their own development banks and directly pursue what is officially stated to be the interest of the state in terms of regional economic development. The same can be said about public savings banks and the influence exerted by politicians at the municipal level.”⁹⁷ A degree of cross ownership in public banks does help mitigate the influence of a single municipality or state, however. For example, the municipal savings banks (sparkassen) are each usually owned by groups of municipalities and the ländesbanken are owned not only by the states, but also by the regional associations of municipal savings banks (sparkassen associations). There is also

⁹⁶ Fischer K-H and Pfeil C, p 296

⁹⁷ Fischer K-H and Pfeil C, p 297

considerable cross ownership between the different ländesbanken.⁹⁸ Nevertheless, the close ties of public sector banks to the economic interests of the governments that influence them remains a major reason why these banks do not always see profit maximization as their paramount objective.

⁹⁸ Fischer K-H and Pfeil C, p 297

Chapter Four: The Role of Central Banks in the German Banking System and Economy: the Bundesbank (German central bank), Ländeszentralbanken (länder central banks) and the European Central Bank.

European central banks “are complex institutions, which straddle the ground between state and markets, politics and economics, and national, EU, transnational and international governance.”⁹⁹ Typically, a central bank is responsible for monetary policy and maintaining the stability of the national currency. The control of subsidized loan interest rates provides an essential tool for central banks to maintain currency stability and control inflation. The setting of loan rates by a central bank allows these banks to either tighten the availability of credit by setting higher interest rates, which tends to strengthen the value of a currency and hold down inflation, or to stimulate lending by lowering interest rates, which tends to spur economic growth. Lower interest rates may, however, weaken a currency and increase inflationary pressures. Central banks may also function as lenders of last resort to “bailout” the banking sector in a financial crisis. Central banks may also have supervisory powers over banks. However, unlike certain other central banks, such as the Bank of England and the U.S. Federal Reserve, the Bundesbank and the European Central Bank (ECB) are not lenders of last resort that are responsible for maintaining the stability of the financial system. According to the Bundesbank Act and the ECB Statute, the Bundesbank has four areas of primary responsibility, which

⁹⁹ Quaglia L, p 1

it handles to a significant degree in coordination with the ECB. These main areas of Bundesbank activity include: 1) Ensuring the circulation of cash, 2) Acting as a “bankers bank” (functioning as a clearing house and providing banking supervision), 3) Functioning as the state’s banker, and 4) Its role as the manager of currency reserves.

Prior to 2002, with the physical advent of the euro currency, the Bundesbank set the monetary policy for the Deutsche Mark, the currency of the Federal Republic of Germany. The Bundesbank was the first central bank to be given full independence from its government, creating the so-called Bundesbank model of an independent central bank. The European Central Bank (ECB) is responsible for the monetary policy of the euro, which is, of course, the currency of the 15 member countries of the Eurozone. The euro replaced the Deutsche Mark in Germany in 2002. The ECB was established by the European Union on the model of the Bundesbank as an independent central bank. Its headquarters is in Frankfurt, Germany. With the advent of the ECB and the euro, the monetary policy functions of the Bundesbank were taken over by the ECB.

The Role of the Bundesbank and the Ländeszentralbanken

The original central bank plan for the German Federal Republic conformed to the Allies' aim to foster decentralized federal structures to break with the prior unitary consolidation of power in Germany. "The precursor of today's Bundesbank was a creation of the Allied Military Governments. In each of the German Länder (states), the American, British and French Authorities set up Ländeszentralbanken (Länder central banks, or LCBs) in their zones of occupied Germany."¹⁰⁰ The British also insisted that a federal central bank be established to coordinate the länder central banks. This bank was referred to as the Bank deutscher Länder (BdL). The BdL's structures and powers were very similar to those of the Bundesbank that was established by legislation in 1957 as the successor of the BdL. The legislation that established the Bundesbank evoked a compromise in a debate at the time over whether the German central bank should have autonomy from government control. The legislation of 1957 established the independence of the Bundesbank from the instructions of the federal government, but compromised by incorporating a provision that the Bundesbank still generally support the economic policies of the federal government as long as these policies did not prejudice its monetary and oversight policies.¹⁰¹ The resulting Bundesbank has succeeded in functioning as "one of the most independent central banks in the world, with a solid reputation for

¹⁰⁰ Kennedy E, p 12

¹⁰¹ Kennedy E, p 13

price stability.”¹⁰² Subsequently, with the adoption on the European Monetary Union (with the euro as the currency), the Bundesbank’s responsibilities for setting monetary and exchange-rate policies shifted to the European Central Bank (ECB). In fact, the ECB’s design, as well as its adoption of a conservative anti-inflationary policy, was modeled heavily on the Bundesbank.¹⁰³

Over the years, the Bundesbank has been famous for its unswerving campaign against inflation. These anti-inflation policies were the overriding *raison d’être* for the institution in the eyes of many Germans. Certainly, this can be understood from the historical perspective of the hyperinflation that Germany suffered after World War I and the return of virtually worthless German currency for a time after world World War II. These events reduced the country’s economy to a barter system or a black market economy based on foreign currency. These monetary failures, particularly the hyperinflation after WW I when the currency exchange rate went from 4.2 marks to the dollar before the WW I to more than 4 billion marks to the dollar in November 1923, had profound social and political consequences.¹⁰⁴ Most people were financially wiped out by this inflation and it undermined the public confidence in the institutions of government, which helped to push the country into the arms of the radical nationalist movement of the Nazi’s. As the result, the “distinctive ethos” of the Bundesbank is a refusal to compromise on inflation. “‘There is no such thing as a little bit of inflation’, Bundesbank officials

¹⁰² Quaglia L, p 47

¹⁰³ Quaglia L, p 51

¹⁰⁴ Kennedy E, p 7

like to say...Even single digit inflation destroys a currency's value over the medium term and gradually destroys the economy as a whole", according to the economic policy directors of the Bundesbank.¹⁰⁵ According to Kennedy, the Bundesbank operates almost in a constitutive manner, although it is not truly a constitutional branch like the judiciary, legislative or executive. The Bundesbank's "norm of monetary stability is [considered] more like a constitutional principle, such as private property rights, than like a simple directive or order, such as the price of postage."¹⁰⁶ The other objective of the bundesbank, the macroeconomic dimension of monetary policy, particularly the trade-off between monetary policy objectives favoring price stability and those favoring economic growth, have always been secondary to price and monetary stability at the bundesbank. The bundesbank has been able to carryout its strict anti-inflationary policy over the years primarily because of its political independence. This political independence has usually, although not always, allowed the bundesbank to hold to its anti-inflationary policies in the face of pressure from the federal government and international pressure from sources such as the U.S. that have typically advocated pro-growth bank policy (with potential for inflation) in times of economic distress.

Before 2002, the main policymaking body of the Bundesbank was the Central Bank Council (Zentralbankrat). The Central Bank Council (CBC) was comprised of the presidents of the ländeszentralbanken (landes central banks, or LCBs) and the Bundesbank Executive Board. The federal president appointed the LCB presidents

¹⁰⁵ Kennedy E, p 8

¹⁰⁶ Kennedy E, p 11

at the suggestion of the Bundesrat (the upper house of the German parliament). The Bundesrat based its recommendations for these posts, which were for eight-year terms, on proposals made by the LCB's state government, in consultation with the CBC. These presidents are often members of the party that is in power in the state government at the time of their appointment, so in that sense they are initially political appointments. They are, however, generally reelected for a second eight-year term until reaching retirement age (65-67). The organization of the LCBs varies by state, but the members of the LCB supervisory boards are generally drawn from local businesses, banking, agriculture and trade unions. LCB presidents were potentially able to advocate for regional or local interests at the Bundesbank in Frankfurt, and could potentially influence the policies of the Central Bank Council.¹⁰⁷ The Executive Board of the Bundesbank was eliminated by reforms of the Bundesbank in 2002 to achieve a more centralized decision making structure, as will be discussed below.

Public law restricts the transactions and dealings of ländes governments with local banks except through their ländeszentralbank (LCB). LCBs act as local administrative branches of the Bundesbank and continue to provide a degree of decentralized (federalized), local power that has historically diffused some of the central authority of the Bundesbank. Reforms enacted in 2002 strengthened the central power of the Bundesbank, but according to some did not go far enough in

¹⁰⁷ Quaglia L, p 53

de-federalizing the authority of the Bundesbank.¹⁰⁸ LCBs have central and branch offices in their states. Credit divisions of LCBs administer credit operations under the Bundesbank and European Central Bank interest policy. Banking divisions of LCBs supervise local bank operations and report to the Bundesbank on any irregularities in the banks of their state. The statistics division collects statistics, and the economic division analyzes the economic conditions in their state and reports to the LCB president. The LCD bond division supervises securities transactions and credit needs. These LCBs, often through their Advisory Boards made up of local appointees from various economic sectors, provide feed-back and act as local “listening posts” for the Bundesbank in the provinces, injecting some degree of (unelected) local representation into the Bundesbank’s structure.¹⁰⁹

In 2002 the Bundesbank was reformed to streamline its governance structure. This restructuring was also aimed at increasing the central authority of the Bundesbank by limiting the number of LCBs and state-based decision makers in the Bundesbank’s Central Bank Council, thereby making the decision making process of the Bundesbank more efficient. That same year the Bundesbank also lost its monetary policy authority to the European Central Bank with the advent of the euro. At the Bundesbank, the Central Bank Council was replaced by an new eight person Executive Board that became the supreme governing body of the Bundesbank. The Executive Board members include four members (or half of the board) who are nominated by the federal government and appointed by the federal

¹⁰⁸ Quaglia L, p 55

¹⁰⁹ Kennedy E, p 18-19

president. The other four Board members are nominated by the Bundesrat and appointed by the federal president. The Bundesrat nominations represented a concession to the states to mitigate an increase in central power resulting of an all-federal appointed board.

The second reform of the Bundesbank involved a consolidation in the bodies that supervise financial services (including banking, securities, and insurance services) into one body called the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, or BaFin). This single regulator replaced the supervisory functions of three previously existing federal authorities that dealt separately with each of these three financial sectors. A protocol was issued to clarify the relations of the Bundesbank to the BaFin, specifying the competencies of the Bundesbank in banking supervision. The European Central Bank supported this expansion of the supervisory function of the Bundesbank as a means to strengthen the stability of the financial system. It was felt that these regulatory reforms would “increase the competitiveness and attractiveness of Germany as a financial center [by] providing an improved regulatory framework.”¹¹⁰

The functions of the Bundesbank , as noted above, include ensuring the physical circulation of cash. For example, it checks the deliveries of cash by banks and transport companies and removes counterfeit and damaged notes from circulation, etc. The bundesbank also supports cross-boarder payments between German domestic commercial banks and foreign commercial banks. In addition, the

¹¹⁰ Quaglia L, p 50

Bundesbank also functions as a “banks’ banker” and acts with the ECB as a refinancing source for the commercial banks. This refinancing is used to cover the needs of the banks for central bank funds (through the Bundesbank and the ECB). By controlling the money supply by this method, the Bundesbank historically helped maintain price stability. Since 1999, establishing the policies for control of this money supply function shifted to the ECB. The Bundesbank also acts as a banker for the state, providing banking services for federal, state, and local authorities and statutory social security organizations, but all such accounts must have a positive balance, as the Bundesbank cannot grant credit to the public sector. The Bundesbank also is legally obliged to advise the government on monetary policy and it prepares position papers for the government.¹¹¹ The Bundesbank also holds non-euro denominated currency reserves, including gold reserves and securities in foreign currency.

Since 2002, as noted above, the Bundesbank and the BaFin have agreed to a division of regulatory supervisory duties that leaves the Bundesbank responsible for most of the operational tasks of banking supervision. The BaFin supervises the large public and private banks, including the *landesbanken*, whereas the Bundesbank mainly supervises the savings and cooperative banks and small private banks.¹¹² After the advent of the European Monetary Union and the shift of monetary policy to the ECB, the Bundesbank has attempted to carve out an enhanced policy role by increasing its supervisory duties into the entire financial sector, but it has only

¹¹¹ Kennedy E, p 36

¹¹² Quaglia L, p 70

partially succeeded in this endeavor through a “gentlemen’s agreement” with the BaFin that divides up supervisory duties in the financial sector between BaFin and the Bundesbank. This agreement left the Bundesbank with only partial responsibility for regulating the banking sector, with the BaFin responsible for supervision of most of the rest of the financial sector.¹¹³

The Role of the European Central Bank

The European Central Bank (ECB), established in 1998, is an extraordinary supranational banking institution necessitated by the voluntary ceding of monetary sovereignty that resulted in the sharing of a single currency, the euro, over the 15 states that currently make up the eurozone. The adaption of the euro represents the first time since the Roman Empire that a large part of Europe has shared a single currency. With the realization of this Economic and Monetary Union (EMU), the participating eurozone countries, including Germany, no longer have their own sovereignty over their monetary policy, with this policy now delegated to the ECB. The Bundesbank, therefore, no longer makes monetary policy for Germany. While the ECB makes these policy decisions, the national central banks of the member countries (including the Bundesbank) still play a role in collectively deciding on these decisions through the Governing Council of the ECB. This Council is modeled after the federal governing structures of the Bundesbank, which had to

¹¹³ Quaglia L, p 71

accommodate the input of the *ländeszentralbanken* (LCBs) in setting Bundesbank policy. Like the Central Council of the old Bundesbank governing structure, the Governing Council of the ECB is also made up of “regional” central banks; but, in this case, the regional central banks are the central banks from each of the ECBs member countries, represented by the governors of these banks. In addition to the governors of the national central banks of the eurozone member countries, the Governing Council consists of the Executive Board (again analogous to the Bundesbank structure). This Executive Board of the ECB Governing Council is made up of the president, vice president, and four other members. The ECB, together with the national central banks, including the Bundesbank, make up the European System of Central Banks (ESCB).¹¹⁴ Like the Bundesbank, particularly before the Bundesbank’s governance reforms of 2002, the ECB and the ESCB system have been criticized for being too decentralized with too much power left in the hands of the national central banks. Therefore, the national central banks of the ESCB remain significant players in the eurosystem.¹¹⁵

The ECB’s independence, governance structure, and functions were laid down in the international Treaty on European Union, also known as the Maastricht Treaty. The ECB’s primary objective is specified in this treaty as price stability. The ECB primary objective of price stability, like its governance structure, is also adapted from the Bundesbank, as was spelled out for the Bundesbank at its founding in 1957. The ECB and ESCB implement the monetary policy of the

¹¹⁴ de Haan J, Eijffinger SCW, and Waller S, p 1

¹¹⁵ Quaglia L, p 3

eurozone in accordance with this objective of price stability (the holding down of inflation). While the ESCB does conduct foreign exchange operations and holds and manages eurozone foreign reserves while facilitating the payment systems, overall competencies in exchange-rate policies are shared between the monetary authorities of the ESCB and the political authorities. The ECB has the exclusive right to authorize the issuance of bank notes for the eurozone. Unlike many other central banks, including the Bundesbank, the ECB/ESCB does not have direct responsibility for banking supervision. However, the Maastricht treaty does specify that the ESCB contribute to “the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system” (Article 105.5).¹¹⁶

The Maastricht Treaty also grants the ECB political independence from politicians in legal terms by prohibiting the ECB from taking orders from politicians. From a political prospective, this is reinforced by the appointment of Executive Board members for eight-year non-renewable terms. These single eight year terms serve to insulate appointees from political pressures, since they do not have to worry about politicians reappointing them.¹¹⁷ Of course, this does not mean that politics have no influence on the policies of the ECB, whose Governing Council is made up largely of the governors (presidents) of the central banks of eurozone countries. For example, as was pointed out in the *Economist*, “The Governing Council [of the ECB] is supposed to set interest rates according to the conditions in the euro

¹¹⁶ Qualgria L, p 107

¹¹⁷ de Haan J, Eijffinger SCW, and Waller S, p 5

area as a whole, but...national [central bank] governors [are] influenced by conditions in their home country.... A weak centre, combined with strong national interests, could create conflicts that undermine the whole system's credibility."¹¹⁸

This argument is similar to the argument for a stronger central (federal) influence in the governance of the Bundesbank. The desire for stronger central control of the Bundesbank first led to a reduction of the number of länderbanken on the old Bundesbank Central Bank Council (CBC), and then the elimination of the supreme authority granted to this council and the investment of this authority in the Executive Board appointed by the German federal president, beginning in 2002. In the case of the Bundesbank, the overriding objective of price stability still generally prevailed, despite the influence of the länderbanken in the CBC over the years. The overall adherence to the policy objective of price stability by the ECB seems to be holding, although as the number of member countries continue to increase in the future, with a resulting increase in the number of national central bank governors on the ECB's Governing Council, the possibility of the governing power of the ECB shifting to the "periphery" and away from the center remains. The codification of price stability as the central purpose of ECB monetary policy in the Maastricht Treaty makes it likely that price stability will continue to direct the common monetary policy of the ECB, despite the presence of the national central bankers on the Governing Council who might at times favor pro-growth policies based on the local economic conditions in their countries. During the time that the Bundesbank

¹¹⁸ "Euro Towers or Faulty Towers?" *The Economist*, 10/31/1998

operated under an analogous decentralized governance structure, adherence to the overriding policy of price stability typically prevailed, with a few exceptions. Presumably, the same will hold for the ECB, although evolutionary reform of ECB governing institutions is inevitable over time, as was the case for the governance institutions of the Bundesbank.

As noted above, the ECB has no significant supervisory authority over European banks, but only a supervisory monitoring role supported by the ECB's Banking Supervision Committee. Europe's financial stability system is based at the national level and there is little supervisory authority or leverage at the European level. Efforts have been made to orient national banking stability structures to accommodate pan-European banks that operate outside their country of origin, across Europe and further abroad. Despite the traditional focus of German banks on their domestic market, German banks have also increased their international investments, including the publically owned *landesbanken*. The *landesbanken*, as well as German commercial banks, have taken on investment banking activities abroad in an effort to increase profits. Unfortunately, the nationally based bank regulatory structures in Europe lag behind this increase in cross-border banking activity.

This lag in European supervisory and regulatory strength has occurred despite efforts such as the European Commission's 1999 Financial Services Action Plan and the so-called Lamafalussy framework for financial rule making that brought together all European banking supervisors and agencies into the Committee

of European Banking Supervisors (CEBS) in 2004. Unfortunately, “the interlocking of many national sources of authority has also created complexity and blurred the lines of responsibility for supervision and crisis management. [Furthermore,] CEBS is an advisory body, with no decision-making powers.”¹¹⁹ The supervisory framework for regulating the pan-European and international banking activities of European (including German) banks is a spider web of national authorities, including the 51 members of CEBS. This system has not been tested in a pan-European banking crisis. “No national or European authority presently has routine access to supervisory information on all pan-European banks...”¹²⁰

As German and other European banks increasingly internationalize their business operations, German and other nation-based European banking regulatory authorities become less able to deal with financial crises on a national basis. As we have seen, the European Central Bank (ECB) does not adequately address this function because it lacks regulatory authority. This need has not gone unnoticed. “Since its creation the ECB has tried to expand its supervisory tasks, but has met with the resistance of the national central banks, the national supervisory authorities and member states’ governments.”¹²¹

¹¹⁹ Veron N, *Bruegel Policy Brief*, August 2007, p 4

¹²⁰ Veron N, *Bruegel Policy Brief*, August 2007, p 5

¹²¹ Qualgla L, p 137

Chapter Five: A Cross-Country Comparison of the Performance of German Banks to the Banks of other European Countries

At first glance, Germany's banking system appears unique and therefore difficult to directly compare to the banking systems of other countries. The German banking system is more fragmented and German banks play a more extensive role in stimulating and influencing the regional and national economies than do the banking systems in other countries of similar size. As already noted, the aims of Germany's semi-public and co-operative banks do not always correlate with achieving maximum profit, as is the accepted common goal of other Western banks. Instead, German public banks are often said to function as a development asset to their local governments and by providing aid to domestic business by offering ample investment at favorable interest rates that spurs the long-term growth of their German corporate business "partners." Through these functions, the banks foster the wellbeing of the German economy, but are said to be willing to forgo high rates of return. Furthermore, banks in Germany play a much more prominent role in the German economy as a whole than do their counter parts in liberal market economic systems such as the U.K. or U.S. where corporate debt securities and stock market capitalization play much larger role. However, if we stay within the eurozone, it is not hard to find reasonable comparators for the German Banking system.

Banks play a similar high profile role in the social market economies of other eurozone countries as they do in the German economy when measured as the ratio

of the banks' total assets to GDP, or in bank loans to GDP. This ratio of bank loans to GDP is three times higher in both the eurozone and in Germany as it is in the U.S., which is dominated by its securities markets.¹²² The similar prominence of banks in the economies of other European countries of similar size to Germany, such as Italy, Spain and France, and even the U.K. makes a cross-country performance comparison of the German banking system relevant. These European countries also have roughly similar macroeconomic conditions and institutional frameworks.

Although the structure and roles of banks in these comparator countries is similar, the German banks still do play a larger role in the German economy than the banks in the comparator countries if assessed by other measures. German banks typically provide a higher number of larger sized loans to non-financial sector borrowers, and these loans have longer maturities (with the bulk of these loans in excess of five years) than do the banks in the comparator countries.¹²³ There are also many more banks operating in Germany than in the other comparator countries, although German bank employment is not significantly higher than in the other countries if normalized to total banking assets or loan levels.¹²⁴ In line with the high total number of banks in Germany, the typical bank manages a smaller amount of assets than does a typical bank in the comparator countries, with the exception of Italy.¹²⁵ The median size of assets of German banks across almost all

¹²² Worms A, p 163

¹²³ Brunner A et al, p 7

¹²⁴ Brunner A et al, p 7

¹²⁵ Brunner A et al, p 7

pillars is less than half that in any of the other countries. There is also less concentration of total bank assets in the five largest banks in Germany, which hold a lower percentage of their country's total bank assets, as compared to the relative percentage of total bank assets held by the five largest institutions in each of the other countries.¹²⁶ Given the large presence of publically owned banks and cooperative banks in Germany, it is not surprising that incorporated, joint stock commercial banks account for a lower percentage of bank system assets in Germany than they do in the other countries. In Germany, these banks account for about 25% of banking assets, whereas similar incorporated commercial banks account for 50% or more of assets.¹²⁷

In Germany, all pillars of the banking system post lower profits than do similar banks of other countries. The private commercial banks in Germany earn particularly low returns. Over 20% of these banks earned less than or equal return for their owners than the rate of return on risk-free treasury bills in the years of 1997, 1999, and 2001, for example. The public savings banks and the cooperative banks in Germany were more profitable than German commercial banks.¹²⁸ The average return on assets (ROA) for German banks was only about 20% of those for the banks in other European countries.¹²⁹ Low returns reflect the fact that the banks in Germany seem to charge only modest interest rates even when the risk is deemed high. Elsas and Krahnen showed that the risk premiums charged by German banks

¹²⁶ Brunner A et al p 7

¹²⁷ Brunner A et al p 8

¹²⁸ Brunner A et al p 8-9

¹²⁹ Brunner A et al p 11

(the interest difference charged to a customer for a high default risk loan compared to a low default risk loan) was only 94 basis points (.94%).¹³⁰ In the 1990s, the German post-unification boom in banking business volume relating to construction lending buoyed German bank profits in the 1990s despite these low margins, but since the millennium, German bank profits have particularly lagged compared to other countries.

The low profitability of German banks also seems to be in good part because German banks have been poor in developing sources of non-interest revenue compared to the banks in other countries. This lack of alternative revenue development reflects the more limited engagement of German banks in nontraditional bank business activities compared to the banks in other countries.¹³¹ Interestingly, this cross-country comparison showed that the public savings banks and cooperative banks, which would be presumed to have the least interest in maximizing profits, do not operate with higher costs.¹³² Overall bank competition in Germany was deemed to be more intense than in the U.K. or France, but not compared to Italy or Spain. The reasons for the low profitability of German banks was summarized by Brunner, et al as being only partly due to high competition among German banks and the presence of public banks that did not always seek to maximize profits. Low profitability was system wide and appeared to largely result from wide spread under pricing of risk and a low proportion of high value added

¹³⁰ Elsas R and Krahnen JP, p 214-15

¹³¹ Brunner A et al, p 12-15

¹³² Brunner A et al, p 15

activities due to less innovation throughout all the pillars of the German banking sector.¹³³

In summary, Brunner et al in their International Monetary Fund (IMF) *Occasional Paper 233* draw eight main points from a cross-country comparison of the German banking system to the banking systems in other European countries.¹³⁴ First, banking involvement in the German economy is more extensive than in the comparator countries, even though banks also play prominent roles in the economies of comparator countries. Second, German banks are comparatively small and private shareholders play a limited role in the capitalization and control of German banks. Thirdly, the German banking system is weaker than other European countries if assessed according to profitability, even though German banks wield more influence within the German economy than other banking systems exert on their country's economies. The profitability of German banks is lower in part because public banks may tend to forgo some profit in working for the public good of their states and municipalities, which allows the banks to be concerned with long-term investment and the greater economic good, rather than short-term profitability. In return, state guarantees for banks helps ensure stability. Since World War II, Germany has not witnessed a major national banking crisis.

The fourth point made by Brunner et al is that each of the banking segments within the three pillars of German banks underperforms their closest counterpart

¹³³ Brunner A et al, p 18

¹³⁴ Brunner A et al, p 7

banks in other countries of comparable size. Fifth, the lack of profitability is due to weaker revenues. Relatively weak revenue is a constant throughout all the pillars of German banking when compared to the counterpart banks of other countries. This reflects an apparent cultural tendency to accept lower rates of returns relative to risk compared to the banks of other countries. This tendency to accept lower revenues occurs throughout all pillars of German banking and is not limited to public banks. Sixth, the IMF considers the problem within the German banking system to be structural rather than cyclical. Seventh, the sparkassen (public savings banks) and the cooperative banks out performance the commercial banks, but when compared to equivalent bank pillars in other countries, they also under perform to the same relative degree as the German commercial banks. Eighth, and lastly, low profitability of German banks is a characteristic throughout all pillars of the German banking system compared to the banks of other countries. No significant difference in relative profitability is apparent between the public and private sector banks.¹³⁵

¹³⁵ Brunner A et al, p 7

Chapter Six: Structural Adaptation Pressures on the German Banking System Exerted by the Global Financial Market

Ulrich Ramm, the executive vice president of Commerzbank, Germany's fourth largest commercial bank, somewhat facetiously claimed that "Germany has the largest public-sector banking market behind North Korea."¹³⁶ In an environment of increased global competition with the accompanying international investment opportunities and risks, a natural question arises as to whether the German government should remain the owner of a large portion of German banks. This question is particularly relevant following the termination of the statutory guarantees of public sector bank investments in 2005, a change that was forced on the German Banking system by the European Commission. This means that public sector banks now face higher costs in the capital markets, even though these costs may still be somewhat protected by the fact that these banks remain publically owned. Higher costs of capital for these institutions will lower profit margins still further and will ultimately undermine the ability of these banks to invest in projects that may have lower rates of return but are of high public interest. Even before the loss of public guarantees, the profit margins of German banks were already comparatively low, as noted above. Without government guarantees and cheap capital, the public banks need to obtain a market return on their capital investments.

¹³⁶ Lander M, *New York Times*, 8/10/2004

At the time that the public guarantees expired, on July 18, 2005, pundits predicted that the *landesbanken* would be “increasingly exposed to the fierce wind of competition, and not all of them may be able to survive.”¹³⁷ In anticipation, some of the banks were already joining forces, such as mergers between the *landesbanken* of Baden-Württemberg and Rhineland-Palatinate, as well as the banks of Kiel and Hamburg, for example. Gerhard Schröder, the German chancellor at the time, predicted that only three *landesbanken* might be left in the long run.¹³⁸ This degree of voluntary consolidation did not take place, however. Such consolidation is limited by *länder*-specific laws that govern *landesbanken* and *sparkassen*. These banks are limited in their business plans not only by the bank regulation laws of their *länder* (states), but also by the fact that local public officials often have seats on the boards of their *landesbanken*. Therefore, mergers and integration plans face both regulatory and political challenges.

German banking laws hinder the consolidation of both public and private sector German banks. Such consolidation would theoretically increase the economic efficiency and financial prowess of German banks and help them compete against larger competitors in the international banking world. Private banks cannot, by law, buy public banks, although the law does allow public banks to buy private banks. With few exceptions, German banking law has not allowed states and municipalities to sell off or privatize public institutions. Furthermore, strict labor laws and strong unions in Germany drive up the costs of laying-off employees made redundant by

¹³⁷ “German Banks Lose State Backing,” *Deutsche Welle*, 7/19/2005

¹³⁸ “German Banks Lose State Backing,” *Deutsche Welle*, 7/19/2005

mergers. Since consolidating the workforce after a merger is a major factor in achieving increased efficiency, the high costs off lay-offs in Germany can be a deal killer that continues to prevent German bank consolidations, despite the fact that analyses, such as outlined in Chapter 5, continue to show that Germany is “over banked.”

The relatively small size of German banks, with each bank typically having fewer assets than comparator banks in other European countries, also makes growth by acquiring banks in other European countries difficult for German banks. The small relative size of German banks compared to foreign rivals is also true for private commercial banks as well as public banks in Germany. According to Ulrich Ramm, “As consolidation goes on in our neighboring countries, their banks are becoming larger and larger. That makes them difficult targets for us. Perhaps we are easier targets for them.”¹³⁹ The plentitude of German consumer banks of relatively small size that results from the three pillar German banking system creates a fragmented but competitive market, particularly in areas such as commercial banking where banks from the different pillars compete with each other. The relatively high competition level faced by German banks, as well as their small size, contributes to low profits and acts as a disincentive for foreign banks to acquire or merge with German banks. When Italy’s Unicredit took over Munich-based HypoVereinsbank, Germany’s second largest private bank, in 2005, they

¹³⁹ Lander M, *New York Times*, 8/10/2004

subsequently reported that their acquired German subsidiary had lower profits than the rest of Unicredit because of “a particularly competitive market.”¹⁴⁰

The Pros and Cons of Public Sector banking

In Chapter 3 we considered the role of German Banks in the economy. This analysis suggested that the existence of public sector banks may afford special advantages to the German economy, for example by allowing public banks to provide patient, low cost capital to foster the growth of small and medium sized firms. This is possible because public banks do not have to maximize short-term profit. This *hausbank* function requires long-term trusting relationships with firms that include the sharing of insider information between client firms and their banks that may not be possible in a shareholder economy in which such information would breed corruption and lead to questions about a bank’s long-term investment returns that could scuttle such deals. While this argument may apply to the *sparkassen* that grant most of their loans to small local firms, such loans make up a relatively small percentage of *landesbank* loans (about 20%). *Landesbanken* actually devote twice this amount to loans made to foreign companies.¹⁴¹ These foreign loans presumably serve no long-term benefit to German firms, other than providing the *landesbanken* with profits or losses that affect their ability to make new loans.

¹⁴⁰ von Heusinger R, *The Atlantic Times*, August 2006

¹⁴¹ Brunner A et al, p27-8

Another argument used to support public banks is that public banks (principally the sparkassen) provide consumers with increased access to financial services such as checking and free savings accounts, as well as reasonably priced loans, that they would not have access to if they had to deal only with large “monopolist” banks. A report on banking services in the U.K., the Cruickshank report of 2000, has been used to back this claim.¹⁴² This report shows that fewer Britons have a checking account and that there is a relative shortage of loans available to small business and that Britons are more heavily in debt compared to Germans. From the German perspective, profits at the large British “monopoly” banks “are outrageously high.”¹⁴³ While the sparkassen do provide good access to consumer and small business financial services, the need for them to be publically owned in order to provide these services remains doubtful, according to Brunner et al in their IMF occasional paper analysis, since the government could mandate the provision of such services and even tender a subsidy to deliver such services, if need be, without resorting to public bank ownership.¹⁴⁴

The potential benefit provided by public banks, such as the ländesbanken, that take on public projects with a greater public service return than a private monetary return is used to support the need for public banks to act as “development banks”. Specific government development banks do exist in Germany, as noted above, but are only a relatively small part of the public banking system. These

¹⁴² Cruickshank D. *Cruickshank Report*, 2000

¹⁴³ von Heusinger R, *The Atlantic Times*, August 2006

¹⁴⁴ Brunner A et al, p 27

development functions are reasonable reasons for the existence of the development banks, but could be separated from the sparkassen and ländesbanken, which have more limited roles as local development banks. It is possible to eliminate the dual role of ländesbanken as both “private” banking business providers and public development banks, for example. Some länder have already separated these functions from their ländesbanken to a significant degree¹⁴⁵ and this goal has been part of public banking policy since the reforms that followed the bank crisis of 1931. This argument cannot be used to justify the extensive public sector presence in the German banking market.

The German public sector banks have, perhaps, managed to sustain credit flows during some economic downturns, such as during the recession in the early years after the millennium that followed the bursting of the American “dot com bubble” when contractions in the availability of private sector capital spread across the Atlantic. During this time, public sector banks in Germany were able to expand their granting of credit to companies, unlike the downsizing that occurred in their private sector counterparts. This may have had some buffering role on the cyclical effects of this recession.¹⁴⁶

The down side of German public banking includes the market distortion that comes with government subsidy that renders these banks potentially less efficient, as seen in part by their lower profit margins. Some of the poor profits of the public

¹⁴⁵ Brunner A et al, p 27

¹⁴⁶ Brunner A et al, p 28

banks reflect less innovation in expanding into non-traditional sources of revenue, compared to their European rivals, for example. The overall revenue of the German public banks is also significantly lower than their counterparts in other countries. As noted above, this likely also reflects the poor pricing of loans. Ultimately, if return on investments is inadequate, a cycle of government dependence is created in order to sustain operations. With a phasing out of the government guarantees, and threats from the European Commission regarding still other German public bank benefits that are under scrutiny as anti-competitive, the status quo is not sustainable.

Public banks are being forced to increase their revenue and increase their profits. This pressure left German banks vulnerable as some *landesbanken*, for example, sought to increase their return through increased foreign investments, particularly the securitized sub-prime mortgage instruments that caused the banking crisis that is currently threatening the German banking system. When the government is there to pick up the losses, public bank executives may feel that their institution is not responsible for losses, only for gains. Under such conditions, public bank executives may more easily turn into gamblers. Even before the current sub-prime crisis, there have been a number of such “gambling” scandals perpetrated by some *landesbanken*. For example, “Munich-based BayernLB did it with stocks in Singapore, Bankgesellschaft Berlin with real estate investments [in the immediate

post-unification real estate bubble of the early 1990's] and WestLB with holdings in British companies."¹⁴⁷ All required government bailouts.

The example of the Bankgesellschaft Berlin real estate scandal is a cautionary example on the pitfalls of semi-privatization. The State of Berlin created the Bankgesellschaft when it rolled its Ländesbank Berlin and public mortgage bank, the Berlin Hypo, into a consolidated joint stock corporation that also included the state's holdings in a commercial bank, the Berliner Bank. Poor management exacerbated by political entanglements caused major losses when the post unification real estate bubble burst. The State of Berlin had to bail out this semi-privatized version of its ländesbank with an initial sum of 1.73 billion euro, said to represent 2.3 percent of the Berlin GDP, and this still left Berlin on the hook for future losses.¹⁴⁸ As Brunner tells us, this example shows that simply turning a public bank, such as a ländesbank, into a joint stock corporation operating under private law, and perhaps under less public scrutiny, does not free the government of its public ownership obligations.¹⁴⁹

Of course, the same problem can occur when a large private bank fails, even if that bank has no history of government ownership. In any number of national financial systems, such a bank may be deemed "too big to fail" and the government may elect to bail it out to circumvent the catastrophic collapse of multiple financial institutions that might follow in a domino effect. Certainly, such problems are not unique to the German financial system. This problem was recently highlighted by

¹⁴⁷ Reuter W, *Spiegel Online International*, 2/20/2008

¹⁴⁸ Brunner A et al, p 28

¹⁴⁹ Brunner A et al, p 28

the U.S. Federal Reserve-provided guarantees for the bailout of Bear Sterns, which, of course, is not a traditional bank, but a securities firm and investment bank. The recent German government bailouts of state owned banks necessitated by the current sub-prime mortgage investment debacle are discussed in the next chapter.

In theory, “financial systems that feature stronger competition, greater diversity, and closer integration among intermediaries are more likely to direct finance to its most productive use. In such systems, flows of finance are more closely guided by financial signals, and financial resources are more competitively priced.”¹⁵⁰ This premise tends to assume a diverse, privatized and sophisticated financial system and is used to support innovative investment markets that provide new financial instruments that increase the availability of credit by attempting to spread the risk. Such innovation has been lacking in the German banking system, which has been faulted in failing to expand into areas other than traditional interest bearing loans. The current financial crisis, in which innovative American investment instruments such as asset-backed securities and collateralized debt obligations sustained huge losses in the sub-prime mortgage meltdown, has shown us that with such innovation comes considerable risk. The “ideal” of a highly innovative, private financial services industry creates challenges to private and public prudential arrangements that must oversee such a sophisticated financial system, as the current financial crisis demonstrates.

¹⁵⁰ Regional Economic Outlook: Europe, IMF, November 2007, p 28

A more sophisticated financial system requires greater transparency with the open sharing of financial data so that regulators and buyers of financial instruments can effectively assess their risks. The German financial system has typically provided less sophisticated credit through traditional lending. The present German system has grown up based on an insider network of industries and banks that fails to provide adequate transparency for more sophisticated and potentially riskier investments. Despite the internal “controls” provided by insider information within German industry, this insider network was of no help as German banks increased their investments abroad and bought into derivativized mortgage instruments and other such investments in which their insider knowledge of the German economy was of no help. Prudential frameworks must keep up with any change in the financial market as the German (or any other) financial system evolves if the risk of financial crises is to be minimized.

Can Public Sector Banks be privatized?

Other European countries, particularly Sweden and Austria, previously had large public sector banking systems similar to Germany’s and in some cases even larger than Germany’s. For example, France, Italy, Spain, Austria, and Sweden all had three pillar banking systems similar to the structure of Germany’s, with savings banks, cooperatives, and commercial banks. Some of these country’s banks were under even greater public control than the German public banks because up until

the mid-1980's some of these governments also owned major commercial banks. In the 1980's and 1990's these countries undertook major banking divestment programs, particularly following the economic slow-down of the early 1990's. These reforms typically followed a path of consolidation through mergers and the divestment of the states holdings in the commercial banks. Several countries required or allowed their publically held savings banks to form joint stock corporations, while France transformed them into cooperatives. Although these divestments and consolidations appear to have resulted in more competitive banking systems, these countries retain significant public sector control in the governance of savings banks through foundations or "golden shares".¹⁵¹ The changes that have taken place in the banking systems of these neighboring countries appear to have strengthened the competitiveness of their banking systems, as compared to that of the German system, by lessening their dependence on the public banking sector.

Italy's transformation of its relatively undersized bank and public sector dominated financial market through a large scale privatization program in the 1990's has led to a more efficient and less concentrated Italian banking sector.¹⁵² Many of the privatized Italian banks are listed on the stock exchange, making it possible for these Italian Banks to raise capital from a diverse source of investors. This has increased the degree of market-based discipline in the Italian financial system. The increase in non-bank intermediation brought on by the Italian reforms

¹⁵¹ Brunner A et al, p 29

¹⁵² Regional Economic Outlook: Europe, IMF, November 2007, P 31

required a boost to the legal and regulatory frameworks of Italy to maintain investor confidence.¹⁵³ The same is true for the financial system reforms that have taken place in other European countries and which may take place in Germany. The results of privatization of public sector banks in other European countries suggests that similar moves are possible in Germany and will likely be expedited by EU policies and enforced by the European Commission, as we have already seen. Such reform of the German banking system will increasingly bring German banking into line with banking systems in the rest of Europe and will aid cross border banking integration in Europe and the expansion of Pan-European banks, whose activities span several countries. If the German system eventually embraces such reforms, German banks will be in a better position to take part and lead such efforts, likely through consolidations and the freeing up of regional public ties that bind much of the German financial sector. This may allow the creation of German “champion” banks that can lead in the global arena, as well as in Europe.

Since most of European banking regulation remains nationally based in the home countries of its banks, increased Pan-European (and international) banking will increasingly require cross-boarder stability frameworks and greater EU regulation of banks.¹⁵⁴ The EU must consider this need for cross boarder bank regulation and stability frameworks as part of European banking reform if it is to have credibility in calling for the reforms of the financial systems in specific member states, such as the European Commission-applied pressure on the German system.

¹⁵³ Regional Economic Outlook: Europe, IMF, November 2007, P 31

¹⁵⁴ Veron N, *Brugel Policy Brief*, August 2007

Chapter Seven: The German Banking System Under Stress: State-Owned Banks on the Verge of Collapse from the U.S. Sub-Prime Mortgage Meltdown

International financial markets are currently in a crisis precipitated by huge financial sector losses and a resulting credit squeeze that has been extraordinary in its magnitude and global reach. This crisis has affected financial systems across the globe, but primarily in the financial markets of advanced economies whose financial institutions invested in so-called structured finance instruments and related credit derivatives backed by U.S. sub-prime mortgages undone by the bursting of the U.S. housing bubble. This shock drained the interbank money markets of liquidity following the realization that complex derivatives backed by packaged U.S. mortgages were grossly overvalued and of much higher risk than their investment ratings had suggested. European banks that had invested in these instruments for their relatively high yield and presumed safety now found themselves holding virtually worthless commercial paper. Uncertainty of the size and scope of the resulting losses has magnified the shock to the banking industry. The market for Mortgage asset-backed commercial paper (bonds) (ABCP) and derivative investment paper (bonds) based on ABCPs dried up, forcing huge write downs by European and American banks, and other banks across the world, including in Germany.

The securities that created the problem are examples of “innovative” financial instruments that have been touted as the hallmark of a sophisticated financial system that can devise such means to expand the pool of credit; the American securities market. The crisis precipitated by the collapse in the value of these instruments shows what happens when such innovation runs amok, with the bursting of a credit bubble created by the existence of these instruments.

How Sub-prime Loans Became “High-Grade” Investments.

Roger Lowenstein, in the *New York Times Magazine*, describes the process of creating so called high-grade investments out of a pool of sub-prime mortgage loans.¹⁵⁵ These pooled, or grouped, loans were made up from loans extended to borrowers with relatively poor credit histories. Lowenstein describes an example of a bundle of 2,393 mortgage loans issued by a West Coast non-bank lending company under conditions that prevailed at the height of the recent U.S. housing and mortgage bubble. The individual loans that made up this pool were typically issued under liberalized terms that often required no money down so that the borrower had no “skin” invested in the loan. Unlike banks that tend to know their loan customers, these lending companies often failed to verify the income reported by borrowers. As these lenders vied for increased shares of the loan business, they typically promoted adjustable rate mortgages (ARMs) with low “teaser” interest

¹⁵⁵ Lowenstein R, *The New York Times Magazine*, 4/27/2008, p 38

rates and payment amounts, even though these loans stipulate sharp increases in interest rates (and therefore increases in the payments required to service the loans) in the periods after the loans are issued. Such marginal borrowers will predictably not to be able to afford the higher rates on their ARMs, but the assumption by borrower and lender alike was that the lenders would subsequently be able to refinance on better terms because the value of their houses would continue to rise, thereby increasing their equity and qualifying them for better terms on refinance loans. As Lowenstein points out, “This is the classic sign of a bubble—lending on the belief, or the hope, that new money will bail out the old.”¹⁵⁶

The mortgage issuing company could continue to make such loans because they could bundle them for sale as securities (ABCPs) by taking them to a New York investment bank that would subdivide the loans into pools of loans, or investment vehicles, that would “predictably” spread the rate of defaults among different pools of loans based on historical statistical data on loan default rates. These statistics presumably allowed for calculations of the risks and yields of the pooled loans, or vehicle. These pools of loans could then be sold to investors as bonds, returning profit and capital to the mortgage lender. A flaw in this reasoning is that that any statistical prediction is only as good as the data on which it is based. Valid predictions require that the predictive statistical data must be based on loans that were made under the same conditions as the new loans. This was a fatal flaw. The freewheeling conditions under which new loans were issued at the peak of the

¹⁵⁶ Lowenstein R, *The New York Times Magazine*, 4/27/2008, p 38

housing bubble had little in common with the more standard lending conditions that prevailed when the comparator loans were issued. Statistics based on these historical comparator loans were, therefore, unlikely to predict the performance of these new loans, made to borrowers under considerably different conditions that included no money down (compared to requirements of 25% down on the comparator loans), borrowers with lower credit scores, and borrowers who were buying property for speculation in an overheated market.

Nevertheless, these loans were bundled and then presented to a credit rating agency such as Moody's, who analyzed the loan package based on these statistics and assigned a credit rating to the package. The credit rating company then received payment from the lender for its credit rating service, creating a conflict of interest that some say predisposed the agencies to grant these vehicles higher than deserved credit ratings.¹⁵⁷ These loans were then used to issue bonds to the so called "special-purpose vehicle" (SPV), which is a ghost corporation that "purchases" the specific pool of mortgages. This SPV then issues bonds to investors that are backed by the pool of mortgages that it owns. The SPV then uses the monthly mortgage payments to cover the required dividend payments to its bondholders, unless it is unable to do so because of an excess of defaults within the mortgage pool (vehicle). Since the pool is made up of mostly B grade (sub-investment grade) mortgages, the investment bank and the credit agency must be able to somehow turn this poor quality investment (the SPV) into investment grade (e.g. AAA) rated bonds so that

¹⁵⁷ Lowenstein R, *The New York Times Magazine*, 4/27/2008, p 38

institutional investors, such as banks, can buy them—otherwise the bonds would not be generally marketable. This was done by floating 12 classes of bonds backed by the same pool (vehicle) of mortgages. These bonds varied from triple A to a lowly Ba1.

Although the differently rated bonds were backed by the same loans, different bond ratings were rationalized based on a differential priority for repayment. The higher rated bonds have first priority on the cash received from the mortgage holders (the home owners) until they are fully paid, then the next tier of bonds get priority, and then the next tier until all the bonds are repaid. The low rated bonds at the bottom of the pile give their investors the highest interest rates, but if the homeowners default, they are the first to absorb the loss. If the calculated percentage of defaults turned out significantly higher than predicted, the higher-grade bondholders also stand to lose. This stratified, or “structured,” financial vehicle can be compared to a “seaside condo beset by flooding: just as the penthouse will not get wet until the lower floors are thoroughly soaked, so the triple-A bonds would not lose a dime unless the lower credits were wiped out.”¹⁵⁸ These structured financial vehicles allowed sub-prime loans to be sold as investments, thereby making more capital available to lenders to make new loans. However, under the wrong economic conditions, or if the predictive calculations on default rates are wrong, the entire investment may go under. This is exactly what happened to these investments.

¹⁵⁸ Lowenstein R, *The New York Times Magazine*, 4/27/2008, p 39

For the sample pool of loans (vehicle) cited by Lowenstein, Moody's (the private credit rating agency) estimated that the default rate would be 4.9%. The lowest rated bonds would be covered if the loss rate did not exceed 7.25%. Within 6 months of the 2006 issuance of this particular vehicle, 6% of the mortgages in the vehicle were in default. By 2007, 13% of these mortgages were in default, with the default rate rising by the month. This example is typical; many of these mortgage vehicles had even higher default rates. Clearly, those who invested in these mortgage-backed bonds lost money, even those who bought the higher rated, structured bonds based on the same mortgages as the low rated bonds.

The issuing of stratified bonds with different ratings, despite the fact that all the bonds were backed by the same assets (the same sub-prime mortgages), was not the investment bank's final convoluted turn for turning sub-prime "lead" into gold. The original mortgage backed security, described above, was used to back even more esoteric investment vehicles called collateralized debt obligations, or CDOs. CDOs were also financed by issuing similar "ladders" of bonds that were rated by the credit agency from triple-A on down. The CDO bonds were not backed directly by the original pool of loans, but rather by the bonds (paper) that were issued by the original SPV. Such a CDO is called a second-order derivative. (The bonds of the original mortgage backed SPV were the first-order derivative investment bonds, directly backed by the mortgages.) There were even third-order derivative investments, known as CDOs squared, which bought bonds issued by other CDOs. There was no way for investors to determine the quality of the mortgage assets that backed the initial SPV, other than the highly calculated ratings provided by the

credit rating agencies. This lack of transparency becomes extreme when trying to assess the quality of the collateralized bonds that backed the CDOs.¹⁵⁹

The Worst German Financial Crisis Since 1931?

A number of German banks, including ländesbanken, heavily invested in securities backed by U.S. sub-prime assets. For example, the ländesbank WestLB, based in Düsseldorf had five major “conduit” investment programs, including two known as Harrier Finance Funding and Kestrel Funding, that raised capital by selling short-term commercial paper to investors. The Bank then attempted to make profits on this money by investing it in higher-yielding securities that included securities such as structured investment vehicles, described above, that were derived from American sub-prime mortgages.¹⁶⁰ The trading of these asset-backed securities ground to a virtual halt starting in 2007, due to the inability to accurately value these securities in a market in which many of the mortgages that backed them were worthless. As the result, the state of North Rhine-Westphalia was forced to inject one billion euro into WestLB and provide another 3 billion in loan guarantees because of the bank’s losses relating to these investments.

The situation was even worse in the state of Saxony. The state had to issue 2.73 billion in loan guarantees to its ländesbank, Sachsen LB, and the other state-

¹⁵⁹ Lowenstein R, *The New York Times Magazine*, 4/27/2008, p 39

¹⁶⁰ Dougherty C, *New York Times*, 12/4/2007

owned banks (sparkassen) had to provide another 14 billion in guarantees to bailout Sachsen LB. Hamburg-based HSH Nordbank required one billion in capital to bail it out and the Bavarian state bank, BayernLB, declared losses of 4.3 billion euro and reported that it was transferring risk-affected securities amounting to 24 billion euro into a fund backed up by warranties of 6 billion euro that would be backed by the Bavarian sparkassen and the State of Bavaria.¹⁶¹

As the structure of these bailouts show, the German state owned banks are supposed to bail each other out in a crisis, but many of these banks are also in trouble and therefore they are not in a position to help their peers. It is estimated that if an industry giant like WestLB were to fail, at least two other ländesbanken with cross ties and a dozen savings banks (sparkassen) linked through the German Savings Bank Association (Sparkassen-Finanzgruppe) would crumple along with it. The failure of a major ländesbank and its interlinked network of sparkassen could also affect corporate and small business customers, who would be deprived of capital and possibly be put at risk of bankruptcy as well.¹⁶²

Losses from American sub-prime securities have also occurred at German private banks, just as such losses have accumulated on the ledgers of banks around the world, particularly in the U.S. and Europe. The cooperative bank, IKB Deutsche Industriebank AG, a corporate lender, had to be bailed out by the German federal government in February 2008, for the second time since August 2007, due to

¹⁶¹ Reuter W, *Spiegel Online International*, 2/20/2008

¹⁶² Reuter W, *Spiegel Online International*, 2/20/2008

massive write-offs from its sub-prime mortgage securities losses. This bailout consisted of 1 billion euros provided by the German federal government through its development bank, KfW, which is IKBs principal shareholder. Other banks and investors were expected to cover another half a billion euros in losses at IKB. This federal bailout was rationalized by the need to avoid a significant loss of confidence in the German financial sector that would result from the failure of IKB. Various German banks provided the previous bailout package for IKB in August 2007. In both cases, IKB was essentially deemed too big to be allowed to fail, even though it is a relatively small lender.¹⁶³ Deutsche Bank, the giant German private commercial bank, also took write downs from sub-prime losses of 2.2 billion euro in the third quarter of 2007 and another 2.5 billion in losses in the first quarter of 2008.¹⁶⁴

The Role European Central Banks and the European Union in the Sub-Prime Banking Crisis in Germany

The liquidity crisis that resulted from the draining of the interbank financial markets because of uncertainty and losses in sub-prime mortgage securities helped to push affected banks into crisis. The central banks in Europe have acted to inject cash back into the system. The European Central Bank (ECB) surprised markets with a 15 billion euro infusion of extra loans for banks to use to firm up their balance sheets over the Easter holiday weekend, 2008, for example. The timing

¹⁶³ Reuter W, *Spiegel Online International*, 2/14/2008

¹⁶⁴ "Deutsche Bank Warns of \$4 Billion Write-Down," *New York Times*, 4/1/2008

coincided with the end of the financial quarter, a time when accounting requirements often cause increased demands for cash by the banks from the money market lending pool that banks tap for day-to-day operations.¹⁶⁵

These actions by the European Central Bank, as well as similar actions by the central banks of several European countries, are attempts to defuse the credit crisis with infusions of capital for cash-strapped banks to borrow to cover losses or a lack of liquidity resulting from their sub-prime investments. However, European regulators are casting a jaundiced eye on the German state guarantees and bailouts of the German public banks, since guarantees on German public bank investments were supposed to have ended in 2005 according to Germany's agreement with the EC, as noted above. These state bailouts may be violations of the EU rules on state aid for ailing enterprises. Under European rules, the German banks that were bailed out might be required to pay back the aid that they received if the EC determines that these rules were violated. The EC is particularly looking at the state aid that was provided to IKB Deutsche Industriebank and SachsenLB. The German government is arguing that their assistance conformed to the "market economy principle" in which the state is merely providing the equivalent of the aid that any private investor would provide for a private institution to protect his investment. Germany has also argued that the bailouts were necessary to avoid a broader financial crisis. Some analysts maintain, however, that these two banks are too small to cause widespread problems if they fail. The European commissioner for competition, Neelie Kroes,

¹⁶⁵ Dougherty C, *New York Times*, 3/21/2008

maintained that, “It is hard for European citizens to understand why they have to suffer from the economic downturn, while taxpayer’s money is poured into once-profitable banks that took excessive risks and might now avoid paying for their risky strategies.”¹⁶⁶

From the German perspective, the EU position creates a paradoxical situation. The Germans feel that the 2005 dictate from Brussels, which required the elimination of state guarantees on the investments of publically owned German banks, was a major factor in the current German banking crisis. In the view of some German analysts, the consequence of this change meant that the public banks were no longer able to borrow money at lower rates than their private competitors. This change precluded the continued feasibility of the previous business models for public banks, since they could not generate high enough returns on their traditional investments to sustain their higher borrowing costs. Hard up for funds, many of these public sector banks began their speculation in high-yield sub-prime mortgage vehicles and derivatives. This scenario seems to explain why Germany’s public sector banks speculated far more heavily in American sub-prime mortgage securities than the private banks. “Hard up for funds, many of the public-sector banks began speculating with high risk securities....Lacking a functioning business model, they turned to what was essentially gambling—and lost.”¹⁶⁷

¹⁶⁶ Dougherty C, *New York Times*, 2/28/2008

¹⁶⁷ Reuter W, *Spiegel Online International*, 2/20/2008

Chapter Eight: Conclusion

Germany is typically held up as the prototypical example of a country with a bank-based financial system that conforms to the model of a so-called cooperative market economy. The German system is often juxtaposed to U.S. or British examples, which are held up as the prototypes of liberal market-oriented economies, whose financial systems are based on securities markets rather than banks. An analysis of the German banking system both supports and refutes the truths of such “black and white” comparisons. In fact, global market forces have already impacted German banking, a fact brought out by the heavy involvement of German banks in the elaborate investment vehicle systems peddled by American financial markets. The increased involvement of German banks in the securities markets reflected an effort by German public banks to move away from their traditional reliance on low profit interest margins generated by their traditional lending practices as the *hausbanken* for German firms. The quest of German banks for higher profits through increased involvement in global financial markets reflects their efforts to change their business model and represents an example of global convergence in the banking and securities markets. This quest for higher profits through securities investments on the part of German banks was also pursued by banks around the world, many of whom have been similarly stung by the bursting American mortgage bubble. Unfortunately, this changed business model has been a disaster for German public banks, at least in the short term.

The current German bank crisis will likely propel changes that will fundamentally alter the German banking system. Prior crises, going back to the 1920s, have typically resulted in consolidations of the German banking system, for example. Consolidations are already afoot or threatened as the result of the current German financial crisis. The need for bank consolidations in Germany is an oft-repeated refrain by analysts of the German banking system, even before the present financial crisis. These analysts point to the fact that the German banking system is unusually splintered with a large number of small banks.¹⁶⁸ The resulting competition among German banks is thought to hold down profits and efficiencies of scale that tend to make German banking less profitable and less competitive when compared to their counterparts in Europe and elsewhere.

The presence of the very large public bank sector in Germany has also distorted bank competition. For example, public guarantees previously granted to public banks allowed them to obtain capital at cheaper rates than their private competitors, thereby decreasing the need for these banks to innovate to achieve the self-sustaining profit levels required in the absence of public subsidies. The recent stated withdrawal of the government guarantees on public bank investments, which was required by the European Commission (EC), has underscored the need for a more complete divestment of public ownership in German banks. This need is becoming increasingly obvious since a system with public ownership still leaves the government responsible for bank losses. Furthermore, the new business models of

¹⁶⁸ Brunner A et al, p 30

the public banks have led to decreased returns to the public in the form of low interest financing for projects deemed to have a greater public good. Instead, German public banks are moving into riskier, higher yield financial investments offered by the world's financial markets. In this setting, there is less incentive for German governments to pay for the losses of these banks when they get decreasing "gains" in return. The existence of ongoing risk to the government, and therefore to German taxpayers, is underscored by the continued *de facto* government "guarantees" resulting from the simple fact that the public owns the public sector banks. Although the European Union had insisted on the elimination of statute-mandated guarantees on public bank investments, the government is backing the current investment losses of the public banks anyway. This persisting, *de facto* guarantee has resulted in huge government payouts to cover public bank losses on sub-prime mortgage securities, despite the displeasure of the EC.

Government payouts to cover losses in the public banking sector are not new in Germany. It is estimated that more than 20 billion euro have been drained from German treasuries over the last decade to cover losses at public banks.¹⁶⁹ These losses have been laid at the feet of government inefficiency and weakness in dealing with public banks resulting from a fatal mix of greed, political protection, and the amateurism of public officials that sit on public bank boards.¹⁷⁰ These past losses may be dwarfed by the on-going government bailout of public banks triggered by the U.S. sub-prime mortgage investment losses and the resulting evaporation of

¹⁶⁹ Reuter W, *Spiegel Online International*, 2/20/2008

¹⁷⁰ Reuter W, *Spiegel Online International*, 2/20/2008

liquidity in the money market. The liability of the government for these bank losses, which could reach devastating proportions if the banking crisis deepens, speaks to the need for public divestiture of these banks. Such a divestiture could follow the models used in the 1980s and 1990s by Germany's neighbors to achieve banking systems with smaller public banking footprints. This European banking transformation was often achieved through bank consolidations and by allowing public banks to transform into joint stock corporations or cooperatives. Consolidations took place both within and across the banking pillars of these comparator European countries. The end result for these countries was an apparently strengthened and more profitable banking sector, and a much smaller public banking pillar. Although Germany actually started with a smaller public banking sector than many of its neighbors in the 1980s, Germany failed to transform and privatize its banking system and its public banking system is now the largest of these comparator countries.

The bank system transformations that took place in Germany's European neighbors in the 1980s and 1990s offer blueprints for Germany. Such a German transformation will likely be imposed by the European Union over time if Germany fails to act, as can be seen by the actions of the European Commission (EC) in 2001 and 2002 that stipulated the elimination of German government guarantees of public bank investments in 2005. If further bank system transformations are imposed on Germany by the EC and not embraced and directed from within, there will be an increased likelihood of instability in the German banking system. In this scenario, German banks will be increasingly forced to straddle the divide between a

privatized, market driven system and a public banking system. The Germans must build their own bridge across this divide.

The restructuring of the German banking system will require a number of changes. This will have to include a restructured bank stability system, including a bank stability system that crosses European borders to accommodate an increase in Pan-European banks. This later stability framework will require cooperation within the EU and will likely have to involve the European Central Bank (ECB) in greater regulatory responsibilities. Unfortunately, simply “privatizing” the German public banks by issuing joint stock companies does not get the German taxpayer off the hook if the private banks that result are not properly structured and removed from politically incestuous relationships with their local governments. The example of the joint stock corporation that created the Bankgesellschaft Berlin bank out of the Landesbank Berlin and other Berlin state government bank holdings, which was cited in Chapter Six, demonstrates the pit-falls of semi-privatization, and the need for proper prudential and regulatory arrangements at the national level that will accommodate changes to the German banking system that are not covered by current banking stability structures. Both the banking system and the bank regulatory-stability framework will need to be reworked at the same time. This is essential if real gains to the public are to be achieved by privatization and if the historical and remarkable stability of the overall German banking system since World War II is to be maintained after restructuring.

German public banks operate under the local laws of their länder (states). These laws often preclude bank consolidation and restructuring that extend across länder borders. Since ländesbanken and sparkassen are public banks, private sector institutions cannot acquire them. These issues must be addressed, presumably through new federal laws that will allow for the consolidation and privatization of public banks under a federal bank restructuring program. Also, regional limitations on the business operations of sparkassen and other public banks must be lifted, as these laws preserve the fragmented German banking market and thereby distort competition. The governance of public banks must be taken out of the hands of public officials when the banks are privatized, for reasons already discussed, and to encourage private investment.¹⁷¹ Although privatization of the public banks carries risks that dictate careful government supervision and regulation to avoid risky behavior on the part of the privatized banks, we have seen from the behavior of current public bank managers, with their recent gambles on sub-prime mortgage investments and derivatives, that public bank management is fraught with the same risks in the present global financial market. Ideally, privatization and a smaller public banking system will allow German bank managers to heed proper market signals and incentives without the distortion of public involvement.

I do not propose that downsizing the German public banking system, with a commensurate increase in the private banking sector, represents a panacea for all

¹⁷¹ Brunner A, et al, p 30-1

the problems facing the German banking system. Private banks, such as Deutsche Bank, have also sustained large losses from structured sub-prime vehicle investments, for example. Still, the examples provided by other European banking systems suggest that the sustainability and strength of the German banking system depends on such changes, particularly if German banks are to compete in the global market place. Although the notion of privatization seems to run counter to the German cooperative model of capitalism, there are cultural factors in German capitalism that drive some of the positive features of this model. These cultural factors are not necessarily dependent on public banks. For example, German commercial banks play the role of *hausbanks* for the large corporations and the relatively smaller firms that they service, and these are not public banks. The role of Deutsche Bank in the affairs of the Daimler Corporation, cited in the Introduction, is a classic example of the role that banks play in the German corporatist economy. Deutsche bank is, of course, a private bank. The proposed restructuring of the German banking system assumes the continued existence of government owned development banks to continue public development projects that *landesbanken* sometimes assumed.

The German economic train has not always followed the same “cooperative model” economic track. The German economy does not have to invariably and indefinitely follow this model if certain aspects of the present economic structure lose their benefits. Aspects of the current federalized (decentralized) public banking structure originated in the Allied reconstruction plans after World War II and in that sense are not even German. It is fascinating to note that the German system was not

always so bank-based. Germany had the most developed stock market in Europe prior to World War I. In 1913, stock market capitalization relative to GDP was six times higher in Germany than in the United States. At the same time, bank development in Germany was on par with the U.K. and lower than in the U.S.¹⁷² Therefore, German capitalism was much more market-driven and less bank oriented in the past. This relationship was, of course, reversed after World War II. A return to a more market driven economy is therefore quite possible for Germany, although it is assumed that Germany would follow a European model of market capitalism rather than an American model of market capitalism, as Germany becomes increasingly integrated into the economies of Europe through the adaption of EU policies. The structure of German banking is, therefore, almost certain to change over the relative near term.

¹⁷² Krahanen JP and Schmidt RH, "Purpose and structure...", p 7; and "Taking Stock...", p 506

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