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Germany's banks: Overview and international comparison

Germany's banks are currently in the process of overcoming the slump in earnings seen in recent years. Cost cuts and the nascent economic recovery are having an impact.

There were several factors behind the poor performance in the past. First and foremost was weak economic growth in Germany. The number of corporate insolvencies rose steeply in recent years, sending banks' provisions to record levels. In addition, the drop in investment activity left its mark on the demand for loans. In 2002 and 2003 non-financial corporations repaid bank loans to the tune of EUR 60bn net.

The slump on the stock markets, which was particularly pronounced in Germany, also played a key part in the slide in banks' earnings. In 2001 and 2002 the market capitalization of firms listed on the German Stock Exchange halved. This dealt a savage blow to capital market business, knocking commission revenues from equity issues, stock trading and M&A for six.

Moreover, blame must also be pinned on the banks' own failings. In the years up to 2001 cost control was inadequate. The overall administrative expenditure of German banks rose by a good third from 1997 to 2001. At the big banks, expenditure more than doubled over the same period. Behind this sharp rise in costs were increased investment in new information and communication technologies (ICT) and the expansion of investment banking.

The banks were confronted with these external and internal challenges against a backdrop of far-reaching changes in the international framework. In parallel with the rapid progress on the ICT front, the financial markets also saw a stormy development. Derivatives opened up new opportunities for investment and risk transfer. Moreover, the competitive environment also

changed. In Europe, monetary union and legislative steps to harmonize the regulatory framework resulted in an intensification of cross-border competition. German banks, which had enjoyed a substantial competitive advantage with the Deutsche Mark in the past, were particularly affected.

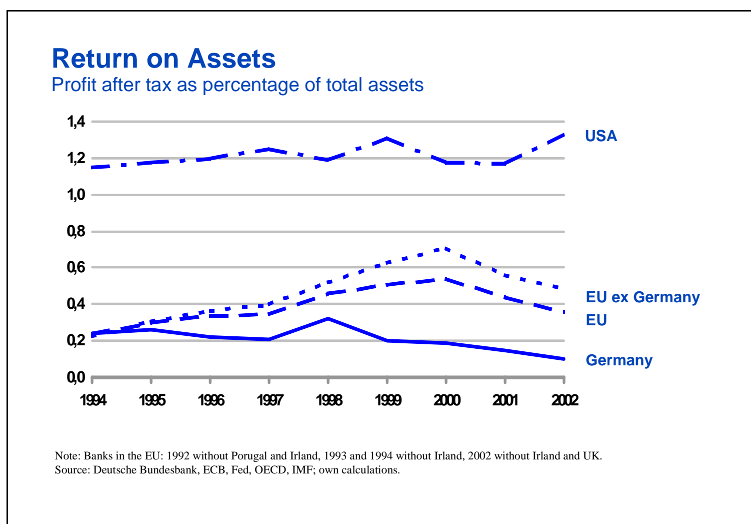
By contrast, the competitive structures in Germany have changed little in the past years. Despite ongoing concentration, particularly among savings banks and credit cooperatives, a key feature of the German banking market is the high density of banks and branches by international standards. For this reason, Germany is often labeled overbanked and overbranched. What is more, Germany also has the lowest degree of market concentration in Europe. Without question, the pressure to become bigger has increased substantially as a result of technological advances in the easy-to-standardize mass retail business of late. This means that Germany's market structures, with the lower market shares held by the market leaders as a result of the low levels of market concentration, are a strategic disadvantage because they limit the opportunities for creating economies of scale. By contrast, other banking markets in Europe (e.g. Italy, Spain, France, Scandinavia) have witnessed dynamic restructuring processes in the past, giving rise to more efficient market structures. Frequently, state privatization programs provided the initial spark.

Profitability

These developments are reflected in the banks' earnings and costs[1]. The profitability yardstick "return on assets" (RoA) has developed differently in the USA, Europe and Germany. The profitability of German banks has steadily deteriorated over the past few years. The sole exception to this rule was in 1998, when net profits for the year at the major banks in particular were skewed upwards by substantial extraordinary earnings.

The US banks, by contrast, recorded a substantially higher RoA across the board. After a turbulent phase in the 1980s (deregulation, savings and loans crisis), their profits surged at the beginning of the 1990s, and have remained at this high level ever since. The US banks' profitability edge stems from a combination of higher earnings power coupled with relatively low total assets; this is reflected first and foremost in very high interest margins (see below). Banks in the EU (excluding Germany) – in contrast to German banks - did at least manage to narrow the gap to their US counterparts in the 1990s. However, the end of the stock market boom and the beginning of the downturn in Europe brought this development to a halt.

[1] All figures for banks in Germany are based on Bundesbank data on the earnings of German banks, currently available up to and including 2002. Figures for the USA are taken from the Fed ("Profits and balance sheet developments at US commercial banks"). Figures for EU banks up to 2001 are based on OECD information ("Bank profitability"); figures for 2002 are taken from ECB reports.



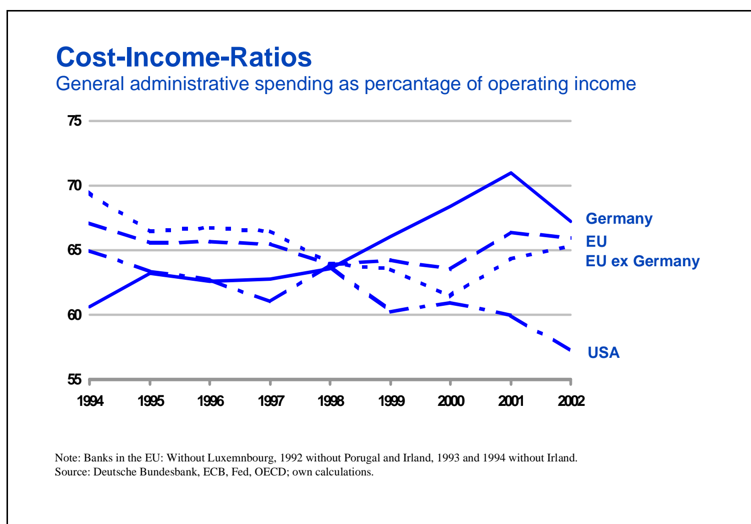
All of Germany's three main banking groups have seen similar developments. Both the public sector banks (savings banks and *Landesbanken*) and the private banks have seen their profitability drop over the past few years. Only the cooperative banks (credit unions and cooperative central banks) managed to halt this downward trend back in 2002. That year also saw a change in the pecking order among the banking groups. The private banks, badly clobbered by the investment banking crisis, were no longer the most profitable group and fell behind their rivals.

Costs

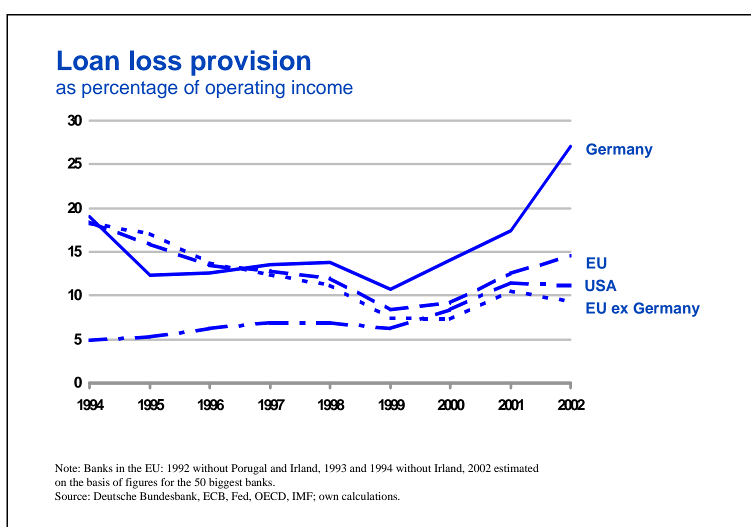
The reasons for the poor profitability of German banks can be traced back to both the cost and the earnings side. The development of the cost-income ratio (administrative costs as a percentage of operational earnings) is particularly revealing.

Up until the year 2000, banks in both the US and the EU (excluding Germany) achieved a more or less steady improvement in their cost-income ratios. Over the past two years, however, a gap has emerged between US and EU cost-income ratios. It would appear that on the costs front, banks in the EU (excluding Germany) were far slower to respond to the end of the stock market boom than their counterparts in the US.

German banks, by contrast, saw their cost-income ratios rise by a total of ten percentage points from 1994 to 2001, a feature largely common to all banking groups. Even during the stock market boom, they failed to convert the costly introduction of new technologies or the expansion of the investment banking business into commensurate earnings growth. However, this trend was reversed in 2002. The vast majority of banks will also have recorded further improvements in their cost-income ratios in 2003 and in the course of 2004 to date.



The trend on risk provisions has seen a relatively similar pattern worldwide in the past, with risk provisions rising significantly across the globe following the end of the stock market boom. In the USA and the EU (excluding Germany), the ratio of provisions to operational earnings rose from a low level to figures between 10 and 15 % (2002). In Germany, by contrast, it rocketed to 27 %. This was partly due to the severe economic slump in Germany, combined with the low equity ratios of medium-sized companies. Furthermore, the fact that the German financial system is generally very heavily tilted towards loans means that company risks are concentrated in the banks' balance sheets. While US banks – and increasingly EU banks, too – deploy a large number of off-balance risk management instruments, it would appear that the boom years in Germany were characterized by a greater willingness to take risks. The necessary reforms have, however, already been introduced in this area. Following the dramatic increase in 2002, the four major banks managed to rein in their risk provisions by almost a quarter last year. The cooperative banks almost managed to halve their provisions. Overall, therefore, the ratio of provisions to operational earnings is likely to have fallen substantially in 2003.

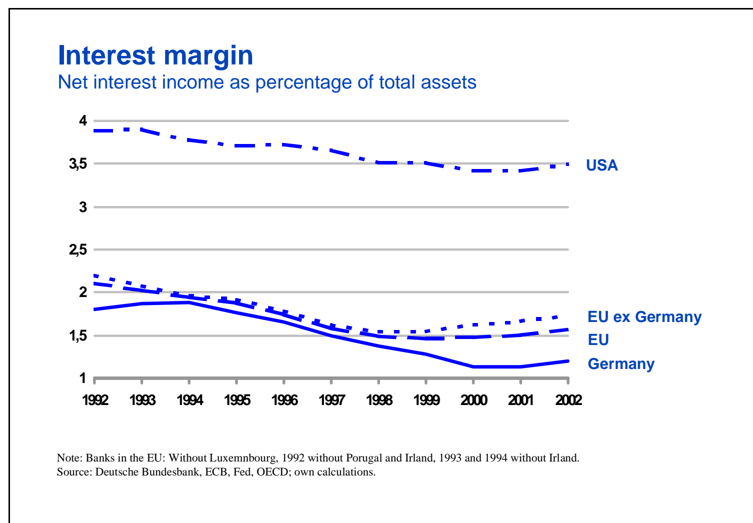


Earnings

Over the past few years, interest margins (net interest income as a percentage of average total assets) have come under pressure around the globe, with competition in the lending and deposit business intensifying further: internationalization, the arrival of new competitors on the market such as car firms, department stores or leasing companies, and the increasing focus of investors and companies on the capital markets, are hitting banks' traditional business hard.

However, the interest margins of US banks are still very high by international standards. This edge is likely to be one of the main factors behind the high profitability of US banks. The reason is probably to be found in the business model of US banks, which enables them, in a capital market-based financial system, to securitize low-margin assets, e.g. mortgages or corporate loans, and thus remove them from the balance sheet. The difference in total assets among the banks substantiates this: while in the USA, the total assets held by banks amount to 70 % of GDP, the figure for the EU-15 is 270 %, and for Germany 310 %.

The interest margins banks in the EU (excluding Germany) and in Germany, on the other hand, have lagged substantially behind their US counterparts. However, since 1998 the trend has drifted apart. EU banks (excluding Germany) managed to stabilize their interest margins, while in Germany the downward trend continued for a further three years. The point in time at which this divide emerged suggests that the introduction of the euro could have been a factor: the overall drop in interest rates to the German level took pressure off the refinancing side at all European banks – with the exception of those in Germany.



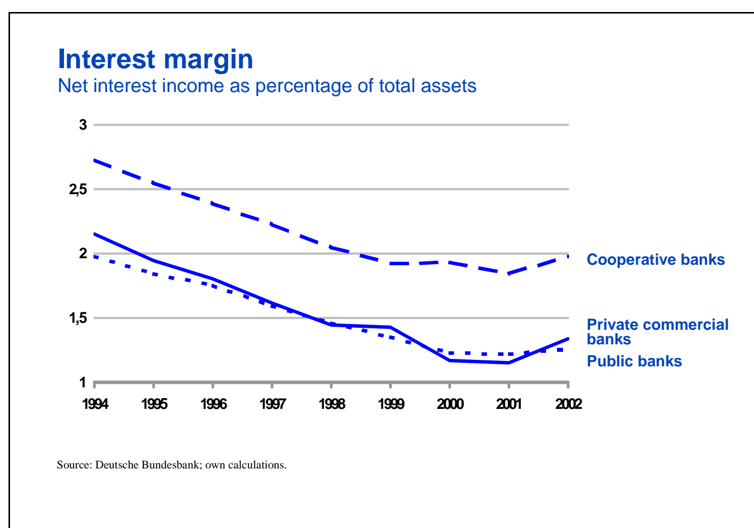
Note: Banks in the EU: Without Luxemnbourg, 1992 without Porugal and Irland, 1993 and 1994 without Irland.
Source: Deutsche Bundesbank, ECB, Fed, OECD; own calculations.

There is also scant variation in the development of interest margins within the individual German banking groups. Public sector banks and private banks have the same low interest margins, while the cooperative banks have by far the highest interest margins. The large gap between the public sector banks and the cooperative banks is surprising given that both have a similar market set-up with their broad retail networks and strong deposit base. The difference is attributable to the

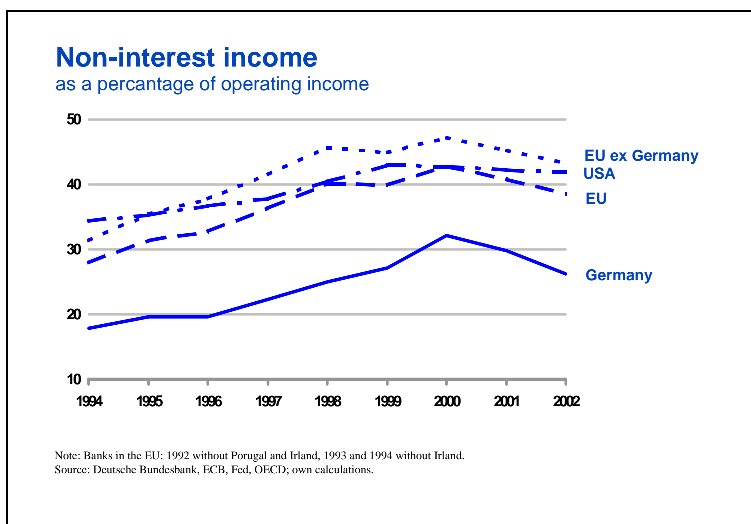
importance of the central institutes – which in both cases have very low interest margins – in each group. In the public sector banking group these are of particular importance.

In 2002, all banks saw the new focus on a risk-adequate lending policy push up interest margins again, despite declining loan demand. In 2003 this trend will have continued, supported by a steep yield curve. This is reflected in the new EMU statistics on interest rates. These show that in 2003 German interest rates for new corporate lending were consistently below the EMU average.

The flip side of the growing risk awareness among banks are rising demands on companies when it comes to borrowing. As part of the risk analysis, banks are generally demanding more transparency on the part of the borrower. Smaller companies find themselves confronted more frequently with the demand for collateral; doubts about the creditworthiness can lead to the rejection of a loan application. However, these difficulties signal neither a general credit crunch nor the withdrawal of individual banks or whole banking groups from SME-lending. Rather, they are the upshot of the adjustment to capital market conventions which in the long term will benefit not only the banks but also their customers. The bridge to the capital market which now needs to be built will in future open up new financing options for small and medium-sized enterprises as well.



In terms of non-interest income, too, developments across the globe have been more or less in sync over the past few years: substantial increases until 2000, followed by a slowdown spurred by the end of the stock market boom. German banks have the lowest share of non-interest income as a proportion of total operational earnings. This demonstrates the low capital market exposure of the German financial system as a whole. Not only does lending continue to be the preferred means of corporate financing, but the retail business, too, is still trailing other countries in terms of commission income from the sale of financial products. This can be seen in the relatively low number of products sold per customer, the so-called cross-selling ratio. According to a report by Mercer Management Consulting, this figure averages around 2.6 in Germany. Other banks in Europe and in the USA notch up figures of over 3 and 4, respectively.



Outlook

The 2003 single-entity financial statements of the four major banks (financial statements of the public limited companies in accordance with the German Commercial Code (HGB)) indicate that the banks have reined in their costs sharply. Risk provisions were reduced by almost EUR 1.4bn, while administrative costs were cut by almost EUR 0.5bn. Other banking groups were only partially successful in reining in costs – with the exception of a few *Landesbanken*. Both the savings banks and the cooperative banks saw administrative costs rise further, if only modestly. However, the cooperative banks managed to slash risk provisions by almost EUR 2.8bn; among the savings banks, by contrast, this cost block fell only slightly.

On the earnings side the picture is reversed. Both savings banks and cooperative banks were able to lift their profits thanks to their strength in the less volatile retail banking sector. On balance, they improved their profitability in 2003. By contrast, the four major banks continued to be hit by the weak economic environment. Furthermore, radical "clean-up operations" at some banks weighed on earnings. As a result, overall profitability slipped again to –0.4 %. The picture was similar at the *Landesbanken*.

All in all, therefore, 2003 is a year of transition. The efforts of the banks to boost profitability are starting to bear fruit. However, at the same time, the restructuring still poses a major burden and the new business models still have to prove themselves in practice. This means that, for the market as a whole, 2003 is unlikely to see a fundamental recovery in the profitability of German banks. The restructuring process, above all at the big German banks, is not yet complete.

A sustained reduction in administrative costs remains a key task. Given the measures already introduced – outsourcing, back office cooperations, tighter grip on cost management among other things –Germany's banks should be able to bring their cost-income ratios back down to the European average relatively swiftly. The same applies to risk provisions. Improved risk

management and the systematic implementation of risk-adequate pricing for loans represent the key to further reducing risk provisions despite the difficult backdrop – low capital bases at companies, falling real estate prices.

Risk-adequate pricing for loans is equally important with regard to improving the interest margin. In addition, the development of the securitization markets to “cleanse” bank balance sheets of low-margin assets, should help to boost interest margins.

The main challenge faced by banks, however, lies in the expansion of the capital market business. In Germany, too, corporate financing and private pension schemes will become increasingly geared to the capital market. Banks can push this long-term process along by offering companies integrated financing solutions and by producing and marketing tailor-made financial products for private customers.

These efforts by the banks will be supported by an improvement in the overall economic framework in 2004 and most likely in 2005 as well. The nascent economic recovery will rekindle demand for loans. The drop in the number of major corporate insolvencies should help reduce provisions. A pickup in capital market activities is also on the cards. There are initial signs of a revival on the markets for new issues and M&A. These positive fillips point to a sustained increase in bank earnings.

Moreover, things have also started to move on the German banking market. The modification and gradual elimination of state guarantees from mid-2005 is putting pressure on public sector banks to adjust. The number of cooperations – also cross-pillar – is on the increase. And finally, changes in the competitive environment in Europe are leading to a growing presence of foreign providers. These trends are a sign that market structures in Germany are gradually becoming more efficient, if less so than would be possible given a radical overhaul of the three-pillar structure.

The phase in which a cumulation of negative factors knocked German banks back in international terms appears to be over. Rather, changes in the economic and competitive environment as well as in internal structures suggest that a new cycle has begun in which German banks make up lost ground against their international competitors. Banks in the USA and in many European countries will struggle in future to boost their performance still further. They have already largely completed their restructuring processes and, in many cases, their costs are starting to rise sharply again. By contrast, banks in Germany, while with much work still to do, can also look forward to harvesting the fruits of their efforts.