Economic Research
Allianz Group
Dresdner Bank

Working Paper

No. 28, December 17, 2004

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The late 1990s were a heyday for optimists. Exuberance was rife on the financial markets in Germany. The stock market boom, the rise of the Neuer Markt for technology and growth stocks, the floating of Telekom hailed as marking the advent of Germany's equity culture, introduction of the electronic trading system Xetra and last but not least establishment of the European Central Bank in Frankfurt fueled fond hopes of the part that city would play in an increasingly integrating Europe. Sadly, though, this keyed-up mood did not survive the bursting of the stock market bubble.

Two years ago it was the turn of the Cassandras. German banks were headed down the Japanese road, they prophesied, and the financial community in Germany's premier banking location Frankfurt was in the process of disintegration. Unlike the Cassandra of antiquity, these prophets did indeed find an audience, although fortunately their predictions turned out to be wrong.

The German banks have mustered the strength to tackle their difficulties. Painful as the necessary retrenchment has unquestionably already been, a glance at their international rivals shows that the process of boosting their earnings power is still not complete. But this has hardly anything in common with developments in Japan: There have been neither any spectacular bank failures or accounting scandals, nor has the government had to stump up billions of euros in financial aid. Whereas Japan teetered on the brink of a financial crisis for an agonizing decade, even in the "crisis years" 2002 and 2003 the financial system in Germany proved stable.

Indeed, deliberate provocation with doom and gloom scenarios has given the players on the financial market fresh impetus. For almost exactly a year now, the "Initiative Finanzstandort Deutschland" (IFD) has successfully been implementing a plan of action to strengthen Germany's position as a financial center. There are two particular features that set the IFD apart from the usual lobby groups. First, the policymakers – the German finance ministry – are on board; and second, the initiators – leading banks and insurance companies – have committed themselves to

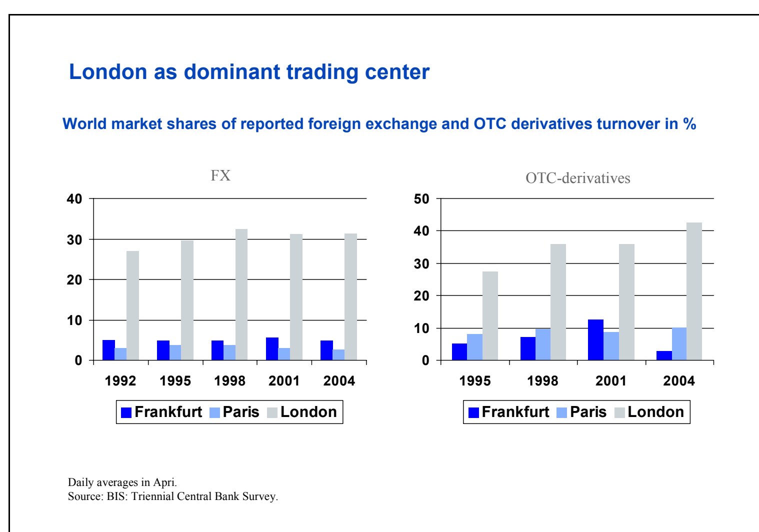
implementing the measures and products. The IFD does not merely make demands, it is also capable of creating its own momentum.

The German financial markets and market players have mastered the real stress test of latter years. However, complacency with this achievement would be equally as misplaced at present as the extreme mood swings of the past. After the emotional roller-coaster in recent years, it is time for some objective stock-taking. Even now that the most pressing tasks have been dealt with, the challenges facing Germany as a financial center remain considerable, because the coordinates in the European financial landscape are changing rapidly.

Challenges

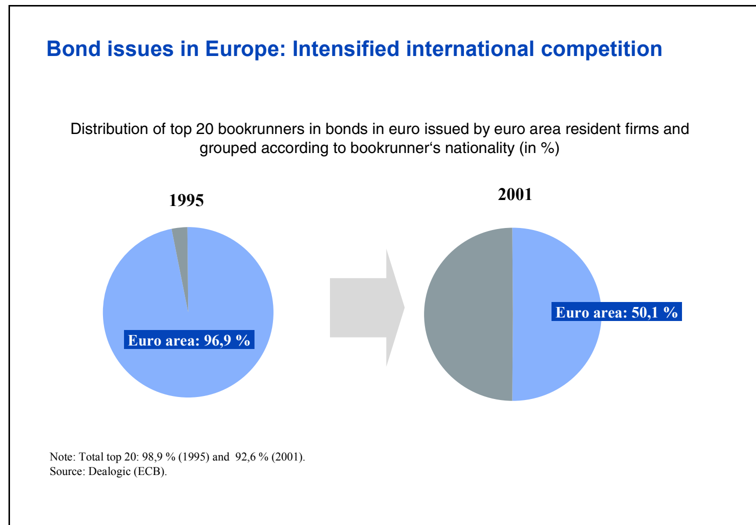
Since the launch of the euro, if not before, competition in Europe has intensified appreciably. This is most keenly felt by Germany, which enjoyed an exclusive interest-rate and currency edge on other European financial locations in the bygone era of the D-mark.

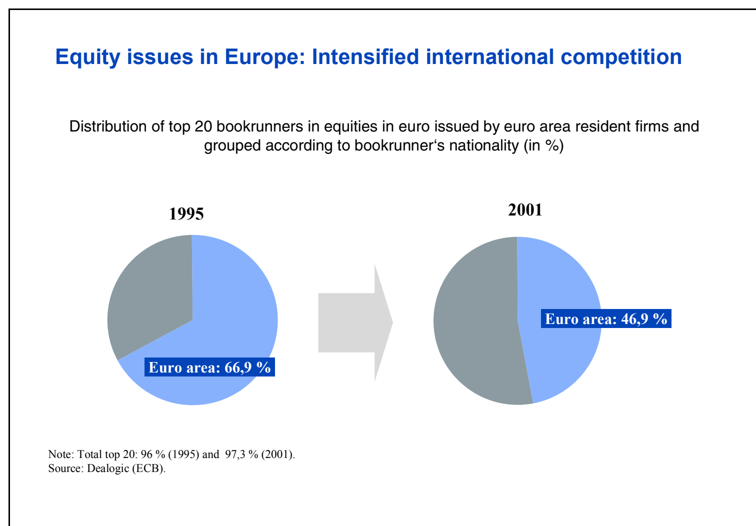
Even though the euro, and also ongoing moves to harmonize and standardize the legislative, regulatory and tax framework, have not yet created a genuine single financial market, there can be no doubt that national borders are becoming less important for many financial market activities. Besides the money market (unsecured interbank market) the foreign exchange and derivatives markets (currency and interest rate swaps) already constitute single markets. They are broadly self-regulated and operated by professional players. The agglomeration advantages – scale effects, market depth and liquidity and personal networks – have enabled London to establish itself on these markets not only as the predominant European, but indeed global trading center.



On other markets, though, that depend on a uniform infrastructure (e.g. securities clearing and settlement) and a harmonized legal framework (e.g. regarding collateral for repo transactions) the level of integration is lower.

In customer-driven business it is mainly in the field of wholesale banking that providers, not least the American investment houses, are increasingly adopting a pan-European strategy. This has considerably intensified competition, to which the fundamental shifts in market share in euro area corporate issuance are testament. There are no such things as national fiefdoms in European investment banking any more; these days the market is determined largely by global players.





Relative to big-ticket wholesale business, internationalization of the retail sector is still making very slow progress. Even in the euro area, the share of loans to customers abroad is still under 3 % (third quarter 2002), having risen less than one percentage point since the launch of the euro. The negligible proportion of cross-border activity is certainly due partly to natural factors, given that language, cultural aspects and business customs play a particularly important part in transactions with individual customers. But it is also symptomatic of incomplete harmonization of financial regulations as well as a fragmented consumer protection, taxation and contract law environment.

In view of this, moves toward consolidation in the retail sector so far have been confined largely to the national context. In many countries, Germany being the notable exception, this process is now

almost complete. In the coming years, it will find its logical continuation on the European stage. For all the differences that still exist between the individual national markets, in the face of mounting global competition Europe will hardly be able to afford the luxury of some 20 big banks against a mere handful of American banking titans. Instead of European mergers coming about in the aftermath of further progress on integration, the situation will be reversed, with growing pressure for European banking consolidation speeding up the pace of integration.

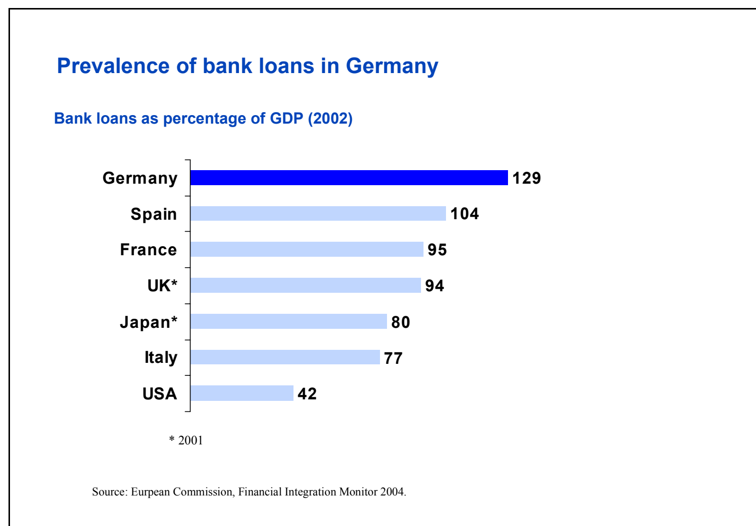
However, it is not only the emergence of an increasingly integrated European financial market that is shifting the parameters in the world of finance. Progress in information and communications technology is revolutionizing both the banks' distribution and process infrastructure, their back office operations. Banks are increasingly turning into "producers". This "industrialization" of the financial industry is encouraging a new kind of division of labor along the value chain. Standardized processes such as account management, securities settlement or payments processing are being outsourced and consolidated.

A second revolution is taking place in the field of financial engineering. In its headlong expansion, the cosmos of derivative financial products is creating new ways of sharing and managing risk. These days, modern risk management is increasingly taking place off-balance rather than on-balance.

Germany's financial markets, too, must respond to these seismic changes. At issue is not the establishment of one single European financial center. It is very unlikely that all business sectors and elements of the value chain will be concentrated at just one location. On the contrary, the configuration of activities will differ from one location to another, with each financial center building up its own unique profile. The challenge facing Germany is to capitalize on the potential inherent in its position as the biggest economy in Europe to generate the matching competitive power for its financial sector.

Potential

Germany's financial structure is seen as the prototype of a bank-based system. This is apparent, for one, in the high ratio of outstanding bank loans to gross domestic product. For another, the banks are still by far the most important providers of external funds for the corporate sector. Whereas in the United States, for example, the share of bank loans in overall corporate financial debt has now fallen to below 20 %, in Germany it remains stubbornly high at around 70 %. The stock market boom and European financial market integration have so far done nothing to dim the banks' starring role as the principal financial intermediaries.

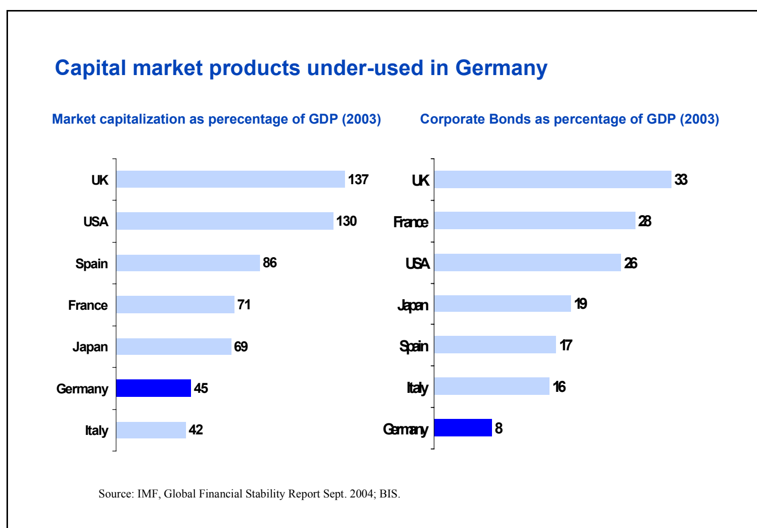


The bank-based organization of the German financial system reflects an economic structure strongly hallmarked by small and medium-sized Mittelstand businesses. Particularly for smaller companies, access to external funding is very important indeed, as information asymmetries can have grave implications for them. The relationship banking inherent in the German system offers a way out of this conundrum. The intensive interaction of company and bank gives the "house bank" a position of trust in the lending relationship. This encourages increasing investment in the relationship, leading to the generation of private information, with positive repercussions on the availability of loan funds. Empirical research by Elsas and Krahnen (2004) shows that in the event of financial difficulties house banks assume the function of a kind of "liquidity insurance".[1]

However, the past years of economic stagnation have exposed this bank-based financial system to considerable strains and uncovered evident weaknesses. Owing to their low capital ratios – the flip side of ample credit availability – many Mittelstand companies lack the risk buffer needed in such situations. On the other hand, the predominance of credit financing has led to the concentration of risk at the banks, which have not transferred their loan exposure to the capital market on the same scale as in other countries.

Moving ahead, lenders will have to hedge their credit risk more, and differently, than in the past. In Germany, too, more and more loans are being securitized, making them tradeable on the capital market. Innovative securitization instruments can build a workable bridge from loan finance to capital market business as a more efficient way of managing risk in future. This is also in enterprises' own interest as excessive concentration of corporate risk on banks' balance sheets lowers their willingness and ability to provide further loans. In broad terms, greater use of capital market products will bolster the financial health of both companies and banks.

[1] Ralf Elsas and Jan Pieter Krahnen, Universal Banks and Relationships with Firms, in: The German Financial System, Oxford 2004, edited by Jan Pieter Krahnen and Reinhard H. Schmidt.

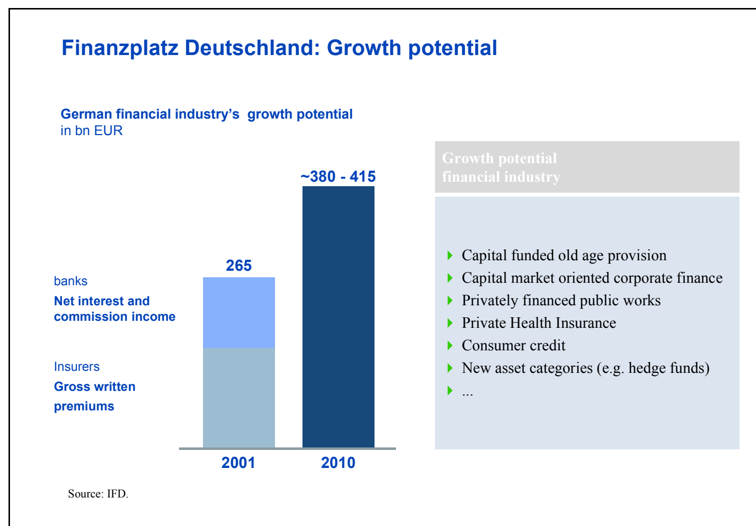


Source: IMF, Global Financial Stability Report Sept. 2004; BIS.

But more market orientation is also required of the providers as well as the takers of capital. The household sector will be obliged to build up more assets, with the driving force coming from reform of the social welfare systems dictated by demographic trends. As government slims down its offer of comprehensive social welfare, so personal provision will move to the forefront. Growing willingness to assume individual responsibility will focus attention on products offering an attractive risk-return profile, such as investment funds, direct investment in stocks and bonds and alternative investments.

“Nest-egg” saving is intended primarily for retirement purposes, and it is here that the need to catch up on full funding is most pressing. But in future, the financial consequences of illness and unemployment are also likely to be perceived as personal financial risks calling for higher individual saving. The same applies to the cost of children’s education.

Strengthening corporate finance through closer alignment to the capital market, and the need for more precautionary saving mark the major challenges to the financial markets in Germany – and equally their greatest potential. Ideally, these shifts on the demand and supply side could lead to a virtuous circle, with expansion of the range of financial instruments for companies broadening the spectrum of investment products for future nest-egg savers and their agents (mutual funds) and the influx of fresh investment capital from these savers encouraging the formation of new and liquid private equity and derivative markets. Earnings growth in the order of 4 to 5 % a year could then be obtained in the financial sector.

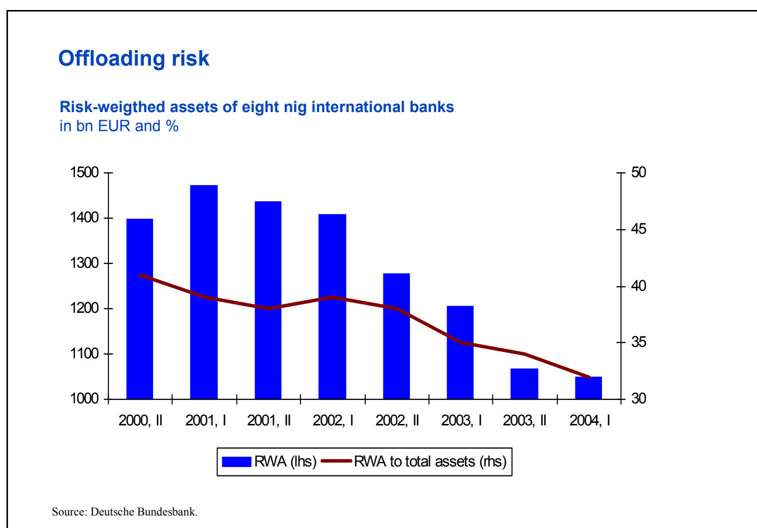


Outlook

Of course, realization of this growth potential depends in no small measure on speedy improvement of the institutional framework. This requires further and ongoing cooperation between political and financial decision-makers in the IFD.

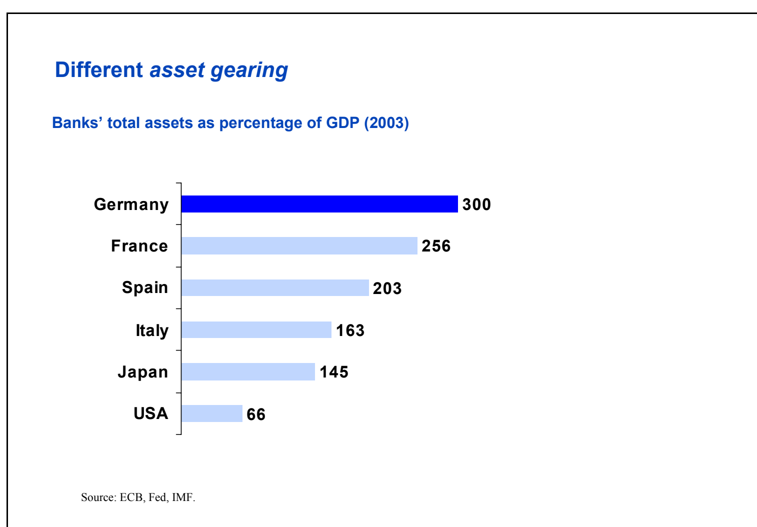
Equally important, though, is stronger economic growth. Without investment and the corresponding financing needs there is quite simply not enough demand to make new instruments marketable. One example is the German banks' securitization initiative, TSI. Their platform has hardly been used yet, since still-slack credit demand – and hence under-utilization of the banks' risk capital – makes the use of alternative refinancing seem obsolete. However, after years of successful but equally painful corporate restructuring, the German economy is showing signs of overcoming the slump in investment. The present earnings and debt picture should give companies new scope.

What is more, intense discussion on the new Basel II Capital Adequacy Directive has led to an altered risk awareness on both sides of the market. These days no one seriously questions the need for risk-adjusted lending. The growing significance of credit rating is highlighting the importance of being in robust financial shape. The differences in resilience between the German banking system and more capital market oriented systems have opened people's eyes to the ground the former needs to make good. The big banks have already learned their lessons from this by massively reducing their risk assets in recent years, not least through the use of secondary markets for troubled loans.



Has the German financial sector therefore reached a crossroads? Do we need a paradigm shift from the German-style bank-based system to the market-based system practiced in the US? No. It would be foolish to throw the baby out with the bath water. Yes to greater capital market focus and more intensive use of the many risk diversification tools – but at the same time maintaining close bank-client and trustful lending relationships.

Shrinking the role that the banks have to play in the capital allocation process is not on the agenda. But the relationship between bank and client will change, implying redefinition of the role the banks have to play. Looking forward, banks will remain an indispensable partner for takers and suppliers of capital, indeed they are likely to become even more important. The more complex the world of financial products becomes, the more importance attaches to banks as financial entrepreneurs capable of offering their clients customized risk management solutions. But this risk transformation will no longer automatically imply taking exposure onto their own balance sheets. In Germany, too, it will no longer be possible to gauge the banks' importance for capital allocation from the size of their balance sheets.



So what we want is not a paradigm change, but a melding of bank and market. The polarization in corporate finance between bank loans or the capital market should be replaced by credit financing and the capital market. Credit financing will remain the predominant vehicle for German Mittelstand companies, but supplemented with capital market products. New instruments such as asset backed securities or credit derivatives allow the banks to place the general credit risk on the capital market. In this symbiosis, classical credit financing becomes more attractive again – and with it traditional relationship banking. The possibility of transferring risk makes banks more willing to continue "investing" in their customer relations, i.e. to generate customer-specific information, as intended in the rating-based Basel II approach.

Equally, "banks" and the "market" are ideal complements in personal banking. The transformation of social welfare systems from PAYG to more fully funded models calls for altered savings behavior in Germany. What will be needed in future is active and systematic engagement with the subject of asset formation and consumption. Internationalized and more sophisticated investment strategies are wanted. In short, customers will demand more retirement vehicles, but above all they will require additional advice. And who better to satisfy this than the banks with their longstanding client relationships?

If this symbiosis between the banks and the market can be realized, Germany as a financial center will emerge strengthened from the crisis years. Indeed, it could even scale new heights, assuming a preeminent position in Europe resting on a combination of size and excellence.