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Cross-Country Perspectives in Europe

Allan Brunner, Jörg Decressin, Daniel Hardy, and Beata Kudela

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The following symbols have been used throughout this paper:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (e.g., 2000–01 or January–June) to indicate the years or months covered, including the beginning and ending years or months; and

/ between years (e.g., 2000/01) to indicate a fiscal (financial) year.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

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I Overview

Germany's banking system is composed of three pillars—public sector banks, cooperatives, and commercial banks—which differ with respect to ownership and objectives. The public sector banks—comprising the Landesbanken, mostly owned by the states; Sparkassen (savings banks), mostly owned by local governments; and development institutions—operate commercially but also have a public mandate and currently benefit from a government guarantee. The cooperatives serve the interest of their owners, who are also their depositors and borrowers. Even among the commercial banks, several of the smaller institutions are held by only a few, stable shareholders.

Banking systems in several other European countries have a similar three-pillar structure but have recently introduced more flexibility for cross-pillar restructuring. Those countries formerly had banking systems similar to that of Germany (often indeed modeled on the German system), which were transformed during the 1980s and 1990s to introduce more varied forms of ownership, reduce the role of the state, increase market incentives, and facilitate ongoing restructuring and reorientation. That experience and the recent performance of their banking systems, in economies that in many ways parallel the German economy, are helpful in identifying some of the factors affecting German banks and suggesting approaches to reform.

This paper takes a cross-country perspective on the performance of German banks and some of the challenges that lie ahead. The objectives are twofold: (1) to compare the performance of German banks with those in the other countries; and (2) to reflect on the role of the public sector in the German banking system and how the structure can be adapted to changed circumstances. The comparison is mainly with the banking systems of France, Italy, Spain, and the United Kingdom, with some information also on developments in Austria and Sweden.

The cross-country comparison suggests that banks in Germany tend to be less profitable—even in comparisons across similar pillars—than those in the comparator countries. Further, profitability has fallen sharply over the past five years, unlike in the other countries reviewed. The paper seeks to establish whether German banks post lower profits because of cost inefficiencies or low revenue. The comparison first focuses on cost and revenue ratios. Then it estimates the deviations relative to "best-practices" cost and revenue functions that are fitted to microeconomic data on banks operating in the countries reviewed. The findings indicate that banks in Germany are less profitable than banks in the other countries mainly because of lower revenue mobilization, and in particular their inability to increase noninterest revenue to compensate for narrowing spreads. The fact that profit maximization is not the primary motive for large segments of the banking system may explain part of the gap.

Further pressure on bank profitability in Germany is likely because government guarantees for public sector banks will be terminated starting in mid-2005. This change is likely to affect primarily the Landesbanken, which are mainly engaged in wholesale intermediation with narrow margins. The results suggest that the phaseout of state guarantees could put the profit margin of the Landesbanken sector at risk, unless they change their current business model. This would also have repercussions for the Sparkassen (savings banks). The various Landesbanken and their associated Sparkassen are already responding with the development of different business models. These new strategies, however, do not involve the introduction of private capital because of legal and other obstacles, thus constraining options for innovative restructuring and the strengthening of market incentives.

The paper also reviews the various arguments for and against public involvement in banking in Germany. It analyzes two specific questions: first, does efficiency differ markedly between publicly and privately owned banks? Second, are market failures in Germany sufficiently extensive that their correction warrants public ownership of almost half of the banking system? The analysis comes up with largely negative answers to both questions: there seem to be no major differences between the efficiency of public and private sector banks; nor are there major market failures. The paper concludes with a review of the efforts of the other countries to reform their public sector banks, observing that a greater role was afforded to the private sector during the 1990s and that this accompanied financial strengthening.