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## **BACKGROUND PAPER**

### **THE GERMAN BANKING SECTOR: COMPETITION, CONSOLIDATION & CONTENTMENT**

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# THE GERMAN BANKING SECTOR: COMPETITION, CONSOLIDATION & CONTENTMENT

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## Abstract

*The German banking sector is undergoing tremendous changes. Its' time-tested three-pillar model has come under fire from within and without. On the one hand, both inter- as well as intra-sector rivalry is increasing. On the other hand, the European Union is forcing the government to liberalize the market for financial services and has removed the state-guarantees for the public sector banks. Yet further, the threat of entry by foreign banks has increased on account of the globalization and the extension of the European Union.*

*German banks are therefore under tremendous pressure to perform even better. Retail customers, who were looked down upon by many "big banks" are suddenly being wooed by all and sundry. The business is full of competition and the pressure to consolidate obvious. In this scenario, it is natural that German banks are today faced with the need to get innovative ideas to retain and extend their customer base while trying to increase profitability. This paper provides a background overview over these developments.*

**Keywords:** German banking sector, three-pillar model, globalization, liberalization

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## Introduction

In order to undertake a context-sensitive assessment of the situation specific to the German banking sector it is imperative to have at least a brief overview of the composition of the banking sector in Germany, so that meaningful recommendations can be derived for banks active in this segment.

### Germany's banking system

Germany's banking system consists of a large number of credit institutions. At the year-end 2004 there were 2400 credit institutions in Germany, running a network of 45.467 full-fledged branches [Bundesbank, 2005a, p. 129]. This network included the *Deutsche Postbank AG*, the erstwhile banking-related business of the German Postal Department (*Deutsche Post*) and now organised as a legally independent, publicly listed subsidiary with the Deutsche Post as major shareholder. Its branches are usually located in the same office spaces as those of the Deutsche Post.

The following table shows the contrast in the number of credit institutions with an obligation to maintain minimum reserves with the *European Central Bank* (ECB) in selected European countries at the year-end 2004 [ECB, 2005, p. ix].

Germany	France	Italy	Netherlands	Spain
2148	897	787	461	346

**Table 1: Credit institutions with minimum reserve obligation to ECB**

The German banking sector is thus obviously fragmented and, almost necessarily, consists of a large number of small players. Often described as a three-pillar system ("*Drei-Säulen-Modell*")<sup>3</sup> it can be divided into three main categories:<sup>4</sup>

- i) **Public sector banks:** The public sector banks comprise of savings banks ("*Sparkassen*"), organised on a regional basis, and their head institutions known as "*Landesbanken*", usually organised on a provincial basis. The development banks (e.g. "*Landesbausparkassen*") also belong to this group. In recent years there have been instances of mergers amongst "*Landesbanken*" (e.g. *Hamburgische Landesbank* and *Landesbank Schleswig-Holstein* have merged into a new entity

<sup>3</sup> There are banks however that are assigned to an extra category "others".

<sup>4</sup> See for this complete section [Brunner et al., 2005, pp. 2-6] unless specified otherwise.

called *HSH Nordbank*). The public sector banks control almost half of the banking market in Germany. The Sparkassen and Landesbanken control over two third of this share. The public sector banks are expected to promote the economic development of their respective regions e.g. by financing viable business plans and subsidising local public goods. They therefore do not follow the objective of profit maximization and are allowed to operate only within the geographic region of their owner, usually a municipality. The competition amongst Sparkassen is for this reason virtually non-existent. The Sparkassen, which are required by law to open a current account (giro account) for anyone interested, enjoy state guarantees in return. The state carries a liability obligation (“*Gewährträgerhaftung*”) as well as a maintenance obligation (“*Anstaltslast*”). So that public sector banks carry virtually no risk of default. However, state guarantees are now being phased out due to sustained pressure from the EU that regards them as a distortion of competition. Obligations entered into after 18<sup>th</sup> July 2005, thus, do not enjoy outright state guarantees. The state however retains the ownership of these banks and may step in to save a bank from defaulting, subject to approval from relevant competition authorities of the EU. There were 477 Sparkassen and 12 Landesbanken in Germany at the year-end 2004 [Bundesbank, 2005, p. 104]

- ii) **Cooperatives:** The cooperatives usually adhere to regional principle but are not required to do so. They are often the main, sometimes the only, competitors of the Sparkassen in small towns and rural areas that not lucrative enough for private sector commercial banks. Cooperatives are owned by their members, whereby each member can only own a certain amount of shares. Also cooperatives do not work for profit maximization. The main source of their funding are retained earnings and equity contributions from new members. There were 1338 cooperative banks and their 2 head institutions at the year-end 2004 [Bundesbank, 2005, p. 104].
- iii) **Commercial banks:** The third pillar of Germany’s banking sector comprised at the year-end 2004 of 357 private sector commercial banks that included 5 large domestic banks that are referred to as “big banks” (“*Großbanken*”), 128 foreign banks with branches in Germany and 224 other domestic, smaller sized banks [Bundesbank, 2005, p. 4]. The “big banks” are *Deutsche Bank AG*, *Bayerische Hypo- und Vereinsbank AG (HVB)*, *Dresdner Bank AG*, *Commerzbank AG* and *Deutsche Postbank AG*. The Deutsche Postbank AG was included in Dec. 2004 in

this category [Bundesbank, 2005, p. 104]. The private sector commercial banks operate on the principles of free-market economy and have no restrictions on their area of operations. They do not enjoy state guarantees and are obliged to maintain statutory minimum reserves with the ECB.

## Main characteristics of the German Banking Sector

In the following we discuss some main characteristics of the German banking sector in order to identify the challenges facing it.

- i) **Pressure to consolidate:** The banking sector in Germany has seen a decline in the number of credit institutions from 2697 in the year 2001 to 2400 in the year 2004 [Bundesbank, 2005b, p. 104; Brunner et al., 2004, p. 2]. Banks are under tremendous pressure to consolidate [Karsch, 2005, pp. 1-2]. They are even being encouraged by the government to actively look for mergers within national boundaries to avoid hostile takeovers by foreign banks, see e.g. [Hulverscheidt and Hönighaus, 2003, p. 1; Krosta, 2003, p. 1]. Even public sector banks are now planning to coordinate their moves in order to better protect themselves against commercial banks and to follow aggressive market-strategies [Schmid et al., 2005, p. 23]. The competition is at the same time, however, seriously distorted since there is little or no competition within the public sector and cooperative segments as of now.
- ii) **Increased competition from foreign banks:** The number of active foreign banks in Germany increased from 79 in the year 2001 to 128 in the year 2004 [Bundesbank, 2005b, p. 104; Brunner et al., 2004, p. 2] Hence it may be assumed that foreign banks regard Germany as an important and/or attractive market. The recent takeover of *Bayerische Hypo- und Vereinsbank AG* by *Unicredit* of Italy is a proof for an increased interest of foreign banks. The ongoing globalisation and the integration of the EU are expected to further intensify this trend.
- iii) **Relative low profitability:** The profitability of German banks across all pillars of the banking system is relatively low in comparison to other developed countries [KfW Research, 2005, p. 1; Brunner et al., 2004, p. 8]. The profitability has fallen over recent years which might be partially explained by increased competition. Brunner et al. [2004, p. 30] suggest that the low level of profitability is caused among others by a weak revenue-to-asset and a high cost-to-asset ratio, existence

of a large public sector for which profit maximization is not the primary objective and finally a lower proportion of high-value-added activities.

- iv) **High Productivity and customer satisfaction:** German banks are regarded to work efficiently. Their productivity growth is higher than in most other sectors of the German economy. In international average only Japan amongst developed countries is reported to exceed productivity gains of German banks [KfW Research, 2005, p. 13]. A flip side of the low profitability seems to be cheaper services for the customers [Brunner et al., 2004, p. 30]. Over 85% of Germans are reported to be satisfied with the services of their bank and 79% welcome their technological innovativeness [Die Bank, 2005, p. 1].
- v) **Growing role of direct banks and other institutions:** Direct banks communicate with their customers via phone, Internet or other such mediums without maintaining branches or offering advisory services. Since a significant number of bank customers is, meanwhile, able to make use of the Internet to get information and carry out transactions, direct banks can indulge in a price-oriented competition. The growing clout of direct banks can be gauged from the fact that *ING DiBa*, the largest direct bank in Germany, meanwhile boasts of a customer base of 4.4 million, comparable to the 5 million customer base of *Dresdner Bank*, the third largest commercial bank in Germany [Maier et al., 2005, p. 1]. Such developments are causing alarm in the banking sector. Though some commercial banks run their own direct bank subsidiaries, the public sector banks had till now by and large refrained from this form of banking and as a result lost a considerable market share to direct banks [SZ, 2005, p. 1]. Some Landesbanken, e.g. *Bayerische Landesbank* and *Landesbank Hessen Thüringen*, have begun to set up or acquire direct bank subsidiaries that operate without geographic restrictions [Einecke, 2005, p. 26]. If this trend continues it would ignite competition within the segment of public sector banks. Additionally, there is an ever-increasing number of other financial institutions specialising in niche products. They provide brokerage and other investment services designed to suit the special needs of particular customer groups.
- vi) **Growing competition to win retail customers:** Many commercial banks in Germany had reduced their retail activities (“Privatkundengeschäft”) in the boom years of late 1990’s, in order to concentrate on the corporate sector. The subsequent economic downturn and the resultant decline in the business volume

have forced banks to increasingly look towards private customers once-ignored. Dresdner Bank, for instance, announced in May 2005 an offensive price war to win back private customers [Maier et al., 2005, p. 1].

The above discussion shows that the banking sector in Germany can be characterized as one with a significant amount of inter-pillar competition. The intra-pillar competition is expected to grow further owing to sinking state influence and the increasing role of direct banks and other financial institutions. The banking sector is already working efficiently so that there is little scope of further cost-cutting without consolidation. The consolidation process is however hampered by political and regional interests on the one hand and the rigid three-pillar system on the other.

## **Summary**

In this situation, as discussed above, banks are more than ever forced to win and retain retail, private customers and animating them to avail more financial services. For this purpose they need to employ innovative strategies while finding ways to cross-sell their products in order to increase revenues.

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