The Future of Banks in Germany

What perspective do German banks have for the future? Most media commentaries today are sceptical. As always, though, there is a problem here with simply extrapolating a current situation into the future. The medium-term perspective is fundamentally different from today's snapshot. "The darkest hour is just before dawn."

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German banks are clearly undergoing a structural and earnings crisis at present. Unfortunately, there can no longer be any doubt about this diagnosis. As is usually the case when a situation escalates, several factors are responsible for this:

- The global economy is weak – and the situation in Germany is even weaker due to the country's structural growth problems. As a result, insolvencies have risen to record levels.

- The financial markets have been hit by a wait-and-see policy on the part of investors after the New Economy bubble burst and a large number of corporate scandals came to light. Developments on the stock markets are correspondingly disappointing. In the euro zone, share price losses since summer 2000 equate to around 40 % of gross domestic product.

- The German banking sector and its historic three-pillar structure – private banks, savings banks and cooperative banks – is fragmented. Today, Germany's five largest credit institutions have a joint market share of 20 %, compared to an average of 55 % in the rest of the euro zone. Public banks – still subsidised at present via the government's maintenance obligation and guarantors' liability – are using their market share to dictate (too) low margins for banking transactions in Germany. The pressure to consolidate that has built up as a result is considerable.

- Cost pressure on banks is considerable. Cost-income ratios of 80 % are impacting profitability, making painful cutbacks unavoidable, particularly in human resources.

In some places this wave of bad tidings has led to an atmosphere of crisis: rather than asking what future there is for German banks, should we in fact be considering a future without German banks? The difference between risk and opportunity is in the eye of the beholder. From a different perspective, the list of negative factors that have tripped us in the past becomes a road map for the future. What do we have to do to steer through the crisis successfully?

First and foremost, there is the cost aspect. Systematic cost management must get to the roots of the cost explosion. This requires the courage to reverse decisions made in the past and, above all, a change in our way of thinking. After a kind of "winner-takes-all" mentality spread to the banking world as well in the boom years, we have now come to understand that banks – even investment banks – are not Hollywood: restraint and team spirit are in demand again.

Closely linked to the question of costs are the issues of consolidation and of creating the optimal organisation size. Private banks have limited leeway here, and the competitive playing field will not begin to level out until 2005, when the public banks will have to renounce their privileges. However, there are still previously unexplored options open to us within each of the three pillars. In future, possible synergies will have to be systematically leveraged by selectively combining business segments, particularly in the back office area. And, as the capital markets in Europe grow closer together, the European dimension is becoming increasingly significant.

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Banks also have a key part to play in restoring confidence in the capital markets. On the one hand, this means they have to improve their own corporate governance, which is a matter of striking the right balance between the interests of the banks' different stakeholders – shareholders, customers and employees. On the other hand, banks can also contribute to greater transparency within companies and on the stock exchanges by introducing a lending policy that is more in line with the risks involved.

Last but not least, banks need to help overcome the structural crisis in the German economy as a whole. Merely complaining about politicians' inability to implement reforms is not enough. Rather, the inevitable overhaul of the social security systems is forcing banks and other financial service providers to take action themselves. Without the development and provision of suitable finance products, the increasing responsibility of individuals for their own retirement provision is inconceivable.

So, there is no shortage of things banks should be doing. But are they up to the job? And what will the bank of the future be like after it has successfully implemented the necessary restructuring measures?

Banks are still in the middle of the restructuring phase, but the signs are good. Right now, banks are meeting the challenge head on and without hesitation. The cost-cutting measures that banks are currently implementing are unprecedented in the industry – let alone in the public sector.

Successful restructuring measures are not possible without painful cuts. If further proof were necessary that the frequently made comparison between German and Japanese banks doesn't work, then it is the speed and willingness to face the consequences with which German institutes are tackling their problems. In contrast, the Japanese banks are only now actually beginning to grasp the extent of their problems, after years of stagnation and spending billions of taxpayers' money.

Progress has also been made in the consolidation of the banking sector. The three major Frankfurt banks have finished merging their mortgage banking business. Similar moves in the fields of payment transactions and securities settlement have also been initiated or are under discussion.

Restoring confidence is undoubtedly a more difficult and more long-term task. This can also be seen from the frequent criticism of more conservative lending practices for SMEs. However, risk adjusted lending processes, which will become commonplace under the Basel II framework in future, amount to nothing more than taking a responsible approach to the money entrusted to banks by their depositors. There can be no question of a credit crunch. Creating a new basis of trust will take mutual understanding and openness. The German Corporate Governance Code was a vital first step in this direction.

Confidence in the capital markets must be restored.

Confidence in the capital markets and banks needs to be restored in order to establish the idea of private retirement provision. The fact that demand for "Riester products" has been disappointing so far, is due in part to investors' uncertainty as a result of the slump on the stock markets. The solution to Germany's structural problems and the pending overhaul of the social security systems are closely linked. Only profitable banks can gain trust and hence meet their responsibility to the economy as a whole.

The significance of the capital markets for finance and social security will continue to grow. Parallel to this, the way banks look will also change, since the markets are becoming more and more complex as a result of advancing globalisation and the growing number of financial innovations. Banks are fast outgrowing their role as an intermediary who transforms maturities and risk, and their advisory function is becoming crucially important. The new role of banks will be to reduce complexity, tailoring safe and simple products for their customers from the near unlimited possibilities offered by the capital markets.

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Coping with complexity requires complex structures. The bank of the future is no longer just a bank that offers individual, standardized finance products; it will instead be a knowledge carrier, developing and marketing comprehensive finance solutions. In other words, banks are becoming integrated financial services providers. In future, competition will be between different models of integrated financial services providers. Cooperative, network, or holding solutions: the search for the best strategy is already on. The ability to manage complexity within their own structures is becoming a critical success factor for banks. Integrated financial services providers – the banks of the future – must combine within themselves the apparent paradoxes of complexity and transparency, innovation and solidity, organisational learning and individual achievement.

Are German banks facing a bleak future? Hardly. In the longer view, financial institutions are not active in a shrinking market, as is the case with crisis industries. The financial assets of private households, the demand for investment and pension products and companies' need for financing will continue to grow. These growing markets offer fascinating business opportunities for agile and farsighted financial services providers. What's more, under less hostile financial market conditions, the strict cost-cutting and streamlining measures currently being implemented by companies will allow profits to rise all the more. And it is precisely the private financial institutions that will profit as competition moves to an increasingly level playing field.