Comparing and Contrasting the Us and German banking system with emphasis on the financial crisis in 2008

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An Honors Thesis submitted in partial fulfillment of the requirements for Honors in the name of the Department for Finance and Economics for the College of Business at Georgia Southern University

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Under the Mentorship of
Edward Sibbald

ABSTRACT

This thesis will compare and contrast the Financial Systems of the United States and Germany, the structure, institutions and regulations. Furthermore, we investigated the impacts that the Financial Crisis in 2008 had on Financial Systems, the outcomes and effects. First, we looked at both Systems and the structures more closely, and compared them to each other. Next we looked at the regulations and regulatory agencies in both countries and the work they do. We realized that the different competitive natures the banking systems are under influence their businesses and business decisions.
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“If you want to understand geology, study earthquakes. If you want to understand the economy, study the Depression.” according to Ben Bernanke, Chairman of the Federal Reserve.

Studying the impact of the 2008-2009 financial crisis and recession will help explain the relative strengths and weaknesses in the two most influential banking systems in the world: the United States and German Banking systems.

There are some similarities, but also some key differences between the U.S. and the German Financial Systems. Each system has its own positive features, yet the benefits may be shared by different groups in each country. Further, as noted in many research reports, each system has its own unique weaknesses, and the significance of these drawbacks may vary at different points in the economic cycle.

This paper will review the size, scope and structure of each banking system. It will also review the differences in the business models between German and American banks and the regulatory environment they operate within. Finally, we will look at the different impact of the financial crisis and recession in 2008-2009 on both systems (i.e. the "fallout") and the public and political response to stabilization and recovery programs (the "backlash") in each country.

As the research progressed, a key question became a main area of focus: If the German banking system was far less profitable than the Unites States system, and had a much smaller capital base, why was the impact of the financial crisis and recession less severe for German Banks? The research leads to the conclusion that the business model of German banks provides a greater degree of protection for banks during periods of financial stress.
Size and Scope of the Banking Systems

The United States and Germany have the largest banking systems in free-market economies in the world in terms of the number of banks and assets.

Germany has 1,686 banking institutions, with 39,441 branches, serving a population of approximately 80.2 million. Per capita, each bank serves 47,580 and 1,931 per branch.

There are a total of 6,812 banks in the United States, with approximately 93,000 branches. Based upon an estimated population of 313.9 million, the per capita figures would be 50,450 per bank and 3,164 customers per branch.

Total assets of the United States banks were $14.7 trillion in 2013 and German banks had total assets of €7.1 trillion ($US 9.8 trillion) - amounts that exceed the annual Gross Domestic Product of virtually any country.

Another aspect of scale is a comparison with other member banks of the Euro Union as illustrated in the chart below:

Germany has almost 50% more banks than its largest counterparts - France and Austria and accounts for 23.9% of the 7,067 banks in the Euro Union counties. Similarly, the
United States Banking system has almost the number of bank of all Euro Union countries combined as of 2013.

Exhibit 1 provides a list of the xx largest banks in the world. Although neither country has the largest bank, key banks in Germany and the United States are among the largest. The largest investor-owned private sector banks in Germany, such as Deutsche Bank, Commerzbank and Hypo-Vereinsbank, are comparable to their largest American counterparts. Deutsche Bank is the 5th largest bank with $2.6 trillion in assets and Commerzbank ranks 37th in size with $837 billion. By comparison the three largest American banks are J.P. Morgan Chase, ranked 12th with 1.9 trillion in assets, Bank of America, ranked 18th with $1.5 trillion in assets and Citibank with $1.2 trillion in assets.

Comparison of Financial Systems

The U.S. and German Banking system appear to be similar in several respects, and share some common trends. Both systems have separate categories of banks such as commercial and savings banks. Both systems have experienced a significant growth in assets despite a substantial decrease in the number of institutions, primarily due to mergers and acquisitions to achieve economies of scale. Both systems have comprehensive insurance plans paid by bank premiums to protect the principal amount of customers’ deposits.

Digging deeper, however, there are significant differences in the structure, business models and level of public support of the two banking systems.

Let’s first look at the structure of each banking system and then consider the differences in their business models. In doing so, unique features of each system will be briefly discussed. Lastly, the paper will address the level of support provided by the respective government and taxpayers.
The American banking system is composed of two types of banks: commercial and savings banks. The banking system is dominated by commercial banks and savings banks are declining rapidly, losing market share, and often, the strongest are converting their charter to become commercial banks.

Key statistics of the banking system include the following as of December 2013:

(Assets in Billions of dollars)

<table>
<thead>
<tr>
<th></th>
<th># Banks</th>
<th>% Total</th>
<th>Assets</th>
<th>% Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>5,876</td>
<td>86.3%</td>
<td>13,670</td>
<td>92.8%</td>
</tr>
<tr>
<td>Savings Banks</td>
<td>936</td>
<td>7.2%</td>
<td>1,052</td>
<td>7.2%</td>
</tr>
<tr>
<td>Total Domestic Banks</td>
<td>6,812</td>
<td>100.0%</td>
<td>14,723</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

The United States Banking System is a study in contrasts and concentrations. Most of the banks are small, yet the vast majority of assets are held by less than 125 banks. As a system, the industry is extremely top heavy. The following two pie charts illustrate the contrast between the number of banks and the amount of assets held by banks in different size ranges:
As noted on the graphs, banks with less than $100 million in assets represent 30% of the total, and when combined with banks between 100 million to $1 Billion in assets, the percentage increases to 90% of the total commercial banks. However, these banks control only 8.5% of the total assets in the system.

On the other hand, only 107 banks, or 1.6% of the total, have assets greater than $10 billion. Nevertheless, these banks control 80% of the total commercial banks assets.

- Another example of the disparity between the number of banks and the concentration of funds is deposit percentages as noted in the following statistics: The top 50 Banks in the United States represent less than 1.00% of total banks but have 68% of total deposits.

- The 107 Banks with assets greater than $10 billion have 76% of total deposits.
Given this situation, U.S. banks are broadly classified for analysis purposes into several categories:

1. Large multinational and money center banks such as J.P. Morgan Chase, Bank of America, Citibank, HSBC, etc. with worldwide lending and access to global funding sources.

2. Super regional banks which operate in more than 10-12 states, typically publicly-traded companies with funding access for equity and debt in the domestic capital markets to supplement customer deposits. Wells Fargo is the classic example of a domestic bank with a nationwide network of branches.

3. Regional Banks operating in several states, usually in a defined area (e.g. multistate operations in the southeastern states) with a mix of funding between customer deposits and capital markets.

4. Local or community banks operating in one of several counties (usually contiguous), typically privately-held and almost completely reliant on customer deposits for funding.

A second segment of the U.S. Banking system is the savings banks and Savings and Loan Associations. Approximately 60 banks have assets exceeding $1 billion in 2013. These banks are not active in business lending, ands primarily provide mortgage and home equity loans. They offer a range of deposit savings including limited checking capabilities and time deposits and are particularly active in seeking tax exempt retirement accounts and annuities issues through third insurance and pension funds.

Finally, the banking system is supported by federal government agencies and government sponsored agencies (currently under the conservatorship of the U.S Department of the Treasury. These institutions serve specific roles in financing commercial banks, and especially community banks or buying the mortgages originated by banks. These agencies include the Federal Home Loan Bank, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.
A unique aspect of the American financial system is a separate depository and lending type of institutions: credit unions. Credit unions are member owned by depositors and lend to other members. Membership is limited by common bonds such as an employer, civic organization or, more recently, county of residence. There are more than 8,500 credit unions in the country. Although they range from very large organizations to small institutions, the average size of a credit union is less than $69 million and the median size was $13.2 million in 2012. These companies compete with commercial banks for deposits, but primarily do small dollar consumer installment lending. The primary market for credit unions are customers too risky for commercial banks or transaction sizes too small to handle given a commercial bank operating expense structure.

The largest investor-owned private sector banks in Germany, such as Deutsche Bank, Commerzbank and Hypo-Vereinsbank, are comparable to their largest American counterparts.

Financial Systems in Germany

The German Banking System is based upon a "three pillar" system. It has clearer delineation of banking activities and serves distinct markets with limited competition. There are three groups of banks: private sector banks, public sector banks and cooperatives.

The private sector can be divided into the three big banks, regional and other credit banks, as well as branches from international entities. The private commercial banks are investor-owned or privately held the profit maximizing entities and include the four biggest banks, Deutsche Bank, Commerzbank, which acquired Dresdner Bank in 2009, KfW Bankengruppe and DZ Bank (Kuck, 20136). These banks are comparable to the larger U.S. Banks.

The second group is the Public sector composed of Savings Banks, established under public law and owned by states or local district government authorities. These banks
were established to help economic growth, and are the dominant presence for retail (smaller loans and deposits) and small business banking. In Germany, most savings banks offer long term loans for houses, as well as loans to small to medium-sized businesses and the local municipalities.

Savings banks are required by law to open accounts for every applicant. These banks are under "guaranteed obligations", which mean they are liable without restrictions, in the event of default. Furthermore, they have "maintained obligations" and are able to meet their financial obligations at all times, or the local authorities will have to take them over. Hence, the saving banks are almost unable to default. In extreme cases, mergers have been implemented. Savings banks are limited to designated market areas under the German banking policy of the 'regional principle" each institution is prohibited from working and operating outside their territories. (Krahnen & Schmidt, 2004). Accordingly, competition between savings banks is extremely limited.

Savings banks are operated to promote economic growth and increase the income of its borrowers. These banks offer loans at rates lower than any private sector bank, and, as such, represent 75% of all small business lending and 40% of all lending within Germany.

As part of the public sector, the savings banks work with regional central banks, called Landesbanken. There are nine Landesbanken operating within Germany, which may operate in multiple states. Traditionally, the Landesbanken handled larger loans and assisted the savings banks under its jurisdiction with credit, debit and online transactions. They are also used to finance states and communities loans. They are usually owned by the States, the local saving banks or communities. The LBBW, Landbank Baden-Wuerttemberg is the most prosperous. The LBBW is also one of the ten biggest banks within Germany, and among the top 100 in the world.
Figure 1: Landesbanken and area covered in Germany

The third primary banking sector is cooperative savings associations. Cooperatives have the greatest number of banks within Germany, but share a rather small percentage of total assets. Examples of these cooperatives include the Volksbanken, established to help with the expansion of the trade and businesses, and the Reifeiesenbanken, formed by farmers to buy bulk fertilizer and such and to strengthen their position within the market.

Cooperative saving banks are closely connected to their cooperative Central Banks. They are based on a member-structure where each member, independently from its capital share, has one vote. In 1974 the Cooperative saving banks started letting non-members take out loans. The requirements and laws surrounding the institutions are strict, and the saving of weaker institutions in the area is done by other institutions. There are no institutions in the US that can be compared to this banking concept.
Finally, Germany has Specialty Banks. These are mortgage banks, home saving banks, specialized credit institutions for infrastructure development and the continue integration of the East Germany into the economy.

In comparison with the US Banking system, German banks are more evenly spread with their deposit market shares than the US banks. The big private banks had a market share of 24.9% in 2012, the Landesbanken had 17.5% and saving banks 17%, followed by cooperatives with 8.4% market share, and Mortgage banks had 11%. Total assets for each bank are spread fairly even. Commercial banks have about € 2.6 trillion ($US 3.6 trillion), while the central saving banks have about € 2,300 billion ($US 3.2 trillion). The cooperatives and mortgage banks are smaller, with each having about € 750 billion ($US 1.1 trillion) in assets.
The regulatory systems in the United States and Germany are different in structure and activities, as well as the degree of independence in economic and monetary policies. These differences had implications in terms of the financial crisis and subsequent recovery programs.

The American bank regulatory system is based upon the concept of dual oversight by federal and state agencies and the primary regulators differ based upon a specific bank's charter.

Banks in the United States can elect to have a national bank charter or state bank charter based upon their own considerations of which charter best meets the banks operating needs and market circumstances. Banks can also change charters as long as they are not under an existing formal restrictive agreement with their current regulator.
It is a common misconception that only the largest multinational and super regional banks all have national charters. Many do, but small community banks also have national charters. For example, 270 banks under $100 million assets and typically operating in one or two counties have national bank charters. This number increases to 923 banks with assets less than $1 billion in 2013. However, large or small, every national bank is required to be a member bank of the Federal Reserve system.

State chartered banks a choice also. These banks can be state member banks of the Federal Reserve System or state non-member banks under the jurisdiction for local state banking commissions. The primary difference is that a state member bank invests in the stock of the Federal Reserve and, prior to the recent recession and financial crisis, has access to specific Federal Reserve borrowing facilities.

There are three primary regulatory agencies in the United States overseeing bank activities. The primary regulator for any bank is based upon the bank’s charter.

- National Banks are regulated by the Office of the Comptroller of the Currency (OCC).
- The Federal Reserve Bank is the primary regulator for state-member banks, its parent holding companies and all U.S. subsidiaries of foreign banks.
- The State Bank commissions are the primary regulator for state non-member banks and are assisted in this responsibility by the Federal Deposit Insurance Corporation (FDIC).

As the agency providing deposit insurance for all banks, the FDIC can conduct financial or operational audits for any bank. This agency also has the responsibility to close banks and transfer its assets and liabilities to another bank on a competitive bidding basis.

By comparison, the German bank regulatory system is far less fragmented. The German Central Bank (Bundesbank) has many of the same responsibilities as the U.S. Federal Reserve Bank. The Central Bank is responsible for printing and issuing banknotes,
managing the currency reserves and supervising the commercial banks. It is something similar to a clearing house. There are nine offices spread throughout Germany, supervising and overseeing each area. The German Central Bank is considered the most important member of the European System of Central Banks, as it is important to the stability of the Union. It is also the first central bank in the world to be given independence by the country.

In 2002, in response to the forming of the Euro Union, Germany founded the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin, 2014), an agency more commonly known as "BaFin". This was established by combining the three old main regulatory agencies together: credit, investments and insurance. It works with and regulates the financial markets. BaFin is governed by public law and is considered an independent agency. It is run by the Administrative Council and the chair is appointed by the Federal Ministry of Finance. Funding is provided through fees and assessments from the banks supervised, not by the German government. While, the German Central Bank retained some supervisory roles in regulating banks such as examinations, prudential audits, and financial crisis management, BaFin has the final decision-making authority on regulatory matters. It can conduct investigations, as well as require the cessation and closure of unauthorized activities by any bank or financial services institution. BaFin also supervises the security industry, enforcing standards of professional conduct aimed at the preservation of the trust of the investors in the securities markets. Some of the securities exchange supervision is delegated by BaFin to local governments, where the banks are located.

In evaluating the two regulatory supervision systems, the German system appears to be a simpler approach and, more importantly, has supervisory responsibility over the entire financial services industry in the country. As the recent financial crisis indicated, the U.S. banking regulators had no authority to regulate key aspects of its "non-bank" financial services industry - investment bankers, hedge funds, insurance companies, private equity companies - where most of the riskiest activity and development of highly
complex investment securities that subsequently turned into toxic assets occurred. The Dodd-Frank Act passed by the U.S. Congress sought to address this weakness, but remain in the early stage of implementation in terms of policies and agency authorities.

At the same time, The U.S. system has a positive feature relative to the German system. It is truly an independent agency, as evident in its response to the financial crisis. It established new precedents in policies and programs to reduce the financial and liquidity crisis when a dysfunctional U.S. Congress could not reach agreements on appropriate recovery programs.

Although the German Central Bank is an independent agency, many German banks are under the ownership of the state or government. in addition, The German banking system is under the oversight of the European Union.

The European Credit Bank (ECB) is the Central Bank for the Euro, the currency used in Germany and other parts of Europe. The main task of the ECB is to maintain the purchasing power and the price stability in the Euro area. The Euro system’s main task is to keep the inflation rate below but close to 2% and the prices stable, as well as to implement monetary policies. The decisions are made by the Governing Council of the European Bank, which is made out of all the governors of the European Central Banks and the members of the executive board of the Euro System. In 2011 the Committee of European Banking Supervisors, CEBS, founded the European Banking Authority. Located in London, this authority is used to implement new regulations and sets the standards for the European Union.

The bond that Germany has with the European Union is helpful in many ways, but it could also be seen as a disadvantage for the banks. Policies made by the European Union might be good for Europe as a whole, with all the member countries, but not for Germany. This can lead to less than optimal policies and could have a negative effect on the German banking system. An example of this issue was the "Brussels Agreement" signed in 2002 by all members of the Euro Union. The agreement prohibited members from providing state guaranties to support new long term financing by its banks after
2005, and with a phase out period for existing guaranties of 2015. This agreement affected the German Landesbanks and resulted in significant losses and bank defaults after the financial crisis in 2008 and 2009.

**Business Models: A Study in Contrasts**

The U.S. and German banking systems' business model are significantly different from one another. To understand the differences in the business models between the United State and German Banking system, it is necessary to understand the market principles in each economic system.

Both countries have free market economies, as do most of the G-8 countries. The other extreme is state managed economies with the best examples being China, North Korea, Venezuela, and most classic historical cases, the Soviet Union and East Germany.

Within the free market economies, variations in the concept of capitalism emerged and evolved after World War II. Although the basic principle exists that the private sector is the most efficient allocator and utilization of resources, the role of government varies between countries, shaping the different variations of capitalism.

For lack of a better term, the American system practices "laissez-faire" capitalism, which encourages the "invisible hand of the market conditions" and rewards companies who can identify and manage opportunities successfully. However, the perception is not always reality as the government at various levels regulates undesirable practices (i.e. unsafe working conditions, activities that damage the environment, minimum compensation levels, monopolistic practices, etc.) and provide tax incentives for activities perceived to be "economically beneficial".

Many countries in Western Europe engage in similar regulatory activities and with incentive based tax policies. However, several of these economies seek a middle ground between capitalism and socialism to promote economic growth and social welfare. Often this is found in state sponsorship or ownership of specific "vital" industries to smooth out the "rough edges" of pure capitalism.
Social market economies aim to combine free initiative and social progress on the basis of a competitive economy. (Social market economy) The social market economy is opposed to "laissez-faire" policies and to socialist systems and combines private enterprise with regulation and state intervention to establish fair competition, maintaining a balance between a high rate of economic growth, low inflation, low levels of unemployment, good working conditions, social welfare, and public services. (Hook, 2004)

The German economy is as good example of 'social market capitalism" ((often referred to as "Rhine capitalism"). It is an economic system where private companies are still recognized as the most efficient allocator and user of resources, but that that government has a responsibility to serve as an active sponsor of business practices and programs to promote economic growth and social welfare.

The key features of the U.S. Bank business model and environment include:

- All banks are owned by private investors and either publicly traded or private held by a smaller group of shareholders. Local, state and federal government have no ownership interests in commercial and savings banks.

- The primary business goal is to maximize shareholder value through increased earnings, higher stock values and dividends. Moreover, in recent years, increases in short term profitability appear more desirable than companies that use strategies to increase longer term profitability.

- By law, commercial and savings banks can only engage in traditional banking activities (e.g. - making loans, accepting deposits and providing services for a fee). Banks can serve as referral agents to third parties for insurance and investment services, but cannot engage insurance underwriting or investment banking. The only exception exists for large banks that establish a financial holding company, and are permitted by regulatory approval to set up separate
subsidiaries to handle insurance and investment activity. In such cases, the bank must be a separate subsidiary without any involvement with the non-bank subsidiaries under the financial holding company.

- American banks operate in open, highly competitive markets with full interstate banking and a significant presence of U.S. subsidiaries owned by foreign banks. Two of the twenty largest banks are subsidiaries of Canadian and British banks. The largest German bank, Deutsche Bank, ranks among the top 50 banks in the United States.

- American banks are not permitted to own stock in any non-financial company. Stock may be pledged as collateral for a loan.

The German Banking model is quite different in most areas including:

- All savings banks and Landesbank were created by law, and are owned by local, district or the state government. Cooperatives are member-owned entities and support each member during periods of financial problems. Overall, more than 70% of the banks are state or member owned. Banks are supported by local authorities with taxpayer monies if its financial condition deteriorates.

- the primary business objective of the public sector banks and cooperatives is to promote economic growth and increase the income of the borrowers. Bank profitability is a secondary concern, except for the private sector banks.

- 97% of the banks are "universal" banks providing the full range of banking, insurance and investment services. This provides greater convenience for bank customers and builds deeper long term customer loyalty between the banks and their clients.
• Banks face limited competition for its services due to public ownership and the concept of the regional principle”, restricting banks from extending beyond their designated markets. There is no "interstate banking" in Germany except where Landesbankens assist each another.

• German banks serves as the primary source of financing for small and medium size businesses and are permitted to take stock ownership in their borrowers. The private sector is the most active in taking ownership interest and having representatives on the Board of Directors of German banks.

The implication of the differences in these businesses models is evident. German banks develop closer relationships with their customers, generate greater loyalty and enjoy a safety net of public support. The public sector banks can work to promote economic growth without serious concerns about competition, achieving specific profitability goals or the risk of failure.

In addition, the relationship between the public sector banks and the small and mid-size businesses which dominate the German economy is a good example of mutual interests to promote economic growth. One of the unique features of the German economy is the relationship between the Sparkassen and the Mittelstand.

¹ Most people have heard about the big German brands, such as BMW, Mercedes and Bosch, but probably the most unique feature the German system has to offer is the Mittelstand, a group of small to medium sized business that bring in a combined share of 53% of Germany’s overall GDP. It is exceptional in a way that the businesses represent 99.7% of the business structure in Germany, which is around 3.5 million businesses, and these companies employ 78.5% of the total German workforce. As this aligns with the idea of the saving banks coordinating their money mainly to the

¹ More information about the Mittelstand and its importance can be found in sever articles from the Wall Street Journal (BRIAN BLACKSTONE, 2011)
economy, many of the Mittelstand business are small, 80.1% have under ten employees overall. The definition of the Mittelstand are small businesses, up to nine employees and income of up to €1 million, medium businesses, ten to 499 employees and income between €1 and €50 million per year. Lastly, are the big businesses with over 500 employees and an average income of €50 million or above. The main idea is to specialize in a product or niche of the market and become the leading, high quality provider of the product to Germany and the rest of the world. These companies are successful in their niche (German Mittelstand, 2014) differentiations, as the average equity ratio was above 40% in 2013. (Lehnfeld, 2013) The so called “German Made” label promises high quality and production, which most customers know. Companies included in this are Melitta, a coffee company and Rationpharm, a pharmaceutical manufacturer. (Association, 2014)

Most of these companies are family owned businesses that have their own liquidity at stake in the company, and this is where a close alliance with the 432 saving banks in Germany, collectively known as the Sparkassen, becomes important. As government owned entities, the support for economic growth is well funded. The saving banks offer a lot of debt financing to the companies and have important, long lasting relationships. This is important especially to the smaller companies, as expansions or niche differentiation can become expensive, as well as higher credit risk rankings and fewer assets would be problems in another system. Many saving banks are considered “Hausbanken” (House banks), as the close relationship with the financial institution is used not just for the businesses, but also the financial needs of the owners and their family. This means that one bank sometimes services multiple generations of the same family and can be counted as almost a part of the family.
The American banking model also has positive features which cannot be ignored. Despite setbacks in 2008-2010, the overall U.S. banking industry is one of the most efficient, innovative and profitable ones in the world.

American commercial banks have a primary objective: to maximize shareholder wealth through prudent lending and investing, primarily in commercial markets. There is a natural limit on loan and deposit pricing which arises from very competitive markets in the US. There are a multiple ways in which the banks seek additional profitability, such as inventing new products and services and gaining comparable advantage through greater efficiency in streamlining back office operations to reduce costs. Also, banks seek new markets for extra growth and also secure acquisitions to build size and achieve greater economies of scale. This often leads to the willingness to invest in higher yielding complex bond investments to receive higher returns on the investments.

Competition in the United States creates more choices for commercial and retail customers, but also creates opportunities to gain market share and profitable growth.

The largest U.S. Banks have also been a leader in financing multinational growth and economic development. Prior to the 1980-1990s, restrictive branching statutes in the
United States led the largest banks to seek profitable opportunities in international markets. In many cases, they followed their corporate clients as their borrowers expanded overseas. As an example, J.P. Morgan Chase, Bank of America and Citibank have local sites or conduct business in more than 200 countries each.

Of course, the downside to this large multinational presence and their significant domestic market share is to be designated as Systematically Important Financial Institutions, otherwise known as “Too Big to Fail”. As Forbes magazine reported in November 2013 (Touryalai, 2013), 28 banks were identified by the Financial Stability Board, a group commissioned by the G20 countries, as representing systematic risks to world financial markets and economies were they to fail. The United States has seven banks on the list- indicating the high degree of international involvement. Germany had only one bank, Deutsche Bank, while other countries such as France, Japan, China or the United Kingdom had 3 or 4 banks each².

Nevertheless, the larger publicly traded U.S. banks are favorite investments by many equity investors and bondholders. The stocks and bonds offer above average returns during good economic periods, and the potential for gains when prices fall at or after the low point in an economic recessions. The stock and bonds are traded on the largest markets in the world and are considered highly liquid investments.

Of course, the higher risk/higher return model is not for every investor. Yet, larger publicly traded American banks' securities are generally considered more attractive than the limited amount of publicly traded banks in the private sector in Germany. German bank are considered safer and stable, but a "bit staid" for many investors as pointed out in a November 2012 Economist article "Old-fashioned but in favour" (Old-fashioned but in favour, 2012).

² See Appendix about list of “Too big to fail banks” (Touryalai, 2013)
The Financial Crisis and Recovery Programs

The financial crisis in 2008 can be viewed in terms of its impact as well as the recovery programs and the public/political response to such efforts.

The Impact

The financial crisis did not begin in 2008 with the failure of Lehman Brothers, one of the oldest Wall Street firms. Nor a year earlier, when another Wall Street giant, Bear Stearns, was acquired by J.P. Morgan Chase, with the financial assistance of the Federal Reserve Bank for "pennies on the dollar". Chase acquired the investment firm for $2.00 a share for a stock that had traded at $80.00 a share six month earlier.

One cause of the financial crisis was a huge real estate bubble that was financed by highly complex debt issues that were poorly understood by investors and rating agencies. Many of these higher yielding securities had a mix of high quality mortgages as well as marginally qualified borrowers and sub-prime loans. Once the real estate bubble burst and the economy was also in recession, defaults on these securities began to increase sharply and investors worldwide were left with illiquid toxic assets. As pointed out in the excellent animated video, The Crisis of Credit Visualized, the damage caused by these "toxic assets" was widespread.

The four largest savings banks either failed or forced to merge with stronger, well capitalized commercial banks. The largest investment brokerage firm, Merrill Lynch, was acquired by Bank of America before it would fail and the surviving largest investment banking firms converted into bank holding companies to gain access to liquidity borrowings from the Federal Reserve Bank.

The crisis for smaller community banks in the United States was the concentration of commercial construction loans in their loan portfolios. As real estate values fell, housing demand fall sharply and developers defaulted on their bank loans. The problems were widespread for smaller community banks, but it was especially bad for banks in states
with real estate centric economies such as Georgia, Florida, Arizona, Illinois and California.

The smaller community banks did not have the capacity to absorb large losses, nor the ability to access additional capital from investors. Many banks failed - 486 in total during the 2008-2012 periods. Particularly vulnerable were newer banks which established charters in the late 1990s and the 2000-2004 periods. These start-ups, called "de novo" banks had aggressive asset growth models, focused heavily on commercial real estate loans - many of which were turned owned by older, more mature banks. Based upon preliminary studies, the Center for Excellence in Financial Services at Georgia Southern University believes more than a third of the bank failures were chartered in the 1999-2004 period.

Prior to this recent financial crisis, the U.S. banking industry had a recent history of failures dating back to 1982. Between 1982 and 1992 1,248 banks failed and many were savings banks. In 1989-1990, the U.S. government established a stabilization and recovery program for distressed banks which proved quite costly for the American taxpayers.

German banks did not escape the damage either, although the losses were largely isolated to the private sector banks and the Landesbanks. According to The Economist, “The savings and co-operative banks have come through the crisis with barely a scratch so far”, as only a few banks failed throughout the financial crisis. Banks are owned by states and under regulations they cannot fail. The Waserbank in Berlin was closed in April 2008, with only 3,000 clients and around € 120.4 million ($US 160 million) in assets it was considered a small bank. West LB, a Landesbank located in Düsseldorf, and partly owned by the state of North Rhine-Westphalia, was the only Landesbank that failed as an aftermath of the financial crisis.

Overall, only two banks failed in Germany compared to 486 banks in the United States. However, losses in capital were significant for the largest private sector banks and
several banks were forced to merge or were acquired by larger stronger private sector banks.

Recovery Efforts

During the financial crisis and economic recession, the United States and Germany created programs to support banks and maintain stability in the financial markets.

The United States Treasury allocated $250 billion in funds as preferred stock investments in banks. Approximately $205 billion was disbursed to 707 banks, including 450 small and community banks located in 48 states based upon statistics provided by the U. S. Treasury Department\(^3\). The U.S. Treasury defined the purpose of the program as follows:

*The Capital Purchase Program (CPP) was launched to stabilize the financial system by providing capital to viable financial institutions of all sizes throughout the nation. The CPP program was designed to bolster the capital position of financial institutions and instill confidence in the financial system as a whole.*

In addition, the U.S. Treasury and the Federal Reserve Bank established programs to maintain short term liquidity for banks including guaranties for commercial paper, unlimited deposit insurance for checking accounts, and purchasing illiquid investments held by banks and other financial institutions.

Even today, the Federal Reserve maintains programs to purchase U.S. Treasury bonds and mortgage-backed securities to stimulate the economy and maintain low interest rates.

Germany created its own recovery programs for banks, primarily designed to support the private banking sector and the Landesbank. By law, the government was required

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\(^3\) More information about the Capital Purchase Program can be found on the United States Treasury website http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/cap/Pages/default.aspx
to support any public sector savings bank with additional capital as needed to maintain their existing operations and avoid defaults.

German bank losses during and in the aftermath of the financial crisis were primarily due to investments held in U.S. structured credit products, based upon studies completed by Felix Humer cited in his paper, The German Banking System: Lessons from the Financial Crisis (Humer, 2010). The total amount of investments in "toxic assets" was estimated at € 200 billion ($280 billion) and German Banks accounted for 7% of the total losses in these securities. Hardest hit were the Landesbanks which had approximately one third of all losses suffered by German banks.

Initially, Germany provided funds directly to four troubled banks in the form of capital injections, credit lines and asset back security loss guarantees. Subsequently a broader support program was established with a € 480 billion ($US 672 billion) Financial Market Stabilization Fund (SoFFin), designed to provide financial stability and rescue banks in need. ((Bloomingdale, Parker, & El-Khatib, 2009). The aid package was composed of € 400 billion ($US 560 Billion) in loan guarantees for bank financing and € 80 billion ($US 112 billion) in capital infusions and asset purchases.

Finally, Germany established a good bank/bad bank program where banks could improve their balance sheets by selling distressed assets at a substantial discount to a special entity ("the bad bank"). Only a few banks used this program, but it highlights the extent that the German government was prepared to support its financial system.

Public and Political Response

The public and political support for financial recovery programs was vastly different between the two countries.
Based upon a long history and tradition of state support for its savings banks, and the value placed upon the public sector’s effort to promote economic growth, the recovery programs were widely accepted as business as usual in Germany. There was limited political dissent and no real negative public opinion. If anything, German politicians and taxpayers were far more concerned about Germany’s role in supporting the economies of the weaker members of the Euro Union (Portugal, Italy, Greece and Spain, commonly known as the “PIGS”).

By contrast, the political and public opinion backlash in the United States to financial recovery programs was harsh and severe. Many opposed “bank bailouts”, feeling that taxpayers should not have to pay for the excessive risks taken by the banking industry. Concerns were raised about “moral hazard” that banks can engage in risky activities and earn the profits in good times, knowing that the government and taxpayers would rescue them during periods of financial difficulties caused by the banks’ decisions. A popular perception was that banks were looking out for their own interests instead of the overall economic interests of the country. Articles in popular magazines suggested that “Wall Street” (a collective term for all financial institutions) lost its focus in supporting economic growth on “Main Street” (a collective term for businesses) and concentrated on its own growth in profitability instead.

Although the recovery programs were well designed and accomplished its objectives of financial stability, the U.S. Department of Treasury, the Federal Reserve Bank and the administrations under two presidents were constantly in a defensive mode to justify their activities.
Conclusions

My research leads to several key conclusions regarding the comparative merits of the German and U.S. Banking Systems, including the following:

1. The German banking system, and especially its public sector banks, is better aligned with the businesses in Germany to promote economic growth.

2. The U.S. Banking system is much more profitable and more flexible in addressing changing market conditions and opportunities.

3. The German unified approach to regulatory supervision is superior to the limited and fragmented authorities of U.S. regulatory agencies which address only one portion of the financial system.

4. Universal banking provides more convenience, but limited competition reduces the range of choices available for banking customers.

5. The German banking system is safer and more stable, but less profitable and weaker capital bases. In periods of financial stress, the German system with the positive working relationship between the public sector banks, the local and state authorities and smaller businesses appears to be the more desirable alternative.

6. For investors, U.S. Banks offer greater potential gains on investment and greater liquidity than German Banks.
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