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Thomas Döring\*

## German Public Banks under the Pressure of the EU Subsidy Proceedings

*The European Commission regards the existing liability structure of the German public banking system as indirect government subsidisation. The German federal government has therefore been forced to agree to modify this structure by 2005. But are the reform options currently being pushed the best solutions from an economic point of view? Are there better alternatives?*

Unlike in most other industrial countries, in Germany almost half of the banking business is carried out by public banks. This is something most Germans probably are not aware of, especially because liberalisation and privatisation has been the order of the day since the early 1980s in the member states of the European Union (EU). The EU played a vital role in these deregulation processes. In that respect, Art. 86 EC Treaty concerning monopoly rights and public enterprises as well as Art. 87-89 EC Treaty concerning the elimination of distortions of competition by subsidies that are granted by many EU member states to the private and public firms on their territory were crucial.<sup>1</sup> But in contrast to industries such as telecom, aviation, road freight transport, or the railways and the energy sector, public banking in Germany – i.e. in particular the state-owned landesbanks (Landesbanken) and the locally owned savings banks (Sparkassen) – remained until recently steadfastly outside this development.<sup>2</sup> However, since the end of last year the situation has changed. By applying the policy of government aid control more rigidly, the European Commission (EC) has triggered off a process of liberalisation in the German public banking sector.

### German Public Banking and European Competition Law

Basically, public banks in Germany operate in the same fields of business as private banks. Nevertheless, the remaining differences are considerable. Creditors of landesbanks and savings banks are at no risk as their investments are guaranteed by state and local governments. This reaps refinancing advantages on the international capital markets since it is almost impossible for public banks to go bankrupt. It is thus hardly surprising that the Federal Association of German Banks as well as the European Banking Association, both of which represent the interests of private banks, have repeatedly complained to the EC claiming

distortion of competition, whereupon the Commission launched proceedings to investigate such government-backed blank guarantees as a kind of disallowed aid.

Beside the Cologne savings bank, in these proceedings Germany's biggest and most internationally oriented landesbank – the Westdeutsche Landesbank (WestLB) – was from the very beginning at the centre of attention. In 1992, the State of North Rhine-Westphalia integrated the Wohnungsbauförderungsanstalt (Wfa) into WestLB by way of a contribution in kind and thereby increased the Bank's liable equity capital by €2 billion. This was a key factor for WestLB's growth and strong increase in value in the nineties. In 1994, the Federal Association of German Banks lodged a complaint with the EC against the amount of remuneration paid for the Wfa capital. This complaint by Germany's private banks led to the Commission's decision in 1999 to consider the integration of Wfa illegal government aid.<sup>3</sup> Independent of this proceeding, the European Banking Association lodged a complaint with the EC about the liability structures of public-law financial institutions in general. According to the private banks,

<sup>1</sup> For details, cf. W. Kerber: German and European Competition Policy: Perspectives for the 21st Century, in: H. Ono (ed.): Structural Changes in the Japanese and German Economies, Tokyo 2002, pp. 36ff. For a comprehensive overview of European competition policy see also R.J. Van den Bergh, P.D. Camesasca: European Competition Law and Economics, Antwerpen 2001; V. Korah: EC Competition Law and Practice, 7th ed., Oxford 2000; European Commission: European Union Competition Policy, 31st Report on Competition Policy, Luxembourg 2002.

<sup>2</sup> For a full account cf. J.B. Donges, J. Eekhoff, W. Möschel, M.J.M. Neumann, and O. Sievert: Privatisierung von Landesbanken und Sparkassen, Bad Homburg 2001. See also T. Döring: Reform Needs and Reform Options in the German Public Banking Sector, in: H. Ono (ed.): Structural Changes in the Japanese and German Economies, Tokyo 2002, pp. 126ff.

<sup>3</sup> The EC's decision was implemented in the form of a so-called value increase model. But the EC did not accept this implementation proposal and filed proceedings for failure to fulfil an obligation against the Federal Republic of Germany. A decision by the European courts in these proceedings is not expected until the middle of 2003 at the earliest. Cf. Westdeutsche Landesbank: WestLB of the Future – Building on Proven Values, Seizing New Opportunities, Düsseldorf 2002, pp. 12ff.

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the existing liability mechanisms represent state guarantees unlimited in time which improve the rating of landesbanks and savings banks and are therefore government aid, which is incompatible with European competition law and, as a result, has to be eliminated immediately. In the negotiations preceding the Treaty of Amsterdam the German federal government tried but failed to have a clause included granting exemption to public banks. However, in July 2001, a compromise was reached between the opposing parties involved under the EU government subsidy proceedings. While not disputing the ownership of public banks by state and local government authorities, the agreement does provide for the modification of the existing liability structure of public banks in Germany by 2005.

Against this background, it will be analysed below whether the decision in which the EC considered the liability structure to be illegal government aid is economically justified in consideration of all commonly voiced reasons for the special status enjoyed by landesbanks and savings banks. In addition, it will also be analysed critically whether the currently pushed reform options of the public banking system in Germany, all of which the EU has already classified to be compatible with European competition law, are the best solutions from an economic point of view. The analyses will start by outlining the current position of public banks in the German banking system and the economic problems resulting from this position.

### Public Banks in the German Banking System

The German banking system is divided into universal banks and special-purpose banks (such as mortgage banks and building societies).<sup>4</sup> The landesbanks and savings banks along with a large number of private banks (for example Deutsche Bank, Dresdner Bank, Commerzbank, Hypo-Vereinsbank) and cooperative credit institutions (Volksbanken, Raiffeisenbanken) are universal banks. However, public banks can also be found among the special-purpose banks, such as the public real estate banks (like, for example, the Landeskreditbank Baden-Württemberg or the Hamburgische Wohnungsbaukreditanstalt) or the special-purpose financial institutions (like, for example, the Kreditanstalt für Wiederaufbau as development bank). These public banks play a smaller role, but one that should not be overlooked.

Currently there are 12 landesbanks and 578 savings banks with more than 18,000 branches in Germany. Whereas the main target group of savings banks is

limited to small customers in their own specific catchment area,<sup>5</sup> landesbanks are mainly responsible for providing service and supplementary functions for savings banks in their respective larger region. These include organising cashless payments transactions and liquidity balancing between the savings banks, offering a range of investment instruments, and providing venture capital. Apart from that, landesbanks also cater to large customers, including their own company holdings. In this, they mainly act like private banks in that they carry out industrial and real estate financing. Finally, they also perform the function of a house bank for the states and the local government authorities, for whom they are important providers of loans. At the same time, the savings banks system is essentially the basis of the landesbanks. In Germany the savings banks system has developed to one of the main places where capital accumulates. The landesbanks can use these collected savings to finance their several business operations.

In 2001, the landesbanks and savings banks have an overall balance sheet total of €2.1 trillion and together make up the largest single banking group in Germany. They account for just 37 per cent of the entire business volume of all the universal banks, while private banks account for a market share of 25 per cent and cooperative banks about 13 per cent. Including public special-purpose financial institutions, the market share of public banks amounts to around 48 per cent. This market share is not an exceptional recent development, but is typical for the position of public banks since the Federal Republic of Germany was founded.<sup>6</sup> But the situation in Germany is clearly very different from that in many other European countries. Only in Spain does the government share in banking (42 per cent) reach a comparable level, while the market share of public banks in EU member states like the United Kingdom, France, Netherlands, or Belgium, ranges from 2 per cent to 28 per cent. Following a current empirical study using data on government ownership of banks from 92 countries around the world, the given government share in banking business in Germany can be seconded only by countries with low levels of per capita income, backward financial systems as well as interventionist and inefficient governments, i.e. most of the underdeveloped countries.<sup>7</sup>

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<sup>4</sup> For the following considerations cf. H.-W. Sinn: *The German State Banks. Global Players in the International Financial Markets*, Cheltenham and Northampton 1997, pp. 3ff. See also R. Biswas, H. Löchel: *Recent Trends in U.S. and German Banking: Convergence or Divergence?*, Hochschule für Bankwirtschaft, Working Papers No. 29, Frankfurt am Main 2001, pp. 6ff.

<sup>5</sup> In Germany, savings banks dominate retail banking with a market share of over 40 per cent, followed by the private banks (25 per cent), the mortgage banks (16 per cent), and the cooperative banks (15 per cent). The savings banks also account for over 60 per cent of banking volume among small industries, skilled trades and medium-size companies. Cf. B. Herz: *Finanzinstitutionen*, in: R. Hrbek, M. Nettelshheim (eds.): *Europäische Union und mitgliedstaatliche Daseinsvorsorge*, Baden-Baden 2002, p. 124. Cf. also R. Biswas, H. Löchel, *op.cit.*, p. 12.

<sup>6</sup> Cf. H.-W. Sinn, *op.cit.*, pp. 4f. Cf. also R. Biswas, H. Löchel, *op.cit.*, p. 13.

**Government Guarantees as Indirect Subsidisation**

Compared with private banks, the advantages landesbanks and savings banks have as government owned banks are substantial. These advantages stem from the unconditional safeguards that the government provides for the creditors. In contrast to private banks, the landesbanks and savings banks are not corporations whose shareholders' liability is limited. Instead, they are public institutions for which the government takes on unlimited responsibility. This unlimited responsibility stems from legal concepts called "institutional liability" (Anstaltslast) and "guarantor liability" (Gewährträgerhaftung). Institutional liability simply means that the public entity which established the institution secures its economic basis and operability for the duration of its existence and fills any financial gap by subsidies or other suitable measures. In contrast, guarantor liability refers to external obligations. It is the direct liability of a government authority for all obligations of its bank to its creditors. It guarantees the latter a surety-like legal claim. In cases where a bank's equity capital is not sufficient to cover such a claim, the government authority is jointly, and without limit, responsible to the bank's creditors.<sup>8</sup> However, the guarantor liability never actually needs to become effective, because the institutional liability always takes effect earlier. The public authority must step in to help before a creditor needs to claim his rights under the guarantor liability. The practical importance of the guarantor liability is that it reinforces the institutional liability. This total liability mechanism makes it impossible for public banks in Germany to go insolvent.

These government guarantees provide two kinds of advantages to the public banks.

- Thanks to the government guarantees, in particular the German landesbanks become involved in the kind of business that the private banks avoid because the risks are so high. They are very active in the risky derivatives business which has flourished in recent years and they participate in a big way in industrial firms in a wide variety of branches. It comes as no surprise that in this way investment risks can easily be shouldered by the landesbanks.
- It is the liability structure – and not the economic performance or sound business practice of the landesbanks and savings banks – that explains their high credit rating,<sup>9</sup> giving them a competitive edge over private banks. The main advantage resulting from this for the public banks is lower refinancing costs as creditors demand considerably lower risk premiums.

From the perspective of European competition policy this indirect subsidisation of landesbanks and

savings banks by specific government guarantees can lead to distortions of competition, because on the European financial market banks without such government subsidies have to compete with others that get subsidies. Especially the low refinancing costs of landesbanks and savings banks, which make it possible for these banks to make riskier loans than the private banks can, signify considerable advantages in a hotly contested competitive market like the European banking sector. In addition, this indirect subsidisation that is granted by the German state and local government authorities to the public banks on their territory can trigger off a race for subsidies leading to a situation in which other member states begin to subsidise their (private or public) banks. From an economic point of view, such a situation can be characterised as a prisoner's dilemma situation, which is wealth-reducing for all EU member states.<sup>10</sup> Against this background the prohibition of the given practice of indirect subsidisation of landesbanks and savings banks by institutional and guarantor liability according to Art. 87 (1) EC Treaty can be seen as part of a consistent EC policy of creating a liberalised European banking market.

**Additional Economic Problems**

Beyond these issues, i.e. the elimination of distortions of competition by indirect subsidies that are granted by state and local government authorities, the German public banking system poses an additional number of problems, all of which can be critically assessed from an economic point of view.

- The landesbanks' and savings banks' competitive advantage resulting from the government guarantees now carries much greater weight than it did 30 years ago, because in the meantime structural changes and intensified competition in the banking

<sup>7</sup> Cf. R. La Porta, F. Lopez-De-Silanes and A. Schleifer: Government Ownership of Banks, in: *The Journal of Finance*, Vol. 57, 2002, pp. 265-301. For similar empirical evidence, cf. J. Barth, G. Caprio Jr, and R. Levine: *Banking Systems Around the Globe: Do Regulation and Ownership Affect Performance and Stability?*, mimeo, World Bank 1999.

<sup>8</sup> Cf. Westdeutsche Landesbank, op.cit., pp. 16ff. The guarantor liability is not the same as the deposit insurance fund which the private banks have available, because this fund only protects the deposits of the private account holders, but not the investments of the bank's creditors. Cf. H.-W. Sinn, op.cit., p.28.

<sup>9</sup> The three major rating agencies – Moody's, Standard & Poor's and Fitch IBCA – place all the German landesbanks in the "Long Term Deposit Rating" assessing creditworthiness, earnings power and capitalisation in the highest or second highest category (Aaa and Aa1 or AAA and AA+). It is also a remarkable fact that five German landesbanks are in the top group of only eight banks which have been given Triple A ratings by all three agencies. None of the four large German private banks (Deutsche Bank, Dresdner Bank, Commerzbank, HypoVereinsbank), which are sometimes assumed to enjoy latent government protection (being "too big to fail") have been rated this high. For the WestLB, for example, this advantage is estimated to have a monetary value of about €360 million annually. Cf. J.B. Donges et al., op.cit., p. 16f.

<sup>10</sup> Cf. W. Kerber, op.cit.

sector have led to numerous bank collapses and crises, especially in recent years. Moreover, the costs of the government guarantee paid by state and local government are also higher than they used to be.<sup>11</sup>

- The owners of landesbanks and savings banks, i.e. the state and local government authorities, are also among their major customers since as a rule state and local governments try to do their banking in-house. This does not necessarily affect the terms of the banking services required, even if a certain grey zone probably exists. But as long as the deal offered by a landesbank or savings bank is not worse than what is available from a private bank, they practically have the right of first choice.
- Due to public banks' higher credit rating, the capital market's regulating and controlling effect on landesbanks and savings banks can only work to a limited degree. This makes monitoring and control by the owners (state and local government authorities) all the more important. Up to now, the owners have not appeared to be particularly interested in exercising this control, probably because the income which local and state government authorities can expect from these sources is zero or almost zero. While none of the savings banks are allowed to pay out dividends, the landesbanks usually press for a high rate of profit retention. This strategy is caused by the fact that retained profits provide the landesbanks with equity capital which they can use to expand their business activities.<sup>12</sup>
- In Germany, the state authorities use their landesbanks and the local councils their savings banks as tools of economic policy. This happens irrespective of what party happens to be in power. This political use of the banks takes the form of politically expedient guarantees, loans and company investments. This influence on industrial policy is not transparent as it is normally not subject to public or parliamentary control. Above all, this procedure also violates the rule that all government expenses must be authorised and controlled by the government.<sup>13</sup>

In a free market, like the European Common Market, from an economic point of view private economic activities should be the rule and government economic

activities the exception. Accordingly, under a market economy interpretation of the subsidiarity principle,<sup>14</sup> mentioned in Art. 5 EC Treaty, private activities should always take priority over government responsibility. Given all the problems (distortions of competition, additional economic problems) associated with public banking activities in Germany, the role of government as banker requires specific justification. But if that government ownership can be economically justified and accordingly public banking potentially leads to wealth increasing effects, the current decision under the EU subsidy proceedings is lopsided. Against this background, the main question seems to be whether there are any specific reasons which perhaps economically justify public banking activities in order to compensate the negative economic effects mentioned above.

#### Reasons Given to Justify Public Banking Activities

The legal foundations on which the public banking system in Germany is based cite a number of reasons. However, these are not reasons which follow from the common categories of market failure (natural monopoly, ruinous competition, external effects, large economies of scale in production, asymmetrical information) which are normally used to justify government intervention, and which are also compatible with European competition policy. Instead, mention is made of the government owned banks' specific public task or responsibility, which finds its concrete expression in various functions. The following considerations present a short but critical analysis of these functions.

*Encouraging saving.* In most laws relevant to public banks, one reason given to justify their existence is that they are meant to encourage saving and wealth accumulation. This is a task which dates back to the 19th century when the savings banks were founded to support the economically weak population and encourage provision for old age and illness. But nowadays in a well developed welfare state like Germany, this function seems rather anachronistic. Furthermore, the German savings ratio is about average in international terms.<sup>15</sup> Against this background, it ought to be enough for the government's involvement to be limited to creating more incentives to encourage people's willingness to save.<sup>16</sup> At any rate, having an extensive

<sup>11</sup> The best known recent example was the impending insolvency of the Mannheim savings bank, which was only saved by a €240 million rescue package, with the Mannheim city council contributing a liquidity guarantee of €51 million. This guaranteed sum corresponds to 6% of the annual municipal budget of Mannheim. In the current fiscal crisis of the Berliner Bankgesellschaft, which was caused by failed financing of high property development risks, the initial estimate of the financial gap amounts to €2 billion, that is 10% of the annual public budget of Berlin. Cf. B. Herz, op.cit., p. 129.

<sup>12</sup> The landesbanks (as well as the savings banks) can increase their loans in proportion to the amount of profits retained because the German Bank Law prescribes a certain minimum ratio of loans to equity capital.

<sup>13</sup> This, for example, also concerns expenses for subsidies for purposes serving the general interest and for cultural purposes which are incurred because savings banks are not allowed to distribute their profits. In some areas, these subsidies are higher than the local council arts budget.

<sup>14</sup> Cf. T. Döring: Das Subsidiaritätsprinzip in der Europäischen Union, in: ORDO, Vol. 47, pp. 293-323.

<sup>15</sup> Cf. OECD: Economic Outlook, Vol. 2001/1, No. 69 (June), Paris 2001.

public banking system to perform this task really does not appear necessary today.

*Provision of banking services and loans.* Another argument is that without public banks, there would not be a full coverage of banking services, especially with focus on economically underdeveloped regions. This argument is primarily used to justify the savings banks system with its multitude of branch offices that covers the whole of Germany. The representatives of the savings banks' organisations frequently argue that this wide geographical dispersion is the reason for the public status of the savings banks. However, this concern that the public at large is undersupplied with banking services is not convincing. As can be seen from European Central Bank data, the density of banking services is even somewhat higher in Germany than in other EC countries.<sup>17</sup> In addition and contrary to a widespread assumption, the savings banks do not have the densest network in Germany. The cooperative banks have about the same number of branch offices as the savings banks, and in most German cities and municipalities one can find branch offices of both type of banks.<sup>18</sup> Moreover, new technology (ATMs, credit cards, other forms of cashless banking) have steadily increased the availability of banking services. Another variant of this argument emphasises the special role played by savings banks in lending cash to small and medium-sized companies. But lending to medium-sized companies is primarily a question of willingness to cater to their specific needs and to bear the related risks and to ask the higher price (i.e. the interest rate); after all, the loss of credits in this sector is particularly high. Therefore, the low market share of private banks in this market segment is probably merely a reflection of comparative advantage among the different types of banks. Cooperative banks have the same comparative advantage, and medium-sized companies have always been among their target groups. This demonstrates that public banks are not indispensable to ensure the provision of banking services either. In addition, the theory of public goods states that even if there is a demand for a public service, this service need not necessarily be supplied by the government itself.<sup>19</sup> Instead it can be left to private companies, provided they are given the necessary incentives (including possible subsidies).

*House bank function.* Savings banks and landesbanks are referred to as the "house banks" of local and state government authorities because they are their primary business partners for banking transactions such as distributing public funds and solving financing problems. But banks do not need to be owned by state or local government for this purpose – this would only be necessary if competition between private banks did not work, resulting in excessively high cost. In this case, state and local governments

might be able to cut costs by having their own banks to manage their banking transactions. So, if it were only a question of costs, consistent with the European competition law the more economic approach would be to make sure that competition works properly in the banking sector, not to preserve an extensive public banking system.

*Contribution to regional development.* The intention behind this function is that public banks should contribute to balanced regional economic development.<sup>20</sup> In fact, however, landesbanks and savings banks are often used to exercise the economic policy of state and local government authorities. Accordingly, it could be argued that as an instrument of regional policy public banking should be handled like other exceptions within the scope of the EC policy of government aid control, e.g. subsidies for firms in poor regions. An economically sounder solution, however, would be to set up a special-purpose financial institution which would stay outside of general banking business. As long as such public institutions stick to their special banking tasks, their existence can be regarded as economically acceptable. Economically speaking, the worst solution is the presence of government owned banks on all markets. This cannot be justified by their contribution to balanced regional development and accordingly public banking activities do not comply with the typical exceptions of Art. 87 (1) EC Treaty. Indeed, whenever public banks are exposed to competition, their job of promoting regional development tends to be neglected. The only way to prevent this would be for the banks to be subsidised and protected by the government – which would obstruct the basic

<sup>16</sup> From this point of view increasing willingness to save may be a legitimate goal for the government to pursue because people who have savings accounts have less need for welfare payments and other government support measures. Nevertheless, even taking this reason into account, it hardly justifies the government having an about 50% share of banking. Cf. B. Herz, *op.cit.*, p. 126. In addition, current empirical studies provide only mild support for this argument because the measured effect of government ownership of banks on savings is positive but insignificant, although there is no evidence of an effect on capital accumulation, which is central to that view. Cf. R. La Porta, F. Lopez-De-Silanes and A. Schleifer, *op.cit.*

<sup>17</sup> Cf. European Central Bank: Possible Effects of EMU on the EU Banking System in the Medium to Long Term, Frankfurt am Main 1999. While the branch office density (number of bank offices per 100,000 inhabitants) is high in EC countries like Spain (95), Luxembourg (81), or Belgium (79), the lowest rates can be found in Portugal (50), Finland (39), or Ireland (39). In comparison with these rates the German figure (62) is quite close to the EC average (61). These figures also show that Germany does not seem to be over-banked or over-branched as sometimes stated. Cf. also Deutsche Bank Research: The Effects of EMU on the Structure of the European Banking System, EMU Watch No. 59, Frankfurt am Main 1998.

<sup>18</sup> They have 38.1% of all branches which is a little higher than the savings banks' share of 37.9%. Cf. H.-W. Sinn, *op.cit.*, pp. 58ff.

<sup>19</sup> For more details, see H.S. Rosen: Public Finance, Boston and Sydney 1992, pp. 78ff.

<sup>20</sup> For a full account cf. B. Herz, *op.cit.*, p. 127. Cf. also J.B. Donges et al., *op.cit.*, pp. 35ff.

function of the markets. Whichever way one looks at it, the result is a conceptual flaw.

*Safeguarding competition.* It is sometimes argued that the public banking system provides a counterweight to the power of the private banks and that this helps to create a competitive market relationship. If this argument is accepted as true, the assessment under the EC government aid proceedings fails because landesbanks and savings banks lead to intensified competition in the German banking sector. This argument draws attention to the group competition which has evolved over the years between private banks, cooperative banks and public banks. Yet this argument, too, is economically flawed as group competition is based on the (inferior) concept of a closed market<sup>21</sup> – whereas (from an economic point of view) the banking market should be an open market. In addition, the sheer number of private banks in Germany refutes the idea that in the absence of public banks there will not be enough competition between the private banks. There are approximately 2800 banks in Germany, and many of them have large branch networks. Moreover, it is just as obvious that the public banks among themselves do not act like real competitors. The closely linked landesbanks normally accommodate one another, and the savings banks operate under the regional principle which, in effect, protects their markets from each other. Against this background, it can also be argued that the existing market segmentation practised by public banks, which has often led to a monopolistic position (especially for savings banks in their region), should be replaced by privatisation. That would have the additional effect that competition within the German banking sector would increase.

The critical discussion of the arguments commonly put forward to justify the existence of public banks has shown that from an economic angle nothing less than the reform of the existing system of landesbanks and savings banks is defensible. This assessment can be buttressed by empirical findings which support the thesis that government ownership of banks leads to a misallocation of (financial) resources that is detrimental to productivity growth and ultimately economic growth itself.<sup>22</sup> This empirical evidence on resource misallocation is consistent with a large literature on government owned firms.<sup>23</sup> In addition, these empirical findings also show that countries with less efficient governments have greater government ownership of banks. In contrast, higher tax compliance, higher bureaucratic quality and lower political corruption are all associated with lower government ownership of banks. Therefore, reform options are outlined below.

### Currently Pushed Possibilities of Reform

From the viewpoint of the EC policy of government aid control the main problem of public banks in Intereconomics, March/April 2003

Germany is the distortion of competition owing to the liability rules in place. Therefore, the key question of reform should be how the economically negative effects of unlimited governmental responsibility, which arise from “institutional liability” and “guarantor liability”, can be abolished or changed. Currently, there are two main lines of reform under particular political consideration. The first line concerns the abolishing of the existing liability structures, while the second line deals with the implementation of the so-called separation model. Both reform options have to be seen as closely connected with each other.

*Abolishing the liability principles.* Considering the existing liability mechanism of German landesbanks and savings banks to be illegal government aid, one obvious reform option would be to abolish the existing liability principles. The compromise reached between the EC, the complaining private banks (and their representing associations), and the landesbanks and savings banks (i.e. the German government) in the EU subsidy proceedings mentioned above can be seen as a main step in this direction.<sup>24</sup> The compromise leaves the legal form of landesbanks and savings banks under public law unaffected. This means that the state and local government authorities would remain the owners of these banks. They will, of course, still be entitled to provide their public law financial institutions with equity capital. This has to be done at market terms in order to ensure compliance with European government aid legislation. Institutional and guarantor liability will, however, be abolished after a transitional period ending on July 18, 2005. The liability structures will be modified in such a way that they will correspond to the relationship between private shareholders and joint-stock companies or limited liability companies. The regulations and transitional periods stipulated by the agreement with the European Commission can be summarised as follows:

- All liabilities agreed by July 18, 2001 will remain fully covered until the end of their maturity by institutional

<sup>21</sup> The group-competition argument is more concerned with the concept of countervailing power, which has nothing in common with the economically preferable concept of contestable markets. For the former see J. K. Galbraith: *American Capitalism: The Concept of Countervailing Power*, London 1957. For the latter, see J. W. Baumol: *Contestable Markets. An Uprising in the Theory of Industry Structure*, in: *American Economic Review*, Vol. 72, 1982, pp. 1-15.

<sup>22</sup> Cf. R. La Porta, F. Lopez-De-Silanes and A. Schleifer, op.cit. For consistent empirical findings for Italian banks see P. Sapienza: *What do state owned firms maximize? Mimeo*, Northwestern University 1999.

<sup>23</sup> See, for example, A. Schleifer: *State versus Private Ownership*, in: *Journal of Economic Perspectives*, Vol. 12, 1998, pp. 133-150; or A. Schleifer, R.W. Vishny: *Politicians and Firms*, in: *The Quarterly Journal of Economics*, Vol. 109, 1994, pp. 995-1025.

<sup>24</sup> Cf. European Commission: *State Aid, No E 10/2000 – Germany. Institutional Liability and Guarantors Liability*, COM (2002) 1286; and European Commission: *Understanding on Anstaltslast and Gewährträgerhaftung*, Brussels on July 17, 2001. Cf. also Westdeutsche Landesbank, op.cit., pp. 14ff.

and guarantor liability. For creditors of landesbanks and savings banks this means that there will be no change for liabilities agreed on or before July 18, 2001.

- In the transitional period from July 19, 2001 to July 18, 2005, institutional and guarantor liability will remain in effect in their present form. Liabilities agreed during this transitional period will be fully covered by guarantor liability, provided their maturity does not go beyond December 31, 2015.

The economic and legal background of these negotiated regulations is as follows. In principle, the public ownership of banks by itself does not violate EU law. Under Section 295 of the Treaty on European Union, banks are part of the member states' property rights system and are therefore not subject to EU regulation. However, the European Commission stated in its report "Commission communication on services of general interest in Europe" that public companies (which include public banks) competing with private companies are subject to the rules of the Common Market.<sup>25</sup> On this basis, the existing liability principles of landesbanks and savings banks must be regarded as prohibited subsidies pursuant to Art. 87 (1) EC Treaty. This can be substantiated within subsidy monitoring by reference to the terms of "reasonable private investor" or the "market economy investor". Even if such an investor accepted unlimited liability, they would not be able to offer the bank the same refinancing conditions as government could, because the government can always levy statutory contributions (taxes) to ward off insolvency. Yet even if a private investor did have this possibility, given the institutional background it would not normally be willing to give such a far-reaching guarantee. As the savings banks are not allowed to pay out dividends and the landesbanks do so only to a very limited extent, a private investor could not expect to earn a yield from his equity matching the risk incurred. The investor would be in the unenviable position of having to answer for losses without being able to reap the adequate profits. If the government, however, accepts this liability, this is a form of government aid or subsidy. The existing liability mechanism for public banks could only be justified (with regard to Art. 86 (2) EC Treaty), if landesbanks and savings banks performed a special public task entailing particular burdens. These special liability principles could then be interpreted as a kind of compensation. This, however, presupposes that private and public banking activities are separate – which leads to another possibility for reform.

*Separation of activities.* The "separation model" provides for the separation of two types of banking activities:

- banking on behalf of the government (with government liability)

- commercial banking activities (without such a guarantee).

Under the pressure of the Brussels subsidy proceedings, the former WestLB (Westdeutsche Landesbank) was divided into two separate banking institutions in the course of 2002. With retroactive tax and commercial effect from January 1, 2002, both banking institutions were established on August 30, 2002.<sup>26</sup> The newly founded Landesbank North Rhine-Westphalia, a financial institution under public law, provides all public mission business. In its function as a state and municipal bank, Landesbank NRW supports state and local government authorities in their structural policy tasks such as the promotion of new businesses, financing public infrastructure projects or supporting housing construction. In addition, the investments held under the public mission is pooled in a special business unit. By contrast, the WestLB AG, a newly founded subsidiary of Landesbank North Rhine-Westphalia, runs under private law and comprises all commercial bank activities of the former WestLB. These include the commercial and investment banking activities as well as the investments in other landesbanks. All branches, representative offices and foreign subsidiaries are assigned to WestLB AG. Moreover, WestLB AG acts as the central institution of the savings banks and as the house bank of local government authorities. According to the agreement reached between the European Commission and Germany regarding institutional and guarantor liability supporting public banks, the current liability mechanisms will continue to apply for both institutions under the new parent-subsiary structure only until July 18, 2005. This means that the owners of Landesbank NRW will also be directly liable for WestLB AG. From an economic perspective, this separation of business activities can certainly be regarded as a step in the right direction. Although the European Commission has confirmed that the established parent-subsiary model is market-compliant and in conformity with European law, indeed, from an economic point of view two important issues have not been discussed so far. First, it is not yet clear whether such a separation between public and private mission business activities will (or maybe can) also be introduced in the savings banks in Germany. Second, the reorganisation of WestLB AG

<sup>25</sup> Cf. European Commission: Commission Communication on Services of General Interest in Europe, COM (1996) 443; European Commission: Commission Communication on Services of General Interest in Europe, COM (2000) 580. Cf. also J.B. Donges et al., op.cit., pp. 39ff. and pp. 51ff. See additionally P. Herrmann (ed.): European Services of General Interest – Touchstone for the German Social Economy, Baden-Baden 2002.

<sup>26</sup> Cf. Westdeutsche Landesbank AG: Opening Balance Sheet, Düsseldorf 2002; Landesbank Nordrhein-Westfalen: Opening Balance Sheet and Organisation Chart, Düsseldorf 2002. Cf. also State Parliament of North Rhine-Westphalia: Act on Redefining the Legal Status of Public-Law Banking Institutions in North Rhine-Westphalia of July 2, 2002, Düsseldorf 2002.

as a private-law bank represents only a privatisation in form, not in content. Landesbank NRW and WestLB AG will, rather, continue to be owned by the current public-sector owners of the former WestLB.<sup>27</sup>

### Alternative Economic Reform Options

Against the background of the issues mentioned above, two further possibilities for reform exist, both of which can be interpreted as consistent with a market economy view. While the first option deals with the enlargement of the existing government liability mechanisms, a complete privatisation of public banks is another possibility for reform.

*Enlargement of government liability mechanisms.* The EC government aid control legislation is only designed to ensure fair competition between private and public companies. In regard to this objective as one part of European competition policy, the main problem associated with the way capital is supplied by German public banks involves the asymmetries which result from the enormous competitive advantages of these banks. One way to mend these asymmetries could be to broaden the application of the existing government liability mechanisms to private banks. An alternative but economically similar reform option would be to set up a government insurance fund to protect the creditors of all banks (public as well as private ones).<sup>28</sup> The main effect of such a general system of investment insurance would be that it could help all German banks to get high ratings and favourable refinancing conditions. In order to avoid added distortions of competition, the introduction of a fee as a fiscal equivalent for the economic advantages resulting from this enlarged government insurance mechanism would be necessary.<sup>29</sup> Otherwise only the German banks would benefit, at the same time discriminating against all the other banks in the EC member states. Indeed, the introduction of such a compensation payment denotes the main failing of this otherwise economically rational solution. The implementation would be difficult insofar as the advantages cannot be exactly measured. In any case, these compensation payments would have to be completely independent of profit. Changing circumstances such as growing business volume or altered business structure would have to be taken into account. But the more exactly the fiscal equivalent is meant to correspond to the competitive advantages, the more difficult the practical implementation becomes. A lump sum payment, on the other hand, would be an imperfect and probably unfair solution. And, in addition, such a lump sum payment must also be calculated in the right way. Therefore the enlargement of the existing or a modified version of government liability mechanisms (necessarily combined with compensation payments) does not seem to be the ideal reform option, but is more a theoretical one.

*Complete privatisation.* Against this background, the best solution from an economic point of view would be to completely privatise landesbanks and savings banks, i.e. government withdrawal from all (commercial) banking activities. Like the preceding reform option, such a solution is also not stipulated by the EU government aid legislation. The full privatisation of public banks, however, would completely eliminate all the problems mentioned in previous sections of this paper, i.e. the problems connected with EC competition policy as well as the additional economic problems. Although there are no legal objections to the privatisation of landesbanks, the privatisation of savings banks could be complicated by the fact that local self-government is enshrined in the German constitution (section 28). It could therefore be left to the discretion of each local authority to decide whether to privatise the local savings bank or not. According to the EU Commission, this would not be necessary for at least some savings banks. The Commission has indicated that smaller savings banks with just a local target group would not be regarded as a violation of Art. 87 EC Treaty, meaning that at least these savings banks are exempt from the demand for reform. This decision is based on the so-called "interstate clause" stating that effects distorting competition are only relevant from the angle of the EU if trade between member states is impaired. This is thought not to be the case for smaller savings banks. But this view is questionable given the very close organisational links between the savings banks in Germany. However, this opinion cannot be shared from an economic perspective as the problems connected with the public banking system in Germany stem not so much from the size of the banks concerned but rather from fundamental flaws in the system. To mend these flaws, the privatisation of public banks by turning them into public corporations is only the first step. The necessary second step should be to sell the shares of these corporations in the stockmarket. From an economic perspective and contrary to what currently happened with the focus on Germany's biggest and most internationally oriented government owned WestLB, this solution seems to be a practicable as well as an effective one in the sense that it would eliminate the fundamental economic flaws inherent in a system of government-owned banks.

<sup>27</sup> As mentioned in the blueprint of the implementation of the new parent-subsidiary structure, a direct investment option will permit the owners of the WestLB to invest directly in WestLB AG. The savings banks and regional public associations will be entitled to swap shares in Landesbank NRW for shares in WestLB AG. Landesbank NRW will, however, retain at least 50% plus one share in WestLB. Cf. Westdeutsche Landesbank, op.cit., p. 33.

<sup>28</sup> A rudimentary version of this proposal can be found in H.-W. Sinn, op.cit., p. 95.

<sup>29</sup> For a full account of this discussion see J.B. Donges et al., op.cit., p. 50.