Taking the sector’s temperature

As an independent indicator for structural developments, the ikf simultaneously acts as a signal of change processes in the financial industry—and this also holds true for our first wissen & handeln.

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assesses

central development trends of value management and capital markets which are relevant to banks, insurance companies and corporate finance departments.

indicates

ways to overcome practical problems in business, starting from solid theoretical grounds.

offers

a forum for scientific discussion and

calls for

the exchange of views and ideas between science and practice.
GERMAN BANKS ARE SUFFERING from “Japanese fever”. At least this is the impression gained from the rather impressive number of contributions featuring memorable headlines encountered in the press. During multi-voiced debates a colourful mixture of crisis terminology and calls for consequences are exchanged.2 The difficult situation of the German banking sector (“the house is on fire”)3 — at least according to the basic tenor of many contributions — is raised to the threatening ranks of the “disease” the Japanese banking industry is suffering from. Such a statement labelling “German banks — Turning Japanese”4 (to be deemed at least a negligent remark) was the very issue of the Merrill Lynch study of equal title.

Crisis Talks and the Risk of Self-fulfilling Prophecies
Careless generalisations, in this particular case, are naturally highly dangerous since the past has shown that they can possibly conjure up a crisis in the respective banking sector. The probability of such self-fulfilling prophecies augments with the problems of market participants to convince themselves of the truth of such hearsay crises. To grasp this can be rendered more difficult objectively, i.e. if a company and subsequently the “crisis rumours” heard about it are difficult to analyse for interested external parties. On the other hand, a subjective element can be added to such extent as the limited professionalism of certain parties involved may deprive them of the ability to adequately assess information they obtained about a “crisis”.

In view of distinct information asymmetries acting to their disadvantage, they then tend to be oriented not only toward their self-interest, but also toward other market participants. The individualised rational calculation can turn into herd behaviour, leading in the end to a devastating outcome for the entirety of those involved, as well as for triggering individuals themselves.

The susceptibility to this type of crises of confidence is particularly pronounced among banks, due to the characteristics of the services and information they offer. The difficulty of an accurate assessment of a bank’s financial soundness by outsiders, that is, first of all, their private depositors, is one of the decisive arguments in favour of the necessity of the special protection of depositors and of supervisory agencies monitoring it. The anatomy of runs is primarily developed for banks, whereby the theory regularly contains empirical proof for runs on banks — last seen during the Argentinian financial crisis. Analogue in principle, the run phenomena on insurance companies can be traced — here also mainly for the long-term private account segment.6 Although the probability of contagious effects — emanating from one bank onto other institutes all the way to a system crisis — can easily be assessed as critical, there is absolutely no deficiency of indications as to crisis-reinforcing and possibly even (co-)creating effects of crisis assumptions. The most severe crisis of confidence in German finance economy to date is the one triggered by the insolvency of Herstatt-Bank in 1974, yet the recently concluded legal dispute surrounding the role of feature articles published in “Focus” magazine in the bankruptcy of Hamburg’s Mody-Bank of 1995 renders the relevance of information problems a very current issue.

As a result it is surprising just how naturally the current economic situation of the German finance industry is interpreted as a “banking crisis”. Clarification is thus required for two central reasons: On the one hand, an accurate diagnosis — as will have to be shown — is desirable in view of the severity of the implied affliction. On the other hand, it forms the necessary
foundation for the development of correct proposals not only along the line of treatments solving (current) problems, but in particular also of monitoring concepts preventing (future) problems.

Building on a careful analysis of the critical phenomenon in the German banking industry, consequences are subsequently derived in relation to the current planning of the reorganisation of the European financial supervision, and of monetary institutions. The triad of diagnosis, therapy and prophylaxis will create the frame here, since the crisis term is technically rooted in medicine and furthermore practically applied in well-known metaphors such as “the sick man of Main”.

Insolvencies of Banks
A growing number of bank insolvencies can actually serve as the “strongest” symptom of an acute crisis — given an immediate disclosure of bankruptcies. In practice, however, different disclosure requirements, quiet winding-ups or corrections through takeovers make the absolute number of bank insolvencies only a conditionally expressive indicator of a crisis.

In Germany, cooperatives and savings and loan associations (S&Ls) substantially cloud the true situation by regularly granting rescue solutions within their networks preference over open insolvencies. As a result, the statistics of Germany’s central bank of the past ten years show a mere dozen bank failures. Compared with this, the Federal Financial Supervisory Authority (BAnkin) determines for the last two years alone some 240 problem cases “which for more than one hundred financial institutes even evolved into closing or insolvency” — thus delivering an idea as to the significance of S&Ls and cooperatives no longer listed in the statistics, but also of insolvencies which could be successfully averted.

In Japan, the Deposit Insurance Corporation (DIC) openly publishes 124 insolvencies for the years 1991–2000, ninety per cent of which fall into the last five year-period. Bank insolvencies, however, are politically also a taboo issue there, which is why these official figures hit Japanese tolerance limits and most likely will have to be corrected by a number of unrecorded cases.

Diagnosis: German & Japanese Afflictions
In medical terms, a crisis is deemed the extremum of a severe affliction, when the decision of life or death is made. Translated to an economic context, this implies a threat to the existence of at least one market member. Current discussions about banks, however, very often fail to make a distinction at this very point, between individual institutions, and the banking sector as an entire system. A “banking crisis” , in a broader sense, has already arisen if a single bank (and a single bank only) is in crisis. To this extent SchmidtBank, just like Gontard & Metallbank and Bankgesellschaft Berlin, is currently experiencing its very own “banking crisis”.

However, such crises do not justify creating either explicitly or even negligently the impression of a general crisis in banking that extends beyond individual institutes, i.e. to the crisis of a system. This is only the case if the existence of a banking system in its entirety, or a least a critical share of financial institutions constituting such system, is lastingly at risk.

So, to gain clarity with regard to the status of Germany’s banking sector compared to its Japanese counterpart, the following systematically examines the elements of the “genesis” of a banking crisis — as illustrated in picture 1. In the beginning, there is always the perception of certain visible signs indicating the critical condition of the respective patient.

Changes in the market / competitive environment of a solid banking system

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<tr>
<th>Cause of crisis</th>
<th>Force to adapt</th>
<th>Irresolute and latently endangered banking system</th>
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<th>Crisis trigger</th>
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Pic. 1: Creation and typical evolvement of banking crises
Return on Equity

When examining the stage prior to insolvency, profitability gains major importance. Since any corporate decision — also mismanagement creating a crisis — is reflected in a bank’s return on equity, either very modest or very negative returns serve as a further crisis symptom. As picture 2 illustrates, German banks — measured by this indicator — with an average return on equity of seven per cent per annum after tax, are at best average on an international scale, yet are still far above the negative average return of minus nine per cent per annum determined for Japan. These results are substantiated in the detailed observation of the two countries: In a comparison adjusted by the effect of profit taxes, statistics show for four of the ten periods from 1992 – 2001 for Japanese banks a double-digit negative equity return rate, and therefore obviously a sustained threat to the existence of the institutes there. During the same period of time the return on equity in Germany halved. However, values were clearly positive until last — a fundamental difference to the situation in Japan.

Different Qualities of Capital Cushions

Additionally, one has to consider that the capital buffers of Japanese banks are of poorer quality than in our country. Only formally do the most important institutes fulfil the BIZ ratio, according to which the equity compared to risk-weighted assets is to amount to at least eight per cent. Available data of larger Japanese banks show that their equity at the end of March 2002 was made up of public funds by more than 20 per cent, while tax repayments carried forward constitute approximately the same share, yet can only be collected if banks generate sufficient profit over a five-year period. The fact is, Japanese institutes are thus undercapitalised and on route to being nationalised.

Non-performing Loans

When turning from the risk bearers to the risks as such, a further symptom of crisis is the poorer quality of the bank’s credit portfolio. An indicator here is the amount of allowances for losses incurred by non-performing loans. Hereby it must be taken into account that no net figures are available for German institutes, as a result the amounts listed for these in the following refer to the “visible share” of their entire allowances for loans and securities. For Germany, this value accumulates over the past ten years (1992 – 2001) to roughly € 150 billion. This can be confronted with a more than four times higher figure of € 670 billion for Japan. If this information is brought into relation with the partial operating results, i.e. standardised toward the existing risk buffer from operative business (pic. 4), Germany truly faces a worrying melt-down: 95 per cent of partial operating results were last consumed by provisions (also) for bad loans. However, this still falls short of the Japanese situation: For Japan, the aforementioned rate since 1993 has been chronically beyond full consumption, reaching peak values clearly exceeding 300 per cent. If the figures presented so far already provide a clear indication as to the German banking sector still substantially falling short of Japanese standards, a concluding judgment should integrate a thorough assessment of specialised information intermediaries as well as of the financial market itself. Widening the perspective in this way is, as a matter of fact, also due to the mentioned difficulties outsiders encounter with regard to
completeness and comparability of data provided by banks, supervisory authorities or politicians.

What Rating Agencies Have to Say

Relevant information intermediaries in this context are international rating agencies. Following their assessment of financial soundness, low bank ratings can also be interpreted as a symptom of crisis. Particularly revealing is the Bank Financial Strength Rating introduced by Moody’s in 1995. Removed from outside influences such as the home country’s credit standing or external support mechanisms, it measures a bank’s intrinsic financial strength.

This, for example, helps to answer the question how likely the search for outside assistance might be. Picture 5 shows the current situation. Three quarters of Japanese banks assessed in this manner are classified in the lowest rating categories D and E. On the other hand, more than half of the German institutes are given a C rating, a further third even a B rating — which not a single Japanese bank receives.

For listed banking corporations, share prices reflect — in information-inefficient markets to a complete degree and without delay — all relevant information about a company. Constantly falling share prices, or, vice versa, growing costs of share capital could therefore be seen as crucial outside indicators of a banking crisis. In a nutshell, they express a changed evaluation of anticipated opportunities and risks.

Empirical research has also shown that share prices respond comparatively swiftly to initial signs of a crisis, anticipating the appearance of the same.16

Evaluation by Capital Markets

Picture 6 presents the development of the banking indices in Japan and Germany. Both indices have clearly moved away from past maximums. Starting from an index base in November 1992 = 100, the Japanese banking index evolved to today’s 26.7 (November 2002). This corresponds to a destruction in value of almost three quarters over the past ten years. In the same period of time, shareholders of German banks faced an increase in value of 44.5 per cent, which — although critically behind the maximums reached in between — still presents a substantial rise.

In addition, when comparing the development of bank share prices to that of general stock exchange trends during the period under review, it becomes clear that in both countries banking corporations performed worse than the (national) overall market. In Germany, this disadvantage weighing in at approx. 25 per cent is significantly below that in Japan, where the banking index falls behind the overall index by more than 60 per cent.

System Crisis in Japan, Structural Crisis in Germany

The mere comparison of the central symptoms of a crisis shows fundamental differences between the developments in the Japanese banking system, compared to the German banking system. For Japan, the overall data build up a clinical pattern. The exposition of a system crisis with the further risk of infection for the industrial economy there continues to exist — the latter in particular since the problem of non-performing loans is no longer “only” a not fully mastered negative heritage from the days of the bubble economy: the structural changes in the Japanese corporate sector by now flush a frighteningly high amount of new “second generation” bad loans.
onto the balance sheets of banks, where they equally encounter a change in banking behaviour with a procyclical effect in their efforts to regain profitability and greater financial soundness.

In contrast to this, the German banking sector can currently not be diagnosed with the serious risk of contracting “Japanese fever” in the sense of a system crisis. To remain within this picture: The actual temperature is clearly below the current apparent temperature. Crises of individual banks can not be denied, and it is also visible that the size and number of affected institutes in the recent past has increased. The diagnosis also confirms the manifestation of a structural crisis. This, too, carries a danger for the local industrial economy, i.e. to procrastinate in the current degenerative phase — in particular when taking into account the recent loss in value due to the slump of shares and the respective consequences for the gross domestic product.17

Other than that, however, there are further weighty differences beyond the revealed symptoms between Japan’s system crisis and the structural crisis in German banking. When analysing the cause for the failed development, severe defects become visible in Japan’s regulatory system — such as, for example, the fragmentation of the supervisory authorities, or the asymmetrical relaxation of interest rate regulation for assets and liabilities,18 which do not apply here in Germany. Looking at what triggers the banking crisis, a very distinct issue in Japan is the bursting of the “double bubble”: A correction of assessments which were removed from fundamental factors on the stock exchange and — contrary to Germany — simultaneously on the real estate market. For Japanese financial institutions this entailed on the one hand the diminishing of a mighty share of their equity (in the form of revaluation surplus); on the other hand, the properties and buildings deposited as securities by the lenders suffered a dramatic loss in value.

Possible Therapies

The various strategies aimed at curing the banking crisis are rather striking. In Germany, the structural problems were already concisely described ten years ago by Ulrich Cartellieri in his Bochum paper, saying “banks are the steel industry of the nineties”19, which, however, fell into oblivion following the German reunification and the stock exchange boom.

Only since the end of 2001 has the structural crisis become a topical issue again within the industry itself, such as by Rolf-E. Breuer, upon taking up his post as president of the Federal Association of German Banks (“the skeleton is deep red”). This coincides by now with lasting efforts to remove (mainly) cost-, but also earnings-related problems, for example by laying off staff at a previously unsuspected level, a more consistent separation of marginal activities in favour of stronger strategic focusing, and also a more careful management of scarce equity resources. Especially the latter partially already goes so far that due to the induced reluctance to increase credit services (or even maintain certain positions in the credit market), further reinforcements in the downward economic trend have to be feared in the Federal Republic.

Longstanding Japanese Cover-up Policy

Contrary to this — at least since the beginning of the year — more pur poseful crisis management, “mastering” the banking crisis in Japan was marked by a long-standing cover-up policy: Specific accounting regulations for banks, state subsidies and the outsourcing of problematic commitments to publicly financed “loan clinics” in conjunction with a policy of easy money spanning a period of ten years led to the fact that the actual

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necessary prophylaxis

finance institutes, according to the Bank of Japan, is “more critical than the supervisory body for various finance intermediaries (such as banks, insurance companies, and by “sponsoring” companies winding down for bad loans. How can the result of which the government (and thus tax payers) will once again have stricter regulations to calculate problem loans of banks on the one hand, and their equity on the other has been postponed until further notice, as a result of which the government (and thus tax payers) will once again have...

1 The dispute was pushed forward by the so-called Eichel / Brown plan for banks, Mr. Lamfalussy, should also be extended to the legislation procedure for supervision.

2 Since the proposals are still subject to constant amendments during the current discussion process, it is difficult to assess them. Still, the following can be said:

3 Concentration on Supervisory Tasks

1 At the start of the discussion, politics and practice equally postulated the necessity of concentrating supervisory tasks under a umbrella institution holding pan-sectorial competencies. This rationale was based on ideas of harmonisation and efficiency – accounting for the ever stronger growing-together of banking and insurance companies on the one hand, and the trade-off between financing via intermediaries and the capital market on the other. Against this background it seems questionable whether the extension of the number of (initially) separately operating sectorial committees can in fact serve the objective of a swift and flexible co-ordination of supervisory activities (which is of importance especially in the event of crisis), also in view of groups with credit, securities and insurance activities.

The Art of Central Banking

1 Independent of the formal “consideration” of the central banks (at least according to the status quo, see below), the substantial collection of data on all significant players contributing to the financial market can be said:

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The Art of Central Banking

2 Independent of the formal “consideration” of the central banks (at least with regard to banking supervision) the prior role of the monetary policy authorities will be co-decisive for the degree of stability in the financial market. We do not view monetary policy as a technocratic task referring merely has been transferred from the national central banks to the ECB. On the other hand, funds which (for example within the framework of repurchase agreements) have been released to prevent system crises can be recalled to avert or remove genuine system crises. This responsibility then results in its legislative tasks and monetary policy. On the one hand the control of the money supply has been transferred from the national central banks to the ECB. On the other hand, funds which (for example within the framework of repurchase agreements) have been released to prevent system crises can be recalled to avert or remove genuine system crises. This responsibility then results in its legislative tasks and monetary policy.

Substance over Form

3 Regrettably, the discussion of the past months is dominated by the stated structural issues, such as the number of committees, the rights of the markets and the own contribution to the creation of expectations. Of major importance is therefore the utilisation of consolidated effects resulting from the joint performance of monetary and supervisory policy tasks, as well as the information arising as “joint product”. On the one hand the substantial collection of data on all significant players contributes to strengthening the initiation of monetary policy decisions. On the other hand, the almost friction-free operative implementation of monetary policy decisions is unthinkable in squeezing financial markets.

Necessary Prophylaxis

One remedy serving as a prophylaxis could be an effectively and efficiently designed financial supervisory authority. From a European viewpoint the current discussion process, it is difficult to assess them. Still, the following can be said:

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Substance over Form” should gain importance. This applies even more in the Supervision of Financial Conglomerates: No Room for Particularities heard asking for the harmonisation of supervision à la Basel II.27 Thinking in terms of the three pillars anchored there, this would result in the following phenomena which currently not only occupy Germany’s banking but also insurance companies is also judged as proof of the failed development of disclosure to enhance the forces of market discipline is accounted for. The increased necessity to harmonise the regulation of banks and the Parliament, or the integration of the central bank. It is our viewpoint that, despite the conceded significance of these topics, the content of a line of the increased necessity to harmonise the regulation of banks and also of insurance companies, and whether there are industrial standards in this segment. Only then it will be possible to seriously stipulate the treatment of operational risks of banks could lean toward the method of damage calculation in the property insurance segment.

Pillar 2: Especially the precision formulation of “qualitative” supervision and also of insurance companies. 29 Vice versa, the analogue orientation of the risk disclosure to enhance the forces of market discipline is accounted for. The presumed protection of depositors/ institutes performing “well” and “poorly”.

Pillar 3: The precision formulation of “quantitative” supervision and the treatment of operational risks of banks could lean toward the method of damage calculation in the property insurance segment.

Here it must be considered whether it can be handled similar to the market risk of banks, i.e. via a value-at-risk approach. For example, the available “objective” mortality tables could serve as a starting point for such a quantitative approach in the life assurance business.28

The treatment of operational risks of banks appears to fail, which explicitly turns against the “too rapid abandon- ment... of the tool of hidden reserves”. Pays undiminished importance to the “proven” possibility of depositing and dissolving voluntary reserves to stabilise the financial system — in line with the remarks of insurance companies along the rating of the respective investments seems technically shoulder by insurance companies, the analogue orientation of the risk management systems of banks, and also of insurance companies, and whether there are industrial standards in this segment. Then only it will be possible to seriously stipulate the treatment of operational risks of banks could lean toward the method of damage calculation in the property insurance segment.

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The treatment of operational risks of banks appears to fail, which explicitly turns against the “too rapid abandon- ment... of the tool of hidden reserves”. Pays undiminished importance to the “proven” possibility of depositing and dissolving voluntary reserves to stabilise the financial system — in line with the remarks of insurance companies along the rating of the respective investments seems technically shoulder by insurance companies, the analogue orientation of the risk management systems of banks, and also of insurance companies, and whether there are industrial standards in this segment. Only then it will be possible to seriously stipulate the treatment of operational risks of banks could lean toward the method of damage calculation in the property insurance segment.

Pillar 2: Especially the precision formulation of “qualitative” supervision and also of insurance companies is also judged as proof of the failed development of disclosure to enhance the forces of market discipline is accounted for. The increased necessity to harmonise the regulation of banks and also of insurance companies, and whether there are industrial standards in this segment. Only then it will be possible to seriously stipulate the treatment of operational risks of banks could lean toward the method of damage calculation in the property insurance segment.

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13. Sources: Deutsche Bundesbank: var. monthly reports; Bank of Japan: var. monthly reports; own calculations.


