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The U.S. Subprime Crisis and the German Banking Market

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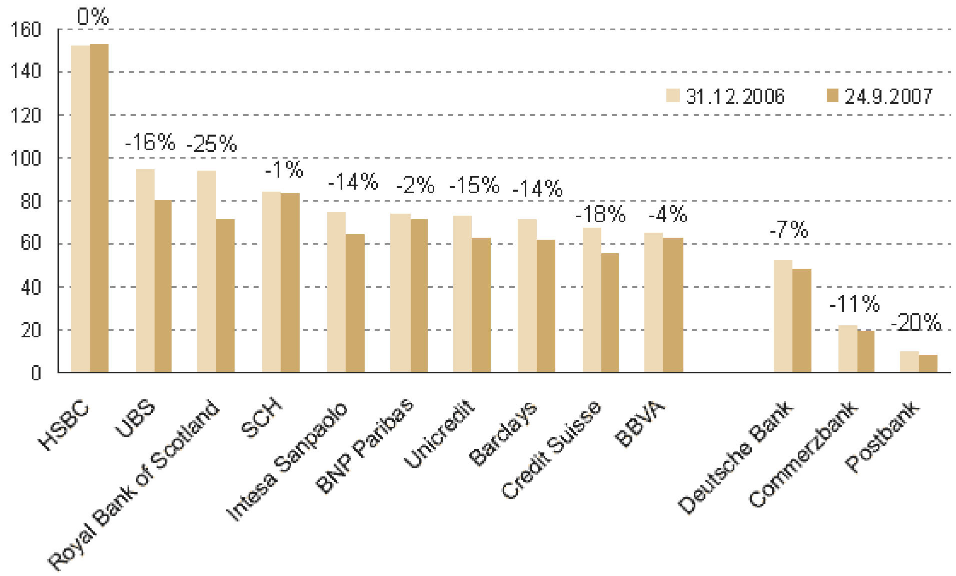
At first glance it seems paradoxical: Loan defaults in the U.S. real estate market threaten the viability of two major German financial institutions-both with deep national roots. But although the full extent of the current banking crisis remains yet unknown, the first steps toward a critical reappraisal of future market scenarios can begin now.

The growing number of mortgage defaults in the U.S. real estate loan industry has triggered the current turbulence in world financial markets. Since the beginning of the year, loan default rates, particularly among borrowers with poor (subprime) credit histories, have increased dramatically. This has precipitated a sharp drop in the price of securitized real estate investment products–also known as asset-backed securities (ABS)–leading to the ultimate collapse of the ABS market. This trend continues, regardless of the securities' actual level of default risk. Since July 2007, many ABS securities with ostensibly good credit ratings could no longer be sold; the few that were salable faced steep price markdowns. The resulting liquidity squeeze for these and other securities has increased pressure among banks to sell, pushed down prices, and impacted the market for interbank loans (leading to a funding gap at Northern Rock, Britain's fifth largest mortgage bank). Although market capitalization among Europe's largest banks has overall declined since the beginning of the year, capital markets do not seem to expect a fundamental banking crisis.

Figure 1: Market capitalization of European banks (in billions of Euros)

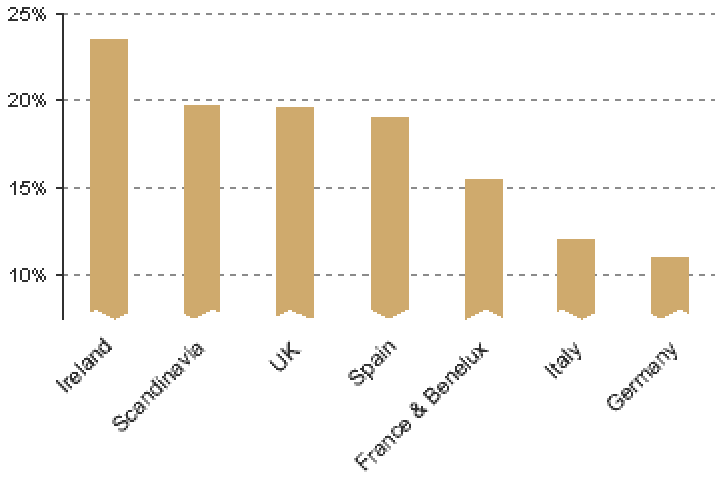


Source: Reuters

The crisis has nonetheless created difficulties for two German financial institutions, both with a national business focus. Because of their investment holdings in "off-balance-sheet" special-purpose vehicles (conduits), IKB, a German small company lender, and Sachsen LB, Saxony's Landesbank, were heavily exposed to the hard-hit ABS market. This exposure forced both banks to meet growing liquidity requirements in recent months which, in the end, exhausted available refinancing options. As a result, the IKB received liquidity guarantees from KfW, the German state development bank, while Sachsen LB was sold to Landesbank Baden-Württemberg (LBBW) over the course of a single weekend. The full extent of the actual losses sustained by both banks through ABS transactions has yet to be determined.

ABS, CDOs and other mortgage-backed securities make up only 10 percent of the total worldwide market capitalization in stock and other obligations. Given the relatively small size of this market segment, many observers were surprised by the high level of exposure among Germany's publicly-owned institutions. One key explanation is the fragmentation of the German banking market, stemming from its three-pillar structure; low interest margins; and–compared to other European countries–low rates of return on equity (see Figure 2). This has increasingly forced banks to tap alternative earnings sources to satisfy shareholder expectations. Particularly in recent years, ABS transactions have been a vital investment vehicle with attractive returns, but also with substantial risk.

Figure 2: Return on equity of European banks 2006



Source: Keefe, Bruyette & Woods

The withdrawal from the market of financial instruments with greater perceived risk, coupled with the expected introduction of higher risk management standards, will place growing pressure on the German banking system to consolidate. Financial institutions will have fewer opportunities to offset the shortfalls of their core business earnings with alternative investments in the capital markets. Although private banks have been consistent in pursuing specialization strategies along with active cost management, publicly-owned institutions have not yet done so. When viewed against this background, we can expect an accelerated consolidation of the German market, particularly at the Landesbank level–as well as growing pressure to reform German banking's three-pillar structure.

This topic will be thoroughly treated in the upcoming book:

Burger, C. and Hagen, J. (Forthcoming). *Structural change in the financial services industry: Process transformation in the industry and its effect on competitive and banking market structures*. Wiesbaden: Gabler Verlag.

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About ESMT

ESMT European School of Management and Technology was founded in October 2002 on the initiative of 25 leading German companies and institutions. The founders aimed to establish an international business school, based in Germany, with a distinct European focus. As a private institution of higher education, ESMT provides executive education (since 2003) and an international MBA programme (since 2006). ESMT headquarters is located in Berlin. Further campuses are in Munich and Cologne. ESMT is fully accredited by German authorities as a private institution of higher education.

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