INVESTIGATING DIVERSITY IN THE BANKING SECTOR IN EUROPE

THE PERFORMANCE AND ROLE OF SAVINGS BANKS

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PREFACE

In some countries, savings banks are amongst the most important elements of the financial sector. For decades, however, the growing political and liberal market consensus in some countries has favoured the shareholder-value (SHV) model in banking where the almost exclusive objective of bank managers is to maximise shareholder value and often in a fairly short time horizon. In this environment, non-SHV institutions, such as savings banks, have been criticised for being an exception to the rule, for being relatively inefficient, for not being subject to the discipline of the capital market and corporate control, and for having weak corporate governance arrangements. Above all, it has been alleged that their objectives are not clear because there is no single focus.

However, these views have recently come under challenge as a result of the global financial crisis, particularly with respect to short-term SHV strategies and the assumption that, in efficient markets based on SHV models, markets are self-correcting. This major and admirably comprehensive CEPS study is, therefore, particularly timely not least because much of the criticism directed at alternative models adopted by savings banks has been found to be unwarranted.

As this CEPS study demonstrates, there is diversity in the ownership structure and business model of savings banks from one country to another. Nevertheless, there remain three common elements: 1) they are not exclusively profit orientated but, as the study suggests, adopt a 'dual-bottom line' business model or what is also called a Stakeholder Value (STV) ethos; 2) they have something of a 'social mission', which is partly a product of their historical origins and 3) compared with SHV banks, ownership stakes cannot be sold in a secondary market.

When analysing alternative business models in the financial sector, there are three particular issues to consider: the relative merits of different models, their systemic stability characteristics and the benefits to be derived from having a mixed system. A general theme of the study is that, most especially with regard to stability characteristics, it is advantageous to create a mixed system incorporating both the SHV and STV models. The focus of this CEPS study is on savings banks in particular.

Above all, the savings bank formula remains a viable governance model in the financial system: it is not to be regarded as an aberration from the SHV norm. On the basis of both theoretical analysis and recent experience, there is no presumption that the typical Anglo-Saxon governance model is best suited for all types of financial institutions. There are advantages and disadvantages in all governance models. Irrespective of the strengths and weaknesses of particular governance models, there is a systemic advantage in having a mixed system of models and a strong critical mass of savings banks and other STV institutions, such as mutuals and cooperative banks.

The prevalence and long history of savings banks and cooperatives in the financial sectors of many economies, together with their relative scarcity in non-financial sectors, suggest that the STV model may be particularly suited to the provision of financial services, and most especially those related to longer-term contractual relationships such as mortgages and savings. This may be due to a greater ability of financial, as opposed to non-financial mutuals, to address any inherent agency problems.

Since external suppliers of capital to SHV institutions need to be remunerated (in the form of a required rate of return on equity), the absence of external shareholders in the STV model can be deemed to be an inherent 'efficiency advantage' of financial mutuals in the sense that, other things being equal, they should be able to operate on lower margins.

Given the potential inherent 'margin advantage' of mutual financial institutions and the systemic advantages of a mixed financial structure, there are economic and welfare benefits to be derived from a viable and successful savings bank sector in the financial system. The study finds that savings banks enhance competition in the financial sector, enhance stability characteristics, contribute to alleviating social exclusion and contribute to regional development.

More generally, there is a powerful *systemic* interest in sustaining a strong STV sector and, therefore it is a legitimate public policy issue. There are several key issues in this regard:

- A larger critical mass of savings banks (and other STV institutions) is likely to enhance competition in the financial system.
- Because STV banks are not owned by investment institutions, they are not subject to the short-term pressures of the capital market, and a myopic focus on the share price.
- There is benefit to be derived from a mixed ownership structure in the financial system, and the systemic value derived from mixed corporate governance arrangements.
- Most savings banks are locally based and have a particular focus and expertise on the local community. This reduces powerful centrifugal tendencies in the financial system, and the evidence of this study is that savings banks have a positive impact on regional development.
- There is a systemic advantage in having a mix of institutions with different portfolio structures with the potential to reduce overall systemic risk by virtue of institutions not being homogeneous. Furthermore, savings banks tend to adopt a lower-risk profile. A pluralistic approach to ownership is likely to be conducive to greater financial stability. With their contrasting capital structures, SHV and STV banks balance their risks and loan portfolios differently. Systemic risk is thereby reduced. The more diversified is a financial system in terms of size, ownership and structure of businesses, the better it is able to weather the strains produced by the normal business cycle, and in particular avoiding the bandwagon effect. The traditional business model of savings banks (particularly the dominance of retail funding) is less prone to the systemic instability problems that have recently arisen.
- The evidence also suggests that savings banks contribute to a reduction in social exclusion and offer wider access to financial services.
- In an uncertain market environment, diversity has advantages as it cannot be predicted which form of corporate structure is best suited to all particular circumstances. The case for diversity includes, as the study suggests, "reducing institutional risk, defined as the dependence on a single view of banking that may turn out to have serious weaknesses under unexpected conditions such as the current crisis".

The issue of having a financial system populated by a diversity of organisational forms is as significant as the merits and drawbacks of each particular form of organisation. The case for maintaining a significant savings bank sector in the financial system is wider than any alleged intrinsic merits of the 'dual-bottom line' model. It is in this respect that a significant public policy issue arises.

Notwithstanding problems encountered by some savings banks in one of the worst financial crises ever experienced, the experience of the banking crisis offers some support to the argument that a financial system based on a mixed governance structure, and which includes a significant savings bank sector, is likely to be inherently more stable and less crisis-prone than one populated exclusively by shareholder value institutions. There are, therefore, economic and welfare benefits to be derived from the continuation of a viable and successful savings bank sector.

It is not to be expected that savings banks would be immune to collateral damage caused by the enormity of the banking crisis. Nevertheless, as this CEPS study argues, savings banks have generally been less scathed by the financial crisis than have banks in general. This suggests that a financial system characterised by a mixed array of corporate structures will be inherently more stable than one populated by only SHV institutions: this is analogous to the case for bio-diversity.

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EXECUTIVE SUMMARY

The value of biodiversity is more than the sum of its parts.
Bryan G. Norton

This study provides a contribution on the role of institutional diversity in the banking sector in selected European countries. The analysis emphasises the performance and role of savings banks as 'dual-bottom line' financial institutions and their contribution to economic performance, competition, stability, growth and financial inclusion in countries where their presence is prominent and in others where they have progressively disappeared.

Chapter 2 elaborates on traditional and new theoretical arguments in support of savings banks. These include improved access to financial services, compensating for negative external effects, fostering regional development, mitigating intertemporal risk and capitalising on the value of diversity. This chapter also provides a discussion on the political debate about savings banks at international, European and national levels over the last two decades.

Chapter 3 finds that there are no radical differences between savings banks and their commercial peers in terms of profitability, efficiency and earnings stability. However, it appears that they contribute positively to competition, stability and regional development. Taken together, these findings imply that in addition to co-existing with other banks under similar conditions, savings banks have responded to shifts in market developments.

The surveys provided in the country studies on the national savings bank systems of Spain, Germany and Austria in chapters 4, 5 and 6 confirm and complete the main findings of chapter 3, while elaborating on the distinctive competitive and social features of savings banks.

In **Spain**, savings banks are private institutions with a social mandate. The consequences of the liberalisation trend in the 1980s, the expansion of branches and the fully established relationship-based banking model led savings banks to gain substantial market shares. In addition, they are leading the main initiatives aimed at combating financial exclusion mainly through their investment in 'Obra Social', their establishment in deprived and less populated areas and the development of specific products for family businesses and SMEs, remittances platforms and micro-finance services.

In **Germany**, savings banks are organised as independent local institutions, governed – in most cases – by a public law regime conforming to the savings banks laws of the individual federal states. They are part of a network of affiliated institutions that jointly form the so-called 'S-Finanzgruppe'. For a long time, they have been the market leaders in retail banking in general and even more so in most of the local markets that their operations have traditionally focused on. Moreover, their performance is more stable over time than that of their private competitors. By being stable financial institutions themselves, they perform a stabilising role for the entire financial system. By tradition and according to their business model, they play an important role in preventing social and financial exclusion.

In **Austria**, savings banks have also transformed themselves into modern and efficient financial institutions that provide services to broad segments of the population, and they are important players in the national market for retail financial services. There is one specific characteristic worth highlighting in that country's savings bank system: it is built around one central institution, the Erste Group Bank AG, an important player in the Austrian financial market and at the same time the hub of one of the most extensive banking groups in Central, Eastern and South-East Europe. Its success begs the question of why this anomology has developed only in Austria and not in other parts of Europe, and whether it might be regarded as a model of how savings bank systems should be organised in general. As it seems, the answer to this question is that it is not a general model of best practice. A high degree of concentration of assets, activities and power would seem to reflect a rational response to very specific local problems and opportunities.

The country studies of Italy and Belgium in chapters 7 and 8 examine the impact of the progressive disappearance of savings banks in countries where the political stance was more in favour of privatising or abolishing this form of banking. The overall assessment is not straightforward and it remains to be seen whether the disappearance of savings banks in these countries has contributed to less competition, less access and more financial exclusion.

Finally the study draws some general policy conclusions and offers some thoughts, which are necessarily speculative, on how savings banks might survive the crisis and even strengthen their positions in their respective national financial systems. The most important conclusion is that the current crisis has made it even more evident than before how valuable it is to promote a pluralistic market concept in Europe and, to this end, to protect and support all types of ownership structures without abandoning the principle of 'same business, same risks, same rules'. The investigation of the role of savings banks in this study demonstrates the value of their presence in terms of the financial, economic and social welfare of the countries in which they operate.

1. INTRODUCTION

The value of biodiversity is more than the sum of its parts.
Bryan G. Norton

1.1 Motivations

The financial sector, which encompasses financial markets and institutions, especially banks, is an important part of the infrastructure of any economy. Theoretical and empirical arguments lend support to the view that a high state of development of the financial sector not only correlates with economic growth and increases in welfare, but also even causes growth and increases in welfare.[1] However, it is less clear in this context what exactly constitutes a strong and healthy financial sector or financial system,[2] and what serves as the exact transmission mechanism to the real economy.[3] Is a bank-based financial system in some way better than a capital market-based financial system, or vice-versa, and which characteristics of a banking sector are more conducive to fostering growth and welfare?

Savings banks are a part of many financial systems, not least in some of the most advanced economies. In a number of them, savings banks have in the past greatly contributed to economic and social progress. For instance, in Japan the Post Office Savings Bank played an important role in

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[1] This view is now widely shared among policy-makers and economists, For theoretical and empirical arguments supporting it, see especially King & Levine (1993), Levine (1999), Allen & Gale (2000), World Bank (2001), Berger et al. (2004), and Demirguc–Kunt & Levine (2008).

[2] We use the terms "financial system" and "financial sector" interchangeably in this study.

[3] Wachtel (2003).

supporting the stunning growth of that country for many decades after World War II by mobilising savings in rural areas and channelling them to the urban centres in which investment activity was concentrated. In Spain, Germany and Austria, three of the countries covered in this study, savings banks are still today – or even more so now than in the past – among the most important elements of the financial sector.

At the same time, in a number of countries, savings banks no longer exist as a distinct class of financial institution. In a few cases, such as that of Belgium, they have simply disappeared. In others, such as Italy, they changed their characteristics in such a way that they can no longer be considered as savings banks. In others, e.g. the UK, they have been absorbed by commercial banks. And of course, there are also countries where they never existed or at least played only a minor role. These observations may suggest that, as an element of a financial system, savings banks may not be useful anymore, that they may be outdated. Even having financial institutions that can (still) be characterised as savings banks may be a sign of backwardness of a given financial system and possibly even a handicap for the development of those countries that still feature genuine savings banks, at least savings banks in a narrow and traditional sense of the term.

The fact that the current financial crisis has hit many financial systems very hard, especially those that seem to be particularly modern, underlines the importance of the overarching questions that motivate this study. Is it beneficial in economic, social and political terms for a country to have savings banks? Should political authorities aim, within the limits of their legal powers, to support savings banks or simply tolerate their continuing existence or even try to contribute to their transformation into commercial banks of a different legal and institutional form? The current situation suggests adding another question: What lessons can be learnt from a financial crisis, in which academics and politicians are calling for a return to more traditional approaches to banking and finance?[4]

Examining the merits, or the lack thereof, of savings banks and recommending an appropriate political stance vis-à-vis these institutions is

[4] For a sample of calls for a return to more traditional banking, see, De Grauwe (2008), Group of Thirty (2009) report chaired by Paul Volcker and Jacob Frenkel, and the de Larosière (2009) report.

not an easy task, for a number of reasons. One is that it is now no longer clear what the defining characteristics of a savings bank are. Formerly, savings banks used to be different, and this has to do with the way in which they emerged in the currently more advanced countries in the 19th century, and how they were structured until only two decades ago in most countries. Nowadays, savings banks largely differ from what these institutions were in the past, and it is even unclear how one should define them. Today, they are a very heterogeneous group of financial institutions whose main common feature is that they are not exclusively profit-oriented.

Another reason for the difficulty of assessing the merits of savings banks is that the standards for such an assessment are not straightforward. Clearly, they need to be assessed in terms of pure economic performance, since economic performance determines their ability to survive as a financial institution over the longer term. However, economic or financial performance cannot be the only standard of assessment, since economic or financial success is not an end in itself for any organisation.[5] This consideration is all the more relevant for organisations that have been created for other purposes than that of being successful in financial terms, as is the case of savings banks. Other relevant standards include the economic and social effects that their operations have on others, especially their clients. Therefore, assessing them on the basis of these effects may be worth considering. However, such an assessment is extremely difficult to perform because it would require having precise information concerning the banks' economic and social involvement in the regions where they operate and the value derived by other beneficiaries from their operations. Moreover, in methodological terms it would require comparing real situations in which savings banks exist with hypothetical situations in which they do not exist (or vice-versa) under circumstances that are identical in all other respects. The comparison of the situation in countries in which they do exist and in those in which they have always only played a limited role (e.g. the US) or have been abolished (e.g. the UK) is evidently

[5] The financial objectives *of organisations* are merely the means for realising the ultimate objectives *of people*, and these are non-financial in nature (see Simon, 1952). It was mainly the research summarised in this book for which Herbert Simon received the Nobel Prize in Economics in 1978.

not sufficient to derive valid general conclusions, even though such a comparison may be instructive.

Finally, there are other standards of assessment which follow from political considerations: Are savings banks compatible with the governing principles of a market economy? Do they perhaps undermine the proper functioning of such a system, e.g. by competing in an unfair way? Or are they, in contrast, all the more needed if the major part of an economy and its financial system are shaped by purely profit-oriented organisations? As will be shown later, the political aspects are particularly relevant for the purpose of this study in light of the fact that merely looking at the economic and financial performance of savings banks does not answer the question of whether or not they are beneficial.

1.2 The challenge of defining a savings bank

Not too long ago, it was easy to define savings banks and to distinguish them from other banks. Moreover, savings banks in different countries were largely similar. Their common features concerned their origin, their mission, their activities, their organisational form, and their legal status and ownership structure.

The first savings banks were set up around the beginning of the 19th century as public or welfare institutions with the mission of fostering the 'spirit of thriftiness', that is, the willingness of people from the lower economic classes of the population to save money in relatively good times so that they would have at least some modest means if they would fall on hard times, and of offering them safe deposit facilities. Later their mission was extended to providing access to financial services at reasonable terms for people who would not have this access, and to the financing of housing, local small- and medium-sized enterprises (SMEs), and local public investment projects.

Savings banks were created by public authorities or groups of well-intentioned and socially motivated citizens from the higher strata of society to serve others. As a consequence of this origin and mission, they were organised either under a public law regime or as foundations or associations with a non-profit mission. Their operations were largely concentrated or even formally restricted to a geographical region defined by the legal status of the public or private entity that had created them. And in some countries they were often closely linked to the respective municipality and also more or less dominated by politicians representing the public or private entity that had created them. By law or statute, savings banks were not purely profit oriented, that is, they were not meant to be profit-maximising entities, even though the need to achieve profits is, and has always been, recognised.

In one sense, it would be appropriate to say that the municipality or, as the case may be, the foundation, is the owner of the savings bank; but in another sense it would also be correct to say that they do not have an owner since the ownership rights of the municipality or the foundations are different from those of private partners or shareholders in a conventional bank organised in the legal forms of a partnership or a corporation. They tend to be weaker than full legal ownership.

Being locally owned, locally rooted and locally active financial institutions, savings banks in many countries belong to regional associations and directly or indirectly to a national association. Accordingly, they cooperate, in one way or another, with regional second-tier financial institutions that are also part of these networks. Thus, they are, in most cases, elements of decentralised networks with second- and third-tier organisations that would support the decentralised or local units and perform certain functions for them that they cannot fulfil on their own. Nevertheless, by law and by status and especially according to the design and distribution of property rights, the individual savings banks were and still are independent organisations in most countries.

During the past decades, many national savings bank systems have undergone a drastic transformation, a process that began in the 1970s and has continued ever since. This process has greatly increased the differences between the savings bank systems of different countries. But even 30 or more years ago, savings banks in different countries and even different savings banks in one country were not the same. One can easily see how much savings banks differ from country to country and even within a single country when one looks at the list of members of the World Savings Banks Institute.

Today, savings banks have retained three main characteristics:

1) They are not only profit-oriented credit institutions[6] in that they are committed to also pursue other objectives besides that of making a profit.
2) They or, as the case may be, the entities that own them, have a social mission, a regional commitment and a mandate to contribute to the 'general good'.
3) They can be decentralised elements of some larger system, network or nexus.

These three characteristics are helpful to describe savings banks as a special type of financial institution, even though they cannot be used as a strict definition and distinction from other types of credit institutions.

Having a not strictly profit orientation and instead a social mission and being a part of a decentralised network or nexus of related institutions are typical features of savings banks, but neither are they found in all savings banks, nor are they specific to savings banks. One can say the same of cooperative or member-owned financial institutions. Moreover, there are also a number of privately-owned banks whose profit orientation is in some way restricted and that also subscribe to a social mission.

What distinguishes savings banks as well as cooperative banks from private commercial banks is their role as 'double-bottom' line institutions combining social and financial objectives, while what distinguishes savings banks from cooperative banks is, in many but not all cases, the 'public ownership' or public 'Trägerschaft'. The latter German term is not easy to translate since it refers to the public law regime under which savings banks in Germany and some other countries are still organised. Possible translations for 'Träger' are 'sponsor' or 'responsible or supporting entity', meaning the public or private entity, in the case of a savings bank a municipality, a group of municipalities, or a county or a foundation or an association that is responsible for the creation and the general oversight of its operations. The rights of the supporting entity of a savings bank tend to be less extensive than those of an owner in a situation governed by private law.

In some countries, savings banks are public banks in the sense that the sponsoring or responsible entity is a public administration. But not all

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[6] They are credit institutions as defined by the European Banking Directive.

savings banks are public and not all public banks are savings banks. For instance, Spanish savings banks are purely private institutions and nevertheless have a social mandate. The fact that a number of savings banks are in a specific sense public or state-owned plays an important role in the political debates, especially among those who have general reservations against public or state involvement in economic activity. However, the current financial crisis has tempered reservations against government ownership of banks in a number of countries.

1.3 Objectives, main propositions and structure

This study aims to explore two overarching questions: What are the benefits of savings banks to a country or an integrated economic and political region such as the EU? What stance should policy-makers and political authorities take with respect to these institutions?

We cannot pretend to have a conclusive answer to these overarching questions, particularly in the context of the profound financial crisis in which several widely held perceptions about the superiority of certain forms of ownership and business models of banks are almost continuously being questioned and revised. Nevertheless, our aim is to contribute to the debate by presenting and discussing a number of arguments that are relevant and also sufficiently well supported by economic research.

On a more modest level, an overview of the political debate is presented in order to provide the arguments that are openly and also occasionally implicitly used to support or to question the merits of banks with the specific characteristics of saving banks.

To lay the groundwork for what follows, chapter 2 takes a look at the economic policy debate that is going on in the international arena, in the EU, and in individual countries.

The economic performance of savings banks and their contribution to competition, growth and stability are analysed and discussed in chapter 3. The questions that are addressed include:

1) How profitable and efficient are savings banks as ‘producers’ of financial services as compared to other banks, especially those in the legal form of a joint stock corporation?
2) Do the costs structure, the profitability and the earning stability of savings banks differ from those of other banks; and if so, is it true that, possibly due to their specific design and mission, their legal

status or their ownership structure, they have higher costs and lower profitability than conventional banks; and how does their performance differ between countries?

3) How do they contribute to competition in the market, to regional development, to economic growth and to financial stability?

The answers to these questions are highly relevant to the political debate because there is often a perception that savings banks may not be as profitable or as efficient as their counterparts that are privately owned and strictly profit-oriented and this lack of performance and efficiency may impede or even outweigh some beneficial effects savings banks may generate.

However, our empirical evidence suggests that this assumption about the financial performance of savings banks is not correct. In the countries under examination in this study, their financial performance is not inferior, and possibly even superior to that of other types of banks. This implies that it would be wrong to consider savings banks merely as a politically motivated means of providing subsidised financial services to the population that uses these services.

Nevertheless, financial performance is not the only nor the ultimate standard of assessing savings banks, and even if their performance were – to a certain extent – poorer than that of other banks, there might be other reasons why it would be beneficial for a country or a region to have savings banks. Therefore, the merits of savings banks need further analysis and this analysis should in the first place be based on the effects that savings banks have on their clients and the national and regional economies in which they are embedded.

Although it is very difficult to conduct a final and uncontroversial assessment of savings banks on the basis of the effects that their existence and their operations have and can have, it is important to discuss the relevant existing evidence. What are these effects; how strong are they; how can they be assessed in principle; and to what extent do they depend on the different institutional set-ups that savings banks have adopted in the course of the last few decades in different countries? Chapters 4 to 8 provide some answers to these questions, even though these answers are not as 'hard' as those concerning the economic and financial performance, competition, regional growth and financial stability. However, they are no less relevant for the objective of this study.

We believe that, incomplete as they may be, the theoretical and empirical arguments that we summarise and analyse in this study tend to support the view that, generally speaking, it is economically and socially beneficial to have savings banks. For those who accept this conclusion, it would suggest that policy-makers should not take or support actions that could jeopardise a valuable part of the financial systems in different countries in Europe and of the emerging integrated European financial system.

It would be beyond the scope of this study to cover the full set of EU countries or even only all of those that still have an active savings bank system. Therefore our analysis focuses on three countries in which savings banks play an important role and in which the national savings bank system has developed in widely different ways: Austria, Germany and Spain. For the sake of comparison, a closer look is taken at two countries, namely Belgium and Italy, that no longer have such a system.

The final chapter offers main conclusions and suggests new perspectives for further research.

2. THE POLITICAL DEBATE ON SAVINGS BANKS

2.1 The crucial issues of the political debate

The status and role of savings banks have been debated on different levels for many years. Two facts form the basis and the starting point of this debate: 1) savings banks differ in a number of ways from what can be regarded as the prototype of a bank, and 2) in many countries savings banks are important competitors in the market for financial services.

Savings banks and some other types of banks differ from 'conventional' banks in several respects:

1) they are not strictly profit-oriented;
2) in a number of countries, they are owned by an organisation that in some way belongs to the state or the government, or member-owned or foundation-owned and/or
3) they have a mandate to serve their clients and the communities in which they operate and
4) at least according to their critics, they enjoyed and even still enjoy certain privileges.[7]

The first question we address is whether it is desirable, from a public policy standpoint, to have savings banks or, more generally, banks with a non- strictly profit orientation. Even though this question is often not presented as explicitly political in nature, we consider it as highly

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[7] E.g. by virtue of being owned by public entities, there are lower expectations attached to return on investment and savings banks are sometimes the beneficiaries of bail-outs.

politically relevant, since it underlies most of the past and present contributions to the debate.

After discussing this question on a general and conceptual level, we turn to the explicit political debate at the international and the EU levels and on the level of individual countries focusing on those countries where the debate has been particularly vivid.

2.2 The traditional main arguments for 'dual-bottom line' banks

a) Improving access to financial services

Looking back at the time when savings banks and cooperative banks first came into existence, it is easy to explain why these types of banks were needed and why they had the specific feature of being not-for-profit institutions. This may offer a possible first answer to the question of whether these types of banks might still be needed today.

It was a time in which modern banking was not widely spread. Even in Europe and North America, banking was largely confined to urban areas. Banks served only a small fraction of the population, mainly established businesses, landowners with sufficient collateral and a few other people from the more affluent classes who had the relevant connections and social ties to the existing banks and bankers. Moreover, deposit-taking and payment services were at that time not considered as genuine banking business but rather as services that would merely complement the 'real business', which was providing trade credit and enterprise credit.

As a consequence, large segments of the population did not have access to financial services; they were 'financially excluded'. Those who had no access to formal banks could only resort to money lenders, but they were considered to be usurers charging interest rates in excess of what poor people were able to bear.

A similar situation prevailed in almost all developing countries up until only a few years ago and still prevails in a large number of these countries until today. For several years now, some government-owned and foreign-funded development finance institutions have tried to compensate for this lack of access by offering specialised lending facilities. As is well known, many of the early attempts to overcome this problem failed because the development finance institutions were inefficient and ineffective. They employed strategies that did not allow them to become financially sustainable institutions and to reach the intended clients in the first place, and then to offer them permanent and reliable access to financial services.

But this failure does not suggest that the underlying idea of filling a gap in the supply of financial services went unmet by conventional banks in these countries was inappropriate in principle, since for many years a policy of so-called 'financial repression' had made it virtually impossible for the existing banks to lend to poor people and to the local micro, small- and even medium-sized firms as a profitable line of business.[8] More recently, a small number of specialised micro-finance institutions has emerged that have succeeded in providing financial services to poor clients and other formerly excluded potential borrowers on a permanent basis. Interestingly, most of these institutions are also in some sense non-profit organisations; they are credit unions, NGOs, self-help organisations, in a few cases reformed state-owned banks or private commercially-oriented banks that nevertheless have a clear social mandate and mission and in most cases also enjoy some form of public support.

Why did – and in some cases do – 'conventional' banks not serve the middle and lower classes? Certainly, there were socio-psychological reasons, such as social prejudices, stubbornness and ignorance on the part of the established bankers. But what is more important is the fact that it was, and sometimes still is, economically unattractive for profit-oriented bankers to serve these difficult clients. They do not possess sufficient collateral, the risks are considered too high and the transaction costs appear excessive given the financial technologies available to 'conventional' banks and bankers.

However, high costs of lending and high default probabilities would appear to force bankers to request high interest rates as a matter of prudent

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[8] The term 'financial repression' refers to a policy applied by governments in most countries – developed as well as developing – well into the 1980s, which consisted of prescribing caps for credit and deposit interest rates, burdening banks with high requirements of holding deposits with central banks and strictly limiting the scope of their operations. The pitfalls of the policy were first criticised by McKinnon (1973) and Shaw (1973) in two influential books. Their critique was one of the building blocks of the policy of financial liberalisation initiated in many countries in the 1980s. Unfortunately, liberalisation did not lead to the intended effects, since it ignored the need of complementing liberalisation with sound regulation.

and sound banking.[9] But high interest rates have negative effects for the lending banks; they lead to adverse selection[10] and moral hazard[11] and thus themselves induce even higher default rates. In this situation, raising interest rates to a level commensurate with the presumed cost of lending to poor and unknown borrowers increases the risk-related costs so that it is better for banks to ration credit rather than to lend at high rates.[12]

Credit-rationing is endogenous in markets, such as the loan market, in which information is unevenly distributed and lenders have reason to believe that they are less well informed than the potential borrowers. It is 'rational' behaviour for banks.[13]

It may be too radical and thus also unrealistic to assume that people with low income and with a poor data history are completely rationed out in credit markets, even though this could be expected in markets in which (only) strictly profit-oriented and not so well informed economic agents operate as lenders. There have always been some economic agents who would be prepared to lend to these people, although at high rates. Two

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[9] This fact has been grossly neglected in the subprime lending business, an oversight that has been the initial reason for the 2007-08 problems in the international financial system.

[10] Adverse selection means that with high interest rates only those borrowers who have risky projects would apply for loans.

[11] Moral hazard means that high interest rates would make it attractive for borrowers to avoid repayment or to increase the riskiness of the investment projects funded with a bank loan.

[12] This tendency will be even more pronounced under the new Basel risk sensitive regulatory rules. Borrowers are treated differently with respect to equity requirements depending on the level of sophistication of their internal risk management processes. Those asking for loans but who have no collateral and a poor credit history or no credit history at all will not even be considered as potential borrowers by banks.

[13] The standard source on credit rationing is Stiglitz & Weiss (1981). As these authors demonstrate, raising interest rates would lead to an increase in the riskiness of borrowers, such that there is no market-clearing equilibrium interest rate. Therefore banks ration credit irrespective of the existence of interest rate caps imposed by governments or central banks. The argument developed by Stiglitz and Weiss superseded the older view that held that credit rationing and limited access to finance was merely a consequence of ill-designed public policy.

groups of economic agents can be mentioned here: money lenders and people inspired by political and philanthropic considerations.

Money lenders can succeed in their lending where banks would not even attempt to do business, not least because they typically have very good information about their potential borrowers and because they can use means of enforcing loan repayment that others cannot apply or would not want to apply. However, these features of the so-called 'curb market' – high information intensity and questionable means of enforcing repayments – are the reasons why entry into this market is difficult and competition is largely absent. This leads to a market structure that allows lenders to abuse their market power and to request borrowers to pay even higher interest rates than those warranted by a difficult lending environment. Even a casual look at reality – then as much as now – proves that this is exactly what happens: either there is exclusion, or there is exploitation, and possibly both.

Exclusion and exploitation cause real problems for potential clients. From a social and economic perspective, this is a very undesirable situation. In this case, there is always a motive for some people, who are mainly inspired by political and/or philanthropic considerations, or some organisations with a similar orientation, to seek ways to change the situation of those people who are either excluded from access to credit or find themselves in the clutches of exploitative lenders.

Finding ways of combating poverty that has its roots in a lack of access to credit can be done by creating institutions that pursue different objectives than just that of making a profit. They can be charitable institutions – an important element of the early history of socially oriented lending – or NGOs, or self-help institutions, the precursors of cooperative banks, or institutions created by benevolent entrepreneurs or, last but certainly not least, public banks, which include savings banks as a special group. This is the historical reason why savings banks, cooperative banks and other institutions of the types mentioned have been created: to serve people who would otherwise not have access to finance, but without the incentive to 'overcharge' their clients.

The common feature of these institutions is that they pursue a dual purpose; they are – to use a term that has recently been introduced into the debate – dual-bottom line institutions[14] (henceforth abbreviated as DBLIs): one objective and standard of assessment is the impact that they have on the lives of their clients; and the other one is profitability. Ultimately and over the long term, impact and effectiveness are the overriding goals of this approach, while in a short to medium perspective, profitability is more important. Profit is necessary since without profit DBLIs would not be able to survive as institutions and to continue performing their socially valuable functions.

This leads to the first important result: savings banks and other DBLIs are needed from a political and social point of view. They are 'inclusive' financial institutions offering services to people who would not otherwise have access to financial services. One might be inclined to think that financial exclusion is only a phenomenon of developing countries and, as far as advanced economies are concerned, belongs to the past. Unfortunately, this is however not correct.[15]

It is important to understand the duality of the objectives of DBLIs. The relative weights of the two objectives necessarily change in the course of time, and they need to change when conditions change. The stronger the competitive challenge, the more weight that needs to be attached to the

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[14] As it seems, the term 'dual-bottom line institutions' was first used in a CGAP publication by Christen et al. (2004).

[15] The World Bank has just published a concise summary of the state of knowledge concerning financial exclusion (see World Bank, 2008). The authors demonstrate that financial exclusion is still a pervasive phenomenon in most countries, especially in the developing countries, but also in transition economies and even in advanced countries. For additional information on exclusion in advanced countries, see Carbó Valverde et al. (2005) and the collection of essays edited by FUNCAS (2005). Ayadi & Rodkiewitcz (2008) analyse the market response to tackle financial exclusion in the EU15. In countries where ownership diversity prevails, such as in Austria, France, Germany and Spain, institutions such as savings banks, cooperatives and postal financial offices are either required (according to their mission) to allocate a percentage of their profits to social cohesion projects or by regional regulations to ensure the provision of basic financial services. Moreover, because of their dense networks, they operate in rural and remote areas and therefore alleviate geographical exclusion naturally. The competition between these institutions and commercial banks creates strong incentives to financially include a broader range of client groups.

financial objective that secures institutional survival as a precondition for providing socially relevant services, without, however, losing sight of the social objectives. This consideration applies also, or even specifically, to savings banks and cooperative banks. From their traditional retail banking roots of catering to the poorer social groups and providing a limited range of relatively simple financial services, many of them have evolved into full-service universal banks that appear to be indistinguishable from their commercial bank competitors. This appearance may indicate that they are truly indistinguishable from 'conventional' banks, and if this were indeed the case, it would only show that they have completely lost their former social roles.

But the appearance that they are just like any other bank may also be deceptive. Economic survival requires that DBLIs remain economically strong and attractive partners for their clients, many of whom now have vastly different financial needs than 150 years, or only 50 years, ago. Moreover, economic survival as institutions requires that the DBLIs remain competitive in the changing market for financial services, which they can only do if they adopt strategies and methods of modern professional banking. Therefore, the crucial question is not whether DBLIs look like modern banks and whether they have added new services and new client groups to those offered and served many years ago, but rather whether they have discontinued providing financial services to those who would otherwise find the access to finance difficult if not outright impossible. The ethical and political rationale for having this type of institution discussed here would no longer be valid only in the latter case, and other arguments would need to be invoked. However, as the next section shows, there are indeed such other arguments.

b) Compensation of negative external effects

DBLIs are supposed to not only generate private benefits for their owners but also for others. They are expected to create what economists call positive external effects. It is a standard result of economic theory that external effects or other sources of market failure can lead to an equilibrium in a market composed of profit-maximising firms and utility-maximising consumers that does not constitute a social welfare optimum. If equilibrium and social optimum do not coincide, there is, at least in principle, the possibility of achieving welfare gains through appropriate forms of intervention in the market. One role of not strictly profit-oriented organisations can be to aspire to improve social welfare by compensating market failures that are due to external effects or other reasons. Another role can be to 'correct' market outcomes that are perceived as unfair and inequitable, by shifting income and economic opportunities to those who would be disadvantaged in a pure market economy.[16]

This argument applies in principle to state-owned banks and to private savings banks as well as to other DBLIs that aspire to improve economic efficiency and social justice, and it provides a slightly different argument for public banks and other DBLIs than the argument that builds on improved access. Their activity – and thus also their existence – may be socially valuable if they would make certain transactions possible and economically attractive that are valuable from an overall economic perspective, but would not be attractive for one or both parties to the transactions if they only took their own costs and benefits into account.[17]

c) *Relevant open questions*

These two main arguments – avoiding exclusion and enabling socially valuable transactions – apply to savings banks in principle. However, the normal form in which economic activity is organised in a market economy is that of private and for-profit firms. In some countries, savings banks are not fully private and almost everywhere they are not strictly or exclusively profit-oriented. Therefore, demonstrating stringently that it is economically favourable to have this type of banks in a single European country or in Europe as a whole, presupposes having answers to the following questions:

1) Is exclusion or the lack of access to financial services less of a problem in those European countries in which savings bank systems exists

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[16] These rationales for government intervention in markets are discussed in any public finance textbook. Of course, one needs to add the cautioning note that it is not easy to achieve a (socially) better resource allocation than that generated by a market economy that would be free of intervention, and to implement a redistribution that is perceived as more equitable. Market failure is only a necessary but not a sufficient condition for interventions being effective in the aspired sense.

[17] However, credit rationing is also a form of market failure, and providing financial services to people who would be excluded from access to the financial sector can constitute a case in which savings banks and other DBLIs compensate a possible form of market failure.

than in other countries? And would it be more of a problem if DBLIs had suddenly disappeared or changed their legal and institutional status and their objectives and become like any other bank?

2) Do savings banks provide financial services that are socially valuable and that would not be provided by a banking sector that is exclusively comprised of purely profit-oriented banks? Or in other words, is there a gap in terms of available financial products or services that should be filled by savings banks and other DBLIs?

3) Even if savings banks could be said to perform valuable functions, are the benefits that they may produce more important than the costs that their existence would entail? Or, in other words, is the net benefit of having savings banks positive?

4) And finally, are savings banks and in particular publicly owned savings banks better suited than other DBLIs to perform the socially valuable functions that can be expected from them?

In later sections of this chapter and in the following chapters of this study we shall provide detailed arguments which, taken together, suggest the following answers:

1) Exclusion is still a problem in a number of countries, and especially in some of those countries in which the former savings bank systems have disappeared.

2) There are reasons to assume that some services that DBLIs offer would not be available in a banking system composed only of private and purely profit-oriented banks.

3) There are potential weaknesses of savings banks as a form of organisation; however, these depend on the specific features of national savings bank systems and the characteristics of the financial, economic and political system of the country that one looks at. For most countries, the strengths of saving banks dominate their weaknesses.

4) One cannot say in general terms to what extent savings banks perform certain socially valuable functions better than other DBLIs, since this depends on how the different types of DBLIs are organised and how they operate, and on the features of the respective national financial and political systems.

2.3 Additional new arguments

Recent economic research concerning financial systems has led to a set of additional arguments in favour of savings banks and other types of banks that are not purely profit-oriented and do not have owners with the unrestricted property rights that the owners of a private bank have. Three of these arguments are presented below.[18]

a) Fostering regional development

The conventional discussion of the reason why it is good to have savings banks refers to a set of functions that savings banks perform. These functions range from the provision of financial services to a broader population also in more remote areas and fostering competition in regions in which not a sufficient number of private banks would want to do business so that local monopolies could emerge.[19]

Like other banks whose operations are largely confined to a given and narrowly defined area, savings banks also play a special role in fostering local economic development by mobilising savings and at the same time lending out the funds they have mobilised in the same region. In doing so, they help to prevent a 'capital drain' that may occur if savings are mobilised in one region in which economic activity is less developed and then transferred and lent out in economically more active regions. This can induce migration, cement relative under-development and even induce a downward spiral for the less developed region.[20] Moreover, a sufficient supply of banking services helps to make cities and regions attractive for people who consider moving there or not moving away. Longer-term relationships between banks and local businesses tend to strengthen local businesses and even attract new businesses and create local employment. Finally, local banks such as savings banks contribute to a high and stable

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[18] For a brief sketch of additional new arguments and references to the original sources, see Allen (2005).

[19] See Fischer (2006) for the competition-enhancing effects of savings banks in the case of Germany.

[20] A formal model showing that this 'capital drain' effect can occur and that savings banks can counter it, is provided in a theoretical paper by Hakenes & Schnable (2006). The empirical support for the proposition advanced in the Hakenes and Schnable article is found in Hakenes et al. (2009).

tax revenue, which also fosters the local economy, since they are less able and therefore also less likely than large internationally active banks to reduce their tax burden by shifting profits to countries with a favourable tax regime.[21]

b) *Mitigating intertemporal risk*

In any advanced economy, there is a certain degree of competition between banks as financial intermediaries and capital markets. Both have their specific roles, strengths and weaknesses, and both have important functions with respect to managing risk, with each type of institution specialising in managing one specific form of risk. Capital markets are particularly good at managing the risk that materialises in one time period, say a year, since they have a competitive advantage over banks in providing opportunities for investors to reduce risk by diversifying their shareholdings. Moreover, they are particularly good at permitting risk-sharing and the efficient allocation of those risks that are not eliminated through diversification. The type of risks that capital markets are so good at handling, the risk within a given time period, is called 'intratemporal' risk.

However, diversification and risk-sharing are methods that cannot cope with all kinds of risk. There is another form of risk, namely the risk that in the course of time the income for the entire economy varies in an unpredictable way. This is the so-called 'intertemporal' risk, and this risk cannot be eliminated through diversification. Technically speaking, it is the systematic and macroeconomic risk of good times being followed by bad times. Evidently, intertemporal risk is important, and reducing it is a socially valuable function, since the people that make up an economy would want to have protection against this risk.

Capital markets are in a certain sense short-sighted and therefore unable to deal with intertemporal risk. In contrast, banks are in principle able to do just this by creating reserves in good times and reducing these reserves in bad times, provided that they wish to do so. Creating and unlocking reserves is a specific technique of risk-management that closely resembles the role of storage in a primitive and isolated farming society. If

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[21] In an empirical study using a very broad data set, Demirgüç-Kunt & Huizinga (2001) have confirmed that larger banks are more likely than small local banks to employ tax-driven profit-shifting schemes.

there is a bumper harvest in one year, a large part of the harvest is stored, and if the next year's harvest turns out to be poor, the stored reserves can be taken out and consumed. Intertemporal risk is thereby 'smoothed', and utility increases. It is intuitive, and can be proven in a relatively simple economic model, that risk-averse people value this 'storage' option highly. This implies that having banks that can and want to create reserves in good times and unlock them in bad times would be socially valuable. However, it is important to understand that being able to mitigate intertemporal risk is not the same as having the incentive to do it and of wanting to do it.

Unlocking reserves can occur in two forms. One is the isolated or direct sale of the reserves if they have been created in the first place. The other possibility is the sale of the entire bank at a price that includes the value of the reserves. If the direct sale is made impossible by some relevant regulation, it may appear attractive to choose the second alternative.

There is a conflict between what is optimal for the entire economy and what is optimal for the individual bank and its owners and managers. For the owners of an individual bank, disclosing and selling its reserves in good times is always more profitable than keeping them. Therefore, strictly profit-oriented bank owners or bank managers who act exclusively in the financial interest of a bank's private owners would choose the more profitable option, that is, disclose and sell the reserves. And even if the managers would not want to act in this way, stock market pressure would force them to do it and thus expose the economy to higher intertemporal risk and cause severe social damage.

The next step of the argument is straightforward. It would be socially valuable if bank managers and owners were not interested in disclosing and selling the reserves they may have built up or that it would not be possible for them to act in this way. This is the case with savings banks, public banks and cooperative banks. They are not strictly profit-oriented, and because of their institutional and legal design they cannot be sold at their full value. Thus their managers can be expected to create reserves in good time and unlock them if there is a need to do so. Neither earnings pressure nor stock market pressure prevents them from doing something that amounts to the socially valuable function of intertemporal risk management.

This argument has been developed by the economists Franklin Allen and Douglas Gale in a series of influential academic articles.[22] It is an economically powerful and theoretically sophisticated argument for having and retaining banks that are not strictly profit-oriented and whose ownership position cannot be sold. These banks include public banks, banks owned by foundations that would not consider selling the banks – thus different forms of savings banks – as well as, to a certain extent, cooperative banks. In a book that summarises their relevant research, Allen & Gale (2000) argue that macroeconomic shocks, i.e. manifestations of intertemporal risk, affect countries in whose financial sectors non-sellable and not strictly profit-oriented banks play an important role much less than other countries whose banking sectors are composed exclusively of private banks whose shares are listed and traded on a stock market.

c) *Capitalising on the value of diversity*

We now turn to a different argument in favour of savings banks that also rests on recent developments in economic theory but also corresponds to what non-economists would regard as plausible. This argument relates to competition.

Competition is much more complicated than standard accounts of introductory economics textbooks, which only rely on established microeconomic theory, might suggest. According to a view that goes back to the Austrian economist Joseph Schumpeter, competition is a process that is driven to a large extent by knowledge that exists and newly created and discovered knowledge, and by innovation. For competition to work, new ideas must be generated. But this is not enough. There must also be the possibility to transform these ideas into economic reality: invention must be translated into innovation.

Financial systems develop over time; new instruments and new institutional forms are invented and used, and they may turn out to be more or less successful. As a matter of principle, it is impossible to predict what will be successful financial instruments and institutions in the future. A process of creative and dynamic competition must be based on openness.

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[22] See the original research paper Allen & Gale (1997) and, in a less formal version, Allen & Gale (2000), chapter 6.

This argues for diversity. Diversity offers an optimal basis for new ideas to come to life and also for old ideas to make their come-back.

In the context of banking systems, openness and diversity imply that different institutional forms should exist and should be made sufficiently strong so that they have a fair chance of emerging successfully from the struggle in which different forms of organising banking activity compete with each other.[23] One such form is that of a savings bank or, to be more precise, a number of such forms are the different institutional designs that jointly make up the universe of savings banks. In the past, savings banks have demonstrated an impressive ability to compete with other institutional forms of banking, to adjust to new circumstances, to create and harbour new ideas and new products and processes and to survive in environments that are more and more shaped by fierce competition. They are as valuable as other institutional forms of banking such as small and large private commercial banks, cooperative banks and 'other public banks' (in the sense defined above). All of these institutional forms should have their chance to develop and to display their respective strengths. The economic arguments that would suggest that one specific form of organising banking activity, namely that of the large private bank with many shareholders, is definitely the best one, may appear plausible, but they are not conclusive.[24] So far we do not know enough about the merits and the potential of different forms of enterprise, especially in banking, to be able to assign a clear priority to one specific model and to obstruct the development of others.

As Carbó Valverde & Mendez (2004) argue, diversity is all the more important in Europe, an economic and political region that thrives on the benefits of having a long tradition of diversity and that even aspires to make better use of this tradition. Diversity has economic benefits for Europe as a whole and the countries within the region, and it has its own cultural value that is worth preserving, since diversity fosters creativity in many respects.[25] It is a characteristic element of this European tradition that

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[23] This argument was confirmed in Llewellyn (2009) for the case of building societies in the UK.

[24] See Hansmann (1996), especially chapters 1 and 2.

[25] This is one of the reasons why diversity is explicitly protected by the EU Treaty. The relevant legal norm in the context discussed here is Art. 295 of the EU Treaty.

there are many institutional forms in which economic activity is performed that are, in terms of their design and functions, located somewhere between the State and its centralised power structure and fully decentralised and purely private enterprise. There may be substantial benefits to having these hybrid forms. Just like cooperative banks, savings banks are a part of this tradition of diversity and openness, and this is an important argument in its own right on behalf of savings banks. Neither the request of central governments to expand their powers nor an overly simplistic model of a market economy should be used to undermine this tradition and force savings banks into adopting one of the polar forms of a State Bank or a 'normal' private firm.

2.4 The ongoing political debate

For many years, savings banks have, at least indirectly, been the subject of intense political debates conducted at various levels. We will briefly review the debate on the international, European and national levels with a focus on Spain and Germany. Some elements of the discussion on the national level will be elaborated further in the later chapters of this study.

a) The international debate

In the international arena, there has not been any substantive debate for a long time about savings banks as a special type of bank. However, since in a number of countries savings banks are, or have formerly been, public banks, the broader, and indeed very lively debate concerning financial sector development and public or state-owned banks also has implications for savings banks. If one looks at this debate with a longer time perspective, one can see at least two fundamental changes in the prevailing views held with respect to public banks and the policies that were inspired by these views.

Since the end of World War II and into the 1980s, many policy-makers as well as many academics were convinced that the financial sector is such an important element of the infrastructure of any country and that the efficient allocation of capital and an assured supply of credit to

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It states that EU integration policy must by no means undermine the norms, legal as well as economic, by which ownership is governed in the different member states.

businesses and households are of such a vital importance that it would be too dangerous to leave them exposed to unreliable and fickle market forces.[26] This view was widespread both in the developing countries as well as in the developed economies of the West and Japan.

In the developed or industrialised countries, state ownership of banks and other forms of state involvement including rather restrictive financial regulation were the rule rather than the exception in the 30 to 40 years following the Second World War. The general distrust of commercial banks, and even of markets in general, and the lack of long-term funds seemed to make state ownership of banks and heavy-handed banking regulation a pure necessity consistent with the general economic policy regimes of this time. State involvement in banking was possibly even a cause of the economic successes in the reconstruction years. Public banks dominated the financial sectors of most advanced countries during that time. As long as interest rates were moderate and exchange rates were fixed, that is, until the early 1970s, the performance of public banks as well as their economic effects appeared to be good, and the strong role of the state in banking was not controversial.

Because they were in most cases owned or dominated by other public bodies than the central governments, which had the role of shaping overall economic policies, savings banks were not in the focus of national economic policy during that time. But the economic and political 'esprit du temps' was friendly to their status and role.

Experience in the West in the post-war years provided a model for banking and finance in the developing countries. In the 1960s, 1970s and even 1980s, a large number of specialised large state-owned banks were set up with ample technical and financial assistance from foreign and international donor agencies in developing countries.[27] The idea behind founding and funding these development banks was that they should make up for the lack of capital and banking know-how in their respective

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[26] Among the well-known advocates of this view, were, among many others, eminent economists such as Gunnar Myrdal and James Tobin, and among policy-makers Jacques Delors, before he became the President of the European Community in 1985 and still served as the French Minister of Finance.

[27] See the estimate of World Bank support for state-owned banks in developing countries in Von Pischke (1993).

countries. In the early 1970s, the economic situation as well as the views concerning economic theory and economic institutions started to change in a fundamental way. The dominant economic philosophy became much more 'liberal pro-market' and 'anti-government' and 'anti-interventionist' than it had been in the 30 years before.[28] The new orientation, which became known as the 'Washington consensus'[29] called for balanced budgets, low inflation rates, deregulation and especially privatisation. The term 'Washington consensus' for this set of desirable elements is due to the fact that, in addition to the US Government, the two big international financial institutions located in Washington, the International Monetary Fund and the World Bank, which had formerly been the main promoters of public banking in developing countries, re-oriented their strategies and became fervent advocates of the new approach.

Private and strictly profit-oriented economic institutions came to be regarded as the norm, and even the ideal, for any market economy. Of course, this new orientation was also applied to financial systems in general and to banks in particular. Not surprisingly, this 'ideological climate change' was also going to have an effect on the view concerning savings banks, though this effect would at first only be indirect.

Whereas in the years before, the positive experience of the advanced countries with public banks had provided the model for the policies applied in developing countries, the situation was then reversed: Information concerning banks in developing countries that had been available for some time but had also largely been ignored for political reasons, spurred policy changes in the advanced countries.

In the early 1970s, state-owned banks in developing countries, especially in Latin America, were reassessed in a series of rigorous studies and found to be inefficient, corrupt and over-politicised and a heavy

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[28] The political leaders of that time, who strongly supported this policy change, were Ronald Reagan and Margaret Thatcher. Among academic economists, Milton Friedman was the most influential.

[29] The concept and name of the 'Washington Consensus' was first presented in 1982 by John Williams, an economist from the Institute of International Economics in Washington, D.C.

burden for their national and international sponsors.[30] The studies identified a number of reasons for the dismal performance, and they acknowledged that it would be very difficult to trace poor performance to one specific cause. It could have been due to inappropriate management structures and policies, the inhospitable environment of financial repression, corruption and political abuse, or the legal and ownership form of these banks, or any combination of these factors. In the public domain, however, state ownership came to be regarded as the main weakness of development banks, and this lesson was later transferred to industrialised countries, putting these countries' public banks in general under political stress, even though their performance was much less unsettling than that of public banks in most developing countries. By the middle of the 1980s, the dominant view had definitely changed. A large number of public banks were privatised or even closed.

The new policy was reinforced by research findings that showed convincingly that financial sector development is very important for growth in general and seemed to imply that financial sector development required deregulation and liberalisation. This research was to a large extent carried out at the research department of the World Bank, and it is very well summarised in the World Bank publication *Finance and Growth* from 2001. Even though the evidence concerning this point is less clear-cut, this work seemed to also suggest that unrestricted competition in the financial sector is conducive to financial sector development and thus, at least indirectly, to growth.[31] Moreover, this research was more or less universally assumed to imply that the privatisation of banks is called for since it would in turn foster competition.

This was the state of the international political debate until quite recently, and it had also largely been adopted in academic circles. Evidently, it is not favourable for savings banks and other banks that are

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[30] An overview of this research, which had mainly been funded by the American aid agency US AID and the World Bank, is provided in two collections of essays, see Von Pischke et al. (1981) and Adams et al. (1984). Von Pischke (1993) summarises some of this work and its findings.

[31] In view of the events since the summer of 2007 and especially the enormous losses of banks in many countries, this general statement may, in retrospect, appear to have lost a great deal of its credibility.

not strictly and exclusively profit-oriented. They were, and to some extent still are, criticised as following policies that do not contribute to competition and, even more so in some countries, as still being state-owned and thus not conforming to the relevant norm. For instance in Germany, some academic economists have strongly requested that public banks, including savings banks, should be abolished or privatised,[32] and in a number of countries, e.g. Belgium, Great Britain[33] and Italy, this has actually happened. Until recently, the International Monetary Fund was strictly committed to the views that jointly constitute the Washington consensus,[34] even though these views have by now been challenged by several highly respected academics and have, as a consequence, lost their appeal as being unambiguously correct and even self-evident.[35]

However, liberal orthodoxy was not only questioned by academics and their work. The strict confidence in the Washington consensus was first shaken by the stock market bubble at the end of the last century and its aftermath. The turmoil in the American financial system that started in the summer of 2007 and turned into an serious crisis in the international financial system shortly after, has led to requests from many sides, including leading bankers and bankers' associations like the Institute for International Finance, to rethink the role of the state in the financial system and to reconsider more stringent banking regulation.

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[32] See e.g. Möschel (1993), Steiner (1994) and Sinn (1997).

[33] For more details on the UK, see, Drake & Llewellyn (2001).

[34] Thus it is not surprising that the IMF has regularly requested a fundamental change of the German savings bank system, which still features public ownership; see IMF (2003) for the most forceful plea of this kind.

[35] See numerous recent papers by Franklin Allen and his co-authors, including those quoted above, and most recently Allen & Gale (2007), several books and academic studies by Joseph Stiglitz, a former chief economist of the World Bank and the recipient of the 2001 Nobel Prize in economics, such as his widely quoted book (Stiglitz, 2002) on globalisation and Stiglitz (2000), as well as a series of papers by the French economist Jean Tirole summarised in Tirole (2006), Part VI. These three authors are also among those who have greatly contributed to a new line of economic research called the 'new institutional economics' that is based on the assumption that markets do not always function efficiently and instead focuses on the role of information, incentives and institutions, providing a more favourable view of the possible role of the state in financial markets.

This new trend of questioning the ultra-liberal positions that had emerged as the almost universally held view only ten years ago coincides with another intellectual and political development of the past three or four years that is highly relevant for the role of public banks in general and for savings banks in particular.

Very recently, a more differentiated view of financial sector development and growth has begun to attract the attention of policy-makers, academics and other observers. It is grounded in the insight that financial sector development and growth are much too general terms for guiding and assessing policy. Growth is not an end in itself; it should also support development, and development in turn is closely related to the notion of offering opportunities to many people and contributing to social cohesion. Nobel Laureate Armatya Sen has been an early advocate of this view.[36] Now his view has started to gain many followers, who suspect that financial sector development and growth in general might not be in line with the requirement that they should be 'inclusive'. Correspondingly, inclusive financial systems are those that offer adequate access to financial services to broad segments of the population.

It was once more the World Bank that has taken the intellectual lead in this new debate, and this alone may be a reason for attaching great importance to it. In November 2007, the World Bank published a highly instructive non-technical volume entitled *Finance for All?*, which summarises the work on exclusion and inclusion of financial sectors that its research department had produced in the previous years. This volume demonstrates that exclusion is not only a problem in developing and transition countries but also in many advanced economies. The thrust of this book is that one should aspire to make financial systems more inclusive in all parts of the world and that financial sectors should also be assessed on the basis of the extent to which they provide access to financial services to the majority of people. But the World Bank is not alone in its interest in exclusion and inclusion. In recent months, a host of other

[36] Among his numerous relevant publications, see e.g. Sen (1999 and 2000).

publications have appeared that testify that the new perspective is already now widely adopted.[37]

Together with the current financial crisis, the new attention devoted to the issue of exclusion and inclusion shifts the focus of the international debate in a direction that is extremely fruitful. In spite of the weaknesses that they may have, many public banks aspire to work against exclusion, and savings banks are among the most 'inclusive' financial institutions in a large number of countries.[38] Interestingly, in those countries in Europe that still have active savings bank systems, exclusion is less of a problem than in those that do not.[39] This is not surprising given that savings banks were first created for the explicit purpose of fighting exclusion. As it appears, all of a sudden this positive role is now acknowledged and the participants in the debate may even understand that savings banks have been able and willing to continue playing this role because of their specific legal and ownership structure and their specific business models of being connected through national networks as a feature that contributes to their stability. Thus exactly those factors that have once appeared as fundamental weaknesses from a public policy standpoint may start to be regarded as specific strengths.

b) *The debate at the EU level*

In the past decade, EU financial services policy has largely been shaped by the objective of creating an integrated market for financial services characterised by strong and efficient financial institutions, including banks, insurance companies, capital markets and non-bank financial intermediaries, and a high level of competition. The core element of this

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[37] See e.g. the two collections of essays edited by Barr et al. (2007) and Anderloni et al. (2007) and the European Commission (2008) study and the sources quoted in the contributions to these books.

[38] See Peachey & Roe (2007).

[39] The detailed results of the EU Commission Report (2008) on exclusion seems to suggest the general tendency mentioned in the text, and this in turn suggests that savings banks contribute to avoiding exclusion. However, there are some countries, such as Belgium, that do not fit into this simple pattern.

policy was the FSAP[40] which covered the time period between 1999 and 2005. It was extended by the post-FASP activity[41] ever since, and was complemented by competition policy actions[42] with respect to the financial sectors of member countries. Creating an integrated market is the domain of DG Internal Market, and ensuring unrestricted competition is that of DG Competition.

The underlying vision of the policies pursued by these two directorates was to deliver the full potential of a well-functioning market for consumers in terms of a broad range of safe, competitive products and for industry in terms of easier access to a single deep and liquid market for investment capital.

Without simplifying too much, one can say that the general orientation that inspired this policy was that of a liberal market economy based on well-defined private property, unrestricted freedom for the movement of capital, universal and unrestricted competition between all of the actors on one side of any financial market, and an important role for

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[40] The plan initiated by DG Internal Market, contains some 45 measures that have largely been implemented so far. The measures were put forth to provide a legal and regulatory environment that supports the integration of financial markets across the EU member states. Among its various objectives, the plan aimed to facilitate the development of a single wholesale services market and an open and secure retail services market while, at the same time, ensuring the stability of financial markets and eliminating obstacles that inhibit integration.

[41] In December 2005, the Commission published a White Paper on the EU financial services policy which extends the plan to the 2005-10 period. It emphasises the full implementation and enforcement of the FSAP measures, particularly in the retail financial services market, and the removal of explicit and implicit barriers to integration.

[42] Actions by Directorate General Competition mainly aim at ensuring a fair and competitive European financial services market. Besides the traditional competition policy tools on antitrust set out by the EC Treaty under Article 81 (on cooperation on cartels), Article 82 (on abuse of dominant position) and on state aid under Article 87, there is the instrument of sector inquiries which was used in 2005 in retail banking. This instrument has its legal basis in Article 17 (1) of Regulation EC No 1/2003, and gives the European Commission the power to decide to conduct an inquiry into a particular sector of the economy or into particular types of agreements across various sectors, where evidence suggests that competition may be restricted or distorted within the common market.

capital markets – in other words, the Anglo-Saxon model of an economy and a financial system.

As a consequence of this EU financial sector policy, financial institutions in Europe were put under pressure to improve in terms of their efficiency, risk management policies and, above all, value creation for shareholders. At the same time, it was, and still is, considered desirable that financial institutions reach out across borders within Europe in as many ways as possible. Conceptually – or if one prefers this term here, ideologically – this orientation of EU policy implied a strong preference for unrestricted private ownership of financial institutions in Europe and a strict profit or shareholder value orientation of these institutions.

As one might expect, this political orientation was not favourable for savings banks and other institutions that, for various reasons and in several respects, did not, and do not, conform to the underlying model of what financial institutions should be like and how they should operate. In particular, state-owned or public banks and more specifically the institutions belonging to some national savings bank systems were under a certain suspicion of not fully supporting this policy orientation. While it appears to be perfectly compatible with the financial and strategic aspirations of shareholder value-oriented financial institutions to expand their activities in all member states and ultimately to create large pan-European players,[43] this is less so for savings banks, since they have

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[43] Whether this strategic orientation makes sense from a purely financial perspective and an economic policy perspective is, however, less clear than it may appear to be. The relevant empirical literature has so far failed to reach an agreement on whether bank consolidation in the EU has led to decisive economic and social gains. Vander Vennet (1996) finds that mergers enhance the profitability of partner of equal size. However, the findings are not sufficient to disentangle socially beneficial improvements from gains from increased market power. In a later study, Vander Vennet (2002) finds evidence of significant profit enhancements, which may be due to increased market power, with no operational efficiency gains. Altunbaş & Ibañez (2004) show that strategic dissimilarities between consolidating parties may partially explain the apparent lack of cost and profit benefits. Ayadi (2007) shows that the underlying M&A logics (activity reinforcement versus activity expansion within or across regions) matter when assessing the financial and economic performance of 71 bank-to-bank M&As in Europe in the 1996-2003 period and that cross-border M&As are not the most attractive strategy from a financial and economical perspective.

remained committed to their original objectives such as local/regional development and the provision of financial services to the entire population, which are not necessarily profits maximising. Most importantly, many of them are, by design and legal-institutional structure, not open to investments from outside their respective networks and thus also not contributing to the aspired cross-border integration of financial institutions and markets.

However, the European treaties leave it up to the individual member countries to decide how their respective financial systems are shaped and especially what legal and institutional forms of ownership can exist and thus also which forms of ownership their financial institutions should have. This openness is a corollary of the right to ownership as provided for in the EU treaties that guarantee respect for the different configurations protecting national rights. Therefore, the Commission would not have been in a position to even attempt to pursue a policy that would have been openly directed against savings banks and cooperative banks, even if it had wanted to do so. Therefore, it is irrelevant to speculate whether there might have been a certain political apprehension at the EU level against these types of financial institutions. If it existed, it would, most probably, have rested on much the same grounds that were already discussed in the last section.

In contrast, EU competition policy offers some opportunities, and indeed even creates the need, to interfere with national savings bank systems if their behaviour or that of the institutions belonging to them or the way in which a member state interacts with these institutions can be perceived as violating EU competition rules. This was, for instance, the legal basis for the Commission's position in the controversy between the German Government and the German Savings Banks Association on the one side and the EU Commission (and the Association of German Private Banks) over State guarantees for 'Landesbanken' and savings banks, which led to the agreement of 2001 to phase out these guarantees in 2005. And it is also the basis for EU concerns with certain measures of state support for the German Landesbank WestLB.

One instrument of EU competition policy is so-called 'sector inquiries'. DG Competition has the right to initiate an inquiry into a specific sector if it has reasons to suspect that in this sector certain facts or business practices restrict competition. The EU used this instrument with its retail banking inquiry that was initiated in 2005 and finally published in 2007.

The mere fact that this inquiry was started caused some concerns among the savings banks and their associations and federations, since there were indeed grounds for the expectation that savings banks would be found deficient in the sense of not conforming to the strict but one-sided model of how banks should be designed and how they should operate that the Commission was assumed to hold. Most importantly, the network structure that characterises several savings bank systems and the regional principle that is still in force within some networks of DBLIs could have been regarded as anti-competitive.

The retail banking inquiry led to some moderate misgivings that the Commission had with respect to savings banks,[44] but did not provide a basis for the comprehensive attack on private or public sector savings banks or even on all savings banks and other financial institutions with a dual-bottom line, that some observers had expected and, depending on their positions, hoped for or feared.

In summary, as far as the two (important) EU Directorates responsible for the Internal Market and for Competition are concerned, one can say in summary that they had for quite some time held a rather critical position vis-à-vis savings banks, especially those with public ownership, but for various reasons did not or even could not "do anything about it".

However, there are also other considerations and other factors that had an impact on the political standing of savings banks and other DBLIs

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[44] The findings of the retail banking inquiry suggested that some forms of cooperation (strategies, pricing and selling policies) can seriously distort competition and thus be detrimental to consumers, while others, such as credit information sharing and the development of common standards for the operation of payment networks, were recognised to be beneficial and pro-competitive. They increase banks' operational efficiency, improve the risk and cost management of smaller banks and ensure the smooth operation of payment systems and thereby contribute to fostering overall competition in retail banking. Some of those forms of cooperation that were deemed to be more problematic have already been challenged in several member states. For instance in 2006, the German savings banks withdrew a joint advertisement campaign that included pricing details following the concerns raised by the German Federal Cartel Office, and in 2007, following the inquiry of the Spanish Competition Commission, fined several savings banks for market-sharing agreements.

and, correspondingly, the policy of the EU vis-à-vis these institutions. We want to briefly point out three such factors.

1) Also at the EU level, there is now a growing concern about the phenomenon of financial exclusion at the EU level. In 2007, the EU has undertaken a study on "financial services provision and prevention of financial exclusion". The main findings confirm that financial exclusion remains a policy concern in several member states and reaffirms the need for future policy action.[45] Since savings banks and cooperative banks have explicitly been created with the mission to counteract financial exclusion, and have closely adhered to this traditional mission, the outcome of the study can be regarded as strengthening the political position of savings and other banks in Europe.[46] It has become much clearer than it used to be that savings banks, by being 'inclusive' financial institutions, serve not only important economic functions but also highly important social and political functions. To illustrate the weight of this factor, it may be useful to note that the EU activity that aims at combating financial and social exclusion had originally only been initiated by Directorate General Employment, Equal Opportunities and Social Affairs. Now, since it is well under way, this initiative is backed and followed up by DG Internal Market.[47]

2) A second factor that only emerged very recently and has so far not been studied or documented in detail corresponds to the role of savings banks in ensuring financial stability. Being decentralised and 'down to earth' institutions, savings banks play an important role as a stabilising factor in general and, most importantly, also in the current financial crises. There may be indeed potential benefits from their decentralised structures and their established safety nets or mutual support mechanisms, as this

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[45] See European Commission (2008).

[46] See Ayadi & Rodkiewitcz (2008) for details.

[47] In this vein, a consultation paper on the prevention of financial exclusion was published in February 2009 by the services of DG Internal Market. The document aimed at publicly consulting on the requirement of a basic bank account in the 27 MS. This policy response is in line with the Commission's communication entitled "A Single Market for 21st Century Europe" (COM (2007) 0724, adopted by the Commission on 20 November 2007). This communication sets policy initiatives to re-position the Single Market as a socially relevant project. It is accompanied by a communication on services of general interest, including social services of general interest and a paper presenting a new 'social vision'.

tends to strengthen the provision of liquidity for the overall financial system. Even the fact that savings banks are less closely integrated into the international banking system than most other banks and less subject to the shocks that come from the drastic fall of their own share prices – since many of them simply do not have shares and share prices – suddenly appears as a factor that contributes to overall financial stability and thereby shows a specific strength of financial institutions that do not conform to the model that was considered as the ideal in the past years.

3) Finally, and once more relating to the current financial crisis which seems to have reached a point of culmination – as one may hope – exactly at the time of finalising this chapter of our study, one of the most fundamental misgivings that the EU policy seems to have had in recent years, all of a sudden appears in a new light. It relates to the public or semi-public ownership and governance features of the savings banks in some countries. This feature was indeed a major concern of the Commission in the past, even though there did not seem to be much it could "do about it". Now, suddenly, Great Britain and the US and a number of other countries have greatly stepped up state interventions and even state ownership in formerly purely private banks, and similar plans have been approved in the EU. If state ownership appears to be a possible, and even perhaps suitable, means of stabilising the financial system, this feature of some savings bank systems will in the future appear much less problematic than in the past, and any fundamental opposition to a stronger role of public or semi-public banks or banks with some state influence may have lost the intuitive appeal that it enjoyed in the past. As far as the political climate in the EU is concerned, this recent experience may have a lasting effect and strengthen the position of the savings banks in their dealings with the Commission.

c) *The debate in specific countries*

The political debate in **Germany** concerning savings banks has a tradition that goes back several decades. The crucial point of this debate has always been the fact that, with a few exceptions, savings banks have almost forever been 'owned' by the State, though not by the central or Federal State but rather by local municipalities and districts, the subdivision of the individual States (Länder). Ownership in the case of savings banks meant different things at different times. Until the end of the 1920s, most savings banks were simply parts of the respective local administration. Then they received their administrative and legal independence as institutions governed under a public law regime defined by the savings banks laws of the individual States. Even though these laws differ to some extent, they share many features, which jointly constitute the common legal and institutional character of the savings banks in Germany (and for a long time also for those in Austria).

For more than three quarters of a century, 'ownership' of savings banks meant four things at the same time: These banks enjoyed public support in the form of 1) an explicit and complete State guarantee for the deposits of the clients (Gewährträgerhaftung), and 2) an obligation of the municipality to assure the proper functioning of the banking operations, which is the so-called 'maintenance obligation' (Anstaltslast). Then, 3) the governing body of the local savings banks and the committee that was responsible for major credit decisions were staffed, among others, by local politicians. Finally 4) the savings banks laws stipulate that the savings banks had a mission to provide financial services that benefit the local community and the local economy.

However, 'ownership' is limited in so far as, in accordance with most savings banks laws, the ownership position cannot be sold, and the right to have a financial surplus distributed is severely limited. Thus, the ownership rights of the municipalities are weaker than those of the owners of a private corporation. Political influence is regarded as appropriate in principle as far as bank strategy is concerned, but it is curtailed in principle as well as in practice since the laws stipulate that the operations of the savings banks have to strictly adhere to sound business principles. This adherence is closely monitored by the savings banks' own regional supervisory organisations. Since the economic performance of the savings banks in Germany has been in line with that of other groups of banks, or even somewhat better for a large part of the past 20 years, one may be inclined to think that political influence which may have existed, was not used to make savings banks operate in an economically unsound manner.

The debate about the privatisation of the German savings banks started after 1990, the time of Germany's reunification. The first widely perceived call for a full or material privatisation of local savings banks and the regional second-layer institutions in the savings bank system, the State banks or 'Landesbanken', came from the independent German Monopolies Commission in 1992, and it was echoed by a number of academic contributions.[48] Then, in the mid-1990s, the German Associations of (private) Banks complained to the European Commission that the existing State guarantees for savings banks and Landesbanken constituted an unfair competitive advantage for these banks, which is incompatible with EU law. After a lengthy process of negotiations, in which the German savings banks Association and the German Government attempted to save the banks that belong to the Savings Bank Group from the 'attacks' from Brussels and from the private banks, the EU Commission and Germany reached an agreement which amounted to outlawing the State guarantees. This agreement came into force in 2005. It affected the Landesbanken to a larger extent than the local savings banks, but granted both groups of banks an extended period in which State guarantees would still apply to obligations that the public banks had incurred before.

State guarantees were not the only controversial issue. Another one was the impossibility of private banks to acquire individual savings banks or, seen from the other side, the impossibility of municipalities to sell their savings banks. This was considered as an impediment to the free movement of capital and of a fundamental restructuring of the entire German banking system. Especially in view of the dominant role of savings banks in the German retail market – as well as the relatively good financial performance – private banks were keen to obtain the right to buy individual savings banks, especially the larger and economically more successful ones. But the legal and institutional structure of the savings banks made this impossible. Pleas to change this legal structure therefore surfaced. Among those who argued that the special legal status of the savings banks should be altered in such a way that the sale/acquisition of individual savings banks would become possible, was the IMF which, in 2002, advocated transforming the public law institutions into private institutions with equity stakes that are freely transferrable and can be acquired by others, including German and foreign private banks.

As envisioned by those who advocated the legal transformation, it might indeed lead to the sale of individual savings banks and ultimately to the dissolution of the network structure of the savings bank system. Since this network structure is deemed to be of crucial importance for the economic success of the savings bank system, pleas for a legal

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[48] See the references provided in footnotes 30 and 31 above.

transformation raised opposition from the side of the savings banks and their association. So far, this opposition has been successful and the aspired legal transformation has not occurred. Political proclamations such as that by Chancellor Merkel at the 2007 annual meeting of the German Savings Banks Association in Bochum to the effect that the German government will continue supporting savings banks are generally understood as commitments to the current legal and institutional structure which serves to keep the network intact. Nevertheless, the pressure to change the legal status of the savings banks and ultimately also the pressure towards full privatisation is still there.

The recent turmoil in the banking system due to the subprime lending crisis has also affected the internal debate in Germany about public banks in general and about savings banks and Landesbanken. While the individual savings banks are not affected directly by the fallout of the subprime crisis, they are indirectly affected in their role as co-owners of Landesbanken, some of which are seriously affected by the current crisis. This situation has led to the emergence of conflicts between savings banks and Landesbanken. The German Savings Bank Association is more and more taking an active stand in favour of a fundamental transformation of the current system of Landesbanken, a move that might for a certain time alleviate the pressure under which they find themselves.

In **Spain**, the political debate concerning savings banks (cajas) was for a long time also shaped by the controversy concerning their legal status and the role of politics in these banks. Generally speaking, the arguments used by the opponents of the cajas largely resemble those used at the international and EU levels. They relate to what is perceived as public ownership, to the political influence to which these institutions are subject and to the presumed fact that they cooperate among themselves and that this might undermine fair and open competition.

As we will discuss at greater length in the following chapters, the Spanish savings banks are organised as private enterprises but have foundational origins and fulfil social functions. In the past, this idiosyncratic mix of private and social elements was a matter of concern in the political arena and especially among competitors. However, this concern was cleared up in 1988 when the Constitutional Tribunal ruled that the cajas are private institutions. Legally, cajas are foundations, which in turn do not have any owners by design and definition.

Even following the court ruling, the debate about the public status and influence did not end. The social involvement of the cajas, implemented by the foundations, and the extensive public sector representation in the governing bodies of the individual cajas continued to generate a dose of ambiguity as to whether in substance they belong to the private or the public sector. Although legal status and ownership structure in a narrow sense are not matters of political debate on their own any more, there are still controversial political debates concerning two closely related issues: the cajas' governance and the implications for competition in the Spanish banking sector that arise from the cooperation among savings banks.

As far as governance is concerned, despite the broader representation in cajas' governing bodies and the liberalisation measures aimed at levelling the playing field between cajas and other banks, the governance structure of cajas is more extensively regulated – by the State and by the Autonomous Communities – than that of other banks. Since 1985, several reforms were implemented that aimed at changing the cajas' governance structure. In 2002, a law reduced public sector representation in the cajas' decision-making bodies, and thus, the scope for political influence. These reforms responded to the need of ensuring that the cajas' loans and investments would not be considered public aid under European Commission regulations.

The controversy on governance of Spanish cajas is the sum of two ingredients.

The ownership structure of the Spanish savings banks is such that those exercising control in the governing bodies – that is, representatives of the public sector, depositors, employees and others – are neither legal nor economic owners in the sense of being able to appropriate any surplus that these institutions may generate. However, this creates an inconsistency between ownership and control and leads to incentive and accountability problems.

In addition, cajas (in all regions) are required to allocate at least half of their profits to reserves, and they channel the remainder back into the community towards projects that fall under their social mandate (Obra Social). Nevertheless, critics still argue that given such a use and distribution of profits, savings banks are not sufficiently exposed to conventional market discipline and that this problem is exacerbated by the fact that the savings banks do not have listed shares with voting rights for the shareholders.

In spite of their particular ownership and governance structure, the cajas seek to maximise their profits – and thus maximise their allocation to the Obra Social – through their day-to-day business operations, and by fiercely competing between themselves and with all other credit institutions for the provision of financial intermediation services. This feature accentuates the suspicions on the part of private commercial banks that cajas are under less pressure to operate strictly according to commercial rules and that this gives them the freedom to operate in ways that may not be compatible with competitive rules, e.g. by extending their branch networks and expanding the level of their activity more than would be appropriate for a private bank that is under strict pressure from its owners.

Despite reducing the representation ceiling of the public sector to 50%, political influence seems to have remained strong. The Spanish savings banks have also recently responded to these concerns by adopting strict rules concerning what can be done under the 'Obra Social' and a requirement to disclose in a very systematic and transparent manner, and thereby to strictly separate commercial business operations and socially determined profit distribution.

Another controversy is related to the cooperation among savings banks and the consequences that this may have on competition, a concern that was also central to the recent retail banking inquiry undertaken by the EU and to which Spanish cajas and their Confederation have responded by emphasising the importance of strictly distinguishing between pro-competitive, efficiency-enhancing and anti-competitive forms of cooperation.

3. BANKING PERFORMANCE AND CONTRIBUTION TO REGIONAL GROWTH AND STABILITY

The main objective of the chapter is to investigate the performance and role of savings banks in three countries where they are still prevalent (Austria, Germany and Spain) and where they are disappearing or have already disappeared (Italy and Belgium). The first part of the chapter surveys the economic literature on the performance of savings banks as well as their contributions to competition, regional growth and financial stability. Most studies have focused on a relatively narrow set of countries or issues, without taking a look at the broader picture. The lack of a comparative assessment of the conditions and roles of savings banks in Europe and institutional diversity – that is, the degree to which savings banks participate, together with commercial banks and other types of banks – in a financial system has motivated this chapter and the study as a whole. This is why the second part of this chapter reports the results of an empirical examination of the performance and roles of savings banks in the five European countries mentioned above. The results confirm that, according to a number of different performance measures, savings banks are by and large as efficient as their commercial peers. Their presence appears to have a positive impact on competition and on regional economic growth, particularly through their role of lending to smaller businesses. Lastly, they contribute positively to the stability of the financial system as the returns of savings banks are significantly less volatile than those of commercial banks of comparable size.

This chapter is structured as follows: section 3.1 offers a review of the literature covering the performance of savings banks, the impact on competition, the links between small-business lending and small banks (including savings banks) and the contribution of savings banks to the local and domestic economy and stability. Section 3.2 offers a description of the methodology used in a European-wide econometric study of the economic performance of savings banks, their impact on competition and their role for regional economic growth and stability. Finally, the main results of the empirical analysis are reported in section 3.3.

3.1 Review of the empirical literature

a) Performance of savings banks

The economic literature has identified a number of hypotheses regarding the relationship between the likelihood of intervention by owners of capital and an organisation's performance. For privately owned organisations, this relationship is expected to be strong and positive, since shareholder earnings are in line with the company's performance. For publicly and semi-publicly owned organisations, however, such an alignment is weak or even non-existent. In many instances authorities have other priorities than maximising the net present value of a public entity. For example, the social value of an organisation's output often takes precedence over its financial performance. Moreover, there is also the concern that officials may use the organisation to pursue their own agenda, further weakening the relationship.[49]

The performance of savings banks in Europe has been scrutinised by a number of studies. Carbó Valverde et al. (2002) use a large panel of banks to examine the absolute cost efficiencies of European savings banks between the years 1989 and 1996. The authors find that doubling all outputs would give rise to a 90 to 93% rise in total costs, implying the existence of scale economies. Moreover, the same level of output could be produced with only 78% of inputs, indicating the existence of inefficiencies of savings banks. These results suggest that savings banks can reduce their costs by managing their inputs better and by increasing their scale. However, this does not imply that these institutions perform worse than other banks and notably than privately-owned banks.[50]

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[49] See e.g. Shleifer & Vishny (1994).

[50] The results are confirmed in Carbó Valverde et al. (2007) when using a sample of 77 Spanish commercial and savings banks between 1992 and 2001.

A comparison of the performances of commercial banks, savings banks and cooperative banks is provided by Altunbaş et al. (2001). Using individual bank data on German banks between 1989 and 1996, the authors fail to identify any significant performance differences. If anything, cooperative and savings banks appear to have slight profit and cost advantages. In particular, savings banks appear more cost efficient since they seem to waste only 16% of their inputs, while commercial banks waste about 21%. Similar results are found for profit efficiencies.

Altunbaş et al. (2003) undertook a similar study for a sample of banks in 15 European countries and in the US between the years 1990 and 2000. Their results show that savings and cooperative banks are more cost efficient than their commercial peers, except in Finland, Luxembourg and the Netherlands. In contrast, commercial banks are closer to the best-practice (alternative) profit function in all countries. Taken together, these results suggest that savings banks and cooperative banks are better at raising revenues but not at minimising costs.

The studies surveyed so far have revealed that savings and cooperative banks are by no means less profitable than their commercial peers. It is possible that these results arise because of the advantages enjoyed by these banks. For example, one common argument is that the implicit or explicit state guarantees may have allowed these banks to have access to cheaper financing. This line of reasoning has been used repeatedly with reference to the case of Germany as a country that has a sizeable savings bank sector. Chakravarty & Williams (2006) use a simulation technique to find out whether this claim is correct. In their study, they first show that German commercial banks come last in terms of (alternative) profit efficiency, and they then demonstrate that the efficiency ranks of the different groups of banks would not change significantly if borrowing costs were equal for all banks.

Crespi et al. (2004) take a more direct approach by comparing the internal control structures of Spanish banks operating under different ownership structures. Four control mechanisms are analysed, including changes in the board, removal of the chairman, CEO dismissal and mergers/acquisitions. Using data for commercial and savings banks operating in Spain from 1986 to 2000, the authors confirm that Spanish savings banks enjoy a higher return-on-assets (ROA) than other banks. However, the relationship between the removal of management and poor performance is relatively weak for savings banks – an important instrument of governance for commercial banks. For these savings banks, economic performance is more likely to be corrected through mergers, which is seen as the explanatory factor behind the banks' superior performance.

b) *Impact on competition*

There is a reason for concern that the persistent ties that savings banks develop with their local customers may give competitive advantages to these banks. Sharpe (1990) argues that the inside information may indeed give a bank a certain degree of monopoly power in subsequent transactions, which can be transformed into gains for the bank by charging a non-competitive interest rate.

Hempell (2002) empirically examines the competitive behaviour of German banks using a large panel data covering the years 1993 to 1998 by examining how responsive revenues are to changes in banks' input prices, the so-called 'H-statistic' method developed by Panzar & Rosse (1987).[51] The author finds that the behaviour of commercial banks is closer to perfect competition than the behaviour of savings banks. Moreover, the results suggest that competition decreased over the six years for the German savings banks.

Another approach is assessing the market power enjoyed by a bank by measuring the Lerner index for that bank, which measures the distance between prices and marginal cost. Using Spanish data during 1986-2002 covering commercial and savings banks, Fernández de Guevara and Maudos (2006) find that savings banks have a greater market power than commercial banks.

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[51] Panzar & Rosse's (1987) 'H-statistic' approach uses the fact that firms operating under perfect competition or in a contestable market (i.e. with zero profits) have no option but to translate input cost hikes into proportional increases in revenues by increasing output prices. If they increase their prices any less, they will make losses; if they increase prices any more, their prices will be undercut by their competitors. Monopolistic firms or firms operating under oligopolistic competition, in turn, set their prices at a level where demand is elastic (i.e. any other level would violate profit maximisation). For these firms, higher input prices will also lead to higher prices; however the revenues may only increase less than proportionately since the consumer demand is elastic.

c) *Small business lending and bank characteristics*

The relationship between a bank and its borrowers is particularly vital for smaller firms, since for them close personal ties between bank officials and borrowers can allow collecting and using significantly more information than in the case of firms with a more distributed organisational structure.[52] As banks grow and expand across borders, other objectives than satisfying the local borrower and other difficulties may emerge. A number of researchers have argued that larger banks are less capable of processing and transmitting the soft and relational information through their hierarchical structures.[53] This would put local banks, such as savings banks, in a position to better respond to the needs of smaller local enterprises than larger and less regionally focused banks.

Keeton (1995) uses cross-sectional data for 1994 from seven US states to compare the small business lending practices of different types of banks. The author finds that banks with a higher degree of interstate presence lend significantly less to small businesses than their peers. The same result is also obtained for banks that are held by out-of-state banks. These results confirm that small business lending has a local element.

Using a larger sample of banks, Berger & Udell (1995) test the hypothesis that small business lending is inversely correlated with bank size. The results confirm that larger banks are less inclined to finance small businesses. Moreover, the large banks appear to distinguish between transparent and opaque borrowers, as evidenced by the less restrictive loan terms offered to the pool of borrowers that do get financing.

Using survey data on the financing patterns of a large number of German small- and medium-sized enterprises (SMEs), Harhoff & Körting (1998) empirically confirm the anecdotal evidence that many German businesses maintain lending relationships with a single bank.[54] More importantly, loans in cities are more expensive and require more collateral than those in rural communities. The authors interpret these findings

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[52] For a survey of relational lending literature, see Boot (2000) and Elyasiani & Goldberg (2004).

[53] See Stein (2002) and Williamson (1967).

[54] See Harhoff & Körting (1998) and in a similar vein, Elsas & Krahnen (1998).

supporting the idea that a competitive market may be incompatible with strong relational ties, as was first mentioned by Mayer (1988).

Another issue that arises in the context of SME lending is whether small businesses receive fewer loans from foreign banks based at a considerable distance from the borrower's location. Such a hypothesis seems plausible, given the arguments outlined above. Foreign banks are often very large organisations. The decision-makers in these banks often speak a different language and are subject to different regulations than those applicable in the local environment surrounding the small business clients. This is a particularly important issue amidst the current wave of cross-border consolidations. Berger, Klapper & Udell (2001) investigate it using Argentinean cross-sectional data from the end of 1998. The data have been provided by the central bank's credit registry, and they include detailed information on loan characteristics. The authors find that the foreign-owned banks lend less to small businesses, particularly if the banks' headquarters is located in a far-away country and if the businesses are opaque.

d) Contribution to the local and domestic economy

Those who support the *development view* of non-commercial banks argue that such institutions contributed to regional economic growth by providing financial services in regions where private institutions are missing.[55] Indeed, there is evidence that savings banks have played an important role in the development of under-privileged regions. To uncover this relationship, Guiso et al. (2004) construct an index of financial development in different Italian regions and show that the historical presence of savings banks had a positive impact on the long-term regional development.

The literature has identified a number of channels through which the availability of local banks has contributed to regional growth. Hakenes & Schnabel (2006) argue that by investing in their local economies, these banks effectively prevent a 'capital drain' to other regions. Most importantly, the authors show that to become credible alternatives to private banks in local markets, the regional banks should either be

[55] The view that government intervention may be justified to achieve developmental goals in under-developed regions was introduced by Gerschenkron (1962).

subsidised by tax-financed public guarantees, as in the case of savings banks, or operate as cooperative banks, engaging exclusively with their members. More recently, Hakenes, Schmidt & Xie (2009) use regional economic data for Germany to show that the presence of savings banks has a positive impact on regional economic growth, through SME lending and that this effect is significantly stronger in poorer regions.

A parallel argument can be used that also supports the use of regional restrictions on banking activities, such as the 'regional principle' in Germany. If these restrictions do not exist, larger banks can put smaller local banks out of business, effectively restricting the number of institutions active in the region. In addition to competition problems due to increased market power, the disappearance of local banks will also reduce the availability of relational information on lenders, thereby leading to economic welfare losses and reducing the availability of credit.[56]

Large commercial banks also engage in activities that may enable them to shift taxable resources away from the host country or needy regions. In particular, profit-shifting activities enable banks to reduce their tax obligations by allocating income to group entities located in favourable regimes. Using a large sample of commercial bank accounting observations from 80 countries during the years 1988 to 1995, Demirgüç-Kunt & Huizinga (2001) confirm that banks with foreign subsidiaries face a significantly lower tax bill than their comparable domestic peers.

e) Earnings stability of savings banks

The development of literature on the stability of banks with different ownership structures is relatively recent. Using a large cross-sectional dataset covering over 60 countries for the year of 1997, Barth et al. (1999) find that the banking crises are more common in markets with prevalent public ownership. In an attempt to explain this finding, Goodhart (2004) suggests that the finding may be due to the inherent advantages granted to public or semi public banks, which may reduce interest margins in traditional banking and push private sector banks to engage in more risky activities.

Three recent studies have addressed the alleged relationship between bank ownership and stability more systematically. Cihák & Hesse (2007)

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[56] For a similar argument see Greenwald et al. (1993) and Stiglitz (1994).

compare the stability of cooperative and commercial banks by using a panel of a large number of individual banks, covering 29 major advanced economies over the period of 1994 to 2004. The authors use a well-known indicator of bank risk, the so-called 'z-score', to measure solvency risks as a function of a bank's income generating capacity.[57] Cooperative and savings banks are more – not less – stable than their commercial counterparts. As a possible explanation of this latter finding, the authors argue that the customer-oriented strategies of these banks may allow them to better absorb profitability shocks and smooth their returns over time.

Garcia-Marco & Robles-Fernandez (2008) examine whether ownership structure plays a role in the risk-taking of Spanish financial institutions. Using a sample that covers over one hundred institutions over the 1993 to 2000 period, the authors perform a comparative analysis of savings and commercial banks. In addition to the z-score, the authors also base their results on an alternative measure of risk, the 'solvency margin', measuring the bank's exposure to losses. The results are in line with Cihák & Hesse's (2007) findings; commercial banks are more risk prone.

More recently, Beck et al. (2009) examine the stability of German banks under different ownership structures. The authors' results confirm that savings banks have higher z-scores than commercial banks, almost entirely due to the lower volatility of their profits over years. Two additional measures of stability, comprised of the ratio of non-performing loans to total loans and the likelihood of distress,[58] are also reported. Savings banks score better than their peers in terms of these two indicators, having a smaller share of loans as non-performing and facing a significantly lower likelihood of distress. Perhaps more intriguingly, while the authors confirm that larger commercial banks are less stable, possibly due to the 'too-big-to-fail' problem, the opposite holds for savings banks.

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[57] The z-score measure was developed by Hannan & Hanweck (1988) and Boyd & Runkle (1993).

[58] The distress measure indicates "whether a bank has i) faced compulsory notifications about events that may jeopardise the existence of the bank as a going concern ii) suffered severe losses of capital and extreme declines in return on equity, iii) benefited from capital injections from the deposit insurance scheme, iv) been subject to a distress merger, or v) been closed by the bank supervisory agency" (Beck et al., 2006, p. 13).

Indeed, larger savings banks are found to be more stable, possibly due to their increased ability to smoothen their profit streams, giving them an additional boost in terms of stability.

To summarise, the studies reviewed in this section find that savings banks do not necessarily perform worse than their commercial peers. At the same time, owing to their small size and local nature, these banks provide financing to smaller businesses, particularly in economically less developed regions. Moreover, recent studies have revealed that their returns are less volatile. In short, despite questions regarding their governance structures, the performance of savings banks is comparable with their commercial peers while fulfilling an important role in development and contributing to the stability of the financial system.

The next section delves deeper into the comparative analysis of performance, competition, contribution to growth and earnings stability in the five countries included in this study covering the years between 1996 and 2006.

3.2 Investigating profitability, efficiency, competition, growth and stability

The objective of the empirical investigation presented in this section is to examine profitability, efficiency, competition, earning stability and role on regional growth of savings banks in Austria, Belgium, Germany, Italy and Spain during 1996-2006 and for three sub-periods, 1996-1999, 1999-2003 and 2004-2006 while comparing with their commercial peers.

The empirical analysis relies on two data sources. The primary source is the Bankscope database, provided by Bureau van Dijk. Only consolidated information on the balance sheets and income statements of commercial banks and savings banks is included in the study. The coverage of savings banks in Belgium and Italy includes banks which are either joint-stock corporations (Italy) or small banks that are indistinguishable from their commercial peers (Belgium). To facilitate comparison, benchmark figures for EU-15 countries are also provided whenever applicable.

The distribution of the sample information across countries and between savings and commercial banks is given in Table 3.1. The empirical analysis also benefits from several economic and demographic indicators provided by the European Commission's Eurostat database.

Table 3.1 Primary sample. Number of observations by type of institution (1996-2006)

	All Banks	Commercial Banks	Savings Banks
Austria	1116	521	595
Belgium	1283	842	441
Spain	1584	783	801
Italy	1985	602	1383
Germany	6392	2099	4293
EU-15	19139	8104	11035

A secondary dataset is employed to undertake a more detailed case study of Germany, Spain and Austria. The database used for this study includes unconsolidated balance sheet and income statement information provided by the savings banks associations of the three countries. In addition, it also contains information on the territorial distribution of savings banks in these countries, their delivery channels (branches, ATMs), and employees.

The empirical analysis follows four steps:

First, the primary database is used to compute banks performance using accounting ratios and efficiency indicators based on more sophisticated econometric models for the five countries and for EU-15 as a whole when possible.

Second, efficiency and competition indicators are computed and used to undertake an examination of the determinants of competition controlling for a number of explanatory variables including bank size, market capitalisation, entry, contestability and institutional diversity. Separate estimations are made to allow a comparison between savings banks and commercial banks.

Third, the determinants of regional growth in Austria, Germany, and Spain are examined, paying close attention to the role of savings banks.

Fourth, z-scores are computed and used to undertake an examination of the earnings stability of savings and commercial banks.

The following subsections provide details on the estimation methodology. The results of the empirical analysis are presented in the following section.

a) *Measuring bank financial and economic performance*

In the first step, a number of accounting ratios are used to measure the economic and financial performance of banks. Two commonly used profitability measures, return on assets (RoA) and return on equity (RoE), are calculated by dividing pre-tax profits of each bank by total assets and equity, respectively. As a measure of the economic efficiency of a bank, the cost-to-income ratio is used, which is calculated by dividing the total operating costs by total operating income.

The calculation of the second efficiency indicator, the X-efficiency score, requires the estimation of the best-practice cost frontier. Once this frontier is estimated, the score is calculated as the distance between the costs of a given bank and the costs of the bank with the best practice when both banks produce the same output and operate under the same environmental conditions. This efficiency score measures the quality of a bank's cost management. The rest of the section details the derivation of the X-efficiency score.

The estimation of the best practice frontier follows the stochastic frontier approach originally proposed by Aigner et al. (1977). In this model, the stochastic cost frontier has the general log form, $\ln c = f(\cdot) + \varepsilon$, where c represents a measure of costs, $f(\cdot)$ is a functional form that accounts for the relationship between inputs and expenses and ε is an error term. The error term is assumed to be composed of two components, $\varepsilon = v + u$. The first component (v) captures the random variation of the frontier across firms, assumed to be normally distributed around zero with standard deviation σ. The second error component (u) captures the X-inefficiency, or the incremental costs incurred by the bank costs relative to the best practice frontier. This second error term is assumed to be distributed as half-normal with standard deviation $\lambda\sigma$, truncated below from zero. Therefore, the greater the value of u_i is, the further away bank i is from the best practice frontier.

If both components are distributed independently, the frontier can be estimated with maximum likelihood procedures. Individual inefficiency estimates can be calculated by using the distribution of the inefficiency term conditional on the estimation of the composed error term. The inefficiency estimate for bank i is equivalent to the following conditional distribution,

$$E[u_i \mid \varepsilon_i] = \frac{\lambda\sigma}{1+\lambda^2} \cdot \left[\frac{\phi(\varepsilon_i \lambda / \sigma)}{\Phi(-\varepsilon_i \lambda / \sigma)} - \frac{\varepsilon_i \lambda}{\sigma} \right], \tag{1}$$

where $\phi(\cdot)$ and $\Phi(\cdot)$ represent the standard normal density and cumulative distribution functions, respectively. The *X-efficiency measure* is then defined as

$$XEFF_i = 1 - E[u_i \mid \varepsilon_i]\,. \tag{1′}$$

The efficiency index (*XEFF*) in equation (1′) is interpreted as the share of total costs needed to produce a given amount of output if bank *i* were to operate on the best practice frontier. The closer this value is to 1, the more cost efficient is the bank.

The estimation exercise follows the translog frontier cost function treatment already used in Altunbaş et al. (2001), Carbó Valverde et al. (2002) and Chakravarty & Williams (2006). In this approach a bank's costs (*c*) are assumed to be a function of its two outputs, i.e. loans and deposits, and the input prices, i.e. the prices of capital and labour. A time trend variable is included to account for changes in efficiency that may be due to technological improvements over time. The cost equation to be estimated is defined as follows:

$$\begin{aligned}
\ln c_{it} &= \sum_{h=1}^{2} \gamma_h \ln w_{hit} + \gamma_L \ln L_{it} + \gamma_D \ln D_{it} + \tfrac{1}{2} \sum_{h=1}^{2} \sum_{m=1}^{2} \gamma_{hm} \ln w_{hit} \ln w_{mit} \\
&+ \gamma_{LD} \ln L_{it} \ln D_{it} + \tfrac{1}{2} \gamma_{LL} (\ln L_{it})^2 + \tfrac{1}{2} \gamma_{DD} (\ln D_{it})^2 + \sum_{h=1}^{2} \gamma_{hL} \ln w_{hit} \ln L_{it} \\
&+ \sum_{h=1}^{2} \gamma_{hD} \ln w_{hit} \ln D_{it} + \mu_1 Trend + \tfrac{1}{2} \mu_2 Trend^2 + \mu_3 Trend \ln L_{it} \\
&+ \mu_D Trend \ln D_{it} + \sum_{h=1}^{2} \mu_h Trend \ln w_{hit} + v_{it} + u_{it}
\end{aligned} \tag{2}$$

where

i	=	bank index;
t	=	year;
$\ln c$	=	natural logarithm of total operating costs
$\ln w_1$	=	natural logarithm of price of labour, measured by personnel expenses / total assets;

$\ln w_2$	=	natural logarithm of price of capital, measured by total depreciation and other capital expenses / total assets;
$\ln D$	=	natural logarithm of deposits;
$\ln L$	=	natural logarithm of loans; and
Trend	=	time trend.

In order to obtain a measure of competition, which will be discussed in the next section, it is also necessary to get an estimation of the marginal costs – i.e. changes in costs arising from incremental increases in output – faced by each bank. Using equation (2), marginal costs can be written as:

$$\begin{aligned} mc_{L_{it}} &= \frac{\partial c_{it}}{\partial L_{it}} = \left[\gamma_L + \gamma_{LL} \ln L_{it} + \sum_h \gamma_{hL} \ln w_{hit} + \gamma_{LD} \ln D_{it} + \mu_L Trend \right] \cdot \frac{c_{it}}{L_{it}} \\ mc_{D_{it}} &= \frac{\partial c_{it}}{\partial D_{it}} = \left[\gamma_D + \gamma_{DD} \ln D_{it} + \sum_h \gamma_{hD} \ln w_{hit} + \gamma_{LD} \ln L_{it} + \mu_D Trend \right] \cdot \frac{c_{it}}{D_{it}} \end{aligned} \tag{3}$$

Lastly, the cross-country comparisons envisioned in the study require the estimation of a common cost efficiency frontier for all banks in the sample. However, a robust cross-country analysis of bank efficiency requires controlling for heterogeneity in environmental conditions which are beyond the responsibility/influence of bank management. The environmental variables are GDP per capita at constant prices, population density (inhabitants per square kilometre) and bank branches per capita in each national market. In addition, country-level dummy variables are introduced to control for the influence of other country-specific issues, such as regulatory and institutional factors.

b) *Measuring competition and market power*

To assess competition, the Lerner Index is used to measure the market power of banks. The indicator is calculated by taking the difference between price and marginal costs and then dividing it by price. Under standard assumptions, prices converge to marginal costs, as competition in a market increases, implying that the index would converge to zero. Therefore, the greater the index is, the greater is a given bank's market power.

The index is a good indicator of the competitive conditions in a market. The following equation, obtained as a solution for symmetric oligopolistic competition, highlights this relationship:

$$LERN \equiv \frac{p - mc}{p} = \frac{1}{NE_d(p)} \tag{4}$$

where p is the price of a bank's earning assets (measured by total interest and non-interest revenues/total assets), mc is the marginal cost (calculated in the previous step), E_d is the absolute value of the price elasticity of demand and N is the number of competitors in the territory where the bank operates. According to equation (4), firms can enjoy a greater market power when the elasticity of demand is low, i.e. when the bank's services are a necessity for consumers, or when the number of competitors is low. In either case, a bank can get away with charging a non-competitive price, that is, one that significantly exceeds the marginal costs for a given financial service.

c) *Determinants of competition*

The objective for the second empirical step is to identify the determinants of competition, paying close attention to differences between savings and commercial banks. The relationship to be estimated is as follows:

$$LERN_{it} = \theta' X_{it} + \mu_i + \varepsilon_{it} \tag{5}$$

where X is a vector of explanatory factors, μ accounts for bank-level fixed effects and θ is the vector of coefficients to be estimated.

For each country, two separate estimations are undertaken, one for 'all banks' (commercial and savings banks) and one only for savings banks, in order to highlight statistical differences in the competitive behaviour of savings banks. Equation (5) is fitted using panel estimation with fixed-effects routine.

The explanatory variables (X) included in the estimation are identified as follows:

a. *Concentration, size, efficiency and capitalisation*: The first set of explanatory variables includes a measure of market concentration, bank's size (logarithm of total assets), cost-efficiency (i.e. the X-efficiency score), and market capitalisation (ratio of the bank's total capital and reserves to total liabilities). Concentration is measured by the Herfindahl-Hirschmann index (HHI) for bank deposits, which is the sum of the squared market share of the firms in a given market.[59]

b. *Contestability and barriers to entry*: Contestability captures the extent to which competition may increase with the entry of new competitors to the market. The set of variables includes a measure of branch opening (growth in number of bank branches), an indicator of the distribution of branches (ratio of inhabitants to number of branches) and an industry-wide variable to account for foreign entry (ratio of foreign competitors to total banks in country).

c. *Other control variables*: Differences in bank ownership are controlled by including a dummy variable that takes the value 0 for commercial banks and 1 for savings banks. The influence of the business-cycle is controlled by including GDP growth for each observation year. Lastly, the magnitude of retail banking in each country is controlled by including the logarithm of total deposits in the market.

d) Savings banks and regional growth

The third empirical step assesses the impact of institutional diversity on economic growth. Two general assumptions are made for this purpose. First, the analysis is conducted on a regional basis to accurately capture the contribution of local institutions. The locations are based on the administrative regional distribution of savings banks in Austria, Germany and Spain. Second, institutional diversity is defined as the ratio of savings banks' assets to total bank assets in a given region. It is assumed that this measure adequately incorporates the relative importance of alternative ownership models.

The data on bank-level indicators are obtained from the respective savings banks association database while the regional economic and demographic indicators are obtained from Eurostat. The use of dynamic panel data techniques is particularly appropriate within this framework to capture persistent unobservable heterogeneity across regions. As in Carbó Valverde et al. (2003), we use the Generalised-Method of Moments (GMM) estimator for dynamic panel data, first introduced by Holtz-Eakin et al. (1988) and Arellano & Bover (1995). The dynamic panel procedure is

[59] The HHI ranges between 0 (perfect competition) and 1 (monopoly).

employed since the lagged GDP values may partially explain the subsequent behaviour of some of the variables over time (Sala-i-Martin, 2002).

We consider the following regression equation:

$$y_{i,t} - y_{i,t-1} = (\alpha - 1) y_{i,t-1} + \beta' X_{i,t} + \eta_i + \varepsilon_{i,t} \quad (6)$$

where y is *GDP*, X is a set of explanatory variables representing both the general determinants of growth in most empirical models (Sala-i-Martin, 2002) and banking sector developments, η_i is an unobserved regional-specific effect, ε is the error term, and the subscripts i and t represent region and time period, respectively.[60] As general determinants of economic growth, initial (lagged) GDP, level of schooling (measured by the share of population with a university degree), capital stock, percentage of urban population and inflation (derived from the cost-of-living index) are considered. As for the regional banking sector variables, the ratio of lending to private sector to GDP, the growth of bank branches, the institutional diversity indicator (as described above), the Lerner Index and the ratio of the number of ATMs to branches (showing technical change in delivery channels) are also included.

Equation (6) can be rewritten as:

$$y_{i,t} = \alpha y_{i,t} + \beta' X_{i,t} + \eta_i + \varepsilon_{i,t} \quad (7)$$

The (time-invariant) region-specific effects (η_i) can be eliminated by taking first-differences in equation (7) so that:

$$y_{i,t} - y_{i,t-1} = \alpha(y_{i,t-1} - y_{i,t-2}) + \beta'(X_{i,t} - X_{i,t-1}) + (\varepsilon_{i,t} - \varepsilon_{i,t-1}) \quad (8)$$

The use of appropriate instruments is necessary to deal with the likely endogeneity of the explanatory variables. The instruments for the regression in differences are the lagged values of the explanatory variables. The instruments for the regression in levels are the lagged differences of the corresponding variables. All regressions include time dummies.

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[60] Additionally, time dummies are included to address the fact that business cycles may differ over different time periods and between different regions, particularly in the case in Germany and Spain.

e) *Measuring savings banks' earnings stability*

The fourth step of our empirical investigation is to analyse the stability of savings banks versus commercial banks. Following Cihák & Hesse (2007), z-scores are used as a measure of individual bank risk. They are computed for Austria, Germany and Spain in order to highlight the impact of different ownership structures in a consistent manner where differences between savings banks and commercial banks exist in this respect.

The index (Z) is calculated for each bank-year observation according to the following equation:

$$Z_{it} = \frac{(E_{it} / A_{it}) + \mu_i^{RoA}}{\sigma_i^{RoA}} \tag{9}$$

where E/A is the equity capital as a share of assets and μ^{RoA} and σ^{RoA} are the mean and standard deviation of pre-tax return on assets (RoA), respectively. The index measures a corporation's capacity to absorb deviations in income. More specifically, the z-score shows how many standard deviations from the mean income have to fall to make the corporation insolvent by depleting its equity. The greater the value, the lower is the probability of default.

f) *Determinants of savings banks' earnings stability*

A number of exogenous variables are used to examine the determinants of bank risk. First, a dummy variable is used to identify the earnings stability of savings banks. Bank size is measured by total assets. Large banks benefit from diversification opportunities, which may allow them to better absorb shocks. Conversely, large banks could also be more risk-prone due to the implicit deposit insurance guarantees they enjoy. In order to distinguish between the stability of banks with different ownership structures and different sizes, an interaction variable for the size of savings banks is also included.

Other explanatory variables are also incorporated to control for bank-specific factors and market conditions. The cost-to-income ratio is included to account for differences in efficiency between banks. A dummy variable for listed institutions is included in order to control for governance issues relating to commercial banks. In general, better governed and more efficient banks should be able to absorb shocks better, implying a higher z-score. However, it is also possible that these effects will be less important once other individual characteristics are accounted for.

Market concentration, which also serves as an indicator of sector-wide competition, will be measured by the Herfindahl-Hirschman Index (HHI). There are different and partially compensating effects that concentration can have on the risks taken by a bank.[61]

Lastly, in order to control the impact of external imbalances and the ease with which capital can flow in and out of the country, an indicator developed by Chinn & Ito (2008) on financial openness will also be included in the estimation exercise. It is expected that more open markets will also be more volatile and open to external shocks due to the speed with which capital flows can enter and leave the country. Although this variable is not directly related to savings banks, it is nevertheless included to control for the differing levels of current and financial account imbalances.

The equation to be estimated is given as follows:

$$Z_{it} = \alpha + \beta_1 \ln A_{it} + \beta_2 (\ln A_{it} \times S_i) + \beta_3 S_i + \theta' X_{it} + u_{it} \tag{10}$$

where

i	=	Bank index;
t	=	year;
Z	=	z-score as described in equation (9)
$\ln A$	=	natural logarithm of total assets;
S	=	dummy indicator for savings banks;
$\ln A \times$ S	=	interactive variable for size of savings banks;
X	=	other explanatory variables, including cost-to-income ratio, listed institutions dummy variable, HHI, and financial openness index.

[61] The current literature provides little guidance on the net impact of concentration on a bank's earning stability. The 'trade-off' view, recently advocated by Allen & Gale (2004) and empirically supported by Beck et al. (2006), claiming that despite the efficiency gains, less concentrated and more competitive markets exacerbate agency problems and thereby lead to instability. Boyd & de Nicolo (2005), however, counter this argument by noting that the supra-normal loan rates that banks charge when concentration is low may lead to higher bankruptcy risks for borrowers, which may translate into a source of instability for the bank.

In order to ensure that the results are robust to procedural choice, each estimation stage is composed of a pooled OLS regression and a fixed-effect panel regression, which accounts for unspecified individual effects.

3.3 Main results

a) *Profitability, efficiency, competition and earnings stability: commercial vs. savings banks*

This section reports the comparison of profitability, efficiency, market power and earning stability for commercial and savings banks in Austria, Belgium, Germany, Italy and Spain during the period between 1996 and 2006.

Regarding various profitability measures, Table 3.2 and Figure 3.1 depict the evolution of the return on assets (RoA). Profitability has declined in all the five countries over time, which seems to be mainly due to increasing competitive pressures resulting from liberalisation and financial integration. The RoA values are particularly low in Germany and relatively high in Spain. No statistical differences exist between savings and commercial banks at the 1% level of significance. However, in Italy and Germany, commercial banks score higher on profitability measures at the 5% and 10% levels of significance, respectively. While the RoA measures point at these minor differences, there are no observable differences in terms of the return on equity (RoE) of different types of banks (see Table 3.3 and Figure 3.2).

In terms of cost-to-income ratios (see Table 3.4 and Figure 3.3), the banks in the five countries appear to do no worse than the EU-15 averages. Even Italian banks, whose operating costs were elevated over the 1996 to 1999 period, have rationalised their structures over the years. While Spanish banks have consistently remained above average over the years. In comparison, the savings banks are once again to a large extent indistinguishable from commercial banks. The only exception is Austria, where savings banks have higher cost-to-income ratios at 10% significance level.

The estimated X-efficiency scores are shown in Table 3.5 and Figure 3.4. In all five countries and sub-periods the average efficiencies are dispersed evenly around 85%, which is in line with earlier studies.[62] For the EU-15 region as a whole, the measures for the years 1996 to 2006 average at 85.7% and exhibit a consistent improvement over the years. This score means that there is a potential 14.3% improvement in cost efficiency for the average EU-15 bank relative to the benchmark of best practice. Among the five countries, the Belgian and Spanish banks have the highest scores while the Austrian banks come last. More importantly, the results indicate that the cost efficiencies of commercial and savings banks are highly comparable. According to mean-difference tests, there are no significant differences between savings and commercial banks at the 5% level in any of the countries with the only exception of Italy.[63] This suggests that savings banks are at least as efficient as commercial banks, a result that stands out in a marked contrast to widely held beliefs to the effect that savings banks are less efficient than commercial banks.

Turning to the competition measures, Table 3.6 gives the Lerner Index estimates. The average Lerner Index for the EU-15 is 27.4%. Again, differences between commercial and savings banks are not found to be significant, except in the case of Italy where savings banks exhibit a statistically significantly higher market power. However, this is not a specific feature of savings banks since all commercial and savings banks in Italy show the higher level of market power within the countries analysed. In Germany and Spain, where regional competition is particularly strong, there is virtually no difference between the market powers of the two types of banks.

As for the evolution of market power, the results in Table 3.6 show that the Lerner Index has increased from 1996 to 2003 and decreased from 2003 to 2006 in all countries.[64] Interestingly, these studies have also shown

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[62] The result is consistent with Altunbaş et al. (2001), Carbó Valverde et al. (2002) and Carbó Valverde et al. (2007).

[63] Importantly, in most of the countries, any statistical difference between savings and commercial banks vanishes when the environmental conditions in the efficiency estimation are considered.

[64] These findings are to the most part in line with earlier studies. Maudos & Fernandez de Guevara (2004) show that the Lerner Indices for banks in France, Germany, Italy, Spain and the UK have been inching upwards between 1996 and 2000. Using a larger sample, Carbó Valverde & Rodriguez (2007a) confirm that the

that the most competitive activities have been deposit-taking and lending – in which savings banks are specialised – while other non-interest income (fee- and commission-based) activities are the main source of market power in European banking.

The comparative examination of the earnings stability of different types of banks is given in Table 3.7 and Figure 3.6.[65] The weighted averages in Figure 3.6 show that Spanish savings banks score remarkably higher than their commercial peers. These differences are smaller for banks in Austria and Germany.[66]

To sum up, the results above highlight that there are no clearly visible differences between savings and commercial banks in terms of profitability, efficiency, competition and earnings stability in the five countries between the years 1996 and 2006. In Italy, the savings banks score slightly worse than commercial banks in three of the relevant measures. This is all the more intriguing given the fact that these banks have operated as joint-stock corporations since early 1990s and are therefore now indistinguishable

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indices for the old member states (EU-15) and the entire union (EU-27) have been increasing, although at a much slower speed following 2001 until 2005.

[65] Some banks have missing data for certain years while others have shifted their accounting practices during the years 1996-2006. In order to reduce biases resulting from fewer observations, the numbers reported in the figure are weighted according to assets and number of years with observed data. Also, in order to eliminate outliers, bank-year observations within the 1st and 99th percentiles of z-score distribution are removed from sample.

[66] Table 3.7 also provides the outcomes of the difference in means tests. The last column of the table reports the p-values that correspond to the alternative hypothesis that the z-score means for commercial and savings banks differ. The results show that the z-scores for savings and commercial banks differ in Germany and Spain. In particular, Spanish savings banks score more than 50 standard deviations higher in the stability tests. In turn, the German savings banks score an arithmetic average of at least 10 standard deviations lower than their commercial peers in terms of stability. It is possible that the differences highlighted above would be smaller once other factors contributing to volatility were accounted for. There appears to be no distinction between the z-scores of Austrian savings and commercial banks. Additional tests (not reported here) show that the qualitative results remain the same when the variances are also allowed to differ.

from their commercial peers in terms of their legal and regulatory status.[67] In turn, the smaller savings banks in Belgium appear to have aligned themselves with their commercial peers over the years, with no significant differences in any one of the measures considered in the study.

Turning to countries with an active savings bank sector, Austrian savings banks score slightly worse in terms of the cost efficiency, market power and cost-to-income ratios. However, the two types of banks are indistinguishable in terms of the two profitability indicators (RoA and RoE) as well as the stability of earnings. Spanish commercial banks appear to have a small edge in terms of cost efficiency and profitability (only in RoA). However, the earnings of Spanish savings banks are considerably more stable than those of their commercial peers. Lastly, German savings banks score slightly worse in terms of profitability and earnings stability but they are virtually identical to their commercial peers in all other measures.

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[67] See the chapter on Italy for more details on the history of Italian banking.

Table 3.2 Profitability (return on assets): Commercial vs. savings banks (1996-2006), in percentage points

	EU-15	Austria (Com. Banks)	Austria (Savings Banks)	Belgium (Com. Banks)	Belgium (Savings Banks)	Germany (Com. Banks)	Germany (Savings Banks)	Italy (Com. Banks)	Italy (Savings Banks)	Spain (Com. Banks)	Spain (Savings Banks)
1996-1999	0.62	0.79	0.77	0.89	0.84	0.45	0.41	0.96	0.85	1.18	1.06
2000-2003	0.68	0.75	0.72	0.84	0.80	0.40	0.37	0.92	0.88	0.98	0.94
2004-2006	0.79	0.68	0.66	0.72	0.70	0.34	0.30	0.89	0.86	1.02	0.99
1996-2006	**0.69**	**0.64**	**0.68**	**0.83**	**0.85**	**0.41**	**0.37**	**0.93**	**0.87**	**1.03**	**1.00**
Differences in means commercial and savings banks (p-values)		0.321		0.369		0.076		0.032		0.099	

Figure 3.1 Profitability (return on assets): Commercial vs. savings banks (1996-2006), in percentage points

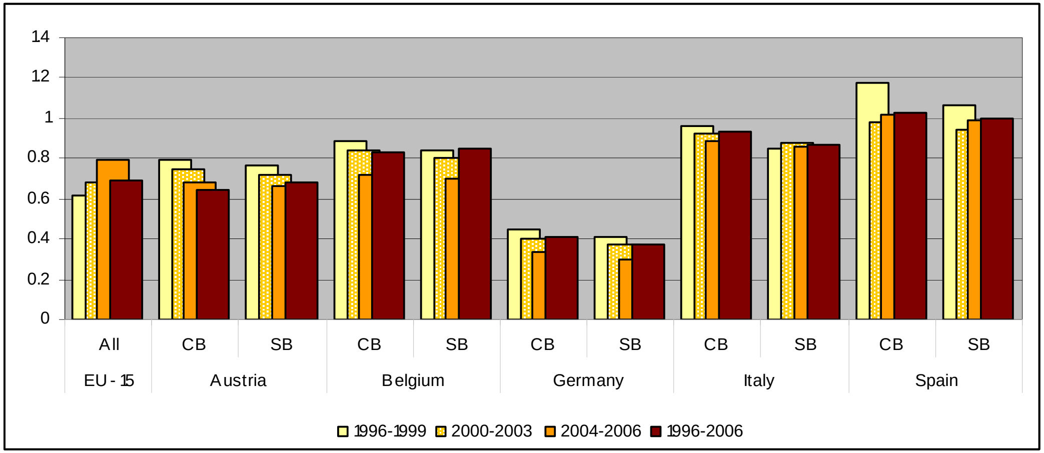


Table 3.3 Profitability (return on equity). Commercial vs. savings banks (1996-2006), in percentage points

	EU-15	Austria (Com. Banks)	Austria (Savings Banks)	Belgium (Com. Banks)	Belgium (Savings Banks)	Germany (Com. Banks)	Germany (Savings Banks)	Italy (Com. Banks)	Italy (Savings Banks)	Spain (Com. Banks)	Spain (Savings Banks)
1996-1999	11.16	13.87	13.33	15.01	14.81	14.86	14.95	14.38	14.16	15.96	15.40
2000-2003	13.73	12.39	12.18	14.38	14.02	13.02	13.58	13.44	13.27	14.38	13.59
2004-2006	14.52	11.61	11.50	13.91	13.63	12.17	12.61	12.75	12.48	13.52	12.88
1996-2006	**13.98**	**12.53**	**12.11**	**14.26**	**14.18**	**13.01**	**13.41**	**13.37**	**13.16**	**14.18**	**13.41**
Differences in means commercial and savings banks (p-values)		0.583		0.444		0.393		0.781		0.256	

Figure 3.2 Profitability (return on equity): Commercial vs. savings banks (1996-2006), in percentage points

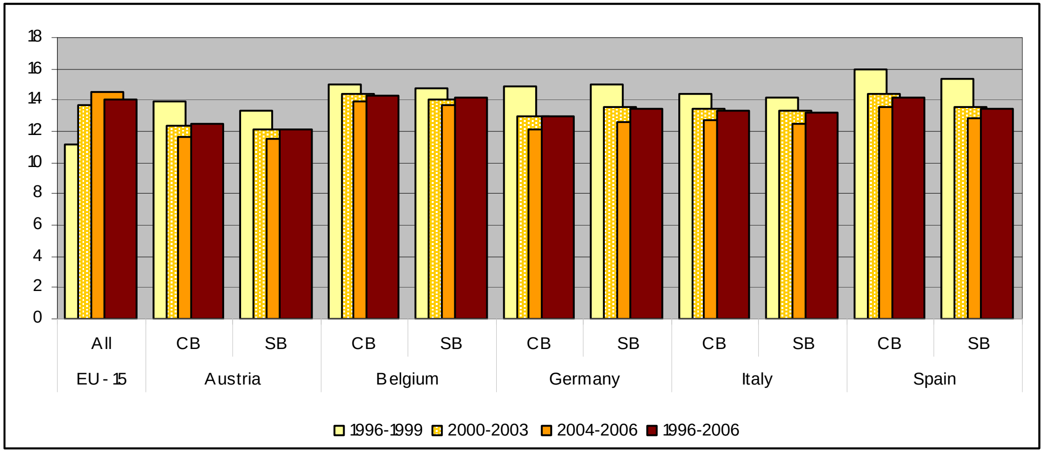


Table 3.4 Cost-to-income ratios: Commercial vs. savings banks (1996-2006), in percentage points

	EU-15	Austria (Com. Banks)	Austria (Savings Banks)	Belgium (Com. Banks)	Belgium (Savings Banks)	Germany (Com. Banks)	Germany (Savings Banks)	Italy (Com. Banks)	Italy (Savings Banks)	Spain (Com. Banks)	Spain (Savings Banks)
1996-1999	66.92	59.36	62.16	59.97	60.16	64.48	65.63	67.39	67.85	58.19	56.36
2000-2003	60.18	54.32	59.03	57.13	59.15	60.19	61.08	60.18	60.32	53.23	54.02
2004-2006	56.20	51.06	54.91	54.93	56.26	56.02	56.53	58.51	58.93	48.27	49.03
1996-2006	**60.97**	**54.33**	**58.42**	**56.27**	**57.63**	**58.11**	**59.25**	**60.02**	**60.34**	**51.06**	**52.70**
Differences in means commercial and savings banks (p-values)		0.063		0.393		0.148		0.627		0.112	

Figure 3.3 Cost-to-income ratios: Commercial vs. savings banks (1996-2006), in percentage points

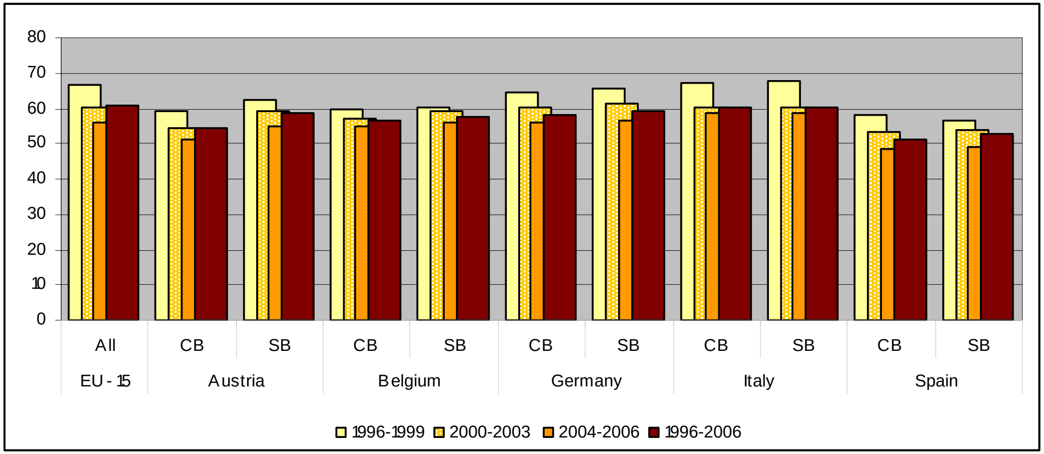


Table 3.5 Cost efficiency (x-efficiency) scores: Commercial vs. savings banks (1996-2006), in percentage points

	EU-15	Austria (Com. Banks)	Austria (Savings Banks)	Belgium (Com. Banks)	Belgium (Savings Banks)	Germany (Com. Banks)	Germany (Savings Banks)	Italy (Com. Banks)	Italy (Savings Banks)	Spain (Com. Banks)	Spain (Savings Banks)
1996-1999	84.1	85.1	82.3	88.2	87.9	83.3	84.4	87.7	84.2	87.8	87.0
2000-2003	85.2	82.3	83.3	86.3	85.8	86.4	85.9	86.6	83.8	88.2	87.4
2004-2006	89.3	83.7	83.1	87.7	86.7	84.3	83.9	85.2	84.1	87.6	87.0
1996-2006	85.7	83.4	82.9	87.5	87.0	85.1	84.6	86.7	84.0	87.9	87.2
Differences in means commercial and savings banks (p-values)		0.089		0.116		0.125		0.042		0.089	

Figure 3.4 Cost efficiency (x-efficiency) scores: Commercial vs. savings banks (1996-2006), in percentage points

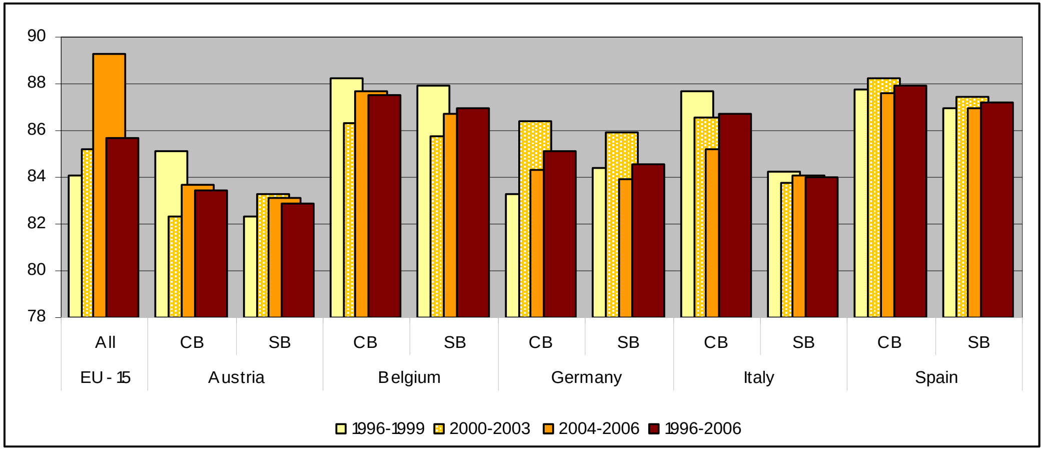


Table 3.6 Market power indicators (Lerner Index): Commercial vs. savings banks (1996-2006), in percentage points

	EU-15	Austria (Com. Banks)	Austria (Savings Banks)	Belgium (Com. Banks)	Belgium (Savings Banks)	Germany (Com. Banks)	Germany (Savings Banks)	Italy (Com. Banks)	Italy (Savings Banks)	Spain (Com. Banks)	Spain (Savings Banks)
1996-1999	29.8	22.2	24.2	31.6	30.3	30.4	32.7	39.3	32.2	27.8	28.9
2000-2003	30.4	24.1	29.5	42.2	43.2	41.7	43.2	47.5	44.6	26.9	27.7
2004-2006	24.1	24.4	24.6	29.7	29.2	31.9	28.8	29.8	36.6	22.4	23.2
1996-2006	27.4	23.2	25.7	33.8	33.1	33.2	33.8	34.6	38.1	25.1	25.5
Differences in means commercial and savings banks (p-values)		0.046		0.126		0.221		0.039		0.229	

Figure 3.5 Market power indicators (Lerner Index): Commercial vs. savings banks (1996-2006), in percentage points

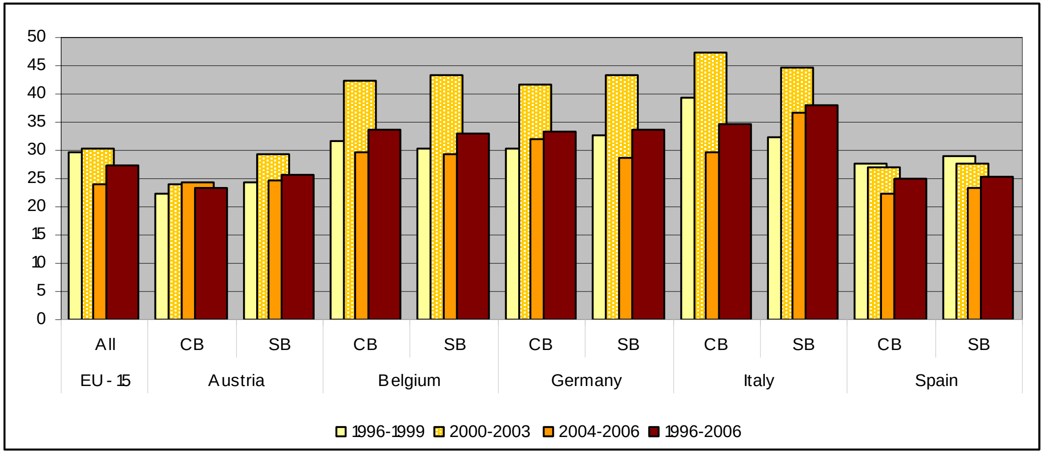
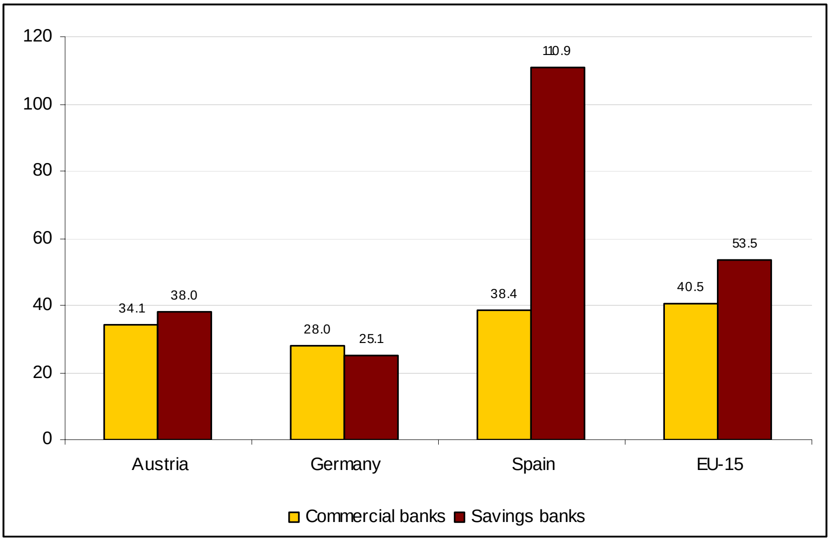


Table 3.7 Comparison of z-scores: Commercial vs. savings banks (1996-2006)

	Commercial banks unweighted avg. (weighted avg.)	**Savings banks unweighted avg. (weighted avg.)**	**Diff. in means test for unweighted avg. (p-value)**
Austria	34.1 (34.1)	37.3 (38.0)	0.113
Germany	33.8 (28.0)	22.3 (25.1)	0.000
Spain	44.8 (38.4)	98.4 (110.9)	0.000

Note: The figures in parentheses are weighted according to assets and number of observation years.

Figure 3.6 Weighted z-score averages: Commercial vs. savings banks (1996-2006)



Note: The numbers in the figure are weighted according to assets and number of years with observed data.

b) Determinants of competition

The determinants of market power in the EU banking industry are shown in Table 3.8, which provides a comparison between different types of banks. As described above, the dependent variable – the Lerner Index – was estimated for each bank using the fixed effects panel data routines. When all banks are included in the estimation, a dummy variable, 'ownership structure', is included to assess whether the market power enjoyed by the savings banks is statistically different from that of commercial banks.

To a large extent, the results are consistent across countries and types of banks. Bank concentration, as measured by the Herfindahl-Hirschmann Index (HHI) for bank deposits, has no impact on market power, with the exception of a weak downward effect for German banks. Similarly, a bank's size (total assets) has no impact on its market power, except for a weak and positive impact in Italy. However, efficiency is found to be negatively and significantly related to market power. In other words, the banks are unable to translate their efficiency gains into market gains and ultimately into prices.[68] Similarly, higher capitalisation is also negatively and significantly related to market power and, in particular in Germany and Spain, showing that adequate risk management also helps improve bank competition in those countries.

More importantly for our purposes, ownership structure does not have a significant influence, except for a weak pro-competitive impact in Germany. Despite this result, differences between savings banks and commercial banks also exist. In particular, the key measure of regional contestability, 'branch opening', reduces market power significantly especially for savings banks in Austria, Belgium, Germany and Spain. Similarly, a sparsely distributed branch structure has a significant negative impact in all countries with an active savings banks industry, i.e. Austria, Germany and Spain.[69] While the entry of foreign players improves competition on average in EU-15 and in Belgium and, to a lesser extent, in Spain, no strong ties are found for the other three countries included in the sample.

Importantly, contestability indicators appear to show that the development of savings banks in the different local and regional territories in the countries analysed has helped to foster competition in those countries to a significant extent.

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[68] One potential explanation is that the efficiency scores act as a proxy for the concomitant competitive pressures, which would have a downward impact on the market power.

[69] Wald tests (not included here) performed on the pair of coefficient estimates for each country show that the impact of branch growth and scarcity is stronger for Austrian, German and Spanish savings banks.

Table 3.8 Determinants of market power in the EU banking industry: All banks vs. savings banks (1996-2006)

Panel data estimations with fixed effects

	EU-15	**Austria (All Banks)**	**Austria (Savings Banks)**	**Belgium (All Banks)**	**Belgium (Savings Banks)**	**Germany (All Banks)**	**Germany (Savings Banks)**	**Italy (All Banks)**	**Italy (Savings Banks)**	**Spain (All Banks)**	**Spain (Savings Banks)**
Concentration, size, efficiency & capitalisation											
Concentration, HHI deposits	-0.0048	-0.0037	-0.0044	0.0221	0.0244	-0.0033*	-0.0016	0.0237	0.0162	-0.0056	-0.0064
	(-0.26)	(-0.19)	(-0.23)	(0.18)	(0.94)	(-1.95)	(-1.42)	(0.24)	(0.21)	(-0.61)	(-0.78)
Size, log(total assets)	0.1947	0.1874	0.0971	0.1714	0.0551	0.0731	0.0897	0.0235*	0.0327	0.0751	0.0704
	(1.38)	(1.11)	(1.34)	(0.99)	(0.37)	(1.13)	(1.05)	(1.99)	(0.88)	(1.14)	(1.00)
Cost efficiency, X-efficiency score	-0.0652**	-0.0725**	-0.0990**	-0.0688*	-0.1977**	-0.0708*	-0.1358**	-0.0392**	-0.0299**	-0.0421*	-0.0921**
	(-3.98)	(-3.21)	(-3.58)	(-2.19)	(-6.11)	(-1.98)	(-4.56)	(-2.98)	(-6.89)	(-1.94)	(-1.94)
Capitalisation, capital & reserves/total liabilities	-0.0964**	-0.0692*	-0.0672**	-0.0058	-0.0011	-0.0633**	-0.0887**	-0.0121	-0.0141	-0.0840**	-0.1660**
	(-6.86)	(-1.91)	(-2.83)	(-0.47)	(-0.35)	(-4.44)	(-7.10)	(-0.53)	(-0.78)	(-4.10)	(-3.28)
Contestability and barriers to entry											
Branch opening, growth in bank branches	-0.0913*	-0.0844	-0.0698**	-0.0624	-0.1406**	-0.0477**	-0.1454**	-0.0211	-0.0302	-0.1195*	-0.1645**
	(-2.14)	(-0.90)	(-3.61)	(-1.07)	(-2.82)	(-2.71)	(-5.25)	(-1.12)	(-0.63)	(-2.25)	(-6.41)
Branch scarcity, inhabitants/branches	0.0147*	0.0057*	0.0044**	0.0071**	0.0014**	0.0296**	0.0850**	0.0081*	0.0091*	0.0218	0.0811**
	(2.16)	(1.96)	(2.82)	(3.71)	(2.74)	(4.04)	(3.01)	(1.94)	(2.12)	(-1.01)	(3.85)
Entry of foreign competitors, number of foreign banks/total banks	-0.0048**	-0.0022	-0.0019	-0.0017**	-0.0060**	-0.0030	-0.0014	-0.0012	-0.0016	-0.0121*	-0.0074*
	(-2.81)	(-1.62)	(-1.41)	(-4.33)	(-3.15)	(-0.19)	(-0.17)	(-1.17)	(-1.02)	(-1.92)	(-1.97)
Other control variables											
Ownership structure, dummy var.for savings banks	0.0667	0.0188	-	-0.0041	-	-0.0317*	-	-0.0111	-	0.0417	-
	(0.34)	(0.12)		(0.45)		(2.14)		(0.!0)		(0.71)	
GDP growth	-0.0008**	-0.0021**	-0.0018**	-0.0018**	-0.0014**	-0.0011**	-0.0010**	-0.0011*	-0.0008*	-0.0016**	-0.0014**
	(-4.22)	(-6.72)	(-5.51)	(-6.63)	(-2.83)	(-3.37)	(-3.75)	(-2.25)	(-2.11)	(-2.92)	(-2.73)
Market size, log (total deposits in the market)	-0.0626**	-0.0970**	-0.0741*	-0.0311**	-0.0414*	-0.0011	-0.0019*	-0.0211**	-0.0492*	-0.0704**	-0.0847**
	(-4.91)	(-2.69)	(-2.11)	(-2.97)	(-2.06)	(-1.01)	(-2.13)	(-3.53)	(-2.34)	(-6.83)	(-3.16)
R^2	0.92	0.89	0.90	0.84	0.88	0.88	0.91	0.81	0.79	0.91	0.93

Notes: *, **: statistically significant at 5% and 1%, respectively; t-statistics in parentheses.

c) Savings banks and regional growth

The last empirical exercise presents evidence on how the presence of savings banks has helped spur a better channelling of financial resources, thereby increasing growth. Table 3.9 summarises the results of the dynamic panel fixed effects regressions on the determinants of economic growth in Austria, Germany and Spain. The standard explanatory factors in growth models are found to be significant and have the expected signs. In particular, level of schooling and capital stock are positively and significantly related to GDP growth. The percentage of urban population, which could be an indicator of development, has no influence on growth. Lagged GDP either is not significant or has weak significance. In turn, inflation has a negative impact on growth. The results are also robust to the inclusion or exclusion of institutional diversity indicators in Table 3.9, columns I and II for each country.[70]

Turning to the banking sector variables, the lending specialisation variable (ratio of private sector loans to GDP) is shown to have a significant positive impact on regional economic growth. Its marginal effect is found to be among the largest in the model, with a coefficient of 0.074 for Germany and 0.069 for Spain. The growth of bank branches, which has been an area where Savings Banks have been particularly active, also enhances growth. In the Spanish case, the impact of for branch growth is found to be particularly strong, with a coefficient estimate of 0.086, followed by Austria (0.069) and Germany (0.032).

The key finding in Table 3.8 relates to the institutional diversity indicator, which is the ratio of savings bank assets to total bank assets.

The results in column II for each country show that markets with greater presence of savings banks also experience significantly greater growth rates. In particular, a 1% increase in the share of savings bank assets leads to 0.04% to 0.07% increase in growth rates in the three countries Austria, Germany and Spain. Additionally, the development of distribution

[70] Sargan's test for over-identifying restrictions does not reject the instruments used in Austria and Spain but points to minor problems in Germany at the 10% significance level. Nevertheless, all the equations pass the overall significance tests, i.e. the F-tests.

channels, which is measured by the number of ATMs per branch, also has a positive impact on regional GDP growth in Germany and Spain[71]

Table 3.9 Banking sector development and regional GDP growth (1996-2005)
Dynamic panel regressions, system estimators

	AUSTRIA		GERMANY		SPAIN	
	I	**II**	**I**	**II**	**I**	**II**
Initial GDP	0.0284 (1.31)	0.0251 (1.17)	0.0325 (1.81)	0.0237* (1.93)	0.0442* (2.16)	0.0484 (1.44)
Level of schooling	0.0584** (5.14)	0.0591** (4.78)	-0.0652 (-0.39)	0.0639** (3.33)	0.0581** (2.83)	0.0455** (3.27)
Capital stock	0.0628** (10.22)	0.0694** (11.58)	0.0977** (8.18)	0.0624** (22.44)	0.0747** (16.52)	0.0648** (4.19)
Percentage of urban population	0.008 (1.06)	0.007 (1.01)	0.03855 (1.33)	0.0329 (0.91)	0.0014 (1.61)	0.016 (0.79)
Inflation	-0.0633** (-3.92)	-0.0685* (-2.32)	-0.0538** (-3.90)	-0.0321** (-4.40)	-0.0495** (-5.24)	-0.0302** (-5.78)
Lending to private sector/GDP	0.0770** (12.83)	0.0796** (7.10)	0.0663** (3.22)	0.0739** (3.49)	0.0744*** (-8.11)	0.0694** (8.22)
Growth of bank branches	0.0804** (6.19)	0.0694** (4.74)	0.0310** (5.21)	0.0326** (4.80)	0.0632** (3.30)	0.0861** (3.91)
Regional institutional diversity (savings banks assets/total bank assets)	-	0.0432** (9.19)	-	0.0552** (8.79)	-	0.0719** (6.27)
Lerner index	0.0118 (0.92)	0.0101 (0.63)	-0.0221 (-0.40)	-0.0822 (-0.25)	0.0451 (0.41)	0.0218 (0.65)
ATMs/branches	-	-	0.0633* (2.10)	0.0504** (2.82)	0.0631** (2.84)	0.04511** (3.82)
Sargan Test (p-value)	0.132	0.148	0.083	0.088	0.117	0.111
F-test (p-value)	0.008	0.009	0.008	0.007	0.011	0.010
Number of observations	560		4570		654	

Notes: *, ** statistically significant at 5% and 1% level, respectively; t-statistics (White heteroskedasticity-robust standard errors) in parentheses.

d) *Determinants of earnings stability of banks*

For the results reported in this section, a close variant of the Bankscope dataset is used. In order to eliminate outliers, bank-year observations

[71] The distribution channels variable was not available for Austria and, therefore, is excluded in the regressions for that country.

corresponding to the 1st and 99th percentiles of z-score distribution are removed from the sample. The results of the regressions that examine the determinants of earnings stability are given in Table 3.10.[72] The odd numbered columns (columns I, III, V, and VII) correspond to ordinary least squares (OLS) regressions, which pool the data into a single sample by not distinguishing between observations corresponding to different time periods or countries. In turn, the even numbered columns (columns II, IV, VI, and VIII) take advantage of these differences and report the results of fixed effects (FE) panel regressions.[73]

The results of the empirical exercise are as follows. The coefficient estimates for the country dummy variables in the first pooled regression (column I) show that the Austrian and German banks have less stable earnings than their Spanish counterparts.[74] Moreover, listed institutions appear to be more stable in Germany and Spain, but less so in Austria. The coefficient estimate for financial openness index is negative and has a high level of significance in almost all regressions, except for the pooled OLS results for Spain (column VII), reinforcing the view that that more open systems could be more risk-prone.[75]

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[72] For each country, two separate procedures are followed to ensure that the results are robust. In the left-side column for each country reports the pooled OLS results. In order to control for the impact of shorter series, dummies that correspond to the number of reported years are also included in these regressions. In the second column, the results of fixed-effect (FE) panel regressions are reported. However, the use of this procedure means that a number of individual-specific time-invariant variables, i.e. the savings banks dummy, listed institutions, etc., are dropped since these effects are absorbed by the fixed intercept estimates.

[73] The panel regression procedures fully take into account of bank-specific effects. It is therefore not possible to include the time-invariant dummy variables *saving bank*, *listed institution* and the two country dummies.

[74] It is not possible to add an additional dummy for Spain due to perfect correlation with the other two country dummies.

[75] The significance of the result on financial openness should be tempered with the fact that the index varies between 2.0 and 2.5 for the country-year observations. In other words, the impact of moving from an open to a less open financial system would have a very modest impact (a drop of 1.5 to 7 standard deviations for the corresponding z-scores) for the countries in the sample.

Table 3.10 Determinants of stability (z-scores): Commercial and savings banks in Austria, Germany and Spain (1996-2006)

	ALL		AUSTRIA		GERMANY		SPAIN	
	I	II	III	IV	V	VI	VII	VIII
Financial openness index	-7.044	-4.189	-13.485	-9.425	-3.190	-4.053	-10.012	11.541
	(0.034)**	(0.000)***	(0.032)**	(0.000)***	(0.071)*	(0.000)***	(0.569)	(0.000)***
Herfindahl-Hirschman Index (HHI)	191.259	288.369	494.855	247.423	-13.886	648.320	335.358	138.789
	(0.152)	(0.000)***	(0.027)**	(0.000)***	(0.936)	(0.000)***	(0.082)*	(0.000)***
Cost-to-income ratio	0.070	0.029	-9.251	-1.254	0.327	0.062	-20.178	-1.037
	(0.879)	(0.71)	(0.005)***	(0.011)**	(0.001)***	(0.442)	(0.002)***	(0.324)
log(Asset)	-0.771	-12.909	1.312	-8.401	-0.333	-15.370	-4.136	-8.528
	(0.189)	(0.000)***	(0.171)	(0.000)***	(0.66)	(0.000)***	(0.015)**	(0.000)***
log(Asset) × Savings bank	6.050	12.488	-1.824	6.885	1.871	12.114	15.190	2.632
	(0.000)***	(0.000)***	(0.141)	(0.000)***	(0.019)**	(0.000)***	(0.001)***	(0.179)
Savings bank	-79.239	..	36.148	..	-33.911	..	-176.583	..
	(0.000)***		(0.027)**		(0.002)***		(0.009)***	
Listed institution	-0.589	..	51.864	..	-19.693	..	15.982	..
	(0.862)		(0.000)***		(0.000)***		(0.011)**	
Austrian bank	-14.528	..	..	..	..	..	..	..
	(0.000)***							
German bank	-14.831	..	..	..	..	..	..	..
	(0.002)***							
Constant	153.159	92.141	52.929	106.542	123.525	110.757	219.708	145.029
	(0.000)***	(0.000)***	(0.004)***	(0.000)***	(0.000)***	(0.000)***	(0.000)***	(0.000)***
Observation dummies	Yes	..	Yes	..	Yes	..	Yes	..
Procedure	OLS	FE	OLS	FE	OLS	FE	OLS	FE
R^2	0.182	0.121	0.199	0.175	0.113	0.146	0.222	0.133
F-statistic	28.48	236.36	18.59	43.32	13.74	228.25	12.27	25.23
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
No. of observations	9800		1188		7560		1052	

Notes: For coefficient estimates, robust p-values are in parentheses. OLS: ordinary least squares pooled regression; FE: fixed-effect panel regression. *, **, and *** refer to statistical significance at 10%, 5%, and 1%, respectively. For FE regressions, only the within R^2 is reported.

A more noteworthy impact, at least in terms of magnitude, is the effect of concentration on stability, as captured by the Herfindahl-Hirschman Index (HHI) variable. With the exception of the OLS results for the pooled sample and for Germany (column V) in particular, the coefficient estimates are highly significant. The impact of a one percent increase in a country's HHI increases the earnings stability by 2 to 6 standard deviations. Thus, banks in more concentrated systems secure steadier earnings streams over time.[76]

The impact of cost-efficiency, as measured by the cost-to-income ratio, is less clear. Consistent results can only be established for Austrian banks (columns III and IV), where efficiency is positively related to stability. This could be a direct effect, in that banks that operate with lower costs may also be able to secure persistent earnings. Cost efficiency may also be a proxy for other variables, such as governance, that could also have a positive impact on bank stability. A comparison of the OLS results with the fixed effects (FE) panel regression results for Germany and Spain (columns V and VII vs. VI and VIII) shows that the impact of efficiency can no longer be identified once bank-specific factors are considered.

The main results of the empirical exercise are obtained by examining the size and ownership parameters. First, bank size, captured by the *log(Asset)* variable, appears to influence stability inversely. In other words, on average larger banks have less stable earnings.[77] The impact of size on stability is particularly striking when individual effects are controlled for by the panel regression procedures. However, the coefficient estimates for the interactive variable [*log(Asset)* × *Savings bank*] show that the negative impact of size on earnings stability does not seem to exist for savings banks. Indeed, in Austria and Germany, the counteracting effects are almost equivalent, meaning that larger savings banks are almost as stable as other savings banks and much more stable than their commercial peers of equal sizes (see Columns II and IV).

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[76] This finding is in line with the findings of Beck et al. (2006), who use a sample of 69 countries over the years 1980-1997 to show that systemic banking crises are less likely in systems with more concentrated systems.

[77] This result is in line with the findings of Beck et al. (2009), who explain the finding by noting that larger institutions may have an added advantage in smoothing out their profits.

In order to test the validity of a broader hypothesis concerning all savings banks, the OLS estimates also include the dummy variable for savings banks. The coefficient estimates for this dummy variable show that German and Spanish savings banks are not more stable in general while the opposite is true for Austrian banks. In Spain, earnings stability increases significantly with asset size, effectively offsetting the negative impact for savings banks.78 Holding all other factors constant, smaller savings banks perform below the country average while larger savings banks have more stable earnings than banks of all sizes. The results are identical but less pronounced in Germany, where the offsetting impact of savings bank size is relatively small.

3.4 Conclusions

These results (summarised in the tables below) confirm that there are no radical differences between savings banks and their commercial peers in terms of profitability, cost-efficiency, market power and earnings stability in the five countries included in the study. Savings banks appear to be slightly less profitable in Austria, Germany, Italy and Spain, but the differences are not consistent and depend on the choice of profitability measure, i.e. RoA, RoE or cost to income. It is worth noting that the only country where a notable difference exists across the three performance measures is Italy, where savings banks operate as joint-stock corporations just like commercial banks. In terms of cost-efficiency, savings banks exhibit a slightly inferior performance in Austria, Italy and Spain.

Savings banks enjoy greater market power in Austria but the opposite is true for Italy; in either case, the differences are relatively small.

The results also highlight two distinguishing aspects of savings banks. First, savings banks fulfil an important role in assisting regional

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[78] In Spain, the largest savings bank, with a logarithm of assets of around 19.2 units, is significantly more stable than all other banks. This can be seen by calculating the cumulative impact of the size variables [(*log(Asset)* and *log(Asset)* × *Savings bank*)] in column VII and the dummy variable, *Savings bank*. Adding these together and holding all else constant, it can be seen that the z-score of the largest savings bank is at least 115 standard deviations (19.2 × 15.2 – 176.6) superior than commercial banks of all sizes. For larger commercial banks the difference is even greater, since stability decreases with asset size for commercial banks (i.e. the coefficient estimate for *log(Asset)* is negative).

economic growth. In the three countries with active savings banks, i.e. Austria, Germany and Spain – regions with a greater presence of savings banks – experience stronger growth rates. Second, in some cases savings banks cope with income volatility better than other banks. Although the statement is true for all Austrian savings banks, in Germany and Spain the larger savings banks are better able to absorb deviations in income.

Taken together, these findings imply that in addition to co-existing with other banks under similar conditions, savings banks have responded to shifts in market developments while fulfilling an integral role for the sustained development and stability of economies.

Table 3.11 Comparison of savings banks to commercial banks

	Performance			Cost efficiency	Market power	Earning stability
	RoA	RoE	Cost-to-income			
Austria	0	0	0	0	+	0
Belgium	0	0	0	0	0	n.a.
Germany	0	0	0	0	0	-
Italy	-	0	0	-	-	n.a.
Spain	0	0	0	0	0	+

Note: n.a. = No data were available for comparison; +/- imply that savings banks scored better/worse (in difference in means test with a p-value < 5%). 0 means that there was no significant difference between the two types of banks.

Table 3.12 Banking sector determinants of market power

	Sector concentration	Cost efficiency	Bank size	Branching
Austria	0	-	0	-
Belgium	0	-	0	-
Germany	-	-	0	-
Italy	0	-	+	-
Spain	0	-	0	-

Note: +/- indicate the sign of the coefficient estimate (statistically different from 0 with a p-value < 5%).

Table 3.13 Banking sector determinants of regional growth

	Diversity	Competition	Branching	ATMs
Austria	+	0	+	n.a.
Germany	+	0	+	+
Spain	+	0	+	+

Note: n.a. = No data were available. +/- indicate the sign of the coefficient estimate (statistically different from 0 with a p-value < 5%).

Table 3.14 Banking sector determinants of earning stability

	Savings bank size	Commercial bank size	Sector concentration	Cost-to-income
Austria	0	-	+	0
Germany	+	-	+	+
Spain	+	-	+	-

Note: n.a. = No data were available for comparison. +/- indicate the sign of the coefficient estimate (statistically different from 0 with a p-value < 5%).

4. COUNTRY ANALYSIS: SPANISH SAVINGS BANKS

4.1 Origins and historical development

The emergence of Spanish savings banks dates to the 19th century in parallel with the main national financial systems in Europe today. They were invariably influenced by some of the previous developments in other countries under liberal regimes where private initiatives fostered the development of modern banking institutions. Since then, they have experienced a significant expansion and have largely contributed to mobilising savings and promoting competition in the Spanish banking sector. They were heavily regulated and dominated by political intervention in the pre- and post-civil war environment, from 1936 to the 1970s. Finally, the process of reforms and economic liberalisation that began in the 1970s led to what Spanish savings banks are nowadays. In particular, with the liberalisation initiatives of the 1970s, Spanish savings banks were converted into modern financial institutions and started to offer their clients a wide range of financial services. They have been, and continue to be, financial institutions with strong local roots, whose mission is extending financial services to large segments of the population and distributing the profits obtained, with the purpose of contributing to the welfare and development of the society as a whole. Thus, they started competing successfully with other banking institutions, until achieving more than 50% of the market share at present.

Spanish savings banks emerged with a clear regional vocation and with the objective of attending to the needs of the families and businesses within their territories. At present (2008), there are 45 savings banks in Spain covering the entire national territory, providing their services to over 96% of the population with branches in their own towns and the other 3.7%

in a more dispersed manner, according to the data provided by the Spanish Savings banks Confederation (CECA).

4.2 Ownership structure, regulation and supervision

The Spanish saving banks are foundations of a private nature that combine their financial activity with a deep social vocation. In particular, they follow the 'French model' where individual savings banks were linked to a 'Mount of Piety' (a literal translation from the Spanish 'Montes de Piedad'). These Mounts of Piety were early modern charitable institutions where advances were made against a kind of collateral in pawn (usually, jewellery or clothes). Consequently, Spanish savings banks would accept low-value and low-volume savings in deposit and, in turn, place these funds in the 'Mounts of Piety' in order to make small loans to the underprivileged classes. Like their counterparts in Scotland and France, Spanish savings banks briefly placed their excess deposits in a publicly-owned institution (Caja General de Consignaciones y Depósitos, 1852-1868). The introduction of this 'business model' was part of a change in government policy that aimed at more involvement in the business of Spanish savings banks and also included the provision of financial aid to the Caja General de Consignaciones y Depósitos, which invested the funds mainly in Spanish government bonds. However, the change in strategy was short lived due to the poor quality of the government bonds in the 19th century. As a consequence, the Spanish savings banks soon turned to using deposits to finance the activities of the 'Mount of Piety'.

By the end of the 19th century, Spanish regulation lacked precision regarding the rules Spanish savings banks had to follow. However, it was precisely this lack of precision that allowed the growth and development of the savings banks. In particular, freedom regarding investment policies resulted in diversification and growth of assets at a greater rate than that of other savings banks elsewhere in Europe. Between 1870 and 1900, the financial strength of the Spanish savings banks increased significantly. During that period, the pawn and emergency loan operations of the Mounts of Piety were unable to absorb all deposits collected at the savings banks. They began making short-term advances and issuing mortgages directly to the public. Initially they issued short-term loans using public and industrial goods in stock as collateral. Diversification continued and around the outbreak of World War I, Spanish savings banks were readily issuing mortgages directly to retail customers. The Mortgage Act of 4 June

1908 contributed to this development as it pioneered exemption from having to pay different forms of taxes on mortgages issued by the Mounts of Piety.

Most savings banks established at an early stage were located in the largest urban centres, and they managed to grow in financial strength through retained surpluses. Between 1900 and 1925 the number of Spanish savings banks tripled to 150 banks, although no major change in regulation or the banks' business portfolio had taken place.

In 1921 the first Spanish banking law was enacted and the Consejo Superior Bancario or CSB (High Banking Council) was established by private commercial banks. The role of the CSB was to coordinate the actions of private commercial banks as their economic power became more important. At the beginning of the Spanish Civil War (1936-1939), private commercial banks dominated the financial markets. They were organised as a cartel that was built around the CSB and were supervised by the Ministry of Employment, Commerce and Industry (and later on by the Ministry of Employment and Welfare).

During the 1920s, the savings banks started to abandon their charitable nature and gradually turned into genuine financial institutions. Growth was limited, however, and it was difficult, and at the same time necessary, to find new business opportunities. Competitive pressure from the private commercial banking sector resulted in a savings banks policy that consisted of expanding the geographic scope of their branch networks and diversifying their business operations.

The Franco regime (1939-1975) reaffirmed the pre-eminence of private commercial banks within the Spanish financial system and introduced regulation that discriminated against the savings banks. Supervision of the savings banks was transferred from the Ministry of Interior to the Bank of Spain.

The first episodes of regulatory change relevant for savings banks were characterised by the intensification of regulatory burden. This affected the overwhelming majority of those new savings banks that were established by local and regional governments between 1939 and 1977. The Franco regime continued a policy that had been developed during the 1920s, called the principle of territoriality. According to this principle, the business of each savings bank was restricted to its home province. This principle remained an informal arrangement until it was formally enacted in law in 1964. At the same time, the increasing asset base of the savings banks prompted the Finance Ministry to start regulating the sources and applications of their funds. As a result, the Finance Ministry directed a growing proportion of the assets of savings banks to finance public expenditures and private banks' short term liabilities. One effect of this regulation was that funds available for the banks' own lending activity were significantly reduced.

The second regulatory change for the savings banks occurred in the early 1960s when attempts were made to ease the regulatory burden on Spanish savings banks (particularly in 1962 and 1964). Nonetheless, until 1974 the savings banks remained outside the Spanish clearing house system and the portfolio of their business activities continued to be restricted. However, under the Fuentes Quintana Reform of 1977, the regulatory regime applicable to private banks and savings banks started to converge, and as a consequence competition became more intense. The reform gave savings banks strong incentives to modernise their infrastructure and develop new competencies and new activities. For example, the Bank of Spain authorised the first automated teller machine for the savings banks in 1977, and by 1996, their combined network comprised 14,169 ATMs, which was the biggest ATM network in Spain and the third largest in the world at that time.

Nowadays, Spanish savings banks are double bottom-line institutions with both financial and social objectives that employ an important part of their profits in the form of 'Obra Social' or social projects. This activity is developed in parallel with their role as financial intermediaries and is intended to tackle the social needs of the population that are not satisfied in other ways, ranging from the integration of the most disadvantaged collectives to cultural activities, from the restoration and conservation of historical and artistic heritage to the conservation of the environment.

As for the ownership structure, there are six distinctive features of Spanish savings banks:

i) According to their legal status, they are private foundations with a heritage showing a markedly social purpose. The current political debate in Spain has left behind some of the main past concerns, in particular those related to their legal status as private enterprises. Although Spanish savings banks do not have any share capital and their equity consists mainly of accumulated reserves generated through retained earnings, since 1988, the Constitutional Tribunal has ratified their private nature and legal status.

ii) They are financial entities with complete freedom of operation.

iii) All their actions and business activities are executed according to market criteria. Thus, they are subject to unrestricted market discipline, and together with their social mission they aspire to the maximisation of their profits, just like any other type of financial institutions and strictly under the same rules that apply to commercial banks.

iv) Although savings banks try to maximise their profits, another distinctive feature is the lack of any private appropriation of these profits. Instead, profits are destined to serve social purposes. In other words, Spanish savings banks seek to maximise their profits and thereby their allocation to what is called 'Obra Social' through their day-to-day business operations. In fact, they compete fiercely between themselves and with other credit institutions for the provisions of financial services.

v) They offer a wide range of products although they remain mainly retail financial institutions specialising in mobilising people's savings and lending to households, family-based firms and other small and medium-sized firms.

vi) They have strong local roots since the majority of clients are from their respective areas of origin. They mainly develop projects in that area and they take most of the decisions at a local level.

As for the supervision of savings banks, they are under the monitoring and supervision of the Bank of Spain like any other depository institution in Spain. However, other legal considerations regarding the composition of their governance bodies are set by the regional government (Autonomous Communities) of the region in which a savings bank is located. There is some public debate and a certain amount of controversy that appears to be the result of the interaction between their ownership structure and their social mission. First of all, the ownership structure of savings banks is such that those exercising control are not legal owners. Different stakeholders, including employees and representatives of depositors, local and regional government bodies, founding entities and community interest groups constitute the governing bodies of the savings banks.

Secondly, Spanish savings banks are required to allocate at least half of their profits to reserves, and to channel the remainder back into the community toward projects that fall under the category of Obra Social.

Since Spanish savings banks are not quoted enterprises, the main 'concern' is that they would not be sufficiently exposed to market discipline exercised by a functioning stock market.

In Spain, as in other countries (i.e. Germany) the substantial representation of the public sector in the governing bodies of savings banks has led to this type of concern in the past. As a response to these concerns, the representation ceiling of the public sector was reduced to 50%, that is, not more than half of the members of the governing bodies should be members or representatives of local governments and political parties. It has been argued, however, that despite this reduction, the public sector remains highly influential in the governing bodies of savings banks and, therefore, this initiative may not have fully dissipated perceptions that there may still be too much political influence.[79] The Spanish savings banks have also responded to these new concerns by internally assuming and fully adopting strict and politically-independent social responsibility initiatives. Among these initiatives, all savings banks (starting with the CECA in 2005) have been progressively issuing very detailed corporate responsibility statements whereby new policies and governance initiatives – both for operating and financial management and for social mandates management – have been described in detail.

4.3 Competitive and other market developments

a) Deregulation and the shift in market shares

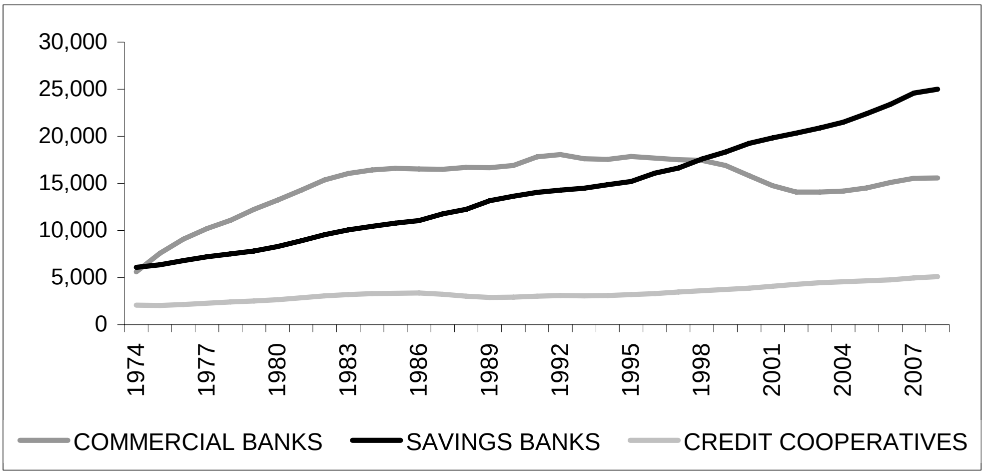
The recent changes in the competitive environment of the Spanish banking system are closely related to the deregulation process that started in 1977 and has since then led to a fundamental transformation of the Spanish banking market. Starting with the Law 2290/77 on the regulation of the governing bodies and activities of savings banks, various regulatory initiatives have permitted Spanish savings banks to fully compete with commercial banks and with each other. These initiatives were followed by other important deregulation measures during the 1980s such as the liberalisation of the interest rates of assets and liabilities and the lifting of territorial branching constraints for savings banks. From 1984 to 2007, the total number of banking institutions decreased from 369 to 275 according to the Statistical Bulletin of the Bank of Spain. As in most other European

[79] There have been recent discussions to further reduce the ceiling.

countries, this reduction is mainly due to consolidation and liberalisation and to the subsequent wave of mergers and acquisitions (M&As). Although all types of financial intermediaries were affected by consolidation, it has been more intense for those that had formerly been subjected to territorial constraints in their activities, as had been the case of savings banks. In 1989 these branching constraints were lifted (Royal Decree 1044/1989). Since then, according to the Statistical Bulletin of the Bank of Spain, the number of savings banks fell from 76 to 54. Similarly, the number of credit cooperatives declined from 149 to 83. The reduction of the number of commercial banks during that period was more limited, falling from 110 to 72.

Although the number of institutions has decreased over the last thirty years, there are significant differences in the branching strategies followed by the three main different banking groups in Spain – commercial banks, savings banks and credit cooperatives. As shown in Figure 4.1, one can distinguish three main stages in the evolution of bank branches within these groups, as outlined below.

Figure 4.1 Number of branches (1974-2008)



Source: Bank of Spain.

1. In a first stage, from 1977 to 1988, savings banks together with commercial banks and credit cooperatives, significantly increased the number of branches by 79.6%, 89.7% and 33.2%, respectively.
2. From 1989 to 1997, the lifting of branching restrictions was followed by differential branching strategies. Despite a consolidation trend, savings

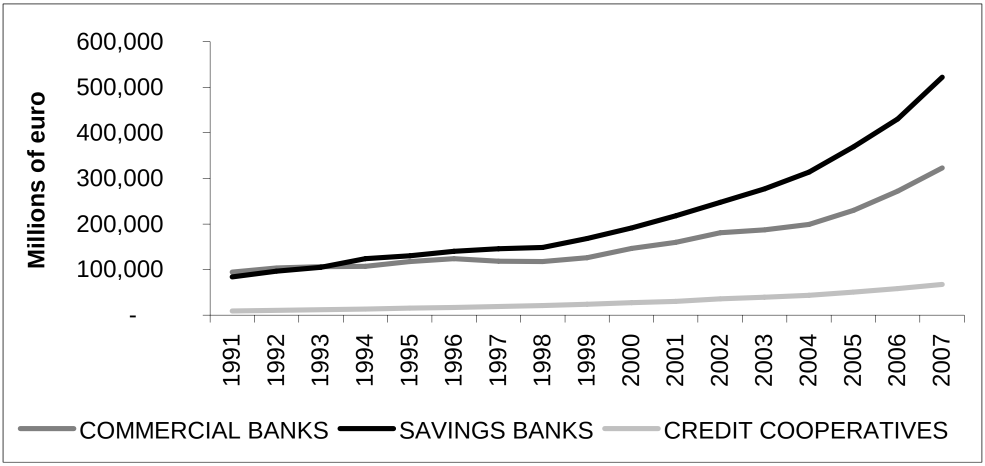
banks and credit cooperatives continued to increase the number of their branches (26% and 20%, respectively), while that of the commercial banks only increased by 5.6%.

3. From 1997 to 2007, savings banks (41.9%) and credit cooperatives (38.6%) have continued opening branches to a significant extent, in contrast with commercial banks, which started to close branches with a total decrease of 13.2% over that period.

The above-mentioned differences have been the seed of what is known today as a distinctive relationship-based banking model of savings banks, a model that is founded on retail specialisation and territorial proximity. Conversely, Spanish commercial banks opted for a model based upon diversification with a mix of retail and investment banking. The combination of these branching strategies with the economic and financial development of recent decades has led to substantial changes in the competitive structure of Spanish banking markets. First of all, as shown in Figure 4.2, deposits from the private sector (households and non-financial firms) have increased significantly, and in particular from 1991 to 2007. Savings banks have played a leading role in this market. In 1991 they managed €84,000 million and in 2007 the stock of deposits was multiplied by more than six reaching €522,000 million. At the same time commercial banks only tripled their deposits (from €94,000 to 322,000 million) while credit cooperatives, although less significant in absolute terms, increased their deposits from €9,000 to €67,000 million.

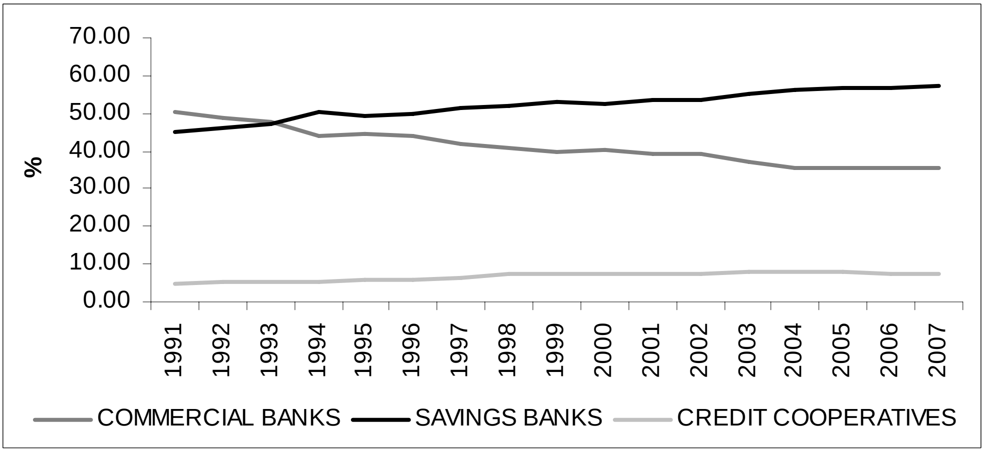
As a consequence of the unequal evolution of deposits for the different types of banks, market shares have considerably changed over time, as shown in Figure 4.3. Savings banks increased their market share from 44.82% in 1991 to 57.21% in 2007, while commercial banks lost market share, falling from 52.31% to 35.29% in the same period. The market share of credit cooperatives also increased from 4.87% to 7.39%. Figure 4.3 also shows that from 1994 onwards, savings banks have dominated the market with more than the 50% of all deposits from the private sector. The consequences of this trend go beyond the mobilisation of savings. Indeed, this trend implies that Spanish savings banks have suffered to a lesser extent from the increasing pressures to which retail banks have been exposed in recent years in Spain and elsewhere since the mid-1990s.

Figure 4.2 Evolution of deposits from the private sector in Spanish banking (1991-2007)



Source: Bank of Spain and own calculations.

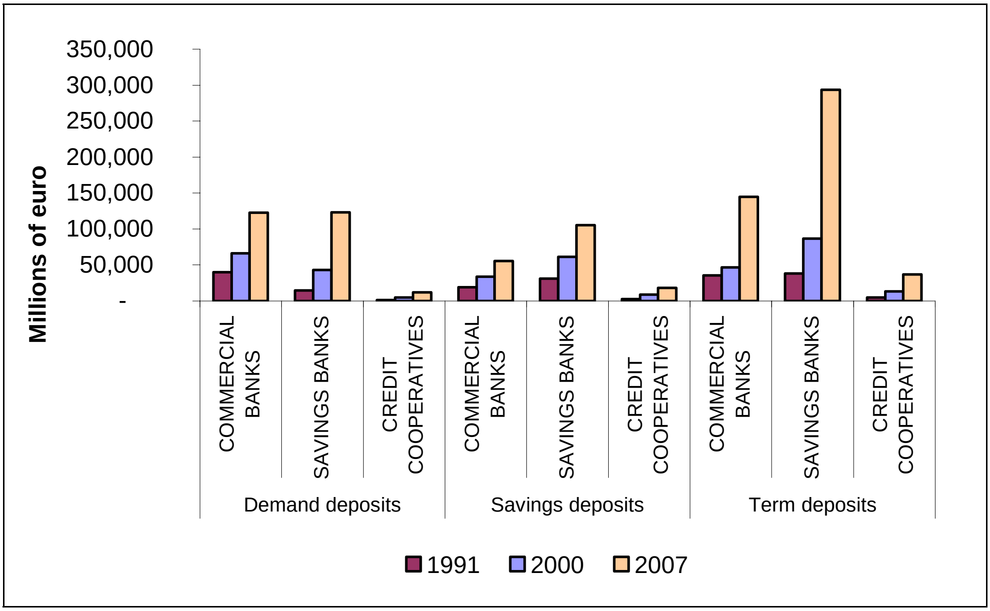
Figure 4.3 Market shares in the Spanish banking sector: deposits (1991-2007)



Source: Bank of Spain and own calculations.

Together with these competitive changes in the market for deposits, there has also been a change in the relative weight of the different types of deposit accounts across the different banking groups. As shown in Figure 4.4, savings banks have increased their market share in all kind of deposit accounts although long-term/savings related deposits (savings and term accounts) have grown more than demand deposits. In the case of commercial banks, demand deposits have grown faster than other deposits, so that the level of demand deposits held by commercial and savings banks in 2007 are largely similar (€122,000 and €123,000 million, respectively). In contrast, there are now considerable differences in the stock of savings accounts (€55,000 million for commercial banks and €105,000 million for savings banks) and term accounts (€144,000 million for commercial banks and €293,000 million for savings banks). These comparisons demonstrate that savings banks have mainly focused on long-term savings which may contribute more to strengthening their customer relationships than short-term deposits would do.

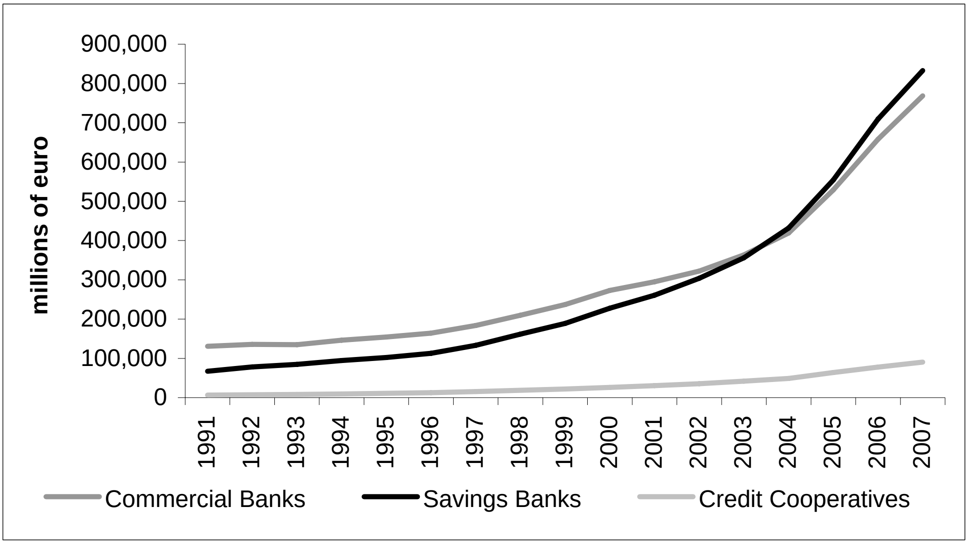
Figure 4.4 Deposits from the private sector in Spanish banking by type of account (1991, 2000, 2007)



Source: Bank of Spain and own calculations.

The Spanish loan market has also experienced a noticeable change in recent years. Although commercial banks traditionally dominated this market, the expansion of savings banks in the market for deposits facilitated their penetration into the loan market based on the long-term relationship banking model mentioned above. As shown in Figure 4.5, the stock of loans granted by savings banks multiplied by twelve during 1991-2007, from €67,647 million to €832,940 million. Commercial banks experienced a growth of only about half of that of the savings banks in the same period (from €131,012 to €762,264 million). The growth of the loan portfolio of the credit cooperatives (€6,319 to €90,759 million) is about the same as that of the savings banks.

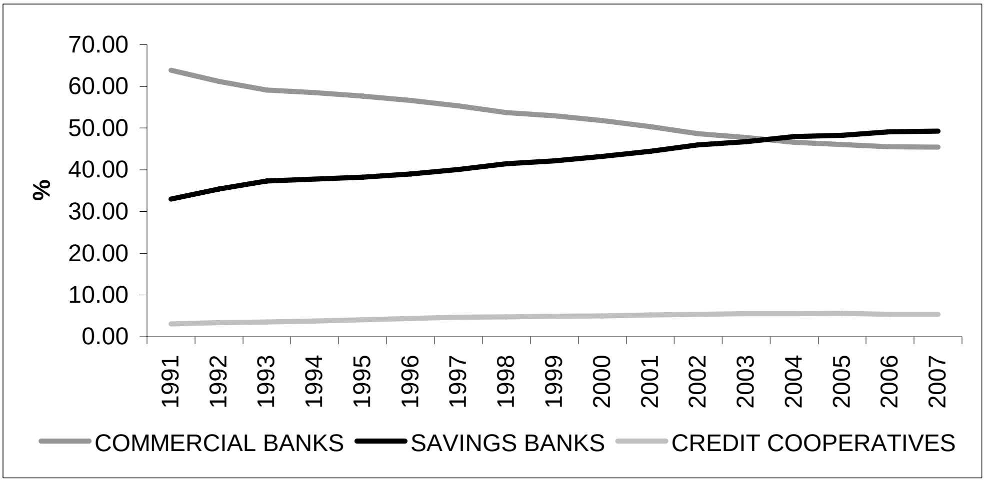
Figure 4.5 Evolution of loans to the private sector in Spanish banking (1991-2007)



Source: Bank of Spain and own elaboration.

The rapid penetration of savings banks into the loan market after deregulation resulted in a major change in the market shares of bank loans to the private sector. Savings banks increased their market share from 33.1% in 1991 to 49.2% in 2007 and since 2003, they have been the leading banking group in the loan market. Cooperative banks have almost doubled their share of the loan market. The flip side of this evolution is the case of commercial banks, whose market shares in loans decreased from 63.9% to 45.4% in the same period. Again, the retail and territorial specialisation of savings banks and their focus on customer-relationships have been the main reasons for their competitive success in Spain over the last 20 years. See Figure 4.6.

Figure 4.6 Market shares in the Spanish banking sector: Loans (1991-2007)



Source: Bank of Spain and own calculations.

b) Competition, margins, efficiency and capitalisation

The changes observed in market shares – with Spanish savings banks becoming the leading institutions in deposits and loan markets – may have affected the degree of competition in these markets. Deregulation and in particular the lifting of branching restrictions have led to increasing competition of local markets with savings banks opening branches in a larger number of territories in which they compete with multi-market commercial banks and other savings banks (Carbó Valverde & Rodríguez, 2007b). As a first indicator, we look at concentration to illustrate what the change in market shares has meant in competitive terms. One widely used concentration measure is the Herfindahl-Hirschman Index[80] (HHI). In 2007, this indicator was 1,328 in Spain. The following thought experiment is instructive: if savings banks were excluded from the market, the HHI for Spain would be 3,440, while if commercial banks were the ones excluded, the indicator would be 798. This simple simulation exercise illustrates the relevance of savings banks in reaching territories where entry was previously banned.

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80 It is defined as the sum of the squared market shares of all competitors in a market, and the values it can take on range from 0 (perfect competition) to 10,000 (monopoly).

Another issue related to the impact of the expansion of savings banks on competition is cooperation among savings banks. In this matter, pro-competitive cooperation should be distinguished from collusive cooperation.[81] Spanish savings banks represent an example of the first case in various ways. They cooperate in gathering certain inputs that require a large-scale operation to be undertaken on efficient technological standards (such as payment settlement systems and the management of foreign operations). Similarly, the Confederation of Spanish Savings Banks (CECA) provides assistance on how to standardise technological processes that result in significant cost savings (such as transfer between deposit accounts across savings banks or direct debit transactions). Another area of intensive cooperation is retail electronic payments and, in particular, card payment networks. As in most developed economies retail payments are organised as networks to fully exploit network externalities from sharing ATMs and point-of-sale devices to allow consumers to enjoy a wider range of possibilities to use their debit and credit cards. Despite this technological cooperation, savings banks fully compete on a commercial basis with each other and with commercial banks.

In order to explore to what extent the increasing role of savings banks may have resulted in changes in prices and costs relative to competitors, Figure 4.7 offers an analysis of interest margins (as a percentage of total assets) of the different groups of banks in Spain from 1991 to 2007. The figure shows that these margins have both converged and declined over time in Spain from values over 1% to values around 0.4%. In any event, the fall in interest margins affects all institutions and it is mainly the result of competitive pressures that are due to the entry of Spain to the European single market and the generalised and sharp decrease in monetary policy interest rates during the second half of the 1990s. Hence, the competitive shift in Spain, with savings banks increasing their market share, have apparently taken place in a more competitive environment, at least as far as loans and deposits markets are concerned.

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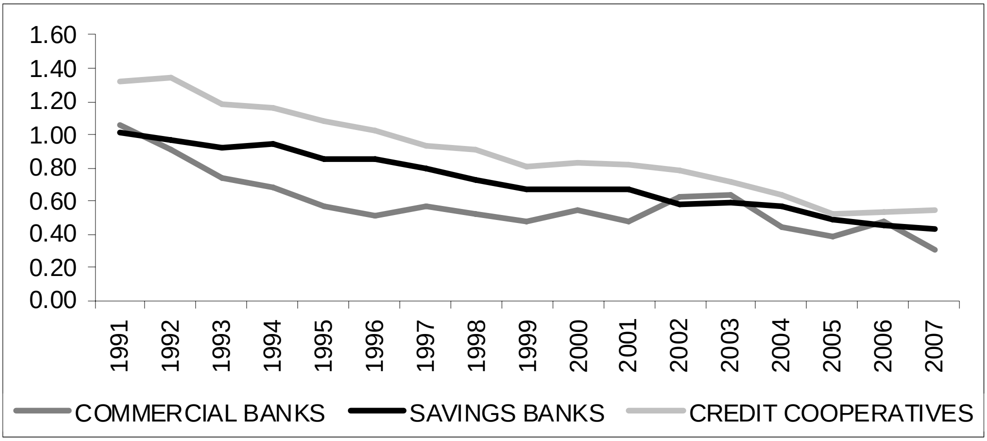
[81] See Laffont (2003) and Bordignon & Brusco (2006).

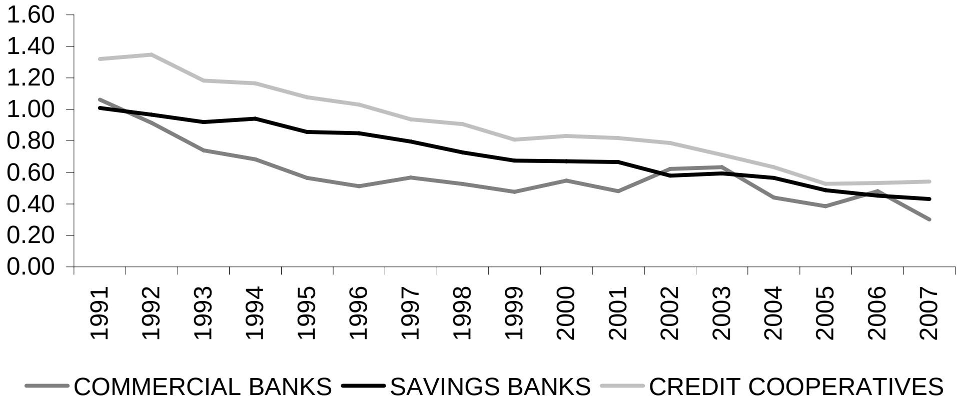
Figure 4.7 Evolution of the net interest margin to total assets in Spanish banking (1991-2007)



Source: Bank of Spain and own calculations.

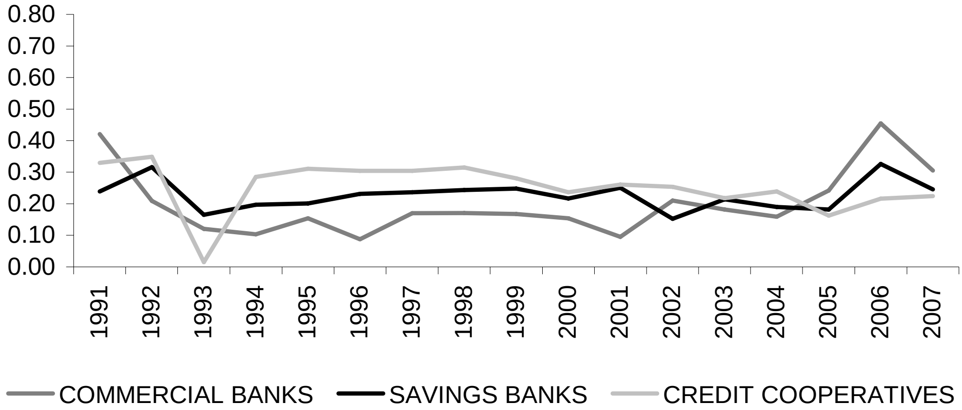
The same downward trend applies to non-interest income which has also declined over time. All commercial, savings and cooperative banks seem to have reduced the relative weight of these sources of income as a proportion of total assets, as shown in Figure 4.8. Similarly, overall profitability – measured by the return on assets (RoA) – has become more similar across the different types of financial institutions and is now on the European standard of around 0.4% (Figure 4.9).

Figure 4.8 Evolution of non-interest income to total assets in Spanish banking (1991-2007)



Source: Bank of Spain and own calculations.

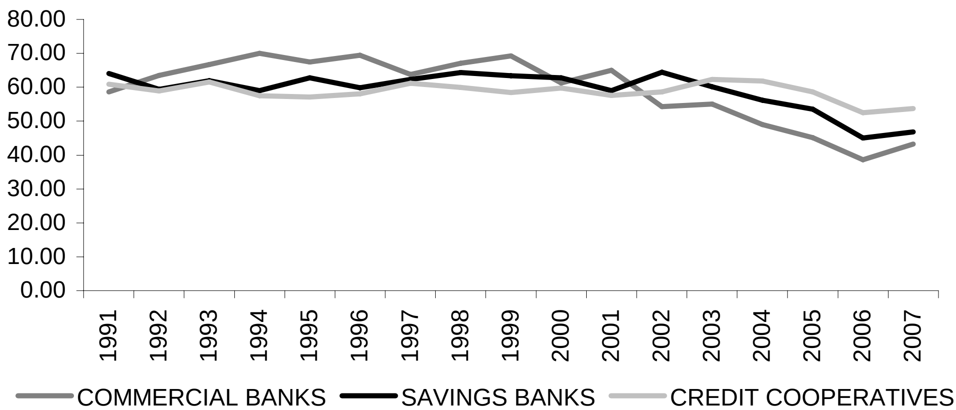
Figure 4.9 Evolution of the return on assets (RoA) in Spanish banking (1991-2007)



Source: Bank of Spain and own calculations.

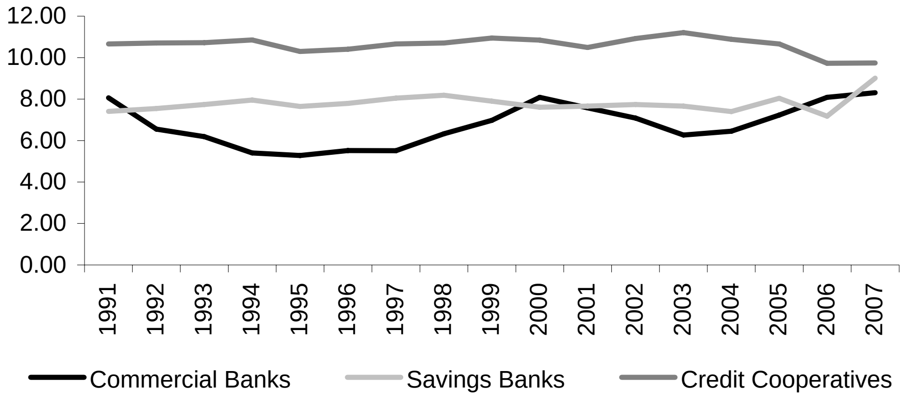
Increasing competition was also accompanied by an improvement in efficiency levels. Figure 4.10 shows that the ratio 'operating costs/gross income' decreased from 58.6% in 1991 to 43.3% in 2007 for commercial banks and from 60.9% to 53.8% for cooperatives. This improvement has been even greater in the case of savings banks changing from 64.0% to 46.80% during the same period.

Figure 4.10 Evolution of the 'cost/income' ratio in Spanish banking (1991-2007)



Source: Bank of Spain and own calculations.

Figure 4.11 Capitalisation ratio ('capital and reserves/total assets') in Spanish banking (1991-2007)



Source: Bank of Spain and own calculations.

As for capitalisation, the evolution of the capital ratio shown in Figure 4.11 suggests that Spanish savings and commercial banks have somehow converged to similar levels of capitalisation even if the composition of these capital resources should necessarily vary since savings banks cannot, by definition, issue stock. However, the evolution of the capitalisation of savings banks contrasts with their hypothetical limited capacity to raise capital beyond reserves. It should be also noted that, to help address these limitations, since 1990 Spanish savings banks can also raise funds through the issuance of so-called equity units (*cuotas participativas*), which are considered part of Tier 1 capital. As financial instruments, *cuotas participativas* are like non-voting preferred shares in some other countries. These equity units may contribute to raising the own funds that savings banks are required under capital regulation to have, and that may be needed to meet the future challenges, particularly as a result of the financial crisis. However, so far the Spanish savings banks have scarcely used this possibility. The negative economic outlook and the quickly deteriorating housing market have also had an impact on Spanish banking institutions. The overall loan quality of credit institutions has weakened considerably as the total non-performing loans more than tripled between September 2007 and 2008.[82] Savings banks scored slightly worse, with non-performing loans representing 3% of total loans by September 2008, compared with an industry average of 2.6%. At the time of the publication of this report, banks in Spain have remained relatively resilient. Despite worsening asset quality, the institutions have been able to absorb the shocks, thanks in part to the counter-cyclical generic provisioning requirements put forth by the Spanish regulator. As deposits in all credit institutions increased, savings banks proved a preferred choice; between September 2007 and December 2008, their deposits from non-banks and households have increased by 14.2% while the same figure was 11.4% for commercial banks.

4.4 Service, access, proximity and financial inclusion

a) Service and access at the regional level

As shown in the previous section, the expansion of savings banks in Spain has an important territorial dimension. The question we ask ourselves is to what extent are regional differences in access to financial services related to savings banks' branching and business expansion during the last two decades.

Tables 4.1A and B show some indicators of the level of bank services and bank penetration in the seventeen Spanish regions. The indicators proxy average savings per person ('deposits/inhabitants'), average debt per person (loans/inhabitants), the demographic reach of banking services ('population/branches'), average branch size ('loans/branches' and 'deposits/branches'), and the relative weight of loans (and deposits) in each region as a percentage of total loans (deposits). The indicators reveal significant regional disparities in banking services across Spanish regions. First of all, the ratio 'loans/inhabitants' is found to be larger in regions such as Madrid (€70,710/inhabitant) and Catalonia (€45,586/inhabitant) and substantially lower in less populated regions such as Extremadura (€19,996/inhabitant). These disparities also apply to the ratio 'deposits/inhabitants' with Madrid (€54,717/inhabitant) and the Basque Country (€30,667/inhabitant) exhibiting the higher ratios and some other large regions such as Andalusia (€13,889/inhabitants) and the Canary

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[82] All data on credit institutions are from *Boletín Estadístico*, Bank of Spain, January 2009.

Islands (€12,337) showing much lower ratios. The regional asymmetries reflect, *inter alia*, demographic and economic differences such as population density and financial wealth. Taking 2007 as a reference, Table 4.2 shows that more than the 60% of all loans and deposits in Spain are concentrated in four out of the seventeen regions (Madrid, Catalonia, Andalusia and Comunidad Valenciana).

It should be noted, however, that the branching expansion of savings banks helps to alleviate regional disparities. Table 4.3 shows that only between 2003 and 2007, the regions with the lower ratios of loans (or deposits) per person have shown larger improvement in the level of service (decrease in the ratio 'population/branches'). During 2003-2007, population per branch has decreased by 355 inhabitants in the Canary Islands and by 208 inhabitants in Andalusia. Considering regional disparities, the outreach of bank business seems to be a critical feature of Spanish banking. Therefore, we study how savings banks (relative to commercial banks and credit cooperatives) are located across Spanish regions. Importantly, the leading role of savings banks in deposits markets is more pronounced in some of the regions that were previously identified as those with higher levels of bank service. In particular, Table 4.2 shows that the market share of deposits of savings banks was 71.93% in Catalonia and higher than 60% in Aragon, Murcia, Castille and Leon and Comunidad Valenciana in 2007. Similarly, Table 4.3 also confirms these differences in market shares in the loan market with savings banks showing a market share of more than 55% in Catalonia and Aragon and progressively increasing their market share in all regions over time.

Table 4.1A Bank business and service indicators across Spanish regions (2003, 2005, 2007)

	2003				2005				2007			
	Loans / Inhabitants (thousands of euro)	Deposits / Inhabitants (thousands of euro)	Loans (% all regions)	Deposits (% all regions)	Loans / Inhabitants (thousands of euro)	Deposits/ Inhabitants (thousands of euro)	Loans (% all regions)	Deposits (% all regions)	Loans / Inhabitants (thousands of euro)	Deposits / Inhabitants (thousands of euro)	Loans (% all regions)	Deposits (% all regions)
Andalusia	12.89	9.03	12.95	10.68	20.50	11.03	13.80	10.48	29.28	13.89	13.89	10.25
Aragon	17.33	16.76	2.79	3.18	25.84	17.45	2.79	2.66	36.27	23.40	2.76	2.77
Asturias	12.89	12.24	1.75	1.96	17.53	14.40	1.59	1.85	24.83	18.85	1.59	1.88
Balearic Islands	19.99	12.56	2.52	1.87	29.71	14.67	2.51	1.75	42.36	18.11	2.52	1.68
Canary Islands	13.40	8.67	3.37	2.57	20.21	9.97	3.40	2.37	28.00	12.34	3.32	2.28
Cantabria	14.37	11.88	1.03	1.00	20.26	14.00	0.97	0.95	27.95	17.70	0.94	0.93
Castille La Mancha	11.34	11.32	2.76	3.24	17.82	12.98	2.91	2.99	27.18	16.79	3.12	3.00
Castille and Leon	14.32	17.06	4.55	6.38	20.55	17.99	4.38	5.41	28.36	22.51	4.26	5.25
Catalonia	21.95	16.14	19.72	17.08	32.38	19.79	19.50	16.83	45.59	24.65	19.35	16.27
Ceuta	8.42	7.26	0.08	0.08	11.95	8.19	0.08	0.07	16.69	10.31	0.08	0.07
Comunidad Valenciana	15.97	11.38	9.66	8.11	25.23	14.94	10.23	8.56	37.13	21.20	10.62	9.43
Extremadura	10.27	10.24	1.41	1.65	14.44	11.47	1.32	1.49	20.00	14.72	1.29	1.48
Galicia	11.45	11.62	3.99	4.77	16.46	12.88	3.84	4.25	23.69	16.60	3.90	4.25
Rioja	19.36	14.37	0.75	0.65	28.23	16.53	0.73	0.60	40.55	22.47	0.74	0.64
Madrid	30.12	27.48	22.78	24.48	44.36	39.26	22.49	28.11	70.71	54.72	25.27	30.42
Melilla	8.56	8.32	0.07	0.08	11.82	8.72	0.07	0.07	16.52	11.48	0.07	0.07
Murcia	13.89	10.26	2.40	2.08	23.22	13.04	2.69	2.13	35.13	17.03	2.86	2.16
Navarra	18.71	19.42	1.42	1.73	26.94	20.28	1.37	1.45	37.83	27.50	1.35	1.53
Basque Country	21.95	21.02	5.90	6.65	29.22	22.90	5.26	5.82	38.53	30.67	4.89	6.05

Source: Bank of Spain and own calculations.

Table 4.1B Bank business and service indicators across Spanish regions (2003, 2005, 2007)

	2003			2005			2007		
	Population/ branches	Loans/ branches (thousands of euro)	Deposits/ branches (thousands of euro)	Population/ branches	Loans/ branches (thousands of euro)	Deposits/ branches (thousands of euro)	Population/ branches	Loans/ branches (thousands of euro)	Deposits/ branches (thousands of euro)
Andalusia	1,361.27	17,552.85	12,297.23	1,267.19	25,980.80	13,972.38	1,153.89	33,788.07	16,026.20
Aragon	767.25	13,298.51	12,862.54	747.50	19,318.92	13,043.16	714.87	25,925.03	16,727.18
Asturias	1,230.74	15,868.25	15,068.42	1,179.51	20,673.88	16,980.23	1,126.46	27,969.68	21,237.99
Balearic Islands	899.43	17,978.01	11,301.07	860.76	25,568.83	12,627.42	806.66	34,170.45	14,610.83
Canary Islands	1,740.05	23,321.51	15,089.23	1,567.82	31,685.31	15,638.66	1,386.00	38,810.08	17,098.38
Cantabria	1,234.98	17,749.46	14,671.29	1,201.04	24,335.51	16,813.77	1,147.66	32,075.79	20,310.13
Castille La Mancha	1,099.12	12,461.99	12,443.51	1,050.71	18,727.99	13,637.94	976.88	26,553.37	16,403.89
Castille and Leon	876.05	12,547.52	14,945.34	853.81	17,545.20	15,362.03	802.49	22,758.64	18,062.65
Catalonia	973.09	21,363.30	15,708.40	928.60	30,071.63	18,382.56	880.50	40,138.78	21,702.17
Ceuta	3,568.30	15,973.18	13,770.93	3,398.38	40,390.21	28,681.24	3,102.87	51,527.70	33,698.30
Comunidad Valenciana	1,143.96	18,271.69	13,023.32	1,064.65	26,857.81	15,909.67	968.74	35,964.80	20,539.66
Extremadura	938.96	9,647.22	9,619.10	929.32	13,414.79	10,662.27	912.15	18,239.13	13,428.15
Galicia	1,161.36	13,295.23	13,492.63	1,140.78	18,775.03	14,690.69	1,103.92	26,148.68	18,324.35
Rioja	710.85	13,758.82	10,211.63	670.41	18,928.96	11,080.41	633.01	25,669.22	14,226.43
Madrid	1,223.41	36,845.38	33,621.77	1,111.19	49,294.43	43,622.89	1,020.93	72,189.67	55,862.83
Melilla	1,211.59	16,830.26	12,426.11	1,128.75	26,209.77	14,720.58	1,033.41	36,302.57	17,599.98
Murcia	883.81	16,537.92	17,159.71	878.65	23,672.64	17,819.94	852.51	68,183.01	33,056.05
Navarra	1,236.92	27,155.91	26,003.03	1,210.26	35,366.15	27,720.04	1,109.56	1,1839.23	8,606.80
Basque Country	1,124.75	19,984.90	16,966.02	1,065.03	28,226.29	19,990.26	998.77	37,526.84	17,979.8

Source: Bank of Spain and own calculations.

Table 4.2 Market share of deposits in the Spanish regional banking sectors (2003, 2005, 2007)

	2003			2005			2007		
	Commercial banks	Savings banks	Credit cooperatives	Commercial banks	Savings banks	Credit cooperatives	Commercial banks	Savings banks	Credit cooperatives
Andalusia	28.16	58.36	13.48	28.77	56.14	15.08	29.89	56.12	13.99
Aragon	21.26	67.21	11.53	19.05	67.17	13.78	19.71	66.58	13.71
Asturias	42.77	47.41	9.81	40.47	49.33	10.20	42.18	47.63	10.19
Balearic Islands	34.32	64.14	1.54	33.83	64.55	1.62	33.86	64.52	1.62
Canary Islands	41.94	52.17	5.90	40.61	51.65	7.74	38.94	53.14	7.92
Cantabria	41.25	58.02	0.73	39.90	59.00	1.10	41.67	56.82	1.51
Castille La Mancha	24.25	60.25	15.50	23.01	60.67	16.32	23.44	60.28	16.27
Castille and Leon	26.29	66.82	6.89	26.17	65.79	8.05	27.91	63.43	8.66
Catalonia	27.24	71.37	1.39	25.26	73.39	1.35	26.71	71.93	1.36
Ceuta	46.36	48.63	5.01	46.14	49.06	4.80	44.55	50.17	5.28
Comunidad Valenciana	31.42	54.50	14.08	28.59	57.41	14.01	25.77	61.97	12.26
Extremadura	32.84	59.76	7.39	32.45	59.09	8.46	32.25	59.61	8.14
Galicia	41.40	57.87	0.73	42.40	56.81	0.79	43.01	56.25	0.74
Rioja	28.41	62.28	9.31	25.77	63.06	11.16	29.31	59.30	11.39
Madrid	67.38	31.94	0.68	71.46	27.88	0.66	69.51	29.85	0.64
Melilla	50.33	45.55	4.12	50.83	44.67	4.50	50.57	45.53	3.89
Murcia	22.72	63.86	13.43	21.86	63.80	14.34	20.80	64.61	14.59
Navarra	18.38	60.46	21.16	19.88	55.09	25.03	22.12	52.90	24.98
Basque Country	29.53	54.76	15.71	29.00	55.08	15.92	30.24	53.44	16.32

Source: Bank of Spain and own calculations.

Table 4.3 Market share of loans in the Spanish regional banking sectors (2003, 2005, 2007)

	2003			2005			2007		
	Commercial banks	Savings banks	Credit cooperatives	Commercial banks	Savings banks	Credit cooperatives	Commercial banks	Savings banks	Credit cooperatives
Andalusia	43.41	46.69	9.90	42.92	47.25	9.83	41.51	49.29	9.20
Aragon	35.08	54.78	10.14	34.83	54.26	10.91	32.83	54.93	12.24
Asturias	52.78	38.83	8.39	50.17	41.16	8.66	45.06	46.06	8.88
Balearic Islands	49.48	49.50	1.02	48.53	50.27	1.21	46.38	52.38	1.24
Canary Islands	56.78	39.45	3.76	53.94	42.53	3.53	50.11	46.20	3.69
Cantabria	45.91	52.95	1.14	42.18	56.22	1.60	38.14	59.58	2.28
Castille La Mancha	32.10	55.74	12.16	32.19	57.26	10.55	29.36	61.40	9.24
Castille and Leon	38.61	53.18	8.22	37.44	54.06	8.50	35.94	55.18	8.88
Catalonia	45.91	53.09	0.99	44.55	54.21	1.24	42.54	56.31	1.15
Ceuta	42.50	52.41	5.09	44.25	51.26	4.49	42.71	53.54	3.74
Comunidad Valenciana	43.48	47.37	9.14	42.38	49.02	8.59	41.50	50.23	8.27
Extremadura	41.89	52.33	5.78	41.60	52.71	5.68	42.07	52.14	5.79
Galicia	53.27	46.22	0.51	51.81	47.67	0.52	46.56	52.98	0.46
Rioja	37.39	54.53	8.08	35.27	56.72	8.02	33.13	57.30	9.57
Madrid	62.11	37.23	0.66	59.60	39.49	0.91	61.03	38.18	0.79
Melilla	55.57	39.25	5.18	59.63	35.90	4.47	57.69	37.84	4.47
Murcia	36.51	53.16	10.33	34.55	53.65	11.81	33.58	54.35	12.07
Navarra	30.71	45.09	24.21	28.74	46.60	24.66	27.50	47.30	25.21
Basque Country	44.60	42.61	12.79	42.06	44.65	13.29	41.20	44.89	13.90

Source: Bank of Spain and own calculations.

b) Financial inclusion: The role of Spanish savings banks

Financial exclusion has become one of the key concerns in the rise of social exclusion in Europe. Several initiatives have been considered to tackle this problem – from both the public and the private sectors. In Spain, the market initiatives dominate and savings banks are leading most of them. In recent years, many Spanish savings banks have explicitly stated their keen interest in reducing financial exclusion in their annual Corporate Social Responsibility Reports by reporting the territorial scope of their financial and social activities, and providing a complete list of their community investment programmes – known as 'Obra Social' – and, in some cases, the estimated impact on employment and/or growth in the territories where they operate. In this context, Spain is probably among the leading countries in tackling financial exclusion via 'private market' means.[83] Leaving specialisation and other generalised business features aside, there are at least five different aspects that should be considered when analysing the active role of savings banks in promoting financial inclusion: i) Obra Social (social mandate); ii) branching and demographic coverage; iii) c) involvement with family and SME businesses; iv) immigration and remittances; v) microfinance. We briefly discuss each of them below.

1. Obra Social

The most explicit social involvement of Spanish savings banks is their mandate to fund community investment programmes (Obra Social). The Obra Social serves to encourage social integration, strengthen economic activity and contribute to conserving the environment. The evolution of these Obra Social from savings banks' surplus is shown in Table 4.4. The €1,692.9 million of allowance for Obra Social assigned to be paid from the profit in 2006 represent 23.8% of the savings banks' net result of last year and it is 2.7 times the amount provided from this source in 1996.

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83 See Carbó Valverde et al. (2005).

Table 4.4 Distribution of savings banks' surplus in Spain (1996-2006)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
For reserves and others	74.25	74.31	73.62	74.26	73.83	73.23	73.22	72.40	71.34	72.91	76.20	82,23	74,45
For Obra Social	25.75	25.69	26.38	25.74	26.17	26.77	26.78	27.60	28.66	27.09	23.80	17,77	25,55
Million of € for Obra Social	620	722	733	867	936	985	1,040	1,10	1,197	1,375	1,693	1.952	1.637
% change	20.3	16.5	7.1	12.2	8.0	5.2	5.6	14.5	0.6	14.9	23.2	15,32	16,13

Source: Spanish Savings Banks Confederation.

As for the composition of the Obra Social (not shown), the main change in the figures for 2006 is that funding for Health Care and Social Care has grown considerably over the past years. At most of the savings banks, there are now more and more short and medium-term plans and projects in these areas, such as specific programme for the health care of the eldest and investments in, and subsidies for, health institutions for other deprived and marginalised groups of people. This area has increased its relative weight in the Obra Social as a whole from 30.4% in 2005 to 32.1% in 2006, reaching a level of €489.2 million. The area that absorbs most of the resources is Culture and Leisure. Funds used for this area have only grown at 7% in 2006, but with a total figure of €609.3 million they still represent almost 40% of total spending for Obra Social in 2006. Other relevant areas within Obra Social include the Historical-Artistic and Natural Heritage Area and the Education and Research Area.

The evolution of the composition of the Obra Social aims at achieving social efficiency by supporting areas that other public or private initiatives do not fully cover. It has typically been focused on low-income groups, the elderly, and less populated areas. A recent study shows that the Obra Social benefits 96% of the Spanish population, with the disadvantaged groups receiving most of the benefits.[84] Spanish citizens, on average, make use of services or public goods provided by savings banks about three times per year. The study concludes that the extensive provision of social and cultural services by the private sector – and specifically by savings

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[84] See PricewaterhouseCoopers (2005), *Valoración del impacto de la obra social*. The study was sponsored by the Confederation of Spanish Savings Banks (CECA).

banks – in Spain cannot be found in any other country. Finally, it suggests that the private provision of public goods through the Obra Social complements the government's provision of such goods very well. Moreover, as Spain's per capita income has increased, Obras Sociales have constantly adjusted the menu of services they provide.

Some figures illustrate the economic impact of Obra Social. As for the impact on GDP, the Obra Social of the savings banks contributed €1,082 million to the national wealth, which is almost one euro for each euro invested. As a result of this active participation in many sectors of the Spanish economy, the Obra Social generated 34,816 jobs in 2006 alone. This figure includes the indirect employment hired, the induced employment and direct employment from the savings banks' Obra Social. The Obra Social generates more jobs than the average of the productive sectors of the economy, with two fundamental characteristics: the great variety of activities in which it generates employment (construction, health, NGOs or services companies, among others) and the higher quality of the employment in terms of qualifications, stability and salary.

2. *Branching and demographic coverage*

The general trend related to the branching expansion of savings banks across the Spanish regions has already been shown in section 4.1. However, there are some other facts related to savings banks' branch network with further implications for financial inclusion. First of all, the increase in branches registered over the last years has made a great contribution to increasing the savings banks' presence in different regions to their traditional areas of action, without at the same time reducing their proximity to their original customers and their regions of origin. 20% of the new branches opened from 2005 to 2007 have been opened in the regions of origin. In 2007, 63% of the savings bank branches were located in their regions of origin and an additional 10% in neighbouring regions, which means that they remain largely locally rooted.

As regards the territorial distribution, together with the profitability criteria, one of the aspects to take into account is the possibility of reaching the highest number of inhabitants. This is why just over a third of the branches opened between 2005 and 2007 have been opened in small and medium-sized towns. These towns currently have more than 11,200 savings bank branches, which is almost half of the total. The continuing increase in the number of branches over the years means that the percentage of the

Spanish population covered or attended by savings bank branches remains at 97.3%, with 4,185 towns having at least one saving bank branch.

The percentages for population coverage have remained high, whether the analysis is carried according to the size of the towns or according to geographical criteria. In the first case, there is total coverage for all towns with more than ten thousand inhabitants; around 93% for towns between one thousand and ten thousand inhabitants; and over 40% for those with less than 1,000 inhabitants. According to geographical criteria, despite the dispersion of the population in some regions of Spain, in 34 provinces (two more than the previous year) the savings bank branches are situated in such a way that they cover over 95% of the population.

3. *Involvement with family and SME businesses*

Despite the specialisation of Spanish savings banks in retail business, savings banks go one step further in their involvement with the segment of family business and SMEs through direct shareholdings. The direct investment in non-financial companies is very close to €20,000 million for the sector as a whole in 2007. The profile of companies that receive these funds with a high level of involvement is very diverse, and it reaches practically all sectors of activity through direct investments in more than 2,000 businesses. The vast majority of these are unlisted companies including start-ups, and a high percentage of them have a capital stock of less than one million euros.

Based on information for 2007, the standard loan to SMEs supplied by savings banks in Spain has an average value of €100,000, with an average nominal (typically floating) interest rate of around 5% and a time horizon of 5-10 years. It should be noted, however, that many savings banks offer a 'subsidised' loan (in collaboration with the Official Credit Institute, ICO, a public institution providing credit to firms with special needs of – and difficult access to – external funding) for SMEs with less than 250 employees and an annual turnover of less than €50 million. There is evidence, however, that the credit to SMEs has taken a heavier blow as a result of the financial crisis that started in mid-2007.[85]

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[85]According to the January 2009 *Economic Bulletin* of the Banca d'Espagne, credit lines are found to be "less buoyant" (p. 63) and the margin between the interest

4. Immigration and remittances

Remittances represent one of the latest instruments used by the Spanish savings banks to combat financial exclusion. Remittances services for immigrants have become an important financial service since immigrants represent a market in full expansion with more than four million citizens from other countries registered in Spain at the end of 2007. Practically all savings banks in Spain offer remittances services for immigrants, whether through the sector initiative, the CECA platform, or individually. Although similar services exist in other financial institutions, the Spanish savings banks remittances services show clearly differentiated objectives. The main distinctive feature that has inspired the remittance sector platform has been the intention to ensure that the resources sent to the immigrants' countries of origin enter the circuit of the formal economy. This is why the operations are carried out with financial institutions, with which the savings banks and CECA have signed collaboration agreements.

5. Microfinance

Microloans are one of the main instruments to combat financial exclusion. Since 1999, Spanish savings banks have been adapting this tool to the specific needs of Spanish society. Different formulas have been chosen to set up their microloan initiatives. However, they all contain the fundamental characteristic that is the social focus conferred to the microloans, predetermined by the presence of an outstanding institution in the savings banks, the Obra Social, which finances or backs the granting of the loans, depending on the case. The definition commonly accepted by the savings banks maintains that a social microloan is a loan of a small variable amount, which is granted for self-employment or economic activities to people at risk of exclusion or with no access to the traditional financial system and to people who do not have guarantees with which they could back their loan requests.

Another feature of the social microloan schemes set up by savings banks is that they place great value on feasibility studies covering the operations that are to be financed. This practice has the consequences of low default rates on the microloan portfolios and high success rates of the

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rate on new loans and interbank rates are widening for "smaller amounts, which are more frequent[ly used] among SMEs" (p. 68).

activities or projects of the borrowers that are financed. This socially compatible way of financing leads to a high level of respect for these schemes and great confidence in them.

Over the period 2001-2006, Spanish savings banks have granted a total of 9,033 social microloans, to a sum of more than €97.2 million. This figure includes the microloans granted by the savings banks in collaboration with the lines of the Official Credit Institute (ICO) that represent around €10 million.

One of the fundamental characteristics of the microloans is the flexibility in paying off the loans. Almost all savings banks offer the possibility of a grace period for loan repayment and other credit terms that are tailored to the situation of the borrowers and therefore lead to a high level of success in the business initiatives. The user profile for the typical microloan client of the savings banks is, and has already been for quite some time, a 35-year-old immigrant woman, with a clear idea of an SME who requests a loan of around €10,000 to set up a business, mainly in the services sector. Moreover, around 60-80% of the people who request microloans from savings banks are foreigners, and people who have immigrated to Spain for economic reasons. According to the CECA Social Responsibility Report for 2006, microloans from the Spanish savings banks have created around 13,000 direct jobs to date. The average interest rate is 4.5%, with rates varying from almost zero to a maximum of 7%.

In 2006, CECA announced the launch of the Spanish Micro-financing network, an initiative of the savings bank sector to promote the extension of the microloan in Spain and to spread its key role in combating social and financial exclusion. Apart from its informative work, the network also aims to set up programmes for preparation and improvement of the management of microloan schemes, particularly aimed at NGOs and social institutions.

4.5 Conclusions

This chapter has surveyed the main distinctive, competitive and social features of Spanish savings banks. In order to summarise these features, six main conclusions can be drawn from the analysis:

i) Following the financial liberalisation processes in Spain during the 1980s, Spanish savings banks were permitted to operate just like any other financial institution and started to offer their clients a complete range of financial services. They already were, and continue to be, financial institutions with strong local roots, whose mission is extending financial services to large segments of the population and distributing the profits obtained in the way of supporting social activities.

ii) The liberalisation trend, their branching expansion and their relationship-based banking model led them to fiercely and successfully compete with other banking entities, until reaching market shares of more than 50% at the present time.

iii) The current political debate in Spain has left behind some of the main past concerns and in particular those related to their legal status as private enterprises. Spanish savings banks are private foundations with a heritage showing a markedly social purpose.

iv) At present, there are forty-five savings banks in Spain covering the entire national territory. They provide their services to 96.3% of the Spanish territory, thanks to wide branch coverage.

v) Spanish savings banks are leading the main initiatives towards combating financial exclusion in Spain. These initiatives include not just their retail specialisation and their investment in Obra Social. They also cover many other relevant areas such as the location of branches in deprived and less populated areas, the development of specific products for family business and SMEs, remittances platforms and microfinance services.

5. COUNTRY ANALYSIS: GERMAN SAVINGS BANKS

5.1 Origins and historical development

The first savings bank in Germany was founded by philanthropically-minded citizens in Hamburg in 1771 in the form of a private foundation. Its main purpose was to further the savings habits of low-earning workers like sailors and housemaids. A limited number of other groups of citizens adopted this model in ensuing years. Public savings banks appeared in 1801 with the creation of a municipal savings bank in Göttingen, and soon this became the dominant form of savings banks all over Germany.

Until the late 1920s, the savings banks were an integral part of the administration of the respective city or county; then, in the aftermath of the banking crisis of 1929, they became independent institutions governed by savings banks laws issued by the respective federal state in which the banks were located.[86] As a consequence of this reform and of the first German Banking Act of 1934, savings banks obtained the right to operate in almost any respect like all other German banks, provided the relevant savings bank law did not impose any specific restriction, and were subject to all the rules that apply to any credit institution in Germany. Thus, for almost eighty years, they have been universal banks by law and in practice.

In spite of this, the business of all savings banks is local and retail-oriented. They play an important role in the collection of deposits, payment transfers and lending to private households, small and medium-sized firms and municipal authorities. According to tradition, statutes and laws, they operate under a regional principle, which implies that as far as their

[86] See chapter 2.

lending operations are concerned they are predominantly to serve clients who live and work in the area covered by the respective municipality.

Until 2005, the savings banks and the 'Landesbanken' (see below) enjoyed certain privileges. Most importantly, they benefited from public guarantees. In the course of the 1990s, private banks raised complaints with the EU Commission that these guarantees created an unfair competitive advantage, especially in the capital market operations of the Landesbanken, and this finally led to a phasing out of the guarantees.

In 2008, there were 438 savings banks in Germany, with a trend of reducing the number through mergers among savings banks. In parallel, the average savings bank size has increased considerably over the past 20 years. Table 5.1 provides the relevant data.

Table 5.1 Number and average sizes of savings banks in Germany, 2002-08

Year	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Number of savings banks	519	489	477	463	457	446	438
Branches	15.628	14.757	14.292	13.950	13.756	13.624	13.756
Avg. total assets/SB	1.88	2.01	2.07	2.15	2.20	2.29	2.22

Source: German Savings Bank Association (DSGV). Average assets per savings bank are in billions of euro.

Three features of the German savings banks are particularly noteworthy.

One is that they are the most successful banking group in Germany on several counts. Relevant data are presented in section 3, below. However, it is important to properly understand the meaning of the word 'group'. As it is used here and in the following text as well as by the savings banks themselves, the term group refers to specific types of bank and also to classifications used by the German central bank in its official statistics. Therefore, it does not have the connotation of a group of institutions under common management and related through equity ties, as this term is used in corporate law and competition law.

The second feature is that they form an integral part of a network, the so-called 'Sparkassen-Finanzgruppe' (or S-Group). Besides the local or primary savings banks, the most important other financial institutions in the Sparkassen-Finanzgruppe are the Landesbanken or regional banks. The

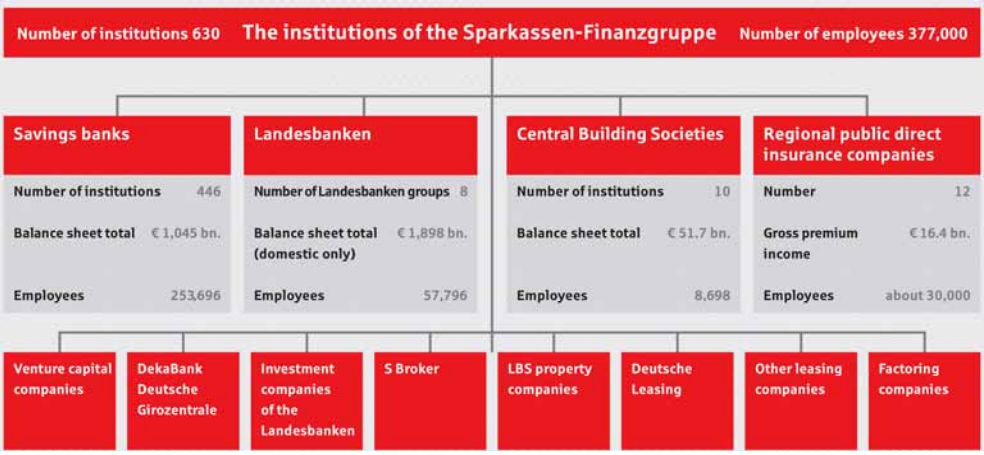
Landesbanken, all of which had formerly also been public law institutions and most of which are now still publicly owned institutions, emerged as important financial institutions in their own right only after the Second World War. Initially, they had mainly served as clearing houses for the savings banks in their respective regions, and at the same time they were the 'house bank' of the respective state. Later on they adopted the additional roles of providing those services to the local savings banks and their clients that would be too difficult to offer to the individual savings banks, due to their size. Now many of them are large banks operating at the national, European and in some cases even international levels.

In terms of total assets, it might be said that the entire group of local savings banks and that of the Landesbanken are equally large. The aggregated balance sheet volume of the local savings banks was €1,045 billion at the end of 2007, and that of all 11 Landesbanken, which existed at that point in time, amounted to €1,587 billion. However, in terms of total staff and branches, the savings banks are much larger than the Landesbanken. Since the beginning of 2008, the number of independent Landesbanken has declined to 8 through mergers and acquisitions. The S-Group also includes a number of specialised financial service providers as well as several training institutes and other financial service firms. In addition to their close affiliation with the Landesbanken, the savings banks are related through a network of associations at state and federal levels. All in all, the number of people employed in the S-Group was 377,431 at the end of 2007. Out of these, some 250,000 were employed by the savings banks, some 50,000 by the Landesbanken, and the rest by the other institutions belonging to the network.

Figure 5.1 provides an overview of the institutions that make up the entire 'Sparkassen-Finanzgruppe'. The graph represents organisational links but does not show the hierarchy or the equity-holding relationships.

The third noteworthy feature of the Savings Banks Group is that it has for many years been the largest group in the German banking system. The main competitors of the local savings banks are the group of private commercial banks with the two subgroups of 'large banks' and others, called regional banks in the terminology of the official statistics provided by the Deutsche Bundesbank, and the Cooperative Banking Group, which comprises local or primary cooperative banks and two large regional/national banks. Table 5.2 shows the sizes of these three banking groups (in terms of total assets) at various points in time.

Figure 5.1 The Savings Banks Group



Source: DSGV, Markets 2008 (data 2007).

Note that there has been a consolidation process among the Landesbanken since 2007. In 2008, the number has decreased to 7.

Table 5.2 Size distribution of the three most important banking groups in Germany (in €bn and in percentages of total bank assets of all German banks, as of year-end 2007)

Year	S-Finance-Group		Commercial Banks		Cooperative Bank Group	
1999	1971.01	35.72	1421.71	25.77	728.87	13.21
2000	2106.06	35.34	1617.85	27.15	742.59	12.46
2001	2205.07	34.92	1802.02	28.54	756.83	11.98
2002	**2267.19**	**35.60**	**1785.10**	**28.03**	**744.70**	**11.69**
2003	2324.18	35.95	1825.41	28.24	748.22	11.57
2004	2362.64	35.80	1862.31	28.22	761.48	11.54
2005	2341.52	34.04	1958.02	28.46	798.33	11.61
2006	2419.45	34.11	2021.40	28.50	829.30	11.69
2007	2521.89	33.94	2187.08	29.44	869.26	11.70

Source: Bundesbank, Monthly reports, various issues. Note that percentages do not add up to 100, since not all banks belong to one of these three groups.

For a first general characterisation of German savings banks it is helpful to place them in the broader context of the German financial system. In spite of certain recent changes, the German financial system is still largely bank-based.[87] This fact shows how important it is that the Savings Bank Group is the largest one among the three banking groups. Traditionally and even only a few years ago, the relationships between most banks and their business clients in Germany were close and largely conformed to the so-called house bank principle.[88] This is much less so today in the case of some large private commercial banks, which have in recent years reoriented themselves to become more capital market-focussed. In contrast, savings banks still see themselves as the house banks of their enterprise clients, most of which belong to the large number of small and medium-sized firms that are the backbone of the German economy called the 'Mittelstand'.

Finally, due to their legal and ownership status, the savings banks are still governed by a broader objective function than being merely profit or shareholder-value oriented. Not too long ago, most banks, including the large private commercial banks, de facto shared this orientation to a large extent too.[89] But for about ten years, these other banks have become much more profit-driven.[90] Now the savings banks and the cooperative banks are the only banking groups in Germany with a clear 'dual-bottom line orientation'. Thus, generally speaking, the savings banks maintained some of those features that had formerly characterised the entire German banking system, and this makes them appear as institutions that preserve

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[87] For a comprehensive survey see Krahnen & Schmidt (2004), especially chapter 2, and most recently Sachverständigenrat (2008).

[88] For an account of the role of banks and bank-client relationships in the time before the First World War, see Hilferding (1910), and for recent empirical evidence pertaining to the 1990s, see Elsas & Krahnen (1998; 2004).

[89] It seems that not too long ago, most large banks in Germany, as well as the people leading these banks, were more concerned with their role and importance in the German economy than with profits and share prices. This business attitude had historical and economic reasons, many of which can be traced back to the early years of German industrialisation at the end of the 19th century. For a historical perspective of the role of banks and the relationship between banks and society, see Abelshauser (2003) and for a political science analysis of the specific German 'variety of capitalism' see Hall & Soskice (2001).

[90] A number of factors seem to have induced this change, most notably the stock market boom towards the end of the last century and a generation change among top managers in large firms and banks.

old, well-proven and likable features that are generally perceived as having contributed greatly to Germany's economic recovery after the Second World War. At the same time, it makes them appear conservative in a clearly positive sense, and this may be the reason why they enjoy great political support on all sides of the political spectrum.

For a general characterisation of the German savings banks, it is equally important to compare them to the savings banks of other European countries. In the Nordic countries and in Austria, the savings bank groups are far more concentrated than in Germany; in Spain, the savings banks have for a very long time been private organisations governed by private law. In Italy, most savings banks have more or less fully converted to becoming private banks and in a number of cases they have been absorbed into large private banking establishments like INTESA and UNI-Credit. In the UK, they have disappeared as a specific type of bank, and in France, they have been converted into the fourth pillar of the cooperative banking group.

Thus, in contrast to those of other countries, the German savings banks have largely remained the same in terms of their organisational and legal structure and status and maintained most of those features which the savings banks of other countries once shared. At the same time, in terms of their institutional features and their business orientation, they changed less than most other elements of the German financial system. There are several factors that explain this characteristic of the German savings banks, which one may, depending on political preferences, either call stability or resistance to change. One factor is that German savings banks experienced less political pressure to undergo far-reaching transformation as happened in other countries. However, not only was the political pressure weaker in Germany than elsewhere, but also the economic pressure to change was less for savings banks in Germany since, in stark contrast to the situation in France or Italy for example, the economic performance of the German savings banks was good for many years and indeed even better than all other banking groups. This may be a reason for the limited political pressure from inside Germany. That German savings banks performed so well can in turn be explained by two factors. One is that German savings banks were put at a very early stage on the same regulatory basis as all other banks. The other factor may be their organisational and institutional structure,[91] which we now address.

5.2 Ownership structure, regulation and supervision

The Savings Bank Group consists of a three-layer structure of financial institutions which comprises the local savings banks, the Landesbanken and Deka Bank, a bank that operates on the national level and serves mainly as the provider of investment products for the Savings Bank Group, and a parallel structure of associations consisting of a set of regional savings banks associations and, at the top, the German Savings Bank Association (Deutscher Sparkassen- und Giroverband – DSGV).

Almost all savings banks are still municipal savings banks – despite numerous efforts to change this and to privatise them, as discussed in chapter 2 above. As to their legal form, they are public law institutions (Anstalten des öffentlichen Rechts). This implies that they have no owner in the legal sense. The municipality or, as the case may be, several municipalities, which may be cities or counties, are the public bodies that bear the responsibility for 'their' savings bank. The German term for this status is 'Träger', which can be translated as 'supporting or responsible institution'. As such, they have certain rights to influence the operations of the savings banks and are in a political sense responsible for them. Even though in economic terms their role has some similarity to that of the owner of a private corporation, the ownership rights of the 'responsible institutions' of a savings bank are more restricted. For instance, a municipality does not have the right to sell its savings bank, as a recent controversial case in North-East Germany concerning the Sparkasse Stralsund made clear, and its right to take out profits or other surpluses are extremely weak; a feature that can easily be explained by reference to the reliance on self-financing.

Until recently, public savings banks enjoyed a dual and quite comprehensive public or state guarantee. Firstly, all deposits were guaranteed by the state in which a savings bank was located. The German term for this guarantee is 'Gewährträgerhaftung', which could be

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[91] These different causes of the stability and the good performance of German savings banks, and their organisational features tend to interact and mutually reinforce each other, see Hall & Soskice (2001) and Hackethal & Schmidt (2000).

translated as 'sponsor's guarantee'. However, in fact this state guarantee was never invoked after the Second World War. If a German savings bank is in difficulties, it is likely to be merged with another savings bank in the same region, and if this is not possible, the S-group's own guarantee system comes into play, thus avoiding the need to invoke the public guarantee.

The second type of public or state guarantee was the so-called 'maintenance obligation' (Anstaltslast). This concept, which has in fact never become relevant in the past 60 years, refers to the obligation of the responsible municipalities to create the conditions under which their savings banks can operate.

These two kinds of guarantee were abolished or at least watered down almost completely in 2005 after a consensus between the EU Commission and the German Federal Government had been reached in 2001, and they will be completely phased out in a precisely defined time frame.

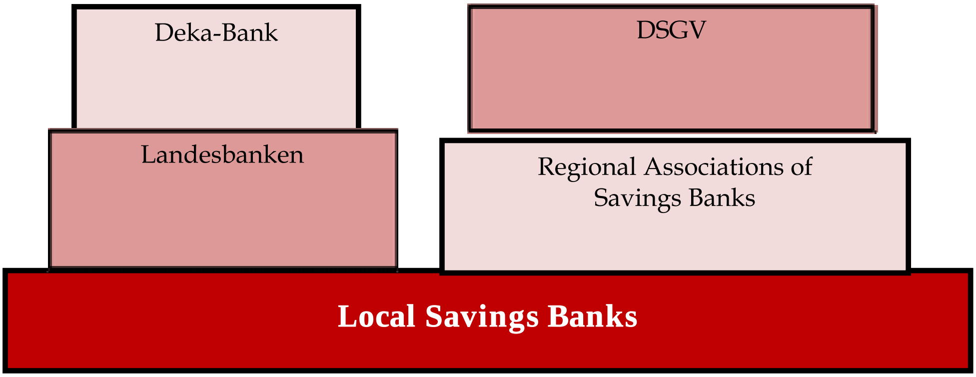
As licensed banks, the German savings banks have to conform to the general banking regulation and are subject to normal banking supervision, which is exercised by the Federal Financial Services Authority (BAFin) in cooperation with the Bundesbank. For instance, they have to have the same level of equity and to follow the same structural and prudential rules as other banks. Also with respect to taxation and labour law, all banks are treated equally in Germany. However, in contrast to other banks, savings banks are also subject to the savings bank law of the respective German state in which they are located. All savings bank laws stipulate that savings banks have to serve the public interest of their region by fostering individual savings and the awareness of the general population of the importance of savings and prudent conduct in financial matters, and by satisfying the credit demand of their local communities. Savings banks have to focus on the needs of employed people, small and medium-sized enterprises and certain public authorities. As a part of their public service mandate, they are obliged to open a transaction account for every applicant. Typically, the laws further stipulate that profit maximisation is not the only or even not the primary business objective of savings banks, although they are obliged by law to conduct their businesses according to sound business principles. And indeed, profits are particularly important for them to self-finance and increase their equity in accordance with a growing lending business, since the municipalities as their 'owners' are rarely in a position to inject additional equity, and since they cannot raise equity by issuing shares in the general market.

The savings bank laws do generally not permit savings banks to hold equity participations in enterprises outside the Savings Banks Group or to undertake certain risky operations. These rules may appear outdated and excessively restrictive. But in the current banking crisis they have proven to be utterly beneficial because they prevented the savings banks from investing in risky assets based on foreign subprime mortgages. Moreover, the savings banks are expected, but not required by law, to observe the so-called regional principle, which means that each institution should focus its lending operations on clients from its local area. This rule serves to limit competition within the group of savings banks. But since by limiting within-group competition it enables the savings banks to cooperate easily with each other, it serves to strengthen competition between the savings banks and other banks or banking groups.

Formally speaking, the governance structure of savings banks resembles that of private commercial banks. There is an executive board that reports to a supervisory board called Administrative Council (Verwaltungsrat). In most cases, two thirds of its members are appointed by the municipality or the municipalities of the city or county in which the Savings Bank is domiciled, and one third is elected by the employees. A third body, the credit committee, comprises at least three members of the supervisory board and gives the sponsoring entity or entities the opportunity to exert a certain influence on important credit decisions. The extent to which the responsible municipality or municipalities are entitled to receive dividends, is more or less limited according to all savings bank laws. In most cases, profits are ploughed back to strengthen the banks and to help them expand their operations and to fund extensive social support activities, which we will address in subsection 4 below.

As Figure 5.2 shows, the Savings Banks Group looks like a three-storey building with a broad base of some 446 local savings banks (in 2007). On this common base rest two separate structures with two storeys each. One of these structures comprises financial institutions, and the other one associations of savings banks. On the second level, we find the regional financial institutions, the Landesbanken, and the regional associations of savings banks, while the third and highest level consists of one financial institution, the DekaBank and one top-level association, the German Savings Banks Association, abbreviated in German as DSGV.

Figure 5.2 The structure of the German Savings Banks Group



However, it is important to see that the two structures do not represent a hierarchical system with the institutions on top being something like the 'corporate centre'. The savings bank system is not a hierarchy with the central power residing on top. Instead, the formal power and in many respects also the real power resides with the institutions at the bottom, the local savings banks. The Landesbanken are neither formally nor de facto superior to the local savings banks, and DekaBank does not in any sense have a supreme authority over the Landesbanken.

In addition to 440 public savings banks, since 1997 there have been six so-called free savings banks that are essentially self-controlled and 'owned' by foundations. Two of these are among the oldest German savings banks, and they operate in large cities and therefore are also among the largest savings banks in Germany, while four are among the smaller German savings banks. In all other respects they are comparable to their public peers. This applies in particular to their mandate and their commitment to the interests of their region and their clients and to their policy of retaining profits to fund internal growth and permit social support activities.

The second main group of financial institutions within the Savings Banks Group, are the Landesbanken. In mid-2008, there were seven legally independent Landesbanken, but in view of the various capital links between them, one can only speak of seven economically independent institutions of that kind. Their legal form varies from case to case. Some are joint stock companies, whose shares are held, in varying proportions, by regional savings banks associations, federal states and other Landesbanken, while others are still public law institutions. Landesbanken are also regulated by the general banking law and supervised like other banks.

For some years now, and especially since the end of the state guarantees in 2005 (see below), reducing the number of Landesbanken to four or three or even a lower number through a consolidation among the Landesbanken has been discussed. The urgency of this consolidation has grown in the course of the current financial crisis, since several of these banks have been seriously affected by the crisis.

Landesbanken have three functions. Firstly, they serve as the house banks of their respective state(s). Secondly, they act as the central banks or clearing houses for the local savings banks in their region. Their third function consists of supporting the much smaller primary banks in providing complex, non-standard products and services to the local savings banks and to their customers. Moreover, they are truly universal banks in their own right providing commercial and investment banking services to larger domestic and foreign banks, non-bank financial institutions and corporate and private clients. They thus compete directly with the large private commercial banks. It is essentially this latter role that was vigorously attacked by the group of private banks as being unfair and incompatible with the various forms of public subsidies, including full state guarantees, from which Landesbanken benefited in the past.

The local savings banks of one federal State or, in some cases, several states, are members of their respective regional savings banks associations. These regional associations provide certain common non-financial services to the member savings banks and represent them in the public and political arena of their respective home state(s), for instance when changes in savings bank-relevant issues are debated in the state legislature.

The financial institution located at the third and highest level of the Savings Banks Group, or the institution housed on the third floor of the savings banks 'building' is DekaBank. It is, among other things, the provider of investment management services for the entire group. DekaBank is also a public law institution (Anstalt des öffentlichen Rechts), but largely patterned on the model of a joint stock corporation. Half of its equity is held by the Landesbanken and the other half by the DSGV. At a formal level, one can say that the status of DekaBank as the financial institution at the top of the pyramid resembles that of the DSGV, the highest level Association within the Savings Banks Group. However, DekaBank's is merely a central service provider for the entire group that specialises in providing investment products and services for the savings banks and their clients and in this capacity operates on a national scale. It does not have a central bank or clearing function with respect to the Landesbanken.[92]

In spite of the high degree of independence of the primary savings banks granted by the 'federal corporatist' type of organisation and in spite of the formal or legal situation, it is instructive to look at the Savings Banks Group as one large bank-assurance group. As such it would constitute the largest financial institution in the world with roughly €3.6 trillion in assets and 377,000 employees at the end of 2007. Furthermore, the market penetration of the savings banks is unrivalled in Germany. With 446 savings banks and some 16,500 branches at the end of 2007, they have an outreach into every corner of the country.

5.3 Competitive and other market developments

a) The financial situation of savings banks

Even though the German Savings Banks have a mandate to provide financial services that are relevant and valuable for a broad segment of the population and despite not being primarily profit-oriented, they are, as a group (in the sense of the official statistics as explained above), surprisingly successful in economic and financial terms. This is most evident when the years between 1970 and 2000 are considered and becomes even more pronounced in the years after the beginning of the new millennium. The early years after 2000 were difficult for all banks, but in particular for the big private commercial banks and the second-tier institutions of the cooperative and Savings Banks Groups. Notably, the primary savings banks were much less affected by the recent financial market turmoil than the other banks mentioned. To illustrate this proposition, we take a brief look at various performance indicators.

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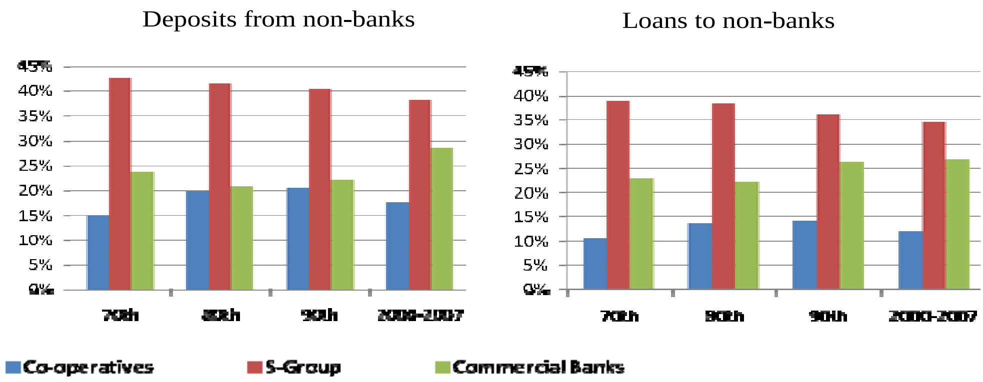
[92] The Savings Banks Group furthermore includes eleven regional public loan and building associations (market share in their market in 2006: 36%), six leasing companies (32%), two factoring companies (12%), the second largest insurance group in Germany with a market share in all- and life-insurance of 10.5% and 10.2% respectively, as well as central data processing and training institutions. (see S-Finanzgruppe/DSGV, 2007). All financial institutions within the group are regulated and supervised like comparable private institutions.

Figure 5.3 shows the market shares of the major German banking groups in terms of loans to non-banks and deposits from non-banks for different time periods. With a market share of 35% for loans and 38% for deposits (for the 2000 to 2007 period) the savings banks grant more loans to German SMEs and mobilise more deposits than any other banking group. Since not all banks are covered, the percentages in Figure 5.3 do not add up to 100%.

Thus, as Figure 5.3 illustrates, the savings banks are the market leader in German retail banking, well ahead of the cooperative and the private commercial banks, who are their most important competitors since they also offer retail banking services and maintain large branch networks. The left hand panel shows the market shares of the entire Saving Bank and cooperative banking groups in regard to deposits from non-banks whereas the right-hand panel shows that of domestic lending to non-banks. However, since the Landesbanken are hardly involved at all in retail banking, the figures for the entire S-Group largely resemble those of the savings banks on a stand-alone basis.

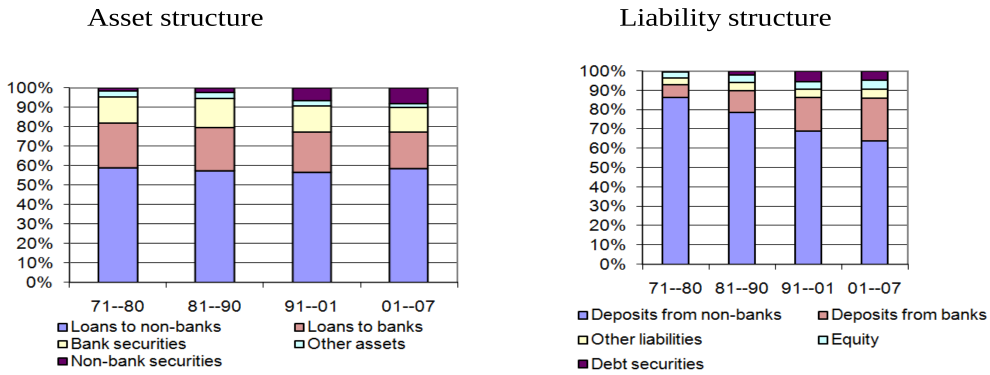
Figure 5.3 Market shares of the three banking groups, deposits and loans to non-banks[93]



[93] The data source of this figure as well as those that follow is Deutsche Bundesbank, monthly and annual reports, various years.

A brief look at the structure of the aggregated balance sheet of the German Savings Banks and their long-term development is provided in Figure 5.4. By far the largest asset class are loans to non-banks, which consistently comprise more than 60% of the assets, while the largest item on the liabilities side are deposits from non-banks with more than 70% on average over the years. This balance sheet structure differs greatly from that of commercial banks and indicates that the savings banks have retained the traditional function of banks as financial intermediaries, namely that of transforming client deposits into loans to businesses and households. All in all, these figures clearly reveal the savings banks' special and indeed quite conservative business model.

Figure 5.4 Development of savings banks' balance sheet structure over time



We now take a look at the efficiency and profitability of the operations of the German savings banks. Throughout the last thirty years of the last century, the savings banks achieved a return on equity that was consistently higher than that of the private commercial banks and, despite the vast branch network, their cost-income ratio, a widely used measure of efficiency, was consistently lower than that of their peers. Thus, in terms of financial efficiency, the savings banks were the most successful banking group during this period of time.

In the years around the turn of the century (1999-2002), the relative positions changed slightly as a consequence of the stock market hype and the dot-com bubble which pushed up the returns of the commercial banks. But already in 2003, the 'old order' of profitability had been restored. According to data published by the Deutsche Bundesbank, the savings banks and the primary cooperative banks were again ahead of the private commercial banks and the central institutions of both the Savings Banks Group and the cooperative banking group. In the very recent past, the situation was difficult to assess due to the consequences of the ongoing turmoil in the financial markets. Even though the savings banks have hardly been affected at all by the crisis through their own operations, they have suffered from having to bear a share of the burden that resulted from the critical losses incurred by some of the Landesbanken in the course of the crisis.

Figure 5.5 shows the return on equity and the cost income ratios as measures of profitability and operational efficiency for the time between 1970 and 2000, while Figure 5.6 covers the more turbulent years at the beginning of the new millennium. These figures show that, almost entirely over the time span depicted, the savings banks as a group had the highest return on equity and the lowest cost-income ratio. Moreover, their profitability and cost-structures were much more stable than those of the commercial banks. This stability seems to be due to their conservative and seemingly old-fashioned emphasis on deposit taking and lending as their core businesses.

Figure 5.5 Return on equity and cost income ratios for the period 1970-2000

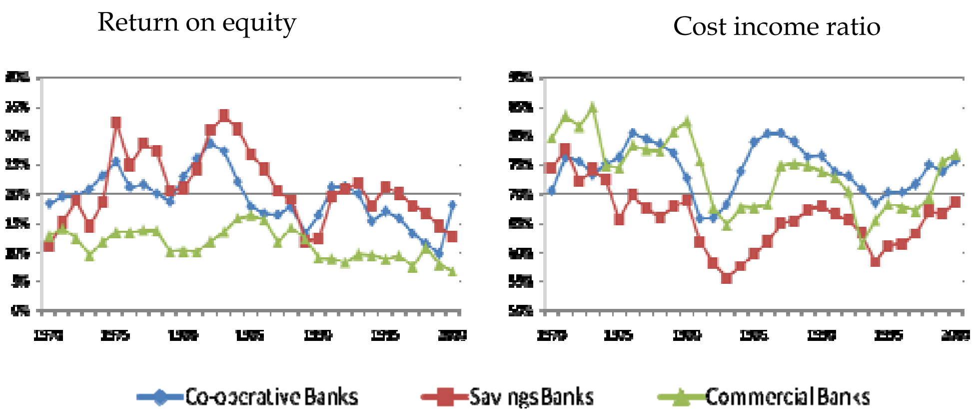


Figure 5.6 Return on equity and cost income ratios for the period 2000-07

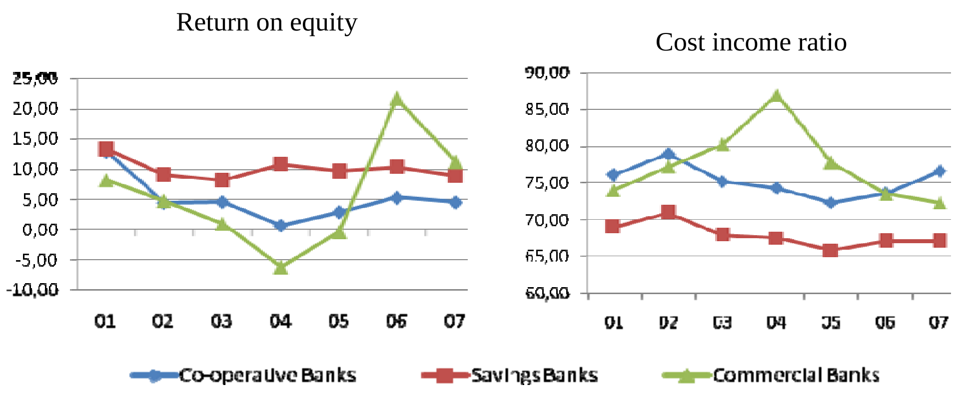


Figure 5.7 provides a comparison of various performance indicators for the three groups of banks covering the last forty years of the old millennium, while Figure 5.8 contains the same information for the years after 2000.

Figure 5.7 Performance indicators for main German banking groups for 1970-2000

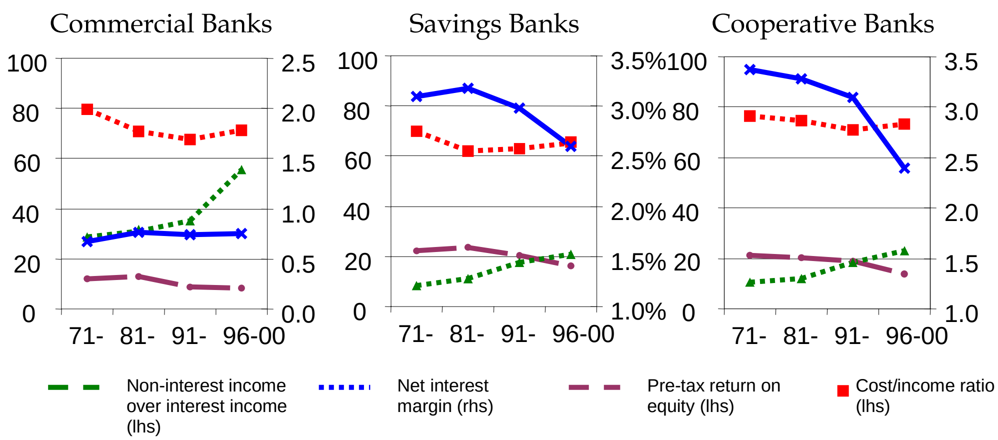
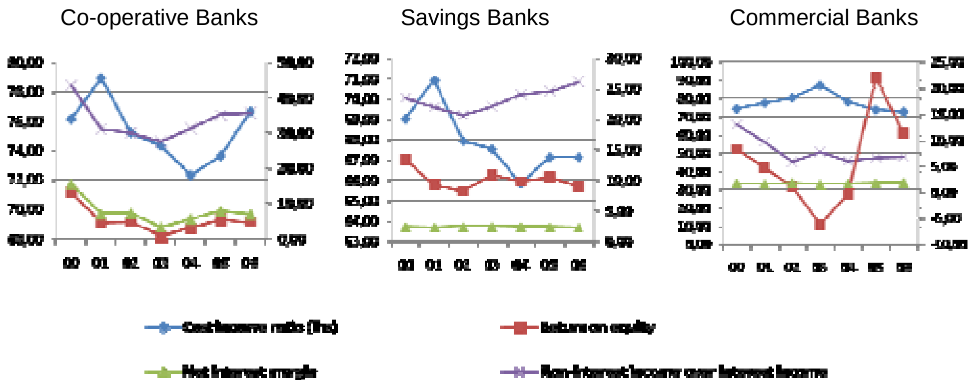


Figure 5.8 Performance indicators for the German banking groups for 2000-06



It should be emphasised that the data used in the figures for balance sheet structures, efficiency and profitability comprise only the savings banks and not those of the Landesbanken.

In many respects, the economic performance of the primary cooperative banks is similar to that of the local savings banks. One of the similarities is that the share of total revenues coming from fees is consistently low. These similarities reflect the fact that they both belong to complex but highly decentralised systems of banks, which are called 'Verbundsysteme' in German. One might translate this term, for which no English expression exists, as 'federated system'. These systems evidently differ in a fundamental way from the conventional organisational structure of an integrated enterprise, and as it seems, this is a strong advantage of the savings and cooperative banks. In particular, if the business focus is on retail banking, these decentralised structures seem especially conducive to a sound and stable financial performance.

b) Competition and market structure

It is well-known that the German banking market is highly competitive as a whole, probably more so than those of all other large countries in Europe. One reason for this is that banking concentration is extremely low by international standards. Banking concentration can be measured in various ways. One way is the so-called C5 ratio, which indicates the market share of the largest five institutions. Germany's C5 ratio stood at 37.8 in 2002 and since then has not changed dramatically. The other method is the use of the Herfindahl-Hirschman-Index, a number between 10,000 and 0 with lower values indicating a lower level of concentration. According to the European Central Bank (ECB) the HH-Index for Germany stood at 183 in 2007. Consequently, concentration in Germany is unusually low, and this may be taken as an indication and possible even as a cause of a high level of competition.

Of course, measuring the intensity of competition only with indicators of concentration may be misleading, since these concentration measures apply for an entire national economy, while competition, at least competition in retail banking, takes place on local markets. Moreover, the standard measurements of concentration for the case of German banking treat the local or primary savings banks and cooperative banks as individual banks. Formally, this is correct, since they are legally independent entities. However, in an analysis of competition, this may be misleading because they also belong to their respective networks (the Verbundsysteme mentioned above), and belonging to these 'federated systems' is probably an important competitive strength. If one treated each one of these the two groups as one big bank, the concentration figures would be more or less in line with those of other European countries.

Moreover, retail competition is essentially local, and the numerous savings banks and cooperative banks operate under their respective regional principle, that is, they hardly compete with each other within their respective groups. Thus, on a local level, there are not hundreds of banks competing with each other, but rather one or at best very few savings banks, one or possibly very few cooperative banks, and possibly a few branches of the big commercial banks. Nevertheless, the level of competition is extremely high in Germany, as one can see from other competition indicators. One of these, the so-called Lerner Index, measures competition directly by identifying the extent to which actual prices charged in a market diverge from those that could be expected if perfect competition were obtained. However, applying this 'direct' measure of competition to narrowly defined local or regional markets for retail banking services in Germany yields the same result as the 'indirect' measurement based on national concentration indicators: competition in German banking is fierce. The reason for this is that savings banks and cooperative banks are, by their design, strictly tied to their local markets. This means they are confined to their markets and compete with others within these markets. They would find it extremely difficult to move out of these local markets like large private banks do easily and have done frequently in the past. Thus, the design of the two 'federated groups' and the regional principle that applies to these groups are the main reason for the highly intense competition in German retail banking markets.

There is also strong indirect evidence for the high level of competition in German banking. One indicator is that the prices for financial services in Germany are very low by international standards,[94] a fact that is clearly beneficial for the clients of the banks. The high level of competition and the low level of prices are also reflected in the fact that by international standards the profitability of German banks is low. It would be wrong to regard this as a consequence of high costs or low productivity, since the costs of German banks are not higher or even lower, and their productivity is not lower than those in comparable other countries, as recent research has clearly shown.[95] The difference in profitability can therefore only be the consequence of low earnings caused by low prices and indirectly by strong competition, a fact for which the institutional design of the savings and cooperative banking groups bear the main responsibility. The competitors of those banks that are tied to their local markets may not like this, and this is why they are so strongly opposed to the regional principle and the 'Verbundstrukturen' of savings banks and cooperative banks and keep calling them anti-competitive. But the clients seem to appreciate the situation as it is – as is becoming all the more evident in the current financial crisis in which the savings banks are substantially gaining additional market share in the deposit and the lending markets!

One aspect of banking competition is merger activity. By their institutional design and their legal status, savings banks and cooperative banks cannot be acquired by commercial banks. Thus, mergers across the dividing lines between the three pillars of the German banking system are virtually impossible. But this does not suggest that mergers do not occur. In fact, the opposite is true. The number of banks in Germany has declined almost dramatically during the past 20 years. In 1990 there were 4,719 Banks, and at the end of 2007, there were only 2,300 banks left. This decline is almost exclusively due to mergers and consolidations within the groups of the savings banks and, even more so, that of the cooperative banks. Smaller and economically weaker institutions have been absorbed by others from their respective groups, thus raising the average size of savings

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[94] For more empirical references, see Fischer & Pfeil (2004).

[95] See KfW Research (2005).

banks and cooperative banks. And since the costs of really small banks tend to be higher than those of mid-sized banks, the process of within-group consolidation has improved the efficiency of these two banking groups and this, together with the benefits of having their respective networks, seems to have enabled them to withstand the competitive pressure from the large commercial banks.

A reflection of the causes of the high level of competition in local German banking markets is the extent to which clients have access to banking services. In contrast to the situation of other countries, the access to financial services does not seem to be a problem in Germany, and this is again due to the existence of savings banks and cooperative banks and their presence in almost all parts of the country. If they were not present, access would be a problem, because under increasing pressure to achieve high rates of return, the big private banks have thinned out their branch networks in remote areas of the country. The fact that in every tenth county (Landkreis) in Germany there is now no longer a single branch of a commercial bank, is evidence of this trend. In former East Germany, the absence of the commercial banks in rural and other less developed areas is particularly conspicuous. Whether their retreat from remote regions is caused by the dominating role and the high market shares of the savings banks in different lines of retail banking or rather the opposite, that is, whether the strong position of the savings banks is a consequence of the retreat of the commercial bank, is an open issue on which, understandably, opinions are divided. In any event, the banks belonging to the 'federated structures' currently assure good access to banking services.

5.4 Service, access, proximity and financial inclusion

Because of their origins, their legal mandate, their institutional design and their ownership structure, savings banks in general are quintessentially dual-bottom line institutions. This implies that they have to make sufficiently large profits to survive, grow and prosper as financial institutions in order to be able to offer more and better services to their clients, and that they should at the same time have a positive effect on the economic and social situation of their clients and, more generally, of the region in which they operate. Thus observers and policy-makers should also have an idea of the extent to which both objectives are met even though it may be difficult to determine precisely for methodological reasons that we have explained in chapter 2.

As we have discussed in the last section, the performance measured in purely financial terms of the German savings banks as a group as well as that of most individual savings banks is positive. Over the medium-to-long term, it is at least as good as that of other German banking groups, as can be read-off from the time series of the cost-income ratio and those for the return over assets and return over equity. For obvious reasons, it is more difficult to measure and assess the extent to which the other, not directly financial objectives are met. One possible indicator that may be regarded as useful in this context is the amount of money that savings banks set aside and use for social and cultural projects and purposes and for sports sponsorship. In the case of German savings banks, this sum is around half a billion euro per year and thus beyond any doubt very substantial. The major part of this sum is provided directly by the savings banks and is taken out of their surplus, but a substantial part also comes from more than 600 foundations that have been set up by institutions belonging to the S-Finanzgruppe. The savings banks provide about one third of all non-governmental funding for social, cultural and other purposes. In the area of cultural and sports activities, they are the largest provider of financial support in Germany.

However, one should not be misled into thinking that the sponsoring and direct support activity of savings banks is all that they contribute to meeting their non-financial objectives. Sponsorship is in fact just the most visible part of their contribution to achieving a better society, but probably not the most important part. The main part is what kind of financial services they provide, to whom they provide these services and how they provide them. It would seem that the savings banks themselves see their role in this way and others too would share this view.

The German savings banks are the most important providers of loans to the numerous German small and mid-sized firms, which employ almost half of the working population. Three out of four firms are clients of the savings banks, and in a very large number of cases, the savings bank is the most important one among the banks with which a given firm has a working relationship. It is exactly this role of being the main financier of small and medium-sized firms that the general public in Germany considers as the most important achievement of the savings banks, as has recently been confirmed in an opinion poll conducted by the opinion research firm FORSA.[96]

It is interesting to look at how this situation has been affected by the financial crisis. According to the latest Ifo Business conditions survey, between 20 to 30% of large and medium-sized manufacturing firms have indicated that access to credit has become restrictive just within the last quarter of 2008 as a result of the financial crisis.[97] Quite surprisingly, the changes of credit availability have been more moderate for the small-sized firms, which by February 2009 face *less* restrictive access to credit than all other firms, reversing a long-standing historical trend. The findings of Bundesbank's Bank Lending Survey (BLS) offers an explanation of why the conditions have not worsened as much for these firms: most of them borrow from their local banks, such as savings banks and credit cooperatives, which obtain their funding from deposits. With more ample funding, these institutions have been able to apply less restrictive standards and lower margins to their customers.[98]

In a similar way, savings banks play an important role in avoiding financial and social exclusion and limiting the effects of regional disparity. One out of two Germans has at least one bank account with a savings bank. But what is more important is the fact that the savings banks are prepared to open an account for anybody, irrespective of his or her financial situation. This policy of the savings banks prevents financial exclusion from being as much of a problem as it is in many other countries in the EU and especially in the UK, where public banks no longer exist.

Moreover, with more than 16,000 branches the savings banks also maintain by far the largest network of branches among all banking groups. Savings banks are also present in areas where the purely profit-oriented commercial banks have closed the branches which they once had or where

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[96] See the summary of the FORSA findings, published by DSGV 2006.

[97] For more, see the Credit Conditions Indicator in *Ifo Business Survey*, February 2009.

[98] See box on p. 17 of *Monthly Report*, Deutsche Bundesbank, January 2009. Also, see the discussion on p. 21 of the same report, which remarks that "lending business with SMEs is conducted to a great extent by credit institutions that fund themselves by deposits rather than the capital and money markets and which are therefore less affected by refinancing problems due to the financial market crisis".

they never opened branches. Indeed, in 31 counties (Landkreise) in Germany, which represent 13% of national GDP, not a single branch of a large private bank can be found today; the only banks that are present are the savings banks and the cooperative banks. The difference in geographical coverage can be seen most clearly when one compares the situation in the (former) East and West German states. The ratio of inhabitants to savings bank branch is essentially the same, namely between 5,000 and 6,000, in both parts of Germany, whereas this ratio differs greatly for the so-called big banks. It stands at nearly 50,000 in the new Eastern Länder compared to 35,000 for the Western Länder.

Maintaining branches in areas and places where it might be more profitable not to have a branch is part of the savings banks' attempt to fulfil their economic and social mandate of supporting the local economy. Not having any bank presence is a severe disadvantage for a town or a county. It would prevent people from moving there or even encouraging them to move away; it would prevent firms from setting up their operations there, and ultimately increasing regional economic disparities.

However, in spite of these impressive achievements as supporters of culture, non-professional sports and various social activities, it needs to be emphasised once more that the savings banks regard the services that they provide and the ways in which they provide them as their most important contribution to society. Still today, the savings banks provide socially relevant services to all groups of clients and in all parts of the countries, including groups of clients and areas which purely profit-oriented banks would now no longer serve. Thus their commitment to society also shows up in how the savings banks earn their money, and not only in how they use and distribute their profits. In this respect it is appropriate to also mention that the total sum of taxes paid by the institutions that belong to the Savings Bank Group is about 1 billion euro and thus twice as large as the amount paid out in the form of project support and sponsorship, and that the group employs a total staff of some 370,000 people, which is about half of all those men and women employed in the German financial sector.

5.5 Conclusions

The German savings banks have a long and successful tradition. Many of them were created in the first half of the 19th century, and ever since that time, they have been an important element of the German financial system. The German savings banks are organised as independent local institutions, which are, however, part of a network of affiliated institutions that jointly form the so-called 'S-Finanzgruppe'. In spite of this name, the S-Finanzgruppe is not a group of companies held together by equity ties and common management, that is, a group of companies in the sense in which this term is used in the context of corporate law. Institutionally, the individual local savings banks are independent entities governed – in most cases – by a public law regime conforming to the savings banks laws of the individual German federal states. In this sense, they are public banks, but they are not public banks in the sense of being under the influence of the central political power.

Currently, the savings bank network comprises some 446 local or municipal savings banks, 7 groups of Landesbanken and a considerable number of other institutions such as insurance companies, building societies and training institutions. The focus of this report is only on the local savings banks.

The German savings banks have long been the market leaders in retail banking in Germany in general and even more so in most of the local markets on which their operations are focused by tradition. As financial institutions and business enterprises, they are also the most successful German banking group in terms of costs and profitability if one takes a medium-term perspective. Moreover, their performance is more stable over time than that of their competitors from the ranks of the private commercial banks.

According to the laws that govern their operations, and according to the way in which they operate, they are financial institutions that strive for financial as well as non-financial success. In order to survive economically and to grow, they need to be financially successful; and they have the mandate to support the economic activities of the people, and especially the small and medium-sized business enterprises, in their respective areas of operation, which by and large correspond to the areas covered by the municipality or municipalities which are responsible for them.

The role of the respective municipality or municipality of being responsible for the savings banks in their region is sometimes designated by the term 'ownership'. But this is incorrect and misleading because the property rights of the responsible municipalities is fundamentally different, and in fact much weaker, than that of the private owners in the case of a private commercial bank.

In contrast to those of most other countries, the German savings banks have largely remained the same in terms of their organisational and legal structure and status and maintained most of those features which the savings banks of other countries once shared. At the same time, in terms of their institutional features and their business orientation, they changed less than most other elements of the German financial system. There are several factors that explain this peculiarity of the German savings banks, which one may, depending on political preferences, call and evaluate as stability or resistance to change. One factor is that there was, in past years, less political pressure on the German savings banks to undergo a far-reaching transformation than on the savings bank systems of other countries. However, not only was political pressure weaker in Germany than elsewhere, but also the economic pressure to change was less for savings banks in Germany than for those in other countries since, in a stark contrast to the situation in countries such as France or Italy, the economic performance of the German savings banks has been good for many years and indeed even better than that of all other banking groups. That the German savings banks performed so well – and probably therefore were also less under political pressure to change – can be explained by two factors. One is that under regulatory aspects German savings banks were at a very early stage put on the same basis as all other banks, and therefore had to really develop and prove their business strengths. The other factor may be their organisational and institutional structure, which prevented them from getting involved in overly risky operations and following all the fashions of the financial industry.

In an economic and social perspective, the importance of the savings banks derives primarily from what they are doing and how they do what they do as partners of local business and households and as one of the biggest employers in Germany. Moreover, by being themselves stable financial institutions they perform a stabilising role for the entire German financial system.

By tradition and according to their business model, the savings banks play an important role in preventing social and financial exclusion, and they do this together with the cooperative banks which are also an important element in the German financial system and are also organised as a federated network that in many respects resembles that of the savings banks. It may be due to the strong role of these two banking groups that SME financing and financial exclusion are much less of a problem in Germany than in a number of other countries. In addition to their role of providing financial services to a broad segment of the population, the institutions that belong to the savings bank network are also important supporters of culture, sports and social activities in Germany.

The current financial crisis has affected the savings banks – and equally the cooperative banks - less than most other banks. This evident crisis resistance has further improved their image with the general population and may also serve to strengthen the political support for both of these banking groups. That they are hardly directly affected by the crisis at all is due to the traditional business model that these banking groups have followed over the years.

However, indirectly, the savings banks are also affected by the crisis because they are, to varying degrees, co-owners of the regional banks *(*Landesbanken*)* which also belong to the S-Finanzgruppe, some of which have suffered greatly from the crisis. In so far as the system of regional banks is concerned, there is an urgent need to undertake far-reaching reforms, and it is one of the main challenges for the German savings banks to make sure that these reforms are effective and substantial without undermining the sound and successful part of the S-Finanzgruppe: the local savings banks.

6. COUNTRY ANALYSIS: AUSTRIAN SAVINGS BANKS

6.1 Origins and historical development

Currently the Austrian Savings Bank Group consists of 53 local and regional savings Banks, the Erste Group Bank AG (henceforth 'Erste Group') as the group's lead institution, the Second Bank (see section 6.4 below) and a number of affiliated service and training institutions.

As in many other European countries, savings banks in Austria came into existence in the early 19th century. They were created in much the same way, and with similar intentions, as their peers in Germany, Spain and other countries: They were local initiatives, undertaken in most cases by public authorities or groups of citizens with a strong sense of social commitment. They were founded with the aim of supporting local development and the economic endeavours of people with lower incomes and wealth. Their business model consisted in collecting deposits locally, transforming them into loans to local borrowers and holding on to these loans until they matured; and they regarded it as their mandate to offer access to financial services to local people who might not have access if savings banks did not exist. In terms of their organisational structure, they also were part of a 'federated network', and had, to varying degrees, as we will discuss below, local public ownership. Thus the similarity to the tradition of German savings banks is hard to overlook.

However, the developments of the past 25 years differ substantially. Austrian savings banks are now more similar to those of Spain and other countries. The regional principle that had once even been imposed by law was abolished. A new trend emerged to adopt legal forms that more resemble joint stock corporations than 'public administrations', and there is a strong trend to concentrate banking assets and banking activity in one central institution. That is, the entire Austrian savings bank system is less decentralised than it once was and less so than those of Germany and Spain. The leading institution, the Erste Group, has a much stronger role in the Austrian savings bank system than corresponding institutions in Germany and Spain. Even though the Austrian savings bank system is a federation, it is one that more resembles a group of companies.

In addition to the tendency towards more concentration and a stronger role of the leading institution, there are four features of the Austrian savings bank system which are particularly noteworthy.

1. The concentration of savings banks exceeds that in Germany. Besides truly local savings banks, there are savings banks that operate on the level of federal states.

2. Not all savings banks are genuinely public institutions. There are three different types of savings banks, as far as their legal status and ownership are concerned (see section 6.2 below).

3. In the history of the Austrian savings banks, unrestricted private ownership of savings banks was legally not allowed. However, non-public and semi-private ownership has always existed to some extent. Since 1987, savings banks are permitted to transfer their banking operations into a 'Savings Bank Stock Corporation'. Through this legal change the Austrian savings bank system has become more similar to the Italian system with institutions that have a mixed ownership status. At the same time, it now also resembles the Spanish system with operating units in the legal form of private banks and foundations that own shares in the operating banks.

4. Finally, the Austrian savings banks have been very active in the recent past in 'going East'. Like several other large Austrian banks, Erste Group plays an important role in a number of Central, Eastern and South-Eastern European countries. Its heavy involvement in this region is the main reason why former Erste Bank reorganised its structure on 9 August 2008 spinning-off of the Austrian core business from the newly formed holding company 'Erste Group Bank AG' ('Erste Group') and transferred it to 'Erste Bank der oesterreichischen Sparkassen AG'.

Last but not least, the Austrian savings banks have experienced an interesting history of their top institution. Formerly, two institutions, Bank Austria and GiroCredit, had played this role. But in 1997 Bank Austria merged with Creditanstalt AG to form the private listed bank Bank Austria-Creditanstalt AG, which ceased to be part of the Savings Bank Group and was later, in 2002, acquired by Germany's HypoVereinsbank and ultimately, in 2005, together with HVB, by Italy's UniCredit. In parallel, Erste Bank (now Erste Group) took over the role of being the top institution of the Austrian Savings Bank Group after acquiring GiroCredit, the former central or clearing bank of the savings bank system, in 1997. At the same time it emerged as the country's largest savings bank with total assets in Austria that make up more than half of those of the entire savings bank system.

To fully appreciate the role and status of the Austrian savings banks, it is necessary to briefly place them in the context of the entire Austrian banking system. For a long time, and still today, the Austrian banking system is characterised by a very strong role of banking firms that are, more or less and in different ways, committed to a dual-bottom line approach. Besides the savings bank group, there are two large groups of mutual or cooperative banks, the group of Raiffeisenbanken, which mainly operate in rural areas, and the österreichische Volksbanken-Gruppe. The market shares of these three groups as well as that of the private commercial banks, measured in total bank assets (without their operations in Central and Eastern Europe) are shown in Table 6.1, and the numbers of employees are shown in Table 6.2.

Table 6.1 Total Assets of Austrian Banks by Sector (Mio. Euros)

Year	**1995**	**2003**	**2007**
Joint stock banks and private banks	111,057	129,264	250,932
Savings banks	120,186	203,214	150,351
Raiffeisen credit cooperatives	78,629	125,760	221,977
Volksbanken credit cooperatives	17,228	29,363	69,300
Others	64,097	100,139	196,043
All banks	**391,198**	**587,741**	**899,542**

Source: Austrian Central Bank.

Table 6.2 Employment (Number of Persons) in Austrian Banks by Sector

Year	**1995**	**2003**	**2007**
Joint stock banks and private banks	18,246	16,371	23,043
Saving banks	24,008	24,810	15,679
Raiffeisen credit cooperatives	19,437	21,035	23,456
Volksbanken credit cooperatives	5,189	5,599	6,616
Others	9,377	8,558	10,386
All banks	**76,257**	**76,373**	**79,180**

Source: Austrian Central Bank.

As the figures in Tables 6.1 and 6.2 indicate, still today the purely private and purely profit-oriented banks have a minority position in Austrian banking.

This brief look at the history of the Austrian savings banks suggests an intriguing question. Is there a recurrent theme, a 'Leitmotiv', that comes up repeatedly in the development of this banking group and possibly also in other similar decentralised or federated groups of banks? This general trend would be that there is a strong and seemingly irresistible pull towards a concentration of power, assets and activity in a central institution that is open to becoming simply a private for-profit firm. This is what had occurred in the case of Bank Austria-Creditanstalt and what might once more occur in the case of Erste Group, which is also partially owned by private investors and listed on the stock exchange. This also seems to be the case with the powerful and resourceful central institutions of the two cooperative banking groups in Austria. And if this should indeed be true, would it suggest that this is, seen from the perspective of all of the decentralised institutions that belong to the respective network and of their clients, a good way to go or one that should better be avoided?

In any event, the particular role that the central institution plays in the Austrian savings bank system is a specific feature of this system, which sets it apart from the savings bank systems of the other countries that this study covers and makes it represent yet another 'model' of how the savings banks in a given country can be organised.

6.2 Ownership structure, regulation and supervision

For many years, there were two alternative legal forms and/or forms of ownership or, to be more precise, of the allocation of property rights that Austrian savings banks could use. They could be supported or 'run' by municipalities as are most of their peers in Germany, or by associations of local citizens, a legal form which corresponds to that of the small minority of the so-called 'free savings banks' in Germany or the savings banks in some other countries. It is important to understand that, like in the German case, this 'running' of a savings bank only vaguely resembles the normal concept of 'owning' a bank.

In spite of some differences concerning the applicable legal regimes, the distinction between these two types of savings banks did not play a great role for a long time. Both types conformed to the general description provided above; they were locally rooted and locally focused in their business orientation, and they were 'dual-bottom line institutions' in the sense explained in chapter 2 above. Among their common features was that the structure of the internal organisation of all savings banks reflected their commitment to the objective of improving the local economy and the welfare of the local people. One might be inclined to think that for this reason they were less professional and less profit-oriented in the way they went about their business than private banks.

The set of legal forms that an Austrian savings bank can have was enlarged in 1987, when an amendment of the Savings Banks Act made a third organisational design available, namely that of splitting a savings bank up into two entities, an operating unit in the legal form of a (private) joint stock corporation (Aktiengesellschaft) and an institution which has the role of being the owner of the operating savings bank. The latter institution is called the owning or administrating savings bank (Träger- or Anteilsverwaltungssparkasse). Since 1999 the transformation of Anteilsverwaltungssparkassen into foundations (Privatstiftungen) has been possible. One motive for allowing the separation of banking operations from bank ownership was to help the savings banks increase transparency and efficiency and thereby making them more professional, more flexible and thus ultimately also more competitive.

Since the time when this possibility was opened up, most of the Austrian savings banks have adopted the new 'dualistic' organisational form. The new form was clearly preferred by the larger savings banks that operate at the level of a Federal State, while the two old forms are now only used by a few local savings banks.

Even though now the legal form of the operating unit is in most cases that of an Aktiengesellschaft, the Austrian savings banks still have their own specific legal status. In order to understand the essence of the legal structure of this system it is important to keep in mind the distinction between the operating savings banks, which are by now in many cases joint stock corporations (Savings Bank-Aktiengesellschaften), and the 'Administering Savings Banks' (Anteils-Verwaltungssparkassen), which have just one role, namely that of owning shares in one or several Savings Bank-Aktiengesellschaften. These Verwaltungssparkassen have no owners in any sense, that is, they belong to themselves or are ownerless like a foundation. In contrast, there may in principle be several owners in the operating units, the Savings Bank-Aktiengesellschaften, and they may also be the owners of other savings bank-Aktiengesellschaften. (The savings banks that have not adopted the new regime are also ownerless like the Verwaltungssparkassen.)

Not by law, but in fact the group of owners in the Austrian Savings Bank-Aktiengesellschaften is in most cases limited to the group of Verwaltungssparkassen and other organizations that also belong to the savings bank system, notably other savings banks including the Erste Bank. And this latter possibility, that is, shares in savings banks being held by other Austrian saving banks, is indeed widely used, giving rise to a complex system of cross-ownership among the savings banks. Currently, the Erste Group holds substantial shares in the equity of other savings banks, especially regional savings banks. One can of course not rule out that it uses its ownership role to influence the business policy of those savings banks in which it is an important shareholder. Even the mere potential of an ownership-based influence is the reasons why the group of Austrian savings banks seems more integrated and more homogenous than their German and Spanish peers.

It is important to note that the Erste Group has a special status. It is a listed joint stock corporation. Close to 50% of its shares are held by institutional investors and the remainder by a foundation, by private investors, by other Austrian savings banks and by savings bank employees. Thus it is more exposed to the pressure of the stock market than the other institutions in the savings bank system.

For a longer time than, for instance, in Germany, the savings banks in Austria were subject to specific and more restrictive regulation than private commercial banks. Restrictions applied to the kinds of permitted business activities and to regional expansion. This special regulatory status has been abolished by the savings banks Law of 1979, which put savings banks in the same situation as other banks as far as taxation, regulation and supervision are concerned, allowing the savings banks to become truly universal banks, and also abolished the former legally mandated regional principle. As a consequence, savings banks could open branches in all parts of the country, and in particular Erste Bank and other larger savings banks made use of this newly gained freedom. Only the special status of being a 'Savings Bank' continued to be legally protected, and this was mirrored in public guarantees for the 'municipal savings banks' that largely conformed to those in force in Germany at that time.

The 1987 Amendment of the Austrian Banking Act made the institutional separation of managing and owning entities by transferring the undertaking or the banking operations of the savings banks into a joint-stock corporation ('Savings Bank Stock Corporation') possible, a move that was complemented in 1994 by another Amendment to the Savings Bank Act that allowed the 'Anteilsverwaltungssparkassen' to transfer their ownership positions to third parties.

In 1979, the legal obligation of the savings banks to act in the public interest was also abolished. However, this legal change only referred to the operating units. Since the social and regional commitment continued to play a dominant role for the Anteilsverwaltungssparkassen and the foundations as the owners of savings bank stock corporations, it can be assumed that it still also matters for how the operating units implement the policies that are, more or less, determined by their owners. Thus social and regional objectives still play an important role as a complement to the profit objective to which Austrian savings banks, like all other banks, must adhere in order to be able to survive and grow. Therefore, they are still 'dual-bottom line institutions', though perhaps less clearly so than in the past.

Under EU pressure, the public guarantees that had been in force for the 'municipal savings banks' until that time started to be phased out in 2003. However, the effect of the termination of the public guarantees was to a certain extent compensated by the creation of a system of mutual guarantees, the so-called 'Haftungsverbund'. Already in 2002, Erste Group had formed the Haftungsverbund on the basis of a set of agreements with the majority of the Austrian savings banks. The purpose and the essence of this Haftungsverbund were to establish a joint early-warning system as well as a system of cross-guarantees for certain liabilities of member savings banks and to strengthen the Group's cooperation in the market. Much like the former public guarantees, the mutual guarantees were a matter of concern for the EU. For that reason, the Haftungsverbund was subject matter of several competition proceedings before the Austrian Cartel Court. In March 2007, the Austrian Supreme Court set an end to this debate when it decided that the agreements which constitute the Haftungsverbund are for the most part in compliance with Article 81 of the EC Treaty.

Moreover, as an additional move to strengthen the character of the Savings Bank Group as a group of companies, Erste Group Bank AG entered into contractual agreements with almost all Austrian savings banks in 2007 and 2008 (with the exception of two savings banks) that grant Erste

Group Bank AG a decisive influence on the other savings banks and their operations and that lead to the establishment of one economic unit within the meaning of the EC Merger Regulation and the Austrian Cartel Act. These agreements were formally approved by the competition authorities in October 2007, January 2008, and May 2008. Thus, the transformation from a decentralised system or a federated network, as it still is the case with the German savings bank group,[99] to a largely centralised system is by now almost completed and thus also the transformation to a group in the narrow sense of the term used in corporate law and competition law is rather far advanced. Nevertheless, in what follows, we will continue to use the term 'group' not in the sense of corporate and competition law, but in the sense of the totality of the institutions that share certain common characteristics and are treated as belonging to the same category (or 'group') in official statistics.

6.3 Competitive and other market developments

a) The financial situation of savings banks

Table 6.3 provides a first general overview of the financial situation of the Austrian Savings Bank Group concerning the last five years. The data refers only to the activities in Austria, thus does not include the data relating to Erste Group's activities, subsidiaries and other equity participations in Central, Eastern and South-East Europe. The data is comparable in so far as the time series begins after Bank Austria had left the group. It reflects a stable and positive financial situation of the group. Total assets and Tier-1 equity have increased at a considerable pace over the past years, while the interest margin has slightly declined, though not dramatically. By international standards, asset growth, equity and interest margin are clearly satisfactory. Naturally, the data concerning the individual institutions that make up the Savings Bank Group differ to some extent, and the financial crisis has also seriously affected the financial situation and the stock price of Erste Group, not least because of its involvement in the neighbouring countries to the East.

[99] In spite of the misleading term 'group' in the German case; see chapter 5 above.

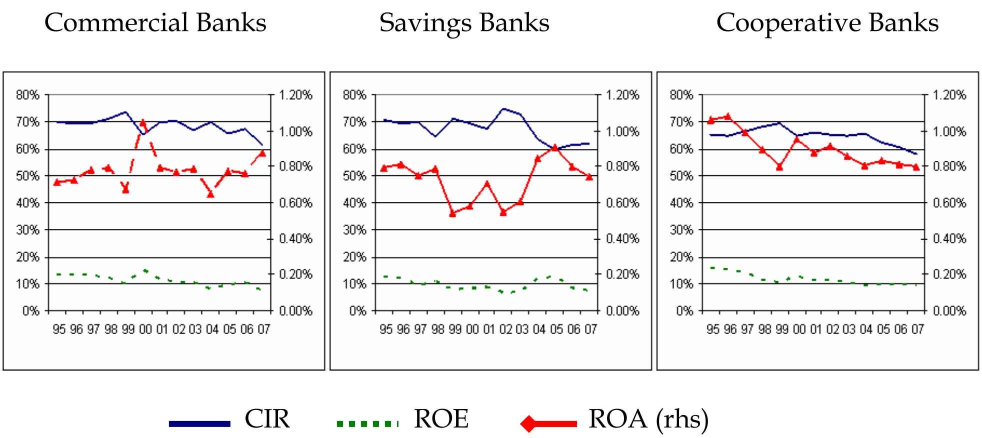
Table 6.3 Financial data for the Austrian Savings banks Group

Year	**2003**	**2004**	**2005**	**2006**	**2007**
Total assets in €m	109,786	116,929	127,029	138,535	150,340
Equity ratio (Tier1-capital in % of RWA)	9.5	10.0	9.6	13.6	15.7
Interest margin (in % of average total assets)	1.62	1.60	1.55	1.47	1.34
Operating profit/ personnel TEUR	71	77	89	88	85

Source: Austrian Central Bank.

However, in order to properly assess the performance of the Austrian savings banks it is necessary to provide comparative data. Figure 6.1 shows time series of cost-income ratios, return on assets and return on equity as three important indicators of efficiency for the three most important banking groups in Austria, covering the time span from 1995 to 2007.

Figure 6.1 Efficiency Indicators of Austrian Banking Groups



Source: Austrian Central Bank.

The first and ultimately also correct impression that Figure 6.1 conveys is a stunning degree of similarity between the three groups of banks. Cost-income ratios vary somewhat between 70 and 60%, and slightly decline for all three groups. Return on asset figures vary more over time, but also do not differ significantly between the three groups, while return on equity is similar and also more stable. Thus the general finding is that of a high degree of similarity between savings banks, private commercial banks and cooperative banks. As we show more extensively in chapter 3 of this study, the situation in Austria also does not differ a great deal from that in other countries, with the slight exception that in Germany and Spain the financial performance of savings banks is even slightly better than that of other types of banks, a situation that does not seem to prevail in Austria.

b) Competition and market structure

Austria is a rather small country with a sizable set of banks and banking groups or networks that have existed for a long time and that largely compete for the same clientele of private households and small and medium-sized firms. The fact that many individual banks and banking groups in Austria are not, or at least formerly were not, strictly or exclusively profit oriented may have contributed to what appears as an over-expansion in the number of bank branches in the course of the 1980s and early 1990s when they were competing for market share.

As a consequence, competition in Austrian banking became fierce and profitability fell. This created the need to find a solution to this problem, and indeed such a solution suddenly appeared possible after 1990. Together with the centuries-old tradition of Austria being politically and economically oriented towards 'the East' and the opportunities that arose after the end of the former Soviet Block the specific competitive situation in their home markets seems to have induced several important Austrian banks to expand into the neighbouring countries of Central, Eastern and South-Eastern Europe. In this new area they are now competing once more for a new, but much larger and still largely underserved clientele.

With its lead bank Erste Group investing in more and more of these countries, the Savings Bank Group is heavily involved in this process of expansion and competition. However, at least until the middle of the year 2008, the rates of growth of the banking markets in these countries are still high and the Austrian banks' profits from operating in these markets are also high and indeed much higher than those that could be achieved in their home market. However, this situation may have changed in the recent months as a consequence of the crisis that also affected the banks in

Central, Eastern and South-Eastern Europe and the banks in the countries of the West that own these banks.

Compared to the competitive battle in the larger area to the East of Austria, competition in the home market seems relatively unimportant. As in Germany, there is, and has always been, a high level of competition between the different banking groups, whereas within-group competition is not that strong. For a certain time after 1979, there had also been strong intra-group competition in the Savings Bank Group. It weakened, when the positions of Erste Group as the new lead bank was clearly established and when this bank and the local and regional savings banks had closed an agreement that amounted to a private re-establishment of the regional principle. The essence of the agreement was that Erste Group gave up most of its decentralised branches outside the Greater Vienna area, transferred them to the respective regional bank and in exchange received shares in other savings banks.

One may wonder why the federated systems of the Savings Bank Group and of both cooperative banking groups in Austria have developed in a way which allocates more power and more resources to their respective central institution than in many other countries. This may be related to the competitive situation that seems to prevail in the Austrian banking market, a situation that has inspired the banks to expand their influence and ownership to the Eastern neighbour countries. As long as expansion and competition took place in the home market, central institutions may have had less importance than at times when stronger institutions and stronger leadership are required for a successful expansion abroad. If this conjecture is correct and if competitive requirements were indeed the driving force for the expansion towards the East, the current structure of the Austrian Savings Bank Group of having one strong lead institution (while others stand more or less in a second line), may reflect this country's special situation rather than truly being a model for how savings banks could be successfully organised in general.

6.4 Service, access, proximity and financial inclusion

Access to financial services is not a problem in Austria. The three groups of banks that are organised as federated group have established a network of branches that is clearly sufficient to meet the existing demand, even though the number of branches has been substantially reduced during the past 15 years. In addition, private banks including those that had formerly been state-owned or had merged with state-owned institutions also maintain extensive branch networks and have a large number of ATMs. Table 6.4 provides information about the number of branches of the different banking groups.

Table 6.4 Number of branches of Austrian banks (1995-2007)

Year	1995	2003	2007
Joint stock banks and private banks	751	531	852
Saving banks	1,397	1,446	1,011
Credit cooperatives	2,213	2,198	2,184
Others	195	226	239
All banks	**4,556**	**4,401**	**4,286**

Source: Austrian Central Bank.

Compared to other European countries, Austria ranks high in terms of banking outlets per inhabitant, even though the total number of bank branches has declined during the past 15 years. The seemingly marked decline in the number of saving bank branches between 2003 and 2007 is due to the fact that Bank Austria has left the system.

Exclusion from the access to financial services does also not seem to be a serious problem in Austria, even though it exists as a phenomenon. That financial exclusion is a problem of limited importance so far in Austria may be related to the present or former 'dual-bottom line' orientation of many important Austrian banks and banking groups. It is a part of the business model of the savings banks and the two groups of cooperative banks that they aspire to be 'inclusive' providers of financial services and focus on providing loans and other financial services to local SMEs and private households from all income brackets. Despite the ongoing global financial and economic crisis, lending to households and non-financial corporations in Austria has grown at a steady pace well into the year 2008.[100] The growth of loans has been particularly strong for savings banks, with a 5.9% of year-on-year growth on September 2008 compared with a

[100] The latest figures available from the online statistics database Austrian Central Bank (OeNB).

2.6% growth for commercial banks. Savings banks were particularly strong in granting new loans to non-financial firms.[101]

Nevertheless, financial exclusion also exists in Austria. In this context it is important to mention the recent creation of a special institution called 'Zweite Wiener Vereins-Sparkasse' which specifically addresses people as their clients who do not have access to even a simple bank account. This 'Second Vienna Savings Bank' was established with a grant from the foundation that owns a large part of the Erste Group shares, and the service provided at the Zweite Sparkasse is pro bono work of former and present savings bank employees. Since its inception, the Zweite Sparkasse has met with considerable demand for its services among people who need this form of support.

Due to their heritage, the Austrian savings banks have always had a commitment to supporting not only the local and regional economy but also cultural and similar activities in their respective regions of operations, even though there is now no longer a legal mandate or even obligation to undertake such activities. Since a few years now, the Austrian Association of Savings banks publishes an annual report about these support activities. The total volume of relevant sponsoring activity was above 20 Mio. € in 2007. The range of areas in which savings banks support local projects and initiatives is extremely broad. It ranges from sports over education and research, from genuinely cultural affairs to charity and traditional local culture.

It is instructive to read in this report that the sponsorship just described is only the minor part of what the savings banks regard as their effort to contribution to social improvement and inclusion. For them, the more important part shows up in the way in which they deal with their staff and their clients. It seems to be essential part of the mission of savings

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[101] Recent data on loans of different categories of banks is not yet available. For more information, see p. 49 of Austrian Central Bank's *Financial Stability Report* for December 2008. A large fraction of loan growth is attributable to the increased deposits that the banks have received from customers who discontinued investing in more volatile instruments. After having remained relatively constant for years, bank deposits jumped by 8.7% between September 2007 and 2008. While deposit growth rates were largely similar for all banking groups in Austria, the growth rates of loans to the private sector differed savings banks.

banks that staff and clients are not merely regarded as providers of labour and buyers of services, respectively. Instead, they are truly regarded and treated as partners in the sense that fair and trustful relations with these core stakeholder groups are of utmost importance. One might be inclined to take such a declaration of the Association as pure public relations activity. However, it may be more and may indeed be a part of the banks' corporate social responsibility (CSR), and it may indicate that staff and clients are treated in ways which are fairer, more openly and supportive or in some other sense simply better than what would be optimal from the perspective of an exclusive profit orientation.

At least this is the interpretation that one can derive from simply looking at where and how this aspect is dealt with in the annual CSR report. And if this impression is correct, it points to an important aspect: In spite of the fact that most of the Austrian savings banks have by now adopted the legal and institutional form of a separate operating savings bank Stock Corporation and an owning Anteilsverwaltungssparkasse or Foundation, the way in which day to day business seems to be conducted by savings banks still differs from that of banks that would simply try to maximise the profits they make for their owners. Thus the separation of operating Savings banks Stock Corporations and bank-owning Foundations does not seem to suggest that only the Foundations are responsible for 'welfare', while the banks are only meant to be efficient in a narrow financial sense and to make profits that can in part be distributed for social purposes by the Foundations that own them. Looking back at the financial performance data discussed in section 3, it seems worth emphasising that the possibly greater concern with corporate social responsibility in all of its forms does not lead to lower efficiency and profitability of the savings banks in Austria

6.5 Conclusions

The origins of the Austrian savings banks are largely the same as those of the savings banks of Germany and a number of other European countries. Also in Austria, savings banks were once founded with the mission of giving broad segments of the population access to financial service and to foster local and regional development, and in spite of the modernisation of the Austrian savings banks and rather far-reaching transformations of the Austrian savings bank system in the recent past, this original mission seems to still play an important role for what savings banks aspire to be and to do and also for what they are and what they do. Still today, they are essentially decentralised 'dual-bottom line institutions'.

This is not the only feature that the Austrian saving banks share with their peers from other countries. Much like those of Spain or Germany, the Austrian savings banks have fared quite well in financial terms during the past years. They have transformed themselves into modern and efficient financial institutions that provide services to broad segments of the population, and they are important players in the national market for retail financial services. However, it would be wrong to assume that because of the social mission to which they still subscribe, the Austrian savings banks would be less profitable than the commercial banks of that country. As in most other countries in which savings banks still exist, their financial performance is almost indistinguishable from those of other banks, if not even better. Finally, the Austrian savings banks have over the years also been the object of political debate and, at times, harsh political criticism. As in almost any other country, the main issues in this debate – and in the criticism that the EU Commission directed at the Austrian savings banks over the years – were the forms and the extent of public support that the savings banks enjoyed and the anticompetitive effects that the cooperation within their federated network, their mutual guarantee system, the so-called Haftungsverbund as the most visible feature of the network structure was said to entail.

Thus, the list of features in which the Austrian savings banks hardly differ from those of other countries is long. However, there is also one very important and characteristic difference. In an international comparison, the Austrian savings bank system sticks out as having adopted a very specific organisational structure. It is much more built around one central institution than the savings bank systems of other countries. The central institution, the Erste Group Bank AG, is one of the largest banks in Austria with total assets that exceed those of all other Austrian savings banks taken together. Erste Group Bank AG is an important player in the Austrian financial market and at the same time the hub of one of the most extensive banking groups in Central, Eastern and South-East Europe. The high degree of centralisation of assets, activities and power at the level of Erste Group makes the Austrian savings bank system resemble a group of companies in the sense of a 'concern' more than the savings bank systems of those other European countries covered in this study.

This peculiarity of the Austrian savings bank systems suggests asking why this organisational form has developed in Austria and not in other parts of Europe and whether it might be regarded as a model of how savings bank systems should be organised in general. As it seems, the answer to this question is that it is not a general model of best practice. A high degree of concentration of assets, activities and power seems to rather reflect a rational response to very specific local problems and opportunities.

7. COUNTRY ANALYSIS: PRIVATISATION OF ITALIAN SAVINGS BANKS

7.1 Origins and historical development

Before the 19th century, the only formal banking institutions in Italy were the ancient public banks whose roles were limited to the provision of current accounts for merchants and the issuance of notes in exchange for metal coins. A modern banking structure was heralded during the first half of 19th century with the creation and rapid expansion of savings banks. The first institution, Cassa di Risparmio delle Provincie Lombarde (Cariplo), was founded in Milan in 1823 using public funds and grew quickly in the region within the first years of its operation. Much like the Austrian and German savings banks it was modelled after, Cariplo was set up to provide a 'safe and convenient method for setting aside money' to craftsmen, workers and members of lower-income classes (Hertner, 1994, p. 646). Other savings banks also flourished in the 1830s and 1840s, mostly in the northern and central regions of the country. Despite being founded to provide services to the working classes and the poor, the lack of clear alternatives during these early years made savings banks appealing to a broader group of clients. By 1850, their numbers reached 60 while their liabilities represented almost half of total bank liabilities in Italy (Polsi, 1996, Table 4).

Three properties of Italian savings banks are worth noting. First and foremost, Italian savings banks were conceived as autonomous non-profit institutions (Polsi, 1996, p. 132). Indeed, some savings banks, such as Cassa di Risparmio di Roma, were set up as partnerships with the joint participation of a group of nobles (Hertner, 1994, p. 641). The operations had to be compliant with the banks' internal charters, which required profits to be either retained or put to charitable uses. The self-imposed rules also restricted the range of activities to safe investments, which helped savings banks grow amidst difficult market conditions and a contracting banking sector towards the end of 19th century and the beginning of the 20th century.

Second, unlike the postal savings banks, the public bodies had no official power over the operations of savings banks.[102] However, the authorities could exercise some political influence on the operations of savings banks. For example, the 1936 Banking Law[103] put forth clear, functional and geographical restrictions on the activities of banks. Almost all banks, including the savings banks, were restricted to short-term activities. This meant that long-term loans could only be originated by special credit institutions owned by the government. The law also imposed strict authorisation requirements to protect the system from the perils of over-banking, restricted the growth and consolidation of the sector and prohibited banks from expanding or operating in multiple regions. In a more direct manner to influence the operations of savings banks, the public authorities started placing their representatives into the savings banks during the 1950s, effectively politicising the provision of credit (Barca & Trento, 1997; Sapienza, 2004).

Third, responding to the needs of the country in the aftermath of the Second World War, the authorities permitted the savings banks and other local banks to expand their activities to provide long-term local credit to start-ups and small businesses. Other banks remained under the strict restrictions imposed by the 1936 law. Policy-makers were concerned that if allowed to expand, large banks would divert resources from underdeveloped regions (Goglio, 2007, p. 21).[104] Several recent empirical

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[102] Postal savings banks were created in 1875 by local authorities to facilitate the financing of infrastructure development projects and to service debts. The postal banking service has been managed by the Cassa depositi e prestiti (CDP), which has been operational since 1850 providing financing for the needs of local authorities. In addition to the funding provided by the deposits of the postal bank (BancoPosta), CDP can also raise funds by issuing public bonds. Since 2003, CDP operates as a public bank with 70% of its share capital owned by the Ministry of the Economy.

[103] Decree No. 375 of 12 March 1936.

[104] See also Hakenes & Schnabel (2006), who show that information asymmetries may lead big national banks to direct capital from poorer to richer regions, i.e.

studies have confirmed that local banks did enhance the development prospects in underprivileged regions in post-war Italy.[105] Indeed, the banking system was quite successful in fostering the growth of the industrial sector, which is composed of a large number of small and medium enterprises.

7.2 Privatisation process

The reform of the Italian banking sector occurred in several steps. A crucial push came in 1990 with the Amato legislation,[106] which called for the transformation of the state-owned banks into joint-stock companies and the transfer of ownership rights. Effectively, this requirement separated the bank functions from the social and cultural responsibilities of the savings banks. Two distinct units emerged as a result. The first was a joint-stock company (Cassa di Risparmio SpA), entrusted with conducting the banking business while the second was a foundation (Fondazioni), which simply held the stock in the joint-stock company and continued, in most cases, to exist as a non-profit organisation with benevolent aims.

'capital drain'. The authors argue that the existence and accessibility of regional banks may prevent such flows and may indeed increase welfare.

[105] Ferri & Messori (2000) show that the close bank-firm relations have been beneficial for the allocation of credit in the Northeastern and Central (NEC) parts of the country. According to their findings, local banks in the NEC areas had significantly lower exposure to bad and doubtful loans. Moreover, the bank-firm relations in the NEC area do not seem to suffer from 'information capture', which would have allowed the local bank to use its monopolistic position to raise the interest rates on loans (see Sharpe, 1990). More recently, Guiso et al. (2004) examine if local financial development was an important indicator for the creation of new businesses in different regions. The authors take advantage of the fact that the 1936 law made the banks' branch structure unresponsive to changes for over half a century, allowing them to disregard the potential endogeneity between financial and economic development. The study's findings show that an individual's odds of starting a new business are significantly higher in financially developed regions and that the heavy presence of local banks and savings banks in the region in 1936 made this event more likely (Guiso et al., 2004, Table III).

[106] The legislation was enacted by Act No. 218 of 30 July 1990 and implemented by Regulation No. 356 of 20 November 1990.

The newly created joint-stock banks resembled their commercial peers.[107] The legislation also created the framework for tax-neutral legal transformations as well as offering tax incentives for mergers between commercial and savings institutions (Berlanda & Masera, 1993). The foundations, in turn, were attributed with public and national aims, mostly focusing on promoting arts, science and research in the country.

While the 1990 Amato law sought to harmonise the legal aspects of banks, there were still disparities between the regulations of different institutions dating from the 1936 Banking Law. In 1993, Italy implemented the EU's Second Banking Directive (89/646/EEC) with the adoption of its Consolidated Law on Banking.[108] The new law eliminated all the regional and functional restrictions and thus formally introduced the universal banking business model in Italy. The lifting of geographical restrictions also paved the way for the creation of banking groups in Italy.

The 1993 Consolidated Law on Banking prepared the groundwork for consolidation. However, the 1990 Amato Law effectively required most foundations to maintain controlling ownership in the original banks.[109] There was some ambiguity about how private an institution could be when controlled by a holding company with a public character. On the one hand, the implementing legislation allowed the foundations to have an 'administrative' role, which could imply that the public body remained as a 'purely *rentier* institution' (Maltoni, 2004). On the other hand, by ensuring that the foundations retain the majority stakes in these banks, the legislation also gave the foundation the ability to exert substantial influence on the internal functioning of this institution. In short, it was not clear if the separation of control from management of the banks really was effective in encouraging banks to operate under market discipline (see Maltoni, 2004).

The requirement for foundations to maintain a majority stake in the banks was eliminated with Law No. 474 of July 1994, allowing the sale of

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[107] The aim of the reform was to facilitate the access of newly created institutions to the capital markets (Zadra, 2005).

[108] Legislative Decree No. 385 of 1 September 1993.

[109] Sales of shares were allowed, but only "in exceptional cases, in order to strengthen the Italian credit system, its international role and asset base" (Berlanda & Masera, 1993).

controlling shares in banks. Moreover, the Dini Directive,[110] implemented in November 1994, introduced tax incentives for a broader group of undertakings, including foundations, to reduce their bank shares over the 1994-99 period. A more direct obligation was put forth in 1998 and 1999 with the Ciampi Regulation[111] requiring the foundations to shed their controlling stakes in banking institutions until June 2003. In order to encourage the foundations to sell off their shares, the regulation temporarily suspended the capital gains tax arising from these transactions. In 2003, the law was repealed for smaller foundations with up to €200 million of assets or those that are based in special-status regions.

Apart from the shedding of shares and the suspension of capital gains tax, the Ciampi Regulation also clarified the legal basis of foundations.[112]

Although the Ciampi law provided clear incentives for foundations to limit their influence in the banking sector, it is debatable whether such motives have been successful. According to Table 7.1, although their numbers have declined since 1990, there are still 15 foundations that hold controlling stakes in the original banks. It is also worth noting that the numbers have barely changed since 2000.

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[110] Directive No. 273 of 18 November 1994.

[111] Law No. 461 of 31 December 1998 and the subsequent implementing Decree No. 153 of 17 May 1999.

[112] More specifically, the regulation specified that foundations were: 1) not allowed to provide financial assistance in any way, directly or indirectly, to profit-seeking businesses, except those that engage in activities furthering the foundations' statutory goals; 2) subject to the same fiscal conditions as "non-profit organisations of social utility" as long as they abided with the requirements; 3) required to devote at least 50% of net income as grants to sectors indicated by the legislation; 4) permitted to take a controlling stake in a company only if the business of the company is in line with the social aims of the foundation and 5) required the diversification of risk and the allocation of resources to generate adequate returns (Grasso, 2002; Parlangeli, 2002).

Table 7.1 Equity interests of banking foundations in original banks (number of foundations)

	1990	1995	2000	2005	2007
Majority shares	88	62	23	16	15
Minority shares	0	26	57	57	56
No shares	0	1	9	15	17

Source: ACRI.

It is also necessary to examine the importance of the banks that are under the control of their original foundations. According to the ownership figures published regularly by the Commissione Nazionale per le Società e la Borsa (CONSOB), Fondazione Monte dei Paschi has maintained its controlling stake in one of Italy's largest banks, Monte dei Paschi, since 1999 (Table 7.2).

Table 7.2 Evolution of the shares of foundations in top Italian banks (% of total voting shares)

	December 1998		September 2008	
	Largest single block	**All foundations**	**Largest single block**	**All foundations**
Intesa	23	23	8*	19*
San Paolo - IMI	16	19		
Unicredito	19	38	5†	8†
Monte dei Paschi	78	78	55‡	55‡

Source: CONSOB.

* In January 2007, Banca Intesa merged with Sanpaolo IMI to form Intesa SanPaolo.

† In October 2007, Unicredito Group merged with the Capitalia Group, to form the Unicredito Group, the third Italian banking group at the time. In May 2008, the group changed its name to UniCredit Group.

‡ Data for June 1999.

Table 7.2 also highlights another important point. As evidenced by Unicredit's ownership structure in 1998, several foundations may hold shares of a single bank. The matter has become particularly important as mergers have created large banks from smaller savings banks. For example, Unicredito was formed between 1996 and 1998 as a result of a series of mergers between several institutions, including five savings banks: Cassa di Risparmio di Verona, Vicenza, Belluno e Ancona (Cariverona), Cassa di Risparmio di Torino, Cassa di Risparmio della Marca Trivigiana

(Cassamarca), Cassa di Risparmio di Trento e Rovereto and Cassa di Risparmio di Trieste. By 1998, the joint stakes of the foundations associated with the first three savings banks was 38% of all shares (see Table 7.1). The biggest single shareholder, Fondazione Cariverona, held half of these shares. By September 2008, the joint ownership had declined to 8%, divided almost evenly between Fondazione Cariverona and Fondazione Cassa di Risparmio di Torino.

Although the direct influence of foundations has declined remarkably within the last decade, the previous discussion reveals that foundations may exercise indirect control through joint ownership. Cross-holdings among foundations and banks may also be another form of control. Indeed, in some cases, a foundation may exercise indirect control over a bank with whom it had no original ties. For example, in December 1998, two foundations, Fondazione Cariplo and Compagna di San Paolo, had around 19% of total stakes of San Paolo – IMI. However, Banca Monte dei Paschi also owned 6% of the shares of San Paolo – IMI. As Table 7.2 clearly shows, Banca Monte dei Paschi, in turn, was majority owned by its foundation, which held over 78% of all its shares (see Table 7.1). Although two foundations owned a total of 19% stakes in San Paolo – IMI by the end of 1998, the potential influence of foundations on Intesa San Paolo is greater once one considers the fact that one of the shareholders, Banca Monte dei Paschi, is controlled by its foundation.[113] In short, although most

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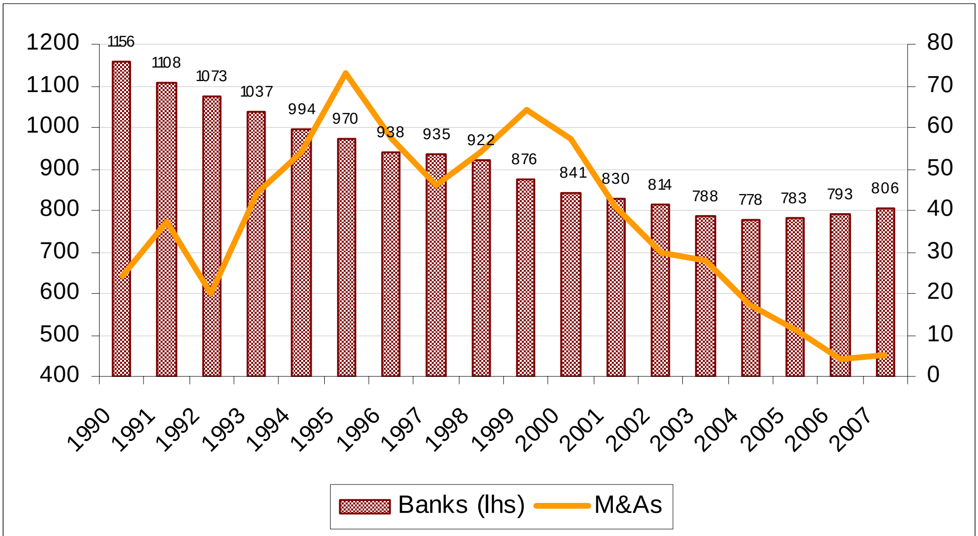
[113] The Finance Reform of 2002 put forth by the Finance Minister Tremonti contained several elements to address these issues regarding the ultimate ownership of a bank (Law No. 448, Article 11 of 2001). In order to mitigate the real influence of foundations and other political bodies, the proposal considered a broader definition of control. In particular, controlling interests would be assumed to exist when there were cross-holdings among foundations or when a core group of shareholders had a majority stake in a single entity. Apart from these changes, the proposed law also contained elements that would reduce the autonomy of the foundations. For one thing, the proposed article gave Banca d'Italia the discretionary power to determine if the foundations had joint control over a particular bank. More importantly, the legislation sought to limit the sectors in which foundations could operate and contained a provision on maintaining a majority of local government representatives on the board of the foundations. The Constitutional Court ultimately rejected the parts of the Tremonti proposal that contained the named amendments in 2003. The court found the powers conferred to local and supervisory authorities unconstitutional and reinstated the

foundations have reduced their influence on the banks, there is some place for concern due to direct or cross-holdings.

7.3 Competitive and other market developments

One of the main objectives of the Italian banking reforms was to foster the development of the financial services sector by making it more competitive. Prior to 1990s, savings banks were seen as an obstacle to competition. Among other arguments, the critics claimed that these banks could hold onto their dominant positions in their local markets, which made it less likely for other (presumably more efficient) banks to enter or subsist in those areas.

Figure 7.1 The evolution of banking sector and consolidation activity



Source: Banca d'Italia (1998 – 2007a).

The gradual privatisation of banks led to an enormous growth of the stock market. Between 1991 and 1998, the market capitalisation of *Borsa Italiana* rose significantly, from 12% of the country's GDP in 1991 to reach

foundations' full statutory and managerial autonomy over their activities. In responding to the amendments on the definition of control, the court ruled that a broader definition would be incompatible with the Italian Civil Code.

44% in 1998 and 47% in 2007. This rise in market capitalisation was largely associated with the growth of the financial services sector, with the share of the banking sector in the stock exchange's total market capitalisation reaching 30% by September 2008 (Borsa Italiana, 2008).

In terms of market structure, the total number of banks contracted by over 30% in the last three decades, decreasing from 1,156 in 1990 to 806 in 2007, as a result of a booming consolidation process,[114] which peaked during the second half of 1990s (Figure 7.1). In terms of concentration, the Italian banking structure has not changed much since the 1990s. Ever since the 1990s, the five largest banks accounted for between 25 to 30% of total bank assets in Italy. When compared to other EU15 countries, the Italian banking sector is one of the least concentrated markets. Indeed, according to Figure 7.2 the Italian banking sector was the second least concentrated market among all EU15 countries by the end of 2006.

Like in most other developed countries, Italian banks have reduced their interest income. As the profitability of traditional banking activities has come under pressure, banks have increased their non-interest income activities (Smith et al., 2003). These observations suggest that the banks have realigned their position as financial intermediaries, increasingly engaging in non-traditional fee-based activities like security underwriting, insurance services, investment advice, etc.

Figure 7.3 confirms that Italian banks have indeed generated increasingly more income from fee-generating activities, which made up roughly 25% of their gross incomes in 2007. Although banks earn less and less from traditional activities, the figure also shows that Italian banks still rely more on interest income than their peers in other EU15 countries. By 2005, the interest incomes of EU15 countries came to about 55% of their gross income on average, roughly 10% less than that of Italian banks.

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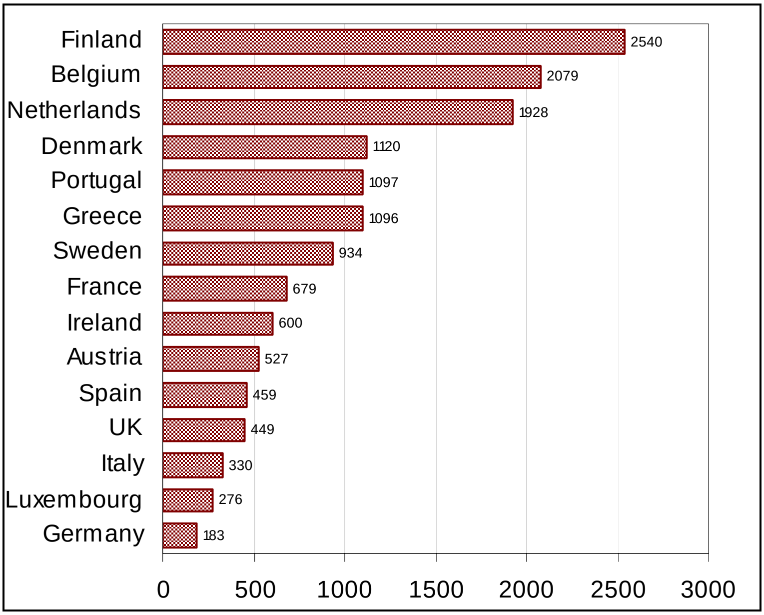
[114] At the same time, the real impact of the restructuring activity has varied over the years. For example, the 57 M&As that took place in 1996 all involved smaller institutions that held in aggregate about 2% of the system's total assets (Banca d'Italia, 1999b, p. 276). In turn, the transactions that occurred over the past few years have had a sizeable impact on the banking sector. In particular, the share of system assets attributable to the handful of transactions that occurred between January 2006 and May 2007, including Banca Intesa's merger with San Paolo IMI and UniCredito's merger with Capitalia is estimated at 23.5% (Banca d'Italia, 2006a, p. 144).

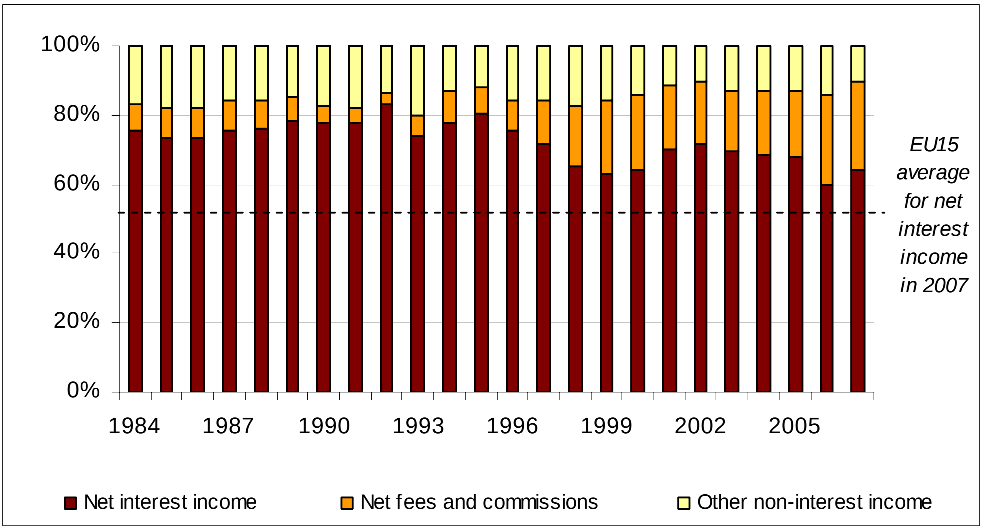
Figure 7.2 Comparison of Herfindahl-Hirschman Indices (HHI) for EU15 countries in 2007 (index ranging from 0 to 10,000)*



* The HHI measures concentration by taking into account the relative size and distribution of the firms, approaching zero when a sector is composed of firms with similar sizes.

Source: ECB (2008).

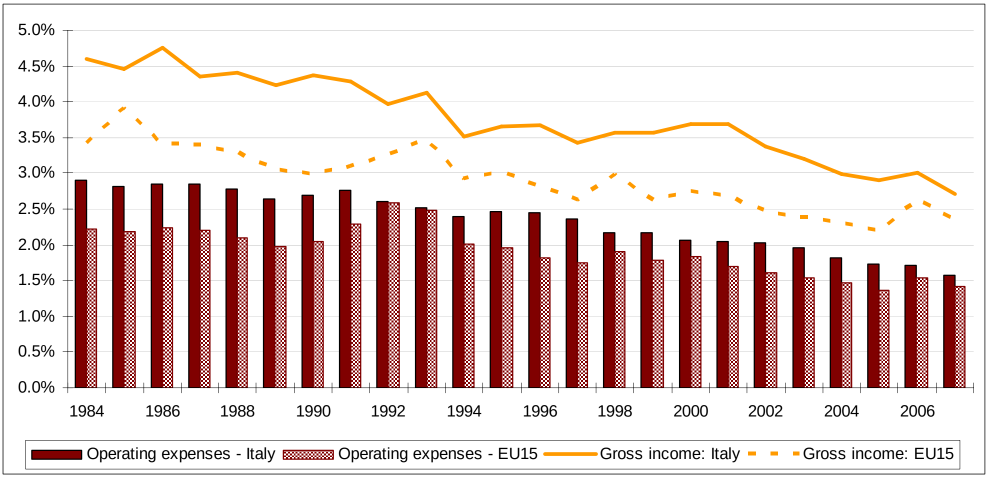
Figure 7.3 Breakdown of income for Italian banks (1984-2007)



Source: OECD Bank Profitability Statistics (2009); Bank of England.

Given that Italian banks rely more on traditional activities than their peers in other EU15 countries, it is questionable whether they can remain competitive in the rapidly changing financial world. The data seem to suggest that the banks are doing rather well. Indeed, one of the key characteristics of the Italian banking sector has been the persistence of high revenues. However, these high revenues also come with persistently high costs. As depicted in Figure 7.4, over the last two decades, Italian banks have both earned and expended more than their peers in EU15 countries. Within the same period, the difference between the average revenues of Italian and EU15 banks is slightly below 1% of total bank assets. Likewise, the difference between average costs is approximately 0.5% of total bank assets.

Figure 7.4 Gross income and operating expenses (% of total bank assets, 1984-2007)



Source: OECD Bank Profitability Statistics (2009); Bank of England.

Although Italian banks differ from their EU15 peers in terms of their revenues and costs, Figure 7.4 also highlights a shared trend. Indeed, both variables have been on the decline since 1984. In particular, the revenues and costs of Italian banks have been diminishing at a stable pace of about

0.8 and 0.6% of total assets per year, respectively.[115] The trend is mirrored, albeit with less consistency, in other countries. Apart from a brief period in the beginning of the 1990s when Sweden and other Nordic countries faced severe banking crises, operating expenses and gross incomes have declined monotonically across the EU15 countries.

Table 7.3 shows that the cost-to-income ratio of Italian banks has improved since the early 1990s, comparatively with the EU15 averages. This trend is more likely due to changing market conditions, i.e. varying income and costs over time, rather than structural reorganisation.[116]

Table 7.3 Cost-to-income ratios in major EU15 countries (average percentages)

	Italy	**EU15**
1988 - 1992	67.3%	71.7%
1993 - 1997	67.9%	66.2%
1998 - 2002	58.0%	63.2%
2003 - 2007	58.9%	62.8%

Source: OECD Bank Profitability Statistics (2009); Bank of England.

Several studies have also noted that Italian banks enjoy persistently high operating profits (Carletti et al., 2005; Drummond et al., 2007). The performance ratios displayed in Figure 7.5 confirm these observations to a large extent. Indeed, Italian banks performed better than their peers in EU15 countries for most of the years between 1985 and 2007, at least in terms of return-on-assets ratio. The notable exception is the period between 1994 and 1996, which corresponds to the initial privatisation era for the Italian banking sector. As more and more institutions were privatised, the banks had to assume large amounts of write-downs on some of the bad loans and securities in order to ensure a "healthy placement in the market" to attract potential buyers (Deutsche Bank Research, 2004, p. 13).

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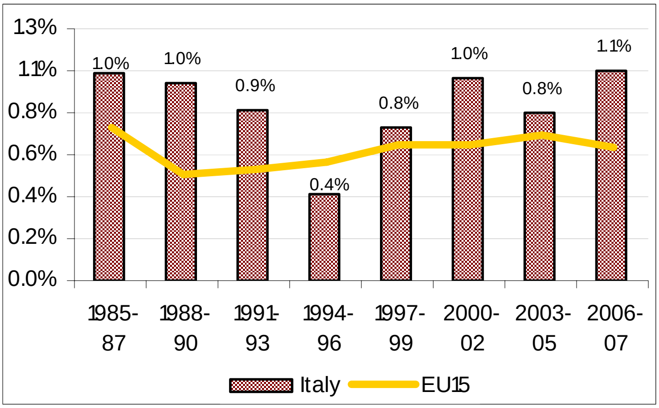
[115] A simple linear trend regression using the Italian data explains about 90% of the annual variation in gross income and operating expenditure.

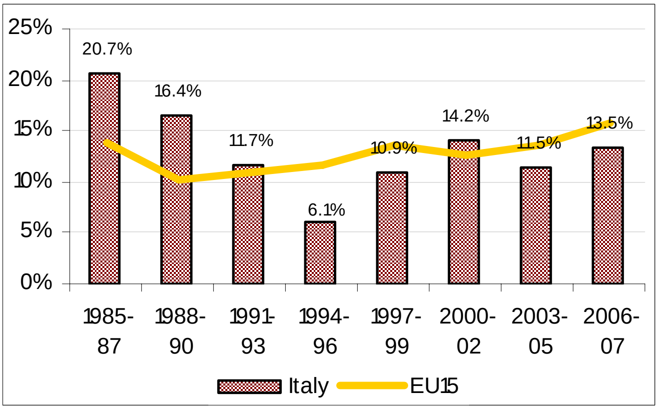
[116] Empirical evidence appears to confirm this hypothesis. According to a recent study, the top 50 Italian banks "are less effective than [most banks in other European countries] in managing costs and generating higher revenues", which is a clear evidence of lower productive efficiency (Drummond et al., 2007, p. 18).

Figure 7.5 Evolution of the performance of Italian banking sector

a) Return-on-asset (ROA) ratio



b) Return-on-equity (ROE) ratio



Source: OECD Bank Profitability Statistics (2009); Bank of England.

Indeed, the net provisions of Italian banks peaked between the years 1994 and 1997, accounting for over two-thirds of net income before provisions during the entire duration of these four years. In the years that followed, the net provisions fell to their pre-1994 norms, never exceeding 40% of net income before provisions. As a consequence of these massive write-downs and value readjustments, the Italian banks performed considerably below the banks of other EU15 countries between 1994 and 1997, but then improved their performances (Figure 7.5).

The findings above show that the Italian banking sector is neither more efficient nor more competitive now than it was in the 1980s. For one thing, although operating expenditures as a share of total assets have been declining, so are the gross incomes as a share of total assets (Figure 7.4). Figure 7.5 shows that apart from a brief period of low profits in the mid-1990s, Italian banks have performed consistently better than EU15 banks. Indeed, the persistence of high profits, "coupled with high revenues and/or high costs" may be an indicator of "anti-competitive behavior" (Drummond et al., 2007, p. 9).

Since 2007, the financial crisis has had a notable impact on Italian banking. Profits have been hit; return on equity has fallen to 9% in the first nine months of 2008, compared to 11% in the same period in 2007. Loan deterioration accounted for an increase of about 40% of allocations to loan-loss provisions and valuation adjustments, which absorbed a significant portion of the profits. These losses have also contributed – and will continue to do so – to a slowing of lending.

7.4 Service, access, proximity and financial inclusion

Historically Italian banking has been one of the least accessible banking systems in Europe. Indeed, according to the findings of a project recently commissioned by the European Commission, financial exclusion – which refers to a lack of access to transaction banking, savings, credit and insurance services – is quite high in Italy (European Commission, 2008). In particular, 26% of all surveyed individuals had no transaction bank account, 19% had no account of any kind, while exactly half of the respondents did not have any savings accounts (ibid., Tables 7.5 and 7.6).[117] These values are significantly higher than the reported EU15 averages of 18, 10 and 30%, respectively.

Part of the reason for the lack of access may be traced back to the regional restrictions imposed by the 1936 Banking Law, which prohibited banks from growing in several regions at one time. By the 1980s, the branch structure was one of the least extensive among the larger countries in Europe. In 1987, the Italian banking structure had just over 0.20 branches per thousand habitants, which was lower than Austria (0.55), Germany (0.51), Spain (0.86), and the UK (0.24).

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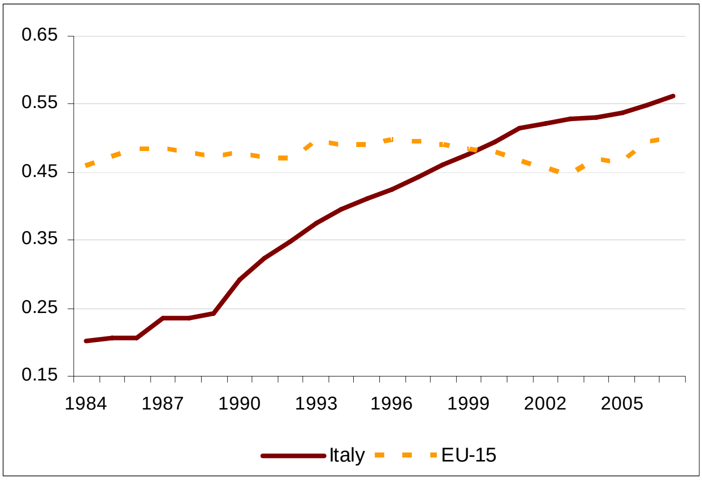
[117] A recent bi-annual survey conducted by the Bank of Italy finds that almost 11% of the respondents had no accounts of any kind (Banca d'Italia, 2008).

Figure 7.6 Number of branches per 1000 habitants (1984-2007)



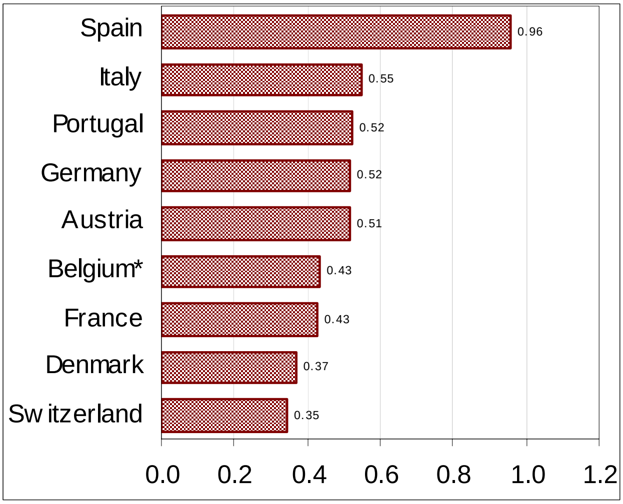
Sources: OECD, Bank Profitability Statistics (2009) and Eurostat.

By abandoning the regional restrictions, the 1990 Banking Law opened a new set of opportunities for Italian banks. The banks quickly developed their networks, providing banking services to remote areas. Figure 7.6 shows that after a period of weak growth during the 1984 to 1989 period, the Italy's branch network expanded rapidly after 1990 and surpassed the EU15 average by the end of 1990s. By the end of 2007, Italy had more branches per habitant than most other developed nations. Indeed, an international comparison suggests that Italy outranks most other developed nations in terms of branch access (Figure 7.7a).

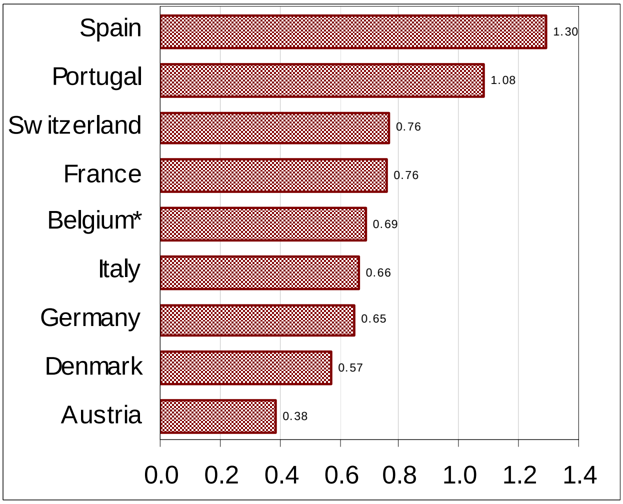
An extensive network structure is necessary for providing services to a larger part of the population. However, it is not sufficient to ensure access to banking services. Although Italy ranks high on a comparison of countries in terms of number of branches, the same cannot be said when one considers access to automated teller machines (ATMs). According to Figure 7.7b, Italy ranks poorly among a list of developed countries in terms of number of inhabitants per ATM. Even though Italy has the second-most extensive branch network among the 11 countries depicted in the comparison, it is fourth from the bottom in terms of the availability of ATMs.

Figure 7.7 Comparison of access to bank networks

a) Number of branches per 1000 habitants



b) Number of ATMs per 1000 habitants

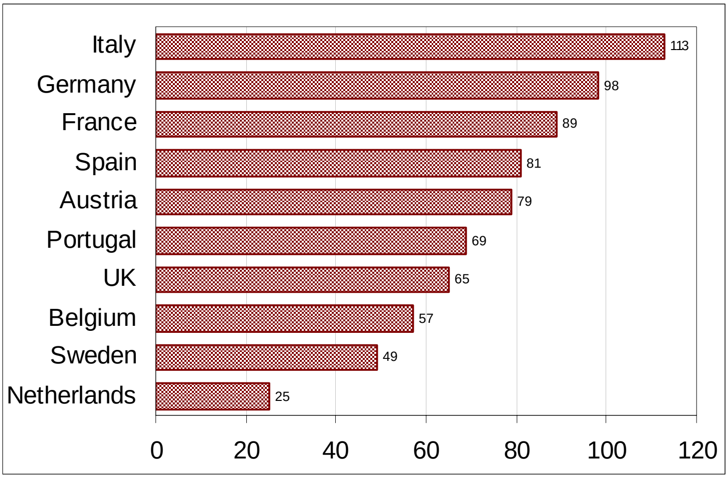


Source: CapGemini (2006).

Another question is whether the benefits of liberalisation have been passed on to customers. The unavailability of historical time series makes a definite answer difficult. However, several studies have shown that the price of basic banking services in Italy remains among the highest in

Europe. Figure 7.8 summarises the findings of a study by CapGemini, which ranks countries according to the average price of basic banking services, including fees and commissions associated with opening and maintaining a current account, debit and credit card services, online banking, wire transfers, etc. Among the major developed countries included in the study, the figure shows that Italy had the highest pricing. Other surveys have also reached similar conclusions. A recent Oxera (2006) report shows that the annual fees on a current account used by a typical median-income family were the greatest in Italy when compared to other developed nations. The results of a survey by Mercer Oliver Wyman (2005) points to a less extreme result after accounting for various implicit overheads associated with holding an account. Despite an improved ranking, the survey finds that the price of a current account is still 23% higher in Italy than the average for the seven major EU countries included in the study. The European Commission's retail banking inquiry also reaches a similar conclusion for a wider range of fees and charges. According to the market survey that was conducted by the Commission, Italy had the highest account management fees among all EU25 countries and the second highest (only after Lithuania) in account closing charges (European Commission, 2007, Figures 12 and 13).

Figure 7.8 Comparison of price of basic banking services (in €, adjusted for local customer profiles)



Source: CapGemini (2005).

Another dimension of access is the use of services by different classes of customers. In general, lending to private sector firms has increased from 56% of the GDP in 1990 to over 100% of the GDP in 2007. Similarly, the use of current accounts has also increased, from 29% of the GDP in 1990 to 46% of the GDP in 2007 (IMF International Financial Statistics, 2008). The loans to households have also increased from 18% of GDP in 2005 to 34% of the GDP in 2007 (Eurostat).

One question is whether these observations apply also for SMEs. One can suspect that by liberalising the local banks, the 1990s reforms have impaired the relationships between local lenders and borrowers, thereby reducing the availability of loans to SMEs (Berger & Udell, 1995). On the other hand, a counter argument is that expanding branch networks and a competitive banking sector might have actually enhanced the credit opportunities for SMEs. While both arguments are plausible, the information that is provided publicly suggests a mixed picture. According to Banca d'Italia (1998a, p. 180), "the credit lines granted to households and small business … rose from 37% of total bank lending in the mid-eighties to 44%" in 1998. Despite these modest gains, the share of lending to small businesses contracted after early 1990s, "falling from 29% in 1991 to 27% in 1998", while lending to households "expanded at annual rates of around 10%, or nearly twice as fast as total lending" (ibid.). Empirical evidence seems to confirm the latter observation. According to the findings of a study by Bonaccorsi di Patti & Gobbi (2001), the structural changes that the Italian banking industry has faced in the 1990s might have had negative effects on SME lending.

European Flash Barometer (European Commission, 2005) suggests that Italian SME managers are the most likely among their peers in other EU15 countries to voice their discontent with the financing of their enterprises. In particular, only 66% of the Italian respondents stated that their company's current financing was sufficient, the lowest percentage among all 15 countries and lower than the EU15 average of 77%.

The impact of the financial crisis has been notable on the Italian economy, with GDP contracting by 1.8% on an annual basis in 2008. One particular problem is the declining business lending. Credit surveys conducted by the Bank of Italy in 2008 show that the terms and conditions of loans are becoming more restrictive for all firms alike.[118] About half of all banks surveyed indicated that the conditions they apply to firms were tightened considerably. Moreover, there is evidence that new loans to smaller firms are declining. Although loans to non-financial corporations have increased by 7% annually by November 2008, the growth of loans to smaller firms was only 2%. These developments point at present and upcoming financing shortages for small-sized firms.

7.5 Conclusions

The 1990 *Amato* reforms and what followed had an enormous impact on the Italian banking sector. The number of banks has declined as a direct consequence of the mergers and acquisitions in the sector. In the meantime, Italian banks have posted improved performances as they increased their non-interest earning activities. Despite these findings, however, cost-to-income ratios have remained constant through the last 20 years, suggesting that the banks are not more efficient than they were prior to the reform. More critically, bank revenues and costs have been persistently high, possibly due to a lack of competition in the sector.

In terms of access to services, the evidence is also mixed. Despite an improved branch network, bank terminals remain relatively scarce and more importantly basic bank services remain expensive. Although lending to the private sector has increased significantly, there is some evidence that small businesses are having a harder time to obtain financing.

These results suggest that the original aim of the 1990s reforms has not fully been achieved in Italy. In fact, apart from several indicators of improved performance and the shift to non-traditional activities, there is little evidence that the Italian banking sector is more efficient or competitive today than it was before the 1990 reforms. Access to bank services is limited and below EU15 averages. The disappearance of savings banks might have worsened the provision of credit to some customers. These conclusions are reinforced by how the financial sector has responded to the financial crisis that started in August 2007 with visible lending restrictions.

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[118] For more information, see pp. 35-36 in the Bank of Italy's *Economic Bulletin*, January 2009.

8. COUNTRY ANALYSIS: DISAPPEARANCE OF BELGIAN SAVINGS BANKS

8.1 Origins and historical development

The origin of savings banks in Belgium dates back to the mid-1810s under Dutch rule. During those years, a number of institutions were developed under the leadership of William I of the Netherlands and the Dutch Society for General Utility (Maatschappij tot nut van't Algemeen). The banks, founded with the initial capital contributions from nobles and the members of Chambers of Commerce, grew locally and remained private, away from the direct influence of the government. The institutions aimed at stimulating saving behaviour among the working classes and at providing them with the means of becoming economically autonomous (Witte & Parmentier, 1986, pp. 73-78).

The political and economic turbulences that hit the country following independence in 1830 and the ensuing banking crises that followed led to the closure of most of the savings institutions between 1840 and 1850 (Buyst & Maes, 2008). In response, the Belgian government set up the General Savings and Pension Fund (Caisse générale d'épargne et de retraite – CGER) in 1865. The bank differed from earlier savings banks in that it was managed by the state. The deposits held at the bank were put under government guarantee while the bank had access to the post office's branch network.[119] Much like its predecessors, its main aim was to provide safe

[119] Over the years, the CGER's use of post offices for the collection of deposits and provision of bank services continued. In 1873, a postal savings system was introduced under the management of the public entity, Office des comptes postaux. In 1995, a Banque de la Poste was formed as a result of a public-private partnership with the Belgian post office and Générale de Banque, which later became Fortis.

deposit accounts for lower-income individuals. CGER grew quickly and managed to capture about half of all bank deposits in the early 19th century (Van Molle, 1986). The bank remained an important player in the sector until its merger with the privately owned Société Générale de Banque to form Fortis in 1999.[120]

In the years following the Great Depression, and soon after enacting the Royal Decrees of 22 August 1934 and 9 July 1935, the Belgian banking landscape was composed of commercial banks, which were collecting deposits and granting commercial loans under the strict liquidity and solvency requirements imposed by Commission Bancaire et Financière (CBF); private savings banks, which managed the deposits[121] of small savers and had no public backing or mandate and were subject to the supervision of a newly created Office Central de la Petite Epargne (OCPE) – a subdivision of the National Bank of Belgium (NBB); and public credit institutions, comprised of the CGER as well as a number of credit smaller institutions specialised in providing small commercial, agricultural and household loans. Among the public institutions, only CGER was subject to regulation by the CBF.

In the years following the Second World War, Belgian banks increasingly became the "banquiers de l'Etat",[122] acting on behalf of the government to collect deposits (Durviaux, 1947). Moreover, the price controls pushed them to develop an extensive branch network (Quaden, 1993; Abraham, 1999). Between 1960 and 1970, the number of bank branches increased from 1,787 to 3,073 branches. Until the end of 20th century, the extensive branch network has remained one of the most important characteristics of the system.

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[120] Fortis was the first true cross-border bank active in Belgium until its demise in October 2008. See the discussion at the end of the section.

[121] The Royal Decrees of 22 August 1934 and 9 July 1935 restricted the activities of these banks, requiring them to invest at least 60% of their deposits in government securities or mortgage loans.

[122] Between 1945 and 1960 the credits to public sector represented roughly half of the total assets of all banks (Cassiers et al., 1998).

Table 8.1 Shares of different categories of banks in major market segments (% of sector total)

		Commercial banks	Private savings banks	Public credit institutions
Total assets	1950	45.2%	4.5%	50.3%
	1960	40.2	8.6	51.2
	1970	52.0	9.9	38.1
	1980	62.5	9.1	28.3
	1990	66.5	10.7	22.8
Total deposits	1950	39.3%	4.9%	55.8%
	1960	33.9	9.3	56.8
	1970	37.9	12.8	49.3
	1980	40.4	14.4	45.2
	1990	48.2	15.3	36.5
Sight deposits	1950	87.1%	..	12.9%
	1960	85.9	..	14.1
	1970	77.4	1.7%	20.9
	1980	67.3	4.8	27.9
	1990	69.9	6.6	23.5
Private loans	1962	30.0%	11.4%	58.6%
	1970	35.8	13.4	35.8
	1980	45.7	14.0	40.3
	1990	51.0	14.6	34.4

Source: Belgian Association of Banks-ABB (1986, 1992).

The restrictions on banking institutions, including private savings banks, were gradually lifted in 1967[123] and in 1975.[124] As a consequence of these legal changes, deposit banks increased their market shares from about 40% in 1960 to over 66% in 1990 (see Table 8.1 above). The banks also provided more loans to the private sector, with their shares increasing from 30% of total private sector loans in 1962 to 51% in 1990. The gains were not limited to commercial banks. Private savings banks also gained some

123 The law of 3 May 1967 authorised banks to hold bonds of non-financial companies as well as allowing them to hold shares for short periods of time for placement in the market

124 The "Mammoth" Law of 30 June 1975 abolished the prohibition of commercial bank participation in the equity market. Perhaps more importantly, the law lifted the asset management restrictions on savings banks, effectively subjecting them to the same regulatory environment as their commercial peers.

ground, increasing their share of total deposits from under 10% in 1960 to about 15% in 1990 even though the share of their assets remained virtually the same around 9 to 10% of total bank assets in the country.

The 1975 laws proved less beneficial for public credit institutions, which lost their dominant position in the market. Between the years 1960 and 1990, the share of their assets dropped from 51% to 23% (Table 8.1). The two largest public credit institutions, *Credit Communal de Belgique* and CGER, remained among the top five banks in terms of total assets throughout the second half of the century until mid 1990s.

In the 1990s, the general trend of privatisation and the implementation of the Second Banking Directive[125] in Europe have contributed to the changing market structure of the Belgian banking industry. Mergers and acquisitions occurred chiefly between different categories of banks. For instance, in 1993, part of the capital of CGER, the largest public bank was sold to Fortis at the government's request; two years later, CGER acquired Société Nationale de Crédit à l'Industrie (SNCI), allowing it to expand into the corporate lending market; in 1998, Kredietbank merged with a savings bank Centrale des Caisses Rurales (CERA) and a number of Belgian insurance companies to form the KBC Bank, in the same year, the Dutch banking group ING acquired Banque Bruxelles Lambert (BBL), which was one of the first large cross-border acquisitions in the EU; finally in 1999, Fortis effectively took over CGER and Société Générale de Banque, to create one of the largest pan-European banks.

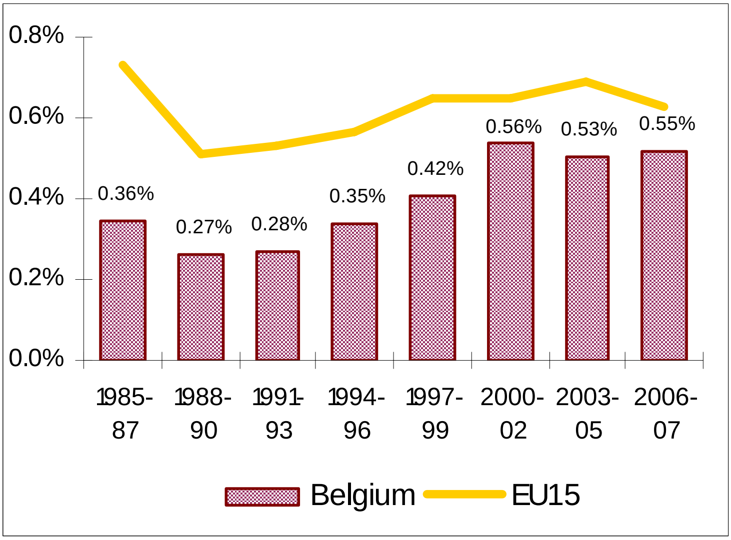
[125] Directive 89/646/EEC of 15 December 1989. The Directive was implemented in Belgium on 22 March 1993 and aimed at harmonising the legal and regulatory framework for all credit institutions. It defined a *credit institution* as a Belgian or foreign undertaking that receives deposits or other repayable funds from the public and gives loans for its own account. The only institutions that were authorised to use the term 'savings bank' were CGER and the small communal savings banks, which have been in existence since the 1930s. It is important to note that since the legal status of all credit institutions were the same, the use of the term savings bank could simply be for "marketing purposes" (Vander Vennet, 2002, p. 34).

8.2 Competitive and other market developments

Following the 1993 reform, profitability and efficiency of the Belgian banking sector have increased. Data shows that Belgian banks started to catch up with their EU15 counterparts (Figure 8.1), right about the same time that they have started to undertake more non-interest earning activities at the expense of net interest income[126] (Figure 8.2). In parallel, cost efficiency – proxied by the cost to income ratio – improved over years until being aligned with the EU15 average by 2007 (Figure 8.3).

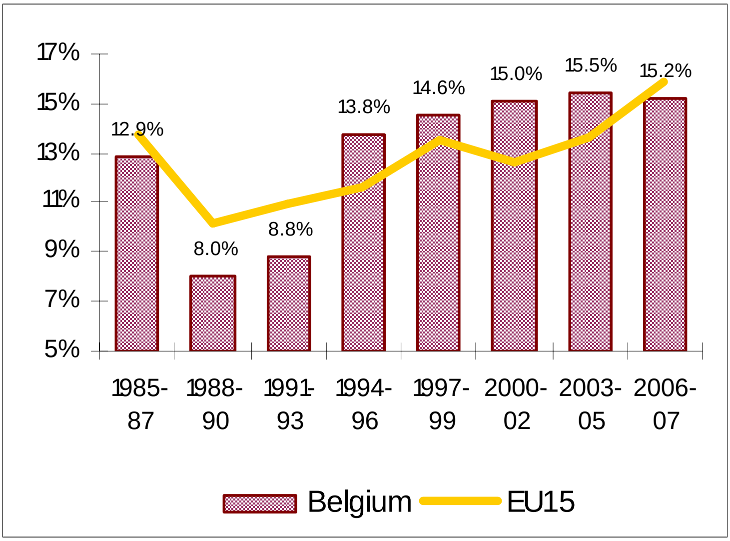
Figure 8.1 Evolution of the performance of Belgian banking sector

a) Return-on-asset (ROA) ratio



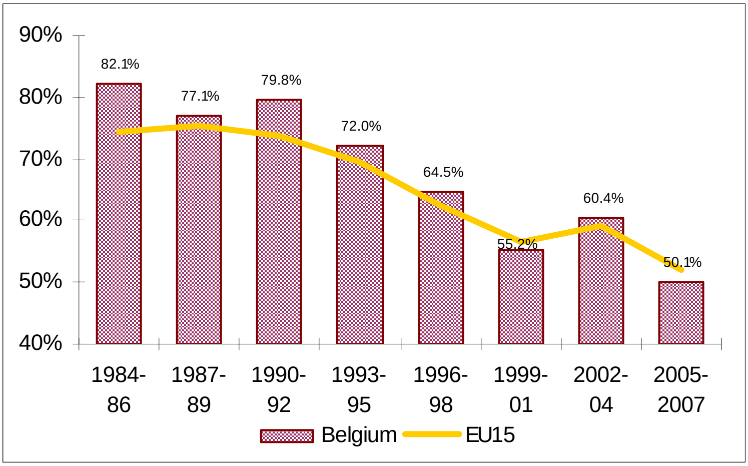
126 The lower returns before mid-1990s are partially explained by the banks' reliance on interest-related revenues (Vander Vennet, 2002).

b) Return-on-equity (ROE) ratio



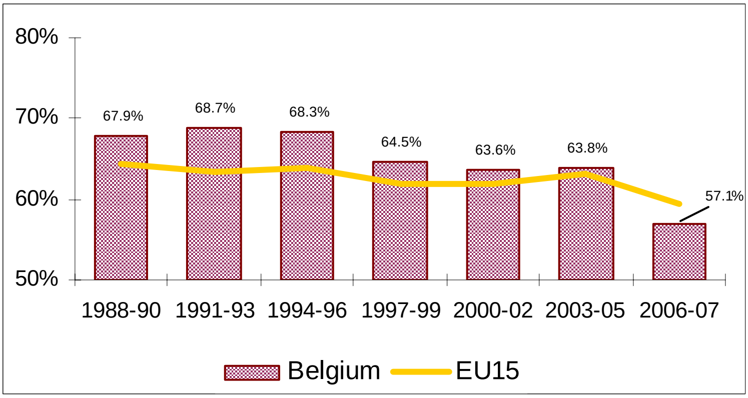
Source: OECD Bank Profitability Statistics (2009); Bank of England.

Figure 8.2 Share of net interest income for Belgian banks (% of gross income)



Source: OECD Bank Profitability Statistics (2009); Bank of England.

Figure 8.3 Cost-to-income ratios of Belgian banks (average values for given years)



Source: OECD Bank Profitability Statistics (2009); Bank of England.

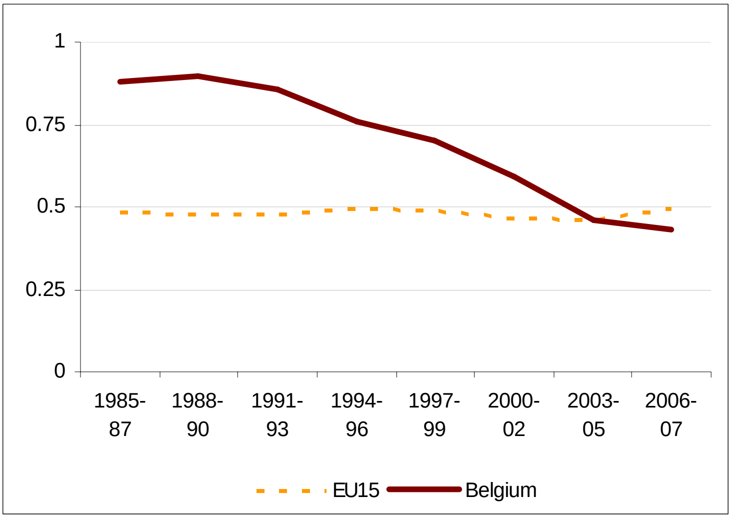
In the fall of 2008, Fortis became the largest European institution to fall prey to the global financial crisis that has engulfed the global markets since August 2007. The bank's troubles stemmed from its acquisition of the Dutch bank ABN AMRO's retail arm in October 2007. In the months following the onset of the global financial crisis, the purchase proved too costly. At first, the bank was able to raise funds from the capital markets and by the issuance of asset-backed securities from its US subsidiary. Then, in June 2008, responding to calls from EU's competition authorities, the bank was forced to sell some of the assets it acquired from ABN AMRO at highly unfavourable terms. By the end of September 2008, the fall of Lehman Brothers worsened the global conditions. Short of borrowing opportunities, the bank had no option but to accept a partial nationalisation by the governments of Belgium, the Netherlands and Luxembourg.

In early October 2008, only days after the coordinated rescue, the Dutch government decided to fully nationalise the bank's Dutch arm. Meanwhile, an agreement with BNP Paribas was initiated by the Belgian government for the eventual sale of the remaining banking and international insurance arms. In the following months, the sale has been blocked due to legal challenges posed by the Dutch government's unilateral decision and by shareholders who challenge the legitimacy of the proposed sale. In December, a Belgian court has ruled that the shareholders must have their say. The ensuing turmoil has led to the Belgian government's resignation on 19 December 2008. After a period of uncertainty and a vote against the sale in February 2009, shareholders voted in favour of the sale on 28 April 2009.[127]

8.3 Service, access, proximity and financial inclusion

A distinguishing characteristic of the Belgian banking sector has been the extensive branch network developed in the 1960s. Up until 2002, Belgium was among the top ten countries worldwide in terms of number of branches per habitant and geographical dispersion of branches (Beck et al., 2007). However, ever since the mid-1990s, Belgian banks have been contracting their branch networks, mostly in an effort to reduce their operational costs (Figure 8.4). Indeed, by the end of 2007, the number of branches per thousand habitants in Belgium (0.42) was below the EU15 average (0.50) (ECB, 2007).

Figure 8.4 Number of branches in Belgium per 1000 habitants



Sources: ABB (1986-2008), OECD (2009), and Eurostat.

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[127] According to the details of the final agreement, the French bank will own 75% of the banking operations (Fortis Bank) in exchange for around €9 billion. BNP Paribas will also take hold of 25% of the insurance arm (Fortis A.G.) in exchange for around €1.38 billion destined for shareholders. The remaining insurance business will remain in the hands of Fortis' shareholders under the Fortis Group.

The contraction in the number of branches and the disappearance of cooperative and public banks, which had the traditional role of providing services to lower-income residents, raises concerns about access to financial services and financial exclusion. In response, the Belgian Association of Banks (ABB), which represents the banking industry, adopted a charter regarding basic banking services by the end of 1996. The charter required the member banks to provide basic banking services to all legal residents. However, a 2001 study commissioned by the Minister of the Economy pointed to the deficiencies of self-regulation (Bayot, 2001). In particular, the number of individuals with no bank accounts had actually grown since the adoption of the charter (p. 84).[128] In response to these shortcomings, the government adopted the law of 24 March 2003, obliging Belgian banks to provide a basic bank account and related services, including transfers, deposits, withdrawals and provision of statements, to all legal residents. According to the findings of a recent survey conducted in 2005, the law has been partly responsible for the drop in the number of residents with no bank accounts (Disneur et al., 2006).[129]

Another issue is whether a more concentrated market enables banks to charge higher prices for their services, thereby limiting access.[130] Indeed, this is a relevant concern in Belgium, where the share in total assets of the top five banks rose from 48% in 1985 to 84% in 2006, putting the Belgian banking sector among the most concentrated markets in the EU (ABB, 1999; ECB, 2007). The concern is that the large banks can exercise their market power by charging higher prices for basic services. Comparative evidence, however, suggests that such services are relatively cheap in Belgium

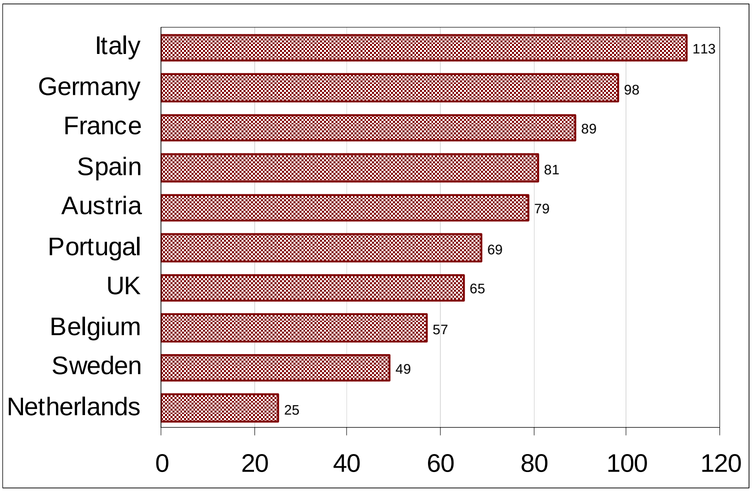
[128] According to the 2001 study, the number of residents with no bank accounts was around 40,000 in the year of publication (Bayot, 2001, p. 75). The principal reason that banks refused to provide basic banking services was insufficient income and existence of other debts (ibid., Table 23).

[129] According to the study, over 5,500 basic bank accounts were created by the end of 2005. The number undermines the actual effect of the law since some potential beneficiaries have opted for normal deposit accounts. Indeed, the study reveals that the number of unbanked residents has declined from around 40,000 in 2001 to about 11,500 in 2005 (Disneur et al., 2006, p. 21).

[130] Although the Law of 24 March 2003 has put a reasonable upper limit on the account fees, it does not cover other direct and indirect costs associated with basic bank services, such as transfer fees, over-charge fees, etc.

(Figure 8.5). In particular, basic bank services are cheaper in Belgium than in Germany, Spain and the UK, which have significantly less concentrated markets.

Figure 8.5 Comparison of price of basic banking services (in €, adjusted for local customer profiles)



Source: CapGemini (2005).

An additional concern is whether the reforms and the banking sector restructuring have harmed the provision of credit to small- and medium-sized enterprises. Empirical evidence suggests that such a concern is not entirely baseless. Degryse et al. (2005) show that there is a robust negative effect between loans to small businesses and mergers, especially for borrowers that had an exclusive relationship with the acquired bank. However, the same study also affirms that firms that maintained a relationship with acquiring banks or with multiple banks are less likely to be impacted by mergers, either because the institution that they have maintained a close relation with remains active or because they have several options for obtaining loans.

A 2005 European Flash Barometer (European Commission, 2005) suggests that Belgian SME managers were relatively content with the financing opportunities available for their enterprises. More specifically, 82% of the Belgian respondents surveyed stated that their current financing was sufficient, which was 5% above the EU15 average. Moreover, only 7% of the respondents found that an easier access to means of financing would assure the development of their companies, again significantly lower than the EU15 average of 14%.

8.4 Conclusions

In the 20th century, the Belgian banking sector has been shaped by the laws enacted in response to the Great Depression, which restricted the activities of different categories of banks, and the easing of these restrictions in 1975 and, more recently, in 1993.

The empirical evidence suggests that banks have improved their performance and efficiencies and caught up with the EU15 averages. The reforms did not lead to a worsening of access to financial services, despite an increased concentration. One reason may be the government initiatives on ensuring financial inclusion. Also, the price of basic banking services is among the lowest in Europe, which either suggests that banks have passed the gains to customers or that they are benefiting from cross-subsidisation anchored in the bank-insurance business model. Although some SMEs might have been disadvantaged with increased concentration, the financing opportunities available to them remain sufficient and are above EU15 averages. The 2007 financial crisis and the fall-out of Fortis will bring new challenges to the Belgian banking sector in terms of competition, access and inclusion.

POSTSCRIPT

The background to this study was the debate about the role of savings banks which has taken place in Europe over the last two decades. The most often used arguments against savings banks concerned such issues as their legal status, political interference, governance and, most of all, their nature as 'dual-bottom line' financial institutions. Our study argues that this dual-bottom line nature and the general contribution of savings banks to institutional diversity are welfare-improving since they enhance competition and limit financial exclusion.

Savings banks and the welfare consequences of institutional diversity

We have found that there is diversity across selected European countries, namely Austria, Germany and Spain, in terms of the legal status of European savings banks and showed that their (natural) evolution has not always followed the same pattern, nor has the increasing similarity of economic and social problems in different European countries been so marked as to lead to similar legal and institutional solutions. There are many important differences in the legal regimes governing what seems to be the most common form of the financial institutions: the shareholder-based bank. Even in Europe, where great harmonising efforts have been made, company law directives refer a multitude of essential points to national legislators, recognising that singularity and particularity are irrefutable. In so far as the banking sector is concerned, the most explicit regulatory recognition of institutional diversity took place with the European Parliament resolution of 5 June 2008 on the European Commission sector inquiry on retail banking (2007/2201(INI)). In this resolution, the European Parliament states:

> The diversity of legal models and business objectives of the financial entities in the retail banking sector (banks, savings banks, cooperatives, etc.) is a fundamental asset to the EU's economy which enriches the sector, corresponds to the pluralist structure of the market and helps to increase competition in the internal market.

With special reference to savings banks, the European Parliament considers that:

> The European Commission (in the sector inquiry on retail banking) underestimates some of the typical features of such banks, such as their presence in areas considered to be outlying, the degree to which they are rooted in the territory and their social role.

It also acknowledges that these features are very important in terms of the efficiency with which financial services are provided. The current crisis has shown that institutional diversity in European financial markets reduces systemic risk. The relative stability of the savings bank sector mitigates against some of the instability created in the sector dominated by other banking models.

We also find that in terms of efficiency, profitability and earnings stability, no particular ownership model for banking can claim overall superiority. In some cases, however, savings banks perform slightly better.

An additional argument for institutional diversity derives from the consideration of social efficiency. Differences between countries in this regard are partly due to the application of very similar strategies by some banking institutions in providing financial services. Collective measures, used as alternatives to public intervention or to an individual approach (of which savings banks are the embodiment) and which are dual-bottom line financial institutions with a clear social vocation and strong community roots, have contributed to spreading financial activity and made financial services available to large segments of the population. In this context, there are many institutions that have begun to develop different responses to the challenges brought about by this phenomenon.

In this respect, the concept of 'proximity banking' in its various forms exists in most developed countries. The term proximity banking refers to a concept of banking that is defined by its orientation towards the client, its territorial outreach and its social character. In any case, attempting to define the term 'proximity banking' is difficult and complex, if one considers the great variety of institutions within this field. To simplify the analysis, many studies have adopted two models to implement the concept. In the US, proximity banking is identified with community banks, which essentially include the institutions with less than a billion dollars in assets – which are, generally speaking, small private banks, savings banks and credit cooperatives. In contrast, the European model draws mainly from the activity of a number of dual-bottom line institutions including savings banks and is especially widespread in countries such as Spain, Germany and Austria. In the American case, the relative importance of community banks has decreased in recent years. This trend has drawn the attention of policy-makers to an important characteristic of the proximity bank in the United States: the need to adopt certain regulatory measures such as the Community Reinvestment Act of 1977 (revised in 1995). It seems that this act was necessary to avoid the complete disappearance of these institutions, which play an important role in ensuring access to the credit and banking services of the population most susceptible to financial exclusion. The European model differs from the American one in three important respects: a) savings banks have embodied the proximity concept in their business model, b) their quotes are as competitive as their commercial peers and c) there is no regulatory umbrella that protects this type of bank, yet its market share has grown steadily in several countries. Thus, the European proximity banks have succeeded in coping with the changes in the sector without neglecting their social mandate.

The developments of the recent past have shown how valuable it is to promote open and pluralistic markets in Europe, thus protecting all types of ownership structures without abandoning the principle of 'same business, same risks, same rules'. A policy of openness offers consumers various options and preserves competitiveness within the European markets.

If financial pluralism were abandoned, a likely result would be increased social exclusion. An increase in market power, resulting from high concentration levels in national markets could lead to a fall in the number of branches and, subsequently, to a decrease in the accessibility of financial services in regions with lower incomes. This can lead to increases in social exclusion.

Financial instability and regulatory changes: Opportunities for savings banks

How can the dual-bottom line nature of institutions such as savings banks help withstand financial instability? One cause of the financial crisis was the hunger for yield in financial markets and the pressure on commercial banks to maximise shareholder return by increasing leverage. The incentives to use leverage as a means to increase the expected return on equity are not as strong in the case of savings banks as they are for shareholder-driven banks. But as the crisis clearly shows, when problems emerge at one bank, leverage becomes the mechanism for transferring problems from one bank to another, thereby spreading bank-specific problems to the economy as a whole.

Another fundamental way of facing the crisis and the likely new regulatory environment is to acknowledge savings banks as solid contributors to financial stability. Recent empirical evidence[131] shows that the risk-shifting incentives are among the lowest in countries such as Spain or Germany, where the presence of savings banks is highly significant. Importantly, capital discipline – solvency regulation – is found to be effective both for commercial and savings banks with no significant differences between them. While combining these results, we can draw some lessons. Since the new regulatory environment will value both solvency and deposit insurance reputation, a good way for savings banks to deal with this new environment is by selling a package of 'deposit insurance plus capital insurance' which is equivalent to selling solvency plus low risk-shifting incentives. All in all, this will help savings banks to raise funds, since any security issued will have to be valued, at least partially, in terms of a 'safety-net reputation'.

[131] See Carbó Valderde, Kane & Rodriguez (2008).

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