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The Privatization of Italian Savings Banks – A Role Model for Germany?*

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Summary: The privatization of the Italian savings banks is often described as a success story. Proponents of privatization argue that a similar reform could cure the current problems in the German banking sector. In this paper, we ask whether the Italian experience can really serve as a role model for Germany. Our analysis confirms that the Italian reforms of the 1990s were a success. Banks' profitability increased, without impairing competition or the availability of banking services and loans. However, this success has to be attributed to a broad set of reforms, which went far beyond the privatization of savings banks. Moreover, Italy had a different starting point before the reforms, and the structure of the public banking sector differed markedly from Germany's. Therefore, one may question the transferability of the Italian experience to Germany. The costs and benefits of privatization should be weighed carefully against each other before abandoning the three-pillar system.

Zusammenfassung: Die Privatisierung italienischer Sparkassen wird häufig als Erfolgsgeschichte bezeichnet. Befürworter einer Privatisierung argumentieren, dass die gegenwärtigen Probleme im deutschen Bankensystem auf ähnlichem Wege behoben werden könnten. In diesem Aufsatz stellen wir die Frage, ob das italienische Beispiel wirklich als Vorbild für Deutschland dienen kann. Unsere Analyse bestätigt, dass die italienischen Reformen der 90er Jahre ein Erfolg waren. Die Banken wurden profitabler, ohne dass der Wettbewerb oder die Verfügbarkeit von Bankleistungen oder Krediten eingeschränkt wurden. Dieser Erfolg ist jedoch das Ergebnis eines breiten Reformprozesses, der weit über die Privatisierung der Sparkassen hinausging. Außerdem war der Ausgangspunkt vor den Reformen ein anderer als in Deutschland, und der öffentliche Bankensektor wies andere Strukturen auf. Daher kann man die Übertragbarkeit der italienischen Erfahrung auf Deutschland in Frage stellen. Kosten und Nutzen einer Privatisierung sollten sorgfältig gegeneinander abgewogen werden, bevor man das „Drei-Säulen-System" aufgibt.

1 Introduction

German private banks have long demanded the abandonment of the three-pillar model (*Drei-Säulen-Modell*) of the German banking sector, which provides for a strict separation of commercial banks, public banks, and cooperative banks. However, as the heavy disputes on the privatization of the savings bank in Stralsund in 2003 have made clear, the savings banks are not going to give up their special status easily.

Apart from legal considerations, the main arguments brought forward against the privatization of the savings banks are threefold. First, only the savings banks can guarantee the provision of banking services to everybody, independent of their place of residence and

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social status. Second, only they can provide sufficient loans to small- and medium-sized enterprises (SMEs). Third, a consolidation across bank groups would lead to undesirable levels of market power and concentration. In contrast, German private banks blame their weak profitability on the limitations to consolidation due to the presence of public banks. They argue that a strong domestic market share is a prerequisite for international competitiveness. Also, public guarantees (which as of this year are gradually being phased out) are said to distort competition to the disadvantage of private banks. Finally, public banks may be managed less efficiently and may be abused for political objectives.

However, neither side of the controversy has presented convincing empirical evidence for their claims. Private banks point towards the Italian experience to corroborate their case for privatization. Since 1990, Italy has gradually privatized its savings banks by separating the banking business from social and cultural activities, by abandoning the "regional principle," and by enforcing a reduction of the government ownership of banks. This privatization is typically cited as a success story because bank profitability has increased dramatically in recent years, particularly at the largest banks. However, no clear-cut analysis has yet shown whether the claims made by the proponents of privatization stand up to the facts.

In this article we will analyze the Italian case in some detail to give tentative answers to the following questions: (1) Can the success of Italian banks be traced back to the privatization of the savings banks? (2) What impact did the privatization have on (a) the provision of banking services to the population, (b) the provision of loans to SMEs, and (c) the intensity of competition in the banking sector? (3) In what respects is the Italian case comparable to the German one? A short case study of a particularly successful Italian bank, UniCredit, will supplement the aggregate analysis. Finally, we will draw some conclusions for the policy discussion in Germany and discuss whether the Italian case can be used as a role model for the reform of the German banking sector.

2 Two Stylized Facts

The comparison between the Italian and the German banking systems starts from two basic facts. Government ownership of banks in Italy has decreased sharply since the banking reforms of the 1990s, from 68 percent in 1992 to 9 percent in 2003; in Germany, it was 45

Table 1

Government Ownership of Banks

In %

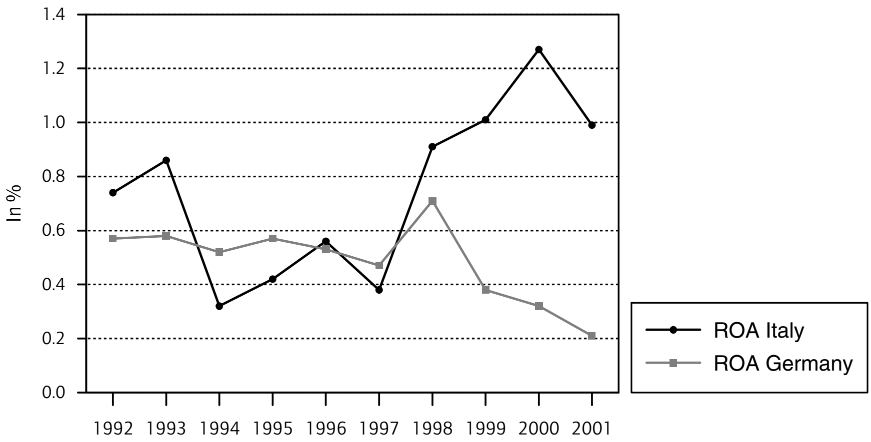
	1992	1997	1998	1999	2000	2001	2002	2003
Germany	44.7	47.7	46.3	45.2	44.7	42.9	43.0	43.8
Italy	68.0	25.0	18.0	12.0	12.0	10.0	10.0	9.0

Notes: For Germany, government ownership is defined as the share of savings banks, Landesbanken and financial institutes with special purposes ("Kreditinstitute mit Sonderaufgaben") in the total assets of the banking system; for Italy, it is defined as the share of assets held by foundations with a majority interest in an Italian bank. In 1992 and 1997, the numbers for Italy refer to all publicly controlled banks.

Sources: Deutsche Bundesbank (Zeitreihen-Datenbank, www.bundesbank.de), Banca d'Italia (1998–2004).

Figure 1

Return on Assets (ROA)[1]



1 ROA is defined as profits before tax over the average total assets.

Source: OECD (2002).

percent in 1992 and has remained roughly constant (Table 1). At the same time, the profitability of Italian banks has soared; that of German banks has dropped (Figure 1).

3 The Italian Privatization of Savings Banks[1]

3.1 The Italian Banking Structure before the Reforms

The structure of the Italian banking system at the beginning of the 1990s can be traced back to the regulations introduced after the Great Depression, most importantly the formation of the IRI (Instituto per la Ricostruzione industriale), which was a public holding company containing the three largest private banks (Banca Commerciale Italiana, Credito Italiano, and Banca di Roma) and a large number of public banks (Körnert and Nolte 2005: footnote 3). Many of the banks that were nationalized at that time were still publicly owned almost 60 years later. One of the most prominent examples is Credito Italiano, which was privatized in 1993 and is now part of the UniCredit Group. The regulations of the 1930s led to a fragmentation of the Italian banking sector. The regional spread and business activities of banks were regulated, and there were no universal banks.[2]

1 This section is based on the laws underlying the reforms, as well as on Klein (1998: 265–283), Deutsche Bank (2000), OECD (2001), Battilossi (2003), Ciocca (2005), Körnert and Nolte (2005), and Moneta (2005).

2 In this respect, the Italian experience is very different from the German one: The banks that were nationalized after the Great Depression in Germany were re-privatized a little later, and – apart from the time period immediately after World War II – there were no restrictions on nationwide branching. There always were universal banks.

One important principle of the 1936 legislation was mandatory specialization. The law distinguished between commercial banks (specializing in short-term business, i.e., shorter than 18 months) and special credit institutions (operating in medium- and long-term business and specializing in one particular sector – agriculture, building, public works, industry, or the Mezzogiorno). Moreover, since 1973, banks had been subject to a "portfolio requirement" and a credit ceiling for loans to the private sector. The former required banks to hold a minimum amount of medium- and long-term government or government-guaranteed bonds, while the latter was an explicit quantitative ceiling on the amount of loans to the private sector. Both measures had a significant crowding-out effect in favor of the public sector, sustaining the demand for public securities and keeping the interest rates on such securities low relative to bank loan rates.

Until the 1990s, the main objective of the Italian banking regulation was to foster local development and to ensure financial stability. In general, mergers between public banks were not allowed; and for savings banks, there were strict authorization procedures for such mergers. This system was quite successful in supporting and stimulating the growth of the industrial sector, which was (and to a considerable extent still is) characterized by a large number of small and medium enterprises.

But at the beginning of the 1990s, the system started to show its weaknesses. The growing needs to operate in an international environment and to achieve greater efficiency and performance, as well as the financial crisis of the early 1990s, called for a reorganization of the system, and in particular, of its ownership structure. The prevalence of public ownership and the prohibition of mergers prevented consolidation in the banking sector, and consequently the possibility of increasing profitability and efficiency.

3.2 Privatization of Public Banks

The Amato law (law 218/1990) of 1990 was the starting point of the reform process. By introducing the joint-stock company as the basic organizational entity in the banking system, the law constituted an important step towards the privatization of the system. In particular, the law provided for transforming savings banks into joint-stock companies (societá per azioni, Spa). The banks' capital was transferred to (publicly owned) foundations, thereby legally separating the banking business from social or cultural activities. These foundations maintained the public mandate of the savings banks, such as the advancement of the local economy. These provisions represented only a first step towards the privatization of publicly owned banks because the control of the spin-off joint-stock companies initially remained in the hands of the publicly owned banking foundations. Only in specific circumstances could the Council of Ministers waive the requirement that the majority of the capital of the new joint-stock companies be owned, directly or indirectly, by foundations. However, such an authorization had to be justified by special circumstances, such as the need to strengthen the banking system or its international presence, and more generally the promotion of public interest.

The transition towards a more open banking system was given a further impetus in 1994, when the Dini law (law 474/1994) repealed the obligation for the foundations to keep control of their joint-stock companies, and introduced substantial tax advantages for those foundations willing to dispose of their banking shares within four years of the implemen-

Table 2

Shares of Foundations at Largest Italian Banks

In %

	Banca Intesa	UniCredit	Sanpaolo IMI	Capitalia	Banca MPS
Share of foundations	44.0	18.0	36.0	30.0	49.0

Notes: Numbers refer to March 2004.

Source: Deutsche Bank (2004b).

tation of the law. This law officially kicked off the privatization of the Italian banking system, and coincided with the launch of the largest state-owned banks, such as Credito Italiano, Istituto Mobiliare Italiano (IMI), and Banca Commerciale Italiana (BCI). The last step in the transformation of the system came in 1998 when the Ciampi law (law 461/1998) fixed a four-year time limit within which the foundations were to sell off the controlling interests they still held in banking companies. Foundations complying with the law could benefit from important tax exemptions, while the others had to be transformed into "common companies," which would eventually be sold by the authorities.

The result of these reforms was a decline in the share of banking assets in the hands of public entities and foundations from 68 percent in 1992 to 9 percent in 2003. Table 1 suggests that the majority of the privatization took place before the Ciampi Law of 1998. However, the numbers given in that table are likely to understate actual government ownership because they do not include banks where several foundations jointly hold more than 50 percent of the capital, and even a share below 50 percent may yield significant possibilities of control. In this respect, it is instructive to look at the shares owned by foundations at the five largest Italian banks (Table 2).

The table shows that the government – in most cases, the local government – has important stakes in all of the largest Italian banks. None of these banks would have been included in the numbers given by the Banca d'Italia (Table 1). Whether one wants to call such banks private, or not, is a judgment call. In any case, they are very different from large German banks like Deutsche Bank.

3.3 Other Reforms

The reform of the ownership structure of public banks was only one part of a much broader set of reforms. Since the 1980s, several provisions of the Italian financial law have changed substantially. One important trigger was the legislation of the European Community, in particular, the First Banking Directive in 1977 and the Second Banking Directive in 1989. The new Consolidated Law on Banking of 1993 finally replaced the legislation of 1936. In this process, most restrictions introduced in the 1930s were removed. The limits to the regional expansion of saving banks, the portfolio requirement to hold government bonds, and the ceiling on credit to the private sector were already abolished at the end of the 1980s. Mandatory specialization was gradually removed after 1990. The limits to geographical diversification for all special credit institutions set up as limited companies were lifted. The distinction between commercial banks and special credit institutions began to blur, even if it was still in place. Commercial banks started to expand their activities beyond the short term and to engage in other financial activities. Furthermore, the notion of a "banking group" was introduced in the legislation. This established the equivalence of different organizational structures for supervisory purposes, allowing banks to choose between three models (universal bank, commercial bank, and banking group), which were subject to the same supervisory requirements. Finally, the Legislative Decree 481/1992 ceded banks the right to become universal banks; this allowed them to raise funds in any form and to undertake any of the activities indicated in the Second Banking Directive, such as factoring, leasing, medium-and-long term credit, and merchant banking.

Case Study: UniCredit

The reform of the banking system led to the creation of several large banking groups. One of them is the UniCredit group, which is now one of the most successful banks in Italy.

Its history, depicted in Figure 2, starts in 1993 with the privatization of Credito Italiano, the first large publicly owned bank to be privatized after being nationalized in the 1930s. The expansion continued in 1995 when Credito Italiano acquired Credito Romagnolo, which itself merged in 1996 with Carimonte (a merger between Banca del Monte di Bologna e Ravenna and Cassa di Risparmio di Modena) to form Rolo Banca 1473. In 1998, the Credito Italiano Group and Unicredito SpA (a merger of Cassa di Risparmio di Torino, Cariverona Banca, and Cassamarca) were merged into the UniCredito Italiano Group. The Group took over the Cassa di Risparmio di Trento e Rovereto and the Cassa di Risparmio di Trieste in 1999. Initially, the group stuck to a federal model designed to exploit the strong local roots; it kept the individual banks' names and abstained from a unified appearance. Gradually, the group went through a deep restructuring with the goal of implementing a common identity and a single brand. In 2002, all banks belonging to the group gave up their individual names and simply adopted that of "UniCredit". After that, the group was again reorganized, moving towards a customer-segmentation structure. This led to the creation of four divisions (Retail, Corporate, Private and Asset Management, New Europe) and three segment banks for the Italian market: UniCredit Banca (households, professionals, and small businesses), UniCredit Private Banking (high net-worth individuals and families), UniCredit Banca d'Impresa (medium- and large-sized corporates).

The domestic expansion was accompanied by an expansion into Eastern Europe. Between 1999 and 2002, UniCredit bought important Eastern European banks, such as Group Pekao in Poland, Zagrebacka Group in Croatia, Bosnia and Herzegovina, Bulbank in Bulgaria, Živnostenká Banka in the Czech Republic, and Unicredit in Romania. The trend continued with the take-over plans of Hypovereinsbank (including indirect control of Bank Austria).

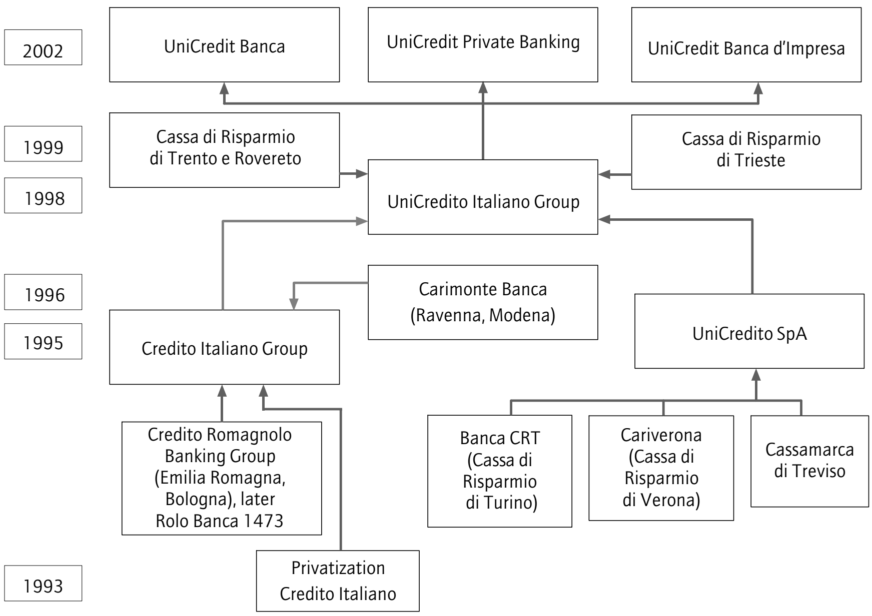
The creation of the UniCredit group has been very successful. From the outset, the group's performance was remarkable, both in terms of profitability and market capitalization. Starting at 1.4 percent in 1994, the return on equity increased steadily and rapidly to 20 percent in 1999 and then stabilized at around 18 percent. In contrast, the average return on equity of the whole banking industry oscillated between only 6 and 12 percent between 1998 and 2004. UniCredit's market capitalization surged from 2.5 billion Euros in 1994 to 25 billion Euros in 2003, with the most striking increase in 1997 and 1998.

What can we learn from the UniCredit experience? First, it is remarkable that the most successful Italian bank has developed almost exclusively from public banks, with the exception of Credito Romagnolo. Therefore, it cannot be considered as an example of a successful merger across different pillars. Second, the geographical spread of UniCredit's activities within Italy is noteworthy. Apart from Credito Italiano, which also operated in some Southern regions, all banks merged into UniCredit operated in the wealthy north of Italy. Third, UniCredit cannot be considered representative of the Italian banking system, which on average performs much worse than UniCredit. Hence, the particular success of the UniCredit banking group may be due to the selection of exceptionally successful banks, and not so much to privatization as such. Finally, one may wonder whether the success of UniCredit has been obtained at the cost of higher risk-taking. Especially, the strong focus on Eastern Europe may be considered a risky business strategy. The take-over of Hypovereinsbank may also prove to be a rather risky undertaking.

Source: UniCredit (www.unicredit.it), Moneta (2005).

Figure 2

History of the UniCredit Group



Source: UniCredit (*www.unicredit.it*).

To conclude, the Italian banking reforms of the 1990s entailed much more than just the privatization of the savings banks. The new regulatory environment substantially changed the entire nature of the banking industry. The objectives of efficiency, performance, and internationalization replaced the old goals of supporting the local economy and system stability. The new regulation embodied the principles of entrepreneurship, competition, and free market economy in the system, and triggered a process of privatization and consolidation. Thereby, it transformed a heavily regulated and highly fragmented banking system with substantial government ownership, severe restrictions of banking activities, and branching restrictions into a system with several large banks, less state intervention, no branching restrictions, and universal banks.

4 Evaluation of the Italian Experience

In this section, we analyze the Italian experience in more detail. We start by considering the profitability of Italian banks; we then evaluate the effects of the banking reforms on the availability of banking services and bank competition.

4.1 Bank Profitability

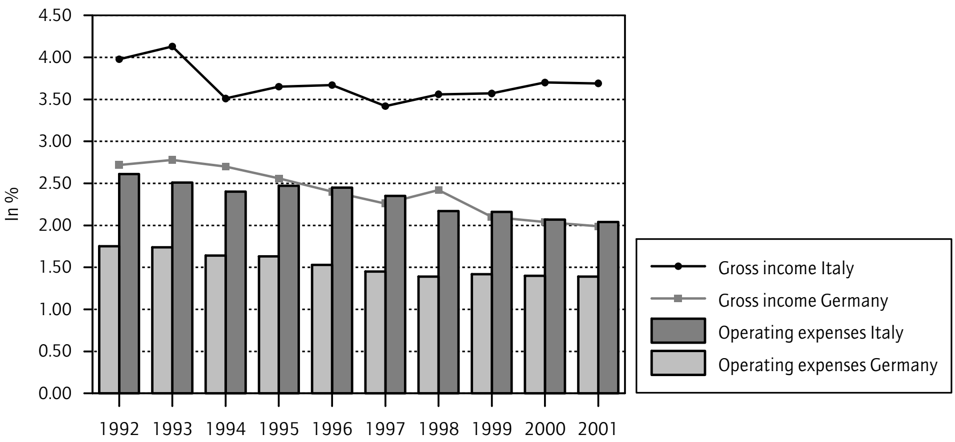
Compared to Germany, the gross income of Italian banks is relatively large, but so are their operating costs (Figure 3). In both countries, the two time series show a negative trend, but in Italy the decrease in costs more than compensates the decrease in gross income.

The negative trend in Italy's gross income is driven by its shrinking interest income (Figure 4), a trend also observed in many other European countries. However, this effect was countered by a marked increase in non-interest income. This suggests that the Italian banking reforms fostered the banks' non-interest activities. However, this has more to do with the lifting of banking activity restrictions than with the privatization of savings banks.

These aggregate figures conceal the discordance within the Italian banking sector. According to Deutsche Bank (2004a, 2004b), the profitability of the largest Italian banks (except

Figure 3

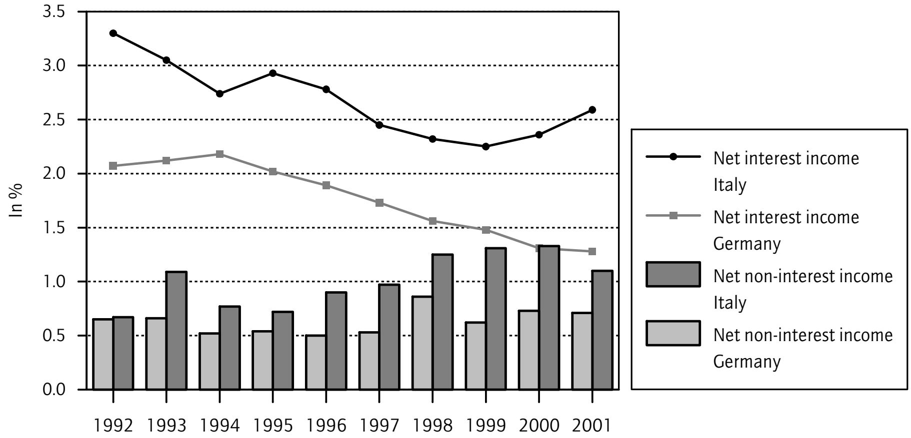
Gross Income and Operating Expenses as Shares of Total Assets



Source: OECD (2002).

Figure 4

Interest and Non-Interest Income as Shares of Total Assets



Source: OECD (2002).

for Capitalia) has been well above the economy's average. The return on equity in 2003 was highest at UniCredit (17.7 percent), followed by Banca Intesa (16.0 percent), Banca MPS (Monte dei Paschi di Siena, 12.1 percent), and Sanpaolo IMI (9.0 percent), whereas the economy's average was only 6.7 percent. Hence, bank size seems to have been an important determinant of bank success. Moreover, as was mentioned already in the case study on UniCredit, a comparison of profitability alone neglects the fact that banks' strategies may have involved different levels of risk-taking.[3] For example, the expansion of many Italian banks into Eastern Europe may be considered a rather risky strategy. A careful analysis would have to take the differences in risk-taking into account; differences in returns alone may be misleading.

Finally, profitability is not a good indicator of welfare. It may well be – as is argued by the opponents of privatization – that higher profitability was achieved at the cost of a lower availability of banking services and loans, and of lower competition in the banking sector.

4.2 Availability of Banking Services and Bank Competition

4.2.1 Branching

One important argument against the privatization of savings banks is that it may lead to a deterioration in the availability of banking services. In fact, the regional provision of banking services can be seen as one of the main rationales for the existence of regional public banks. One indicator of the availability of banking services is the density of branch networks. Interestingly, in spite of the sharp decrease in the number of banks, the Italian

3 This point was also stressed by Franklin Allen at the CFS-IMF "Open Forum on Germany's Banking System" in March 2005 in Frankfurt.

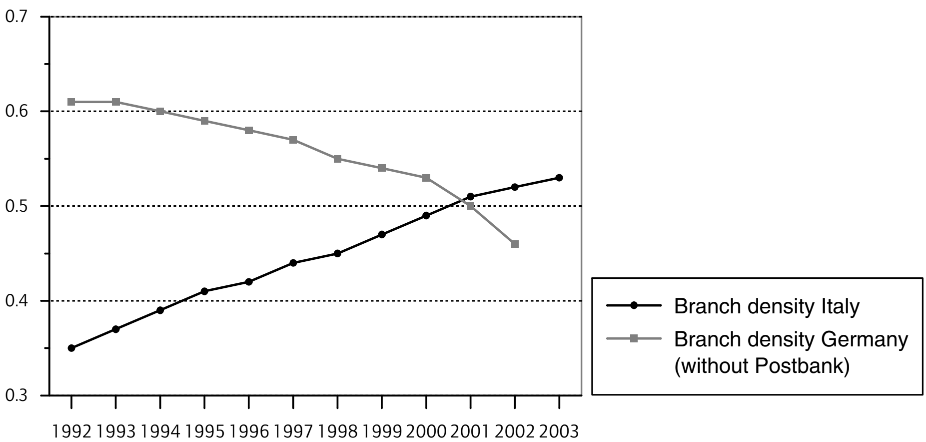
banking reforms appear to have led to a rapid *increase* in the number of branch offices rather than to a decrease, as would have been feared by the opponents of privatization (Figure 5). This observation is frequently cited by the proponents of privatization, who argue that the fear of a regional undersupply of banking services in the light of privatization is unjustified.

Many of the new Italian branches are known as "lite branches", i.e., small units with limited services (Körnert and Nolte 2005: 83). In 2002, 54 percent of all branch offices had five or fewer employees (Banca d'Italia 2003: 213). This may explain why Italian banks have been able to decrease their operational expenses in spite of the expansion of the branch network (Figure 3).

The increase in branch offices is more likely to be a consequence of the lifting of regional restrictions than of privatization. All large banking groups have shown a tendency to expand nationally, and even smaller banks have expanded into new geographical areas. This development was not limited to privatized banks, but included other banks, although the expansion of the latter lagged behind that of the privatized banks (Deutsche Bank 2004b: 16). In 2000, more than half of the banking groups' branch offices belonged to banks that are present in more than 50 of the 103 provinces, and this share has increased in recent years (Banca d'Italia, cited from Deutsche Bank 2004b: 11). Moreover, the share of municipalities served by at least one bank increased from 61 to 73 percent between 1989 and 2003 (Deutsche Bank 2004b: 16), and the average number of banks per province rose from 27 in the beginning of the 1990s to 34 at the end of 2003 (Banca d'Italia 2004: 235). However, it should be noted that the number of accounts in Italy per inhabitant is still rel-

Figure 5

Branch Density[1] in Germany and Italy



1 Number of branches per 1,000 inhabitants.

Sources: Engerer and Schrooten (2004), Körnert and Nolte (2005).

atively low (0.6 compared to 1.0 in Germany in 2003, Bank for International Settlements 2005).[4]

The given numbers may still conceal the countervailing effect – namely of banks withdrawing their activities from the least attractive regions. To gain more insights into this question, one would have to consider the regional distribution of branches across Italy. Unfortunately, such data are not readily available. In the absence of such evidence, the numbers point towards a better supply of banking services in the regional dimension.

4.2.2 SME Lending

The total loan volume in Italy has increased sharply since the 1990s, especially since 1998. In real terms, lending to the private sector increased at an annual rate of 4.8 percent between 1992 and 2003, and even at a rate of 9.9 percent from 1998 onward (International Financial Statistics 2005). At the same time, the market capitalization in Italy has soared, from 18.7 percent of the GDP in 1995 to 41.9 percent in 2003 (World Federation of Exchanges). Hence, the general financing situation in Italy appears to have improved in the last decade.

The question is whether this is also true for loans to small- and medium-sized enterprises (SMEs). Proponents of public banks argue that only savings banks can guarantee the provision of loans to SMEs. Therefore, the Italian reforms may have impaired the availability of SME loans. Furthermore, the reforms led to a consolidation wave, reducing the number of banks from 1,088 in 1992 to 788 in 2003, and raising the average bank size from 1,014 million Euros in 1992 to 2,754 in 2003 (Engerer and Schrooten 2004, Körnert and Nolte 2005, OECD 2002). Larger banks may be less able to extend loans to small customers because such loans are mostly based on soft information that is difficult to transmit across the hierarchy (Stein 2002). Hence, a consolidation may lead to a further reduction in SME lending.

Unfortunately, the information on SME lending is very fragmentary. According to the Banca d'Italia (1999: 180), the share of loans to small businesses increased until the early nineties, but then contracted until 1998.[5] In recent years, SME lending has increased at a more rapid pace than lending to other firms (Banca d'Italia 2003, 2004). Hence, the evolution of SME loans in the 1990s may have been a transitional problem. Interestingly, the share of smaller banks (with total assets of less than Euro 7 billion) in total lending increased sharply between 1995 and 2003, from 24 to 32 percent (Banca d'Italia 2002, 2004). This is consistent with smaller banks taking over business, and possibly mostly SME lending, from the larger banks.

It is also interesting to compare the lending growth across regions. Between 1991 and 2001, the growth rate of lending in the South was three percentage points lower than in the rest of Italy (Banca d'Italia 2003). Only in recent years has lending growth in the South

4 In 1995, in Italy this number was slightly lower at 0.5, whereas Germany had the same value as in 2003 (Bank for International Settlements 1996).

5 The Banca d'Italia defines "small businesses" as sole proprietorships plus partnerships with fewer than 20 employees.

outpaced that in the Center and the North. Over the whole period, loan quality (as measured by the share of bad loans) has been much lower in the South than in the North. Therefore, the uneven distribution of loans across regions may well be justified from a managerial perspective. Nevertheless, it may be worrisome from a welfare perspective. Of course, these numbers tell us little about the effects of privatization and consolidation on the regional distribution of loans. But it may not be outlandish to believe that private banks are less inclined to invest in poorer regions than public savings banks.[6]

4.2.3 Competition

Another argument for savings banks is that they foster competition by providing an additional market player. Concentration ratios (CR5) suggest that the concentration in the Italian banking system increased in the 1990s due to the emergence of national players with substantial market shares.[7] However, this does not necessarily imply that competition in the banking sector decreased. In fact, the strong increase in the number of branches indicates the opposite. The regional Herfindahl-Hirschman index of concentration for deposit markets, calculated by the Banca d'Italia (2004),[8] increased from the middle of the 1990s until 1999; then it decreased by 9.8 percent, falling below the levels recorded in the mid-1990s. The decrease in the Herfindahl-Hirschman index for lending has been even stronger: It dropped by 15.5 percent between 1999 and 2003.

Overall this evidence suggests that competition in banking has increased, especially in recent years. The main reason is probably the disappearance of the regional segregation in banking. Foreign bank entry seems to have played a minor role. In spite of a 13 percent increase in the number of foreign branches and subsidiaries between 1998 and 2003, foreign banks' share in total assets decreased from 8 to 7 percent. This reflects the restrictive attitude of the Italian authorities towards foreign bank entry, which has also become apparent in the recent reactions to foreign banks' attempts to take over Italian banks.

Summing up, the Italian reforms have led to an enormous expansion of branch networks, which presumably has improved the availability of banking services. Overall lending has increased rapidly, but SME lending has not. However, the recent surge in SME lending may suggest that this was a transitional problem. A similar transition seems to have taken place with respect to competition. After an initial decrease in competition, the trend now points towards an increase in competition. Hence, there is no indication that the reforms of the 1990s have led to the problems envisaged by the opponents of privatization. However, the observed developments cannot be attributed solely to the privatization of savings banks. Negative effects of the privatization may have been masked by the positive effects of other reforms, most notably the transformation of specialized local banks into universal national banks.

6 See Hakenes and Schnabel (2005) for a theoretical model of the argument that regional public banks may prevent a capital drain from poor to rich regions. Interestingly, they show that in many circumstances the same function can be carried out by cooperative banks.

7 Our sources give contradicting numbers on the concentration ratio in Italy. In particular, the numbers by the Banca d'Italia exceed those given by other sources (Sachverständigenrat 2004, European Central Bank 2003).

8 The indices are averages, calculated on the basis of market shares in provinces for deposits, and in regions for loans.

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5 Lessons for Germany

In this section we analyze what lessons Germany can gain from the Italian experience. We first sketch the conventional diagnosis of the problems in German banking. We then describe a number of structural differences between the two banking systems and point to some idiosyncratic factors that may limit the comparability of Italian and German banks over the past fifteen years. Finally, we discuss whether the Italian privatization of savings banks can be used as a role model for German banking sector reform.

5.1 Diagnosis[9]

Compared to other countries, the consolidation process in Germany has been slow. This is often attributed to the three-pillar system, which de jure (in the case of public banks) or de facto (in the case of cooperative banks) prevents cross-pillar consolidation. The large number of small banks suggests that many banks do not achieve an efficient scale, which may explain the overall low profitability. However, the OECD (2002) data suggest that the German banks' comparative weakness stems from the disability to generate income, and not from excessive costs; this has also been stressed by the International Monetary Fund (2003a, 2003b). German banks' gross income as a share of total assets was more than a percentage point lower than in Italy (Figure 3); this was due to interest and non-interest income. In contrast, German banks had lower operating costs (again as a share of total assets), but this difference was not able to compensate for the difference in gross income. By 2001, the difference in gross income had grown to 1.7 percentage points, whereas the difference in operating costs had shrunk to 0.65 percentage points. By and large, this explains the difference in profitability shown in Figure 1.

The intense competition in the German banking sector is one frequently cited reason for the low profitability of German banks. According to concentration ratios or nationwide Herfindahl indices, the German banking sector appears to be one of the most competitive ones in the world. However, there is a consensus that such numbers overestimate competition because they neglect the reduction of competition within the pillars due to the regional principle. Some have argued that the savings and the cooperative banks sectors should be treated as single banks. Such calculations yield a concentration ratio (CR5) of 67 percent for 2002 (compared to 22 percent for the standard measure), which is well above the average of other industrialized countries (Sachverständigenrat 2004: 290, Hackethal 2004: 75 finds slightly lower ratios). The true number may lie somewhere in-between. Moreover, competition varies across regions, such that local measures are preferable. Local Herfindahl indices, based on the number of branches, point towards much lower competition than nationwide indices (Fischer and Pfeil 2004: 310). Therefore, the low profitability of banks can probably not be attributed to high competition. However, there is wide agreement that competition in German banking has increased, especially since the middle of the 1990s. One reason was the introduction of money market funds, which increased non-bank competition for refinancing (Fischer and Pfeil 2004: 319–323). This clearly had an effect on bank profitability.

9 This description can only be selective. For a more detailed analysis, see International Monetary Fund (2003a, 2003b), Engerer and Schrooten (2004) and Sachverständigenrat (2004).

Nevertheless, the performance of the three pillars has been very different (Engerer and Schrooten 2004: 40). An examination of the average return on equity (ROE) between 1994 and 2002 shows that the savings banks outperformed all other bank groups. The performance of the cooperative banks was also above average. In contrast, the mean ROE at the largest commercial banks was below average; in 2002, it even became negative. The ROE of smaller commercial banks was not much higher, but the volatility of their returns was much lower. The lowest ROE was to be found at the Landesbanken, some of which revealed severe mistakes in their business policies.

Interestingly, branching has evolved completely differently in Germany than in Italy. Branches have been "dying out" since the middle of the 1990s, even in the absence of privatization. This has led to a lower branch density than in Italy (Figure 5). The sharp decrease in the number of branch offices has been largely due to the tendency of commercial banks to close them. This was justified by the enormous costs of maintaining widespread branch networks. It also mirrors the fact that the largest private banks turned away from the retail business. One important question is whether this reflects the crowding-out of private banks by public ones, or whether such a trend would continue if public banks were privatized. Even the Postbank, whose particular strength is its widespread presence, has sharply reduced the number of branch offices, even before privatization (there was a 36 percent decrease between 1995 and 2002). Part of the decline in branching may have been compensated for by other distribution channels, such as online banking. However, it is questionable whether such alternative channels were able to fully compensate for the reduction in the branch offices.

With regard to bank lending, Germany again shows marked differences from Italy. In the beginning of the 1990s, there was a strong credit expansion, which was started by the reunification boom and continued until the late 1990s. Since then, growth rates of bank lending have continuously dropped (Deutsche Bundesbank 2002). Most of this decrease has been attributed to weak credit demand, due to the cyclical downturn, but banks also appear to have restricted their credit supply. One reason for this is the increased awareness of borrowers' risks, related to the new Basel Capital Accord ("Basel II", Deutsche Bundesbank 2002). The decrease in lending was most pronounced at the commercial banks. In 2002, they even showed negative lending growth, whereas the growth rate was still above 2 percent at the savings banks and Landesbanken and was close to zero at the cooperative banks. This suggests that public bank lending was less procyclical than that of private banks.

Lending to small- and medium-sized enterprises appears to have suffered most in recent years. This is due to the relatively low capital base of these enterprises and to the particularly high number of insolvencies among the SMEs (Deutsche Bundesbank 2003). Another reason seems to be the retreat of the commercial banks from the retail business (Engerer and Schrooten 2004: 33–35). It appears that the remaining bank groups have not been able or willing to bridge this gap. Given the dependence of small firms on bank lending, these developments are particularly problematic (Deutsche Bundesbank 2002).

In summary, the problem seems largely to lie with the commercial banks and with the Landesbanken. Both bank groups underperformed relative to the other bank groups.[10] The

10 However, as the International Monetary Fund (2003a, 2003b) has noted, all German pillars underperform relative to other countries.

commercial banks also were responsible for the majority of the reductions in the number of branch offices and in lending, especially to SMEs. Whether this reflects the crowding-out of private activity by public activity is an open question.

5.2 Structural Differences

The German financial system is more bank-based than the Italian system. The share of domestic credit in GDP is about 1.5 times larger than in Italy; the share of total bank assets in GDP is almost twice as large as in Italy (Engerer and Schrooten 2004: 64–65). While both Italy and Germany are said to have had a three-pillar banking system, the systems appear to have been quite different. In Germany, the banks of all three pillars can be described as universal banks, whereas this was not true for any of the three pillars in Italy before the reforms. The first pillar (commercial banks) in Germany contains several banks with nationwide branch networks; such banks did not exist in Italy before the reforms. The second pillar (cooperative banks) in Germany contains a large number of small credit cooperatives (comparable to the Italian *Banche di Credito Cooperativo*) and cooperative central institutions, which do not exist in Italy. The *Banche Popolari*, which are much larger and have in part been transformed into joint stock companies, are not comparable to the German credit cooperatives.[11] The third pillar (public banks) contains the savings banks (comparable to the *Casse di Risparmio* before privatization) and the Landesbanken, which serve as the savings banks' central institutes; again, there existed no comparable central institutions in Italy. Note also that the Italian savings banks were at no time subject to an explicit public guarantee like the German savings banks. Finally, in both countries, this pillar contains a number of special institutes, such as development banks. In Italy, in addition, the third pillar contained several large banks that were nationalized after the Great Depression, such as Credito Italiano or Banca Commerciale. These banks largely explain the high share of public banks in Italy before the reforms. In both countries, the postal banks have played an increasing role in recent years and have become serious competitors for the remaining banks.

In light of these differences, the comparability of the present German banking system with the Italian banking system in 1990 is rather limited. Most importantly, German banks are already universal banks, some with nationwide branch networks. Moreover, the cooperation within the pillars seems to be better developed than it was in Italy; among other things, this is due to the existence of central institutes. Finally, before the reforms, Italy had a much higher share of public banks than Germany now does. Therefore, the scope for reform in Germany is smaller than it was in Italy in the beginning of the 1990s.

5.3 Idiosyncratic Shocks

The calls for structural reforms in the German banking system are based on cross-country comparisons of the developments since the 1990s. However, it is questionable whether this time period is suited for such a comparison. Several idiosyncratic factors have influenced the evolution of the German banking sector.

11 See Körnert and Nolte (2005) for a description of the differences.

The first, and arguably most important, factor was the German reunification, which was accompanied by an economic boom, but followed by a long period of GDP growth below the European average. The second was the bursting of a housing price bubble in East Germany after the construction boom in the beginning of the 1990s (Deutsche Bank 2003). This caused a severe problem for many banks engaged in real estate lending. The third was the introduction of money market funds in 1994, which exacerbated competition for refinancing by non-bank institutions (Fischer and Pfeil 2004: 319–323). Fourth, the stock market crash in Germany was more severe than in Italy. From the peak to the trough, German stocks decreased by 73 percent, whereas Italian stocks decreased by "only" 60 percent.

A combination of these and other factors, such as strategic mistakes, resulted in severe problems at German banks in 2002. Profitability collapsed, and some of the largest banks and several Landesbanken posted high losses in their annual accounts. Part of the dramatic difference in profitability across countries is due to this crisis period, which may make the German banking system appear overly bleak. In fact, the German banking system proved to be surprisingly resilient to these shocks and the feared crisis never broke out. Recent stress tests confirm the resilience of the German banking sector (Sachverständigenrat 2004: 281–282). One may wonder whether the three-pillar structure may have contributed to the stability of the German banking system.

5.4 A Role Model for Germany?

Our analysis has shown that in many respects the Italian reforms of the 1990s have been a great success for the Italian banking sector and economy. They increased banks' profitability and fostered competition without impairing the availability of banking services and loans. Can this success be duplicated in Germany by privatizing the savings banks?

We start by discussing the positive effects that such a privatization could have. First, it could increase cost efficiency by introducing better governance structures. However, there is overwhelming evidence that German savings banks are not particularly inefficient (see for example Brunner et al. 2004). Second, it could allow for efficient consolidation in the banking sector. However, many empirical studies have shown that economies of scale are depleted at relatively low bank sizes (e.g., Altunbas et al. 2001), even though there are also some papers pointing in the opposite direction (see the survey by Amel et al. 2004 for a general overview). In any case, there is probably some scope for efficient consolidation in the German savings banks sector. Of course, such economies of scale could also be reaped by consolidation *within* pillars. Third, it could increase competition and lead to an expansion of the branch system. However, the effect of the privatization of savings banks on competition and the number of branch offices is unclear. If the savings banks are taken over by local competitors (such as one of the large commercial banks), competition and the number of branch offices could be reduced. In contrast, the Italian example has shown that a lifting of regional restrictions may lead to new market entry, which would increase competition and the branch network. This could improve the availability of banking services in Germany. However, the same results may also be achieved by lifting the regional principle, without necessarily privatizing public banks. Moreover, an increase in competition and an expansion of the branch network would clearly not help to raise banks' profitability. Fourth, privatization could remove competitive distortions in the banking sector.

Some have argued that public banks still benefit from an implicit government guarantee even when explicit guarantees have been phased out (Sachverständigenrat 2004: 293–294). Privatization could remove such distortions. If, however, privatization leads to consolidation, the implicit guarantees to public banks may simply be replaced by guarantees to banks that are "too big to fail." Hence, it is not clear whether privatization would really reduce competitive distortions.

On the negative side, the privatization of savings banks could endanger the availability of loans for SMEs. In Italy, the evidence points to this problem, which, however, may prove to be transitional. So far, there is no compelling evidence that the privatization did not impair SME lending. Given the precarious situation of German SMEs, a further reduction in lending would clearly be undesirable. Similarly, privatization could endanger the availability of loans in poorer regions, even though there is no conclusive evidence on this question. The economic situation in East Germany makes such a perspective unappealing. Finally, it could decrease the resilience of the financial system against shocks. There is some indication that German public banks helped to buffer external shocks and contributed to the surprising stability of the German banking sector in the recent crisis. The Italian banking system still has to prove its resistance to severe shocks, such as a crash in housing prices or a crisis in Eastern Europe, where Italian banks have important stakes.

Overall, these arguments suggest that the privatization of savings banks like that in Italy would probably not serve as a panacea for the problems in the German banking sector. Italy had a very different starting point when it implemented the reforms in the 1990s. The Italian success should be accredited to a broad menu of reforms. It is unclear what can be attributed to privatization alone. Moreover, the public banking sector in Germany differs from that in Italy in several respects. First, it does not contain any banks that were nationalized after the Great Depression; and second, it relies much more on cooperation within the pillars. The Italian reforms do not offer any hints about how to deal with such a structure. We also argued that the unfavorable performance of German banks in the time period under consideration cannot be attributed to the three-pillar system alone. Moreover, one should not overlook the relatively good performance of the German savings banks in the recent crisis.

For all these reasons, the cost and benefits of privatization have to be weighed carefully against each other. Neither the costs nor the benefits of public banks have been systematically explored. Distortions of competition do exist, but they are likely to be reduced when public guarantees are phased out. To enable these banks to fulfill their public mandate, such as the provision of banking services to remote areas and the extension of loans to SMEs, some distortions may actually be necessary.

Finally, there are other ways to reform the banking sector than those employed in Italy. France, for example, chose to transform its savings banks into cooperative banks. In fact, this solution may help to avoid some of the pitfalls of privatization. Mergers within pillars are another alternative. As the case study on UniCredit has shown, these can be quite successful. A systematic evaluation of the different alternatives still awaits to be done.

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