Die Krise but not _La Crise_?

The financial crisis and the transformation of German and French banking systems

Iain Hardie and David Howarth

Preliminary version of the following piece: '*Die Krise* but not *La Crise*? The financial crisis and the transformation of German and French banking systems' *Journal of Common Market Studies*, November 2009, 47:5, pp. 1015-1036

Abstract

This article explores what the financial crisis shows about changes in the German and French banking systems, the two largest in continental Europe. In particular, we highlight processes of financialization – defined here as the increased trading of risk. We focus on an apparent contradiction: Why did the more protectionist and conservative German banking system suffer much higher losses than the more liberalised French system? This article also examines the responses of German and French banks and governments to the crisis and speculates how far these responses might limit future financialization and shape national banking systems.

Keywords: Financialization; varieties of capitalism; financial crisis; banking systems; Germany; France.

Introduction

Recent record losses in complex financial instruments have seriously weakened many large German banks and brought several near to collapse. French bank losses are lower, but still significant. As of August 2008, twelve German and six French banks had writedowns of more than $1 billion, totalling US$55.9 billion for these German banks and US$23.3 billion for the French (Bloomberg, 2008).[1] In both countries, banks previously known largely for domestic retail and commercial lending – notably largely Land government-owned German Landesbanken (LB) and French mutual banks – have revealed major losses across a range of activities. This article explores what the crisis shows about any transformation of the German and French banking systems, the two largest in continental Europe. In particular, we highlight processes of financialization – defined here as the increased trading of risk. We focus on an apparent contradiction: Why did the more protectionist and conservative German banking system suffer much higher losses than the more liberalised French system? This article also examines the responses of German and French banks and governments to the crisis and speculates how far these responses might limit future financialization and shape national banking systems.

Financialization is defined here as the increased trading of, and exposure to, risk. The term is defined in a variety of ways in the IPE literature (see Epstein, 2005; Krippner, 2005). The usage here is closest to Aglietta and Breton (2001, p.437), although financialization is not a term they employ. They link the change from a bank-based to a more market-based financial system to financial liberalisation and financial innovation linked to technological advance. They and also recognise how banks add a 'new market portfolio' to their 'traditional credit portfolio' (2001, p.441). The increasing importance of 'market' relative to 'credit' portfolios, and the implications for the nature of 'investment banking' activity at French and German universal banks, is central to our analysis. Financialization almost always in practice involves internationalisation and, always, the reverse. We understand the financialization of banks here in terms of a range of activities, from increasing retail activities internationally (a relatively low exposure to risk, depending on the host country) to derivatives trading and investment in complex securities.

The German and French financial systems both contain a growing number of non-bank financial institutions, but banks still dominate. German depository institutions held 78.3 percent of total assets in December 2002, only a marginal increase since the 1980s. In France, there was a more significant relative decline over the previous decade, but, in December 2003, depository institutions held 64 per cent of financial institution assets (IMF, 2004). The financialization of German and French banking systems, rather than increasing activity by other financial market actors, is the more important change in the two countries' financial systems over the past two decades, especially, as we discuss below, in the years immediately before the crisis.

We highlight, across all German and French banks, but to significantly varying degrees, the increased importance of both internationalisation and trading activities in the 2000s. The significance of this for possible change in the banking system in Germany and France lies in the nature of banking activities, and therefore the potential sources of future profitability. The debate about the reality, nature, determinants and pace of change in German banking is of long standing (e.g., Deeg, 1999; Krahnen and Schmidt, 2004). Our engagement with this debate is narrow, following Hackenthal (2004) in considering changes in the activities of the banks themselves through examination of bank balance sheets. We compare the German and French banks, showing that the former are at least as, if not more, financialised.

Shifts in national banking systems because of financialization have potential implications for German and French models of capitalism, especially the German system, where ‘patient’ bank-provided capital has been a core element. In particular, the fact that the activities of banks have precipitated a ‘credit crunch’ in a number of countries, whereby companies are having difficulty borrowing, demonstrates the significance of recent developments to a varieties of financial capitalism literature that focuses in large part on how companies finance themselves. While the broader implications of such change are beyond the scope of this article, we discuss this briefly in the conclusion.

Banking systems in the early 2000s

Although both systems underwent financialization in the 1980s and 90s, this process accelerated rapidly from 2002 to 2007. The German model is traditionally described as a three pillar decentralised universal bank-based financial system (Zysman, 1983; Deeg, 1999) with large private banks, the public sector savings banks (Sparkassen and regional LB) and the cooperatives. The three pillars were (are) separated by financial structures, legal status and governance systems. There is a long (though declining) tradition of Länder government interference in LB lending decisions and overall public sector ownership far exceeds that in comparable economies (IMF, 2003). In the 1990s, four-fifths of retail and commercial banking activity in Germany was by public sector banks, which were seen as specialising in banking for the Mittelstand, Germany’s Small and Medium-sized Enterprises. The listed commercial sector has long been dominated by three large, internationally present universal banks (Deutsche, Dresdner and Commerzbank). Deeg (1999) and Krahnen and Schmidt (2004) emphasise the continued domestic focus of the public sector banks and their close relationships with the Mittelstand. However, a fragmented domestic market restricted competition and profits, pushing both private banks and the LB increasingly abroad to increase profitability.

The largest French banks were all previously state-owned and were privatised from 1987 to 2002, with the banking system rapidly consolidating in the 1990s. The system was (is) dominated by two listed commercial banks – BNP-Paribas and Société Générale – and four mutual banks – Crédit Agricole, Banque Populaire, Caisse d'Epargne and Crédit Mutuel. Mutual banks are majority-owned by their depositors and, at least in principle, operated for their benefit, rather than, as with the listed commercial banks, being owned by private shareholders. All banks can opt to become universal banks, engaging in the broad range of retail, corporate and investment banking activity. Regulation was harmonised across banking types, credit specialisation eliminated and most restrictions on competition removed. The relationship of French banks with nonfinancial firms – never as close as in Germany – became more distant (Bertero, 1994; O'Sullivan, 2007), as France moved from a financial network to a financial market form of capitalism (Morin, 1998, 2000). The importance of bank finance for French companies declined dramatically, and large French banks compensated by developing investment banking, as in Germany. However, the comparative strength of French banking was in domestic retail banking, and reduced profit also encouraged the largest French banks to expand retail activities abroad. This strong retail component to internationalisation is in marked contrast to the German banks, whose internationalisation was almost exclusively in corporate lending and investment banking, their traditional areas of expertise. The contrast is highly significant to the differential impact of the crisis in the two countries, and is in large part explained by the historical fragmentation of the German system.

The French banking system is one of the most concentrated in the EU; Germany one of the least. By the late 1990s, four French banks were in the top 15 European banks by asset size, but only one German: Deutsche Bank. More recent figures show that the five largest French banks have 52.3 percent of total assets, compared to 22 percent in Germany, 26 percent in Italy, 36 percent in the United Kingdom and 40 percent in Spain (ECB, 2008).

The German system has been more protectionist and anti-competitive than the French in several ways. Until 2005, guarantees against bankruptcy allowed LB to borrow more cheaply than commercial rivals; furthermore, the LB and Sparkassen do not compete against one another and retain their own fiefdoms. The German government, the Association of German Banks, the European Commission and the Bundesbank all support the elimination of the three pillar German system but change has been strongly resisted by Land governments. With a single legal framework and no sector-wide anti-competitive practices, the French system is comparatively open. However, the provision of some savings products favours the mutual banks (Candida, 2000). The dense provision of French retail banking services also makes the entry of foreign banks very difficult. Foreign penetration into the German and French banking markets is amongst the lowest in the EU. In France, at the end of 2003, foreign banks held only 12 percent of bank assets (IMF, 2004, p.103), with German levels similar.

The equity ownership of French and German commercial banks presents a different picture. Despite cross shareholdings and, particularly in the case of France, perceived government antipathy to foreign ownership, during the 1990s, both the German and French commercial banks fell under increased foreign ownership, although domestic corporate shareholders maintained blocking power. By the early 2000s, foreigners owned 67 percent of BNP-Paribas' equity capital (2002) and 50.8 percent of Société Générale. Developments in Germany were similar, with foreign ownership of Deutsche Bank 46 percent (rising to over half in 2007) and of Commerzbank 35 percent (rising to over three quarters in 2008). Dresdner was in 2001 bought by the insurance giant Allianz, itself 32 percent foreign owned (2002). German public and cooperative banks and French mutual banks have mostly not opened their capital, but Crédit Agricole – one of the largest retail banks in Europe – was partially opened to private shareholding in 2001.

Several developments in the late 1980s and 1990s demonstrate the beginning of a shift in German and French banking cultures, as banks previously seen as focused on the conservative, risk-averse domestic market looked to investment banking and abroad to increase profits. German banks first entered into London investment banking. Deutsche Bank bought Morgan Grenfell of London in 1989. The other commercial banks followed suit in 1995. Then the public bank Westdeutsche LB bought West Merchant Bank Ltd., a London advisory firm for privatizations and mergers. 'In 1999, Deutsche ranked first, Dresdner second, and Commerzbank fourth among large European universal banks in terms of the portion of total capital that was allocated to wholesale and investment banking' (Hackenthal, 2004, p.77). In 1987, Société Générale started derivatives trading within two months of being the first state-owned bank privatised. The French mutuals entered into investment banking relatively late, with Banque Populaire taking over Natexis in 1999, transforming it into an investment bank and, in 2006, merging it with the Caisse d'Epargne's IXIS to form Natixis, one of France's largest investment banks. In 2004, Crédit Agricole set up its corporate and investment banking arm, Calyon.

Two important points emerge from these developments. First, investment banking was developed and expanded both by those banks with (increasingly foreign) private shareholders and those without. By the mid 2000s, the French mutual banks were largely indistinguishable in the range of their operations from the large commercial banks. German LB, with their large public shareholders, were also keen to increase profits. The LB may be 'not strictly profit-maximising entities' (Hackenthal, 2004, p.74), but this had no significant impact on their behaviour in this regard. Second, the nature of what can be broadly seen as 'investment' banking changed over time. The initial impetus for the expansion into overseas investment banking may have been to acquire skills to assist in serving domestic clients (on Germany, Deeg, 1999). The foreign firms purchased were largely advisory fee-earning, not proprietary trading, businesses, but over time, as will be discussed in greater detail below, proprietary trading increasingly dominated investment banking..

Financialization and the Credit Crisis

We analyse below the reports and accounts of the main French and German banks. First, we consider changes in the banks' activities from 2002 to 2007. We show the (in Germany, dramatic) changes in the importance of trading activities in general, and the trading of derivatives in particular. Our second focus is on the losses made by banks in the crisis itself. Of necessity, we concentrate in the first period on those activities that are apparent from an analysis of the banks' balance sheets. The losses announced as a result of the crisis reveal activities that were not visible in this way; most obviously, sizeable losses resulted from off balance sheet activities. Although these investments were not necessarily hidden (Landesbank Baden-Württemberg, for example, discusses its Structured Investment Vehicles [SIVs; see Deutsche Bundesbank, 2007, p.24] in its 2004 accounts), greater detail has now been given.

We reach three conclusions from the data. First, trading activity has increased significantly, especially by the German banks, but also the French. In particular, the use of derivatives in trading activities has increased very significantly, especially in Germany. Derivatives are used to reduce the risks from both credit (e.g., Krahnen and Schmidt, 2004, p.510) and interest rate mismatches (Memmel and Schertler, 2009), but in most banks analysed the volume of derivatives traded massively exceeds that required for balance sheet and financing risk hedging. Nearly all banks that distinguish classify derivatives transactions as mainly for trading purposes. Second, however, there is no correlation between the use of derivatives and impact of announced losses. Some of the greatest victims of the crisis, such as Bayerische Landesbank, Industrie Kredietbank (IKB) and Landesbank Sachsen, were not especially heavy traders of derivatives, but appear to have been engaged in activities that were not enormously profitable but were perceived as safe, notably investment in AAA-rated Asset Backed Securities and the contingent risks involved in Asset-Backed Commercial Paper and SIVs[2] (see Deutsche Bundesbank, 2007, p.24). This was 'disaster myopia' (Guttentag and Herring, 1986). Third, French banks were engaged in many of the same activities as German banks and made substantial, but smaller, losses. While those banks that suffered less were perhaps 'better traders', the main difference is one of degree rather than different practices. Most obviously, French banks were far smaller investors in the assets that became toxic, and less involved in setting up off balance sheet vehicles. In addition, the large retail banking businesses of the French banks lessened the overall impact of the crisis.

Changing Bank Activities Prior to the Crisis: Trading Activity

The banks' reports do not give a single way to track increased trading activity, but the data all point in the same direction. The available data includes the percentage of total assets designated 'trading assets', or, more narrowly, the proportion of securities held for trading purposes. Table 1 summarises the available data for the French and German banks.

<Insert Table 1 here>

For the German LB, the figures, where available, show an increasing focus on trading, although by no means consistently across all LB. The average notional volume of derivatives across the West German LB also rose from 3.5 times total assets in 2002 to 4.3 times in 2006 and 2007.3 As would be expected, the importance of trading generally and derivatives in particular for Deutsche and Dresdner is higher than other German banks, but Commerzbank's trading assets figures are far lower even than many of the LB's; as much an indication of changing LB activity as of Commerzbank's relative caution. This increased involvement in trading by Deutsche and Dresdner, however dramatic, does not represent any change from the general picture of the private banks, but the nature of investment banking, at least for Deutsche and Dresdner, has changed, as it has globally, to be focused far more on proprietary trading than on providing a wider range of services to clients. The figures for the LB are significant. Both Hackenthal and the IMF (2009, p.18) note the importance of wholesale funding for the LB, and the resultant vulnerabilities. Examination of the asset side of the balance sheet, however, also demonstrates an increased vulnerability to market movements. It has been frequently suggested that German banking is moving more in the direction of an Anglo-Saxon model. These data suggest that in the years leading up to the crisis, the trajectory of that change steepened. For a period, this was a successful strategy. Risk-adjusted trading results at the largest banks were seen as improving from 2005 until mid-2007. However, after that, heavy losses were made (Deutsche Bundesbank, 2007, p.67).

French banks overall are not as heavily involved in trading, relative to total assets that included substantial retail operations; nor have they generally experienced the marked increase in this activity in Germany. The one exception is BNP Paribas but, even here, derivatives activity declined relative to total assets, and notional derivatives volume in 2008 was 39 percent lower than Deutsche Bank. Elsewhere, however, the picture is different. Société Générale (which made heavy losses in derivatives trading) has lower trading assets, and derivatives activity relative to total assets closer to Commerzbank, and less than a third of Deutsche. Crédit Agricole is comparable to both WestLB and DZ Bank. The problems at Natixis were serious, but trading assets at Caisse d'Epargne are low (although derivatives activity is higher than most LB). Crédit Mutuel has similarly low trading assets, and derivatives activity fell well before the crisis. While the French mutuals have become universal banks, they remain more rooted in their retail and commercial banking activities than either the French commercial banks or the LB.

French banks nevertheless play a leading role in certain derivatives trading. They have over the past two decades consistently engaged in approximately a quarter of global equity derivatives trading (Fédération Bancaire de France, 2007). For several years Société Générale made greater profits from equity derivatives than any other bank globally. When the recipients of collateral postings for credit default swaps by AIG (using US government support) were revealed, Société Générale headed the list, receiving US$11 billion, 22 percent of the total. Calyon, the Crédit Agricole subsidiary, received a further US$2.3 billion. Named German banks received US$7.7 billion. Nevertheless, relative to the (generally larger) size of the French banks, the volume of derivatives trading is lower. Unlike the German banks, the average volume of derivative trading appears to have barely risen from 2002 to 2007 (although figures are incomplete). This was a period of rapid expansion for BNP Paribas and Société Générale, but the expansion was at least as much in the area of international retail banking as trading activity.

Internationalisation

German bank internationalisation also demonstrates rapid change in recent years. The nature of internationalisation is somewhat obscured by the presentation in some financial reports, particularly not separating Germany from the rest of Western Europe. We focus on credit exposure (contained generally in the risk reports in the annual reports) rather than revenue, because revenue is generally categorised by the geographic entity where a risk is actually recorded. LB Sachsen’s US sub-prime exposure, for example, was largely incurred by a Dublin-based subsidiary.

The available data support two observations. First, internationalisation on the asset side of the balance sheet has been very significant, and has accelerated in recent years. Second, although European financial integration should be expected to result in increased euro area exposure outside the home market,, the increase in exposure outside Europe, particularly in North America, is at least as significant as any increase in lending in the euro area.4 The available data is set out in Table 2.

<Insert Table 2 here>

Amongst the large private banks, data limitations prevent a full comparison. Commerzbank and Dresdner appear more European focused in their activities, but Deutsche has nearly half its exposure outside Western Europe, suggesting exposure in Germany must be well under half of total exposure. The situation of Société Générale is similar, but over half of BNP-Paribas’ assets remain in France. French bank internationalisation has included, in the cases of BNP Paribas, Crédit Agricole and Société Générale, expansion in retail banking, particularly in Italy. BNP Paribas, which has 6000 branches outside France, owns BNL, the sixth largest Italian bank, and BancWest, a US retail bank. Crédit Agricole has considered Greece and Italy to be ‘domestic’ markets since its takeover in 2006 of major retail banks there. As of end 2008, Société Générale’s international retail banking consisted of 40 different entities with 3700 branches. In stark contrast,German banks’ international expansion has been concentrated on investment banking (although Commerzbank, for example, engages in retail banking in Central and Eastern Europe). This greater focus of French banks on retail activities does not preclude future problems, especially in Eastern Europe, but the overall level of financialization in this internationalisation is lower.

Again, the most dramatic changes are at the LB (despite considerable diversity). Lending to their home Land cannot be isolated, except for the probably anomalous LB Sachsen,[5] but the available figures demonstrate significantly increased internationalisation. The process of internationalisation Deeg (1999) highlights has continued at an accelerating rate. These figures are, once again, difficult to reconcile with the view of LB as prioritising the needs of a home region. They are also hard, along with so many of the activities highlighted here, to reconcile with LB as 'not strictly profit-maximising entities' (Hackenthal, 2004, p.74). The absence of private shareholder pressure did not prevent, for example, LB Sachsen in 2003 setting a target for return on equity higher than was then being achieved by Deutsche Bank (Kirchfeld and Simmons, 2008).There is also no reason to see French mutual banks as not profit maximising, but they remain overwhelmingly domestic institutions.

This analysis shows that the view of the German banks as more conservative, as befits a bank-based financial system, does not hold. German banks are at least as financialised as, if not more financialised than, French banks operating in what is generally seen as now a deregulated, more market-based system. The high leverage of German banks is well-documented, and the gap between leverage and regulatory capital requirements is high, thanks to the favourable treatment of many highly-rated assets and derivatives positions (IMF, 2009, p.14). This has in itself created vulnerabilities in the current crisis. However, the analysis above takes this further.

The banks have also been more heavily involved in trading rather than lending, and significantly more internationalised. There has been a global trend in investment banking towards proprietary trading, but that the LB are,in this sense, 'the same as everyone else', in itself challenges the traditional perception of them.

We have so far concentrated on changes in the banks' activities as shown in the banks' balance sheets. However, the financial crisis reveals that many risks taken have been either largely hidden on the balance sheet or were off balance sheets altogether. In this area, differences between French and German banks are also marked.

Analysing the Banks' Losses

Recent European bank losses offer an unusual opportunity to examine the nature of banking. The crisis has obviously been an enormous surprise, but that 'traditionally conservative' German banks have made around a quarter of Europe's writedowns (IMF, 2009,p.12) has been a further shock. Table 3 sets out German and French bank losses until end August 2008,[6] and the announced areas of those losses, sourced from banks' reports and accounts. They therefore show what the banks deemed material enough to highlight. These data are possibly partial, but are very likely to highlight the main areas of loss. These figures can obviously only be preliminary. Leaked figures from the German regulator, Bafin, suggest still higher losses on 'toxic assets' (Süddeutsche Zeitung, 24 April 2009), and French banks have also continued to announce losses. Nevertheless, the crisis already reveals much about banks' activities; it also has the potential to bring about substantial change.

<Insert Table 3 here>

The crisis has not hit the largest or most sophisticated banks hardest. The most severely affected, Hypo Real Estate, IKB and LB Sachsen (all of whom effectively collapsed) are relatively small, and, measured by their activity in the derivatives market, less involved in the trading of the most sophisticated products. HRE is possibly an individual case, because so many of its problems stem from the funding of Depfa Bank, but the other two suffered losses mainly from their ABCP and SIVs (see Deutsche Bundesbank, 2007, p.24, 49; Tett, 2009). This is an area where the French banks have not experienced significant losses (although BNP Paribas has a large exposure). Even without including LB Sachsen, average losses of the LB included are 0.645 percent of assets, significantly higher than the large German or French private banks (0.40 and 0.28 percent respectively).

The data highlight the range of bank activities in both countries. The multiple sources of losses at the large commercial banks is unsurprising, but further demonstrates that ‘investment banking’ is increasingly proprietary trading. This is true also of the French commercial banks, but French losses are significantly lower. At times, French banks appeared to be at the forefront of the crisis in Europe. In August 2007, BNP Paribas froze three investment funds. In January 2008, Société Générale announced losses of €4.9 billion – the largest in banking history – through rogue trading in derivatives. Yet in 2008 both BNP Paribas and Société Générale reported profits. French bank losses compare very favourably with those at Citigroup ($55.1bn) and UBS ($44.2bn) (Bloomberg 2008).

It is LB's losses that most question the more standard view, and further reinforce the claim of dramatic change. The losses made are clearly in areas far from regionally-based lending. The exposure of LB to off balance sheet structures, for example, has been estimated by Moody's at around US$55 billion. The vast majority is likely to be financing the US mortgage market. In contrast, although French mutual banks made losses across a range of activities, with problems at Natixis particularly acute, losses so far reported are far lower. This is in line with the expectations from their lower financialization. French banks (or indeed any banks) did not predict the crisis better, but their more diversified risk, especially greater involvement in retail banking, has reduced the overall impact. German banks, meanwhile, were not primarily focused on patient domestic lending, but were in fact more exposed to market movements than their French counterparts. The change in their activities has been even more pronounced than generally recognised.

Government Action

Intervention by both governments is unprecedented, propping up ailing banks and boosting confidence in the banking sector; responding with credit guarantees; bail-outs through loans; purchasing minority shares or nationalising out-right; coordinated or enforced mergers; conditions on remuneration; tighter regulation and pushing for reinforced regulatory frameworks at the European and international levels. French government action has been more proactive, suggesting a throw-back to an earlier interventionism. With a couple of noteworthy exceptions, the German approach so far been more voluntary, but may be moving towards compulsion (*Die Zeit*, 19 February 2009 Nr. 09; *Spiegel Online*, 20 July 2009). However, despite the rhetoric of a return to a more ‘moral capitalism’ (in France), the regulatory push in both countries and interventions, the impact of government action upon financialization is likely to be limited.

Credit guarantees and loans to banks have been provided by the German (federal) and French governments to calm markets and encourage lending, as in many EU countries (see Quaglia, 2009). The German federal government approach has been more hands off than in France, the UK or the US, allowing banks to decide for themselves on assistance from the Financial Market Stabilization Fund (FMSF) created in mid-October 2008. The fact that so many of the troubled banks have been able to turn in the first instance to their Länder shareholders for assistance so far has limited the use of the FMSF, but the LB remain keen to utilize the federal government’s ‘bad’ bank scheme if agreement can be reached. A few transactions have been completed, notably Commerzbank (twice) and HRE. In the autumn of 2008, the French government moved to recapitalise all the largest national banks, effectively forcing them to accept capital and commit to increase domestic lending. In January 2009, further conditions were attached to a second tranche of capital, including curbs on dividend payments, a ban on executive bonuses for 2008 and export lending. However, none of the conditions have restricted French banks’ trading activities.

Both governments have extended their ownership in several banks. In Germany, the federal government-owned KfW became a majority shareholder in IKB and orchestrated a bail-out involving other banks. Commerzbank has tapped the new FMSF twice to save the merger with Dresdner Bank, for a total in equity and loan guarantees of €33.2 billion (*Handelsblatt*, 11 May 2009). A ‘nationalisation by another name' (*Financial Times* 9 January 2009), with a stake that is, by value, the largest crisis-induced shareholding of any leading European government in a private bank (*Spiegel Online*, 20 January 2009), the bail outs give the federal government a 25 percent plus 1 share in the new entity and veto power on some major company decisions. The German government also opted for the full nationalisation of HRE against the preference of its US investor, JC Flowers, but the HRE situation is unusually severe, and the government offered to buy shares at above the prevailing market price. Nationalisation met with considerable ideological opposition in the German political class and legislative change – agreed in February 2009 – was necessary. Yet, with the exception of HRE – a comparatively small institution – the German government's involvement in bank management to date has been negligible, and shareholders have generally not faced dilution as a result of federal government action, as in the UK. This preference for a hands-off and voluntary approach is very much is line with the industry-led response to crisis in Germany highlighted in the varieties of financial capitalism literature (e.g., Zysman, 1983; Deeg, 1999). The German government has preferred to act according to type. In France, increased government ownership in banks aimed less at rescuing institutions than at ensuring the continuation of domestic lending. In April 2009, the government increased the state's share in BNP-Paribas to over 17 percent while foregoing voting rights. The President's office also directed the merger of Caisse d'Epargne and Banque Populaire and took a substantial shareholding. Controversially, the President's top economic advisor took charge of the new bank. Despite calls by government leaders for direct intervention in the new bank's direction, the impact of increased government control remains as yet unseen.

The European Commission’s response to government intervention under EU State Aid rules will force change upon some banks. The Commission dropped its initial demand that French banks cut operations in exchange for capital following assurances that government funds would be used only to increase lending to mitigate the credit crunch. However, the Commission’s position on the regional bailouts of four LB – WestLB, Bayerische LB, HSH Nordbank and LBBW – and of Commerzbank could have more far-reaching effects. In May 2009, the Commission agreed a restructuring plan with WestLB that will halve assets by March 2011, including both international and domestic assets. Thus the actual overall impact of restructuring upon the relative importance of investment banking activities may be limited. WestLB is not being forced to refocus its activities at the domestic level. The three other LB face similar restructuring plans.

Both German and French governments have used the crisis to push for further consolidation and the construction of national banking champions. This drove policy on the Caisse d’Epargne and Banque Populaire merger – which would likely have failed without a government ultimatum. BNP-Paribas’ takeover of the Belgian and Luxembourg sections of Fortis bank – assisted but not directed by the French government – will make it the euro area’s largest bank. The relative stability that consolidation brings may well encourage ongoing financialization, but BNP-Paribas is also substantially increasing its retail operations. In Germany, the federal government’s voluntary ‘bad bank’ plan to take on toxic assets involved loose conditions imposed on the LB seeking to participate to downsize their operations and merge into fewer banks – with details left to the LB. However, the determined opposition of Land governments and the politicisation of the issue at the federal level[1] may well undermine these efforts.

Both French and German governments and regulators have moved to tighten regulation and supervisory controls on banks. French regulatory changes are more focused upon risks associated with rogue trading (Banking Commission, 2008) and will have no impact on financialization. In Germany, the resolution of debates regarding the regulatory response to the crisis is only marginally more likely to have any impact on financialization. There has been much criticism of the division of regulatory responsibilities between the Bundesbank and Bafin for contributing to the inability of these bodies to supervise banks effectively and predict their exposure to the financial crisis (IMF 2008). However, recent efforts to clarify their responsibilities seem unlikely to have an impact on banking activities. However, other German changes appear more potentially constraining. In March 2009, the federal cabinet approved a draft bill on regulatory reform (the *Gesetz zur Verstärkung der Finanzmarkt- und Versicherungsaufsicht*) which was passed in the federal parliament on 10 July 2009. The law includes enhanced capital requirements for securitization, increasing capital and liquidity reserves above Basel II requirements; binding limits on interbank exposures; increased reporting requirement of banks' off balance sheet exposure; and reporting requirements on bank leverage ratios (including off balance sheet assets). The new reserve rules and limits on interbank lending both have the potential to limit financialization. The adoption of reporting requirements on leverage aims to correct a perceived weakness in Basel II, which allows limited capital against assets with high credit ratings. That has allowed many banks, particularly in Germany

[1] *Financial Times,* 21 June 2009

(IMF, 2009a, p.13) but also elsewhere in Europe, to become highly leveraged despite meeting international capital adequacy rules. However, the new German law stopped short of adopting a maximum gross-leverage ratio which would limit the size of bank balance sheets relative to capital, as exists in Canada. This option is increasingly preferred by European central bankers as a simple mechanism to curb excessive risk-taking. Moreover, neither national government appears prepared to impose tighter requirements on the definition of capital held to satisfy Basel II requirements. The much reported German and French regulatory push at the European and International levels has focused upon bank reporting obligations and greater regulatory cooperation, either at the EU level as a result of the creation of the European Systemic Risk Council or bilaterally between national regulators (see Bafin, 2008, p. 12) but does not seek to place additional constraints on trading activities per se. The long-standing French and German focus on hedge fund regulation has meanwhile continued.

Conclusion

Over the past two decades a range of German and French banks engaged increasingly in investment banking and internationalised. German and French financial systems remain (overwhelmingly) bank-based systems. There has been no rapid rise in French and German private equity firms and hedge funds, although these do exist. Much of the recent change is in the financialization of the banks themselves, rather than changes in the extent to which they dominate the financial system. In France, for example, the largest hedge funds are bank owned (*EuroHedge*, 2008). The German banking system has been hit harder by the financial crisis than the less financialised French, the leading banks of which have nonetheless suffered significant losses. The scaling down of some trading activities amidst the rhetoric of governments and many banks themselves for a necessary ‘return’ to traditional banking activities represents a time-honoured, and most likely time-limited, response to business problems. A retreat to the more cautious nationally-oriented banking of the past is highly unlikely in all but the very short term: the opportunities in domestic markets are limited and the lure of profits in risk-taking remains. Both French and German banks – commercial, public and mutual banks – sought to expand their foreign and trading operations in order to increase profitability after the difficult years of the mid-1990s.

The crisis has not brought substantial changes in the nature of the French banking system. The state has emerged as a substantial shareholder, in the case of BNP Paribas the largest, but without voting rights. The merger of Caisse d’Epargne et Banque Populaire appears something of a throw-back to state interventionism. However, despite government rhetoric to the contrary, micromanagement of the bank appears unlikely. Rather the merger should be seen as an opportunistic move to further concentrate the banking system – by 2008 only 450 credit institutions continued to operate in the country down from 975 in 2002 (Fédération Bancaire de France, 2009). As in Germany, any impact on financialization is likely to be short-term with a scaling back of trading activities across the system, most obviously with the withdrawal from certain activities of Natixis and Calyon. However, the more broad-based French business model has been vindicated, and while banks such as BNP-Paribas and Crédit Mutuel have taken advantage of the crisis to internationalise further, there has been a heavy retail element to this expansion.

In Germany, the picture remains less clear. The federal government has taken a major shareholding in Commerzbank, but appears unlikely to interfere greatly (IMF, 2009, p.18). The government's 'bad bank' plan to clear toxic assets remains at this stage voluntary. The government appears to want its ownership of HRE to be brief. However, the more direct intervention now being considered by a government comprising both the major parties, even if a response to the worst financial crisis since the 1930s (when the German government took large shareholdings in commercial banks) and even if motivated in large part by short-term electoral considerations, would represent a significant change in the German financial system, the longer term implications of which are unclear. The key uncertainty about the future shape of the German financial system, and its 'three pillars', nevertheless concerns the LB, whose medium-term outlook Standard & Poor's has termed 'bleak' (9 June 2009). Their savings bank shareholders support consolidation, the federal government appears determined to exact consolidation in return for participation in the bad bank scheme, and the heads of both the Bundesbank and the financial regulator, Bafin, are reported to favour consolidation (*Reuters*, 28 September 2008). Länder governments seek to maintain their influence, and their heavy involvement in LB recapitalisations has increased their overall shareholdings at the expense of the savings banks (*Spiegel Online*, 27 May 2009). However, the capacity of the Länder to continue to intervene is being questioned (on the rescue of HSH Nordbank, see *Handelsblatt*, 24 February 2009). Further pressure comes from the EU, whose approval is required for any support. It is important to recognise, however, that the LB have been here before. Consolidation has been a constant (and frequently thwarted) theme since the late 1960s (Deeg, 1999).

The strategies of many LB currently involve a return to their core competencies, focusing on their regions, and the Mittelstand at the expense of international trading ambitions. This 'back to basics' response mirrors closely the response of WestLB to problems in principal finance in the early 2000s. The 2003 annual report promised that 'risky, high-volume investments involving significant lending exposures will no longer be a part of our business activities'. In June 2009, WestLB said it sought to remove €80 billion of 'toxic assets' from its balance sheet (*Wall Street Journal Europe*, 9 June 2009). There have been substantial changes in the business models of nearly all LB in recent years, and despite regulatory changes that may apply more stringent capital requirements, it would appear likely that the medium term will continue to see greater financialization, with internationalisation an important part of that process. Consolidation, despite Länder opposition, is similarly only going in one direction. Larger LB, with even further loosened ties to a particular region (and perhaps, as the IMF (2009) recommends, private sector shareholders) seem likely only to speed up financialization.

This article has studied the extent to which financialization has reshaped the German and French banking systems since 2002. Broader claims can also be made about the impact of financialization upon varieties of capitalism in the two countries, although a full study of this lies beyond this article. The financialization of German commercial banks and the LB has undermined the central position of the banks in the German model of capitalism: while German banks looked abroad for profits, large German firms turned increasingly to foreign banks and alternative shareholders. Deeg (1999) outlines the early stages of this development in the 1990s yet argues that bank-Mittelstand ties were not affected. The further financialization of LB activities in the

2000s, however, has affected these ties: real lending activity is flat and considerably lower in relation to total assets. In 1997, 45 percent of LB assets were in domestic lending to nonfinancial companies with only 4 percent going to foreign firms. In January 2002, the figures were 34 and 10 percent and by 2009, 28 and 17 percent. At this point, holdings of non-bank foreign securities were an additional 6 percent of assets.[7] While the Sparkassen and Cooperative banks stepped in to fill much of the gap, this change in LB activities represents a significant shift. The Mittelstand has recently been feeling the impact of the credit crunch brought about by the problems in German banking. Still, the Mittelstand has not yet turned to equity capital and the inroads made by foreign lenders in the German system, while increasing to the end of 2008 (IMF, 2009,p.32), remain relatively limited and may shrink as a result of the financial crisis. Thus, it is important not to overstate the significance of these trends.

The financialization of French banks may have contributed to the unravelling of the cross-shareholding groups created in the 1990s and centred around the three largest banks, but the crucial transformation in France remains the move to a ‘financial market’ form of capitalism, as large French companies turned to the equity markets for finance and French banks looked abroad and to other activities to compensate (Morin, 1998, 2000). Financialization has nonetheless potentially undermined the patient capital that underpinned the cross-shareholding groups. At the same time, French business has not turned to foreign banks. The country is open to foreign banks. However, nearly all of these operate in niche markets. HSBC's purchase of CCF and its retail operations in 2000 has, to date, proven exceptional rather than the start of a new trend. Banque Populaire’s purchase of HSBC’s French retail operations in 2008 moves the country in the opposite direction.

The French banking system has been relatively little affected by the financial crisis and there is unlikely to be a significant shift either because of the banks' own strategic responses or government intervention. The French system will continue its present trajectory of increased financialization and gradual consolidation. The German banking system seems far more affected and the crisis may accelerate some of the trends already encouraged by financialization – notably LB mergers and the further loosening of regional ties. It remains to be seen whether LB and Länder government opposition will succeed, as in the past, in slowing systemic change.

References

Aglietta, M. and Régis B. (2001) 'Financial Systems, Corporate Control and Capital Accumulation', in *Economy and Society*, Vol. 30, No. 4, pp.433-66.

BaFin (2008), Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) Quarterly, March. Available at <www.bafin.de>, accessed 21 July 2009.

Banking Commission (2007, 2008) *Annual Report*, Paris: Banque de France.

Bertero, E. (1994) 'The Banking System, Financial Markets, and Capital Structure: Some New Evidence from France', in *Oxford Review of Economic Policy*, Vol. 10, No. 4, pp. 68-78.

Bloomberg (2008) Available at www.bloomberg.com/apps/news?pid=20601087&sid=a8sW0n1Cs1tY&refer=home, accessed 17 June 2009.

Candida, D. (2000) *The Future of European Retail Banking*, Reuters Business Insight, http://reutersbusinessinsight.com/allreports.asp?pa=FS&page_no=8, accessed 20 May 2009,

Deeg, R. (1999), *Finance Capital Unveiled*, Ann Arbor: The University of Michigan Press.

Deutsche Bundesbank (2007), *2007 Financial Stability Review*, November. Available at <http://www.bundesbank.de/download/volkswirtschaft/mba/2007/financialstabilityreview2007.pdfm>, accessed 21 July 2009.

ECB (European Central Bank) (2008) *Annual Report*, Frankfurt.

Epstein, G. A. (ed.) (2005) *Financialization and the World Economy*, Cheltenham and Northampton MA: Edward Elgar.

EuroHedge (2008) 'Hedge Funds in France: A new esprit de corps', HedgeFund Intelligence, http://www.hedgefundintelligence.com/eh/Article.aspx?Task=Report&IssueID=66649&ArticleID=1904086, accessed 5 May 2009.

Fédération Bancaire de France (2007) *Rapport d'Activité*, Paris.

-- (2009) *Rapport d'Activité 2008*, Paris.

Guttentag, J.M. and Herring R.J. (1986) 'Disaster Myopia in International Banking', *Essays in International Finance*, No. 164, September. Princeton N.J: Princeton University Press.

Hackenthal, A. (2004) 'German Banks and Banking Structure' in J. P. Krahnen and R. H. Schmidt (eds.), *The German Financial System*, 2nd Edition. Oxford: OUP, pp.71-105.

IMF (2003) 'Germany: Financial System Stability Assessment', *IMF Country Report* No. 03/343, November, Washington: IMF.

-- (2004) 'France: Financial System Stability Assessment', *IMF Country Report* No. 04/344, November, Washington: IMF.

-- (2009) 'Germany: 2008 Article IV Consultation – Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Germany', IMF Country Report No.09/15, January.

Kirchfeld, A. and Simmons, J. (2008) *Lehman Toxic Debt Advice Led Leipzig Bank to Ruin Via Dublin.* Bloomberg, 28 October. Available at www.verantwortliche-kreditvergabe.net, accessed 18 June 2009.

Krahnen, J. P. and Schmidt, R. H. eds. (2004) *The German Financial System*, 2nd Edition, Oxford: OUP.

Krahnen, J. P. and Schmidt, R. H. (2004) 'Taking Stock and Looking Ahead: The German System at the Crossroads?' in J. P. Krahnen and R. H. Schmidt (eds.), *The German Financial System*, 2nd Edition. Oxford: OUP, pp.483-516.

Krippner, G. (2005) 'The financialization of the American economy' in *Socio-Economic Review*, Vol. 3, No. 2, pp.173-208.

Memmel, Ch. and Schertler, A. (2009) *The Dependency of the Banks' Assets and Liabilities: Evidence from Germany*, available at http://ssrn.com/abstract=1353927.

Morin, F. (1998) *Le Modele Francais de Detention et Gestion du Capital Paris*: Les Editions de Bercy, 1998.

-- (2000) 'A Transformation in the French Model of Shareholding and Management', *Economy and Society*, Vol. 29, No. 1, pp. 36-53.

O'Sullivan, M. (2007) 'Acting out institutional change: understanding the recent transformation of the French financial system', *Socio-Economic Review*, Vol. 5, No. 3, pp. 389-436.

Quaglia, L. (2009) 'The 'British plan' as a pace-setter: the Europeanisation of banking rescue plans in the EU?', *JCMS*,

Tett, G. (2009) *Fool's Gold,* London: Little, Brown.

Zysman, J. (1983) *Governments, Markets, and Growth*, Oxford: Martin Robertson.

---

[1] The total assets of the banks involved in the two countries is broadly similar (end 2007 except March 2008 for IKB).

[2] Both ABCP and SIVs are off-balance sheet entities that buy assets like mortgage-backed securities, and finance the purchases through issuing debt, mainly short term. Bank's exposure comes from either holding the debt issued or through committing to provide financing if the debt cannot be sold.

[3] Total assets is a measure of the size of a bank, so these increases are significant.

[4] Note, however, that the data generally obscures the euro area by categorising only Western Europe.

[5] LB Sachsen was established in East Germany only in 1992.

[6] From Bloomberg, 2008. Bloomberg gives no figure for Heleba, so figures up to September 2008 are used (source: IMF, 2009, p.13).

[7] Authors' calculations from Bundesbank figures.