Banking in Germany: Constructive Prospects against Many Odds

With its organisation in three strictly ring-fenced pillars, its very limited consolidation potential across pillars, and its low profitability, the German banking sector is generally not considered as one of the most dynamic in Europe. Recent strategic moves, such as the withdrawal of HVB Group from mass-market banking, as well as Deutsche Bank's announcement that it would deconsolidate its stake in Postbank, seem to have confirmed this phenomenon.

However this selective withdrawal does not exactly fit with several strategic announcements from large European banks. Recently, BNP Paribas and Société Générale in France have articulated expansion strategies in Germany, while it was reported that several foreign institutions were interested in buying the 17% stake in Commerzbank held by the German government.

Therefore it seems that the market participants' view on German retail banking is far from unanimous, and this report will try to address this paradox.

The current situation in the sector leaves a lot of room for improvement. The market shares remain fragmented, with the public and cooperative sectors representing a combined market share of more than 50% overall (page 4). However, the profitability of the German private retail banks (or of the divisions covering household and SMEs) has not materially deteriorated since the crisis, even if it remains low at an average underlying post-tax ROE of around 8% (page 5-7). This can be explained by (1) savings banks and cooperative banks having experienced some degree of consolidation (page 2-3) within each pillar; while (2) the only way for savings banks to build up capital is through retained earnings – profitability is therefore important for the savings banks, even if it is not at the core of their strategy.

Yet the prospects of the German banking sector could soon become more encouraging. We believe two factors could help:

- In the short term, the public and cooperative sectors could show more disciplined pricing against persistently low interest rates (page 7);
- In the medium term, the age structure of the private banks' employees should impact the sector's cost base positively. The progressive retirement of many bank employees should, in turn, help banks face the challenge of digitalisation (in particular, potentially lower margins and less dense branch networks). We believe ROEs of private banks could increase by 2.5% on average based solely on the gradual retirement of the workforce. Even if we believe that part of this improvement will be passed to the client base, we still believe that it should give the sector enough time to adequately prepare for the challenges of increased digitalisation (page 7-9).

In this context, it is interesting to review the business model of the large, foreign banks in Germany and note that the most successful strategies have focused on specialisation or non-traditional distribution channels. The affirmation of universal-banking strategies from foreign banks has been more recent and limited overall (page 11).

As for German private banks, a tough competitive environment has forced them to be more agile and decisive in their strategic choices (pages 10-11). This experience in dealing with an adverse environment should paradoxically secure their future.

Scope rates both **Commerzbank** and **Deutsche Bank** A-, stable outlook. Commerzbank has demonstrated it could successfully reboot its retail franchise (therefore underpinning our rating upgrade from BBB+), while Deutsche Bank's rating is now driven less by its retail franchise (following the announcement of Postbank's deconsolidation).

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The number of banks in Germany has fallen over the last 35 years, particularly in the public and cooperative sectors.

We have based parts of this section on the FESSUD[1] study on the German financial system (2013).

Historically, the German banking sector has always been divided in three strictly ring-fenced pillars:

- **Commercial banks**, all of them privately owned and sometimes listed. They are split between four big banks (Commerzbank, Deutsche Bank, Deutsche Postbank, HVB Group) and other privately owned banks that are either regional commercial banks or private banks. This group would include ING-DiBa and Santander Consumer Finance.

- **Savings banks**, known under its most expansive form as the 'Sparkassen-Finanzgruppe' (or S-Gruppe). According to the Bundesbank's institutional categories, this group is divided between the 'Sparkassen' and the 'Landesbanken'. However the S-Gruppe is indeed wider because it includes ten 'Landesbausparkassen', 11 public primary insurance groups, and Deutsche Leasing Group. The **Sparkassen** are owned by local cities and county governments. Their threefold objective is to: serve the common good; focus on their home area (underpinned by their regional principle and municipal trusteeship); and collaborate with the rest of the group. Earnings generation is the only way they can build up capital, but profitability is not a core strategy. They have close local contacts with SMEs and are required to provide a bank account when requested. There were 416 Sparkassen as of Q1 2015, represented across the country by around 15,000 branches and 245,000 employees serving about 50 million customers. The other components of this group are the **Landesbanken**, which are usually jointly owned by the Sparkassen's regional associations and regional state governments. Originally these banks had two functions: act as banker for the regional state and as a central bank for the Sparkassen in their region. The Landesbanken benefitted from regional state guarantees, which they used to develop commercial and investment banking activities. But when these guarantees disappeared in 2005, their business model was jeopardised. The **Landesbausparkassen** are regional building societies. There are ten of them with around EUR 60bn of assets, and they are ranked first in the home-loan savings market. The primary insurance groups are the second largest insurance group in Germany.

- **The cooperative sector** comprises two levels: **cooperative banks** and two **regional institutions**. Members own the credit cooperatives, although these also provide retail banking services to non-members. The two regional institutions act as central banks for the credit cooperatives. The DZ Bank, formed in 2001, has close to 900 members. The WGZ Bank is the central body for 187 local cooperative banks in the state of North Rhine-Westphalia.

Beyond these three pillars, the Bundesbank reports what it calls 'special banks'. These banks comprise **mortgage banks** (including Hypotheken Bank Frankfurt AG – formerly called Eurohypo); the **building and loan associations (or Bausparkassen),** which are split between private entities operating throughout Germany and public entities operating in regionally defined markets; and lastly the **special purpose banks**, which include banks dedicated to promoting investments in specific economic sectors. This sub-sector includes institutions as different as IKB (Deutsche Industriekreditbank, a corporate bank specialist) or KfW (Kreditanstalt für Wiederaufbau), the development bank owned by the German government.

The number of banks by sub-sector over a 35-year period appears on Table 1.

[1] Financialisation, Economy, Society and Sustainable Development (FESSUD) is a project funded by the European Union under the 7th Research Framework Program. It aims to forge alliances across social sciences to understand how finance can better serve economic, social and environmental needs.

Table 1: Number of banks by banking group (1980 to Q1 2015)

	1980	2000	2007	Q1 2015
Private banks	162	290	254	273
of which Big banks	6	4	5	4
of which regional banks	100	199	157	162
of which branches of foreign banks	56	87	92	107
Savings bank sector	611	580	461	425
of which Landesbanken	12	13	12	9
of which primary savings banks	599	567	449	416
Cooperative sector	2,304	2,039	1,259	1,049
of which regional institutions	10	4	2	2
of which primary cooperative banks	2,294	2,035	1,257	1,047
Special banks	56	78	64	57
of which Mortgage banks	39	32	22	17
of which Building and Loan association		32	26	21
of which Special purpose banks	17	14	16	19
TOTAL NUMBER OF BANKS	**3,133**	**2,987**	**2,038**	**1,804**

Source: Bundesbank

Table 1 shows an interesting sector-wide picture. Firstly the number of banks has decreased significantly over the years: the total number of banks has fallen by 42% since 1980.

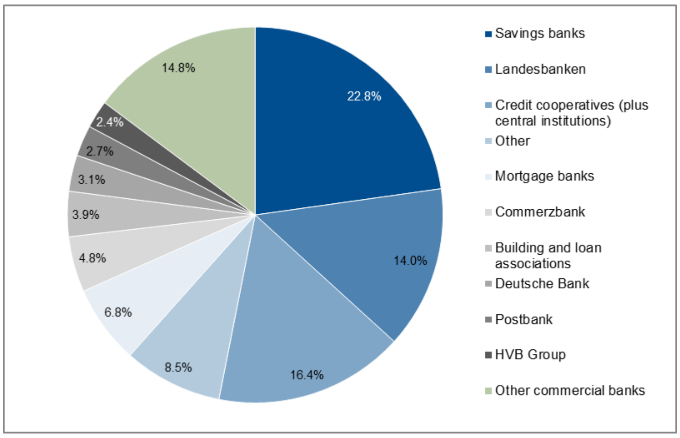
The second conclusion is that even if consolidation is unlikely to happen between pillars, each sector has shown enough discipline to reduce the number of institutions within each pillar. The number of Sparkassen fell by 31% over the period, while the number of cooperatives fell by 54%. The number of large banks reduced from six to four due to the mergers between Bayerische Hypobank and Bayerische Vereinsbank in 1998, and between Dresdner Bank and Commerzbank ten years later.

The third conclusion is that among all institutions surveyed by the Bundesbank, only the number of foreign banks' branches grew significantly (and foreign banks as well, not reported separately in Table 1).

Overall, since the crisis, even if total assets per bank have gone up, they still remain very small at EUR 4.6bn in Q1 2015 (versus EUR 3.7bn in 2007).

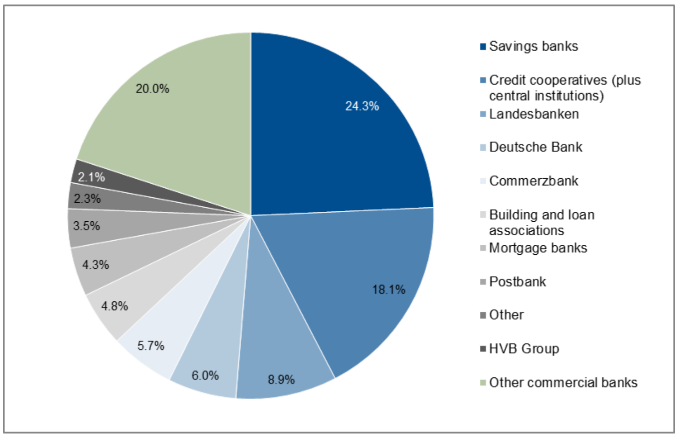
Market shares of private banks remain small…

Chart 1: Domestic loans: market share (%)



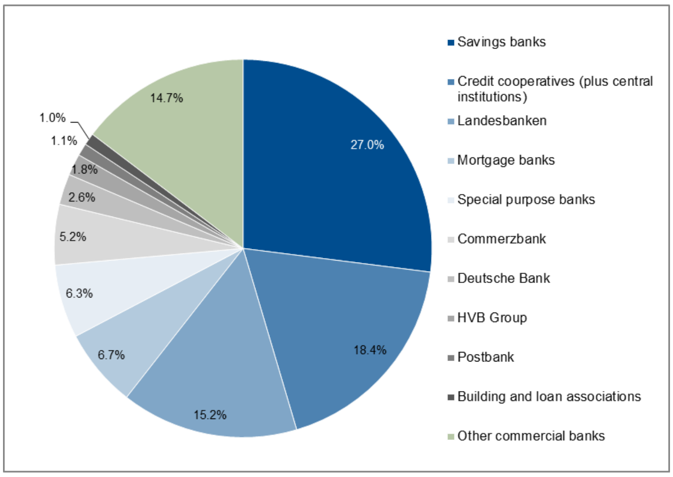
Source: Bundesbank, company data, Scope Ratings

Chart 2: Domestic deposits: market share (%)



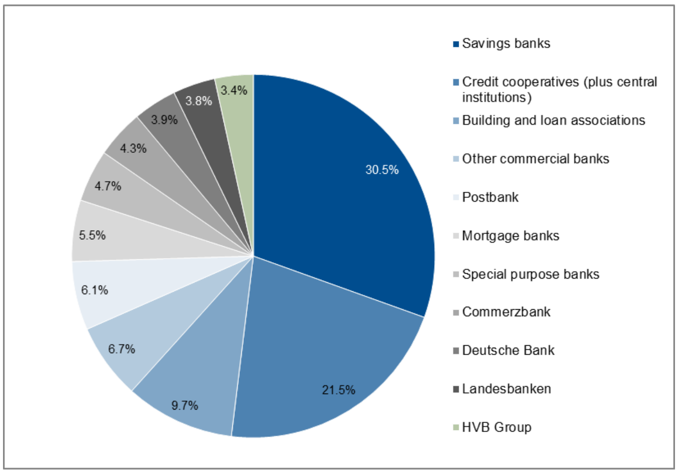
Source: Bundesbank, company data, Scope Ratings

Chart 3: Domestic loans to corporations (%)



Source: Bundesbank, company data, Scope ratings

Chart 4: Mortgage loans to domestic enterprises and resident individuals (%)



Source: Bundesbank, company data, Scope ratings

Charts 1 to 4 give an overview of banks' market shares in Germany. These data (based on the Bundesbank and on individual company data) show the overwhelming importance of public and cooperative sectors in the German banking market.

Indeed the cooperative and public sectors together represent 53% of customer loans and 51% of deposits respectively. As far as mortgages and corporate loans are concerned, the cooperative and public sector's combined market share increased to 56% and 61% respectively.

Charts 1 to 4 demonstrate that the estimated market share of each of the four large private banks remains in the low single-digit range.

Yet some 'specialties' in the large banks emerge. Analysing the four tables, Deutsche Bank appears as a strongly deposit-driven franchise (6% market share), while Commerzbank benefits from a strong 'Mittelstand' franchise at national level (5.2% market share on corporate loans – irrespective of size). Postbank has a solid market share in mortgages (estimated at 6.1% in a market dominated by savings and cooperative banks) while HVB is a Bavarian bank, with comparatively lower market shares at national level among the big banks – we assume HVB's market share is likely among the best in Bavaria, the second largest state in the country.

However, despite market shares being dominated by the public sector and cooperative institutions, profitability in the sector, even if low, is not too much of a concern.

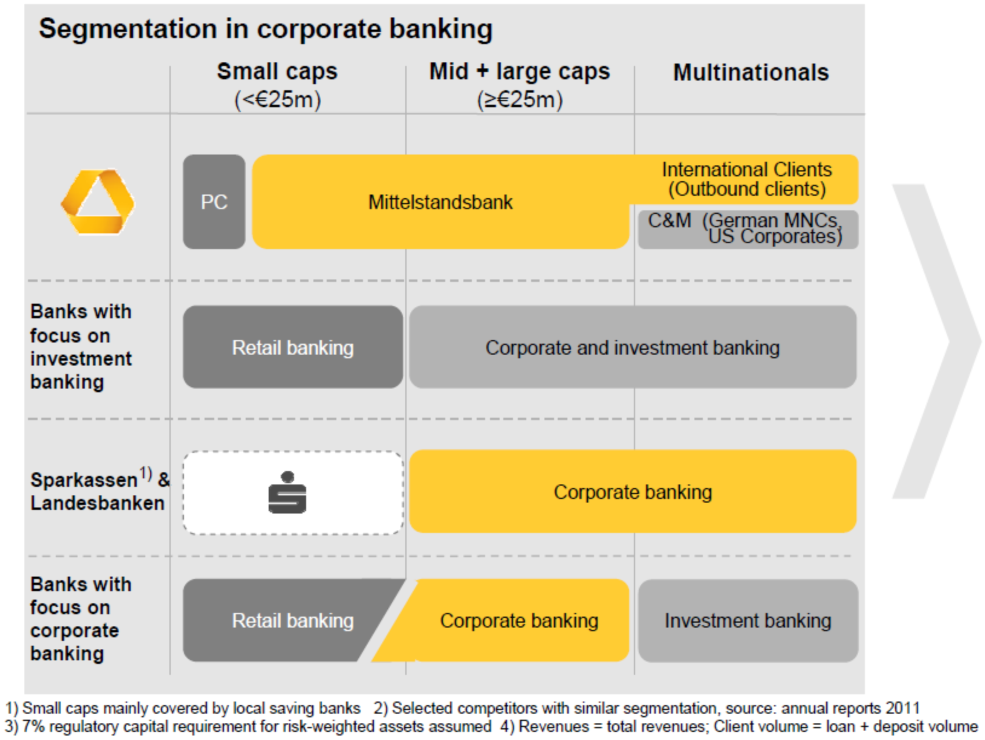
…And profitability is low...

This section analyses key profitability metrics in each of the pillar's main components. We look at the 'Sparkassen-Finanzgruppe', which consolidates mainly 416 Sparkassen, nine Landesbanken (including Bremer Landesbank owned by NordLB and DekaBank, and 10 Landesbausparkassen); the Volksbanken Raiffeisen Cooperative financial network, which includes 1,018 cooperative banks, DZ Bank, WGZ Bank, and the central products specialists; and to add to the peer group we look at Deutsche Bank Private & Commercial Banking, Commerzbank Private Customers & Mittelstandbank (PC & MSB), Deutsche Postbank, and the Commercial Banking division of HVB Group. By doing this, we hope to capture around 66% of the lending market, 68% of deposits, more than 70% of loans to domestic enterprises, and close to 80% of mortgage loans – therefore presenting a reasonably comprehensive overview of the German banking sector in our analysis.

We look at four comparative profitability indicators in Charts 6-9 to show the relative ranking of each institution. It is worth noting that Chart 6 only refers to 2013 revenue because the detailed 2014 results of VRB (Volksbanken Raiffeisenbanken) and S-Gruppe are not yet available. We will update the report accordingly.

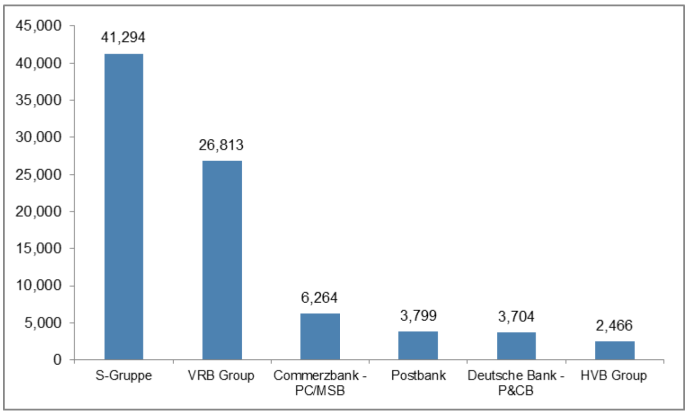
Chart 6 gives an idea of the difference in scale between the different players, which is expressed in revenues as opposed to market shares in Graphs 1 to 4. We note that the perimeter between players may be somewhat different and not quite comparable. In particular, Commerzbank's Mittelstandbank covers some names typically covered by Deutsche Bank's Corporate & Investment Bank. Therefore Commerzbank's numbers could be slightly overstated and Deutsche's slightly understated (see Chart 5). However, we believe that the difference is not that material considering that Commerzbank has much less presence in the large-cap market than Deutsche. Also, in light of Chart 5, we also believe that Commerzbank PC & MSB numbers are solidly comparable with HVB Group's commercial bank, as well as Postbank.

Chart 5: Segmentation of corporate clients at various German banks



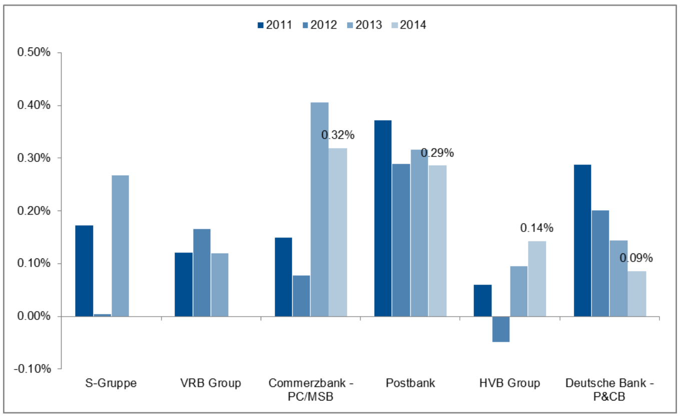
Source: Commerzbank

Chart 6: German retail-banking revenues 2013 – selected banking groups (EUR m)



Source: Company data, Scope Ratings

Chart 7: German retail cost of risks 2011-2014 (in %)



Source: Bundesbank, company data, Scope Ratings

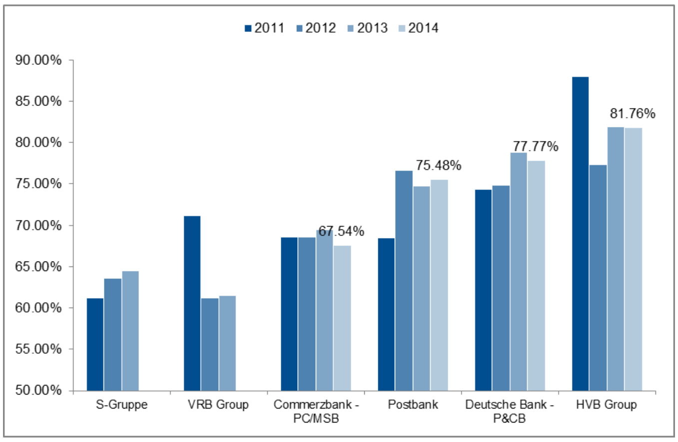
Chart 6 shows that the combined German retail revenues among the four large private banks represent slightly more than 50% of VRB Group's total revenue. The chart therefore reflects the imbalances in the German banking market.

In this context the muted financial performance of the four large banks should not come as a surprise (see Charts 7-9).

First of all, as shown on Chart 7, asset quality has remained relatively benign in Germany in 2011-2014. S-Gruppe reported a very low peak provisioning of 27 bps in 2013, which was due to specific Landesbanken-related provisions. Excluding this one-off item, the cost of risk ranged between roughly zero (S-Gruppe and HVB Group in 2012) and 41 bps (Commerzbank in 2013). In 2014 the cost of risk declined overall from already low levels due to more stable economic conditions in Germany.

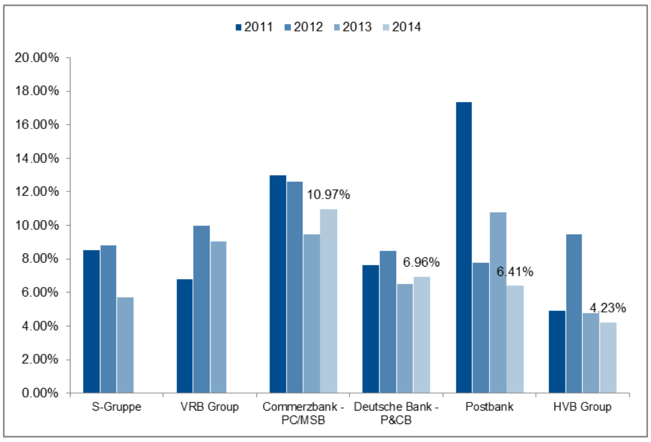
Trends in efficiency were key in explaining the profitability gap between the public and mutualist sectors, and the private sector. Both S-Gruppe and VRB have historically posted cost-income ratio trends within the 61-64% range. This compares very favourably with the four large banks, which have posted cost-income ratios at around 75%, or higher, since 2012. Interestingly, there has been no material sign of improvement for the large private banks except for Commerzbank, which benefitted from (1) an important restructuring following the merger with Dresdner; followed by (2) a reboot of the bank's commercial strategy since 2012, positively impacting the P&L. The opposite applies to Postbank. The bank had to go through significant restructuring costs following the acquisition by Deutsche Bank, and an attempt at integration that ultimately did not work, if the disappointing revenue performance of Postbank is anything to go by. These lower revenues explain the bulk of the high cost-income ratio of the bank, and not the cost base itself, down by 17% on an underlying basis in 2014 versus 2011.

Chart 8: Cost-income ratio: German retail banking sector 2011-2014 (%)



Source: Company data, Scope Ratings

Chart 9: Underlying post-tax ROE 2011-2014 (in %)



Source: Bundesbank, company data, Scope Ratings

Chart 9 leaves us with the bottom line, that is, the underlying post-tax ROE of retail banking in Germany. We note that S-Gruppe (excluding a one-off Landesbanken provision in 2013) and VRB Group maintain a post-tax ROE between 8% and 10%, which is low in light of the market shares of these two institutions, and their theoretical pricing power.

Considering these headwinds, the profitability of Commerzbank (largely driven by its Mittelstanbank franchise) is, in effect, quite satisfactory. The profitability of Postbank and Deutsche Bank remain quite low (maybe reflecting that retail was not a management priority at Deutsche Bank and that integration with Postbank proved disappointing), while the low ROE of HVB can be explained partly by the bank's overcapitalisation (CET1 ratio of 21.3% - which we used to allocate the capital of the commercial banking division).

Viewed in a pan-European context, these returns appear quite low, particularly compared to the UK or Nordic banking sectors. However, we note that retail banking profitability in Germany over the last five years has tended towards stability and is not prone to the volatility of other countries. The only exception was Postbank, but as mentioned we believe the merger with Deutsche Bank had some impact on the company's reported profits, therefore the numbers in Chart 9 should not be taken at face value for this company.

Therefore, one could argue that despite this difficult environment both domestically and internationally, German banks have been quite resilient, even if at a low level.

We believe the situation could improve going forward.

…But the outlook of the German banking sector seems encouraging…

The public and cooperative sectors should react against a low-interest rate environment

With interest rates where they are, the cooperative and public banking sectors (VRB and S-Gruppe) are suffering like any other European retail institution, and are dealing with a falling deposit margin. In this context, we view as encouraging the words of the president of the German Savings Banks Association (DSGV), Georg Fahrenschon, at their financial press conference on 12 March 2015.

'If interest is practically abolished, this is bound to have an impact on the savings banks' net interest income in the medium term. High-interest-bearing exposures fall due, and new exposures are only available on much less favourable terms. Income from maturity transformation will therefore decline, as will the return on equity. We will have to cushion these effects by strengthening the capital base […]. In practical terms, this means (1) savings banks have to retain the earnings they have generated. In our view, making higher payouts to municipal owners is not an option; (2) we will have to explain to our customers that better terms are not possible if savings banks are to remain stable in the long-term.'

If the public sector is committed to remaining competitive against other banks in a low-interest-rate environment, we believe this can only be positive for the future profitability of the whole sector. It could particularly help deposit margins. We also note that the dividends from the Sparkassen are important for their municipal owners and that maintaining some decent profits is important for these banks.

Germany's ageing population may be positive for the sector's profitability.

In its sovereign report on Germany published on 29 June 2015, Scope pointed out that demographics represent a key factor in shaping the country's economic outlook and public finances. The report notes that Germany's median age is the highest in the Euro-area countries, at 46.3 years, and the rate of population decline is likely to accelerate within the next 35 years.

An ageing population will accompany the population decline, triggering significant shifts in structure. The most important is the decline of the labour force and the rise in the number of pensioners.

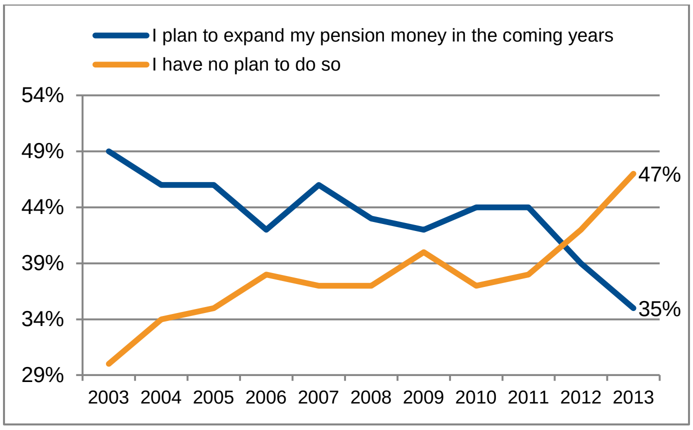
Demographics has important implications on Germany's economic outlook and public finances. Rising labour-force shortages constrain potential economic growth; Germany's current-account surplus is then likely to diminish first because the shrinking labour force puts pressure on competitiveness, and second because the increase in the number and proportion of pensioners should lead to a deterioration of the country's savings ratio.

Lastly, a slower GDP growth rate and rising old-age-related public expenditures could eventually erode government budget balances and push up public debt.

Demographic trends have a mixed impact on the banking sector:

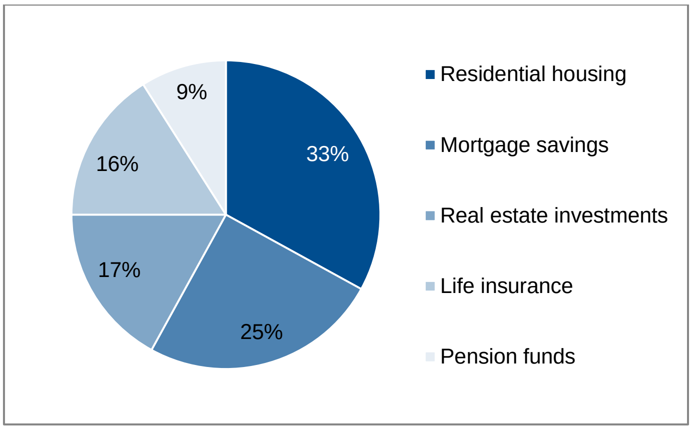
1. **Demographic pressure should not lead to a material shift in German household savings.** According to a study titled 'Private old age pensions' by Postbank in 2013, nearly half of German working professionals have no intention of expanding private old-age pension provisions because of the low interest rates (Chart 10). However, among those who would (35% in 2013 – see Chart 10), one-third would like to build or purchase property for their own residential use. After buying residential properties, the next most popular forms of pension savings are building up a mortgage savings plan and acquiring investment property. Other forms of pension investments, such as life insurance or topping existing pensions, are less popular. Modelling this trend is quite difficult, as this implies higher mortgage-loan demand (slightly counterintuitive because to model pensions usually means to adjust the bank's balance-sheet liabilities by reducing deposits and increasing off-balance-sheet pension or life-insurance products). We assume that the current population aged 25-65 will have to increase efforts to provide for retirement using products mentioned above (Chart 11). According to data collected on www.destatis.de, we believe 44.7 million people correspond to the 25-65 age group as of YE 2014. With the German household savings ratio that we estimate at 21% out of a disposable income of USD 31,252 (around EUR 28,000) per head (based on several sources, particularly the 'OECD Better Life Index'), the German 'potential pension savings pool' would be close to EUR 260bn. Using conclusions from the Postbank study and Chart 9, 35% of the 'potential pension savings pool' could be available at sector level to expand pension provisions, that is EUR 92bn. Assuming conservatively that this is a reallocation of existing savings (and not additional savings above the 21% savings rate), the breakdown of that money could look like Chart 11. The attribution per large banking group would indeed be based on individual deposit's market shares, implying 10% for the big banks, 36% for S-Gruppe, and 23% for VRB. Looking at S-Gruppe, annual supplementary revenues of EUR 350m a year seems like a maximum for the largest German banking network. The impact on profits would be small as new volumes of mortgages would imply new capital consumption. Therefore, we do not expect any material changes in revenues from demographic factors.

Chart 10: Working professionals willing to expand pension provisions (%)



Source: Postbank

Chart 11: Estimated breakdown of savings reallocation for pension purposes (%)

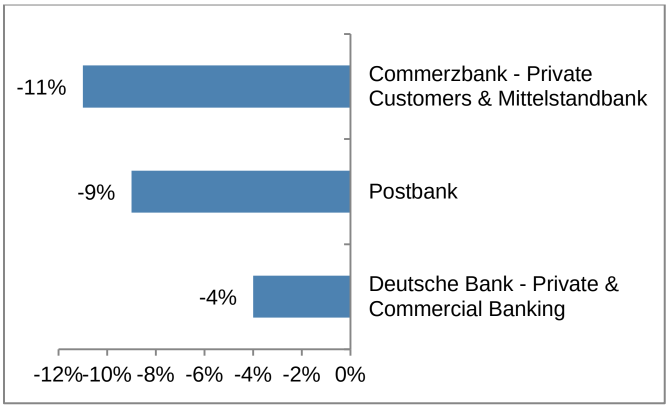


Source: Scope ratings estimates, Postbank

2. **The age structure of German banks should be supportive for the sector's cost base, particularly in the context of increased digitalisation.** This argument is linked with Germany's ageing population as the age distribution of the employees of German private banks somewhat mirrors the trends of ageing in the population. The progressive retirement of a large part of bank employees should also help banks face the challenge of digitalisation (in particular, potentially lower margins and less dense branch networks).

   Before presenting our conclusions, though, we note that numbers in Chart 12 and Table 2 (below) should be viewed with caution. We have found enough data on the age distribution in the banks' sustainability reports, but much of it is slightly dated (2011 for Deutsche, 2012 for Commerzbank, 2013 for Postbank). We have also used group personnel expenses as a proxy for divisional personnel expenses (except for Postbank where personnel expenses were directly available), as well as assuming that possible pre-retirement starts from age 54. Because of the lack of meaningful data, we have decided not to include HVB Group in these charts.

Chart 12: Potential cost reduction (% of total divisional costs)



Source: Scope ratings estimates, company data

Table 2: Potential gross profit improvement at three large German banks (%)

	Underlying ROE (%)		Cost income ratio (%)	
	2014	w/ cost savings	2014	w/ cost savings
Commerzbank - PC&MB	11.0%	14.1%	67.5%	60.2%
Postbank	6.4%	10.0%	75.5%	68.5%
Deutsche Bank - P&CB	7.0%	8.0%	77.8%	74.7%

Source: Scope ratings estimates, company data

As shown on Charts 12 and Table 2, pre-retiring (and in effect not replacing) employees aged 54+ could have a positive impact of 1%-4% on the ROEs of banks under review. This increase assumes no restructuring charges – which would in any case be very material. Table 2 also shows that cost-income ratios would be lifted by 400-700 bps – which is probably too aggressive as we expect most gains to be passed to the client base due to the increasing digitalisation of the banking networks. However, considering the increasing pressure on branch banking, the age distribution of German banks can be a helpful way for banks to plan the shift to digital without major and additional forced costs, or a forced restructuring. Scope's report 'Multichannel Banking and Overcapacity: Cost Saving Opportunity or Competitive Threat?' (December 2014) addresses this topic. The note shows the relatively strong position of German banks in terms of branch by inhabitant – already quite low by European standards – as well as online and internet banking penetration, where German banks are average compared to peers. We note that Postbank's numbers should be taken with extra care considering the status of many employees (still civil servants for 34% of the headcount as of YE 2014).

We also note that the age structure of German banks should still be favourable in the long run, considering the importance of the 45-54 age group among full-time-equivalent employees (particularly at Postbank and Commerzbank).

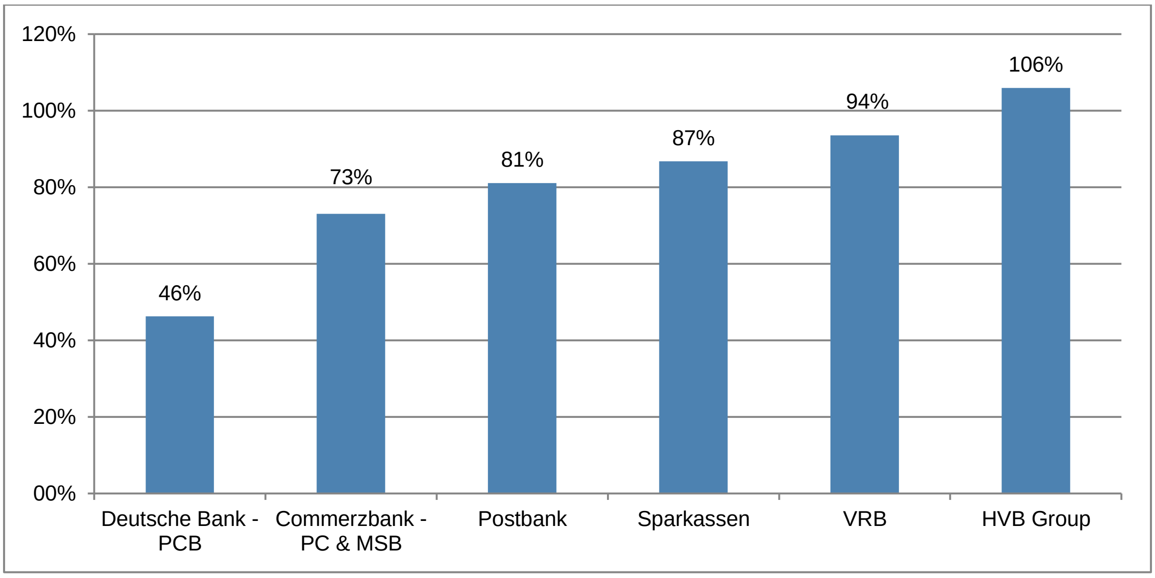
We recall that a favourable age distribution impacted largely the profits of French banks' networks in 1995-2005, bringing some flexibility to a sector which had a weak profitability due partly to a large mutualist/cooperative sector.

Deutsche Bank and Commerzbank's retail businesses have significant excess deposits that penalise net interest margin

Chart 13 shows the dependency of each large banking group to interest rates. According to our estimates it is interesting that most German retail banking networks have excess deposits. This deposit 'overfunding' goes from moderate (Sparkassen) to quite extreme (Deutsche Bank). Even if this ample funding in itself is positive for the liquidity of the divisions, it raises questions about the impact of low interest rates on the profits of the domestic retail divisions.

In a way, the current situation is interesting as the interest-rate situation is unlikely to get any worse, creating scope for deposit margins to go up, but the 'lower forever' situation has to first subside.

Chart 13: Loan to Deposit ratios of large German banking networks (%)



2013 for VRB and Sparkassen; 2014 for the rest. Source: company data; Scope ratings estimates

Most German private banks have changed their strategy and amended their positioning since 2012

The large private banks have adopted a very efficient retail business model in the context of lower profits in a depressed economic environment and low interest rates. These strategies have paid off nicely so far: they were defined in 2012 by Commerzbank, in 2013 by HVB, and fined-tuned at Deutsche Bank by its 'Strategy 2020', which was presented to the market last April. Looking back at each strategy in chronological order:

For **Commerzbank**, the retail franchise needed a complete reboot. On our estimates, the bank lost about one-million retail clients (out of 12 million) in 2008-2012 following the merger with Dresdner and the bank's support from the German government. The strategy of Commerzbank therefore had to be focused on (1) rebuilding confidence; (2) accelerating the modernisation of the network; (3) reducing the weight of transaction-based business on revenue; and (4) de-risking. The bank was successful on all accounts, using a strategy based on the traditional values of banking, such as trust, reliability, transparency and fairness. At the same time, the bank engaged in an ample modernisation strategy (the mortgage open architecture proved quite successful), and Commerzbank had the idea of incubating financial IT companies through its fund, Fintech, helping digitalisation in the network.

Commerzbank's Mittelstandbank has always been a strong performer within the group, helped by a very dense domestic network at national level. It remains a key driver of the retail business's profitability as it represents 75% of the pre-tax profits of the PC and MSB divisions combined (versus 83% in 2013 and 88% in 2012).

HVB Group announced a change in strategy at the same time that its parent, Unicredit, announced a major restructuring in 2013. The bank decided to significantly reduce its network density to focus on the affluent client base (as opposed to mass market). In 2013, the 'Affluent'/'Private Banking' segment represented just 18% of HVB's client base, but 67% of its revenues, and the cost base was far too important. As a result, HVB drastically reduced its number of branches, decreasing from 933 in 2013, 796 in 2014, and 736 as of Q1 2015.

As for **Deutsche Bank** and **Postbank**, the retail strategy defined in 2012 became obsolete when Deutsche announced it would deconsolidate Postbank. This withdrawal from mass-market retail is at the core of 'Strategy 2020'.

Postbank's deconsolidation fulfilled two objectives defined in 'Strategy 2020': first, re-focusing on clients offering 'mutually beneficial partnerships' (not exactly the case of the mass-market component of Postbank); and second, tightening the bank's product perimeter to avoid Deutsche becoming all things to all people. It was also clear that with total consolidated assets of EUR 155bn as of YE 2014, Postbank's leverage exposure was too high in view of Deutsche's new objective to reach a Tier 1 leverage ratio of 5%, or better, in the medium term.

Deutsche's remaining domestic-retail business (P&CB) is to transform into a leading digitally-enabled advisory bank for private and commercial clients. Two-hundred branches will close by 2017 and Deutsche Bank plans to invest EUR 500m-600m in digital capabilities by 2020 (of which EUR 100m already invested).

While the strategy is clear for Deutsche's retail business, there are a lot of uncertainties for Postbank. Assuming Deutsche's new CEO adopts 'Strategy 2020', the attempted integration of Postbank with Deutsche is now over, and Postbank will have to find a strategy that is more consistent with its mass-market culture.

Foreign banks in Germany are reasonably successful, but not under the traditional 'universal banking' umbrella.

Foreign banking in Germany is reasonably large, but not oversized. Excluding Unicredit-owned HVB – covered earlier in the report – foreign banking represents more than EUR 600bn of German banking's total assets, so around 8% of total assets in the sector. This is the same proportion with sector loans (EUR 326bn excluding HVB) but bigger as a percentage of deposits (EUR 400bn, 11% of total). There are three business models currently used by foreign banks in Germany.

In general, successful foreign banks in Germany have developed specialist franchises, either dedicated to specific products or distributing a whole range of products through direct banking platforms. This is the **first** business model.

Santander arguably owns one of the largest consumer lending businesses in Germany (14% market share in term credit) with a loan book of EUR 30bn and total assets of EUR 38.6bn (YE 2014), capital of EUR 3.1bn and net income of EUR 110m, which is smaller than prior years due to higher operating expenses from loan-processing fines that plagued the sector in 2014. The bank is a leader in consumer-durables financing, and ranks second in auto finance and direct lending. Santander also conducts commercial-banking operations through 173 branches acquired from SEB in 2010, which enabled the bank to double its network.

ING DiBa is the German subsidiary of ING Direct Banking. Excluding HVB, ING DiBa is the largest foreign bank in Germany, with total assets of EUR 137bn (YE 2014), EUR 90bn of loans, EUR 115bn in deposits, and eight-million clients (these figures also include Austria but only 10% per our estimates). The bank ranks undisputedly first as a direct bank in Germany and in Europe, with a business model based on deposits and mortgages. Like Santander, ING maintains a separate entity, ING Bank, which is more involved in commercial banking and much smaller than the Direct Bank.

Targobank is the former retail-banking subsidiary of Citibank Germany, sold to France's Crédit Mutuel in 2008. The bank's product range is similar to Santander as it focuses on consumer finance. Targobank operates 363 branches in 200 cities but is quite small (EUR 13.4bn of total assets). The loan book stood at EUR 12bn and was funded fully by the same level of deposits. It serves four-million clients in Germany and reported EUR 267m of pre-tax profits in 2014. Like all other German retail banks, fines on loan-processing fees prevented the bank from having much higher profits.

The **second** business model is a dedicated corporate and institutional-banking model based on pre-existing franchises. **SEB AG** is a traditional corporate bank with total assets of EUR 31.8bn. SEB reached a good size in Germany by acquiring Bank für Gemeinwirtschaft (BfG) from French bank Crédit Lyonnais in 2000 (BfG was created in 1949). It reported pre-tax profits of EUR 150m in 2014 with a ROE close to 10%. Being a dedicated corporate bank, SEB operates in one of the most competitive market segments in Germany, but profits are good for what SEB considers to be a core market.

In Germany, HSBC operates under its own dedicated brand, **HSBC Trinkhaus & Burkhardt**. HSBC kept the brand name of the former trading house created in 1785. HSBC's total balance-sheet assets in Germany are quite small (EUR 26bn) but the business model is marked by its asset management capability (HSBC has EUR 210bn of assets under management). The ROE of the bank is not very high, at around 8%, and the major profit drivers are the corporate and investment banking businesses.

Among foreign banks active in Germany, the two large French banks, **BNP Paribas** and **Société Générale,** are the only ones aimed at building a proper German bank out of existing platforms (and this would be the **third** business model). BNPP aims to build a deposit base as well, therefore creating a proper universal bank organically. In terms of strength, BNPP benefits from a consumer-finance joint venture with Commerzbank. The combination of CortalConsors and DAB Bank also enabled BNPP to become the 'Number 1' online broker and the fifth largest digital bank in Germany with 1.5 million customers and EUR 63bn of assets under management, of which EUR 17bn are deposits. BNPP aims to grow German revenue at 8% each year in 2013-2016. The bank reported 5% growth (below expectations) in 2014 at EUR 1.2bn. SocGen's presence in Germany is smaller (EUR 744m of revenue in 2014, pre-tax profits of EUR 191m and estimated loan book of about EUR 15bn) but was boosted by the purchase of equipment-finance, leasing and factoring businesses from Deutsche Bank in 2001 (GEFA and ALD). The bank now employs around 3,100 people in Germany and we estimate its loan book at around EUR 10bn.

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