

Significance of Capital Adequacy Regulations and Relationship Banking in German Retail Banking

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Overview

This article targets Germany and seeks to develop a financial regulation theory that grasps the capital adequacy regulations and relationship banking as basic financial administration policies that complement each other.

In Germany, which initiated financial deregulation ahead of other countries under the universal bank system, each banking group since the late 1980s has been developing rating methods, which have become a model for internal ratings-based approaches in the “International Convergence of Capital Measurement and Capital Standards: a Revised Framework,” known as the Basel II Capital Accord.

The Basel II regulatory and supervisory framework promotes self-organized risk management. Financial institutions’ risk management includes balance sheet adjustments. For such adjustments, German banks have in recent years utilized internal ratings-based approaches and relevant consulting services for transaction partners. In this respect, they have promoted the securitization of loans and the development of the relevant platform.

Capital adequacy regulations are seen from a stock-based viewpoint, while relationship banking adopts a flow-based viewpoint to reduce costs, expand profit and improve risk management. Regarding cost-benefit analysis, this viewpoint can explain the segmentalization of customers for balance sheet adjustments.

Financial institutions must utilize capital adequacy regulations and relationship banking systematically to ensure sound and effective business management. If necessary, they must exploit business alliances and other measures to reduce costs.

<Key Words> Germany, retail banking, Basel II, relationship banking

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1. Introduction

Capital adequacy regulations (BIS regulations) and relationship banking have been key policies of Japan for the protection of depositors, the facilitation of banking and the stabilization of the nation's financial functions. But some people interpret the two key policies as indicating that the United States would introduced the BIS regulations in a bid to stifle strong Japanese banks and relationship banking is introduced to resolve politically the contradictions of the regulations. This interpretation takes the development of capital adequacy regulations and relationship banking promotion policy as exogenous factors for financial institutions. In this sense, relationship banking policy might have been understood an additional lending order made by authorities to cover up defects of capital adequacy regulations.

Such emotional interpretation may lead in the practice to a widespread view that a new non-performing loan problem shall occur but is inevitable. This could be a problem for the actual financial administration. From the academic viewpoint, the problem is that the two policies have yet to be grasped systematically. These policies should be incorporated into an academic system like a financial administration or institution theory, where understanding is replaced by reason. The challenge is therefore that we should interpret the capital adequacy regulations and relationship banking as complementary to each other and develop a financial regulation theory free from contradictions.

To this end, it is most appropriate for us to analyze a country where the two policies have inherently developed. In this respect, Germany has seen no emotional opposition from the administrative, industry or academic sectors to the introduction of capital adequacy regulations. Furthermore, Germany had discussions on relationship banking when the capital adequacy regulations were introduced fully in the 1970s. These developments are promoted by financial deregulation and came inherently, rather than as a result of foreign political pressure.

This article analyzes the background of the German capital adequacy regulations' development into the Basel Capital Accord and the effects of the new Basel Capital Accord (Basel II or new BIS regulations) on Germany's present retail banking strategy. Finally, we present discussions on relationship banking from the German perspective and approaches, and attempt to interpret the strategies of financial institutions.

2. Development of Capital Adequacy Regulations

West Germany (Federal Republic of Germany) introduced capital adequacy

regulations in 1961. Since the second half of the 1980s, Germany has refined and improved the regulations under the Basel Capital Accord and relevant EU directives. Banking regulations have reached a turning point as the Basel II Capital Accord calls for inspection and supervision regarding whether financial institutions have established internal discipline to ensure their soundness. Germany has issued multiple notifications on inspections regarding how financial institutions are organized. These notifications will develop into the MaRisk (Minimum Requirements for Risk Management) to give greater priority to the supervision regarding internal discipline.

This chapter reviews the development of banking regulations in the first and second sections and specifies supervisory authorities' desirable inspection and supervision for the future in the third section.

2.1 Production of Basel I

For a period after the war, the 1934 Banking Act (Reichsgesetz über das Kreditwesen) remained effective in each state of West Germany with no new financial law enacted.¹ Unlike Japan where the securities business has been separated from the banking business, Germany has retained a typical universal bank system. In addition, progress came in the liberalization of bank branch openings and interest rates in 1967.² The liberalization has allowed Germany to take the initiative in expanding balance sheet regulations.³

The initial credit guidelines (Kreditrichtsätze) provided that short- and medium-term loans at a bank should not exceed 18 times its core capital (amounting to the present Tier 1 capital) in a non-crisis situation. In 1962, Principle I was introduced to subject all loans to the calculation.⁴ From 1969 to 1972, Principle I was revised to introduce risk weights (equal to those in Basel I) for the calculation. Then, the classic capital adequacy regulations were completed. Later, German banking crises (including the 1974 Herstatt crisis and the 1983 SMH crisis) accompanying the development of international financial transactions prompted Germany to develop foreign exchange position restrictions, large exposure loan ceilings and other derivative balance sheet

¹ Vgl. Wolf [1998] S.67

² See Yamamura [2004] p.46

³ Regarding liquidity regulations and capital adequacy regulations, the Bank Deutscher Länder (which later became the head office of the Deutsche Bundesbank) initially established the credit guidelines (Kreditrichtsätze) as its bank inspection manual. Since the German Federal Banking Supervisory Board, known as BaKred, was created in 1962, the guidelines have been compiled by BaKred as "principles." Since the German Financial Supervisory Authority, known as BaFin, was inaugurated in 2002, the Federal Ministry of Finance has been designed to develop solvency principles through orders. But the "principles" have remained effective.

⁴ Vgl. Wolf [1998] S.118ff and Ambrosius [1998] S.162ff

regulations.⁵

In 1988, supervisory authorities participating in the Basel Committee on Banking Supervision agreed on the Basel I Capital Accord. Since then, Germany, a key member of the committee, has introduced Basel I into its domestic regulations. But Germany as well as other European countries has not introduced international financial agreements into domestic law directly. Instead, they have coordinated at the European Community or European Union level and issued EC or EU directives, which have been incorporated into domestic law. In response to Basel I, the EU Own Funds Directive (89/299/EEC)⁶ and the EU Solvency Ratio Directive (89/647/EEC)⁷ were issued in 1989.⁸ EU members were required to adapt their domestic law to these directives by January 1, 1993, to meet the implementation of Basel I. After its reunification, Germany introduced the concept of Tier 2 “supplemental capital” and the capital adequacy ratio of 8% through the fourth revision to the Credit System Law and made a relevant revision to Principle I in 1992.

France and West Germany took the leadership in considering the definition of own capital and solvency ratio regulations at the EC level as capital adequacy regulations were discussed in Basel. The EC then took the stance that EC members should achieve a minimum harmony regarding capital adequacy regulations and should be left free to define details of the concept of capital under their respective domestic law.⁹ Meanwhile, the United States then faced a series of domestic bank failures and concluded that capital adequacy regulations should be introduced to ensure the soundness of banks. But there was a fear that the creation of tough regulations in the United States alone could cause U.S. banks to lose competitiveness.¹⁰ In the first half of the 1980s, the United States began to call for unified international regulations on bank capital ratios at the Basel Committee. The dominant view at the committee then had been that any unified regulations would be difficult. But the United States achieved

⁵ Regarding the expansion of balance sheet regulations in Germany, see Yamamura [2003a] p.41 and Yamamura [2004] pp. 48-49. The time of the introduction of risk weights remains unspecified due to the limited availability of relevant information.

⁶ The directive was adopted on April 17, 1989. It was abolished on the adoption in 2000 of the Codified Banking Directive (2000/12/EC). It has been reflected in Articles 34 to 39 of the Codified Banking Directive.

⁷ The directive was adopted on December 18, 1989. It was also abolished on the adoption in 2000 of the Codified Banking Directive (2000/12/EC). It has been reflected in Articles 40 to 47 of the Codified Banking Directive.

⁸ Behind the consolidation of capital adequacy regulations in Europe, the second banking law coordination directive (for coordination by the end of 1992) in 1989 allowed financial institutions to freely do business within the common market while being under the supervision of their respective national authorities (Rudolph [1988] S.487-488).

⁹ Rudolph [1998] S.488.

¹⁰ Sawabe [1998] p.154.

relevant agreements with Britain and Japan in 1987, to take advantage of their international bargaining power.¹¹ Then, major European countries including West Germany made some compromises to cooperate with the United States, Britain and Japan in creating unified capital adequacy regulations.

In this respect, we should take note of the German compromise. In formulating international regulations, German supervisory authorities had been opposed to the introduction of the concept of supplemental capital as proposed by the United States and Japan. Particularly, they had resisted a Japanese proposal for incorporating unrealized profit on assets into supplemental capital.¹² By putting an old EC directive based on the compromise was put into German law, banks in Germany asked the supervisory authorities to allow unrealized profit to be incorporated into capital to increase their capital adequacy ratios. After discussion, German law had not allowed banks to book such profit as capital. Eventually, a rule was introduced to allow unrealized profit to be included in supplemental capital to a level up to 1.4% of risk-weighted assets only if core capital covers at least 4.4% of risk-weighted assets. This means that the German supervisory authorities gave priority to the soundness of the German banking system and established tougher regulations than international standards by utilizing their right to set details of the capital adequacy regulations.¹³

Germany thus resisted the regulations being pushed by the United States. Many Japanese people may suspect that Germany, like Japan, was attempting to obtain looser regulations. In fact, however, Germany resisted the U.S. proposal in a bid to protect its tougher capital adequacy regulations. Germany had already completed financial industry liberalization including the elimination of the boundaries among banks, savings & loans, and credit cooperatives and of restrictions on interest rates and branch openings. In this sense, tougher capital adequacy regulations were required in Germany than in other countries. The reason why Germany has successfully forestalled economic bubbles or relevant serious financial crises even in the completely deregulated environment may be attributed to the independence and discount rate policy of the Bundesbank in line with the globally dominant theory of the currency school. Based on

¹¹ For the background of the Basel I Capital Accord, see Sawabe [1998] Chapter 6. Britain reportedly intended to exploit its agreement with the United States to lead the unified regulations to accept perpetual subordinated bonds as part of capital. Japan reportedly tried to take advantage of the agreement with the United States to have unrealized profit on assets accepted as part of capital in the unified regulations.

¹² Japan and Germany feature a predominance of indirect finance. But Japan reached agreement first with Britain and the United States, the leaders of Anglo-Saxon direct finance. This was because Germany differed greatly from Japan in the treatment of secret reserves in capital adequacy regulations (Sawabe [1998] p.162).

¹³ Vgl. Rudolph [1998] S.489.

German conditions and the viewpoint of the banking school, however, we can conclude that the German supervisory authorities then attempted to prevent excessive credit creation or bubbles by maintaining their inherent capital adequacy regulations.

2.2 Development of Basel II

The capital adequacy regulations, formulated in this way, still contained problems. The biggest one was that the regulations simplified risk weights into fixed figures to ease the technical complexity of regulatory and supervisory procedures while real risks of loans were diversified.

The capital adequacy regulation framework has been viewed as an obstacle as major banks have developed refined risk measurement methods. In Germany, savings bank and credit cooperative groups as well as big banks have believed that they should have credit-rating systems to finely assess risks for individual loans and set reasonable lending terms and conditions. They have viewed such approach as indispensable for implementing business discipline. As Basel I came in the late 1980s, German banks began to look for an internal rating system to efficiently and rationally fix lending terms and conditions for specific borrowers.¹⁴ This is the origin of the internal rating-based approach adopted in Basel II. For German banks, therefore, Basel II is significant as the result of serious discussions among themselves, rather than any foreign pressure.

After various Basel Capital Accord revisions including the introduction of market risks in the 1990s, the Basel Committee on Banking Supervision launched efforts in 1998 to substantially revise credit risk regulations. It released the first consultative paper for the new Basel Capital Accord in 1999 to deepen discussions on the new accord. After two more consultative papers were published,¹⁵ the committee released the “International Convergence of Capital Measurement and Capital Standards – A Revised Framework,” known as Basel II, in June 2004.

Basel II has three pillars—minimum capital requirements, supervisory review process and market discipline. The first pillar adopts the “internal ratings-based approaches” for credit risk measurement and the “advanced measurement approaches” for operational risk measurement. The second pillar calls for supervisory authorities to review banks’ internal capital assessment, strategy development and monitoring systems (risk management systems) in a bid to prompt them to increase their capital bases beyond the minimum capital requirements. The third pillar provides for banks to step up information disclosure and come under control by market discipline.

¹⁴ Vgl. Everling [2003] S.176.

¹⁵ These papers are the second consultative paper in January 2001 and the third consultative paper in April 2003.

The first pillar designs supervisory authorities to review and approve risk management systems developed by banks in order to overcome the problem whereby supervisory authorities' fixed general rules cannot catch up with the advancement of risk management processes. Supervisory authorities will make judgment on bank management defects, order management improvements and remove malicious institutions from the market to ensure the soundness of the financial services market. This is the minimum necessary patrol function. The second and third pillars, which ensure the mechanism for the market's cybernetic control on banks through the promotion of information disclosure, are more important. They also encourage banks (banking groups) to enhance their voluntary internal control and supervision to enable the market's control mechanism to work well.¹⁶

Basel II says, "The Committee has designed the revised Framework to be a more forward-looking approach to capital adequacy supervision, one that has the capacity to evolve with time."¹⁷ From the cybernetic viewpoint, the past capital adequacy regulations have depended on a feedback system where supervisory authorities inspect past risks for the present supervision to control banks' future actions. In contrast, Basel II regulations provide for organizations seen as necessary for risk management purposes and encourage banks to take necessary measures based on future predictions to control their risks. In this sense, Basel II calls for a feedforward risk control system.¹⁸ Philosophically, this indicates a shift from Darwin's theory to Lamarckian theory.¹⁹ In terms of the social sciences, this may be seen as a shift from an economics-oriented approach taking economic units as atoms to a management organization theory viewing economic units as organizations.

¹⁶ Japan's Financial Services Agency has put forward a similar principle for financial inspections: "Financial inspection assumes internal controls by the financial institution itself based on the principle of self-responsibility and rigorous external audits by external auditors, and it seeks to complement these systems (principle of complementation). Therefore, authorities must use inspections to strongly encourage financial institutions to establish proper internal controls and external audits based on the principle of self-responsibility. In addition, inspections should assume that these controls and audits are indeed being performed in an appropriate manner, and should emphasize ex-post checking that focuses on 'process examination' for the internal control and external audit systems. The onus is on the financial institution to explain whether internal controls are appropriate; the authorities are in the position of verifying this. It is neither possible nor necessary for financial inspection to inspect everything." (FSA [2004] Inspection Manual for Deposit-Taking Institutions)

¹⁷ Basel Committee on Banking Supervision [2004] "International Convergence of Capital Measurement and Capital Standards: a Revised Framework" para. 15

¹⁸ See Maruta [2005] for relations between feedback and feedforward systems and applications of these relations to controlling (management accounting). In Germany, management accounting is important for bank management as well as non-bank business management.

¹⁹ Evolution theories include Darwin's theory (survival of the fittest through competition and natural selection) and Lamarckian theory (evolution through willingness to make efforts and through obtainment of relevant modes). Apart from natural evolution, human society evolution must be response to objective conditions and depend heavily on society members' willingness to make efforts.

2.3 Development of Risk Management System Regulations

Basel II is nothing more than international standards for regulation and supervision of banks. Basel II regulations take effect only when they are reflected in national law. In Europe, as noted earlier, international banking regulations are transplanted into national law via EU directives. Domestic regulations under Basel II will thus be based on an EU directive (Brussels II) responding to Basel II. In Germany, the BaFin financial supervisory authority will transplant Basel II into domestic law.²⁰ In October 2003, the BaFin and Bundesbank launched a working group²¹ for the transplantation of Basel II. The group held eight meetings up to June 2005. The group's basic stance is that regulations that are as tough as or tougher than Basel II standards should be imposed not only on internationally active banks but also on financial institutions having no overseas operations.

As noted above, the new regulations accept internal ratings-based approaches that banks have developed. Therefore, supervisory authorities review the appropriateness of these approaches in inspections and supervisions.²² In Germany, BaFin undertakes the establishment of ordinances (solvency ordinance) regarding capital adequacy ratios, the issuance of the MaRisk Minimum Requirements for Risk Management notification, and the inspection and supervision of financial institutions in accordance with the legal base as indicated in Table 2.1 and the authorization by the Federal Ministry of Finance. However, BaFin must establish the solvency ordinance after agreement with the Bundesbank within the EC law framework.²³ In inspections,

²⁰ Regulations under the relevant EU directive (Brussels II) are not so different from those under Basel II. But there is a difference regarding the risk weight for covered bonds, or "Pfandbrief" (Basel II gives a covered bond the same risk weight as that of the bank issuing the bond, while a more favorable risk weight is designed under the EU directive.) Vgl. Deutsche Bundesbank [2004] S.98-99.

²¹ Participants in the working group include representatives from not only from BaFin and Bundesbank but also from five associations of banks (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, Bundesverband Deutscher Banken, Federal Association of German Public Banks, Deutscher Sparkassen- und Giroverband, and Association of German Mortgage Banks) and individual banks (DZ Bank, Württembergische Hypothekenbank AG, Deutsche Bank, Postbank, WGZ Bank, Eurohypo, Landesbank Hessen-Thüringen, Cologne Savings Bank and West Landesbank). Vgl. Arbeitskreis "Umsetzung Basel II" Protokoll der Auftaktsitzung.

²² This indicates the Basel II accord's Pillar 2 "Supervisory Review Process." "A further important aspect of Pillar 2 is the assessment of compliance with the minimum standards and disclosure requirements of the more advanced methods in Pillar 1, in particular the IRB (internal ratings-based) framework for credit risk and the Advanced Measure Approaches for operational risk. Supervisors must ensure that these requirements are being met, both as qualifying criteria and on a continuing basis." (Basel Committee on Banking Supervision [2004] "International Convergence of Capital Measurement and Capital Standards: a Revised Framework" para. 15)

²³ BaFin, given the authority by the Federal Ministry of Finance through ordinances, hears opinions from banks and reach agreement with the Bundesbank before establishing ordinances within the framework of EU law. (Article 10(1), Credit System Law) Vgl. Hannemann [2005] S.557, Abb.2.

the assessment by relevant branches of the Bundesbank is important.²⁴

Table 2.1 Germany's Adaptation to Basel II Framework

	General Case	Individual Case
Capital adequacy regulations (amounting to the first pillar)	Primary legislation - Article 10(1), Credit System Law Secondary legislation - Solvency Ordinance	- Article 10(1b), Credit System Law *Additional legal base for individual capital requirements
Supervisory review process (amounting to the second pillar)	Primary legislation - Article 25a(1), Credit System Law Secondary legislation - Minimum risk management requirements (MaRisk)	- Article 25a(1), Credit System Law *The third sentence is the legal base for additional lending orders to individual financial banks

Source: Author

Note: As for BaFin's MaRisk Minimum Requirements for Risk Management notification, the first consultative paper was produced in February 2005. At present, the solvency principle corresponds to the secondary legislation for capital adequacy regulations. In the future, the solvency principle will be replaced with the solvency order regarding the regulations.

Under Article 10 (1) of the Credit System Law, regarding procurement of funds, the Ministry of Finance compiles solvency principles (Solvabilitätsgrundsätze) through legal orders to be issued after consultations with the Deutsche Bundesbank within the framework of EU law regulating banks' capital adequacy. Based on the orders, BaFin decides whether requirements in the first sentence have been met in regular cases (Regelfall). (The Federal Ministry of Finance can transfer the compilation authority to BaFin.) Based on the solvency principles as established in this way, supervisions will be conducted on capital procurement. Until the new ordinance is established, Principles I and II will remain in effect. The principles were compiled by Bundesaufsichtsamt für das Kreditwesen, known as BaKred, after its agreement with the Bundesbank. Based on the Banking Act's Article 10 (1b) on capital procurement, BaFin is authorized to go beyond the solvency principle and set conditions for decisions on individual banks'

²⁴ Major Bundesbank branches (formerly state central banks) routinely monitor documents submitted by banks, banks' audited year-end financial statements, their capital sizes and their risk management assessment. Under an agreement with the Bundesbank, BaFin can use these Bundesbank branches' data and decisions for administration punishment of banks (Article 7, Credit System Law). The relationship between BaFin and major Bundesbank branches is thus similar to that between Japan's Financial Services Agency and local finance bureaus of the Ministry of Finance.

capital requirements.²⁵ This provision, inserted recently, is apparently designed to pave the way for the implementation of bank supervision through advanced approaches based on Basel II.

The legal ground of inspections and supervisions on business organizations is Article 25a (1) the Credit System Law, on banks' special organization requirements. This provision requires banks to build orderly business organizations (die ordnungsgemäße Geschäftsorganisation).²⁶

The word of "orderly business organization" is frequently seen in bank management theories as well as in financial law in Germany and reminds us of Grundsätze ordnungsmäßiger Buchführung (principles of orderly bookkeeping) in German accounting. The German accounting system, focusing on technical problems regarding the development of leasing accounting, has developed via the effective formation process from economic phenomena to accounting practices, accounting

²⁵ Article 10 (1b) of the Credit System Law's provides:

In determining the adequacy of the own funds the Federal Financial Supervisory Authority may, in particular cases,

1. stipulate own funds requirements exceeding the solvency principles for institutions which because of their asset or business profile have a risk structure which compares unfavourably with that of most other institutions engaged in similar business, in line with that of most other institutions engaged in similar business, in line with the institution's extraordinary risk structure (extraordinary circumstances), and
2. approve, upon application from an institution, a different method of calculating the own funds requirements in order to avoid risks being reflected inappropriately in particular cases. Such approval must be compatible with the framework laid down by European Community legislation.

²⁶ Article 25a (1) of the Credit System Law's provides:

A financial institution shall have a proper business organization (die ordnungsgemäße Geschäftsorganisation) that ensures compliance with laws to be observed. People cited in Article 1 (2) (operating officers) are accountable for their banks' proper business organizations. The orderly business organization covers the following:

1. An appropriate strategy that gives considerations to the relevant bank's risks and own funds.
2. An appropriate internal control system consisting of an internal control system and internal auditing. The internal control system includes appropriate regulations for risk management and surveillance.
3. Appropriate regulations that the relevant bank should observe in order to determine its accurate financial conditions at any time.
4. Appropriate security precautions for the deployment of electronic data processing.
5. Complete documentation of executed business transactions permit full and unbroken supervision by the Federal Financial Supervisory Authority for its area of responsibility. Accounting vouchers shall be retained for ten years and other requisite records six years. Section 257 (3) and (5) of the Commercial Code applies as appropriate.
6. Appropriate safeguards suited to its respective business and customers against money laundering and against fraudulent activities to the detriment of the institution. In the event of dubious or unusual practices in the light of past experience or knowledge of money laundering methods, the institution shall investigate these in the context of the current business relationship and individual transactions.

In individual cases the Federal Financial Supervisory Authority may issue orders to an institution that are appropriate and necessary for putting into place safeguards within the meaning of sentence 3 numbers 1 to 6.

theories, official bookkeeping principles and legal system, and the original development process that reverses the effective process.²⁷ The cybernetic, complementary development of realities and rules can be found in organization-building regulations.

Germany is now working out a single notification for identifying the presence or absence of the orderly business organization. The notification is on the Minimum Requirements for Risk Management (Mindestanforderungen an das Risikomanagement der Kreditinstitute, or MaRisk).²⁸ Multiple notifications have been issued for the interpretation of Article 25a.²⁹ The MaRisk notification is basically designed to eliminate overlaps in these multiple notifications and unify them. It was not accidental³⁰ that the establishment of the MaRisk notification was announced in 2004 prior to the Basel II implementation. Germany has begun preparation of the MaRisk regulations in a bid to allow supervisory authorities to use the MaRisk for reviewing the internal discipline or management organization under the Basel II framework. The MaRisk is intended to develop regulations linked to real past cases.

3. Financial Institutions' Risk Asset Adjustment

In the capital adequacy regulations, risk-weighted assets are determined by multiplying assets on the debit side by their risk weights. The regulations aim at keeping the ratio of a certain portion of capital on the credit side to the risk-weighted assets at or above a certain level (8%). They amount to balance sheet regulations. Banks willing to comply with the regulations may basically try to increase their capital on the credit side or adjust risk-weighted assets on the debit side. They may thus implement stock-level adjustments. But capital increases are not general measures that can be implemented routinely.³¹ So, we here would like to focus on risk-weighted assets.

Risk-weighted asset adjustments may be taken in the following way from the viewpoint of risk management. Loan loss risks are different from market risks. They are economic losses similar to risks under the insurance science. Under insurance science, risk management is divided into risk avoidance, risk reduction, risk diversification, risk

²⁷ Endo [1991] (cited in Endo [1998]p.173)

²⁸ Preparations of the MaRisk notification started in April 2004. The first consultative paper was released in February 2005 for further consideration (see BaFin's website for published information).

²⁹ These notifications include the MaK minimum requirements for credit institutions' lending business (Rundschreiben in December 2002), the MaH minimum requirements for credit institutions' commercial transactions (Verlautbarung in October 1995) and the MaIR minimum requirements for credit institutions' internal inspections (Rundschreiben in January 2000).

³⁰ Hannemann [2005] S.556

³¹ Generally, however, stock banks or public financial institutions may routinely accumulate profit as reserves to expand their capital bases. In this sense, earnings improvements through relationship banking would be important.

retention and risk transfer.³² Regarding bank loans, these risk management measures may correspond to cancellation (or rejection), improvement, diversification and loan-loss provisions. Banks may avoid risks by selecting borrowers and canceling or rejecting loans to some borrowers. They may reduce risks by leading borrowers with worsened financial profiles to acknowledge problems and make improvements. Banks may also reduce risks by cutting loan sizes and diversifying borrowers. They may retain risks by using interest income to accumulate loan-loss provisions and capital for insurance purposes. Or they pass risks on to others by taking advantage of financial derivatives and securitization.

German banks' risk management strategies over the past years are divided into three categories – reduction of loan sizes, utilization of internal ratings-based approaches and securitization.

3.1 Smaller Loan Sizes – Enhancing Mortgage-backed and Individual Loans

Basel II views the law of large numbers as effective for loans to small businesses and individuals and takes mortgage loans as different from commercial real estate loans. It thus provides for less capital to back small business, personal and housing loans. Some German banks have adopted similar approaches.

Small business and personal loans that qualify under the following four criteria may be considered as “included in a regulatory retail portfolio.” Exposures included in such a portfolio may be risk-weighted at 75%, except for loans that are past due for more than 90 days³³ :

-- Orientation criterion - The exposure is to an individual person or persons or to a small business.

-- Product criterion – The exposure takes the form of any of the following: revolving credits and lines of credit, personal term loans and leases, and small business facilities and commitments. Securities, whether listed or not, are specifically excluded from this category. The treatment is provided later for mortgage loans that qualify for treatment as claims secured by residential property.

-- Granularity criterion – The supervisor must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight.³⁴

³² See Tone [1993] p.7.

³³ Basel Committee on Banking Supervision [2004] “International Convergence of Capital Measurement and Capital Standards: a Revised Framework” para. 70.

³⁴ Basel II says, “One way of achieving this may be to set a numerical limit that no aggregate exposure to one counterpart can exceed 0.2% of the overall regulatory retail portfolio.”

-- Low values of individual exposures. The maximum aggregated retail resources to one counterpart cannot exceed an absolute threshold of one million euros.

Lending fully secured by mortgages on residential property will be risk-weighted at 35% under a standard approach. But this concessionary weight should be applied restrictively in accordance with strict prudential criteria. Supervisors can ask banks to increase the standard risk weight as necessary.

Table 3.1 Residential Property-Secured Loans' Share of Total Loans

	1st quarter of 1999			1st quarter of 2005		
	(1)	(2)	(1)/(2)	(1)	(2)	(1)/(2)
Big banks	111.695	355.514	31.4%	126.739	317.012	40.0%
Regional banks and other commercial banks	27.399	160.450	17.1%	59.692	235.577	23.5%
Branches of foreign banks	0.024	17.653	0.1%	0.039	26.036	0.1%
State banks (Landesbanken)	58.587	231.562	25.3%	48.597	255.548	19.0%
Savings banks	133.492	498.570	26.8%	225.974	570.331	39.6%
Regional institutions of credit cooperatives	0.096	29.100	0.3%	0.011	21.136	0.1%
Credit cooperatives	63.148	307.580	20.5%	142.791	341.618	41.8%
Mortgage banks	133.132	217.357	61.3%	137.298	241.469	56.9%
Building and loan associations	69.467	94.136	73.8%	79.528	103.753	76.7%
Special purpose banks	32.132	81.555	39.4%	46.299	104.219	44.4%
All categories of banks	629.112	1993.477	31.6%	866.968	2216.899	39.1%

Source: See the time series database on the Deutsche Bundesbank website.

Note: (1) for mortgage loans secured by residential real estate and (2) for lending to domestic enterprises and households.

If a bank focuses on mortgage, small business, personal or other retail loans, lowers loan sizes and diversifies borrowers, it may be able to reduce overall risks with risks ignored for individual loans. As this point has been taken into account, the risk weights for these loans have been set at low levels, as specified above. Given rational bank management, the expansion of small-size loans is one of the strategies that banks could adopt.

In fact, loans secured by mortgages on residential property have been increasing their share of total domestic enterprise and personal loans at many categories of banks in Germany over the recent years. Particularly, such loans have been growing fast at large banks, savings banks and credit cooperatives. From 1999 to 2005, credit cooperatives doubled such loans.

3.2 Utilization of Internal Ratings-Based Approaches

Introduction of Unified Internal Rating System

Basel II features a system for supervisory authorities to accept banks' own credit risk estimates as internal ratings-based approaches through their supervisory review process. German financial institutions are about to fully introduce this system.

Basel II still accepts the traditional credit risk calculation (a standard approach) using estimates designated by supervisory authorities. The standard ratings-based approach, though simple and convenient, is insufficient for measuring specific risks. Banks adopting the standard approach could attract poor companies looking for loans.³⁵ Alarmed by such possibility, most of financial institutions in Germany are positively trying to introduce internal ratings-based approaches (including advanced ones).³⁶ As in the past, internal ratings-based approaches may not be used for a small or tiny company that receives a less-than-1-million-euro retail exposure "included in a regulatory retail portfolio" as indicated in the previous section. But any medium-sized company³⁷ receiving a loan above the standard amount from a financial institution may become subject to internal ratings-based approaches under Basel II.

Instead of internal ratings, external ratings may be utilized. But house banks' internal ratings for borrowers reflect information based on their medium- to long-term business relations and are superior to external ratings.³⁸ Incidentally, the introduction of internal ratings-based approaches will prevent external ratings from diffusing with corporate ratings published to lower the barriers of the banking industry.³⁹ This means that the internal ratings-based approaches are expected to have not only risk management effects but also marketing effects that can raise the banking industry's barriers.

For the introduction of internal ratings-based approaches, however, a unified system should be developed to rate and classify a large number of loans. The system development costs much and cannot be undertaken by a savings bank, a credit

³⁵ When being asked to choose a bank adopting an internal ratings-based approach or another bank to provide a loan, a company viewing itself as sound may choose the former. A firm viewing itself as not sound may choose the latter.

³⁶ Based on a hearing from the Baden-Wuerttemberg Association of Savings Banks (March 2004).

³⁷ The EU definition used since January 1, 2005, describes small and medium enterprises as those that have fewer than 250 employees, and up to 50 million euros in annual sales or up to 43 million euros in gross assets. Therefore, companies excluding tiny ones may be viewed as medium-sized.

³⁸ Based on an interview from Bundesverband der Deutschen Volksbanken und Raiffeisenbanken.

³⁹ Vgl. Everling [2003] S.175.

cooperative or any other small financial institution alone. Therefore, umbrella organizations of savings banks and credit cooperatives (the German Association of Savings Banks known as DSGV, and the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken known as BVR for credit cooperatives) are taking leadership in developing unified rating systems.⁴⁰

The background that allows such unified systems to be introduced includes regional associations of savings banks and credit cooperatives that run deposit insurance systems through routine inspections of individual financial institutions. A regional association of savings banks conducts routine inspections of member banks. If any problem emerges, such regional association will give a notification to BaFin and use its own deposit insurance fund to relieve a member bank of the problem. In a bid to prevent any problem from affecting a deposit insurance system for each category of financial institutions, each regional association has been trying to conduct its own inspections to promote member banks' discipline and find irregularities as early as possible. Regional associations are willing to improve the accuracy of their inspections even at a huge monetary cost in order to remain independent from government and survive in the fierce competition.⁴¹

Exploiting Internal Ratings-based Approaches as Consulting Tool

Internal ratings are useful not only for negative actions to measure and avoid risks or make loan-loss provisions, but also for positive purposes. Germany is attempting to make positive use of internal ratings.

As German banks have been required to cope with frequent corporate bankruptcies and as corporate information for rating analyses has increased with banks' analysis capacity expanded, they have developed their own systems to rate corporate borrowers since around 1990.⁴² But these ratings have been kept in secret at banks. They might not have necessarily been used for setting accurate terms and conditions for loans. There has been no requirement for banks to do so.

Internal ratings-based approaches under Basel II differ from traditional rating systems in a sense that banks are required to be accountable for the management of loans under the Basel II regulations. Banks may then be able to take advantage of internal ratings-based approaches based on Basel II to make their rating approaches

⁴⁰ Based on interviews from DSGV and the Baden-Württemberg Association of Savings Banks (in March 2004).

⁴¹ BaFin can depend on routine inspections by regional associations and devote itself to its primary surveillance missions. See Yamamura [2003a] for details of the German deposit insurance system.

⁴² Vgl. Kastner [2005] S.483

accountable and forcible. Supported by Basel II, German banks are willing to rate their corporate borrowers with advanced estimation used and positively exploit rating data for giving customers financial advices. Financial experts' advices would be useful for small and medium-sized enterprises whose management teams lack financial experts while featuring excellent technologies.⁴³ Banks would take advantage of positive advices to secure customers' strong financial profiles and forestall their default.

Improving Corporate Debt and Capital Mix

The problem of undercapitalization is a matter of concern to banks regarding small and medium-sized enterprises in Germany. According to a 2005 diagnosis of medium-sized companies (Diagnose Mittelstand) by DSGV, capital ratios for SMEs have improved over the past years but have been limited to 7.5%.⁴⁴ Capital can serve as a buffer to avoid any default even amid a crisis at non-financial companies as well as financial institutions. Companies having greater capital bases can be seen as less likely to default on loans.⁴⁵ Since German companies depend heavily on loans from banks, their undercapitalization is frequently cited as indicating their weak financial profiles.⁴⁶

In a bid to fight against the undercapitalization problem, banks have looked to their equity participation in their corporate customers. Particularly, they have used their venture capital units to invest in startup companies. This indicates banks' strategic plans to serve as house banks for these corporate customers and develop long-term relations with them.⁴⁷

The federal government has been preparing the KfW Banking Group's capital enhancement programs for SMEs. Among such programs, so-called mezzanine finance (positioned between equity participation and loans) through anonymous equity participation and subordinated loans is expected to increase from the present low level.

⁴³ Based on an interview from the German Association of Savings Banks known as DSGV (in March 2004).

⁴⁴ Statistical data about small companies' financial profiles have been compiled by the Bundesbank and the KfW Banking Group as well as DSGV. A survey report on such data was carried on the August 2004 issue of the Federal Ministry of Finance monthly journal. This report indicates small companies' capital ratios differ depending not only on corporate size but also on corporate category, industry and geographical conditions (former West Germany or East Germany). Such differences have been widening in some parts. Vgl. Bundesministerium der Finanzen [2004].

⁴⁵ Vgl. Konesny [2005] S. 570-571

⁴⁶ Various factors for undercapitalization have been cited. One factor is that interest rate costs for raising borrowed capital in Germany are less than in other countries. Some 40% of German companies deal only with their respective "house banks." As a result, German companies can obtain low-interest loans to save fund-raising costs. But a lending race has intensified over the recent years, reducing profit margins for banks. Vgl. KfW Bankengruppe [2003] S. 3-4.

⁴⁷ Based on an interview from Landesbank Baden-Württemberg (LBBW) (in February 2005).

Subordinated loans would account for 40% to 50% of house banks' total loans to enhance the financial profiles of SMEs.⁴⁸

Measures to Promote Internal Ratings-based Approaches

The SME Research Institute in Bonn and the *impulse* economic magazine have conducted large-scale polls of SME managers and executives, called "Mind – Mittelstand in Deutschland," including those on corporate ratings.

Table 3.2 indicates polls on advantages of high corporate ratings.

The polls finds that a large portion of respondents view higher ratings as helping to ease terms and conditions for raising own and borrowed capital. This portion has been rising. The portion for respondents seeing no advantage in high ratings declined from 25% in 2001 to 15% in 2003. But the portion has been leveling off for respondents expecting higher ratings to contribute to public relations and advertisement activities. Generally, a rising number of SME executives expect higher ratings to have financial effects while falling short of producing market effects.

Table 3.3 indicates a poll on the images of ratings and expectations placed on ratings.

As for the images, 50% of the respondents expect higher ratings to improve rated borrowers' positions in negotiations with potential lenders. A majority of respondents believe that higher ratings would help ease terms and conditions for raising funds from not only house banks but also the capital market.⁴⁹

However, 23.9% of respondents complain that internal ratings given by some financial institutions may not be accepted by other institutions or potential lenders. In fact, borrowers have to obtain new internal ratings when they change lenders. Ratings given by old lenders may serve only as guidelines. But these old ratings may be used by borrowers as indicators for their objective decisions on their financial profiles when they deal with new lenders.

⁴⁸ The KfW Banking Group's mezzanine finance includes a subordinated loan program for entrepreneur capital. The program is divided into three phases by age of companies: (1) A less-than-two-year-old company can receive up to 500,000 euros (up to 40% of loans from its house bank) in subordinated loan from KfW Mittelstandsbank. The subordinated loan can be used for investment, product inventories and market exploration. The 15-year lending term includes the first seven years for a grace period. An entrepreneur may have to personally guarantee the repayment, but may not have to offer collateral on the loan. (2) A company aged between two and five can receive a similar loan for the purposes other than market exploration. (3) A company aged above five can receive up to 2 million euros in 10-year loan. A half of the loan comes as a borrowed capital from a house bank with a two-year grace period. Another half is a subordinate loan from KfW and does not have to be collateralized. It has a seven-year grace period. (See the KfW Banking Group website)

⁴⁹ In this case, ratings may include both internal and external ones.

Table 3.2 Advantages of High Ratings

Useful for making it easier to raise funds through borrowings	52% 63%
Useful for making it easier to raise own funds	37% 41%
Useful for lowering fund-raising costs	26% 31%
Useful for making it easier to change lenders	19% 24%
Useful for public relations activities	17% 16%
Useful for finding new business customers	17% 15%
No advantage	25% 15%

Sources: Paul und Stein [2002] S.81 (based on Mind01 [2002]) for 2001. Mind03 [2004] S.21 for 2003
 Note: Respondents were allowed to make multiple answers.

Table 3.3 Images or Expectations Regarding Ratings

Ratings may improve borrowers' positions in their negotiations with potential lenders	49.6%
Ratings are costly	38.5%
Ratings can suggest success opportunities regarding future business strategies	37.0%
Data submitted to banks must be renewed for ratings	29.7%
Positive achievements can be publicized	26.3%
Ratings given by some lenders may not be accepted by other lenders.	23.9%
Borrowers' classified information could be provided to third parties	20.5%
Negative business results can be publicized	17.5%

Source: Mind03 [2004] S.21

Note: Respondents were allowed to make multiple answers.

In this respect, internal ratings must be unified and comparable between banks or in the market.⁵⁰ Therefore, the Initiative Finanzstandort Deutschland (IFD), which consists of 17 financial institutions, associations, the Bundesbank and the Federal Ministry of Finance, has created the IFD rating scale (Ratingskala). IFD member banks are required to exploit the scale for dividing ratings into six grades by expected default probability.

Apart from these polls, a survey finding (in September 2004) said many companies saw their lenders exploiting Basel II to make terms and conditions for loans unfavorable to borrowers.⁵¹ Given the prolonged economic slump in Germany, it may be reasonable for small and medium-sized enterprises to be concerned that financial institutions could utilize Basel II to squeeze lending.

⁵⁰ The IFD trading scale unifies grades based on expected default probabilities. The methods to classify specific ratings into the grades differ among banks (or unified system-operating groups such as associations of savings banks and credit cooperatives.)

⁵¹ Vgl. Kastner [2005] S.469-470

In a bid to eliminate such concerns at SMEs, banks are willing to lead their corporate customers to understand the following advantages of ratings: First, corporate borrowers should understand information subject to rating by banks and should improve their financial profiles, and terms and conditions for borrowing through efforts to obtain higher ratings. Through a corporate financial analysis by banks, corporate borrowers can promptly identify themselves as faced with any business crisis and get opportunities to avoid serious difficulties.⁵²

3.3 Securitization of Assets

Risk weights for loans may be reduced through diversification and internal ratings-based approaches. But they cannot be eliminated. Risk weights for loans to medium-sized and big companies under standard approaches are left unchanged and relatively higher. If banks retain capital credits as stock, they may eventually lose lending capacity with capital depleted for covering loans.

In the ultimate way to coordinate risk assets under a given capital base, banks may take advantage of derivatives to transfer risks or may remove loans subject to risk weights from balance sheets by liquidating them (securitization). Such measure will eliminate credit risks and allow banks to use their capital for covering new loans.

Asset securitization has been prevalent in the United States since the 1980s.⁵³ This means that loans are securitized and removed from balance sheets. Japan developed its securitization process through the Special Purpose Company Law in 1998. In Germany, the government-controlled KfW has taken the initiative since 2000 in utilizing credit derivatives for synthetic securitization of loans.

But securitization has been realized as a “regulatory arbitrage.”⁵⁴ Banks may hold securities for lower-rated portions of exposures even after securitization because they may be difficult to sell in the market. Basel II sets the risk weights for such securities at higher levels than those for conventional loans.⁵⁵ Therefore, we must take note of the fact that risk asset coordination may not necessarily work to reduce capital required for loans depending on securitization methods.

⁵² Vgl. Kastner [2005] S.505

⁵³ Recent problems and the development of regulatory frameworks for securitization in the United States with an advanced securitization market have had influences over the treatment of securitization under Basel II. See Aoki [2003] for details.

⁵⁴ See the New Basel Capital Accord, Third Consultative Paper, Basel Committee on Banking Supervision (April 2003), translated by the Financial Services Agency and the Bank of Japan.

⁵⁵ Under the standard approach, for example, the risk weight is estimated to be 1,250% for exposures that are given B+ long-term debt rating or no rating. (Such risk weight is described as capital “deduction” as the risk weight of 1,250% multiplied by the capital adequacy ratio of 8% equals 100%. This means that capital is required to cover 100% of such exposure.)

Securitization of Loans

The securitization mechanism is still underdeveloped in Germany. A market for securities emerging from the securitization of assets must be developed urgently. Therefore commercial banks are now proceeding with the securitization of sound loans in which investors may be found more easily. The federal government once proposed the securitization of non-performing loans, but the proposal has been aborted in the face of opposition from banks.⁵⁶ Non-performing loans have been disposed by debt liquidation/collection and corporate turnaround organizations that are set up within large banks and in the savings bank and credit cooperative sectors. These loans are also sold to financial institutions specialized in debt liquidation/collection and corporate turnaround.

The federal government has positioned the securitization of loans as indirect support for small and medium-sized enterprise finance. The government expects to take advantage of the securitization for removing existing SME loans from banks' balance sheets and increasing these banks' room to provide new loans. It also designs the development of the securitization market to allow SMEs, which have no access to the direct financing market, to raise more funds in the indirect financing market.⁵⁷

Asset-backed securities issued through securitization are broken down by collateral category as follows:

Breakdown of Broadly Defined ABS

- ABS (narrowly defined asset-back securities)⁵⁸
- MBS (mortgage backed securities)
- RMBS (residential mortgage backed securities)
- CMBS (commercial mortgage backed securities)
- CDO (collateralized debt obligation)
- CBO (collateralized bond obligation)
- CLO (collateralized loan obligation)

The RMBS have the largest share of the ABS market in Europe including

⁵⁶ See Yamamura [2003a] pp.37-38. In Germany, direct and indirect write-offs of non-performing loans may have tax effects under agreements between federal and state ministries of finance. Tax-free reserves have been used writing off most of non-performing loans. Therefore, banks may choose to liquidate or collect non-performing loans on their own to their advantage.

⁵⁷ See KfW's PROMISE descriptions.

⁵⁸ Narrowly defined ABS include non-MBS and non-CDO securities backed by credit card and auto loans (see the website of True Sale International GmbH).

Germany. But Germany features a higher share for CLOs than in other European countries. Germany accounts for some 70% of total European CLOs. This is attributable to the KfW Banking Group's securitization program.

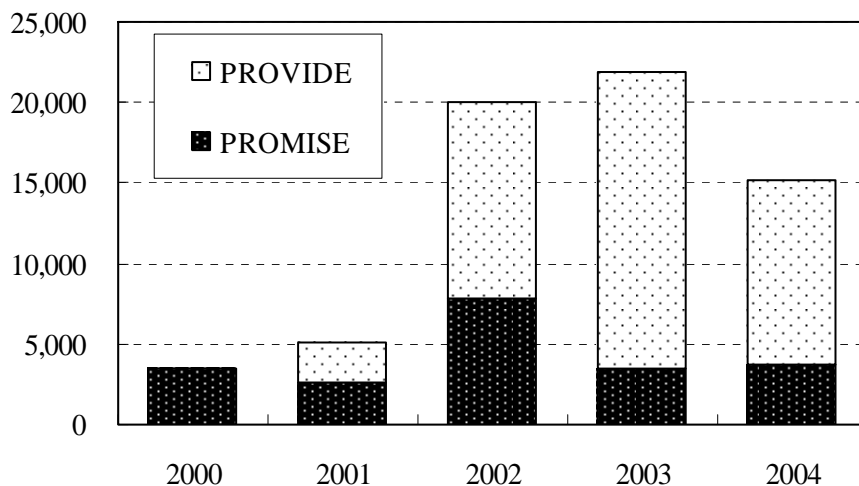
KfW's Securitization System⁵⁹

In addition to the mezzanine capital investment to solve SMEs' undercapitalization and improve their internal ratings, the federal government's KfW (Kreditanstalt für Wiederaufbau) has created securitization programs for banks to promote the securitization, recover their lending capacity and increase lending to SMEs.

PROMISE and PROVIDE

Since late 2000, KfW has operated securitization programs to implement big banks' securitization of loans (issuance of CLOs above). Specific programs include PROMISE (promotional mittelstand loan securitization) and PROVIDE (provide residential mortgage securitization).

Figure 3.1 PROMISE and PROVIDE Securities Issuances



Source: Annual KfW financial reports
 Note: In million euros

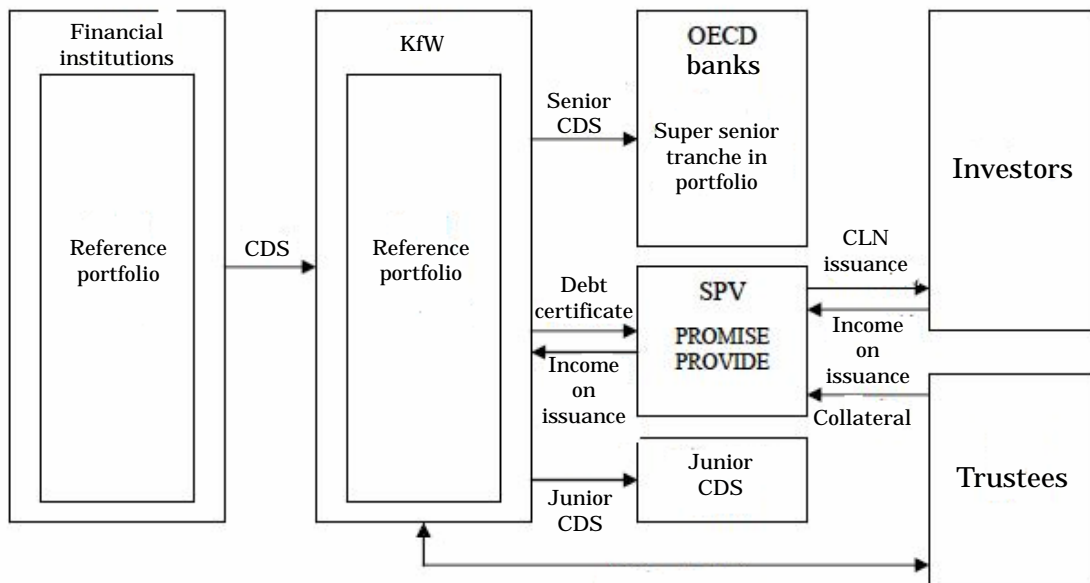
The PROMISE has been operated by KfW Mittelstandsbank (KfW SME bank) of the KfW Banking Group. Under the program launched in December 2000, 14 securitization deals worth 21 billion euros (for some 52,000 SME loans) were

⁵⁹ See Development Bank of Japan [2004] for details (in Japanese) about KfW securitization and other policy-based financing programs.

implemented by the end of 2004. These deals involved not only German banks but also financial institutions in other European countries.

The KfW-led program takes advantage of KfW's excellent ratings. It allows SMEs to receive low-interest bridge loans from house banks that obtain global loans upon securitizations.

Figure 3.2 PROMISE/PROVIDE Mechanism



Source: KfW presentation on PROMISE/PROVIDE (December 2002)

Notes: CDS for credit default swap. CLN for credit linked note.

The SPV (special purpose vehicle) is called "treuhaender" in German. Specifically, SPVs include bank divisions, special firms or law offices that are commissioned to manage loans for securitization.

Under the PROVIDE program managed by KfW Förderbank (KfW promotional bank), housing loans have been securitized since 2001. By the end of 2004, 26 securitization deals worth 42.5 billion euros (for some 770,000 loans) were implemented. PROVIDE expanded faster than PROMISE mainly in the peak year of 2003 and has made great contributions to the development of the RMBS market in Germany. A secondary market should be established for developing such securitization market. To this end, creditworthy securities should be issued in the initial phase. In this respect, the securitization programs led by the creditworthy KfW group have been successful.

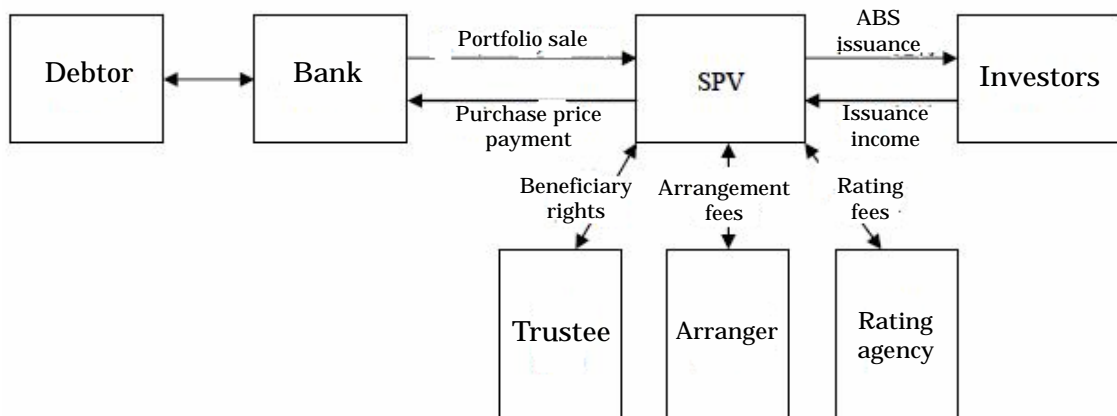
Synthetic Securitization and True Sale

Securitizations include a synthetic securitization involving no loan transfer to a special purpose company and a true sale or cash securitization for such transfer.

KfW's securitization programs are synthetic. Banks as the loan originators pay premiums to KfW and conclude credit default swap (CDS) contracts to transfer credit risks of loans. These procedures alone do not represent any loan transfer or provide liquidity to loans. KfW combines these programs with the "global loan" lending program to provide a low-interest loan of the same amount as loans subjected to the securitization, making the synthetic securitization as liquid as the cash securitization.

Banks have recently sought cash securitization or true sale programs for real transfers of loans. In April 2003, big banks announced a true sale initiative and launched preparations to set up a joint company for developing securitization platforms.

Figure 3.3 True Sale Securitization Mechanism



Source: TSI Presentation "True Sale International" (May 2005)

Note: The special purpose vehicle (SPV) is a special purpose company founded by three public foundations in Frankfurt and issues asset-backed securities. The mechanism can maintain its features such as the isolation of bankruptcies even under German law.

In this respect, they had to solve trade and value added tax problems before launching an effective true sale program. As for the trade tax, the German Trade Tax Ordinance (GewStDV) issued in August 2003 provided special purpose companies with the banking privileges. Regarding the value added tax (VAT), the Finance Ministry issued a letter on Article 13c UStG (VAT law), confirming that a loan seller would be relieved of a VAT obligation for a special purpose company that pays for loan purchases.⁶⁰ The measure solved the double sales tax problem in which both a bank selling loans to an SPC and the SPC selling loans to investors could be required to pay the VAT.

⁶⁰ No sales tax does emerges regarding a bank's relationship with a special purpose company for securitization as any true sale deal does not include a loan sale from a bank to a special purpose company. Synthetic securitization programs are not subject to any sales tax.

Anticipating the tax problem's solution, big banks⁶¹ in Germany jointly founded True Sale International GmbH on April 30, 2004, just before the letter. The joint company is designed to lobby for legislation for the development of true sale programs, develop standards for the qualitative improvement of the securitization market and issue certificates for true sale programs meeting the standards. The company is also engaged in founding SPCs for securitization.

After the platforms for true sale programs were established, the first true sale deal was clinched in November 2004. The deal was related to auto loans⁶² of Volkswagen Bank. Securitization programs for SME loans, which have failed to expand against robust housing loans over the recent years, will attract attention. It is remarkable due to their connection with the "Allfinanz" strategy.

4. Interpreting Bank Strategies under Relationship Banking Theory

As well as capital adequacy regulations for balance sheet regulations, organizational regulations under Basel II may be considered as stock regulations in a sense that a temporary picture is subjected to regulations.

But any analysis from a stock viewpoint alone cannot indicate how banks' strategies affect earnings under the present regulatory regime. An earnings analysis should target flow data such as profit and loss statements, rather than balance sheets.

In this chapter, we specify banks' income structure (in the first section), systematically put in order key points of relationship banking, relationship lending and consulting services for borrowers as profitability-boosting measures (in the second section) and indicate patterns of these measures emerging as strategies (in the third section). In this way, we attempt to systematize relationship banking concepts, develop relevant conceptual devices and interpret banks' strategic actions.

4.1 Banks' Income Structure

In general, banks and other financial institutions, despite being private firms, are given social characteristics and expected to serve as public organizations. In this sense, financial institutions are expected to meet changing monetary and financial needs in society and protect their customers.

In order to continue stable operations as a private economic unit independent

⁶¹ The big banks number 13 -- Bayerische Landesbank, Citigroup, Commerzbank, DekaBank, Deutsche Bank, Dresdner Bank, DZ Bank, Eurohypo, Landesbank Hessen-Thüringen, HSH Nordbank, Hypo Vereins Group, KfW Banking Group and West Landesbank.

⁶² The deal covered some 110,000 loans worth about 1.2 billion euros (as estimated at the end of 2004). These auto loans were securitized through Driver One GmbH as the special purpose company and ABN Amro as the arranger.

from public finance, however, a financial institution must secure at least a break-even point. In addition, any financial institution must have reserves to overcome effects of economic changes. It must accumulate profits to this end. Securing profitability for the whole of the banking industry, banking groups or individual banks is one of the key conditions for ensuring stable financial functions within the market economy framework.

Bank income can be expressed in a simple equation: Income = net interest income + net fee income – management expenses. This can be developed into the following equation with considerations given to such factors as risk premiums paid on financial markets and credit risks.

Bank Income Equation⁶³

Income = A (interest income – interest cost) + B (appraisal gain – loan-loss provisions) + C (fee income – fee cost) – management cost – tax cost

*A+B comes from interest-dependent services and C from fee-earning services.

Bank actions can be categorized by their effect on each factor in the equation (but these factors are not necessarily independent variables).

If the interest cost is fixed or an independent variable, a bank can increase income by expanding interest income (average lending rate x loans) through lending. The bank can also adopt the low-margin, high-turnover strategy to increase interest income by lowering lending rates to expand lending. Japanese banks adopted this strategy before the BIS regulations. This served to increase potential loan-loss provisions to be accumulated in the future, leading to failures of some banks.

In order to prevent loan-loss provisions from increasing or an appraisal loss from being booked, banks must reduce risks of corporate borrowers. In this respect, banks may adopt strategies to positively make financial policy advices to borrowers and reduce their risks through medium- to long-term relations. This is a kind of relationship banking (more accurately, relationship lending) (as detailed in Section 2). Another strategy would be to expand small-lot loans extended through simpler procedures and diversify risks to save loan-loss provisions (as detailed in Section 1, Chapter 4).

Services income (including net fee income and net financial services income) means that banks receive fees on provisions of financial products and relevant services. (The income corresponds to net fee and financial services income as indicated in Table 4.1 in Supplement). The services represent relationship banking (sales of diversified

⁶³ Büschgen [1998] S.764

financial products) in an academic sense. If the scope of products for sales expands beyond banking products, it would mean “bancassurance” or “Allfinanz strategies.”⁶⁴ Diversified financial products sales may bring about additional burdens on basic personnel and non-personnel systems at banks, requiring additional system investment and personnel training costs.

Banks may attempt to save management costs by concentrating some technical services through alliances, outsourcing or mergers, or by reforming service steps and wage scales. If personnel costs are reduced excessively, however, it may lead to lower morale, leakages of secrets or system glitches, having adverse effects on other factors.

Factors in the income equation are not completely independent variables. They form the equation while depending on each other. Among various business management strategies combining these factors, banks choose and implement those to meet needs and secure appropriate income in response to international and domestic economic changes.

Supplement: Comparison of Income Structures for 3 Biggest Universal Bank Categories

Let's look at financial institutions' income structures in Germany to gain an understanding of more specific conditions. Table 4.1 indicates the income and cost structures in 1999 and 2003 for the three main categories of financial institutions (big banks, savings banks and credit cooperatives)⁶⁵ that have high lending market shares.

In lending service income, savings banks and credit cooperatives secure higher net interest received (interest received minus interest paid) than big banks.⁶⁶ But big banks hold down general administrative spending to boost net profit on financial operations and make up for their net interest received gap with savings banks and credit cooperatives.

All the three categories booked net charges from the valuation of assets. Particularly, savings banks and credit cooperatives expanded such charges from 1999 to 2003.

On a posttax basis, big banks conspicuously posted a loss in 2003. The loss was attributed primarily to an extra loss (Der Saldo der anderen und außerordentlichen

⁶⁴ An “Allfinanz” strategy is for banks and insurance companies to form alliances to expand income by providing all financial services that their customers request. See Nobuo Yamamura [1998] pp. 197-198. As for the separation from house banks, see Nobuo Yamamura [2002] pp. 88-90.

⁶⁵ In December 2004, big banks accounted for 15.4% of all financial institutions' total loans to companies and self-employed people in Germany, savings banks for 22.9% and credit cooperatives for 12.5% (Vgl. Deutsche Bundesbank [2005] Banken Statistik).

⁶⁶ Table 4.1 indicates each item's ratio to the total on the balance sheet for each category. The net interest income here thus means such income's percentage of gross assets.

Eträge und Aufwendungen)⁶⁷ (including profit on equity stake sales, dividend income on equity stakes in affiliates, and income on securities treated as investment assets). Such charges emerge on structural reforms of financial institutions and cannot be expected to be posted continuously. Since the number of the big banks is limited to five, “one bank’s massive loss may have a great impact on a five-bank average.”⁶⁸ For the big banks as a whole, the interest income and cost percentages declined from 1999 to 2003 along with net interest received. Furthermore, the big banks failed to expand net commissions received and net profit on financial operations, for which they have been stronger than savings banks and credit cooperatives. (This is in line with the recent situation where the big banks have been required to review their strategies while giving priority to investment banking.)

Table 4.1 Income and Cost Structures for Each Category of Financial Institutions in Germany

	Big banks		Savings banks		Credit cooperatives	
	1999	2003	1999	2003	1999	2003
1) Interest received	4.85	3.42	5.71	5.24	5.60	5.15
2) Interest paid	3.69	2.57	3.23	2.82	3.10	2.62
3) Net interest received	1.15	0.85	2.48	2.42	2.49	2.53
4) Net commissions received	0.63	0.54	0.52	0.53	0.62	0.61
5) General administrative spending	1.50	1.37	2.01	1.99	2.30	2.33
6) Partial operating result	0.29	0.02	0.99	0.96	0.81	0.81
7) Net profit or net loss on financial operations	0.17	0.32	0.03	0.02	0.01	0.02
8) Net income or net charges from the valuation of assets	-0.24	-0.31	-0.17	-0.54	-0.39	-0.56
9) Operating result	0.20	0.04	0.87	0.47	0.54	0.46
10) Net other extraordinary income or charges	0.04	-0.52	-0.27	0.02	-0.06	0.06
11) Profit for the financial year before tax	0.23	-0.48	0.60	0.49	0.48	0.52
12) Profit for the financial year after tax	0.20	-0.44	0.24	0.18	0.21	0.26

Source: Deutsche Bundesbank [2004] pp.31-33

Note: The figures represent items’ percentages of total on the balance sheets for each category of financial institutions in 1999 and 2003. Definitions of items follow:

3) Net interest income = 1) interest income – 2) interest cost

6) Partial operating profit = 3) net interest income + 4) net fee income – 5) general management cost

9) Operating profit = 6) partial operating profit + 7) Net banking income + 8) appraisal gain

11) Pretax profit = 9) operating profit + 10) extra gain

⁶⁷ Deutsche Bundesbank [2004] S.26

⁶⁸ Deutsche Bundesbank [2004] S.26-27

Meanwhile, savings banks and credit cooperatives also have some problems with their income and cost structures. While their consolidation has made progress with each institution reorganized, they have maintained higher general administrative spending than big banks. Credit cooperatives have seen their general administrative spending rising further. At both savings banks and credit cooperatives, net charges from the valuation of assets have had considerable effects on their overall income and cost structures.

Given these facts, we may be able to give the following conclusion: Big banks have less net interest income than the other categories of financial institutions, but have efficiently secured net banking income by holding down general administrative spending. In contrast, savings banks and credit cooperatives have high general administrative spending and have utilized high net interest received to secure net profit on financial operations. Particularly, credit cooperatives feature high net commissions received, indicating the effects of the above-mentioned relationship banking (or the “Allfinanz” strategy).

4.2 Putting Relationship Banking Concepts in Order

Generally, relationship indicates relations in a certain period of time or an attitude vector at a differentiated point. It is a flow concept, instead of a stock concept. It is natural to keep profitability as a flow concept in mind when controlling the financial effects of relationship banking. Japan’s ongoing Action Program Concerning Enhancement of Relationship Banking Functions includes not only “efforts for revitalization of SME finance” but also “efforts for securing the soundness of financial institutions and improving their profitability.”⁶⁹ The action program can thus be systematized as a financial administration policy from a flow viewpoint, in contrast to balance sheet regulations from a stock viewpoint.⁷⁰

But the Japanese financial industry has generally publicized relationship

⁶⁹ See FSA [2005] p.433. The “efforts for revitalization of SME finance” can be understood as a policy for implementing the “smooth operation of financial function” (including facilitation of lending) among the FSA missions. The “efforts for securing the soundness of financial institutions and improving their profitability” may be interpreted as a policy to secure the “protection of depositors” or the “stability of Japan’s financial functions and implement the “smooth operation of financial function” through the improvement of profitability. Yamamura [2003b] p.7 noted that the enhancement of profitability through community relationship banking contributes to the “facilitation of finance” through the “balance sheet improvement” and the “secured stability of financial functions.”

⁷⁰ In foreign countries including Germany, relationship banking has not become a problem for financial administration. This may be because most local financial institutions there are carrying out relationship banking functions responsibly as a matter of course. Particularly, local financial institutions in Continental Europe have worked as public institutions to serve local communities or their stakeholders’ communities, or as credit cooperatives. They departed from the convoy system faster and have learned achievements of management theories.

banking as a lending approach based on information collected through continuous business transactions about the qualifications of corporate borrowers' top managers or their business potentials. Relationship banking has been explained one-sidedly for lending-expanding purposes.⁷¹ Propaganda is usually one-sided. If such explanations are fed back to realities, theories and disciplines, however, true relationship banking and lending may grow vaguer with the profitability-boosting purposes covered up. This is the problem.

In this section, we attempt to specify and systematize relationship banking concepts.

“Relationship Banking” and “Transaction Banking”

The academic term of “relationship banking” is an application of “relationship management (Beziehungsmanagement)” classified as a kind of marketing theory under the general management economy theory (Allgemeine Betriebswirtschaftslehre) to the bank management theory (Bankbetriebslehre). “Relationship management” indicates an attempt to earn as much as possible from the established relationship with customers as transaction cost begins to be taken as investment through long-term relations⁷². Therefore, relationship banking is “designed to obtain customers, contain them permanently and draw their loyalty to banks (Bankloyalität).”⁷³

In relationship management, banks collect marketing information from their customers to know the products or services they want. Companies conducting relationship management may diversify their operations in a bid to provide all products or services meeting customers' requests. Therefore, relationship management generally means diversification in bank management theory. In Germany where universal banks have developed, the advantage of relationship development is that a financial institution can provide corporate customers with comprehensive financial services while their customers benefit from such services. Financial institutions may develop the “Allfinanz” strategy by adding insurance and pension plan services to universal banking services for customers.

Relationship banking deals contrast with transaction banking business that are not based on relationship.

In conducting transaction banking, banks analyze credit risks quantitatively

⁷¹ This interpretation is based on explanations on some banks' websites acquired through search engines. We refrain from specifying these banks since we have made no attempt to assess any specific banks.

⁷² See Yamamura [2003b] pp.1-7 for details about “relationship management.”

⁷³ Suechting und Paul [1998] S.634

and automatically to decide whether to provide financial services like lending or to set terms and conditions for such services. There may be two conceivable cases for transaction banking. In one case, a bank may be willing from a marketing viewpoint to get a new customer that has so far had no dealings with the bank. In another case, a bank may believe that it would be better to repeat independent dealings with a customer without building up bilateral relationship.

Beneficial effects that qualitative or unpublished information or transaction growth through continuous business relationship with customers would have on earnings may be compared with real and potential cost for building such relationship. If the cost-benefit performance for transaction banking is expected to be better than that for relationship banking, it may be reasonable for a bank to choose transaction banking without emphasizing relationship.⁷⁴

Table 4.2 Relationship Banking and Transaction Banking

	Relationship banking	Transaction banking
Objective	Building or establishing relationship with customers	Carrying out transactions to meet customers' demands
Relationship with customers	Developing mutual trust (mutual dependence)	Maintaining independence from customers subject to short-term relationship
Term	Long-term investment viewpoint	Short-term viewpoint
Target	Enhancing existing customer relationship through provision of problem-solving capacity and services.	Exploring new customers
Business focus	Negotiations with same customers for renewal of contracts	Introducing loans to all customers and clinching deals with as many customers as possible

Source: Süchting und Paul [1998] S.633
Original source: Wehrli and Jüttner [1994] p.2

“Relationship Banking” and “Relationship Lending”

Relationship banking is basically designed to improve earnings through diversification of products. Loans are the traditional key part of banks' product lineup.

⁷⁴ In Germany that has adopted the universal bank system, banks give priority in marketing to providing multiple financial services to boost earnings. In this sense, banks have cost performance reasons to focus on the relationship strategy in dealing with favorable customers expected to have steady demand for comprehensive services. Vgl. Roggemann [1998] S.382.

New or expanded loans to the same customer can be taken as sales of other products.

Relationship banking can be expanded to lending services in the following way: Cost paid for building business relations with customers is conceptualized as capital and banks build on the capital to sell more financial products to the same customers. On such occasions, particularly, the banks provide loans to meet the customers' new fund demand.

If the banks have completed preliminary examinations and obtained basic information on the customers as a result of continuous business relations and localized business operations, new business cost may be reduced. The lower cost may allow the banks to offer cuts in interest rates on new loans to the same customers. The banks may thus be able to outdo other banks in attracting customers and expand or maintain loans to them.

The banks' utilization of the relationship banking theory to set more favorable lending rates than other banks is nominally the same as but logically different from the "relationship pricing" practice in which important qualitative information gained by banks through existing relations with their customers for credit risk examination is exploited for scrutinizing their financial profiles and setting lending rates at appropriate levels (lower than those offered by other banks).⁷⁵ The relationship pricing interprets lending from the viewpoint of finance, while the relationship banking gives considerations to bank management including business cost.⁷⁶

The two concepts may be unified and systematized in the following way:

First, the original meaning of the relationship banking may be understood in the form of the following equation:

Equation for sound bank management in relationship banking

$$(\text{Income from lending} + \text{income from other operations}) - (\text{relationship-building cost} + \text{fixed cost}) = 0$$

The equation indicates that banks may try to increase profit margins by setting interest income at higher levels than relationship-building cost and by taking advantage of relationship for increasing deals that can contribute to "income from lending" and "income from other operations."

⁷⁵ In fact, relationship banking can lead to higher lending rates as their customers favor familiar stores that tell customers of how to use products and provide product maintenance services, rather than discount stores that may be closed at any time.

⁷⁶ While the two concepts must be separated from each other in principle, the separation may be difficult in practice. A bank can take an action that is significant for two strategies.

Through the relationship-building efforts, banks can get not only marketing information but also important qualitative information for credit risk examination from their corporate customers. Lending operations where such information is used may be understood in the form of the following equation regarding “income from lending.”

Equation for sound bank management regarding relationship-based lending

$$\text{Income from lending} = (\text{interest income}) - (\text{loan-loss provisions} + \text{credit examination cost} + \text{fixed cost}) \quad 0$$

In the equation, the credit risk measurement, a unique action for relationship pricing, is represented by a combination of loan-loss provisions and credit examination cost. In this way, relationship lending and true relationship banking may be understood systematically.⁷⁷

Room for Improvement through Consulting Services

When advanced relationship banking is prevalent, lending terms offered under relationship banking may be more unfavorable for unsound corporate borrowers than those under transaction banking. These borrowers may not seek to build a long-term relationship with banks. As a result, banks that emphasize relationship banking can attract cooperate borrowers that are confident of their excellence. By exploiting lending terms based on examination results, banks can contain corporate borrowers that are rated as excellent by other banks. On the other hand, banks that base their lending services on transaction banking may attract unsound corporate borrowers. Given the reverse selection mechanism, corporate borrowers that have established long-term relationship with banks can expect to take advantage of the fact to publicize themselves as sound (reputation effect). Expecting such effect, a greater number of sound companies may hope to build long-term relationships with banks.

But companies seeing temporary financial deterioration may not necessary lose their relationship with banks. The relationship seems to be dependent on banks' decision on whether to lend money only because borrowers' creditworthiness is a tacit precondition for loans. Banks that adopt the relationship banking strategy have an option to spend more on building relationship with customers, positively intervene in their financial policy and improve credit risks.⁷⁸ Under the internal ratings-based

⁷⁷ Further elaboration measures include a division of interest income into the standard interest rate and the risk premium.

⁷⁸ Banks' intervention in customers' internal affairs may not be limited to financial policy. Banks may even help customers expand sales through the introduction of new trading partners. Such consulting

approaches as accepted by Basel II, risk weights for loans are based on ratings that are given to loans in accordance with risks. The Basel II framework offers the improvement of corporate borrowers' financial profiles as a key means for banks to clear capital adequacy regulations.

Basel capital adequacy regulations have traditionally featured their procyclicality. If banks educate borrowers to reasonably control their financial profiles and refrain from depending on unnecessary borrowings, it may work to offset such procyclicality.

4.3 Interpreting Adjustment of Risky Assets

Significance of Borrower Segmentation by Lending Size

Banks' customers may be divided into some segments by benefits⁷⁹ compared to costs for building relationships.

Customers with which banks have not built lending relationship at some point are divided into two groups. One group cover small-lot loans that cannot be expected to bring about considerable benefits like income even at cost of massive expenses. This group corresponds to "regulatory retail portfolios" as described in Basel II.⁸⁰ Another group covers deals for initiating relationship-building efforts. For new customers like startup companies, for example, banks may initially use transaction banking services and gradually build relationship. Banks may also adopt a strategy to invest capital funds into promising startups to become their insiders and build solid relationship.

Banks build close relationships with customers as far as such relationships with them are expected to bring about considerable benefits including income. For such customers, banks serve as house banks (for universal banking) or main banks (mainly for lending services). When such customers plunge into crises, banks may implement additional lending and other management improvement measures in anticipation of future income.

Significance of Asset Securitization

The capital adequacy regulation framework imposes some constraints on banks' activities to meet diversified customer needs. Then, house banks attempt to

services take additional cost. Then, costs and benefits of such services to improve borrowers' earnings and prevent them from defaulting can affect banks' management strategy.

⁷⁹ The benefits important for the management policy may include borrowers' achievements of social responsibilities and advertisement effects. But the benefits here are limited to income.

⁸⁰ Customers may include small and medium-sized enterprises and individuals.

recover credit creation capacity by securitizing existing loans.⁸¹ In this way, house banks link the capital market to the retail banking market to develop new channels for flow of funds.

It is important to note that even after house banks' loans to customers are transferred to others through derivatives transactions and securitization, the banks will maintain relationships with these customers. This is because house banks take charge of credit management and loan collection. Securitization is not any strategy to abandon old relations and make new relations. It can be taken as a strategy to maintain old customers and exploit expanded lending capacity for exploring new customers.

If securitization were to provide additional credit creation capacity, considerations may have to be given to its effects on liquidity and capital. It is wrong to believe that the replacement of existing deposits with securities does not necessarily lead to any corresponding liquidity or any additional lending capacity. If risky assets decline with capital remaining unchanged, banks can exploit credit services to create deposit money.⁸²

If a loan is divided into tranches including a mezzanine tranche that a bank as loan originator continues to hold, the bank will have to set aside a portion of its capital for the mezzanine tranche. In this case, the bank's credit creation capacity may fail to recover sufficiently. If the mezzanine tranche's rating is not so bad, if the rating is upgraded successfully through the good maintenance of the loan, or if a loan does not have to be divided into tranches including a mezzanine portion, however, a relevant capital requirement will be eliminated.

Furthermore, if banks can sell securities issued through loan securitization to depositors and other relationship-based customers, they may be able to get sales or depository commissions from these customers. Banks may thus get credit management and collection commissions or sales commissions as income sources, instead of profit margins. In addition, banks may accumulate these commission revenues as reserves to expand capital and credit creation capacity.

5. Conclusions

As specified above, the capital adequacy regulations are the relaxed version of regulations developed to avoid bank failures in Germany where deregulation of banking

⁸¹ This stands for loans to individual borrowers as well as corporate borrowers. Individual customers may include those who make deposits at banks and receive housing loans from them. The PROVIDE program that has diffused for securitization of housing loans allows banks to get room to provide housing loans to new customers. In this respect, housing loan programs are advantageous for banks.

⁸² "Credit creation" in the United States and Japan is called "Gelschöpfung (money creation)" in German.

services has made progress under the universal bank system. The German regulations have been relaxed at the request of the United States and Japan, leading to the present international regulations. In Germany, not only big banks but also retail financial institutions, like savings banks and credit cooperatives, have developed internal ratings-based approaches to promote efficient and reasonable decisions on lending terms and conditions for specific borrowers. The regulatory framework, which has developed into Basel II, tolerates such German efforts. More precisely, the German efforts have been one of the preconditions for the framework.

Basel II allows banks to depend on their own approaches instead of traditional uniform risk weights. The Basel II framework allows banks to improve credit examination capabilities through relationship with corporate customers, intervene in their financial policy on an ex post facto basis, be relieved of some of capital adequacy requirements and expand lending further. The framework itself encourages banks to enhance their own risk management capabilities. In this sense, Basel II prompts banks to form risk management organizations. It thus shifts from the feedback system to the feed-forward system.

Internal ratings-based approaches that exploit relationship-based information for risk management cannot be applied to all customers uniformly. Banks break down customers into groups from the viewpoint of risk management cost reductions or transaction cost savings for their mutual benefits. In this way, banks decide on products or approaches to be used for solving financial problems and managing risks for each group of customers. If risk management is sufficient to recover cost, banks may adopt internal ratings-based approaches. This can enhance the directions of two strategies.

In a non-crisis situation, internal ratings-based approaches lead banks to estimate higher risk weights for riskier borrowers and apply unfavorable lending terms and conditions to them for the immediate future. Even if banks use soft information gained through relationship built with borrowers to more finely measure their risks, they will be required to consistently comply with some rating approaches.⁸³ This would prevent lending officers from making discretionary decisions to lower lending rates for some borrowers.⁸⁴ Ratings must be upgraded to improve lending terms and conditions.

⁸³ Basel II provides for the following common principle about minimum requirements regarding internal ratings-based approaches: "The overarching principle behind these requirements is that rating and risk estimation systems and processes provide for a meaningful assessment of borrower and transaction characteristics; a meaningful differentiation of risk; and reasonably accurate and consistent quantitative estimates of risk. Furthermore, the systems and processes must be consistent with internal use of these estimates." (Basel Committee on Banking Supervision [2004] "International Convergence of Capital Measurement and Capital Standards: a Revised Framework" para. 389)

⁸⁴ Petersen and Rajan [1994] noted that there would be no significantly negative relations between the length of relationship and lending rates because lending officers' rate reductions using soft information

To this end, banks intervene in small and medium-sized borrowers' financial policy and reduce their risks through the enhancement of their relationship. Particularly, German SMEs are called on to solve undercapitalization problems to improve their financial profiles. Eventually, banks give greater priority to strategies to increase borrowers' capital rather than their liabilities.

In an emergency situation, under the present regulations that have grown sensitive to risks through the introduction of internal ratings-based approaches, banks have less room to exploit lending services for rescuing and reconstructing borrowers faced with difficulties.⁸⁵ In Germany, therefore, house banks will give priority to forestalling corporate borrowers' financial difficulties through ratings and mutual exchanges, instead of rescuing and reconstructing borrowers faced with difficulties on an ex post facto basis⁸⁶. In Germany in the past, corporate borrowers' loyalty to banks (Bankloyalität) was expected to be rewarded by banks' retention or extension of credit agreements when difficulties face those borrowers. Such function of banks will decline. Rather, house banks, as defined, will serve as "home doctor" banks⁸⁷ to provide most of universal banking services to some corporate customers.⁸⁸

For some customers, the diversification of risks may be more favorable for banks in terms of cost than internal ratings based on relationship. Banks may take advantage of the "regulatory retail portfolio" system to expand small-lot loans to such customers under the transaction banking approach. If real effects of relationship banking (additional services) are expected, banks may explore new customers and build relationship with them through investment in them. In a bid to increase customers beyond the capital adequacy regulations, banks may seek to recover lending capacity through securitization of existing loans to separate risks that result in regulatory constraints on bank assets.⁸⁹ Even if existing loans to some borrowers are securitized, house banks will remain as credit managers regarding securitized loans and maintain

gained through relationships would conflict with internal rules at banks and would be difficult.

⁸⁵ Under the European Union's competition policy, local governments in Germany have eliminated debt and business maintenance guarantees for savings banks that have served as lenders of last resort for small and medium-sized enterprises. This might affect the problem by boosting refinancing costs.

⁸⁶ For example, Kastner [2005] notes that the MaK and MaRisk regulations meeting Basel II may affect traditional relations between banks and their customers. This means if banks are required to anticipate risks emerging at borrowers, it will prompt lending terms and conditions to deteriorate for risk-ridden companies and make it difficult for banks to rescue and reconstruct borrowers on an ex post facto basis. Such rescue and reconstruction have been a key role of house banks. Vgl. Kastner [2005] S.505-506.

⁸⁷ As "Hausarzt" means a home doctor, a house bank or "Hausbank" indicates a financial institution for comprehensive services for customers. See Yamamura [1999] p. 230 (footnote).

⁸⁸ Krumov und Gramlich (Hrsg.) [1999] S. 677 (Hausbank)

⁸⁹ Strictly, securitization of loans does not necessarily allow banks to separate risks involving the loans. In this sense, Basel II shall regulate securitization.

some relationship with the borrowers.

Given the above, relationship lending can be taken as in line with capital adequacy regulations as a risk management method. Not being limited to lending, banks should provide other financial services including investment in corporate customers to meet their needs and qualitatively improve their financial profiles. Customers' financial needs may not be limited to borrowings but be diversified. Therefore, relationship lending itself prompts banks to offer various financial services meeting these needs. In this way, "relationship banking" or "house bank" represents the diversification of services as originally defined. The improvement of risk management through relationship lending may be combined with the cost reduction and income expansion through relationship banking to generally increase bank earnings, recapitalize banks and enhance their credit expansion capacity.

As a matter of course, such effects cannot be expected to emerge by themselves. Such effects depend on whether banks strategically develop, understand and utilize a system of targets. It would be inefficient for each bank to design and develop an overall system on its own. Banks should cooperate with each other (in development of internal ratings-based approaches) and with public organizations (in forming securitization platforms). Such socialization may be effective.

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