Hermann Remsperger: Financial market trends in Germany

Speech by Professor Hermann Remsperger, Member of the Directorate of the Deutsche Bundesbank, at the European Summit of Financial Journalists, Frankfurt, 29 October 2001.

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Banks play a relatively dominant role in the German financial system. At the end of 2000 bank lending amounted to € 3 trillion, and € 2.2 trillion worth of debt securities were in circulation. That means loans by banks accounted for most of the finance raised by the economy as a whole. Of those debt securities again, € 1.4 trillion were issued by banks, which used this instrument to refinance their lending business. The market capitalisation of all companies listed on German stock exchanges was € 1.4 trillion in December 2000. That is around 70 % of GDP, which is relatively low by international standards.

However, the German financial system is going through a period of considerable change. Important longer-term trends include the mounting importance of securities markets, the increasing institutionalisation of investment and the German financial system's deepening integration with international financial markets in general and with other European financial markets in particular. Entry into Stage Three of EMU at the beginning of 1999 caused the elimination of intra-European exchange rate risk and the lifting of foreign exchange restrictions on investors in the euro area, and therefore made a major contribution to broadening the base of investors in bonds and equities and to fostering an increasingly European outlook in investment strategy.

1. Increased significance of securities markets

The sharp increase in sales of corporate bonds in 1999 and 2000 as well as the record amounts of stock market issues during the same period are particular testimony to the increasing importance of the securities markets in Germany. Over 80 % of the total amounts outstanding of € 200 billion of German companies' debt securities are issued via their foreign financial subsidiaries. These financial resources are then channelled back to the parent company as loans. Advantages relating to the trade earnings tax are likely to be the main reason for this "indirect" method of raising finance in the capital market; 50 % of the interest on long-term debt (bonds) is included in the tax base, whereas interest on short-term loans – lending by the foreign financial subsidiary to the parent institution – remains tax-free.[1] The increasing substitution of bonds for bank loans has proved to be particularly effective in raising the large volume of funding needed by the telecommunications sector and other big corporations.

Whereas the amount outstanding of corporate bonds and commercial paper rose by nearly 80 % in each of the last two years, it grew at a considerably slower pace in the first six months of this year. In August of this year, in particular, hardly any long-term corporate debt instruments were issued in Germany. That is probably because companies, facing increasingly bleak economic prospects, have reduced their demand for capital. The larger spread of premiums for varying risk categories of bonds shows in addition, that investors are increasingly aware of higher risks. That development has also been observed in the "more mature" Anglo-American bond markets.

Following the two boom years of 1999 and 2000, share-issuing activity in Germany also slowed down as prices began to slide. The value of equities issued in German markets was less than € 3 billion in the first half of 2001, whereas in the first half of the preceding year the volume of IPOs overshot the € 17 billion mark.

Despite the currently very volatile state of equity markets, marked by setbacks in share prices, the establishment of new market segments – examples being the *Neuer Markt* for innovative growth industries or the SMAX for small and medium-sized enterprises – will in the long run represent an additional source of external own funds for corporations. The market for venture capital, which has been growing strongly since 1997 – although at a slower pace in the first half of the year 2001, will also make it increasingly possible to raise equity finance rather than debt finance for risky new

[1] See: Deutsche Bundesbank, The relationship between bank lending and the bond market in Germany, Monthly Report, January 2000.

enterprises through holding companies as well as through insurance companies, banks and pension funds. The tax-exempt status of corporate capital gains from the sale of participating interests, which will take effect from 2002, will have a positive impact.[2] Corporate bonds are attractive to yield-oriented investors and can help brand-name enterprises raise large amounts of funds. On the whole, in the future capital market-based corporate finance will probably gain in importance.

2. Institutionalisation of investment

A further development which can be observed in German capital markets is the growing institutionalisation of investment through the increased involvement of insurance companies and asset management companies. At the end of 2000 insurance companies held over € 600 billion worth of securitised capital investments (debt securities, shares and investment fund certificates issued by residents and non-residents).[3] Along with the growing involvement of institutional investors in the markets, an increasing volume of funds is being invested in professionally managed products and thereby entering the capital market indirectly rather than directly. In the past ten years this kind of institutionalisation has led to an eightfold rise in the value of investment fund certificates issued by residents and non-residents held in safe-custody accounts with credit institutions. In 2000 these investment fund certificates represented a value of over € 800 billion.[4]

With the introduction of a government-promoted funded pension scheme, the additional promotion of corporate pension funds and the growth of private retirement plans due to demographics, the demand for professionally managed investment instruments will probably expand strongly in the future. The institutionalisation of investment in German capital markets will continue to grow.

3. European and international integration

German financial markets' fortunes are increasingly tied up with those of other European financial markets, and international integration is also on the rise. Whereas European financial market integration is being given a special boost by the introduction of the euro, international integration on the supply side is based on increasing cooperation with the world's financial centres. On the demand side, international integration is being propelled by the increasingly global orientation of investors and the rise in world trade. In the past five years, the value of foreign sales and purchases of equities by residents has gone up more than tenfold, reaching € 1.5 trillion in 2000. In the same year, foreign investors sold and purchased German stocks to the same value, a sixfold increase compared with 1995. The volume of foreign bonds traded in Germany trebled in the same period, to € 2.4 trillion in 2000. During that time, sales of German bonds abroad remained largely unchanged; these also amounted to € 2.4 trillion in 2000.

The integration of securities markets, however, has not always been accompanied by a harmonisation of structures and uniformity in European products. In some sub-segments, national methods of launching issues have certainly been preserved. Whereas the bond market can now be described as a largely single European market for corporate bonds, individual segments of the government bond sector are still marked by the use of national debt securities as benchmarks. Ten-year German Bunds are a benchmark for long-term capital market yields in the entire euro area. This position is underscored by the fourfold increase in option contracts on the Bund future issued since the end of 1998. For indexed bonds the French OATis (Obligations Assimilables du Trésor inflation-indexed) have established themselves as the benchmark used to derive inflation expectations and real interest rates for the entire euro area.

Bank-issued *Pfandbriefe* have also prevailed in competition; they provide security independently of the individual debtor by having a public-sector body provide a guarantee or through the existence of a real-estate lien. With the introduction of Jumbo *Pfandbriefe*, with an issue volume of over € 500 million, the establishment of book-building as a method of issue and the assignment of an

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[2] This tax exemption applies to participating interests held by the seller for at least one year and, in the event of a disinvestment, will increase yield after taxes.

[3] Data are from aggregate financial flows account.

[4] Data are from the Deutsche Bundesbank's securities deposit statistics. They do not include safe custody accounts held by foreign subsidiaries; therefore, data are distorted downwards.

external rating, which is not yet standard practice for private bonds in the euro area – for German *Pfandbrief* issuers this rating is mostly AAA – *Pfandbriefe* have evolved from a German speciality to an international investment vehicle.[5]

German share markets have been marked by a tendency to adapt to Anglo-American structures. In addition to the increasing importance of sector indices – including pan-European indices – and the establishment of a market segment for high-tech, innovative enterprises, the number of cross-listings of German shares abroad and foreign shares here in Germany has increased. In 1997 there were 700 domestic companies and 2,784 foreign companies listed on German stock exchanges; by August of this year the figure had ballooned to 1,080 domestic companies and 9,964 foreign companies. However, it remains to be seen whether the stock market downturn could lead to greater concentration on the more familiar domestic markets.

Outlook

On the whole, the German financial system can expect to see a further expansion of more market-oriented structures. However, the identity of the German financial system will remain intact. That will be particularly true of historically evolved financial relationships, especially the bank-lending based financing of small and medium-sized enterprises. And that will also be true of the particularly prominent position of *Pfandbriefe* in Germany.

5 Over 95 % of the market volume of public-sector *Pfandbriefe*, and over 40 % of that of mortgage *Pfandbriefe*, are German-issued. Of those, more than 40 % are sold abroad.