Another Merkel Blunder

By Klaus C. Engelen

In financial market supervision reform, the Bundesbank loses big.

Now that policymakers have begun picking up the pieces from the financial crisis, reforming failed financial market supervision structures, and strengthening regulation, there have been winners and losers.

In the United States and United Kingdom, the central banks—the Federal Reserve Board and the Bank of England—have gained responsibilities and power, as the Dodd-Frank Act and as the British government's new financial regulation reform consultation papers of June 2010 and February 2011 made clear.

But what about Germany, where the battle cry of Chancellor Angela Merkel's new governing coalition was "Tear down BaFin!"?

In the Winter 2010 issue of *TIE,* we alerted global market participants to the Berlin government's plan to dismantle Germany's cross-sector financial market watchdog, the Federal Financial Supervisory Authority, or BaFin, in a move that was seen by many as politically motivated.

Putting all the blame for supervision failures during the horrible German banking meltdown—especially for such disaster cases as IKB, HRE, and the Landesbanks—on BaFin and not the Bundesbank as "dual supervision" partner was an easy sell in the election campaign. After all, BaFin was established as part of the most important financial market modernization project of the eleven-year reign of Social Democrats running the Ministry of Finance. It was, therefore, disliked by conservative and liberal politicians from the beginning. When the SPD was voted out of power in the federal elections in September 2009, BaFin lost its political protection.

Established as an independent public-law institution, BaFin is subject to legal and technical oversight by the Ministry of Finance. It is funded,

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however, by fees and contributions from the banks and other institutions that it supervises and therefore is not dependent on the federal budget.

After a resounding election victory, the coalition of the Christian Democratic Union, its Bavarian sister party, the Christian Social Union, and the pro-business Free Democratic Party under Chancellor Merkel promised followers to make the Bundesbank the country's leading financial market supervisor.

This was an opportunity that Bundesbank President Axel Weber didn't want to miss. Just after the election, in a stunning preemptive strike, Weber put forward a seven-point reform plan under which the Bundesbank would assume full authority to supervise banks and other financial service firms such as insurance companies, giving it fully integrated solvency supervision (as opposed to market supervision which, at that time, was to remain at BaFin). Weber called it the "integration model." Germany's present system, partially modeled after the British Financial Services Authority, would be scrapped.

On October 2, 2009, the Bundesbank's board backed Weber's proposals to the Berlin government, arguing that streamlined supervision could help fix gaps and overlaps in financial oversight that had contributed to the massive losses German banks incurred in investments linked to subprime mortgages. The board implicitly tried to shift the blame for the collective failure in supervision to BaFin, in spite of the fact that the Bundesbank as "dual supervisor" also contributed its share of breakdowns in supervision. Pointing to the failure of the Financial Services Authority in the United Kingdom, the Bundesbank and the ruling coalition legislators advanced the so-called "twin peak model" as a better solution, under which solvency and market supervision would be separated in order to manage conflicts of interest in a more transparent and explicit manner.

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Since the ruling coalition legislators came to their deliberations on the reform law with a strong pro-Bundesbank bias, things didn't look good for BaFin, a federal agency with 1,600 employees and offices in Bonn and Frankfurt. And what was headlined as "the takeover of BaFin" was seen as a major personal setback to Jochen Sanio, BaFin's president, who took over the new federal agency when its doors opened in May 2002. The prospect of having to move from Bonn to Frankfurt—a much more expensive area—under an unknown organizational structure at the Bundesbank caused uncertainty and demoralization among BaFin staff at a time when supervisors were still struggling with the banking crisis.

Unlike Weber and his colleagues at the independent Bundesbank, who were able to mobilize the institution's public relations machine, Sanio, as head of a federal agency, is supervised closely by the Federal Ministry. He was not in a position to speak freely in public. But after assuring his top management and staff that he would not take an expected retirement at age 63 in early 2010 but stay on to defend the organization's interests, Sanio hit back. He

Political Fortunes

Jochen Sanio

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warned in an interview with *Wirtschaftswoche* that he could not see any sound reason for putting banking and insurance under the Bundesbank. "The division of labor [between the Bundesbank and BaFin] is spelled out in all detail in respect to rules and directives and things are moving without a hitch," he said. He added, "There were situations where the whole German banking system was threatened that were defused because two banking supervisors brought all their power to bear on those concerned," and "The Bundesbank would have to yield some of its independence by submitting itself to political control as financial market supervisor."

This turned out to be a correct prediction. But as discussed in the Winter 2010 *TIE*, Germany's major banking associations adjusted to the changing political winds with two exceptions. First, Germany's insurance association revolted against being supervised by central bankers with no practical experience in their segment of the financial service industry. And second, veteran Deutsche Bank Research expert on financial market supervision Bernhard Speyer elaborated all the reasons why the politically motivated takeover of BaFin by the Bundesbank couldn't work in the German financial system.

Right from the beginning, the Bundesbank's key negotiator on the reform legislation, Franz-Christoph Zeitler, vice president and managing board member for banking supervision, took a hard line on preserving the Bundesbank's independence.

In defining "independence," the Bundesbank's Weber set the hurdles very high. Although he did not specifically state that prudential supervision must be included in the Bundesbank's independence, he pointed out, "This independence is not to be understood in the narrow sense, and not merely as concerns original monetary policy decisions." "It also comprises independence regarding cash and non-cash payment transactions or contributions for ensuring financial stability. It is furthermore manifest in the Bundesbank's autonomy regarding budget and human resources, since otherwise technical autonomy, no matter how it is understood, would be all too easy to undermine. Preserving the Bundesbank's independence is however not merely a condition *sine qua non* in the transfer of further financial market oversight functions. Vice versa, the bundling of oversight at the Bundesbank also affords the opportunity to enhance the independence of oversight in Germany. This kind of enhancement would by no means stand in contradiction to the appropriate involvement of the German Federal Government in far-reaching supervisory decisions, were it associated in such cases with mandatory detailed information and close coordination."

In the view of the Bundesbank board, this could be achieved best by integrating BaFin into the Bundesbank, and thus putting the solvency supervision of banks and insurance companies under the Bundesbank. In important cases where the authority of the Ministry of Finance was required, the Bundesbank could present the matter to the ministry. In cases of disputes, the Bundesbank could delegate the decision to the ministry under the condition that it would take full responsibility. An example of such a case would be if the supervisor had to close a bank, fire managers, or use support funds from the Financial Market Stabilization Fund.

Coalition legislators and experts from the Berlin Ministry of Finance—run by CDU veteran Wolfgang Schäuble—got stuck in April 2010 with their "holding group model" under which the new law would establish three pillars of institutions. The Bundesbank would control the first two pillars.

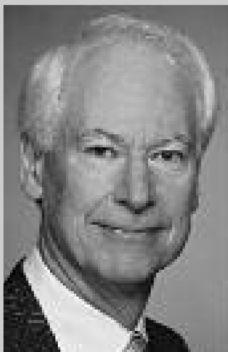
Pillar one would comprise the supervision of banking, insurance, and securities trading. (This would replace the present "dual concept" where BaFin and the Bundesbank share banking supervision)

Pillar two would be monetary policy and the central bank's extended task of securing financial stability as well as contributing to the European Systemic Risk Board.

Pillar three would supervise the Financial Market Stabilization Fund that was set up in October 2008 in response to the financial crisis and which would be developed into a permanent emergency and restructuring fund for banks and possibly for insurers.

At that time, it had already become clear that the coalition reformers had to climb down from their high perches and confront harsh realities. Even after the recent collective supervision failure and banking breakdown, Germany's political system was not able to come up with needed reforms.

After haggling with Bundesbank representatives for almost a year, Leo



Buba's Hard Line

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Dautzenberg, the CDU finance spokesman, eventually tried a new ploy. "I can see a concentration of banking supervision under BaFin," he told the German financial and economic daily *Handelsblatt.* This would mean that the Bundesbank's 945 bank examiners and other staff would be shifted to BaFin—a stunning reversal on the original plans. As Dautzenberg told the paper, "The Bundesbank has shown no willingness to compromise and to accept any control by government or parliament in financial market supervision." Its proposal that in important cases of supervisory intervention the Bundesbank would present the issue to the finance ministry "is not practical." This statement was polite but significant, as many experts and politicians believe that financial supervision and bank restructuring must operate under the control of at least a parliamentary committee since financial supervision can trigger bail-outs which imply the use of taxpayers' money.

A major rating agency such as Standard & Poor's now takes the view that Germany's "institutional framework" has become a negative factor for banks.

German Finance Minister Schäuble now faces a dilemma. On the one hand, he takes the position that grave government interventions in financial market supervision must have democratic legitimacy. On the other, one has to observe the autonomy of the Bundesbank, which is protected by Germany's constitution.

And the Berlin government now faces the Bundesbank's demand for an "additional macroprudential mandate" as spelled out in its Financial Stability Review of November 2010: "The crucial importance of financial stability and central banks' special position suggest that it would be appropriate to widen national central banks' mandate accordingly as a logical complement to the institutional arrangements at European level. Adding a legal mandate for macroprudential oversight and policy to the Bundesbank's current range of tasks through a corresponding amendment of the German Banking Act would strengthen and safeguard its role in national, European and international stability policy."

It took the coalition reformers until December 16, 2010, to bury their long-held election promise to put BaFin under Bundesbank control.

"The coalition reaches agreement on key points for national financial market supervision reform," read the press release. It was signed by three members of the Bundestag: Leo Dautzenberg, Bartholomäus Kalb, and Michael Meister, key negotiators of the governing CDU/CSU. They put out a ten-point outline under which the Ministry of Finance should draft a reform bill this summer.

"The mountain moved for a year with a lot of commotion and what came out was a mouse, a nice write up on the status quo," admits a senior finance ministry official. While the political outcome is far below expectations, the Merkel government seems to demonstrate political inability to take consistent action toward reforming the supervisory system in Germany.

Under the ten-point reform outline, Bafin will get—what a change—more supervision authority since it will also acquire new responsibilities, for instance for the Financial Market Stabilization Fund under the act on the restructuring and orderly resolution of credit institutions. As Sanio points out, "Our staff now numbers about two thousand, and there is authority to hire two hundred more."

Stephan Paul, who teaches banking at Bochum University and has done ample research on financial market supervision in Germany, warns, "In the future we will see problems in the division of labor in banking supervision between BaFin and the Bundesbank." And his colleague Dirk Schiereck, who teaches banking at the Technical University of Darmstadt, says, "It is a riddle how the split of responsibilities between BaFin and Bundesbank will work under the new compromise agreement. This hasn't worked in the past and will not be improved under the new law."

Professor Martin Hellwig of the Max Planck Institute, who has authored several expert papers on financial market supervision, points to the dismal record of finance ministers in their role as heads of government-controlled supervision agencies like BaFin in the run-up to the financial crisis. They tended to misuse their authority in a framework of mercantilist policies to push for more deregulation. They neglected the risk of the coming financial crisis. In this context, reckons Hellwig, the case for supervisory independence from the government becomes more compelling, but the integration of supervision into the central bank might well compromise the central bank's monetary policy.

For Germany's "Council of Experts" (Sachverständigenrat) who presented their annual report in November 2010, such legal, administrative, and constitutional issues are less important. As in their previous reports, they continue to ask for the "full integration of financial

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market supervision into the Bundesbank" and warn that this "should not be delayed any further." But the economists also admit that in spite of the lessons of the financial crisis, "It's highly probable the fragmentation of financial supervision in Germany will remain."

The bitter fight between Germany's banking associations and Standard & Poor's on the proposed revised criteria for rating banks points to an alarming development. A major rating agency such as Standard & Poor's now takes the view that Germany's "institutional framework" has become a negative factor for banks.

Comparing national supervisory authorities in France, Germany, Italy, and Spain, the German supervisors, especially BaFin, get a negative evaluation "for failing to take early, preemptive action on banks which were particularly badly hit by the 2007–09 financial crisis," says the Committee of German Banking Associations, or ZKA. "Supervisors intervened only when the banks were no longer able to meet minimum regulatory standards (e.g., Tier 1 capital and solvency ratios)."

In response to a Standard and Poor's request to comment on rating methodology changes, the ZKA argues: "Both the regulatory culture in Germany and BaFin's own understanding of its role require BaFin, as the regulator responsible for taking any interventionary measures, to operate strictly within its legal remit. This means that it refrains from intervening or interfering in a bank's business activities unless there is a legal basis for it to do so. Until 2009 there was no legal basis for far-reaching intervention unless a breach of minimum regulatory standards had already occurred. BaFin cannot, therefore, be criticized for taking action only at a comparatively late stage."

Some outstanding banking and capital market experts characterize this line of defending Germany's supervision failures as acting "penny wise and pound foolish."

In the view of the ZKA, markets and rating agencies should not overlook the reform measures taken in response to the banking crisis. In extensive amendments made in 2009 to the German Banking Act, supervisors can now take action at an early stage—for instance, if it seems likely that a bank will be unable to meet major regulatory capital and liquidity requirements. BaFin has recently instructed banks to submit details of their long-term capital planning so that it can assess whether they will able to meet the new, more stringent Basel III requirements.

This shows, in the view of the ZKA, that "BaFin's new, more extensive and proactive powers have not only been enshrined in law but are already being acted upon."

Since the new conservative–pro-business coalition under Angela Merkel first came into power, major actors in the "Tear down BaFin" drama are leaving or have left the stage, and others are taking charge.

Jens Weidmann

Sabine Lautenschläger-Peiter

New Team

The surprising Merkel appointments for the Bundesbank: **Jens Weidmann,** the Chancellor's economic advisor and a former Bundesbank department head, will get the Bundesbank presidency. And—a big surprise—**Sabine Lautenschläger-Peiter,** BaFin's executive director for banking supervision, will become vice president of the Bundesbank, thus strengthening banking supervision and the links to BaFin.

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Axel Weber, Germany's central bank president, will step down early at the end of April 2010 after taking himself out of the running to succeed Jean-Claude Trichet as president of the European Central Bank. Franz-Christoph Zeitler, the Bundesbank's chief negotiator on supervision reform and responsible for banking supervision on the board, also will step down in May of this year as his term runs out. Leo Dautzenberg, the finance spokesman of the CDU/CSU and chief negotiator on the financial supervision reform, left the parliament in order to take a high-paying lobbyist job.

What has also changed are the surprising Merkel appointments for the Bundesbank. Jens Weidmann, the Chancellor's economic advisor and a former Bundesbank department head, will get the Bundesbank presidency. And—a big surprise—Sabine Lautenschläger-Peiter, BaFin's executive director for banking supervision, will become vice president of the Bundesbank, thus strengthening banking supervision and the links to BaFin.

There is a good chance that Lautenschläger will be working with a former colleague as the new BaFin president. BaFin's director for insurance supervision, Thomas Steffen, was called from BaFin to the Ministry of Finance and is rumored to return as the new BaFin president should Jochen Sanio—as some expect—retire this year. ◆