Germany's Fight Over *BaFin*

BY KLAUS C. ENGELEN

The ramifications of a Bundesbank takeover.

In Germany these days, strange things are happening in the effort to reform financial market supervision.

When the Social Democrats were voted out of power in the federal elections last September, Germany's integrated financial watch dog, the Federal Financial Supervisory Authority (BaFin), lost its political protectors. Modelled after the British Financial Services Authority, BaFin is falling victim to those conservative and liberal politicians who from the beginning almost a decade ago had been rejecting a German version of the FSA, opting instead to put banking supervision under the umbrella of the Bundesbank. "Tear down BaFin," seems to be the battle cry of the new German government.

Thus, the new center-right majority in Berlin—with strong support from the states governed by CDU/CSU/FDP, whose taxpayers are suffering very much under ailing Landesbanks—wants to undo the failure of the once-mighty Bundesbank to become the leading bank supervisor. This goes back to the beginning of the decade, when then-finance minister Hans Eichel (SPD) pushed through his single-regulator concept for financial market supervision. As Europe's largest economy and financial market rejected the concept of central bank oversight, the weight in European financial market supervision was shifting towards decentralized financial regulators responsible to

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Just after the election, in a stunning pre-emptive strike, **Axel Weber,** *Germany's central bank president, put forward a reform plan under which the Deutsche Bundesbank would assume full authority to supervise banks, other financial service firms, and insurance companies—that is, full integrated solvency supervision.*

elected governments and lawmakers. This shift had far-reaching consequences not only for European financial institutions and their customers, but also for many participants in world financial markets. In reforming Germany's financial system more along the lines of the British single-regulator model, Eichel was leading the way towards what became the "Lamfalussy Process"—an approach to the development of financial service industry regulation used by the European Union. Originally developed in March 2001, it is named after Alexandre Lamfalussy and is comprised of four levels, each focusing on a specific stage of the implementation of legislation.

BUBA'S AXEL WEBER SEES HIS CHANCE

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According to Weber's seven-point reform outline, the present "dual banking supervision" system—under which the Bundesbank essentially performs the operational banking examination in the field and BaFin acts as the enforcing arm of the government—should be terminated. BaFin would lose most of its supervisory functions and would be limited to performing "market supervision" and consumer protection. Weber argues that such a "twin-peaks model" is used in the Netherlands and Italy, and that France also intends to put insurance supervision under the Bank of France.

By having all members of the Bundesbank's managing board support his daring and unprecedented initiative, Weber lent his proposal added weight. His reform plan refers to the "complementarities" of monetary policy and banking supervision, and how his "full integration model" would result in more efficiency, how the independence of the Bundesbank could be maintained, how governance and financing should be secured, how the integration of banking and insurance supervision into the central bank's organization could be achieved, what laws must be changed to achieve this goal, and why the Bundesbank could only accept the proposed "full integration model" and would have to reject other options like an "agency solution."

By putting forward his integration model for BaFin, Weber responded to changing political winds, since the victorious conservative and pro-business parties had announced far-reaching institutional changes in financial market supervision—in particular, dismantling BaFin, since it is disliked by influential conservative and pro-business politicians in Germany as the most prominent financial market modernization project from the eleven-year reign of SPD in Germany's ministry of finance.

BANK SUPERVISION: BUBA GETS ALL

As the Free Democrats—liberal-minded, business-friendly, eager to cut taxes, and the closest Germany has come to a true Thatcherite movement——joined Chancellor Merkel's conservative Christian Democratic Union and its Bavarian sister party, the Christian Social Union, to form a center-right market-oriented coalition government, the push to make the Bundesbank the country's single banking supervisor moved high on the reform agenda. Some former and present CDU/CSU politicians have spearheaded powerful state and parliamentary opposition against BaFin and its strong-willed president, Jochen Sanio, since the federal agency opened its doors for business on May 1, 2002.

The three parties included unified banking supervision in their coalition agreement. "The working group also agreed that banking supervision is to come under the umbrella of the Bundesbank in a way that safeguards the central bank's independence," the agreement said. But BaFin should be allowed to remain located in Bonn, the working group added.

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Because the new coalition government also plans to put insurance companies under the Bundesbank's supervision, it would face legal problems under the Maastricht Treaty that precludes the European Central Bank and the European System of Central Banks from supervising the insurance sector.

Some proponents in the conservative and pro-business camps insist that the intended changes are not "purely political" but reflect important lessons from the financial crisis. Due to the collective failure in supervision, there is a need for a "new architecture." The FSA model that was developed in the United Kingdom turned out not to be an optimal solution to organizing national financial market supervision. Some see the so-called "twin-peak model" as a better solution, under which solvency supervision and market supervision would be separated. This would be more than a further evolutionary step of the pure FSA model, but would lead to a "new architecture" of financial market supervision.

It remains to be seen whether Bundesbank president Weber will get from the new German government what he wants—full authority to supervise banks, other financial service firms, and insurance companies in what he calls an "integration model." It is hoped that the new German government and the parliamentary majority in the Bundestag will discover in time the conflict-of-interest quagmire into which the Bundesbank would sink should it follow Weber's plan of full integration.

BANKING COMMUNITY ADJUSTS— BY REVERSING ITS LONG-HELD POSITION

In a stunning reversal of their long-standing position that "dual supervision" by BaFin and Bundesbank had served Germany well, even in the worst financial crisis in generations, the major banking associations came out with statements in support of putting banking supervision under the umbrella of the Bundesbank. This way, the Association of German Banks, the German Savings Bank Association, the Association of German Public Sector Banks, and the Association of Cooperative Banks adjusted to the new political realities.

"A concentration of banking supervision with the Bundesbank offers the chance of delivering a comprehensive supervision," says Matthias Bergner, head of banking supervision at the German Savings Bank Association. "BaFin's focus on single financial institutions and the Bundesbank's focus on financial stability can be put together to create a larger picture. But in putting both organizations together, one has to be careful to preserve their specific strengths. All legal questions must be answered. The independence of the Bundesbank in its monetary policy should not be compromised."

Such official statements of support were mitigated by big question marks that experts from the banking associations are privately expressing. "Weber and the Bundesbank have missed the chance to lay down the conditions under which the central bank would be able to act resolutely in confronting bank failures and assuming full accountability for its actions," says a high-ranking bank association expert. Another expert characterizes the Bundesbank's plan for full control of banking and insurance supervision as "presenting a concept on how to pick up all incoming grenades and throw them to the German finance ministry to handle."

When leading bankers, accountants, and academics discussed the planned changes in financial supervi-

Axel Weber and his top colleagues should look at the dismally damaged reputation of the Federal Reserve, the result of its role in banking supervision.

After assuring his top management and staff that he would not—as some expected—take retirement at age 63 next year but stay on to defend the organization's interests, BaFin President **Jochen Sanio** is hitting back at the new government. BaFin won't accept losing its independence through a takeover of banking and insurance supervision by the Bundesbank, warned Sanio in a rare interview with *WirtschaftsWoche.*

—K. Engelen

Buba's Failures

One reason for the stunning move by the new German government to dismantle BaFin and put banking and insurance supervision under the central bank may be that even some political proponents of change—such as the German public at large—fell victim to the gross misconceptions peddled by a splendidly performing Bundesbank PR machine. And these were not challenged by failing financial market watch dog BaFin, whose president has been muzzled by his superiors, the Berlin Ministry of Finance.

When the fallout from the U.S.-led subprime disaster claimed its first German victim, Dusseldorf-based IKB, there was a lot of finger-pointing by insiders in the direction of the Bundesbank. "As part of the regular banking supervision procedures, it was the responsibility of the Bundesbank to detect and signal alarm at the extraordinarily high credit commitments item in IKB's annual report," says a former banking examiner. "There must have been a lot of red faces at the Bundesbank when IKB had to be rescued."

But as in subsequent banking failures, BaFin, not the Bundesbank, got the blame for not having detected much earlier how bank managers and their often distinguished supervisory boards were playing casino with their institutions and the whole financial system.

And when three opposition parties—the Greens, the Liberals, and the Linke—got the opportunity to grill the former "grand coalition" in a parliamentary investigation into the Hypo Real Estate mega-meltdown, the image-makers of Angela Merkel's chancellery and Peer Steinbrück's Ministry of Finance in Berlin, along with the Bundesbank's PR machine in Frankfurt, worked hand-in-hand to paint BaFin and its president Sanio into the villain corner. This was the strategy to minimize potential damage in a federal election campaign. This may explain why—so far—opposition Social Democrats have kept silent as their political adversaries tearing down the most important modernization project of eleven years of SPD financial sector policy.

From the Bundesbank's perspective, this was a clever tactic in preparing for the dismantling and takeover of BaFin. From the perspective of the politicians in power, one may get the impression that humiliating and punishing a once-proud federal agency and its top management is used as a distraction from their own dismal failures.

—K. Engelen

Deutsche Bundesbank

sion at a conference in November 2009 organized by the Bavarian "Finanz Zentrum" in Munich, Wolfgang Gerke, Germany's leading banking professor, didn't mince his words. He characterized the shift of BaFin to the umbrella of the Bundesbank as "mere actionism" that fails to tackle the most urgent problems in Germany's financial market supervision. Said Gerke, "We need better training and pay for supervisors so they can deal with their financial industry counterparts on equal footing." At the conference, Michael Kemmer, CEO of BayernLB, warned the Bundesbank and the government that changing the supervisory structure "will add to the uncertainties in a highly volatile and difficult banking environment."

From the financial industry associations, only Germany's powerful insurance industry openly criticized the Weber proposals and the new government's plans. Jörg von Furstenwerth, head of the German Insurance Association, articulated the insurance sector's concern that joint supervision of insurance companies and banks will cause problems when banks need to be rescued, since around 60 percent of insurance companies' investments are placed with banks. "We are the largest creditor of the banks," says von Furstenwerth. "Either the Bundesbank protects the creditors or the banks, or we get lousy compromises. We have to avoid this conflict of interest." He continues: "To supervise the insurance industry, we need special insurance experts and cannot work under banking supervision rules. Mixing different supervision philosophies would bring new problems and increase insecurity."

Yet before the Social Democrats were voted out of power, the major spokesmen for Germany's banking

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community and the president of the Bundesbank were quoted in the press extensively praising how well Germany's "dual supervision" system had been functioning even in times of crisis. And at every opportunity, Weber made the point of how closely and efficiently he has been working together on bank rescue operations with Jochen Sanio, BaFin's president.

BAFIN PRESIDENT JOCHEN SANIO HITS BACK

As head of a federal agency supervised closely by the Ministry of Finance, Jochen Sanio is not in a position to talk as freely as Weber or, for that matter, former finance minister Peer Steinbrück, who had to deal with Germany's major banking failures.

Sanio heads a federal agency with offices in Bonn and Frankfurt, with approximately 1,700 employees. BaFin supervises about 2,700 banks, 800 financial services institutions, and over 700 insurance firms. Established under the Law on Integrated Financial Services Supervision (FinDAG) enacted in April 2002, BaFin combines the former Federal Banking Supervisory Office (Bundesaufsichtsamt für das Kreditwesen), the Federal Supervisory Office for Securities Trading (Bundesaufsichtsamt für den Wertpapierhandel) and the

Bundesbank: Political Dumping Ground

Since Europe's biggest economy suffered cruelly in the financial crisis largely because public-sector Landesbanks experienced huge losses in toxic securities, Germany's weak governance and supervision structures have become evident to global observers. The continuing politicization of the country's central bank is further damaging Germany's international reputation. Yet the FDP—who sharply criticized the politicization of the Bundesbank leadership during more than a decade in opposition—are also using the central bank managing board as dumping ground for veteran members of parliament. Carl-Ludwig Thiele, a member of the Bundestag, is set to replace Hans Georg Fabritius on the Bundesbank's executive board when his term expires in April. The term of fellow board member Hans-Helmut Kotz will also expire. Three state governments, all governed by the center-right Christian Democratic Union, will vote on Kotz's replacement.

As spokesman on fiscal policy, Thiele, a lawyer without international experience, has served on the budget committee of the Bundestag and on the BaFin's supervisory board. Thiele would become the third former politician to join the six-member Bundesbank managing board, following Thilo Sarrazin (SPD) and Rudolf Böhmler (CDU).

Handelsblatt, Germany's business and financial daily, found sharp resistance to the notion of the Bundesbank's board becoming overly politicized. Fears are spreading that the encroaching politicians could hamper the central bank's ability to serve as Germany's banking regulator if responsibility is shifted fully to the Bundesbank. Thiele is known as a vociferous critic of BaFin, but was not aware of how Germany's banks, particularly the Landesbanks, were playing casino on global markets at a cost of hundreds of billions of euros to German taxpayers. On the contrary, he relentlessly pushed for more deregulation and for trimming public-sector bureaucracy to the bone.

After the current reshuffles, the Bundesbank's managing board will have no one—except of BuBa President Axel Weber—with international experience. Some therefore are pushing Gerd Häusler, who formerly had the Liberal Party's backing, as a candidate. Häusler formerly served on the Bundesbank council before joining the managing board of Dresdner Bank, then becoming head of the capital markets division of the International Monetary Fund. He then joined the investment bank Lazard and is now a managing partner of the international private capital firm RHJ.

Thilo Sarrazin

Sarrazin, a former senator for finance for the state of Berlin, has courted controversy recently by making racist remarks. He has since been stripped of responsibility for the Bundesbank cash management division. Board members are each responsible for various functions of the Bundesbank and are expected to represent the institution at international central banking events.

—*K. Engelen*

Federal Insurance Supervisory Office (Bundesamt für das Versicherungswesen).

After assuring his top management and staff that he would not—as some expected—take retirement at age 63 next year but stay on to defend the organization's interests, Sanio is hitting back at the new government. BaFin won't accept losing its independence through a takeover of banking and insurance supervision by the Bundesbank, warned Sanio in a rare interview with *WirtschaftsWoche.* He "cannot see any sound reason" for putting banking and insurance supervision under the Bundesbank. "The division of labor (between BaFin and the Bundesbank) is spelled out in all detail in respective rules and directives and things are moving without a hitch," says Sanio. "I cannot see a more efficient way to organize German banking supervision." And he pointed out: "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." The Bundesbank would have to yield some of its independence by submitting itself to political control as financial market supervisor, warns Sanio.

DRASTIC CHANGES, BUT ON WHAT EMPIRICAL BASIS?

Looking from an international perspective, some recent developments surrounding the dismantling of BaFin are incomprehensible.

First, imagine this. Suppose the Federal Reserve, the Bank of England, or the Bank of Japan came out with a reform proposal to their respective governments to put banking and insurance supervision under the umbrella of the central bank since—in the view of the managing boards of these central banks—they could do a better job. Is this how a developed parliamentary democracy is supposed to work? But this is what is happening in Germany lately.

Second, the proponents of dismantling BaFin and putting banking and insurance supervision under the Bundesbank are tearing down part of the existing financial market supervision structure without providing any credible research into the performance of Germany's "dual banking supervision" leading up to and during the worst financial crisis in modern times.

Third, the proponents of change do not provide any impact studies on how far reform could go against an emerging EU system under which central banks get more authority in macro-prudential systemic risk surveillance, but leave the operational banking and insurance supervision to the existing supervision authorities.

"It is noteworthy that the proposal is being presented without having been preceded by an analysis as to whether the current supervisory structure aggravated the impact of the financial crisis in Germany," writes Bernhard Speyer, financial market supervision expert at Deutsche Bank. "Even a cursory glance at this issue would seem to suggest that such an analysis is unlikely to yield an unequivocal result. On the one hand, it can be noted that, up until now, both BaFin and the Bundesbank have been active in a day-to-day supervision and, *prima facie,* it is not evident that possible failures have been concentrated at BaFin." (See box, "BuBa's Failures.")

At a time when the proponents of far-reaching institutional change—including the Bundesbank—are calling for more transparency and better governance in the G20 and EU process of reforming financial market regulation, they have not so far provided any credible research on, for instance, how BaFin and the Bundesbank have performed in the run-up and during the still-smouldering financial sector crisis.

And the most recent research on BaFin's performance—the German Institute of Economic Research survey, commissioned by the Ministry of Finance, in which 808 banks were questioned in the summer of 2006 about their experience with BaFin—zoomed in on instances of "overregulation" or "rigidities" in oversight. This was done at a time when politicians, central bankers, and supervisors were accommodating the financial services industry with more and more deregulation. And it appeared that for some banks, BaFin appeared too strict and not accommodating enough.

Also, when the former coalition government—including the Social Democrats—moved to abolish BaFin's "presidential" system and replace it with a five-person "Board of Executive Directors" in 2007, there was no talk of dismantling BaFin and put banking and insurance supervision under the umbrella of the Bundesbank.

Deutsche Bank's financial regulation expert Speyer has some good advice for the Bundesbank and its ambitious president. Axel Weber and his top colleagues should look at the dismally damaged reputation of the Federal Reserve, the result of its role in banking supervision.

"TEAR DOWN BAFIN" DAMAGES "FINANZPLATZ GERMANY" INTERNATIONALLY

Speyer questions the new German government's plans based on the Weber proposals—leaving aside the "perennial, but by no means trivial issue of a potential conflict of interest between monetary policy and supervisory responsibility."

This conflict of interest is dramatized not only when the Bundesbank shows up on Lehman Brothers' creditor list with claims of more then US$10 billion. These conflict of interest problems have developed into staggering dimensions as central banks have used balance sheet expansion to absorb gigantic amounts of securitized debt paper in order to save their banking systems.

"The solution apparently favored by the advocates of change—to have the Ministry of Finance endorse critical supervisory decisions on a case-by-case basis—is hardly convincing," argues Speyer. "Not only does it erroneously suggest that only critical decisions would raise the question of compatibility of sovereign power and autonomy, but the proposed solution also looks strikingly similar to current arrangements in which BaFin, acting on behalf of the Ministry, issues orders prepared by the Bundesbank."

If supervisory powers were transferred to the Bundesbank, full transparency and control of the budget for supervisory work would need to be ensured, argues Deutsche Bank's Speyer. It would not be acceptable if the Bundesbank maintained its long-held stance that its budget is off-limits to control by a court of auditors.

But there are other implications to the new institutional changes that, so far, neither the proponents of change in the ruling parties nor the ailing German banking sector and its industry representatives have yet on their screen. "The proposed reform would kill the sensible approach of a comprehensive, integrated supervisory structure, which was the philosophy underlying the creation of BaFin—and this in spite of the fact that the crisis has underlined the close interconnection between banking, insurance, and securities markets," argues Speyer. "It is hard to see how comprehensive monitoring of the risks in all financial market segments can be organized more effectively in the new structure than within BaFin."

Now that the spirit of reform is out of the bottle, the debate will paralyze Germany's supervisory agencies with changes to organization and personnel. As resources are tied up, it will guarantee that Germany—with Europe's largest financial market—will continue to have little to contribute to supervision reform in Europe.

Judging from experience of the battles fought with those powerful state governments who objected to a single regulator and wanted to put banking supervision under the Bundesbank because they wanted to secure more political influence, importance, and employment on the regional level, I see much darker implications.

Germany—because of its still-smouldering Landesbank disaster and the ominous implications of the G20 demands to substitute large parts of its banking systems capital base—is under international observation as never before.

The moment when the Anglo-Saxon markets perceive the hasty move as a ploy by the conservative and pro-business majority to better shield its ailing financial sector, hell might break loose. Only then will some of the proponents of change in Berlin's ruling parties and their ambitious friends at the Bundesbank realize how much they are damaging "Finanzplatz Germany" and undermining the critical modernization of the EU financial market supervision structures after the worst financial crisis in generations.

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SOME ADVICE

Here is some advice to new German finance minister Wolfgang Schäuble: Don't be pushed by an ambitious Bundesbank president into tearing down the seven-year-old BaFin. Contrary to prevailing perceptions among some governing politicians, BaFin and Sanio have achieved world-class standing, particularly in their role as key negotiators in the respective international bodies.

Take time to commission truly independent research into what went wrong with banking supervision in the context of the "dual supervision" system of BaFin and the Bundesbank. Unlike other major economies hit by the crisis, Germany has not yet done its homework. Use the not-yet-transparent facts to tell the public what went wrong with financial market supervision in Germany.

Schäuble has indicated that he is not rushing things. There are hints from the finance ministry that preliminary supervision reform proposals will be presented no sooner than in the second half of this year. As for dismantling BaFin, the new Berlin coalition would prefer to postpone bad news until after the May elections in the biggest German state of North Rhine-Westphalia. ◆