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Legal Aspects of Unified Financial Services Supervision in Germany

*By Kenneth K Mwenda**

A. Introduction

This paper examines recent institutional and structural developments relating to unified supervision of financial services in Germany. The main thrust of the academic debate concerning unified supervision of financial services was started in the UK.[1] More recently, international organizations have taken an interest in the subject.[2] Some of the issues confronting countries the world-over with respect to the unified supervision of financial services are whether to adopt unified supervision and, if so, how to structure the institutional and regulatory framework for unified agencies. At the outset, it must be pointed out that issues of regulatory organization are essentially second order issues. Far more important—and the first order issue—is the implementation of financial regulation, in particular supervisory capacity and its quality and the soundness of the legal framework underlying the regulatory process.

Over the years financial regulation and supervision, in many countries, has been organized around specialist agencies that have distinct and separate responsibilities for the banking, securities and insurance sectors. But there has been an apparent trend towards restructuring the financial supervisory function in many countries in

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[1] *See*, for example, views presented in conference papers presented at a conference in Estonia, Tallin, 2001, appearing in the following publication: The World Bank and Ministry of Finance of the Republic of Estonia, *Challenges for the Unified Financial Supervision in the New Millennium*, (Tallin: Ministry of Finance, 2001).

[2] For example, the World Bank has provided technical assistance to a number of its member countries on this matter. Also, the International Monetary Fund, Asian Development Bank and USAID have shown interest in the subject.

recent years, and in particular unified regulatory agencies—that is, agencies that supervise two or more of these areas.[3] A number of papers and commentaries have been written on the subject of unified supervision of financial services, highlighting, in part, the advantages and disadvantages of unified supervision of financial services.[4] Further arguments on the advantages of a unified model have been advanced by scholars such as Briault.[5] These arguments relate to issues such as economies of scale and scope that arise because a single regulator can take advantage of a single set of central support services; increased efficiency in allocation of regulatory resources across both regulated firms and types of regulated activities; the case with which the unified regulator can resolve efficiently and effectively the conflicts that inevitably emerge between the different objectives of regulation; the avoidance of unjustifiable differences in supervisory approaches and the competitive inequalities imposed on regulated firms through inconsistent rules which have arisen across multiple specialist regulators; and, if a unified regulator is given a clear set of responsibilities then it should be possible to increase supervisory transparency and accountability.[6] This paper, taking a different approach, builds on that work and on other related papers to take stock of various developments relating to

[3] *See*, for example, case studies in: The World Bank and Ministry of Finance of the Republic of Estonia, *Challenges for the Unified Financial Supervision in the New Millennium*, (Tallin: Ministry of Finance, 2001).

[4] See, for example, the bulk of the literature reviewed in the following papers: K.K. Mwenda and A. Fleming, *International Developments in the Organizational Structure of Financial Services Supervision: Part I*, 16 JOURNAL OF INTERNATIONAL BANKING LAW No. 12 (2001); K.K. Mwenda and A Fleming, *International Developments in the Organizational Structure of Financial Services Supervision: Part II*, 17 JOURNAL OF INTERNATIONAL BANKING LAW No.1(2002); and, K.K. Mwenda, Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries, 10 TILBURG FOREIGN LAW REVIEW No.2(2002).

[5] *See*, C. Briault, "The Rationale for a Single National Financial Services Regulator," Occasional Paper Series No. 2, (London: Financial Services Authority, May 1999).

[6] *See*, C. Briault, "The Rationale for a Single National Financial Services Regulator," Occasional Paper Series No. 2, *Ibid.* In another paper, Briault (see, C. Briault, *A Single Regulator for the UK Financial Services Industry*, FINANCIAL STABILITY REVIEW (November 1998)), observes that the benefits of a unified regulator include the harmonization, consolidation and rationalization of the principles, rules and guidance issued by the existing regulators or embedded within existing legislation, while recognizing that what is appropriate for one type of business, market or customer may not be appropriate for another; a single process for the authorization of firms and for the approval of some of their employees, using standard processes and a single database; a more consistent and coherent approach to risk-based supervision across the financial services industry, enabling supervisory resources and the burdens placed on regulated firms to be allocated more effectively and efficiently on the basis of the risks facing consumers of financial services; a more consistent and coherent approach to enforcement and discipline, while recognizing the need for appropriate differentiation; and, in addition to a single regulator, single schemes for handling consumer complaints and compensation, and a single independent appeals tribunal. *See, also*, M. Taylor and A. Fleming, *Integrated Financial Supervision: Lessons from Northern European Experience*, Policy Research Working Paper 2223, p. 11 (Washington DC: The World Bank, 1999).

the organizational structure of financial services supervisory agencies.[7] It seeks to provide a perspective on the structural issues confronting the supervision of financial services in Germany.

The paper argues that until there is a longer track record of experience with unified agencies it will be difficult to come to firm conclusions about the optimal structure of such agencies. In some countries, and for various reasons, some of which are political, the unification of all the major financial services regulatory bodies is desirable whereas it might not be appropriate to do so in a country that has a financial sector with limited inter-connectedness among the various sector components and, further still, where there is no practice of universal banking nor evidence of conglomerates. There are some countries that benefit better from unification of only a few regulatory agencies. For example, the unification of the two agencies responsible for the supervision and regulation of pension funds and insurance businesses in Poland, on 1 April 2002, contributed to the strengthening of the Polish financial services regulatory framework.[8] Every framework must be structured, therefore, with the objective of meeting the challenges of the financial sector of that particular country. So, what, then, is the ideal structure of a unified financial services regulatory agency? There is no hard-and-fast or rigidly-fixed answer regarding the structure of a unified financial services regulator. Different countries have taken different routes and approaches. The reasons for these differences are varied and they include ideological, historical, economical and political factors.

B. Methodological Issues and the Discourse

An exploratory examination of some of the more recent contributions to the debate on unified supervision of financial services is provided in this section and the next. The analysis shows that unified supervision of financial services has been adopted differently in many countries and that its application has varied from country to country. There is, indeed, no single right way of introducing or implementing unified models of supervising financial services . In Africa, for example, Mauritius has legislation, which provides for the establishment of that country's unified financial services regulatory agency.[9] South Africa, too, has a model of [partially] unified

[7] See, for example, papers cited above in supra. (n.4), and those that are referenced in the section of this paper under the head, 'Review of the Literature and Some Country Developments'.

[8] See, K.K. Mwenda, *Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries*, TILBURG FOREIGN LAW REVIEW, *op cit*.

[9] The Financial Services Development Act 2001.

supervision of financial services.[10] In the case of South Africa, the securities and insurance sectors have a common regulator, while banks are regulated by a specialist agency. In Nigeria, the regulation of pension funds and banking business is undertaken within the same regulatory agency, while the regulation of securities and insurance business is done by separate agencies.[11] Zambia is another African country that has a partially unified supervisory system.[12] While the Central Bank of Zambia regulates financial institutions such as banks, building societies and bureau de change, the Zambia Securities and Exchange Commission is responsible for securities regulation. A newly established Pensions and Insurance Authority in Zambia regulates the business activities of pension funds and insurance companies. The experience of Africa, hitherto, shows that a good number of African countries are leaning towards partial unification.[13]

Worldwide, experience shows that in order for a country to manage effectively the transition to a unified supervisory agency, one of the factors to consider include the effective and efficient co-ordination of information sharing among the major stakeholders in the unified supervisory system, namely, the Ministry of Finance, the central bank, and the unified supervisory agency.[14] Also, if there is an independent deposit insurance agency and an independent payments and settlements clearing agency, they, too, must be consulted.[15] Co-ordination and consultation here provides for efficient means of sharing information between the various stakeholders.

Indeed, different countries have approached the introduction and implementation of the unified supervision of financial services differently. In those countries where segments of the financial sector are quite inter-connected, a good case of moving towards unified supervision exists. In these countries, the nature of banking and

[10] See K.K. Mwenda and A. Fleming, *International Developments in the Organizational Structure of Financial Services Supervision: Part I*, 16 JOURNAL OF INTERNATIONAL BANKING LAW No. 12 (2001); and, K.K. Mwenda and A Fleming, *International Developments in the Organizational Structure of Financial Services Supervision: Part II*, 17 JOURNAL OF INTERNATIONAL BANKING LAW No.1(2002).

[11] *See*, *Ibid*.

[12] *See*, *Ibid*.

[13] *See*, *Ibid*.

[14] *See*, *Ibid*.

[15] *See*, *Ibid*.

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financial services business is often developing and encompasses more complex and multi-functional operations.[16]

C. Review of the Literature and Some Country Developments

A network of unified supervisors, comprising mainly supervisors from developed countries and transition economies, has now been established. Members of this network have been meeting in various parts of the world to share, among other things, some lessons on the unified supervision of financial services. In July 2001, a meeting held in Tallinn, Estonia, organized by the supervisory agency of Estonia—in collaboration with the World Bank—also brought together a group of practitioners from unified agencies.[17] A number of papers presented at this conference provided more up to date discussions on apparent trends in unified supervision world-wide.

Dr. Alex E. Fleming and I took stock of the various contributions by scholars and practitioners prior to 2001, examining the institutional and structural issues facing unified financial services agencies in the United Kingdom, Canada, Hungary, Iceland and Scandinavian countries.[18] We argued that, although a good case of moving towards unified supervision exists in countries where segments of the financial sector are quite inter-connected, until there is a longer track record of experience with unified agencies, it is difficult to come to firm conclusions about the restructuring process itself and the optimal internal structure of such agencies.[19]

Dr. Yoshihiro Kawai observed that the international body responsible for setting international standards on banking supervision differs from the international bodies responsible for setting international standards on insurance and securities regu-

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[16] In Hungary, for example, the emergence of universal banking is one of the reasons that supported the setting-up of a unified regulator, while in Norway the emergence of 'bankassurance' financial institutions gave a good case for establishing a unified regulator.

[17] The conference was organised jointly by the World Bank and the Ministry of Finance of the Republic of Estonia, focussing mainly on lessons of experience with unified supervision of financial services in Europe. Proceedings of the conference were published as, The World Bank and Ministry of Finance of the Republic of Estonia, *Challenges for the Unified Financial Supervision in the New Millennium*, (Tallin: Ministry of Finance, 2001).

[18] *See*, K.K. Mwenda and A. Fleming, "International Developments in the Organisational Structure of Financial Services Supervision," conference paper presented at a conference organised by the World Bank and the Ministry of Finance of Estonia, and held in Tallinn, on unified supervision of financial services in Europe, 2001.

[19] *See*, *Ibid.*

lation, respectively.[20] He explained that, while the Basle Committee for Banking Supervision is responsible for banking supervision standards, the International Association of Insurance Supervisors (IAIS) is responsible for insurance standards and the International Organization of securities Commissions (IOSCO) for securities regulatory standards.[21] Kawai argued that while insurance supervisors, for example, focus more on techniques for assessing "risk," securities regulators are pre-occupied with "information disclosure" requirements.[22] However, Kawai noted, in order to promote economies of scope here there is need to coordinate risk management by pulling together the efforts of all these three bodies.[23]

Mr. Andres Trink observed that it is not the institutional structure of the regulator that creates effective and efficient supervision.[24] The institutional structure, Trink explained, serves only as a prerequisite for effective and efficient financial services supervision.[25] In Estonia, as part of the preparations for setting up a unified regulator, it was argued that "in a small economy, the unified agency should first, be better able to supervise large financial groups, since the Estonian financial sector is very much dominated by a few universal banks active in all segments of the financial sector; second, be better placed to attract qualified staff and other resources to guarantee an equal level of supervision in banking, securities and insurance sectors; third, have more authority and independence to be more effective in carrying out supervision; and fourth, be better placed to prevent regulatory arbitrage."[26]

With the establishment of an integrated supervisory authority in Estonia, the Bank of Estonia will now be working closely with this new agency.[27] Mr. Vahur Kraft

[20] *See*, Y. Kawai, "Global co-ordination and collaborative activities of supervision in three different financial sectors," conference paper presented at a conference organised by the World Bank and the Ministry of Finance of Estonia, and held in Tallinn, on unified supervision of financial services in Europe, 2001.

[21] *See*, *Ibid*.

[22] See, *Ibid*.

[23] *See*, *Ibid*.

[24] A. Trink, "Challenges for Estonian financial sector unified supervision," conference paper presented at a conference organised by the World Bank and the Ministry of Finance of Estonia, and held in Tallinn, on unified supervision of financial services in Europe, 2001, at p. 3.

[25] *Ibid*. at p. 3

[26] *Ibid*. at p. 4.

[27] V. Kraft, "Tasks of financial supervision in safeguarding the financial stability," conference paper presented at a conference organised by the World Bank and the Ministry of Finance of Estonia, and held in Tallinn, on unified supervision of financial services in Europe, 2001, at p. 8.

noted, however, that the Bank of Estonia willretain the responsibility of regulating the banking sector.[28] Kraft argued that since the pan-European consolidation of the banking industry has resulted in rapid increase of cross-border ownership of banks, the question of co-operation between central banks and supervisors is now a key factor in maintaining sound financial systems.[29]

In Norway, according to Mr. Martin G. Halvorsen, one of the reasons for establishing an integrated supervisory authority was to strengthen the supervision of insurers.[30] In Ireland, by contrast, a number of factors made the reform of the Irish regulatory system a political imperative. In Ireland's case, as Mr. Michael McDowell observed, the increasing pace of integration of banking and insurance services, on an international and European level, provided an impetus for the unification of supervision of financial services.[31] A not wholly unrelated development - the establishment in Dublin of the International Financial Services Centre (IFSC), also contributed as an impetus for the unification of supervision of financial services in Ireland.[32] A third factor was the public perception in Ireland that financial regulation was being conducted by the central bank and by the insurance regulatory mechanism with a primary focus on solvency and prudential matters and with very little emphasis on the interests of consumers of the services provided.[33] There was a perception in Ireland, according to McDowell, that value for money and consumer rights had been subordinated unduly to the interests of stability and solvency.[34] Taking into account all these factors, McDowell argued that smaller states, by necessity, cannot afford to have very complex or costly regulatory institutions and systems.[35] In financial terms, the burden of regulation has to be kept under control. Even so, the experience of Ireland shows that there is no single stereotype model

[28] *Ibid*. at p. 8 .

[29] *Ibid*. at p. 9.

[30] M. G. Halvorsen, "The Process of Merging Different Supervisory Agencies," conference paper presented at a conference organised by the World Bank and the Ministry of Finance of Estonia, and held in Tallinn, on unified supervision of financial services in Europe, 2001, at p. 4.

[31] M. McDowell, "Challenges for unified financial supervision: experience of Ireland," conference paper presented at a conference organised by the World Bank and the Ministry of Finance of Estonia, and held in Tallinn, on unified supervision of financial services in Europe, 2001, at p. 4.

[32] *See*, *Ibid*.

[33] *See*, *Ibid*.

[34] *Ibid*, at p. 6.

[35] *Ibid*, at p. 9.

for the regulation of the financial services industry.[36] Professor David T. Llewellyn adds:

"A review of international experience indicates a wide variety of institutional structures for financial regulation (see Goodhart, *et al*, 1998). Some countries (*e.g*. Sweden, Canada, Denmark, Korea, Iceland) have reduced the number of regulatory agencies and in some cases (UK, Iceland, Korea, Finland, Sweden) created a single *mega* agency. Other countries have opted for multiple agencies. Differences reflect a multitude of factors: historical evolution, the structure of the financial system, political structures and traditions, and the size of the country and financial sector. With respect to the last mentioned, for instance, if there are economies of scale in regulation, a single agency might be especially appropriate for small countries."[37]

Professor Llewellyn observed that the debate on the introduction of a unified regulator in each country inevitably reflects country-specific factors and the currently prevailing institutional structure.[38] He pointed out arguments which have influenced countries to set up unified regulators, and these include the emergence of financial innovation and structural change in the financial system; the emergence of financial conglomerates; the occurrence of financial failures; the complexity and extensiveness of objectives behind regulation in some countries; the emergence of new financial markets; and the increasing internationalization of financial operations.[39] In setting up the institutional structure of a regulatory system, Llewellyn observed that a country should consider issues such as the appropriate number of regulatory agencies; the appropriate structure of regulatory agencies (that is, which firms and functions are to be allocated to which agencies, and how the objectives for each agency are to be defined); the degree of co-ordination, co-operation and information sharing between different agencies; the effect of the institutional structure on the cost of regulation; the role of competition authorities in the regulatory process; the role to be given to self-regulation and mechanisms for practitioner input; the institutional mechanisms for facilitating efficiently the international co-ordination and co-operation of national regulatory agencies; and the independence and accountability of the regulatory agencies.[40]

[36] *Ibid*, at p. 6.

[37] D.T Llewellyn, "The creation of a single financial regulatory agency in Estonia: the Global Context," conference paper presented at a conference organised by the World Bank and the Ministry of Finance of Estonia, and held in Tallinn, on unified supervision of financial services in Europe, 2001, at p. 4.

[38] *Ibid*. at p. 2.

[39] *See*, *Ibid*.

[40] *Ibid* at p. 4.

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Llewellyn proceeded to advance reasons in support of the introduction of a unified regulator.[41] On the one hand, he argued in favor of prospects for: (a) the introduction of economies of scale within the regulatory agency (most especially with respect to skill requirement); (b) the introduction of economies of scope (or synergies) to be reaped between different functional areas of regulation; (c) the introduction of a simplified single regulator whose system of operation is user-friendly to firms being regulated and to consumers as well; (d) the introduction of a regulatory structure which mirrors the business of regulated institutions; (e) the avoidance of problems of competitive inequality, inconsistencies, duplication, overlap, and gaps which can arise with a regime based upon several agencies; (f) the rational utilization of scarce human resources and expertise; (g) more effective accountability under a single (and simplified) regulatory agency; and (h) the reduction of costs imposed upon regulated firms to the extent that these firms would need to deal with only a single regulator.[42]

On the other hand, Llewellyn is quick to point out some of the possible shortcomings of a unified regulator. He observed that such shortcomings include the views that there can be: (a) erosion of traditional functional distinctions between financial institutions; (b) the lack of clear focus on the objectives and rationale of regulation (that is, not making the necessary differentiations between different types of institutions and businesses, *e.g*. the distinction between wholesale and retail business); (c) possibilities of cultural conflict in the unified agency since regulators come from different sectoral backgrounds; (d) possibilities of creating an overly bureaucratic single regulator that has excessive and over-concentrated power; (e) possibilities of creating a moral hazard that portrays a picture that the risk spectrum among financial institutions has disappeared or become blurred; and (f) possibilities of actually watering down the concept of 'economies of scale' by creating an inefficient and monopolistic single regulator.[43]

Mr. Clive Briault observed that, in the case of the UK, the four statutory objectives of UK's newly created unified regulator, the Financial Services Authority, are as follows:

(a) to maintain confidence in the financial system; (b) to promote public understanding of the financial system, including the awareness of the benefits and risks

[41] *Ibid*. at pp 7-8.

[42] *Ibid*. at pp. 7-8.

[43] *Ibid*. at pp. 9-10.

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associated with different kinds of investment or other financial dealing; (c) to secure the appropriate degree of protection for consumers, having regard to the degrees of risk in different kinds of investment or other transaction, the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity, the needs consumers may have for advice and accurate information, and the general principle that consumers should take responsibility for their decisions; and (d) to reduce the extent to which it is possible for a financial services firm to be used for a purpose connected with financial crime.[44]

While unified supervisory agencies in countries such as Denmark are not closely linked to operations of the central bank,[45] the UK Financial Services Authority cooperates closely, and exchanges information, with the Bank of England and the Treasury.[46] A Memorandum of Understanding, agreed and published in 1997, provides a framework for co-ordination of functions involving the UK Financial Services Authority, the Bank of England and the Treasury. A similar arrangement is present in countries such as Hungary.

D. The case of Germany - Unified Supervision of Financial Services

I. Germany's New Unified Supervision Scheme Introduced

This section, and the next one, examine institutional and structural developments relating to unified supervision of financial services in Germany. The decision to set up the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – Federal Financial Supervisory Authority) was made against the backdrop of fundamental changes in the financial market which called for a legislative response to secure the future stability of the German financial system. As a policy paper published by the BaFin notes:

"The BaFin has three main supervisory objectives: its paramount aim is to ensure the functioning of the entire financial industry in Germany. From this objective, two others can be inferred: to safeguard the solvency of banks, financial services

[44] C. Briault, "Building a single financial services regulator," conference paper presented at a conference organised by the World Bank and the Ministry of Finance of Estonia, and held in Tallinn, on unified supervision of financial services in Europe, 2001, at p. 4.

[45] H. Bjerre-Nielsen, "Objectives, functions and structure of the unified agency," conference paper presented at a conference organised by the World Bank and the Ministry of Finance of Estonia, and held in Tallinn, on unified supervision of financial services in Europe, 2001, at p. 11.

[46] There is a memorandum of understanding facilitating this process.

institutions and insurance undertakings - which in the past was mainly a task of the BAKred and the BAV - and to protect clients and investors."[47]

Closely related to the three objectives above, two main reasons underlie the setting up of BaFin. First, BaFin was set up as a response to the emergence of universal banking in Germany. A second and related point is that, in the past, banks and insurance companies maintained a loose inter-connectedness whereas, today, powerful financial conglomerates have emerged in Germany and they operate at a global level.[48] Examples of such conglomerates include group companies such as Allianz/Dresdner Bank and Münchner Rück/HypoVereinsbank. In terms of market capitalization, these two groups rank among the world's largest financial conglomerates.[49] The growth in the number of companies involved in inter-linked insurance and banking businesses, or what is commonly referred to as "bankassurance" groups, is expected to continue.

Although less persuasive than the two views discussed above, it is also believed that the creation of BaFin would lead to the avoidance of imbalances that could result from unhealthy competition between the various regulators, and that such competition could easily occur as a result of regulatory differences in a fragmented supervisory system.[50] The BaFin policy paper postulates further that the fact that the new German regulator is responsible for all market participants is an advantage.[51] And, with regard to foreign companies, this advantage should not be underestimated, considering that in the past these companies have had to deal with several supervisory offices when trying to offer their products in Germany.[52] The foundation of a single regulator is also expected to facilitate the exchange of information between BaFin and foreign supervisory authorities.[53]

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[47] *See*, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003.

[48] *See*, *Ibid*.

[49] *See*, *Ibid*.

[50] *See*, *Ibid*.

[51] *Ibid*.

[52] On examples of previous supervisory offices, see *Ibid*.

[53] *See*, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003..

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An argument is made in the BaFin policy paper that the voice of the new German regulator will carry more weight in international supervisory forums and, as a result, German interests can be represented more effectively at an international level.[54] According to the BaFin paper, this will help strengthen Germany as a financial centre and, as regards supervision in Germany, the new organisational structure will result in synergies.[55]

A further argument is advanced in the BaFin policy paper that the integration and merging of the former financial regulatory agencies into a single regulatory body enables the newly created body to use the know-how and experience of all the former agencies more efficiently, especially with regard to the trend towards product convergence and the emergence of financial conglomerates.[56] The policy paper notes that there is no further need for coordination between individual supervisory offices, which in the past was often time consuming and caused considerable expenses.[57] According to the BaFin policy paper, although financial services supervision is now organised around a single regulatory body this does not mean that existing sectoral differences between the banking and insurance businesses will be disregarded.[58] These differences are actually said to lead to the development of specific supervisory methods and rules, for both banks and insurance companies, which are now proving to be successful.[59]

The BaFin policy paper adds that when creating the new regulatory structure the parliament decided not to change substantive laws underlying financial services supervision in Germany.[60] These laws include the *Gesetz über das Kreditwesen* (KWG – German Banking Act) , the *Versicherungsaufsichtsgesetz* (VAG – Insurance Supervision Law) and the *Gesetz über den Wertpapierhandel* (WpHG – German Securities Trading Act). Overall, the structure of BaFin takes into account "the sectoral differences: separate organisational units were created for banking supervision, insurance supervision and securities supervision/asset management."[61] As noted in the

[54] *Ibid*.

[55] *Ibid*.

[56] *Ibid*.

[57] *Ibid*.

[58] *Ibid*.

[59] *Ibid*.

[60] *Ibid*.

[61] *Ibid*.

BaFin policy paper, cross-sectoral tasks arising out of the developments in the financial markets are carried out by several cross-sectoral departments, which are organisationally separated from the traditional supervisory functions.[62] The tasks of these departments include the supervision of financial conglomerates, the coordination of international forums dealing with financial services supervision and the fight against money laundering across all sectors. The fight against money-laundering has now become increasingly important after the terrorist attacks in New York and Washington DC.[63]

The BaFin policy paper notes also that the new German regulator, as a unified regulatory agency, is better able to develop effective rules to manage risk.[64] In addition, the new regulatory framework for Germany's financial sector contributes to strengthening Germany's position as a financial centre. Also, the framework promotes Germany's ability to compete favourably at an international level.[65]

Jochen Sanio, President of the *Bundesaufsichtsamt für das Kreditwesen* (Federal Banking Supervisory Office of Germany), adds that the objective of the law governing BaFin is to create a new federal authority for supervising financial services in Germany.[66] As pointed out above, the financial institutions supervised by BaFin include credit institutions, insurance companies, investment firms and other financial institutions.

Interestingly, the creation of BaFin resulted from the merger of separate regulatory bodies responsible for the supervision of various segments of the financial sector; that is, the Federal Banking Supervisory Office (based in Bonn), the Federal Insurance Supervisory Office (based in Bonn), and the Federal Securities Supervisory Office (based in Frankfurt). From a prudential perspective, the powers of the new integrated authority cover the supervision of all the financial institutions listed above. And, from a market supervision perspective, promoting consumer protection, market transparency and market integrity are some of the important goals of

[62] *Ibid*.

[63] As an illustration, the World Bank and the International Monetary Fund have started a pilot program of anti-money laundering (and counter-terrorist financing) assessments, using the comprehensive methodology endorsed by both the Bank and Fund Boards, and adopted by the Financial Action Task Force (FATF) for assessing compliance with the FATF 40+8 recommendations.

[64] *See*, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003.

[65] *Ibid*.

[66] *Ibid*.

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BaFin. To achieve these goals, it is contended, "What we don't want to see is the outbreak of a *Kulturkampf*, a cultural struggle between different types of supervisors who have to live under one roof. …you only need to think of the British FSA – you may ask yourself: What is so special about the new German approach?"[67] Indeed, responding to a related question, Sanio argues,

"The answer, of course, is the significant role the *Bundesbank* will play in banking supervision, and that is the reason, why I would like to call the new BAFin a 'modified' single regulator as compared to the British FSA, for example. It is interesting to compare the new German approach with the recently approved Dutch model of a cross-sector structure for financial supervision. From precisely the same reasons that in Germany made persuasively the case for a single regulator – strengthening systemic stability, prudential supervision and conduct of business – a rather different conclusion was drawn by the Dutch legislator. The Nederlandsche Bank shall remain responsible for systemic stability and for prudential supervision of banks, the Pensions and Insurance Supervisory Authority remains in charge for the prudential supervision of financial conglomerates and insurance companies. By giving market supervision to a separate supervisor, the Authority for Financial Markets, the Netherlands have committed itself to the doctrine of the separation of supervisory powers, a clear cut division, on a cross-sectoral basis, between prudential supervision and conduct of business supervision…"[68]

According to Sanio, the new German model of unified financial services supervision differs significantly from the Dutch approach in terms of how far supervision is integrated.[69] Sanio argues that Germany has set sail to full cross-sectoral supervision, combining both prudential and market aspects.[70] To that extent, Sanio observes that Germany's new approach to financial services supervision could be described as a single regulator model, even though "the new regime has its particularities which have been tailored to meet the specific German needs which are often very complex."[71]

[67] Jochen Sanio, President of the *Bundesaufsichtsamt für das Kreditwesen* (Federal Banking Supervisory Office of Germany), "The new Single Regulator in Germany," speech given at the Banking Supervision at the Crossroads Conference of De Nederlandsche Bank, Amsterdam, April 24th, 2002, pp. 1-2.

[68] *See*, *Ibid*., pp.1-2.

[69] *See*, *Ibid*., pp.1-2.

[70] *See*, *Ibid*., pp.1-2.

[71] *Ibid*., pp.1-2.

II. The Institutional and Structural Elements of Germany's New Unified Supervision Scheme

BaFin was set up pursuant to the Law on Integrated Financial Services Supervision in Germany. This law was adopted by parliament on 22 April 2002. And, on 1 May 2002, BaFin was formally established.[72] BaFin is a federal institution[73] and is part of the portfolio of institutions under the Federal Ministry of Finance, although it has its own separate legal personality.[74] Its two offices are located in Bonn and Frankfurt/Main, and it employs about 1,000 staff.

Although BaFin is the primary regulatory agency, it co-operates closely with *Deutsche Bundesbank*.[75] *Deutsche Bundesbank* is, in turn, responsible for the ongoing supervision of credit institutions and communicates any relevant data to BaFin.[76] Overall, BaFin supervises about 2,700 banks, 800 financial services institutions and over 700 insurance undertakings.[77]

1. Governance structure of BaFin

a) Administrative Council

This body supervises the executive level of BaFin and advises it on how to achieve the organisation's goals and tasks.[78] In addition, the Council decides on the budget

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[72] Freshfields Bruckhaus Deringer, THE FINANCIAL SERVICES SECTOR IN EUROPE: REGULATORY INVESTIGATION AND ENFORCEMENT ISSUES IN GERMANY, (Frankfurt am Main: Freshfields Bruckhaus Deringer, 2002), executive summary.

[73] *See*, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003.

[74] *See*, *Ibid*.

[75] Freshfields Bruckhaus Deringer, THE FINANCIAL SERVICES SECTOR IN EUROPE: REGULATORY INVESTIGATION AND ENFORCEMENT ISSUES IN GERMANY, *op cit*., executive summary.

[76] *See*, *Ibid*.

[77] See, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003.

[78] *See*, *Ibid*.

of BaFin.[79] This budget is almost completely funded by levying supervision and licensing fees on market participants (mainly, companies that BaFin supervises).[80]

The Council is composed of 21 members and comprises representatives of the Federal Ministry of Finance and other ministries, members of the German Bundestag (Lower House of Parliament) as well as representatives of credit and financial services institutions and insurance companies.[81] The Council is chaired by the Federal Ministry of Finance.[82]

b) Advisory Board

The Advisory Board comprises representatives of financial enterprises and consumer protection associations as well as academic parties.[83] The principal function of the Board consists in providing general advice to BaFin and - beyond its specific mandate - giving recommendations on the further development of supervisory practice.[84] The Board provides a framework for the industries concerned, consumer protection associations and academic parties to become involved in the work of BaFin.[85]

c) Management

The management of BaFin is undertaken mainly by the President and the Vice President of the organisation.[86]

2. Functional units of BaFin

BaFin has three supervisory directorates, each headed by a First Director.[87] These directorates perform the supervisory tasks of the three formerly separate supervi-

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79 *See*, *Ibid*.

80 *Ibid*.

81 *Ibid*.

82 *Ibid*.

83 *Ibid*.

84 *Ibid*.

85 *Ibid*.

86 *Ibid*.

87 *Ibid*.

sory offices.[88] The directorates do not, however, deal with cross-sectoral issues. Such issues are assigned to three cross-sectoral departments.[89] In a essence, the German model offers a twin pillar system with a silos matrix, on the one hand, constituted by the supervisory directorates, and a functional matrix, on the other, constituted by the cross-sectoral departments. The supervisory directorates of BaFin include the following.

a) Banking Supervision

The first directorate has regulatory powers that deal with solvency-oriented aspects of supervising banks.[90] The Banking Supervision directorate aims at securing the functioning of the banking industry in order to keep the economy stable, while at the same time providing maximum protection to clients for the capital they have deposited with banks.[91] Banking supervision in Germany is essentially based on the German Banking Act (KWG) as well as on specific legislation such as the *Hypothekenbankgesetz* (Mortgage Bank Act) () and the *Bausparkassengesetz* (Building Societies Act) . As noted in the BaFin policy paper discussed above, the *Deutsche Bundesbank* will continue to be involved in the ongoing supervision of banks in accordance with Section 7 of the Banking Act,[92] and that "the tasks of the directorate for Banking Supervision are manifold, given that banks have to meet many legal requirements before they are allowed to provide banking services."[93] For example, the BaFin policy paper notes that banks must comply with capital adequacy requirements and have an appropriate organisational structure as well as at least two professionally qualified and reliable managers before they can be authorised to carry-out banking business.[94] BaFin monitors compliance with these requirements to make sure that banking services are provided only by undertakings that are solvent and that can manage their banking business properly.

[88] *Ibid*.

[89] The first cross-sectoral department, Financial Market/International Issues, deals mainly with cross-sectoral issues concerning financial markets, financial instruments and financial conglomerates. The second cross-sectoral department looks at issues relating to the protection of deposits, investor and consumer protection and retirement provision. The third cross-sectoral department is concerned with combating money laundering and prosecuting cases of illegal financial transactions.

[90] See, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003.

[91] *See*, *Ibid*.

[92] *See*, *Ibid*.

[93] *See*, *Ibid*.

[94] *See*, *Ibid*.

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Staff working in the directorate of Banking Supervision monitor banks on an ongoing basis in order to verify that banks are complying with capital adequacy requirements and that they have sufficient liquid funds.[95] Regarding the lending business of banks, BaFin ensures that banks comply with statutory risk limits (*e.g.* large exposure limits) and that their bad debt provisions are in line with their risk exposure.[96] In terms of the internal structure of the directorate of Banking Supervision, the directorate consists of four departments and thirty-one sections.[97]

b) Directorate for Regulating Insurance Business

Closely related to the Banking Supervision directorate, the Insurance Business directorate is responsible for supervising insurance companies in accordance with the Insurance Supervision Law (VAG).[98] The key objectives of the Insurance Supervision directorate relate to protecting interests of the insured and making sure that insurance companies are able to meet their liabilities at all times.[99] The Insurance Supervision directorate comprises six departments, with a total of thirty-three sections.[100]

Insurance companies are allowed to carry out insurance business only after they have been authorised to do so by BaFin.[101] Companies authorised to underwrite insurance policies in Germany have to meet various requirements. Before an insurance company is granted such authorisation, an insurance supervisor from BaFin conducts a comprehensive legal and financial examination.[102] For instance, the insurer is required to submit the operating plan as well as evidence of its own funds

[95] *See*, *Ibid*.

[96] *See*, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003.

[97] *Ibid*.

[98] *Ibid*.

[99] *Ibid*.

[100] *Ibid*.

[101] *Ibid*.

[102] *Ibid*.

to BaFin.[103] Also, managers of the insurance company must furnish proof of their good repute and professional qualification.[104]

BaFin regulates insurance companies to ensure that they have set-up sufficient provisions.[105] Banks should also have sufficient uncommitted funds and they should take out reinsurance, to an appropriate degree, to protect themselves against unexpected losses.[106] Further, insurance supervisors check to find out if annual accounts of an insurer have been drawn up properly and are presented in accordance with applicable accounting standards and that they present a true and fair view of the insurer's financial position.[107] In addition, on-site inspection of insurance companies is carried out at regular intervals.[108] The Insurance Supervision Law provides BaFin with various statutory powers to intervene in the business operations of an insurance company for the purpose of preventing or eliminating irregularities or dangers.[109] In a worst-case scenario, the licence or authorisation of the insurance company to conduct insurance business can be revoked by BaFin.[110]

c) Securities Supervision/Asset Management

The main responsibility of the third directorate is to secure the functioning of German securities and derivatives markets in accordance with the Securities Trading Act (WpHG).[111] In addition, the directorate has been assigned some of the duties of the former BAKred.[112] Under the Securities Trading Act, taking advantage of inside

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[103] *Ibid*.

[104] *Ibid*.

[105] *Ibid*.

[106] *Ibid*.

[107] *Ibid*.

[108] *Ibid*.

[109] *Ibid*.

[110] *See*, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003.

[111] *See*, *Ibid*.

[112] As a policy paper published by the BaFin notes (*see*, web-site of the German Federal Financial Supervisory Authority, *op.cit.*), "Before BaFin was founded, Asset Management and its sections belonged to the BAKred. Their responsibilities consist in monitoring both investment companies and financial services institutions as well as the marketing activities of foreign investment companies in accordance with the Foreign Investment Act (*Auslandsinvestment-Gesetz*). Their tasks being closely related to securities

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knowledge and/or the unauthorised passing on of inside information is an offence.[113]

BaFin's securities regulators analyse market trading patterns by means of securities trades reported to BaFin, in accordance with Section 9 of the Securities Trading Act, and evaluate them with regard to unusual price movements or turnover in order to trace any cases of insider dealing.[114] If evidence of insider dealing is noted, BaFin informs the public prosecutor so that the prosecutor can commence proceedings for public prosecution.[115]

The reporting requirements stipulated in the Securities Trading Act play an important part in improving market transparency, given that both retail and professional investors require up-to-date and reliable information for their investment decisions. BaFin acts as a depository for prospectuses, and listed companies are required to publish immediately any new information that is likely to have a considerable effect on the stock market price.[116] Such continuing disclosure obligations can help to promote investor protection and investor confidence. Indeed, a fair level playing field for investors can result from the enforcement of such disclosure requirements.

Further, shareholders with majority voting rights in listed stock companies or in companies whose shares are traded on the regulated market-tier are required to inform the public of the percentages of securities they hold as soon as their share ownership exceeds a certain threshold or once their share-ownership drops below a certain threshold.[117] BaFin has powers to mete out punitive measures against any party violating these reporting requirements.[118] Such measures include the imposition of an administrative fine.[119]

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supervision, they were integrated into the third directorate when the supervisory authority was reorganised. The directorate for Securities Supervision/Asset Management is comprised of four departments, one of which includes a separate group. The total number of units in the directorate is 25."

[113] *See*, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003.

[114] *Ibid*.

[115] *Ibid*.

[116] *Ibid*.

[117] *Ibid*.

[118] *Ibid*.

[119] *Ibid*.

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It is important to note also that when providing securities services to customers, credit institutions and financial services institutions should comply with rules on conduct of business.[120] These rules serve to protect investors. Compliance with conduct of business rules is checked once every year by external auditors on behalf of BaFin.[121] Indeed, the making of information available, by the issuer of securities, about particular terms and risks associated with concerned securities, as well as the costs involved, enables investors to make their own qualified investment decisions. A related argument is made in the BaFin policy paper that an enterprise should have an appropriate organisational structure and establish internal control mechanisms to avoid conflicts of interest within the institution.[122]

From 1 January 2002, corporate takeovers in Germany have been governed by the new Wertpapiererwerbs- und Übernahmegesetz (WpÜG – Securities Acquisition and Takeover Act) . And, while ensuring that issuers of securities comply with prospectus provisions, BaFin also makes sure that takeover proceedings comply with the law.[123]

3. Functions of BaFin

As noted earlier, functions that were undertaken by the former *Bundesaufsichtsamt für das Kreditwesen* (BAKerd – Federal Agency for Banking Supervision) , *Bundesaufsichtsamt für das Versicherungswesen* (BAV – Federal Agency for Insurance Supervision) and *Bundesaufsichtsamt für den Wertpapierhandel* (BAWe – Federal Agency for Securities Supervision) are now under a single state regulator that supervises banks, financial services institutions and insurance undertakings across the entire financial market.[124] Under the new regulatory structure, BaFin only grants licenses for financial services where an institution proves that it is able to comply with the regulatory standards governing adequate capital, organisation and personnel.[125]

[120] *Ibid*.

[121] *Ibid*.

[122] *Ibid*.

[123] *Ibid*.

[124] *See*, *Ibid*.

[125] Freshfields Bruckhaus Deringer, THE FINANCIAL SERVICES SECTOR IN EUROPE: REGULATORY INVESTIGATION AND ENFORCEMENT ISSUES IN GERMANY, *op. cit.*, executive summary.

BaFin also ensures market stability by supervising the orderly conduct of securities trading and compliance with anti-money-laundering legislation.[126]

Overall, BaFin's approach is to pursue a supervision policy that embraces all key aspects of consumer protection and solvency supervision.[127] Indeed, BaFin is expected to make valuable contributions to the stability of Germany as a financial centre and improve its competitiveness.[128] To achieve these goals, BaFin is legally entrusted with enforcement rights, which it can use to counter undesirable developments (in banking and financial services) that could adversely affect the stability of the financial sector. BaFin has wide-ranging powers, which include the right to request information on business activities of a financial institution and, in cases of illegal business practices, it can refuse or revoke that institution's licence.[129] Also, BaFin can use its wide-ranging investigative powers to enter and inspect the business premises of a financial institution.[130] Under certain circumstances, the BaFin can search for documents and other related items.[131] If found, such evidence should be securely kept by BaFin.

It should also be emphasised that BaFin co-operates closely with the public prosecutor in cases of criminal offences.[132] Offences of this kind include unlawful business practices, insider dealing and manipulation of market and stock exchange prices.[133] Only the public prosecutor has legal authority to commence proceedings for the prosecution of criminal offenders. However, BaFin has the right to prosecute and impose administrative fines where the contravention of a statutory provision or a regulation constitutes an administrative offence.[134]

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126 *Ibid*.

127 *See*, web-site of the German Federal Financial Supervisory Authority at:

<<http://www.bafin.de/index_e.htm>>, visited on March 3, 2003.

128 *See*, *Ibid*.

129 Freshfields Bruckhaus Deringer, THE FINANCIAL SERVICES SECTOR IN EUROPE: REGULATORY INVESTIGATION AND ENFORCEMENT ISSUES IN GERMANY, *op. cit*., executive summary.

130 *See*, *Ibid*.

131 *See*, *Ibid*.

132 *See*, *Ibid*.

133 *See*, *Ibid*.

134 *See*, *Ibid*.

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E. Conclusion

The paper has argued, among other things, that in countries such as Germany, where segments of the financial sector are quite inter-connected, a good case of moving towards unified supervision exists. In such countries, the nature of banking and financial services business is often developing and encompasses more complex and multi-functional operations. However, until there is a longer track record of experience with unified agencies, it is difficult to come to firm conclusions about the restructuring process itself, and the optimal internal structure of such agencies.

Although unified supervision of financial services has been adopted differently in many countries, its application has varied from country to country and there is no single right way of introducing or implementing unified models of supervision of financial services. Experience so far seems to suggest that, in order for a country to manage effectively the transition to a unified supervisory agency, one of the factors to consider include the effective and efficient co-ordination of information sharing among the major stakeholders in the unified supervisory system, namely, the Ministry of Finance, the central bank, and the unified supervisory agency. Also, where there is an independent deposit insurance agency and an independent payments and settlements clearing agency, they, too, must be consulted. Co-ordination and consultation here provides for efficient means of sharing information between the various stakeholders.