The Sixth Act Amending the Banking Act

Prior to the 1997 summer recess, the German Parliament passed the Sixth Act Amending the Banking Act.[1] The new amendment to the Banking Act serves primarily to implement three Directives of the European Union: the Investment Services Directive, the Capital Adequacy Directive and the Post-BCCI Directive. Through the implementation of the Investment Services Directive, investment firms will in future be supervised according to the same rules as credit institutions; this has created a level playing field in prudential terms for credit institutions and investment firms. The Capital Adequacy Directive regulates the capital backing of market and large exposures risk arising from the trading book. In the Post-BCCI Directive prudential consequences are drawn from the collapse of the Bank of Credit and Commerce International. Furthermore, the issuance of electronic money (prepaid card business and network money business) was declared to constitute banking business. At the same time, steps have been taken in the Sixth Act Amending the Banking Act and its associated Regulations to streamline banking supervision.

1 A small part of the provisions came into force immediately after being announced on October 28, 1997. Apart from the regulations concerning the adequacy of own funds and concerning large exposures, compliance with which will be compulsory only from October 1, 1998 onwards, the majority of the new provisions became effective as from January 1, 1998.

Supervisory concept unchanged

The Fourth and Fifth Acts Amending the Banking Act laid the basis in Germany for a single European market in banking services. The "European passport" makes it possible for credit institutions which have their headquarters in the countries of the European Economic Area (EEA) and which are supervised according to harmonised rules to establish branches in other EEA countries or to offer cross-border banking services without special authorisation. The Fifth Act Amending the Banking Act implemented the Consolidation Directive and the Large Exposures Directive, which created equal competitive conditions throughout the EEA and enabled the banking supervisory regulations to be brought more into line with the institutions' actual risk situation.

Investment Services Directive

Hitherto, the supervisory regulations in Germany did not apply to investment firms even though they are in direct competition with German-type universal banks. At the EU level the Investment Services Directive lays down minimum requirements for the authorisation and supervision of enterprises which carry on the business of providing investment services.

Thanks to mutual prudential recognition, investment firms, too, can now provide EEA-wide the investment and non-core services covered by the Directive for which they have obtained authorisation through their home country. The enterprises can opt to confine themselves to providing cross-border services or to set up a branch in the other contracting country. It is always the institution's home country that is responsible for supervision.

With the implementation of the Investment Services Directive in the Sixth Act Amending the Banking Act, German prudential legislation now distinguishes between banking business and financial services business. Enterprises which carry on the business of providing financial services on a commercial basis or which provide financial services on a scale which requires a commercially organised business undertaking are financial services institutions. The concepts financial services institution (as defined in the Banking Act) and investment firm (as defined in the Investment Services Directive) are not identical. For one thing, non-EEA deposit broking, money transmission services and dealing in foreign notes and coins are financial services but not investment services; for another thing, the investment services of brokerage and underwriting have been declared in Germany to be banking business and not financial services business. This classification accords with the universal bank principle. In consequence of this, the Banking Act sticks to a definition of the credit institution that is broader than that under EU law (see chart on page 61).

The concept of brokerage services is extended beyond the previous securities-based approach to include other financial instruments and is limited, as hitherto, to pure brokerage business, i.e. trading for the account of third parties. Underwriting business is defined as the purchase of financial instruments for an institution's own account for placing in the market or the assumption of equivalent guarantees.

Difference between credit institutions and financial services institutions

Credit institutions as defined in the Banking Act			Financial services institutions as defined in the Banking Act	
Deposit-taking credit institution		Securities trading banks		
		Investment firms as defined in the Investment Securities Directive		
Deposit business and lending business	Discount business Safe custody business Investment business Purchasing of receivables Guarantee business Giro business Prepaid card business Network money business	Brokerage services Underwriting business	Investment broking Contract broking Portfolio management Own-account trading	Non-EEA deposit broking Money trans-mission services Foreign exchange bureaux

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Financial instruments

Financial instruments are securities or book-entry rights, money market instruments, foreign exchange or units of account as well as derivatives. Defined as a residual concept, money market instruments embrace claims traded in the money market which are neither evidenced by certificates nor take the form of book-entry rights, e.g. deposit notes.

Electronic money

In line with a recommendation from the Council of the European Monetary Institute, the list of banking business has been extended to include the issuance of prepaid cards for payment purposes, where the issuer and payment recipient (service provider) are not identical (prepaid card business), and in addition the creation and administration of units of payment in computer networks (network money business). This makes it possible to counteract undesirable developments in the field of these new electronic forms of payment at an early stage and to better ensure the safety and viability of cashless payments, which play a very important role in the economy as a whole. If a prepaid card system appears to pose no threat to the payment system on account of its minor significance, the issuer may be exempted from individual prudential stipulations.

Financial services

The other types of business covered by the Investment Services Directive and denoted as financial services in the Banking Act are investment broking, contract broking and portfolio management of financial instruments, as well as own-account trading in financial instruments as a service for third parties. Whereas investment broking is confined to the receipt

and transmission of orders from investors, contract broking comprises the conclusion of investment transactions in financial instruments in the name and for the account of the investor. In the case of portfolio management, the portfolio of investments is managed on a discriminatory basis. The portfolios managed may be made up of the assets of different investors. Portfolio managers must deposit the securities which they manage with a custodian and keep customer funds in escrow accounts. Own-account trading differs from brokerage services in that it is carried on in the institution's own name and for its own account as a service for third parties. The own-account traders include, in particular, the official and independent stock brokers at the stock exchanges.

The other types of financial services business listed in the Banking Act, namely non-EEA deposit broking (i.e. the acquisition of deposit funds in Germany and their forwarding to counterparties in non-EEA countries), money transmission services (i.e. the execution of payment orders for others in the payment system) and dealing in foreign notes and coins are not covered by the Investment Services Directive. They have been made subject to supervision, in particular, in order to banish dubious firms operating in the "grey capital market".

Grandfathering of current rights for existing financial services enterprises

The Banking Act contains transitional arrangements for those enterprises which were legitimately carrying on financial services business on January 1, 1998 without a licence from the Federal Banking Supervisory Office. If the firms concerned report their activities that are subject to authorisation under the new Banking Act, and their intention to continue to carry on such business, to the Federal Banking Supervisory Office and the appropriate Land Central Bank within the first quarter of 1998, they shall be deemed to have been granted a licence covering the scope of business reported. Subsequently they, too, must submit the documentation required for granting a licence and furnish the requisite supporting evidence.

In the case of institutions which solely carry on the business of non-EEA deposit broking, money transmission services and dealing in foreign notes and coins, the supervisory authorities will make do with a simplified authorisation and supervision procedure.

Trading book and banking book

Trading book business

Credit institutions and financial services institutions which carry on the business of own-account trading, regardless of whether or not this is done as a service for third parties, have to keep both a trading book and a banking book to which they must assign their business activities as appropriate. The trading book is deemed to include all own-account positions in financial instruments, marketable assets and equities taken on by the institution with the intention of profiting in the short term from price variations and differences between buying and selling prices.

Transactions that are linked directly to trading book positions are likewise considered to be part of the trading book. These include hedg-

ing transactions (e.g. derivatives) and the refinancing of trading book positions. No-name broker business, commissions receivable, interest receivable and dividends receivable as well as repurchase agreements and loan business on trading book positions are likewise to be included in the trading book. The sole exceptions are spot positions in foreign exchange and units of account and commodity and precious metal derivatives. The inclusion of transactions involving financial instruments in the trading book must be based on verifiable internal criteria which institutions have to report to the Federal Banking Supervisory Office and to the Deutsche Bundesbank.

Banking book business

All on and off-balance-sheet positions not allocated to the trading book are part of the banking book, including investments held as fixed financial assets and, as a matter of principle, those of the liquidity reserve and the hedging transactions concluded for these positions.

Exemption option from the trading book rules

Institutions with negligible trading book business are not required to comply with the trading book provisions (backing of market and large exposures risk with own funds). In this case, the banking book provisions apply to those positions which are considered to be part of the trading book. This exemption is subject to the condition that the trading book business does not normally exceed 5 % of the institution's total on and off-balance-sheet business, or ECU 15 million, and even in exceptional situations never exceeds 6 %, or ECU 20 million. To calculate the limits, the trading book positions are valued at their nominal value or market price (or that of the underlying instruments, as appropriate); long and short positions are not netted. On account of the low absolute limits for exemption from the trading book rules, only smaller institutions are likely to qualify. The German Bundestag has therefore requested the Federal Government to press for an increase in the exemption limits for non-compliance with the trading book rules in the Capital Adequacy Directive. That could be done within the framework of the so-called comitology procedure.[2]

New Principle I

The Capital Adequacy Directive harmonises the monitoring of risks that arise in executing transactions in securities and derivatives (financial instruments). It contains rules concerning the calculation of own funds, capital requirements to cover market risk in financial instruments and also concerning capital backing for large exposures risk in financial instruments. The new Principle I – based on the Solvency Ratio Directive and now also on the Capital Adequacy Directive – will replace the previous Principles I and Ia; compliance with the new Principle I will be mandatory only from October 1, 1998, however. In anticipation of the change in the Capital Adequacy Directive adopted by the ECOFIN Council on November 17, 1997 and presented to the EU Parliament for approval, institutions are permitted to gauge the interest and price risk incurred using internal risk management models. The use of risk management models can be limited to individual areas (partial use).

2 By virtue of the secondary-law authorisation of Article 10 of the Capital Adequacy Directive, the European Commission, by means of the comitology procedure and advised by the Banking Advisory Committee, can issue general, abstract regulations to adjust the limits to take account of developments in the economic and monetary field.

Under the terms of the Basle agreement to limit market price risks, internationally operating institutions have been able to use risk management models approved by the banking supervisory authorities already from January 1, 1998. For non-trading book institutions the provisions of Principle I apply to the banking book, with the exception of Part V on interest and equity price risk.

Own funds

Automatic adjustment of rules for own funds

The provisions governing own funds have been changed in two respects so as to make them adjust automatically. If, for example, an institution raises capital represented by participation rights, such capital is immediately considered to be tier 2 capital (additional capital) without a formal recognition by the banking supervisory authorities being required, as before.

Tier 3 capital

An additional element making the own funds requirements adjust automatically concerns the recognition of tier 3 capital as own funds, as provided for by the Sixth Act Amending the Banking Act. Tier 3 capital consists of the net trading book profit (book profits) and short-term subordinated liabilities. The net trading book profit is the result obtained from the notional closing of all trading book positions less all expenses and disbursements and less the probable losses from the banking book in the event of a liquidation of the enterprise. Short-term subordinated liabilities differ from the subordinated liabilities that have been recognised hitherto as tier 2 capital purely on account of their shorter original maturity of at least two years. This tier 3 capital, together with the liable capital consisting of tier 1 capital (core capital) and tier 2 capital, make up the own funds.

Trading book institutions can now back risks arising from the trading book not only with liable capital but also with such tier 3 capital. Non-trading book institutions can use tier 3 capital solely to back foreign currency and commodity risk. But trading book institutions, too, must use exclusively liable capital to back risk assets in the banking book. Positions in the trading book which are subject to market and large exposures risk are to be backed by the tier 1 and tier 2 capital not needed to cover the risk contained in the banking book as well as by tier 3 capital. However, these own funds components may not exceed 250 per cent of the tier 1 capital not needed to cover the risk contained in the banking book.

Interconnection between the banking book and the trading book

As a result of the limitation of the own funds eligible to back the risk arising from trading book business to two-and-a-half times the available tier 1 capital, any banking book transaction (e.g. a loan granted or repaid) changes the eligible tier 3 capital and own funds, as it uses up or releases capital, and thus directly affects the scope for trading book business.

Initial capital of financial services institutions – transitional regulation prescribed by section 64e of the Banking Act

Not only credit institutions but also financial services institutions (see chart on page 61)

Different initial capital requirements

require a minimum amount of initial capital appropriate to the types of business which they carry on. Financial services institutions which trade in financial instruments for their own account and securities trading banks require ECU 730,000; investment brokers, contract brokers and portfolio managers need only ECU 125,000; if they are not authorised to acquire ownership or possession of customers' money or securities in the course of providing financial services, the equivalent of ECU 50,000 suffices. Investment and contract brokers may instead prove that they have taken out an appropriate insurance policy; in that case they will not receive the "European passport", however. Financial services institutions that are not investment firms as defined in the Investment Services Directive (e.g. foreign exchange bureaux) are not required to have a minimum amount of initial capital.

Financial services institutions and securities trading banks which were legitimately operating on January 1, 1998 without a licence from the Federal Banking Supervisory Office need to prove that they have the requisite initial capital only from January 1, 2003. Until then their available capital must not fall below the average of the previous six months in each case; this average figure has to be calculated every six months and reported to the Federal Banking Supervisory Office.

Own funds M 25 % of overheads

In addition to meeting the minimum initial capital requirement for institutions, securities trading houses are required, as from January 1, 1998, to have a level of own funds which amounts to at least one-quarter of the overheads recorded in the last set of annual accounts. Overheads comprise general administrative expenses, other operating expenses, depreciation, value adjustments and provisions for losses on loans. The purpose of this regulation is to ensure the orderly liquidation of a loss-making securities trading house.

Consolidation

The Sixth Act Amending the Banking Act has also changed the provisions governing consolidation. It is thus now possible for a financial services institution, too, to be the parent institution of a group of institutions. The definition of a financial holding group no longer requires that a deposit-taking credit institution is a constituent part of the group. It now suffices that a securities trading house is part of the group.

"Streamlined" concept of consolidation

To simplify the task of supervision, the mandatory consolidation of an enterprise in which the parent institution holds a direct or an indirect participating interest of at least 40 % has been abolished. In principle, the only units that now have to be consolidated are subsidiaries, i.e. enterprises in which the parent institution holds a majority participating interest or over which it can exercise a dominant influence, and joint ventures. Subconsolidation in the case of cross-holdings or participating interests of less than 75 % is no longer necessary.

For the purpose of backing market risk, the netting of long and short positions within a

group is permissible *inter alia* only if the enterprises belonging to the group are included in the central risk management of the parent enterprise.

Extended large exposures provisions for trading book institutions

For all institutions the same regulations as hitherto apply in respect of large exposures in the banking book. As before, the large exposures limit for a single borrower unit applying to the banking book may be exceeded only with the approval of the banking supervisory authorities and only if this excessive amount is backed by liable capital, which is then no longer available for Principle I purposes. In the case of trading book institutions, a large exposure is constituted also if the overall exposure to a single borrower unit in the banking and trading books, taken together, exceeds 10 % (up to the end of 1998: 15 %) of the own funds. The overall exposure to a single borrower unit may not exceed 25 % (up to the end of 1998: 40 %) of the own funds. The aggregate total of all large exposures in the banking and trading books, taken together, must not exceed eight times the own funds.

Wider scope in the trading book

With the approval of the banking supervisory authorities, a trading book institution may extend the total trading book exposure to a single borrower unit to five times its available own funds not required to back the risk arising from the banking book. The amounts by which this limit is exceeded must be backed by own funds. All breaches of the large exposure limit of 25 % of the own funds for the overall exposure to a single borrower unit from the banking and trading books, taken together, which last longer than ten days are limited to six times the available own funds not needed to back risks arising from the banking book. The weighting of trading book positions in respect of the large exposures limits and their backing with own funds are laid down by the Regulation governing large exposures and loans of DM 3 million or more, which also incorporates the provisions of the Capital Adequacy Directive for calculating the large exposures risk arising from the trading book.

Regular summary report instead of ad hoc reports

The Regulation governing large exposures and loans of DM 3 million or more makes use of the option of introducing regular summary reports of large exposures instead of *ad hoc* reports. All large exposures now have to be reported quarterly. Immediate *ad hoc* reports are now only necessary in the case of an unauthorised overshooting of the large exposures limit for a single borrower unit of 25 % of the institution's liable capital or own funds or of the aggregate large exposures limit for all borrowers. Failure to rectify within one month the omission to base the granting of a large exposure on the unanimous decision by all managers likewise has to be reported.

Reporting loans of DM 3 million or more

Range of reporting institutions enlarged

The obligation to report loans of DM 3 million or more has been extended to financial services institutions taking on own-account pos-

itions as a service for third parties and to financial enterprises engaged in factoring. The inclusion of factoring enterprises is, among other things, a response to the collapse of a major factoring firm which had purchased non-existent claims. This case showed that the collapse of a factoring enterprise can likewise affect the stability of the financial system. The inclusion of factoring enterprises in the system of reporting loans of DM 3 million or more increases the transparency of the pattern of indebtedness in the economy and consequently can improve the quality of institutions' credit decisions and credit surveillance.

Enquiry prior to granting loans

Before granting a reportable loan, enterprises required to report may in future request information about the level of indebtedness of the potential borrower, if the latter agrees to the request and the envisaged loan amounts to DM 3 million or more.

Other changes in the Banking Act

Post-BCCI Directive

Under the Post-BCCI Directive, authorisation of enterprises wishing to conduct banking business or provide financial services is to be refused or withdrawn if the structure of the enterprise or the relationships between it and other entities make it impossible for the enterprise to be supervised effectively. The Directive also contains provisions on the exchange of information between supervisory authorities and other bodies and on the obligation of external auditors to provide information.

Supplementary regulations pertaining to the Sixth Act Amending the Banking Act

The amendment of the Banking Act makes it necessary to revise or issue a number of regulations. The authorisation procedure for financial services institutions which were legitimately operating on January 1, 1998 is laid down in the First Reports Regulation and the Supplementary Reports Regulation. The provisions for ongoing supervision are specified in the Monthly Returns Regulation and, for stock brokers as defined in the German Stock Exchange Act, by the Monthly Returns Regulation for Stock Brokers.

The goal of streamlining banking supervision is duly heeded in the Reports Regulation and in the Regulation governing large exposures and loans of DM 3 million or more. For the sake of clarity and convenience, the circumstances in which exemptions apply, which hitherto were contained in the Exemptions Regulation, are now directly assigned to the relevant circumstances warranting a report in the Reports Regulation. In the new Regulation governing large exposures and loans of DM 3 million or more, which replaces the previous Large Exposures Regulation, the previous *ad hoc* reports on the first-time incurrence of large exposures and on their increase by 20 % or more as well as the annual summary reports have been abolished. Instead there will be reports each calendar quarter which institutions must submit in a combined report together with the reports pursuant to section 14 of the Banking Act. The scope of the data required in these combined reports pursuant to section 13 and section 14 of the Banking Act has been confined to the minimum necessary for prudential purposes. Even so, the combined report on large exposures and loans of DM 3 million or more will lay the basis for a more qualitative system of supervision.

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Specific organisational duties

The Sixth Act Amending the Banking Act has defined specific organisational duties for institutions. For one thing, they must have in place appropriate regulations for managing, monitoring and controlling the risks they incur such that the institution's financial position can be determined with sufficient accuracy at any time. For another, institutions are required, besides organising their business properly and establishing an appropriate internal surveillance procedure, to take safety precautions in connection with the use of electronic data processing. If areas of work which are fundamental to carrying on banking and financial services business are outsourced to another enterprise, this outsourcing must impair neither the orderly execution of this business nor the management's ability to direct and control the operations nor the auditing rights of the Federal Banking Supervisory Office.

Extended powers to intervene in the event of irregularities

For the first time, the banking supervisory authorities have been given the power, as part of the duties conferred on them, to issue instructions to an institution and its managers in order to prevent or remedy irregularities at the institution which could jeopardise the safety of the assets entrusted to the institution or impair the orderly execution of business. Hitherto irregularities could be combatted as a rule only by dismissing the managers.

Additional sovereign powers for banking supervisors

In addition, the banking supervisory authorities have now been equipped with the necessary instruments to enable them to effectively combat unauthorised banking and financial services business in the wake of the enlargement of their supervisory brief to include

Streamlining of banking supervision

- Limitations on investments have largely been abolished; only major participating interests are now limited (section 12 of the Banking Act).
- Consolidation requirements have been harmonised as between section 10a and section 13b of the Banking Act.
- Mandatory consolidation upwards of a participating interest of 40 % has been abolished for Principle I.
- Reporting of loans to managers etc. abolished (section 16 of the Banking Act).
- Limit for requiring borrowers to disclose their financial circumstances raised from DM 250,000 to DM 500,000.
- As far as was practicable, the definitions in Principle I and in the Regulation governing large exposures and loans of DM 3 million or more have been harmonised.
- *Ad hoc* reports of large exposures and increases therein abolished.
- Combined quarterly report of large exposures and loans of DM 3 million or more.
- Amount of detail in routine large exposures reports reduced.
- Institutions intending to grant loans of over DM 3 million may request information on prospective borrowers.
- Electronic reporting of loans of DM 3 million or more, having proved successful, is being extended to routine large exposures reports.
- For clarity and convenience, the circumstances justifying exemptions have now been incorporated into the Reports Regulation.

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financial services institutions. For example, the banking supervisory authorities may enter business premises to carry out inspections, conduct searches and secure evidence.

Revocation of old Banking Act provisions

Besides the "streamlining" of the consolidation rules, the burden of regulations on the banking and financial services industries has been eased in three other areas. Thus the stipulation limiting credit institutions' investment in illiquid assets (buildings, participating interests etc.) to the level of their liable capital has been revoked. Only the provisions restricting participating interests of deposit-taking credit institutions in enterprises outside the financial sector have been retained. Furthermore, the requirement to report loans to managers etc. has been dropped. The requirement immediately to report such loans caused a considerable amount of work at the institutions which was out of proportion to the prudential insights gained thereby. Compliance with the provisions relating to the granting of loans to managers etc. will now be monitored as part of auditing the annual accounts. At the urging of the banking industry, moreover, the threshold from which credit institutions have to disclose a borrower's financial circumstances has been raised from DM 250,000 to DM 500,000. An overview of the ways in which the prudential burden on institutions has been eased is given in the box on page 68.

Outlook

With the implemention of the Investment Services Directive and the Capital Adequacy Directive, which extends the mutual recognition of supervision to investment firms, the latter – equipped with the "European passport" – can now offer throughout the European Economic Area investment and non-core services covered by the Directive for which they have received authorisation in their home country.

Still to be translated into German prudential law is the Directive regarding systems for compensating investors, which was adopted by the European Parliament and Council in March 1997. Now that the European Court of Justice has rejected the complaint against the Directive on deposit guarantee schemes, that Directive, too, must be incorporated into the Banking Act without delay.