

The Deutsche Bundesbank's involvement in banking supervision

A properly functioning banking supervisory apparatus is one of the cornerstones on which the infrastructure of a financial system depends. Only a stable financial system, the maintenance of which constitutes a central objective of government regulation and prudential overview, is capable of fulfilling, in an optimal manner, its overall economic function of making financial resources available and of providing for their efficient and cost-effective reallocation. Ever since a general public-sector supervisory authority began operating in Germany, the central bank has had a decisive part to play in its activities. The Banking Act, which provides for its participation in the monitoring of institutions, falls squarely within this tradition.

The history of banking supervision in Germany and the (contemporary) role of the Bundesbank in this field are presented below as a companion piece to the current debate on the restructuring of the prudential system for monitoring credit and financial services institutions. The article closes with a brief summary of the outlook for banking supervision in Germany, which on balance, makes it appear advisable that the prudential structures be fully integrated into the Bundesbank.

Emergence of a public-sector banking supervisory authority

The banking crisis of 1931

In response to a widespread banking crisis in 1931, a banking supervisory authority with jurisdiction over all the German banks was established for the first time on September 19, 1931 by the Emergency Decree of the Reich President on Companies Law, Banking Supervision, and Fiscal Amnesty; it not only specified licensing criteria but also arranged for regular surveillance of the banks. Up to that point only public savings banks (which had existed in Prussia since 1838) and mortgage banks had been subject to prudential review – in the latter case as a means of protecting mortgage-bond holders. The new responsibilities were delegated to the Board for Banking that was established at the Reichsbank (i.e. the coordinating body between the Reich Government and the central bank). A Reich Commissioner for Banking was set up as the corresponding executive body. The Reich Banking Act of December 5, 1934, which superseded the emergency decree, basically confirmed this allocation of functions.

The Banking Act of 1939

The Banking Act of September 25, 1939 transferred prudential responsibilities to the Reich Banking Supervisory Office, which reported directly to the Reich Minister of Economics; it, in turn, was assisted by agencies of the Reichsbank in actually conducting bank audits. In the end, a decree amending the Banking Act granted complete sovereignty over banking supervision to the Reich Ministry of Economics on September 18, 1944.

After the end of the Second World War, banking supervision, like many other federal functions, was decentralised by the Western military governments; responsibility was conferred on the Länder which turned first to Reichsbank branches to conduct their regular surveillance activities before using Land Central Banks as Länder-specific agencies. In order to coordinate banking supervision in the Länder, which was structured along the lines prescribed by the Banking Act of 1939, the Länder Council of the Combined Economic Area founded a Special Banking Supervisory Committee that has met from 1948 to 1961; its members included representatives from supervisory boards operating from the Länder ministries and – as experts – representatives from the Federal ministries involved and the Bank deutscher Länder as well as its successor, the Bundesbank.

Banking supervision entrusted to the Länder after the Second World War

Banking Act of 1961

More than ten years in preparation, the Banking Act entered into force on January 1, 1962. This Act is intended to maintain order within the financial system at a general level and to preserve the efficiency and stability of the financial sector.

Banking Act of 1961

As a result of the “new” Banking Act, responsibility for banking supervision was again centralised to ensure the uniformity of administrative practices throughout Federal territory. The Federal Banking Supervisory Office was awarded sovereign responsibility. At the same time, the Act made room for Bundesbank participation in the surveillance of credit

Uniformity of banking supervisory practices

institutions. The Sixth Act Amending the Banking Act of 1997 widened the scope of the Bundesbank's participation in prudential activities to include the surveillance of financial services institutions.

The liberal orientation of the Banking Act

In keeping with the notion of a free-market economy, the guiding idea behind the Banking Act had been from the very outset to hold government prudential regulation down to the necessary minimum – the fact that the Act had up until 1967 provided for the regulation of interest terms and of the marketing promotions of credit institutions notwithstanding. Still, the Banking Act of 1961 could claim a certain continuity with its predecessors with respect to its material banking supervisory standards.

Dispute between the Federal Government and the Länder and the Federal Constitutional Court ruling

The Act was preceded by a long struggle between the Upper and Lower Houses of Parliament, the Bundestag and the Bundesrat; at the centre of this struggle stood the transfer of banking supervisory competence, which had previously been the preserve of the individual Länder, to a "superior Federal authority", the Federal Banking Supervisory Office. Some of the Länder had submitted a petition for judicial review before the Federal Constitutional Court. They argued that the establishment of a superior Federal authority was unconstitutional on the grounds that it was not covered by Article 87 (3) sentence 1 of the Constitution. In its ruling of July 24, 1962, the Federal Constitutional Court declared that the Banking Act was, in fact, consistent with the Constitution. As for the establishment of the Federal Banking Supervisory Office as an independent superior Federal

authority, it followed from the very notion of an independent superior Federal authority that it could be established only for functions that, by their very nature, were capable of being exercised throughout the entire Federal territory by a single Federal authority without the support of branches or of the administrative authorities of the Länder (except for purely administrative assistance). The Court noted that the danger of a violation of the Länder's administrative jurisdiction did not exist since the newly established superior Federal authority would be working together with another Federal institution – already extant – the Bundesbank.

In its ruling, the Federal Constitutional Court observed further that the functions which the Banking Act assigned to the Bundesbank fell pursuant to Article 88 of the Constitution within its operational jurisdiction as a central bank. In explaining its decision, the Court pointed to the fact that the central bank had always been involved in banking supervision, that it occupied a key position within the German banking industry and that it possessed the requisite expertise. Moreover, issues in monetary policy and banking supervision overlapped. Thus the Court, in its conclusion, deemed the conferral of banking supervisory functions on the Bundesbank to be constitutional.

Banking supervision as a Bundesbank function compatible with Article 88 of the Constitution

Federal Banking Supervisory Office

The Banking Act of 1961 transferred responsibility for the surveillance of credit institutions – and, with the entry into force of the Sixth Act Amending the Banking Act, for the

Functions of the Federal Banking Supervisory Office

surveillance of financial services institutions as well – to the Federal Banking Supervisory Office; the latter was founded as an independent (one-tier) superior Federal authority, which reports directly to the Minister of Economics (since 1972 to the Federal Ministry of Finance) and which took up work on January 1, 1962. The activities of the Federal Banking Supervisory Office are not limited solely to the licensing, monitoring and – if necessary – closure of particular institutions. It can also establish rules in the form of general ordinances for the performance of banking transactions and financial services and for risk mitigation. It does so by issuing principles and legal regulations. In addition, the Federal Banking Supervisory Office is responsible for counteracting undesirable developments in the banking and financial services sectors which may endanger the safety of assets entrusted to institutions, impair the proper conduct of banking business or provision of financial services, or involve serious disadvantages for the national economy, except in cases for which the Federal Supervisory Office for Securities Trading has responsibility under the Securities Trading Act (section 6 (2) of the Banking Act). In the discharge of its duties, the Federal Banking Supervisory Office acts solely in the public interest.

The Bundesbank's involvement in banking supervision

The Bundesbank's involvement in banking supervision may be explained not just in historical terms but also in terms of its functions. While it is true that the objectives and func-

tions of the Bundesbank as a central bank and those of banking supervision are not identical, in the financial field monetary policy and prudential considerations often overlap or complement each other. This continues to hold true even though jurisdiction over monetary-policy decisions has been transferred to the Eurosystem on January 1, 1999.

The Bundesbank has extensive knowledge of the financial sector and a staff well-versed in financial market and stability issues owing to its business relationships with credit institutions, its local presence and its general proximity to the market. Parliament thus had good reason for including the Bundesbank – via section 7 of the Banking Act – in the banking supervision process and for conferring upon it a number of auxiliary functions. Its participation in the surveillance of individual institutions (microprudential surveillance) also provides it with information on the solvency of its own borrowers that is necessary for the proper exercise of its central banking function; this, in turn, contributes to the stability of the financial system (macroprudential surveillance), as defined in Article 105 (5) of the EC Treaty – a goal that the European System of Central Banks also regards as a desideratum. Indeed, in the last few years, a pronounced shift in emphasis has become discernible in favour of reinforcing the stability of the financial system, not least as a result of the financial crises in Asia and Russia.

The Bundesbank is involved in virtually all aspects of banking supervision. These include:

- the issuing of general rules (e. g. principles and regulations),

The Bundesbank has locational advantages and expertise

Monetary policy and prudential issues overlap

An overview of the Bundesbank's involvement in banking supervision

- the process of regular surveillance, excluding (sovereign) isolated measures directed at institutions, the adoption of which is reserved for the Federal Banking Supervisory Office,
- banking supervisory audits and
- international cooperation in/coordination of prudential matters.

It also plays a significant role in crisis management.

Issuing of general regulations

From lending guidelines ...

During the reconstruction of the German banking system after its complete collapse in 1945, banking transactions grew at a very dynamic pace. In order to keep the trend under control and to ensure that lending volumes were commensurate with the capital base of credit institutions, the Bank deutscher Länder specified reference values (lending guidelines) for the ratio of liable capital to credit volume and for the level of credit institutions' liquidity in 1951. These lending guidelines, which were amended several times before 1954 and whose reference values were also revised, were based on firm convictions as to what constitutes a sound balance sheet and reputable business practices on the part of credit institutions.

... to Principles

In 1962, they were incorporated, in modified form, in the Principles in the sense employed in sections 10 and 11 of the Banking Act. In order to ensure that monetary policy considerations would continue to receive due attention, it was stipulated in the Banking Act regulations that the Principles be drawn up

only after the prior consent of the Bundesbank had been secured. In connection with the issuance of prudential legal regulations, the Banking Act envisages for the Bundesbank a scale of participation rights in order of increasing involvement, its participation in the drawing up of the Principles being one example. The extent of the Bundesbank's participation – i. e. whether it is heard, consulted or asked for its agreement – depends on the degree to which the regulation envisaged is entwined with monetary policy interests (details may be found in the explanatory comments on page 36).

Regular surveillance and audits

In the Banking Act, participatory regulations also serve to highlight the Bundesbank's importance for the routine surveillance process. The Bundesbank, including the Central Office, the Land Central Banks (or Main Offices of the Bundesbank), and the local branch offices, occupies a key position within the entire prudential reporting system (i. e. reports and returns as defined in the Banking Act) and plays a significant role in the evaluation of these reports as well (for more information see the table on page 37).

On the praxis-oriented side of surveillance, the Federal Banking Supervisory Office is saved some work by the filtering function exercised by the Bundesbank; the majority of reports are examined and analysed by the Bundesbank, which uses written comments to alert the Federal Banking Supervisory Office to consequential cases from a prudential standpoint and to propose solutions. The

Operational implementation of banking supervision

Analyses of institutions' reports, annual accounts and auditor's reports

The Bundesbank's involvement in the issuance of general regulations

The Banking Act distinguishes three ways in which the Bundesbank can participate in the issuance of such regulations. Where the Banking Act sanctions the devolution of issuing authority from the Federal Ministry of Finance to the Federal Banking Supervisory Office, the Bundesbank's participation rights extend to the next strongest alternative:

Hearing

The lowest level of involvement requires that the Bundesbank be heard; it provides the Bundesbank with the opportunity, as enshrined in law, to express its opinion with regard to a particular issue.

Examples:

The Bundesbank is heard by the Federal Ministry of Finance prior to the issuance of regulations which

- designate enterprises other than those mentioned in section 1 (3) sentence 1 of the Banking Act as financial enterprises (section 1 (3) sentence 2 of the Banking Act),
- include more detailed provisions on the object of the annual accounts audit and on the corresponding auditors' reports (section 29 (4) sentence 1 of the Banking Act) or
- exempt institutions from specific reporting duties (section 31 (1) sentence 1 of the Banking Act).

The Bundesbank is heard by the Federal Government prior to the issuance of regulations which

- order a moratorium or a suspension of banking and stock market business (section 47 (2) of the Banking Act) or
- order the resumption of such business (section 48 (1) sentence 1 of the Banking Act).

The Bundesbank is heard by the Federal Government regarding the nomination of the President of the Federal Banking Supervisory Office (section 5 (2) of the Banking Act).

Consultation

Consultation with the Bundesbank entails that it be given the opportunity to present its views and that they receive due consideration in the interests of reaching an understanding but without the opposite party's being obliged to adopt the Bundesbank's views in the end, if opinions continue to differ.

Examples:

The Bundesbank is consulted by the Federal Ministry of Finance prior to the issuance of regulations which

- specify detailed provisions enabling enterprises which solely conduct prepaid card business to qualify for exemptions (section 2 (5) sentence 3 of the Banking Act),
- include more detailed provisions concerning the own funds of groups of institutions and financial holding groups (section 10a (6) sentence 10 of the Banking Act) or
- include more detailed provisions on the nature, scope and timing of prudential reports (section 24 (4) sentence 1 of the Banking Act).

The Bundesbank is consulted by the Federal Banking Supervisory Office prior to the issuance of regulations which

- exempt institutions from specific reporting duties (section 31 (1) sentence 2 of the Banking Act) or
- exempt enterprises which solely conduct prepaid card business from specific provisions of the Banking Act (section 2 (5) sentence 1 of the Banking Act).

Agreement

Agreement represents the strongest level of Bundesbank involvement and presupposes that the Federal Banking Supervisory Office has secured the Bundesbank's consent prior to establishing prudential standards.

Examples:

The Federal Banking Supervisory Office, acting in agreement with the Bundesbank, issues regulations on

- large exposures and loans of three million Deutsche Mark or more (section 22 sentence 3 of the Banking Act) and
- more detailed provisions on the nature and scope of monthly returns (section 25 of the Banking Act), insofar as monthly balance sheet statistics are not collected in accordance with section 18 of the Bundesbank Act (section 25 (3) sentence 3 of the Banking Act).

The Federal Banking Supervisory Office, acting in agreement with the Bundesbank, draws up Principles concerning

- adequate own funds (section 10 (1) sentence 2 of the Banking Act) and
- adequate liquidity of institutions (section 11 sentence 2 of the Banking Act).

Bundesbank also analyses the annual accounts, management reports and auditor's reports of institutions. The way banking supervision is currently structured, these reports represent a significant source of additional information on the solvency, risk profile, profitability, liquidity and on the assets and liabilities of an institution for the Federal Banking Supervisory Office and the Bundesbank. The Bundesbank can take advantage of the information acquired on the creditworthiness of institutions for its lending transactions with banks as well; this renders a separate credit analysis superfluous for central banking purposes. The Bundesbank is also the party to be contacted by institutions for questions concerning the concrete data to be reported and the design of the reporting system or for individual questions requiring immediate clarification. Important aspects of the Bundesbank's involvement in regular surveillance are treated in the explanatory comments on page 38.

Contacts with institutions

The Bundesbank has access to other important data which enter into the surveillance process. These data stem from its contact with institution managers and other staff members, from the business relations which it maintains with banks and from other sources.

Audits

So far banking supervision in Germany has largely been based on an evaluation of the institutional records described above and on conversations with the representatives of these institutions, which are conducted on a regular basis. In this respect, the new Basle Capital Accord will result in a paradigm shift

Number of banking supervisory operations conducted by the Bundesbank in 1999

Item	Number of operations
Reports to be submitted in compliance with the requirements stated in sections 10 and 11 of the Banking Act	
Principle I	127,576
Principle II	85,596
Individual reports on large exposures to a single borrower pursuant to section 13 of the Banking Act	59,517
Single borrowers included in the regular, summary reports submitted pursuant to section 13 of the Banking Act	332,486
Reports on loans of DM 3 million or more pursuant to section 14 of the Banking Act	1,862,191
Reports on special duties of institutions, their managers, financial holding companies and mixed-activity holding companies, etc. pursuant to sections 24 and 24a of the Banking Act	43,091
Monthly returns pursuant to section 25 of the Banking Act	46,301
Reports on the volume of foreign lending	271
Approved annual accounts of credit institutions	3,401
Auditor's reports on annual accounts	2,690
Reports on the auditing of safe custody accounts	511
Routine, special and deposit guarantee fund auditor's report	1,510
Audits	
of institutions pursuant to section 44 (1) of the Banking Act	57
of ancillary banking services enterprises, financial holding companies and enterprises included in supervision on a consolidated basis pursuant to section 44 (2) of the Banking Act	35
Reports on the Capital Accord of the Basle Committee on Banking Supervision	92
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as on-site prudential audits assume greater importance within the supervisory review process and come to supplement the evaluation of reports and returns from institutions. The Bundesbank has its own banking supervisory auditors (at this point approximately 70 in all), who conduct trading activities audits (on behalf of the Federal Banking Supervisory Office) as well as audits to determine the adequacy of institutions' market risk models (headed by the Federal Banking Supervisory Office). (Details may be found in the explanatory comments on page 39.)

Bilateral and multilateral cooperation among banking supervisors

To be efficient, banking supervision assumes cooperation on the part of the prudential

At the international level

The Bundesbank's involvement in ongoing prudential activities

Banking supervisory reports and returns are monitored by the Bundesbank, recorded in databases and, where appropriate, passed on to the Federal Banking Supervisory Office with the recommended prudential measures.

Principles I and II

Monthly returns on the adequacy of own funds at the institutional level or on a consolidated basis (Principle I) are used to assess the solvency of the institutions under examination or to provide more substantive evaluations and scenario analyses of individual banking groups or of the entire banking sector (sections 10, 10a of the Banking Act). Returns on the adequacy of liquidity provision (Principle II) are used for similar purposes (section 11 of the Banking Act).

Reports on large exposures

Reports on large exposures (section 13 ff. of the Banking Act) are to be submitted to the Bundesbank at quarterly intervals. They provide the banking supervisors with valuable information by allowing for the concentration of risk in the institutions' lending business to be broken down by amount and sector. In an effort to render banking supervision more qualitative and risk-oriented, the Bundesbank has developed a special, computer-assisted evaluation procedure, which enables large exposures of individual lenders to be analysed systematically. For the sake of simplicity and at the Bundesbank's instigation, reports on large exposures (exposures to a single borrower in the aggregate amount of or exceeding ten percent of liable capital) have been consolidated with reports on loans of three million Deutsche Mark or more (sections 13 to 14 of the Banking Act) since the Sixth Act amending the Banking Act.

Credit register for loans of three million Deutsche Mark or more

Section 14 of the Banking Act stipulates that the credit register for loans of three million Deutsche Mark or more be situated at the central bank, as is the case in six other EU member states which have comparable institutions (Austria, Belgium, France, Italy, Portugal and Spain). The Bundesbank identifies the total indebtedness of each single borrower or of borrowers regarded as a risk unit and notifies lenders of their credit status at quarterly intervals. It also uses the same data stock to conduct its own bank-specific analyses (for example, in the event of an impending insolvency) or, more generally, to compile global analyses for the purpose of identifying possible risks to the stability of the financial system. In addition, the Bundesbank exchanges credit information with the six EU central banks mentioned; it also represents Germany in the Working Group on Credit Registers, which forms part of the ESCB's Banking Supervision Committee and which it chairs.

Borrowers regarded as a single risk unit

The reported data on borrowers are reviewed by the Bundesbank with a view to determining whether several borrowers that have been reported individually may be deemed a single risk unit, as provided for by section 19 (2) of the Banking Act, and whether the credit institutions have taken due note of the fact when calculating their large exposures or loans of three million Deutsche Mark or more.

Monthly returns

Section 18 of the Bundesbank Act entitles the Bundesbank, in the discharge of its duties, to collect monthly balance sheet statistics from all credit institutions. At the same time reports submitted for this purpose are deemed to be monthly returns (in the prudential sense discussed in section 25 of the Banking Act). This obviates the need for separate monthly, banking supervisory returns. Specific ratios and relationships are derived from the data recorded in monthly returns which help to show up pronounced trends in the business conducted by institutions. The data are also used to analyse trends for the entire banking sector.

Analysis of annual accounts, management reports and auditor's reports

In addition, the Bundesbank analyses accounting records (annual accounts and management reports) and the auditor's reports for individual credit institutions and – so far applicable – for banking groups submitted in connection with the requirements stated in section 26 of the Banking Act. The information that may be obtained through analysing the auditor's reports on the annual accounts is of special importance to banking supervisors. The focus and the scope of such audits are fixed by section 29 of the Banking Act, but more detailed provisions on auditor's reports may be found in the corresponding regulation issued by the Federal Banking Supervisory Office in fulfilment of section 29 (4) of the Banking Act. The latter stipulates that the auditor's report be so understandable and complete as to make the financial position of the institution immediately evident. The auditor of annual accounts is also required to monitor compliance with banking supervisory regulations and with requirements imposed by the Money Laundering Act. In this way, the Bundesbank and the Federal Banking Supervisory Office are able to obtain an overall picture of the institution, including its assets and liabilities, profitability, liquidity, assumed risks, risk provision and compliance with prudential and money laundering rules.

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agencies working to promote the stability of the international financial system. The participants must coordinate their actions in several respects and exchange pertinent information on a continuous basis. Today national prudential regulations are largely based on international standards (and on the Basle Capital Accord and the EC directives, in particular). Given that the effects of globalisation have made themselves felt in the financial sector to a particularly large degree, it is important that prudential regulations be harmonised on as global a scale as possible and, beyond that, that prudential practices be compatible and that the overall risk incurred by internationally active institutions or by institutions represented in other countries be calculated. Technological developments such as electronic banking have increased the pressure to cooperate at an international level.

*Supervisory
bodies*

Through its participation in committees and working groups, the Bundesbank has for a long time now been actively involved in the harmonisation of banking supervisory standards. In the process it was able to transmit technical knowledge and its own central bank viewpoint, especially where questions concerning the stability of the financial system were involved. The Bundesbank is represented in the Basle Committee, in various committees belonging to the EU Commission and in every other important coordinating group of banking supervisors (usually together with the Federal Banking Supervisory Office). (Details may be found in the explanatory comments on page 40.)

Bank supervisory audits

Auditing of trading activities

An important auditing function of the Bundesbank consists in monitoring compliance with the minimum requirements for the trading activities, which it does at the behest of the Federal Banking Supervisory Office. Minimum requirement audits are designed to monitor the organisational framework within which trading transactions are conducted, this framework having been established by the management of the respective institution; these audits also examine risk controlling and risk management and the way in which trading activities are set up and operations organised. The audits are conducted on a rota basis together with association auditors from the savings bank and credit cooperative sectors or with external auditors.

Auditing of market risk models

Another important auditing activity in which the Bundesbank is engaged involves the authorisation of internal risk-measurement and risk-control models for use as a means of determining the capital charges for market price risks, as specified in Principle I part 7. The qualifying criteria set by these audits include both quantitative and qualitative measures. Among the most decisive of the quantitative criteria are the statistical value-at-risk model and its validation (through back testing). Most of the qualitative criteria are concerned with how the risk model is incorporated in the banks' day-to-day risk management. The audits are conducted jointly by the Federal Banking Supervisory Office (which heads the audit) and the Bundesbank, which provides the great majority of the auditors involved.

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The Bundesbank's involvement in international banking supervisory bodies

Basle Committee on Banking Supervision

The Bundesbank has been a member of the Basle Committee on Banking Supervision (BCBS) since its inception; the Committee was founded by the central bank governors of the G-10 countries at the end of 1974 in response to certain international banking problems. It is comprised of central bank representatives and banking supervisory authorities from the G-10 countries and from Luxembourg and Switzerland as well. The Committee's activities are aimed at establishing uniform banking supervisory standards for internationally active banks. It also maintains relations with regional banking supervisory boards in third countries to ensure that banking surveillance improves in international terms and that prudential regulations and practices become increasingly harmonised worldwide.

Banking Supervision Committee of the ESCB

The Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB) is a committee which consists of central bank representatives and banking supervisory authorities from all 15 EU member states. As part of the European System of Central Banks, the Bundesbank is represented in the BSC. The current chairman of the Committee is the Bundesbank Board member responsible for prudential issues. The BSC helps the ESCB to fulfil the task assigned to it by the EC Treaty, which involves contributing to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of financial systems. The BSC also serves as a forum for EU supervisors to exchange ideas on problems lying outside the jurisdiction of the Eurosystem. The BSC is particularly concerned with macroprudential issues such as those relating to structural trends in the European banking system and to the stability of financial markets in the EU. Given the decentralised structure of banking supervision in Europe, the BSC is an important committee since it enables banking supervisory authorities throughout the EU to cooperate on a multilateral basis and so encourages collaboration on prudential instruments and practices.

Banking Advisory Committee, Groupe de Contact

The Banking Advisory Committee (BAC) is comprised of finance ministry officials, banking supervisors and central bank representatives. Its job is to advise the European Commission in its attempts to formulate directives for European banking law and to ensure that directives which have already been approved are implemented and enforced in the member states. The committee is supported in its activities by the EU Groupe de Contact, in which the Bundesbank is also active.

International Organisation of Securities Commissions

Attempts on the part of banking supervisors and securities regulators to coordinate their operations worldwide have found their practical expression in the activities of Working Party Number 3 of the International Organisation of Securities Commissions (IOSCO). An important result of their having worked together with the Basle Committee was the joint paper "Framework for Supervisory Information about Derivatives and Trading Activities". The Working Party has also published a series of "best practice" standards for securities transactions. The longer-term objective of its members is to collaborate on the establishment of globally accepted capital adequacy requirements for banks and investment firms. The Bundesbank, along with the Federal Ministry of Finance, the Federal Banking Supervisory Office and the Federal Supervisory Office for Securities Trading, is represented in this Organisation.

Financial Stability Forum

The Financial Stability Forum, which was founded by the G-7 countries in April 1999 at former Bundesbank President Dr Tietmeyer's suggestion, acts to ensure that rules acknowledged to be necessary for the satisfactory functioning of financial markets (especially banking supervisory standards) are implemented worldwide by improving cooperation among all the relevant agencies. At the same time it is supposed to identify flaws in the financial market infrastructure, to develop corresponding recommendations for improvement and to monitor their implementation. To this end it is continually following financial market trends with a view to detecting possible vulnerable spots large enough to be of international significance. The Forum is composed of representatives of international organisations and committees concerned with financial market issues and of government officials and central bank representatives from the G-7 countries and from other countries and regions that are regarded as major international financial centres. The Bundesbank is represented in its deliberations by the Bank's Vice President.

Committee on the Global Financial System

The Committee on the Global Financial System (CGFS) presents the G-10 central banks with a forum for monitoring the international financial markets. It also examines specific issues associated with the functioning of the global financial system. The Committee devotes special attention to vulnerable areas not only in the global financial markets but also in the financially most important industrial nations and emerging economies. Issues of particular concern to the CGFS include the maintenance of liquid markets for debt securities, market developments during crises, the transparency of information for market participants and improvements in the international banking statistics compiled by the Bank for International Settlements (BIS).

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*Bilateral
agreements
(Memoranda of
Understanding)*

In addition, the cross-border activities of German institutions or of foreign institutions in Germany require close cooperation with the foreign supervisory authority involved if banking supervision is to be effective. The Second Banking Coordination Directive permits banks in the European Economic Area (EEA) with a licence to conduct business to open up branches in every other EEA country without first having to apply for a licence from the corresponding agency of the host country. For banking supervision purposes the home country authority is considered to bear the brunt of the concomitant responsibilities. In an attempt to operationalise this regulation, the Federal Banking Supervisory Office has, with the assistance of the Bundesbank, now reached agreements in the form of Memoranda of Understanding with almost all the EU countries and the EEA country Norway. Further memoranda with third countries including the United States are in the process of being signed.

These bilateral agreements stipulate in detail the principles, the procedures and the forms of cooperation available to banking supervisory agencies, special attention being given to the obligation to share information and to consult with one another. Although the Bundesbank is not entitled to sign these agreements, it participates in ongoing consultations, in the exchange of information between banking supervisors and in on-site prudential inspections of German branches abroad.

Reform of supervisory authorities

In the past, the prudential supervisory system outlined above has prevented crisis-like developments in the German banking sector, developments which were followed in other countries by a restructuring of supervisory agencies.

However, dynamic changes in the financial markets, especially the increasing complexity of financial transactions, the emergence of mega-banks and technological advances in the financial sector make it necessary to organise banking supervision more efficiently. Another central aim in reorganising banking supervision is to avoid the duplication of work and to focus the available resources to suit a supervisory system that is becoming increasingly qualitative in orientation. In other words, the efficiency of a prudential system depends not only on its having appropriate regulations, supervisory methods geared to market conditions and well-trained and motivated staff; it also depends on its organisation. It is evident that the resources of the Federal Banking Supervisory Office and the Bundesbank must be conjoined if the future efficiency of German banking supervision is to be ensured at the organisational level as well.

To arrive at optimal solutions in German prudential supervision, market developments and the structure of the German financial sector must be given adequate consideration. On the one hand, the increasing trend towards consolidation in the banking sector justifies the prudential focus on systemic risks.

*Stable banking
sector*

*Guaranteeing
the efficiency of
the supervisory
system*

*Need to
consider
growing
systemic risks
and for a
decentralisation
of the banking
sector*

*Comparative
advantages
of the
Bundesbank
in prudential
surveillance*

On the other, the regional structure of institutions will remain unchanged, especially in the savings bank and credit cooperative sectors.

Given that this is the case, the complete integration of the banking supervisory process within the Bundesbank would visibly strengthen surveillance of the German financial market as a whole and would result in the largest gains in efficiency. Insofar as the Bundesbank would then house complementary functions, such as responsibility for system stability, monitoring of payment systems, its own refinancing transactions, its activities on financial markets, and its participation through the President in international bodies (especially in meetings of the G-10 governors and in the ECB Governing Council), it could exploit comparative advantages in access to prudentially relevant information to a degree unparalleled by any of the other proposals for reorganising banking supervision currently under discussion. The Bundesbank's extreme proximity to the markets also represents an important advantage in the regulatory and prudential processes. The effective discharge of banking supervisory duties requires that credit institutions of systemic significance be monitored from the Central Office of the Bundesbank in Frankfurt while the regional orientation of the financial sector suggests that the involvement of the Land Central Banks would prove beneficial for prudential supervision. Consistency in the application of law would be ensured despite partially decentralised banking supervisory activities by the fact that all major decisions would be taken by the Central Office. This would not conflict with the Berlin-Bonn Act of April 26, 1994, which

envisages a relocation of the Federal Banking Supervisory Office from Berlin to Bonn.

The argument sometimes heard, i. e. that the Bundesbank's autonomy cannot be reconciled with its simultaneously assuming responsibility for banking supervision, is invalid; the transfer of prudential competence to the Bundesbank would be quite clearly in keeping with Article 88 of the Constitution. Parliamentary and thus political responsibility for this area could be secured in the form of a right on the part of the Federal Ministry of Finance to issue instructions to the Bundesbank on questions relating to banking supervision. The Finance Ministry's banking supervisory instructions would be addressed directly to the Bundesbank's central managing body and would then be passed on to the departments and Main Offices.

The fact that the President of the Bundesbank is involved in the formulation of European monetary policy is also no argument against assigning responsibility for banking supervision to the Bundesbank since monetary policy decisions in the Eurosystem are taken on a communal basis. Consequently, national interests and banking supervisory decisions are incapable of influencing the monetary policy of the Eurosystem. In any case, the majority of central banks in the euro area either bear prime responsibility for banking supervision as well or play a prominent part in prudential surveillance activities.¹ It was decided

Banking supervision compatible with the Bundesbank's independence in monetary policy matters

Community law permits a transfer of banking supervisory authority to national central banks

¹ Other euro area central banks besides the Bundesbank playing a predominant part in, or bearing prime responsibility for, banking supervision are those in Austria, France, Ireland, Italy, the Netherlands, Portugal and Spain.

in the context of the statutory convergence tests that the exercise of this function is compatible with the national central bank independence required of the European System of Central Banks by the Maastricht Treaty.

European Community law likewise fails to recognise the autonomy of central banks in the performance of banking supervisory tasks. Article 108 of the EC Treaty limits the independence of central banks to exercising the powers and carrying out the tasks and duties conferred upon them by the EC Treaty and the ESCB Statute. An especially important criterion for identifying ESCB functions is whether the function in question may be found on the list given in Article 105 (2) of the EC Treaty; banking supervision does not appear on this list. Like other central banks of the Eurosystem, the Bundesbank would, in keeping with Article 14.4 of the ESCB Statute, regard prudential surveillance as a national responsibility. Since it is expressly stated in Article 14.4 of the ESCB Statute that the additional national responsibilities of the ESCB central banks are not ESCB functions, there is no contradiction in the Bundesbank's

being subject to instructions from a national authority.

The views expressed above on the reform of banking supervisory authorities are supported as well by statements of the Expert Commission on the Structural Reform of the Bundesbank, which, in its report of July 4, 2000, also discusses the organisation of banking supervision in Germany. It justifies its proposal to integrate the banking supervisory process fully within the Bundesbank on several grounds, the most important of them being that

- the payment systems, which are monitored by the Bundesbank, may provide “early warning signals” of consequential banking supervisory problems,
- the central bank must be included in the day-to-day running of prudential operations if it is to be kept abreast of systemic risks and
- since the credit institutions act as borrowers in refinancing operations with the central bank, the central bank must have access to their balance sheet statistics to arrive at a credit rating.

Expert Commission on the Structural Reform of the Bundesbank