EUROASIAN PERSPECTIVES OF THE BANKING SYSTEMS DEVELOPMENT

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Chapter 5

THE GERMAN BANKING SYSTEM: STRUCTURE, BUSINESS OPERATIONS, SUPERVISION AND RECENT GOVERNANCE DEVELOPMENTS

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CHAPTER 5. THE GERMAN BANKING SYSTEM: STRUCTURE, BUSINESS OPERATIONS, SUPERVISION AND RECENT GOVERNMENT DEVELOPMENTS

5.1. INTRODUCTION

Providing integral functions, banks play a major in today's modern economies. This seems even more relevant for Germany, where banks traditionally play a more important role in funding the economy than in other economies. Not only in the highlight of the recent financial and economic crisis since 2007, a sound banking and financial system is critical for the performance of the whole German economy. Banks borrow and lend by means of debt contracts, with different maturity and bank loans are one of the most important source of funding in Germany and therefore with an important role in allocating resources. Banks often decide, which projects will be funded, so they have also an initiatory function in many economies (Schumpeter 1911; Dietrich 2009). Gorton and Schmidt (2000) provide evidence that German universal banks play a major role considering the performance of German firms and German corporate governance as a consequence of the specific German economy which is characterized by bank equity ownership, proxy voting by banks and high concentration of equity ownership (Dietrich 2009). So it is hard for a firm in the German economy to operate without close ties to the banking sector since obtaining equity financing by the stock market is even harder: "When enterprises are deciding on which financing methods to adopt, the advice of their principal bankers may be sometimes be to take up new loans, because the share issue which might be to the advantage of the enterprise is not rated so highly by the bank; however definite statements in this regard can neither be made nor proved" (Deutsche Bundesbank 1984, p. 15). Thus, banks might play an exceptionally important part in Germany's capital allocation process. In the following chapters, we try to highlight the German banking system, its origin and structure, its business operations and importance for the German economy. Furthermore, we describe the financial supervisory and regulatory framework of the German banking system and the monetary policy of the Deutsche Bundesbank in the European System of Central Banks (ESCB). Finally, we broach the issue of recent developments in German banking and corporate governance, against the background of the financial crisis.

5.2. ORIGIN AND EVOLUTION OF THE GERMAN BANKING SYSTEM

The most important point in the history of the German banking system is the year 1871, when the "German Reich" has been founded. After that German banks were able to operate within a unitary economic area. With the introduction of the gold standard 1873 the country had a unitary currency for the first time in German history. In 1876 the German Reichsbank started its economic activity. So, for the first time in German history the country had a German central bank, later on called the German Bundesbank. The German Reichsbank, since its founding in 1876 had been considered as commercial bank of the state. Doing bank businesses for the state it principally had equal rights like private banks. In 1909 the Reichsbank was raised above the commercial banks and its paper money became the functional currency. After the Great Inflation/Depression in 1923 until 1931 the German currency was called a "gold-currency-standard" since other currency given for the German Reichsmark had also been redeemable into gold. Since the great German banking crisis in 1931 and a breakdown of many banks, also big ones, only a national moratorium of could stop a run on banks. As a consequence the German Mark was no longer redeemable into other currencies. In World War II the German currency was devaluated for the second time, as a consequence of inflation but not hyperinflation. After the war in 1948 a currency reform occurred by devaluating the currency at the ratio of 1:10. Accordingly to the decentralised organisation of the German state in lands, firstly, land central banks had been founded, with the Bank Deutscher Länder as a central institute. It took nearly 10 years, since the German Bundesbank, as we know it today, was founded in 1957, with its function as the German central bank (Welcker 1981).

5.3. STRUCTURE OF THE GERMAN BANKING SYSTEM

5.3.1. OVERVIEW

The German banking system is characterized by a great variety of different banking institutions. The predominating institutional banking type is the so-called universal bank (Universalbank) offering a wide range of commercial and investment banking services, either incorporated under private or public law (Schneider/Hellwig/Kingsman 1986). The second important institutional banking type is the specialist bank (Spezialbank) (Klein 1998).

5.3.2. TYPES OF FINANCIAL INSTITUTIONS

Important criteria to differentiate German banking institutions are the legal form, balance sheet total, number of employees, direction of lending business and deposit business, business purpose and ownership structure. Usually single banking institutions are divided via the criterion “legal form”. As a consequence, there is a three-pillar-structure (Figure 1) of the German banking system, consisting of private commercial banks, public-law banks and mutual savings banks (Bofinger et al. 2008).

Private commercial banks are mainly universal banks with the legal form of a corporation, obviously there are also private companies. Private banks are major banks, e.g. Deutsche Bank AG, Dresdner Bank AG, Commerzbank AG or Deutsche Postbank AG. Furthermore, regional banks, individual bankers, local branches of foreign banks and building-credit societies (Schneider/Hellwig/Kingsman 1986).

Public-law banks cover land banks, savings banks, land building associations and banks with special tasks, e.g. the KfW Bankengruppe. They are usually owned by the Federal Republic of Germany, Federal Lands or single communities and should act on common welfare. All together there are eleven land banks. After some fusions only seven of them are economically independent. Like credit banks, the land banks mainly operate as universal banks, but also as principal bank of Federal Lands and as central institutions for savings banks. Savings banks have also a license to operate as universal banks. Contrary to land banks, they are limited in doing business in specific regions (*regional principle*) but they cooperate with each other in specific fields like marketing, data storage and processing or product development to raise economies of scale. Generally, takeovers from abroad are strongly limited, whereas takeovers and fusions between land banks or savings banks are possible horizontally and between land banks and savings banks vertically (Bofinger et al. 2008; Schneider/Hellwig/Kingsman 1986; Klein 1998).

Mutual savings banks cover credit associations, their central institutes (DZ Bank and WGZ Bank) and corporate building associations. The legal form of a German association means that buying stakes of an association makes the stakeholder a member and co-owner and that voting rights' power does not depend on the amount of the stake: every member has one voice. As a consequence takeovers from outside are hindered drastically. Similar to the savings banks, mutual savings banks underlie a historically grown regional principle (Bofinger et al. 2008; Klein 1998).

5.3.3. BUSINESS OPERATIONS OF FINANCIAL INSTITUTIONS

Doing business is pretty different within the different types of financial institutions of the German banking system. Taking a look at the *source of funds* private commercial banks, especially major banks, the land banks and the central institutes of credit associations are highly engaged in foreign markets. Contrariwise, savings banks and credit associations mainly do business with funds from Germany. Concerning re-financing one should consider the high degree of 41.4 percent in inter-bank business of central institutes with a comparably low degree of 20.8 percent of land banks which means an advanced pull-out from business with non-banks and a concentration on the main function of mutual savings banks. Land banks traditionally finance their operations via coupon bonds and savings banks and credit associations do their main business in the private sector. Examining the *disposition of funds (crediting)* private commercial banks, especially major banks, the land banks and central institutes are highly involved in foreign business operations. Contrariwise, savings banks and credit associations are only marginally active abroad. Consequently, crediting with domestic companies and private persons is in the center of those types of institutions' business operations. Furthermore, high degrees of credits for domestic buildings of savings banks and credit associations are noticeable. A considerably high extent of crediting on employees and further private persons shows a broad concentration of those institutions.

Considering the relevance of different types of financial institutions in Germany and their market shares in different segments, savings banks and credit associations in nearly all areas have the biggest market shares, often with more than 50 percent, obviously their balance sheet total is only 29 percent of all financial institutions. High proportions of credits to self-employed persons by savings banks and credit associations are also very remarkable. Land banks and central institutes seem to concentrate mainly on their role within inter-banking business.

5.4. FINANCIAL SUPERVISORY AND REGULATORY FRAMEWORK OF THE GERMAN BANKING SYSTEM

In post-war Germany, regulation of the German banking sector is based primarily on the German Banking Act (KWG) of 1961, which has been relatively liberal for some time. As one of the first countries in Europe, the establishment of banks and bank industries had been deregulated and interest rates were fully liberalized. Apart from solvency-related provisions, there are also no restrictions on lending. Banks are free to invest in non-financial corporations and to engage in a broad spectrum of banking and bank-related activities, including almost all aspects of investment banking (Schmidt/Tyrell 2004), with the main trade-off for politics between necessary regulatory intervention and neutrality within the competitive environment (Tolkmitt 2007; Klein 2008).

In Germany, banking regulation and supervision currently lies with the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* - BaFin) which is assisted by the Deutsche Bundesbank. Their cooperation is governed by section 7 of the Banking Act, which stipulates that, among other things, the Bundesbank shall, as part of the ongoing supervision process, analyse the reports and returns that institutions have to submit on a regular basis and assess whether their capital and their risk management procedures are adequate. BaFin and the Deutsche Bundesbank have on agreed on the details of this arrangement in a Memorandum of Understanding. Supervision is also conducted by the private banking federations. Since it was established in May 2002, the Federal Financial Supervisory Authority has brought the supervision of banks and financial services providers, insurance undertakings and securities trading under one roof. BaFin is an independent public-law institution and is subject to the legal and technical oversight of the Federal Ministry of Finance (its predecessor, the Federal Banking Supervisory Authority (FBSA) was also expected to cooperate closely with the Bundesbank and its regional affiliates, the so-called *Landeszentralbanken*, which were responsible for on-site inspections (Schmidt/Tyrell 2004)). Hence the BaFin is a uniform governmental regulatory authority for all financial institutions (*Allfinanzaufsicht*). While the BaFin takes regulatory decisions, the operational supervisory process lies mainly with the Bundesbank (Bebenroth/Vollmer/Dietrich 2009).

The BaFin is funded by fees and contributions from the institutions and undertakings that it supervises. It is therefore independent of the Federal Budget. BaFin operates in the public interest. Its primary objective is to ensure the proper functioning, stability and integrity of the German financial system. Bank customers, insurance policyholders and investors ought to be able to trust the financial system. BaFin has almost 1,900 employees working in Bonn and Frankfurt am Main (*Figure 2*). They supervise around 2,000 banks, 710 financial services institutions, approximately 620 insurance undertakings and 28 pension funds as well as around 6,000 domestic investment funds and 73 asset management companies (as of March 2010). Under its solvency supervision, BaFin ensures the ability of banks, financial services institutions and insurance undertakings to meet their payment obligations. Through its market supervision, BaFin also enforces standards of professional conduct which preserve investors' trust in the financial markets. BaFin grants commercial bank licenses with a minimum capital entry requirement for opening a bank of € 5 million and no restriction on the percentage of capital held by a single owner. Following Basel II, every bank should have a capital-to-asset ration of a minimum of 8 percent, respectively 12.5 percent for newly established ones in the first three years if business. Periodic external audits are obligatory and auditors have to be licensed or certified and must submit a copy of the auditor's report to BaFin whereas BaFin may not take legal action against external auditors for negliance, but can refuse an external auditor according to section 28 of the German Banking Act (KWG). Nevertheless, BaFin may force a bank to change its internal organisational structure. Following article 19 of the by-laws of the European Central Banks, commercial banks must hold minimum reserves with the central bank on which they earn interest. A subject, very often discussed in case of the recent financial crisis, is that banks must hold enough liquidity reserves, which means that weighted short-term liabilities should not exceed weighted short-term assets.

Regarding the case of Islandic Kaupthing Bank for a long time in Germany there's a deposit insurance system which is comprised of two different schemes which are both funded by the banks (Deutsche Bundesbank 2000). All deposits of commercial banks which are member of the Bundesverband deutscher Banken (BdB) are practically insured without limit where the insurance fund of the BdB also covers the retention remaining from the compulsory scheme as well as any amount above € 20.000 per depositor. The compulsory scheme does not apply to banks for which the viability is safeguarded by virtue of their by-laws, as e.g. to savings banks and land banks. For those institutions being members of such mutually supportive banking groups, direct deposit insurance does not only cover liabilities since the respective banking federation is obliged to guarantee the existence for each single bank (Bebenroth/Vollmer/Dietrich 2009). As part of its investor protection, BaFin also seeks to prevent unauthorised financial business (BaFin 2010):

BaFin's by-laws represent a major set of precepts for how it acts. They contain regulations governing its structure and organisation and its rights and obligations. They also govern the functions and powers of BaFin's supervisory body, its Administrative Council (*Verwaltungsrat*), and details of its budget. BaFin also bases the way in which it carries out its supervisory activities on the Mission Statement it gave itself shortly after it was established. According to this Mission Statement, BaFin's function is to limit risks to the German financial system at both the national and international level and to ensure that Germany as a financial centre continues to function properly and that its integrity is preserved. As part of the Federal administration, BaFin is subject to the legal and technical oversight of the Federal Ministry of Finance, with the framework of which the legality and fitness for purpose of BaFin's administrative actions are monitored.

Banking Supervision, Insurance Supervision and Securities Supervision/Asset Management are three different organisational units within BaFin – the so-called Directorates. They comprise a total of twelve separate departments within which specialist sections supervise credit institutions, insurance undertakings, financial services institutions and investment companies. Issues of fundamental importance for supervisory law are dealt with in basic issues sections. Functions that extend beyond individual sectors are carried out, not by the Directorates, but by cross-sectoral departments. One of these, for example, brings together all BaFin's international activities and represents German interests in EU and other international committees. Other cross-sectoral departments are responsible, among other things, for dealing with complaints and the prosecution of unauthorised financial business. Since they extend beyond individual sectors, basic issues regarding the quantitative mathematical modelling of market, credit, liquidity and operational risks fall within the remit of another cross-sectoral department; its staff tests these models by way of on-site inspections. There is also a group that deals exclusively with combating money laundering and the financing of terrorism.

BaFin must cover its expenditure entirely out of its own income. It receives no funding from the Federal budget. BaFin raises the funds required to cover its costs from the undertakings it supervises instead. The legal foundation for this is the Act Establishing the Federal Financial Supervisory Authority (FinDAG). Pursuant to section 13 (1) of the Act, BaFin's sources of funding consist primarily of *fees* (section 14 of the Act), *separate reimbursements* (section 15) and *contributions* (section 16). The actual amount of fees and contributions is calculated on the basis of the Ordinance on the Imposition of Fees and Allocation of Costs Pursuant to the FinDAG (FinDAGKostV) and in accordance with special rules governing the charges to be applied by BaFin. In certain circumstances the undertakings under BaFin's supervision may also incur other costs, the most important of which are described briefly below: *Firstly*, these are "costs" in the wider sense. What is meant by this are any costs arising as a result of the execution of enforcement measures, especially coercive penalty payments, and the imposition of fines in the event of the unlawful carrying-on of business. *Secondly*, undertakings must bear the costs arising as a result of accountants and other experts being called in or undertakings meeting their statutory disclosure and reporting requirements. However, these costs are not charged by BaFin but on the basis of a private-law agreement between the undertaking and the accountant(s) or expert(s) in each case. For that reason BaFin can provide no information on the amount of the charges that undertaking may expect to have to pay. *Finally*, there are also the costs of the deposit protection schemes and compensation funds that credit institutions and financial service providers are required by law to be members of. These costs are not charged by BaFin either.

Taking a look at recent developments, the financial and economic crisis from the end of 2007 has laid bare some deficiencies in banking supervision, which may in part be related to its shared responsibilities as well as to a lack of independence of the regulator. The German government's plan to consolidate banking supervision at the Bundesbank (as opposed to the prior division of labour between the Bundesbank and the German Financial Supervisory Authority) seems to be a step in the right direction, not least as it should raise the independence of the supervisor and provide the framework for a more macro-prudential approach to supervision. Given the widespread regulatory arbitrage prior to the crisis, the powers of the supervisor should be strengthened beyond recent legislative changes to allow for the possibility to widen the scope for supervision beyond compliance with quantitative requirements. In this regard, supervisors should address more clearly the risks that business strategies entail. In addition, consideration should be given to introducing capital buffers that fluctuate with the business cycle. The government's initial use of *ad hoc* measures to bail out individual banks showed that the current mechanisms to handle banking crisis do not provide sufficient scope for an appropriate response to systemically relevant banks in distress. Thus, in order to allow for a more efficient dealing with future bank failures, existing plans for the introduction of a framework for restructuring and winding-up of systemically-relevant banks should be pursued further (*Chapter 6*). Ideally, such a scheme would allow the negative system-wide effects of an individual bank failure to be limited, while keeping the costs for the taxpayer to a minimum and mitigating incentive distortions. A critical element of such a framework should thus be that supervisory intervention takes place at an early stage, to widen the options for restructuring (OECD 2010).

5.5. MONETARY POLICY OF THE BUNDESBANK IN THE EUROPEAN SYSTEM OF CENTRAL BANKS

The European System of Central Banks (ESCB) consists of the European Central Bank (ECB) and the national central banks (e.g. the German Bundesbank) of the European Union (EU) Member States. The Governing Council of the ECB is responsible for the formulation of monetary policy, while the Executive Board is empowered to implement monetary policy according to the decisions made and guidelines laid down by the Governing Council. To the extent deemed possible and appropriate and with a view to ensuring operational efficiency, the ECB has recourse to the national central banks for carrying out the operations which form part of the tasks of the Eurosystem. The national central banks may, if necessary for the implementation of monetary policy, share amongst the Eurosystem members' individual information, such as operational data, related to counterparties participating in Eurosystem operations. The Eurosystem's monetary policy operations are executed under uniform terms and conditions in all Member States (European Central Bank 2008). The Eurosystem has a number of monetary policy instruments which it uses to achieve its monetary policy objectives. The main components of this set of instruments are open market operations, standing facilities and minimum reserves (Deutsche Bundesbank 2010):

The *main refinancing operations,* with a weekly frequency and a maturity of one week, are the most important monetary policy instrument used by the Eurosystem for money market management. On an annual average, such operations are used to cover around three-quarters of the banks' need for central bank money. The Eurosystem conducts monthly *longer-term refinancing operations* (basic tenders) with a three-month maturity in order to steady the supply of liquidity and to assist banks which are active in the money market in the security of their operations. In addition to the regular basic tenders, the Eurosystem is conducting supplementary longer-term refinancing operations owing to the current financial market turmoil. With these operations, the Eurosystem aims to support the normalisation process and the smooth functioning of the euro money market. Supplementary longer-term refinancing operations are currently being conducted with a maturity of one minimum reserve period, three months and six months, each at the beginning of a minimum reserve period. Longer-term refinancing operations with a maturity of twelve months are offered on a quarterly basis together with the regular basic tender at the end of the quarter. The main and the longer-term refinancing operations are executed according to an indicative calendar published by the ECB each September. The calendar is published at least three months before the start of the year for which it is valid. The Eurosystem may also conduct *quick tenders* in order to smooth unexpected liquidity fluctuations rapidly. The two standing facilities - the marginal lending facility and the deposit facility - are designed to provide or absorb liquidity until the next business day. Furthermore, the Eurosystem prescribes the minimum reserves which the banks are required to hold order to increase the structural liquidity requirements of the banking system.

5.6. RECENT DEVELOPMENTS AND IMPACT ON CORPORATE GOVERNANCE IN BANKS

5.6.1. THE FINANCIAL AND ECONOMIC CRISIS

Since the end of 2007, Germany, as well as many other countries in the modern world, has experienced a crisis which nobody had expected in its extent. The economic crisis that erupted in 2008 and deepened in 2009 is challenging a host of our economic conceptions and theories and has revealed severe shortcomings in corporate governance arrangements. Especially the role of the banking sector within the current crisis has led to a massive loss of trust and put pressure not only on companies within the financial sector but also on policy makers. Nevertheless, shortcomings contributing to the crisis of confidence are not uniquely American as one could expect taking a look at Lehman Brothers or Bear Stearns, however, with banking companies also in Germany adding their own governance shortcomings to the crisis and only political bailout could abandon the financial crash of Hypo Real Estate and IKB Deutsche Industriebank AG or other companies in Germany depending on these companies. More than two years after that, science, politics and regulators are still looking towards the future of the financial sector. The financial crisis represents a political as well as substantive challenge to policy makers. The impact of the crisis on judgements about banking companies' practices is arguably summed up by the remarks of Alan Greenspan at a hearing by the US Congress: "I made the mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and the equity of the firm" (Greenspan 2008, p. 33).

The national and international response to the crisis has been characterised by widespread calls for further (re-)regulation of the financial sector. Bank supervision in particular is being restructured and tightened. Policy makers cannot stay aloof from the debate which raises questions about the relative role of legally binding, requirements and their enforcement as opposed to principles-based, flexible instruments. It is important to take a wider view since banks and others are not fundamentally different from other companies with respect to management (OECD 2009), especially when no one is sure whether the crisis is completely over, and whether banks and the financial system have already hit the bottom (Chambers 2009). Recent cases like the one of Commerzbank AG with a further loss of € 4.5 billion in 2009 (and a need for fresh capital) and a strong financial linkage within the German financial sector, e.g. Allianz SE, Europe's biggest insurance company holds 10 percent of Commerzbank AG, should leave us sceptical.

5.6.2. CHANGES IN CORPORATE GOVERNANCE OF BANKS

It is almost widely discussed internationally if German supervisory boards hold expectations towards monitoring and advising management boards effectively. The financial crisis and especially the role of banks in it could be a further, bad signal for international investors towards German corporations and may confirm them in their reservations towards the German corporate governance system. Since supervisory boards were indirectly responsible for the sharp rise in executive compensation before and after the financial crisis, often little related to company performance, many public figures came to criticize them as improper ("pay without performance", Bebchuk/Fried 2006).

Concerning those remuneration issues, German government has passed two laws concerning remuneration. The first one from 2006 is called the Act Regarding the Disclosure of Management Board's Remuneration (VorstOG), with its main purpose to give companies an incentive towards proper, performance-based executive compensation. Against all expectations, executive salaries have been levelled and (unfortunately) boosted, with a common argument of companies, that one cannot evaluate separately the performance of individual board members, said Klaus-Peter Müller, Head of the German Code Commission, criticising the financial sector heavily (Müller 2009). Consequently, German government has passed the Act Regarding the Appropriateness of Management Board's Remuneration (VorstAG) in 2009, with its main purpose to link the variable remuneration of the Management Board to the company's development based on several years' assessment data. As a first reaction, by example Allianz SE assessed the short-, middle- and long-term elements of managers' variable remuneration equally in the future and enforced its malus system in case of bad performance, as well as Deutsche Bank AG did.

Moreover again, detected shortcomings concerning cooperation between the management board and the supervisory board and the qualification of supervisory boards in general the Code Commission establishing the German Corporate Governance Code (GCGC) has put the issue of improving the professionalism of supervisory boards (§ 100 German Corporation Act, AktG) of listed companies as one of the main issues on its agenda in 2010. This may expand the group of suitable candidates that could in future exercise supervisory mandates and achieve greater diversity within management teams with a focus on more women or foreigners in corporate boards. Furthermore, the Commission addresses the fundamental need to increase the qualifications of supervisory boards in general by expanding additional training that is available to both future candidates for supervisory boards and existing members. This may provide in-depth theoretical and practical information, in particular in the areas of legal principles, group financial accounting and risk controlling or provide in-depth information on the rights, obligations and responsibilities of supervisory boards on the basis of the German Corporation Act (§ 107 AktG) and the GCGC. Further aspects of training may be, to examine how committees work, reporting and control mechanisms as well as providing practical information on the work of supervisory boards with codetermination and addressing conflicts of interest (German Code Commission 2010). Additionally, Germany has passed the Accounting Law Modernization Act (BilMoG) in 2009 with several changes in corporate governance. Beneath the qualifications and duties of supervisory boards BilMoG discusses the establishment of an audit committee (§§ 324 and 264d German Commercial Code, HGB) and its duties of supervising audit processes, effectiveness of internal control processes and audit (§§ 289, 315 HGB) and puts pressure on listed companies to inform its stakeholders about corporate governance specific issues via a Declaration on Corporate Governance (§ 289a HGB). This declaration could be a standardized instrument for companies to present own corporate governance practices on a recipient-specific basis and be a further source for investors to compare companies by corporate governance specific issues. Altogether, there hasn't been any major interference into the corporate governance of big financial institutions at the managerial level concerning specific corporate governance rules or new best practices. So the corporate governance systems of big financial institutions in Germany don't seem to have changed substantially since and during the crisis.

Finally, the impact of high debt ratios of German banks shall be discussed. Following Myers (1977), high debt ratios may lead managers to act too much on the interest of shareholders and let pass by projects with positive cashflow. High debt ratios force management to take cashflow for paying companies' dues which additionally leads to a loss of equity and induces higher risk of illiquidity. Subprime crisis has shown drastically, how the whole German economy can suffer from such overly risk-taking firm politics, e.g. from Hypo Real Estate (which also didn't withstand the recent European stress-tests; Deutsche Bundsbank/BaFin 2010), IKB or Commerzbank. German government has reacted immediately and gave fresh money or guarantees for these institutions with its protective shield of more than € 400 billion. Further action towards higher equity ratios shall clearly be taken by companies within the financial sector themselves (Sanio 2009). There are also some examples like Hypo Real Estate or Commerzbank, where the German state participates now not only as regulator but also as shareholder by giving guarantees to those institutions but not as an active shareholder within the supervisory board. Nevertheless, one shouldn't consider this as a rule. Only few financial institutions used this protective shield of more than € 400 billion (*Figure 3*) and state only intervened at those companies being considered as "system-relevant". Letting those companies going bancrupt has been supposed by policy-makers to be worse for the whole German economy than rescuing them. In order to use this protective shield a financial institution first has to apply for at the German Federal Agency for Financial Market Stabilisation (FMSA) (*Figure 4*).

There's a Financial Market Stabilisation Fund (SoFFin) which guarantees for newly issued debt securities and other liabilities of financial sector enterprises. All liabilities may have a term of up to 36 months in general and 60 months as a maximum. As compensation for the granting of the guarantee, the SoFFin charges a specific percentage of the guaranteed sum reflecting the likelihood of default plus a margin. The granting of the guarantee requires that the benefited financial sector enterprise is reasonably equipped with its own assets. The maximum amount of the guarantee is determined based on the value of the enterprise's assets (including its affiliates).

Other possibilities of SoFFin are *recapitalization* and *assumption of risk positions*. The *recapitalization* is directed towards a reasonable own funds basis of the financial sector enterprise. This may be achieved by the issuance of shares, silent participations, or the acquisition of other elements of own funds. The SoFFin receives a fair market consideration for capital contributions. The maximum amount of recapitalization measures in a single entity (including its affiliates) amounts to 10 billion Euros, subject to the decision of the steering committee. The SoFFin may hold and sell participations beyond 2010. Acquired shares, silent participation rights, and other rights, shall be sold in a manner that avoids substantial impacts on the market. The SoFFin may *assume risk positions* (e.g. receivables, securities) from financial sector enterprises that were acquired prior to

13 October 2008. As consideration the SoFFin transfers to the financial sector enterprises debt instruments of the Federal Republic of Germany. The SoFFin can hold the risk position until their maturity. As compensation for the assumption of risk positions, the SoFFin charged interest in an amount determined on the basis of the assumed risk, at least equal to the cost of funds of the SoFFin. The maximum amount of the assumption of risk positions in a single entity (including its affiliates) amounts to 5 billion Euros, subject to the decision of the steering committee.

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Appendix A

Table A.1. Source and disposition of funds in the German banking system in 2007, percent

	Private commercial banks			Land banks	Savings banks	Central institutes	Credit associations
		Including:					
	Overall	Major banks	Regional banks & further credit banks				
	1st pillar			2nd pillar		3rd pillar	
	Source of funds						
Deposits & borrowed funds							
Domestic	42.3	36.8	59.3	39.4	82.5	52.8	80.6
Including:							
Banks	9.2	8.5	11.6	20.8	18.6	41.4	11.6
Non-banks	33.1	28.3	47.7	18.6	63.9	11.4	69.0
Foreign	34.3	37.5	17.8	22.5	2.7	21.3	2.3
Coupon bonds	11.0	13.2	9.2	29.5	4.6	17.0	6.2
Capital	4.8	4.6	5.9	4.1	5.2	4.2	5.9
	Disposition of funds (Crediting)						
Domestic	46.0	39.2	62.3	52.4	89.4	53.5	86.4
Including:							
Banks	13.1	11.7	16.5	27.5	22.7	42.9	23.4
Non-banks	33.0	27.5	45.8	25.0	66.7	10.5	63.0
Including:							
Companies & private persons	27.8	21.9	39.8	17.3	55.3	7.5	57.0
Including:							
Domestic buildings	11.7	10.1	17.7	3.6	29.3	0.1	30.5
Companies	11.2	9.8	11.5	13.5	13.3	7.2	9.1
Self-employed persons	3.6	3.4	4.8	1.3	13.9	0.2	15.5
Employees & further private persons	12.8	8.7	23.4	2.4	27.8	0.2	31.8
Foreign banks	30.0	32.9	19.9	26.8	2.2	20.1	3.3

Source: Bofinger et al. 2008, p. 89 on basis of figures from Deutsche Bundesbank.

Table A. 2. Relevance of important types of financial institutions in Germany in 2007, market shares in percent

	Private commercial banks			Land banks	Savings banks	Central institutes	Credit associations
		Including:					
	Overall	Major banks	Regional banks & further credit banks				
	1st pillar			2nd pillar		3rd pillar	
Balance sheet total	39.0	24.3	11.9	27.4	18.1	4.5	10.9
Credits to domestic non-banks	32.9	17.1	14.0	17.5	30.8	1.2	17.6
Including:							
Companies & private persons	33.7	16.6	14.8	14.8	31.1	1.1	19.4
Including:							
Credits for domestic buildings	32.1	17.2	14.9	7.0	37.3	0.0	23.5
Companies	37.1	20.0	11.6	31.4	20.3	2.8	8.4
Self-employed persons	23.7	13.7	9.7	5.9	42.0	0.1	28.3
Employees & further private persons	35.3	14.9	19.7	4.7	35.4	0.0	24.5
Deposits & borrowed funds from domestic non-banks	34.3	18.2	15.2	13.6	30.7	1.4	20.0

Source: Bofinger et al. 2008, p. 91 on basis of figures from Deutsche Bundesbank

Appendix B

Private commercial banks e.g. Deutsche Bank AG Dresdner Bank AG Commerzbank AG	Public-law banks e.g. KfW Bankengruppe	Mutual savings banks e.g. DZ Bank WGZ Bank

Figure B.1. Three pillars of the German banking system

BaFin				
Banking Supervision	Regulatory services / Human resources	President	Insurance and Pension Fund Supervision	Securities Supervision / Asset Management

Figure B.2. Organisation chart of the BaFin

Source: http://www.bafin.de

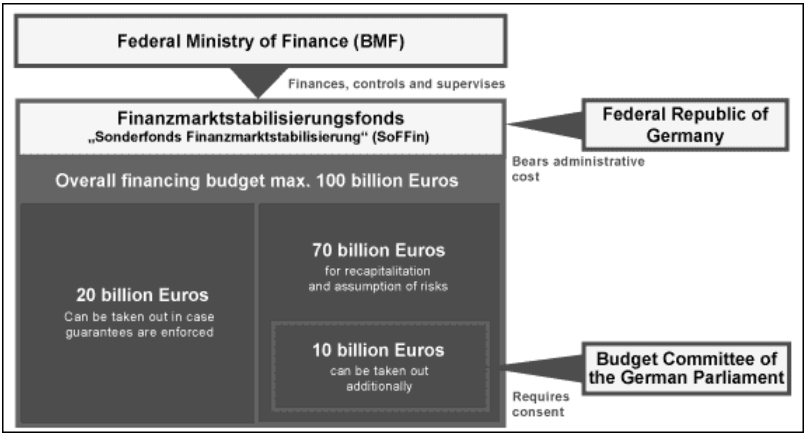

Figure B.3. Financial structure of SoFFin
Source: http://www.soffin.de

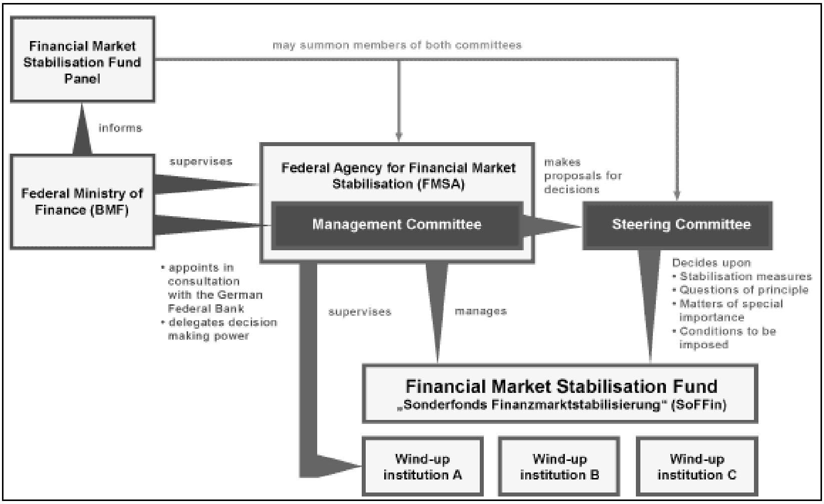

Figure B.4. SoFFin organizational structure
Source: http://www.soffin.de