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**THE GERMAN BANKING SYSTEM:
LEGAL FOUNDATIONS AND RECENT TRENDS**

by

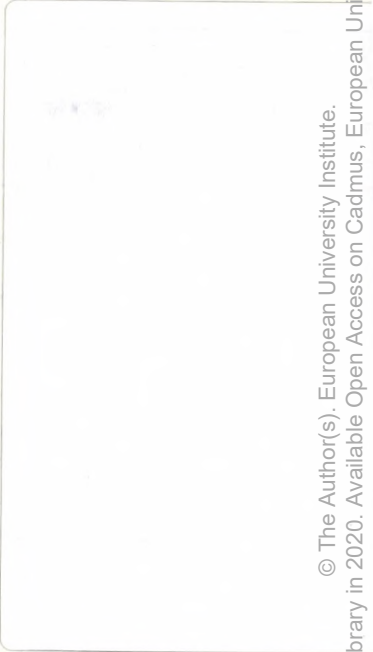
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THE GERMAN BANKING SYSTEM: LEGAL FOUNDATIONS AND RECENT TRENDS

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1. INTRODUCTION

Banking systems of Western industrialized countries can be classified into two main groups. On the one hand, there are countries in which the regulation of financial institutions is based on a complex set of well defined rules. On the other, there are countries in which the regulation of financial institutions relies on the delegation of wide discretionary powers to agencies or other public authorities charged with the responsibility of guaranteeing the safety and the well-functioning of the financial system.

This basic distinction does not depend on the traditional opposition between common law - civil law countries. As a matter of fact, examples exist of common law countries - such as the U.S.A. - in which a clear-cut set of rules regulates the activities of banks and other financial institutions, alongside discretionary powers conferred on the various supervisory authorities (FED, Comptroller of the Currency, FDIC, etc.). And it is not unusual for banks and bankers' associations to challenge in court the (often too restrictive) interpretation of these rules given by the supervisory authorities.

At the other end of the spectrum there are both common law countries - such as Great Britain - and civil law countries - such as Italy and to some extent France - where supervisory authorities are vested with wide discretionary powers. In these countries banks have rarely, if ever, brought a legal suit against the central bank.

Within this classification, therefore, West Germany is a typical civil law country in which banking regulation (mainly at a statutory level) clearly defines the range of permitted activities, quantitative ceilings, ratios and other limits imposed on banks and other financial institutions: little room for discretion is left to the supervisory authorities.

The well-functioning of such an approach to banking regulation assumes, as a pre-condition, a political system in which both the Government and Parliament are capable of promptly modifying and adapting the rules in force, whenever required by changes in general economic conditions or other emergencies. As a matter of fact, such legislative process is much more burdensome and timeconsuming than the exercise of a discretionary power by an administrative body. As we shall see, however, banking legislation in West Germany has undergone the necessary adjustments without delay whenever it has been deemed necessary.

A well defined set of rules, as will be clarified below, is also critical for the smooth functioning of a banking system, such as that of Germany, that has adopted and never rejected the potentially (and historically) more dangerous model of the so-called "universal banks".¹⁾

This brings us to a second and more particular feature of the German banking system. Universal banks (Universalbanken) can be defined as banks covering a whole range of financial activities, i.e. providing both commercial and investment banking services.

We shall analyze in detail the list of permitted activities to see how such a system is not necessarily less safe than a system of specialized financial institutions.

From a historical perspective, the model of universal banking was dominant in Western industrialized countries for a long period of time, with the significant exceptions of Great Britain and, after the collapse of the Crédit Mobilier in 1867, of France. It was only after the bank

1) For a discussion of the model of universal banking also from the historical point of view, see H. Büschgen, Das Universalbankensystem, Frankfurt am Main, 1971, p. 6 ff.

crisis of the thirties that many countries adopted legislation introducing the principle of strict separation of commercial and investment banking activities. One of the most "draconian" of these pieces of legislation is the well known Glass-Steagall Banking Act passed by the U.S. Congress in 1933.

Although German banks were deeply shaken by the bank crisis of 1931, the Reichsgesetz über das Kreditwesen of December 5, 1934 - the first comprehensive statute regulating the banking system in Germany - did not abandon the principle of universal banking.²⁾

On the contrary, German bankers, analysts and scholars unanimously share the belief that the universal banking system is far more efficient and stable than a specialized banking system.³⁾ This belief seems to be supported by the fact that the stream of financial innovation experienced in recent years in most Western industrialized countries has left Germany almost unaffected and, in any case, has not given rise to the feelings of deep concern and apprehension - widespread in many other countries - for the stability of the financial system. At the same time, the economic performance of West Germany has been highly satisfactory in the past few decades.

The links between financial innovation and the principle of universal banking will be explored in this paper in order to test the optimism of German experts mentioned above.

The task of analyzing the legal framework of the German banking system becomes more interesting if we also consider the fact that in

2) See K.E. Born, Die deutsche Bankkrise, 1931, München, 1967.

3) See for example the editorial "Konkurrenz der Systeme", Zeitschrift für das gesamte Kreditwesen, Heft 14, July 1986, p. 649.

the eighties many financial systems have experienced a rapid process of deregulation. Barriers between classes of banks and between banks and other types of financial institutions have been (or are in the process of being) torn down. The trend toward a "despecialization" of specialized financial systems raises the question as to whether old pieces of legislation, such as the Glass-Steagall Banking Act, are still abreast of the times. Can we perhaps foresee in the future a new generalized upsurge of the model of universal banking?

Along with deregulation, another significant institutional trend at an EEC level brings one's attention to the universal banking system. The introduction within the financial systems of EEC member states of the principle of "home country control", which is now under serious consideration, will give German banks operating with branches or subsidiaries in other EEC countries a significant competitive advantage: they will be allowed to engage in both commercial and investment banking activities in countries in which domestic banks are confined either to commercial banking or investment banking activities.

These are the main themes underlying this paper, which will attempt to offer a clear and simple picture of the legal framework, the evolution in recent years and the current major issues of the German banking system.

2. THE STRUCTURE OF THE GERMAN FINANCIAL SYSTEM

Before we turn our attention to the legal structure of the German banking system, it might be useful to sketch the main features of the financial system in general, with the aim of showing how pervasive is the role played by the universal banks and how little room is left for the development of other types of financial institutions specializing in particular financial products.

German banks provide the main mechanism for the transmission of funds from savers to investors and even dominate the organized capital markets.

One simple way of proving this proposition is to consider the liability structure of personal and non-financial company sectors of the economy. Almost two thirds of their total liabilities consist of borrowing from banks.⁴⁾ This figure becomes even more significant, if we consider the fact that in the United Kingdom the corresponding figure amounts to only one quarter. On the other hand, securities represent a source of business finance much less important in West Germany than it is in the United Kingdom (one tenth compared to more than one third).

At the same time, the role played by non-bank institutional investors - such as life insurance companies, pension funds, investment and unit trusts - as financial intermediaries between private savers and borrowers is rather limited in Germany.

There are historical as well as institutional reasons which account for these structural differences between the two countries. It is not the purpose of this paper to compare the historic evolution of the two financial systems. It seems enough here to recall how Germany is listed among those countries known as "late comers" in the process of industrialization. This process started and gained momentum only after Germany reached political unity.

Germany had therefore to catch up with those countries known as "first comers", such as the United Kingdom, where the process of accumulation of financial resources took place gradually and involved many different institutions.

4) See "Business finance in the United Kingdom and Germany", Bank of England Quarterly Bulletin, September 1984, p. 368 ff.

In the absence of other suppliers of financial resources, German banks took the lead in raising and channelling funds to industry and became directly involved in the process of creating a developed industrial structure. Right from the beginning, therefore, German banks - and especially the so-called Großbanken - played a dominant role within the financial system.⁵⁾

But there are also some institutional factors which explain this peculiar feature of the German financial system.

First of all, in West Germany most of the states (Länder) have their own regional stock exchanges: today, there are still eight independent regional stock exchanges, of which Frankfurt and Düsseldorf are the most important. The resulting fragmentation of the capital market partly explains its limited role.⁶⁾

Moreover, only public limited companies (Aktiengesellschaften) are legally entitled to raise liquidity funds in the share market. However, owners of smaller and medium-sized businesses tend to regard the public limited company as unattractive because of the rather strict regulations imposed on the organization of such companies. They are required to set up supervisory boards, to have the annual accounts certified by an independent auditor, to publish their annual reports and, last but not least,

5) See H. Pohl - M. Pohl, Deutsche Bankengeschichte, Frankfurt am Main, 1982; M. Pohl, Einführung in die deutsche Bankengeschichte, Frankfurt am Main, 1976; W. Hagemann, Das Verhältnis der deutschen Großbanken zur Industrie, Berlin, 1931.

6) See "Stock exchange - Toward centralization", The Banker, May 1986, p. 96; W. Röller, "Neuorganisation des deutschen Börsenwesens", Die Bank, August 1986, p. 397 ff.; S. Kümpel, "Börsenrechtliche Fragen bei Schaffung des geregelten Marktes", Festschrift für K. Pleyer, Köln, Berlin, Bonn, München, 1986, p. 59 ff.

to let their employees nominate, under the Labour Management Relations Act of 1952, one third of the members of the supervisory board.⁷⁾

In 1983 there were only 2140 public limited companies. It should also be noted that only a small proportion (one fifth) of these enterprises were listed on a German stock exchange. The apparent reluctance of many public limited companies to go to the stock exchange is partly due to their dependence for official admission on the active support of banks. Banks, in order not to endanger their reputation, are very selective in assessing the quality of the applicant enterprise. Admittedly this is one area in which the lack of specialized financial institutions competing with banks (and the conservative attitude of the latter) seems apparent.

The regime of taxation of corporate equity capital and shareholders' wealth is also somewhat less favourable in West Germany than it is in other countries, although some major tax burdens were removed in 1977.⁸⁾

Finally, the organization of the social insurance system and the legal arrangements of the employee's contributions have had the effect of penalizing the growth of non-bank financial institutions such as pension funds.⁹⁾

As a result of these and other legal factors - and it should be noted that we have dealt so far only with regulations which do not apply directly to the banking system - German banks have acquired and always held a dominant position within the financial system.

7) See "The share market in the Federal Republic of Germany and its development potential", Monthly Report of the Deutsche Bank, April 1984, p. 36 ff.

8) Op.cit., p. 13.

9) See "Company pension schemes in the Federal Republic of Germany", Monthly Report of the Deutsche Bundesbank, August 1984, p. 30 ff.

Their operations cover, along with short-term overdraft lines, discount and acceptance credits, a broad range of medium and long-term loans, instalment credits and even mortgages (generally provided by independent subsidiaries). In addition, they invest in securities markets on their own account and issue their own "bank bonds".

Let us briefly consider these two last activities.

The direct investment by banks in equity shares, although significant (9% by value of all ordinary and preference shares), is relatively limited. But in order to assess the influence which German banks have upon companies, it must be realized that very often they exercise the voting rights on shares deposited with them. The allegation that banks have an excessive hold on industry (an issue discussed under the headline "Macht der Banken") stems more from their exercise of voting rights (e.g. the appointment of their representatives to the supervisory boards of companies) than from their own direct investment. As we shall see later, the Gessler Commission, set up by the Minister of Finance in 1974 to inquire into the main problems of the banking system, concluded that in fact the power of banks is not as pervasive as it might appear at first sight.¹⁰⁾

As far as the bond issuing activity of banks is concerned, it should first be noted that in West Germany the bond market is comparatively more important than the share market.¹¹⁾ It is therefore remarkable that the bond market is almost entirely monopolized by German banks: indeed three quarters of the outstanding domestic bonds are bank bonds. We are not far from the truth if we say that the bond market in Germany serves primarily as a means by which banks raise and invest long term funds.

10) See Bericht der Studienkommission "Grundsatzfragen der Kreditwirtschaft", Schriftenreihe des Bundesministerium der Finanzen, Heft 18, 1979, § 415 ff.

11) See "Business finance in the United Kingdom and Germany", Bank of England Quarterly Bulletin, September 1984, p. 370 ff.

To complete the picture of the German financial system, we have to mention some other institutions located outside the banking system that in recent years have been slowly but increasingly moving into banking-like business. This phenomenon is, however, more significant in countries such as the U.S.A., where legal barriers between different types of intermediaries are more rigid and pose serious problems of competitive equality between banks and non-banks.

Among these institutions, we should first consider the "Post Bank".¹²⁾ This name describes the banking activity of the German Federal Post Office (Deutsche Bundespost), which has two postal savings banks offices (Postsparkassenämter) and 13 postal giro banks (Postscheckämter), with a total of more than 18000 branches, i.e. Post offices. The Post Bank offers money transfer, postal cheque and postal savings services and, to a limited extent, the possibility of an overdraft. A policy issue currently under discussion in West Germany is whether, and to what extent, the banking-like activity of the Post Bank should be increased.

Along with insurance companies, in recent years retail outfits (including warehouses, airline, automobile and oil companies) have been finding financial services business increasingly attractive. Moreover, credit card organizations, such as Amexco or Diners Club have been coming more and more into direct competition with banks.¹³⁾

12) See F. Osselbühl, "Bestand und Erweiterung des Wirkungskreises der Deutschen Bundespost", Bd. 383 der Schriften zum öffentlichen Recht, Berlin, 1980; P. Lerche-C. Graf von Pestalozza, Die Deutsche Bundespost als Wettbewerber, Köln, 1985; A. Eiden-Müller, Grundlagen des Post- und Postbankrechts, Frankfurt am Main, 1983; D. Hahn, Die Postbank - Ihre Stellung in der Bankwirtschaft, Wiesbaden, 1978.

13) See H.D. Spanier, "Wettbewerb um den Privatkunden: Financial Services", Die Bank, November 1985, p. 548 ff.; U.H. Schneider, Die Entwicklung des Bankenaufsichtsrechts, Standortbestimmung: Entwicklungslinien der deutschen Kreditwirtschaft, Herausgegeben vom Deutschen Sparkassen- und

German banks have successfully tried to match the competition of these and other intermediaries by extending the range of their activities, for example by offering their customers combined special savings plans and insurance deals.

The ultimate result is that (as in other countries) the private customer has been more and more flattered by all kinds of institutions competing with each other.

3. THE LEGAL FOUNDATION OF THE BANKING SYSTEM

After having briefly described the main features of the German financial system, we can now focus on the legal framework of the banking system with the aim of disclosing the "arcane secrets" of the principle of universal banking.

Indeed, many non-German observers frequently seem puzzled when faced with the question of why this principle has worked so well in West Germany, while, at first sight, it seems a fairly dangerous and destabilizing principle.

We can anticipate that the answer lies in the finely-tuned regulation of the different kinds of permitted activities, of the capital basis and liquidity requirements (limits and ratios on investments and on the extension of credits).

Giroverband anlässlich seines hundertjährigen Bestehens, Stuttgart, 1984, p. 104 ff.; R. Schwebler, "Die Anlagepolitik der Lebensversicherungen auf Märkten im Strukturwandel", Die Bank, July 1985, p. 346 ff.; W. Zügel, "Wie bestehen die Banken die Herausforderungen der Zukunft?", Zeitschrift für das gesamte Kreditwesen, August 1986, n. 15, p. 712 ff.

First we shall sketch the evolution of the legislation of the banking system.¹⁴⁾

As already mentioned, the first comprehensive piece of legislation in Germany was the Banking Act of 1934 which was passed as a consequence of the breakdown of the banking system in the bank crisis of 1931.¹⁵⁾ Interestingly enough, the Commission of Enquiry set up by the government after the bank crisis did not come up with the conclusion that the principle of universal banking in itself was directly responsible for the crisis. Therefore, while the Banking Act of 1934 introduced a system of governmental supervision of banks on a generalized scale (bank licence, regulation of operations, reporting obligations, rights of investigation of the supervisory authority, etc.), it did not replace the principle of universal banking with the principle of specialization of banking activity.

The Banking Act of 1961 (Gesetz über das Kreditwesen of July 10, 1961), still in force today, preserved unaltered the basic philosophy and the general structure of the Banking Act of 1934.

Some substantial changes were brought about by the Second Act to Amend the Banking Act of March 24, 1976. On that occasion amendments were introduced to close the loopholes in bank supervision which had appeared in connection with the failure of some small and medium-sized banks, and, in particular, with the collapse of the Bankhaus I.D. Herstatt.¹⁶⁾

14) See E. Ketzler, Das Kreditwesen in der Bundesrepublik Deutschland, Köln, 1982; O. Hahn, "Struktur der Bankwirtschaft", Band I, Banktypologie und Universalbanken, Berlin, 1981; H. Wolf, 30 Jahre Nachkriegsentwicklung im deutschen Bankwesen, Mainz, 1980; I. Bähre - M. Schneider, KWG-Kommentar, München, 1985; H. Pohl - M. Pohl, Deutsche Bankengeschichte, Frankfurt am Main, 1982.

15) K.E. Born, Die deutsche Bankenkrise 1931, München, 1967.

16) See M. Peltzer - J. Brooks, Gesetz über das Kreditwesen, Deutsch-englische Textausgabe des Gesetzes über das Kreditwesen mit einer englischen Einleitung, Köln, 1976; Monatsbericht der Deutschen Bundesbank, July 1976, p. 17 ff.

The urgent measures adopted by Parliament included, among others, the strengthening of restrictions on large-scale credits, the establishment of the principle requiring banks to have at least two duly qualified managers (the so-called Vieraugenprinzip), an increase in the reporting obligations of banks, and enlarged rights of investigation and intervention by the supervisory authority.

At an administrative level, the supervisory authority, acting in the exercise of the rulemaking power conferred by Articles 10(1) and 11 of the Banking Act, introduced a new set of rules (Principle I a) imposing restrictions on foreign currency transactions as a reaction to the Herstatt collapse, which was caused largely by foreign exchange speculation.

In November 1974 the Minister of Finance set up the abovementioned Gessler Commission to investigate the main problems that had become apparent in the seventies (even before the Herstatt failure). It was also given the task of reconsidering the structure of the German banking industry and its role in the economy.

Although the final report published in 1979 came to the conclusion that the German banking system, based on the principle of universal banking, had worked well, it did suggest that a list of additional remedies to overcome some perceived shortcomings in bank supervision should be introduced by making certain changes in the Banking Act.

Some of the proposals of the Gessler Commission have thus been recently embraced by the Third Act to Amend the Banking Act of December 6, 1984, which came into force on January 1, 1985.¹⁷⁾ This piece of legislation has

17) See "Amendment of the Banking Act", Monthly Report of the Deutsche Bundesbank, March 1985, p. 35 ff.; J. Eicke, "Vom Umgang mit dem neuen KWG", Zeitschrift für das gesamte Kreditwesen, 1985, n.15, p. 705 ff., n. 16, p. 754 ff.

redefined the concept of capital (haftendes Eigenkapital) as used for supervisory purposes, tightened up the general regulations on the limitation of risk and improved the capacity of the supervisory authority to obtain information. At the same time, it implemented in Germany the Directive of the Council of the European Communities of July 13, 1983 on the supervision of banks on a consolidated basis. Incidentally, West Germany was the first country in Europe to implement this directive.

It is worth noting that, as on the previous occasion, this new piece of legislation was passed in connection with the failure of an important and prestigious bank, the Schröder-Münchmeyer-Hengst & Co. Bank in November 1983.¹⁸⁾

What needs to be stressed here is not the fact that bank failures still occur, notwithstanding a comprehensive system of bank supervision, but the fact that the German political system has shown once again the capacity of promptly changing the legislation in a highly sensitive field such as the banking system, where confidence of the public in the soundness of the financial institutions can be rather volatile.

In considering the overall evolution of the banking legislation in West Germany, one might think that the trend has been somewhat opposed to that of most other foreign banking systems, which have recently been experiencing a process of deregulation. Nevertheless, it should be pointed out that since the German banking system is based on a model of universal banking, it has never faced the necessity of dismantling the rigid barriers between classes of banks that have been erected by the legislation in many other countries.

18) For more details see H. Geiger, "KWG-Reform und Überlegungen zum SMH-Fall", in Sparkasse, 1984, n. 1, p. 7 ff. ; H.D. Dieppe, "KWG-Novellierung und finanzielle Stabilität", Zeitschrift für das gesamte Kreditwesen, 1984, n. 7, p. 288 ff.

Moreover, in accordance with a basic free market stance, West Germany had already removed controls on bank lending and deposit rates and restrictions on capital transactions with foreign countries in 1967 and 1961 respectively.¹⁹⁾

On the other hand, most Western banking systems have perceived the need for closing loopholes and strengthening the supervision of banks. In recent years, many countries have either introduced or are considering the possibility of introducing more restrictive measures.

We can now turn to consider the general structure of the German banking system. One way of outlining the various groups of banking institutions is to follow the classification applied by the Federal Bank (Bundesbank) for statistical purposes.

The banking industry in West Germany can be divided into two main sectors: multipurpose or universal banks (Universalbanken) and specialist banks (Spezialbanken).²⁰⁾

The first sector includes various groups of banks: although they differ considerably in legal form (private or public law banks), administrative organization (cooperative), and size and main fields of business, they may provide, as a matter of principle, the full range of commercial and investment banking services as defined by the Banking Act of 1961.

19) See "Freedom of Germany's capital transactions with foreign countries", Monthly Report of the Deutsche Bundesbank, July 1985, p. 13 ff.

20) See E. Ketzl, Das Kreditwesen in der Bundesrepublik Deutschland, Köln, 1982, p. 80 ff.; A banker research unit, Banking Structures and sources of finance in the European Community - Germany, London, 1981, 4th Ed.; O. Hahn, "Struktur der Bankwirtschaft", Band I, Banktypologie und Universalbanken, Berlin, 1981, Band II, Spezialbanken und Internationale Banken, Berlin, 1984; K. Scheidl, "Die Geschäftsbanken", in G. Obst - O. Hintner, Geld- Bank- und Börsenwesen, Stuttgart, 1982, p. 13 ff.

This sector, which represents the core of the German banking, consists of three main groups of universal banks: private commercial banks (private Geschäftsbanken), commercial banks incorporated under public law (öffentlich-rechtliche Kreditinstitute) and credit associations (Kreditgenossenschaften).

The first group consists of four categories: the three big banks (Großbanken); the regional banks (Regionalbanken); the private banks organized as partnership or as sole proprietorship (Privatbanken); and branches of foreign banks.²¹⁾

The second group consists of savings banks (Sparkassen) and their central clearing institutions (Landesbanken, Girozentralen). Peculiar to all these institutions is the fact that their incorporation is a matter of State law: each State (Land) of the Federation (Bund) approves its own Savings Bank Act (Sparkassengesetz), which determines the structure and the organization of savings banks, provides a special State supervision and imposes full liability for their debits on the founding municipality or district. Restrictions on some risky investments and on areas in which they may operate (the so-called Regionalprinzip) are also a matter of State law.

The third group consists of commercial credit associations (Volksbanken) and rural credit associations (Raffaisbanken).

They are organized in the legal form of cooperatives: most of them are cooperatives in which their members have a limited liability to make additional contributions (beschränkte NachschuBpflicht).

We need not describe in detail all these groups of universal banks. We should, however, stress how, while all these groups of banks, as a matter of

21) See H.E. Buschgen, Die Großbanken, Frankfurt, 1983; H.C. Schroeder-Hohenwarth, "Die privaten Banken - Rückschau und Ausblick", Zeitschrift für das gesamte Kreditwesen, 1985, n. 6, p. 9 ff.

law, may carry out all types of banking activities, in fact, for historic reasons, economic environment, location, and other factors, they have different priorities in the sources of funds, lending business and services provided. In other words, the principle of universal banking, does not preclude a de facto specialization.²²⁾

It is also worthwhile emphasizing how the Banking Act does not provide an explicit classification of the different groups of universal banks. Art. 1 of the Banking Act gives a very general definition of what a bank is according to the meaning of the statute simply by listing - as we will see later in detail - the activities which are considered typical of banks.

The Banking Act takes into account the legal forms and organization of the different groups of banks only indirectly and with reference to specific subjects.

For example, Art. 10 contains a detailed definition of the term "liable capital" (haftendes Eigenkapital) for each of the various legal forms of banks.

For the rest, the technique of the Banking Act is to regulate the banking activity as such.

The second main sector of the banking industry is formed by the specialist banks.

Among these, we should mention mortgage banks incorporated under private law (Hypothekenbanken) or under public law (Öffentlich-rechtliche Realkredit-institute). These banks are specialized according to two types of lending

22) G. Zweig, "Universalbankprinzip", Handwörterbuch der Sparkassen Deutscher Sparkassenverlag, Stuttgart, 1981; H. Büschgen, Das Universalbankensystem, Frankfurt am Main, 1971.

business: long-term loans secured by mortgages and loans to municipalities or other public institutions. The loans are financed by issuing either mortgage bonds (Hypothekendarlehen) or municipal bonds (Kommunalobligationen). Mortgage banks are subject to a special set of rules (Hypothekendarlehenbankgesetz of February 5, 1963, Gesetz über Darlehenbriefe und verwandte Schuldversicherungen öffentlich-rechtlicher Kreditanstalten of May 8, 1962).

One important point is that, while the range of permitted activities of mortgage banks is very limited, the law does not prohibit the acquisition of mortgage banks by universal banks. Indeed, among other universal banks, each of the three Großbanken holds a participation in a mortgage bank.²³⁾

Building loan savings banks (Bausparkassen) represent another group of specialist banks. They extend loans to depositors after completion of a contractual savings plan secured by second mortgages exclusively used for the acquisition, renovation or improvement of private homes. They are governed by the Building Loan Savings Banks Act (Gesetz über Bausparkassen of November 16, 1972).

Other specialist banks include Instalment Finance Banks (Teilzahlungsbanken), specialized in the consumer credit business; security-deposit banks (Kassenvereine), which provide giro-transferable collective custody and security giro-transfer; investment funds (Kapitalanlagegesellschaften); the AKA-Ausfuhrkreditbank GmbH, engaged in the financing of exports of industrial goods, the Kreditanstalt für Wiederaufbau, which extends loans to promote the German economy and provides long-term export credits; and the Industriekreditbank AG - Deutsche Industriebank, which provides medium and long-term loans for enterprises.

23) See M. Pohl, Konzentration im deutschen Bankwesen, Frankfurt, 1982, p. 473.

Some of them are expressly exempted from the provisions of the Banking Act (KWG) (e.g. the Kreditanstalt für Wiederaufbau: Art. 2 KWG). Other specialist banks, such as mortgage banks and building loan savings banks and investment funds, in addition to the special regulation, are also subject to some selected provisions of the Banking Act (for example in the field of supervision: Art. 3 Hypothekbankgesetz and Art. 3 Gesetz über Bausparkassen which explicitly refer to the relevant provisions of the Banking Act).

For the purpose of this paper, the brief outline of the different groups of banking institutions seems sufficient.

Before discussing the main rules defining the activities of the universal banks, it seems necessary to deal with the system of bank supervision.²⁴⁾

The supervision of banks under the Banking Act is carried out by the Federal Banking Supervisory Office (FBSO) (Bundesaufsichtsamt für das Kreditwesen), in close cooperation with the German Federal Bank (Deutsche Bundesbank) (Art. 7 KWG).

The Federal Bank's main function is that of a central bank: it has the duty "to regulate the circulation of money and the supply of credit to the economy with the aim of safeguarding the currency, and to provide for normal banking clearance of payment transactions with the Federal

24) See U.H. Schneider, Die Entwicklung des Bankenaufsichtsrechts, Standortbestimmung: Entwicklungslinien der deutschen Kreditwirtschaft, herausgegeben vom Deutschen Sparkassen- und Giroverband anlässlich seines hundertjährigen Bestehens, Stuttgart, 1984, p. 83 ff.; Das Bankwesen in Deutschland. Eine Einführung in das deutsche Bankwesen; H. Schneider - H.J. Hellwig - J.K. Kingsman, Frankfurt am Main, 1978, p. 32 ff.; E. Ketzler, Das Kreditwesen in der Bundesrepublik Deutschland, Köln, 1982, p. 122 ff.; H. Mayer, Das Bundesaufsichtsamt für das Kreditwesen, Düsseldorf, 1981.

Republic of Germany and with foreign countries" (Art. 3 of the Federal Bank Act of July 26, 1957) (Gesetz über die Deutsche Bundesbank).

The Federal Bank has several instruments which it may use in order to control the circulation of money and to maintain monetary stability. Among these, the instrument which most effectively influences the banks (their liquidity and their lending potential) is the minimum reserve policy. The rules on minimum reserves are contained in Art. 16 of the Federal Banking Act.

Besides this specific power to regulate the activity of banks, the Federal Bank collects and evaluates the various financial reports (monthly returns, statistics, reports of large loans) to be made by the banks. The Federal Bank is required to pass on to the FBSO the reports and the results of statistical surveys (Art. 18 of the Federal Banking Act). It is then the primary responsibility of the FBSO to take the appropriate steps in the light of such reports.

The FBSO was established as an independent federal authority, headed by a president who is appointed by the President of the Federal Republic acting on a proposal from the Federal Government which must consult the Federal Bank on the matter (Art. 5 KWG). The FBSO is subject to the instructions of the Federal Minister of Finance.

The main function of the FBSO is to supervise the operations of banks in order "to prevent abuses in the banking system which might endanger the security of the assets entrusted to banking institutions, adversely affect the proper conduct of banking business or substantially prejudice the economy generally" (Art. 6 KWG).

To carry out these duties, a wide range of administrative powers are entrusted to the FBSO. To take some examples: the FBSO issues the banking licence which every bank must obtain prior to the commencement of operations

(Art. 32 KWG); it may revoke the licence under specified circumstances (Art. 35 KWG); requests from a bank all information pertaining to the bank's operations; inspects all books and records of the bank and carry out an audit; sends some of its supervisors to attend shareholders' meetings (Art. 44 KWG); and dismisses untrustworthy or unqualified managers (Art. 36 KWG).

Arts 10 and 11 of the Banking Act give the FBSO a very important policy-making power to be exercised in agreement with the Federal Bank. In accordance with these articles, the two supervisory authorities determine the principles governing equity capital and liquidity requirements. These principles (Grundsätze I, II, III über das Eigenkapital und die Liquidität der Kreditinstitute) issued on January 20, 1969 and amended many times, must be published in the Federal Gazette. As we shall see later, they encompass some of the fundamental rules upon which the principle of universal banking is based.

Even if we cannot deal in detail with the administrative powers exercised by the FBSO, it is worthwhile noticing that the Banking Act is very specific and analytic in determining situations and circumstances in which the FBSO may or may not exercise its powers. In other words, very little room for discretion is left to the supervisory authority.

An example of this is the banking licence procedure. The FBSO may refuse the licence to the applicant if and only if one of the following four conditions are not met (Art. 33 KWG): the capital necessary for the operation is not available; the bank has not appointed at least two managers (the so-called Vieraugenprinzip); the managers are not "reliable" (zuverlässig); the managers are not "professionally qualified" (fachlich geeignet). In the absence of these negative criteria, the applicant has a right in law to the licence, which can be enforced in Court. To be sure, the evaluation of the reliability and professional qualifications of the managers might leave a margin for discussion and uncertainty, but the discussion is con-

fined to technical matters and does not involve a true policy issue. Interesting enough, some room for discretion was conferred by the Banking Act of 1934 (Art. 4 b)) to the supervisory authority which was empowered to assess the "need" for a new bank with reference to the general economic conditions of the market (the so-called Bedürfnisprüfung) in granting a licence. The Banking Act of 1961 has suppressed this subjective test.

Thus, while the powers exercised by the FBSO are very penetrating in character, they may be exercised only when circumscribed and legally defined events take place.

It is in this legal "environment" that we can best appreciate the principle of universal banking.

The general philosophy underlying this principle is, on the one hand, to analytically define some basic concepts, such as "liable capital" (haftendes Eigenkapital), "credit", "long-term financial resources"; and, on the other hand, to impose some rigid ratios between the different components of the balance sheet of the bank: capital/risk assets ratio; long-term assets/long-term financial resources ratio; investment capital ratio; capital/foreign currency position ratio; etc.

In other words, each universal bank is free to pursue its own business policy within the wide list of permitted activities, so long as it complies with the legal provisions on limitation of risks.

We shall now deal with some of these provisions in more detail. It should be noticed at the outset how the Amendments of the Banking Act of 1976 and of 1984 have redefined and made more restrictive many of these ratios.²⁵⁾

25) See "The Amendment of the Banking Act", Monthly Report of the Deutsche Bundesbank, March 1985, p. 35 ff.; V. Szagunn - K. Wohlschrieb, Gesetz über das Kreditwesen, Kohlhammer Kommentare, Mainz, 1986; J. Henke, "Die Novelle zum Gesetz über das Kreditwesen", Zeitschrift für Wirtschafts- und Bankrecht, 1985, p. 2 ff.

The first step is to point out once again that Article 1 of the Banking Act of 1961 defines banks as enterprises engaged in banking transactions. Such transactions consist of any of the following activities: deposit business; discount business; securities business; investment fund business; guarantee business; transfer and clearing business. This first general definition of the Banking Act lays down the foundation of the principle of universal banking: each banking institution in principle is free to engage in an extraordinary wide range of activities (subject to the supervision of the FBSO).

Yet, a second key statement of the Banking Act warns that "credit institutions, with the view of fulfilling their obligations toward their creditors, and particularly in order to safeguard the assets entrusted to them, must have an adequate liable capital" (Art. 10 KWG). The general freedom to engage in all kinds of banking activities must not put at danger the money depositors commit to them. The need for protecting depositors and, more generally, the stability of the banking system (especially vis-à-vis the so-called "domino effect" of bank failures) provides a legal justification for the imposition of ratios and other limits on extension of credits and on investments.

Among these limits, one of the most important is the rule, stated in Principle I, that a credit institution's lending and participation should not exceed 18 times its liable capital. The same Principle I also includes a set of regulations designed to define the term "credit". In the computation of such ratio, some of the loans (generally the less risky ones) are to be included only in part; other loans, such as loans to public entities, are not to be counted.

The Amendment of 1984 has introduced a significant new item in the definition of "loan" contained in Art. 19 of the Banking Act: leasing business. Therefore, the Amendment, on the one hand, has recognised that leasing in economic terms constitutes lending secured by the asset leased; on the other hand, it has not included leasing business within

the activities listed in Art. 1 of the Banking Act. As a result, it has not absorbed leasing companies into a wider notion of what a bank is under the meaning of the Act.²⁶⁾

As far as the concept of liable capital is concerned, we have already mentioned how Art. 10 of the Banking Act provides a specific definition for each group of banks (private commercial banks, savings banks, cooperatives). The Amendment of the Banking Act of 1984 has introduced significant changes. A major issue in the debate within the Gessler Commission was what should be considered as "liable capital" for the purpose of bank supervision.²⁷⁾

The specific issues were whether subordinated loans should be considered as liable capital and whether an addition of guarantors' contingent liability should be included in the liable capital in the interest of savings banks and credit cooperatives. The solution adopted by the recent piece of legislation is based on the view that only paid-up own funds which are at the bank's disposal over the long-term and share in current losses should fall within the definition of liable capital.

The implementation of these new more rigid definitions is going to be gradual. For example, the addition of members' contingent liability to the credit cooperatives' capital and reserves to an amount of up to 50% of the amounts paid up on members' shares and the reserves will be reduced successively over a period of ten years to not more than 25%.

26) See W. Schick, "KWG und das Leasing", Zeitschrift für das gesamte Kreditwesen, 1985, Heft 2, p. 56 ff.; C. Schüking, "Leasinggeschäfte der Banken nach der KWG-Novelle", Zeitschrift für das gesamte Kreditwesen, 1984, Heft 21, p. 978 ff.

27) See "Bericht der Studienkommission 'Grundsatzfragen der Kreditwirtschaft'", Schriftenreihe des Bundesministerium der Finanzen, Heft 18, 1979, § 1126 ff.

We need not consider these and other technicalities any further. The trend is now clear: the concept of liable capital should not be diluted by the introduction of capital surrogates.

Another limit intended to reduce the risk of banking activity has to do with the extent of individual large loans (Großkredite). Art. 13 of the Banking Act of 1961 originally provided that no single large loan should exceed 100% of the liable capital. This limit has been lowered to 75% by the Amendment of 1976 and to 50% by the Amendment of 1984. Every large loan must be reported to the Federal Bank, which transmits the reports to the FBSO. A reporting obligation also exists for loans of one million deutschmarks or more (Art. 14).

As a result of this information exchange system, each bank can be advised by the Federal Bank of the aggregate obligations of major borrowers. The Amendment of 1984 has improved the system by including in it, among others, mortgage loans and loans granted by foreign subsidiaries of German banks.

Another important provision of the Banking Act is Art. 13, which stipulates that a bank's permanent investment in real estate, ships and participations may not exceed the liable capital. The reason for this limit is easily understood. These investments are highly illiquid and, therefore, only permanent funds should be used.

The Amendment of 1984 has modified Art. 13 in several respects: it has dropped the concept of "permanent" investment and it has replaced the concept of "participation" with the more widely embracing concept of "shares in capital". Again, the Amendment has moved in the direction of tightening up provisions to limit risk.

Furthermore, under Principle II, a bank's assets in the form of long-term loans (with agreed maturity or period of notice of four years and

more), unlisted securities, participations, real estate, furniture and equipment, must not exceed the sum of long-term financial resources. Within the definition of long-term financial resources, Principle II includes, inter alia, capital and reserves, liabilities with agreed maturity or period of notice of four years and over, 60% of savings deposits, 10% of the short-term liabilities. The underlying principle is that long-term assets must be matched by long-term liabilities.

We think that at this point the secrets of the principle of universal banking have been disclosed.

Although the Banking Act does not directly confine banking business to a restricted mandatory list of permitted activities, it employs the technique of determining rigid ratios between components of the asset and liability side of the balance sheet. The effect of this technique is to indirectly limit banks' ability to engage in activities considered too risky and, in particular, to prevent banks from investing demand deposits in long-term assets. Even if things are not so neat in reality, the conclusion could be drawn that under the same "roof" of a universal bank one can discern two banks living together with little osmosis: a commercial bank and an investment bank.

To complete the picture of the functioning of universal banks three more points should be made.

Firstly, banks are also subject to antitrust laws (Gesetz gegen Wettbewerbsbeschränkungen of July 27, 1957): the Federal Cartel Office (Bundes Cartel Amt) may, under certain conditions, prohibit banks' acquisition of or participation in companies.

Secondly, although a compulsory statutory scheme of deposit insurance does not exist in West Germany, the Federal Association of German Banks

(Bundesverband deutscher Banken) set up a Deposit Protection Fund (Einlagen-
versicherungs-fond) in 1976.²⁸⁾

While membership of the fund is voluntary, in order to qualify for membership a bank must meet some conditions.

The purpose of the Deposit Protection Fund, according to its by-laws (Art. 2 (1)), is to provide assistance in the interest of depositors, in the event that a bank gets into financial difficulties (or such difficulties appear imminent) and to avoid damage to public confidence in the banking system.

Thirdly, the process of internationalization of German banks has helped to break down the insulation of the German banking system from other banking systems.²⁹⁾ What needs to be stressed here are the steps taken by the Amendment of the Banking Act of 1984 in order to tighten up the supervision of foreign subsidiaries.

Prior to the Amendment of 1984, German banks had an incentive to open subsidiaries in countries in which capital requirements and other limits on the volume of lending were very low. This provided a way of avoiding the ratios imposed by the German Banking Act.

The Amendment of 1984 closed the loopholes by introducing a system of supervision of banking groups on a consolidated basis and thereby im-

28) See I. Dziallas - Laur, Die Einlagensicherung der privaten Kreditinstitute, Dissertation, Universität Tübingen, 1983; H. Kronester, Einlagensicherung bei deutschen Kreditinstitute, Dissertation, Ludwig-Maximilien Universität München, 1983.

29) See "The offices of German banks abroad", in Monthly Report of the Deutsche Bundesbank, May 1985, p. 25 ff. The process of internationalization of the German banking system has also been favoured by the German subsidiaries of foreign banks.

plemented in German law the directive of the Council of European Communities of July 13, 1983. It falls outside the purpose of this paper to analyze the technicalities of consolidation (e.g. the pro rata consolidation) and the other requirements introduced by the Amendment.

It is enough to stress how the new piece of legislation has successfully prevented the avoidance of some of the fundamental provisions governing the universal banks. As we have seen, the model of universal banking is not a model based on the deregulation of banks' activities. On the contrary, it is based on a complex and sophisticated set of rules.

4. THE GERMAN BANKING SYSTEM IN THE WAVE OF FINANCIAL INNOVATION

In recent years, international financial markets have undergone numerous structural changes. It is enough to cite the process of "securitization" of lending and the use of innovative financial instruments.

The pace and the extent of these processes have been especially important in some countries such as the United States and the United Kingdom. In West Germany, although banks have also made increasing use of the new types of financing techniques, in comparison with the scale of such activities by their foreign competitors, a more prudent and conservative approach has prevailed.

The purpose of this section is to inquire why the German banking system has been less affected than others by the wage of financial innovation and to analyze the main changes that have occurred in the past two to three years.

The first step is to recall the major driving forces behind the introduction of such a variety of new financial products and services in

the last decade and to see how they have affected the German banking system.³⁰⁾

It is generally agreed, that an important factor triggering financial innovation has been the large and unpredictable shifts in real and nominal interest rates caused primarily by high and variable rates of inflation. Banks have tried to develop techniques to minimize interest and exchange rate risks.

In countries in which interest rate ceilings and other restrictive regulations were in force, this economic environment triggered a process of disintermediation of the banking system in favour of other financial institutions (such as money market mutual funds in the U.S.A.) competing with banks. One of the answers to the problems caused by such disintermediation was deregulation, which itself favoured the introduction of many new financial products and services.

Technological changes, particularly in computer technology, have made new types of financial transactions possible, and have made nearly all financial transactions faster and cheaper.

The extensive need for finance of the public sector in a number of countries has been another powerful force behind the creation of new investment assets to finance the budget deficit.

A higher degree of competition in financial markets has been another important factor. In countries in which competition among financial inter-

30) See L. Gleske, "Finanzinnovationen aus Sicht der Notenbanken und der Bankenaufsichtsbehörden", Die Bank, 1986, n. 6, p. 280 ff.; OECD, Financial Market Trends, June 1986, p. 12 ff.; "Innovation in International Banking", Monthly Report of the Deutsche Bundesbank, April 1986, p. 25 ff.

mediaries has increased in recent years, the consumers' choice of financial products has widened much more than in countries characterized by an oligopolistic structure of the banking system.

A more general economic factor has been the reversal in the international balance of payments pattern due to the disappearance of surpluses of the OPEC countries.

We need not deal in detail with each of these factors triggering innovation and the interaction between them. But if we try to consider in particular the German case, we can very clearly understand why the German financial system has undergone comparatively less significant changes.

First of all, West Germany enjoyed in the second world war period, and even in the past ten to fifteen years, a high degree of financial and monetary stability. The rate of inflation in West Germany has been significantly lower than that in most OECD countries. Moreover, market interest rates have been more or less in harmony with the general price level, and, therefore, savers have not suffered great losses due to inflation.³¹⁾

The public deficit sector has always been under control and has never reached troublesome levels.

To compare the process of deregulation experienced in many countries in recent years with the situation in West Germany, it is enough to recall that control of lending and deposit rates and other restrictive measures had been removed already in the sixties. In addition, the German universal-type banking system provides a high degree of flexibility.³²⁾ As already

31) See H.J. Dudler, "Financial Innovation in Germany", Changing Money, (ed.) M. de Cecco, Blackwell, Oxford, forthcoming 1987; K.O. Pohl, "Finanzinnovationen - Handikap für die Geldpolitik?", Börsen-Zeitung, Frankfurt am Main, 12 October, 1985.

32) See "Innovation in International banking", Monthly Report of the Deutsche Bundesbank, April 1986, p. 34.

mentioned, since German banks provide a full range of financial services, most non-bank financial institutions have been left with a minor role to play within the financial system. Moreover, non-bank financial institutions, according to the Banking Act, would have been subject to the same reserve requirements and other regulations as banks, if they had decided to engage in activities defined as banking activities by Art. 1 of the Banking Act.

The principle of universal banking, therefore, nullifies, as a factor triggering financial innovation, the convenience and need for finding ways to avoid too restrictive regulations and legal barriers between different types of intermediaries.

One negative side effect of the principle of universal banking has been, until very recently, a lack of strong outside competitive pressure. This has allowed banks to pay below-market interest rates to small depositors, unable to have access to more competitive and profitable markets (e.g. Euromarkets).³³⁾

Another reason explaining the limited diffusion of financial innovation in West Germany concerns the psychological attitude of the savers. Germans tend to be people who are not very enthusiastic about novelties involving money. History has taught them, especially in the aftermath of World War I, to be prudent and to appreciate financial stability.³⁴⁾

As a response to innovation in international banking and to the increasing integration of international financial markets, the policy of the German Federal Bank until 1985 was to deliberately try to restrain the international use of the D-Mark by blocking the introduction of new DM-denominated financial instruments (zero-coupon bonds, currency swaps,

33) See J.D. Germany - J.E. Morton, "Financial Innovation and Deregulation in Foreign Industrial Countries", Federal Reserve Bulletin, October 1985.

34) See J. Carr, "Germans see no profit in novelty", Financial Times, August 2, 1985.

floating rate notes, etc.). The aim of the Federal Bank was to attempt to limit West Germany's exposure to international interest rate and exchange rate shocks.³⁵⁾

While all these factors have had the effect of retarding financial innovation, technology has played a significant role in West Germany in transforming and streamlining banking procedures and in encouraging banks to provide more sophisticated services to the public (e.g., cashless wage and salary payment) cheaply.

To summarize, factors retarding financial innovation have had more weight in West Germany than factors stimulating it, and this has been particularly true with regard to international banking transactions.

In general, German observers have praised this more prudent stance of supervisory authorities and banks. Some observers do not consider those financial instruments created with the purpose of avoiding tax regulations being examples of true innovation.³⁶⁾ Moreover, some of the new financial instruments have been considered too complicated, confusing and dangerous, especially when the effect is to destroy the distinction between capital and debt.³⁷⁾ Some other commentators have tried to discriminate between enduring and ephemeral innovations. Among the former, the introduction of new technologies is the most significant.³⁸⁾

35) H.J. Dudler, "Financial innovation in Germany", Changing Money, (ed.) M. de Cecco, Blackwell, Oxford, forthcoming 1987.

36) See "Innovationen", Zeitschrift für das gesamte Kreditwesen, June 1, 1985, Heft 11, p. 487.

37) Op. cit., p. 488.

38) See L. Gleske, "Finanzinnovationen aus Sicht der Notenbanken und der Bankenaufsichtsbehörden", Die Bank, 1986, n. 6, p. 284.

In the last two to three years the cautious attitude of the Federal Bank towards innovation in international banking has changed somewhat. Measures to enhance the international role of the deutschmark have been favoured.

The new policy of giving a green light to some financial innovation was a response to the fear that West Germany - and notably Frankfurt - would fall further behind London, New York and Tokyo as a world financial centre. A warning in this respect was the decision in 1984 of the Deutsche Bank, the biggest commercial bank in West Germany, to move its headquarters for its non-deutschmark Eurobond underwriting business from Frankfurt to London.³⁹⁾

In other words, West Germany cannot afford to shut itself off from the trends under way in key competitor countries. The deutschmark must remain competitive against the international investment currencies; otherwise, adverse effects on the exchange rate of the German currency may be predicted in the long term.⁴⁰⁾

As a first sign of the shift in attitude, we should consider the abolition of the coupon-tax in 1984, i.e. the withholding tax on interest income from non-residents' domestic bonds.⁴¹⁾

The tax had been introduced in 1964. At that time fixed exchange rates and large capital imports were swelling the foreign exchange surpluses. The tax was introduced as a means to ward off capital imports. However,

39) See J. Davies, "Frankfurt fights back from strength", The Banker, May 1986, p. 87.

X 40) See "Freedom of Germany's capital transactions with foreign countries", Monthly Report of the Deutsche Bundesbank, July 1985, p. 37, ff.

41) "Freedom of Germany's capital transactions with foreign countries", Monthly Report of the Deutsche Bundesbank, July 1985, p. 15, ff.

the effect of the coupon-tax was discriminatory for non-resident investors, since it reduced their interest income.

The two major steps which go in the direction of the so-called "further liberalization" (Restliberalisierung) were, first, the decision of the Federal Bank to authorize banks from 1st May 1985 to use deutschmark innovative financial instruments such as zero-coupon bonds, double currency bonds, floating rate notes, etc.; second, the decision to allow German subsidiaries of foreign banks to act as lead managers of an issuing syndicate for foreign deutschmark bonds.

This latter measure has been widely praised as an important move towards liberalization.⁴²⁾ Before 1st May 1985, only German banks were allowed to take management leadership in these issues. This was part of a gentlemen's agreement dating back to 1968 between the Federal Bank and German banks: at that time, a sub-committee of the Central Capital Market Committee (six German banks were members of this sub-committee) was set up with the aim of ensuring that there would be no bunching of foreign deutschmark issues that would strain the domestic capital market. The Federal Bank, which had a senior representative sitting in on the sub-committee, was kept informed of the volume and conditions of these issues, and could exercise influence in drawing-up the issuing calendar. There were, however, drawbacks to these arrangements. German banks which were not members of the sub-committee had to submit their list of prospective new issues via the "Club of Six". Subsidiaries of foreign banks had not been allowed to take on the lucrative business of lead-managing foreign deutschmark issues. Again, an anti-competitive effect was apparent.

42) Op. cit., p. 14. See also "Begebung vom DM-Auslandsanleihen", Pressemitteilung der Deutschen Bundesbank, April 12, 1985; "Financial deregulation: Europe takes up the challenge", Financial Times, May 24, 1985.

The decision to open the issue market to German subsidiaries of foreign banks (and the authorization of new types of bonds) has already had the effect of significantly expanding the volume of issues without any of the feared negative effects on the German balance of payments or on the domestic capital market.⁴³⁾

The authorization of new financial instruments already in use in international markets also seems very important, although further steps are needed to complete the liberalization. For example, floating-rate notes are subject to a stock exchange turnover tax (*Börsenumsatzsteuer*). The trading in notes is therefore still hardly profitable in West Germany. The Federal Bank has already asked the Finance Minister to abolish the tax on floating-rate notes and on other securities. The Federal Government in Bonn has agreed in principle, but has deferred the decision until after the next election, due early in 1987.⁴⁴⁾

Moreover, the Federal Bank has not yet permitted the use of certificates of deposits, although it seems ready to allow it in the near future.⁴⁵⁾ German banks with their huge branch networks do not show much interest in this new instrument, but on the other hand, CD's might be very useful for the German subsidiaries of foreign banks. The introduction of CD's could also be an important step towards the creation of a secondary market for investors and multinationals.

43) See "Recent trends in securities transactions with foreign countries", Monthly Report of the Deutsche Bundesbank, November 1985, p. 35.

44) See "Frankfurt fights back from strength", The Banker, May 1986, p. 88.

45) See G. Dierlf-J. Lechner, "Das Depositenzertifikat - Innovatives Finanzierungsinstrument", Zeitschrift für das gesamte Kreditwesen, n. 16, 1985, p. 760, ff., n. 17 1985, p. 806, ff.; "DM-CDs?", Wirtschaftsdienst der Berliner Handels- und Frankfurter Bank, January 19, 1985; "Germans see no profit in novelty", Financial Times, August 2, 1985.

The introduction of new financial instruments in West Germany has induced the FBSO - as well as many supervisory authorities in other countries - to focus on the new risks associated especially with off-balance-sheet business. The main conclusion seems to be that off-balance-sheet risk should be regarded as an integral part of banks' overall risk profile. Therefore, the FBSO has decided to include, as from 1st June 1986, underwriting commitments as warranties for the purpose of the ratio established in Principle I. The back-up facilities are included at half of their value in the calculation of the risk/asset ratio. The weighting is reduced to 20% when the facility has been arranged by a German bank. The underwriting commitments are also counted within the large exposure limits with a weight of 50%.⁴⁶⁾

We have at this point analyzed the most significant changes that the German banking system has undergone in the recent past. If we consider them in the light of the new regulation introduced by the Amendment of the Banking Act of 1984, we can draw the conclusion that there are no signs that the model of universal banking is less abreast of the times today than it was in the past. On the contrary, the technically sophisticated system of ratios, limits and ceilings has been revised and tightened-up, to include new financial instruments. And this is a sign more of the vitality than of the decline of the model.

While the German banking system has moved steadily along its own path already traced by the Banking Act of 1934, in many banking systems of Western industrialized countries the model of specialization has shown its limits. In recent years, legislators and supervisory authorities alike have been considering whether to loosen some of the rigidities introduced by the banking legislation of the thirties.

46) "Grundsatz I künftig auch für NIFS und RUFs", Börsen-Zeitung, February 19, 1986; K.O. Pöhl, "New instruments and risk management", American Banker, New York, June 5, 1986; "Innovation in international banking", Monthly Report of the Deutsche Bundesbank.

Even in the United Kingdom, where the model of specialization was first developed, and is rooted more in tradition than in law, the trend in the last 15 to 20 years has been towards an extension of the range of activities and services provided by banks. Official acknowledgement of this trend can be found in the Evidence by the Committee of London Clearing Banks to the Committee to Review the Functioning of Financial Institutions - the so-called Wilson Committee set up by the British Government in the late seventies. The evidence characterizes the evolution of the Clearing Banks in the past twenty years as a move towards the model of universal banking.

To summarize the results of this paper, the German banking system has historically represented and still represents a viable model which successfully reconciles the claim for flexibility and freedom to pursue an autonomous business policy on the part of the banks and the need for ensuring soundness and stability of the financial system.

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