

**GAO**

Briefing Report to the  
Honorable Charles E. Schumer,  
House of Representatives

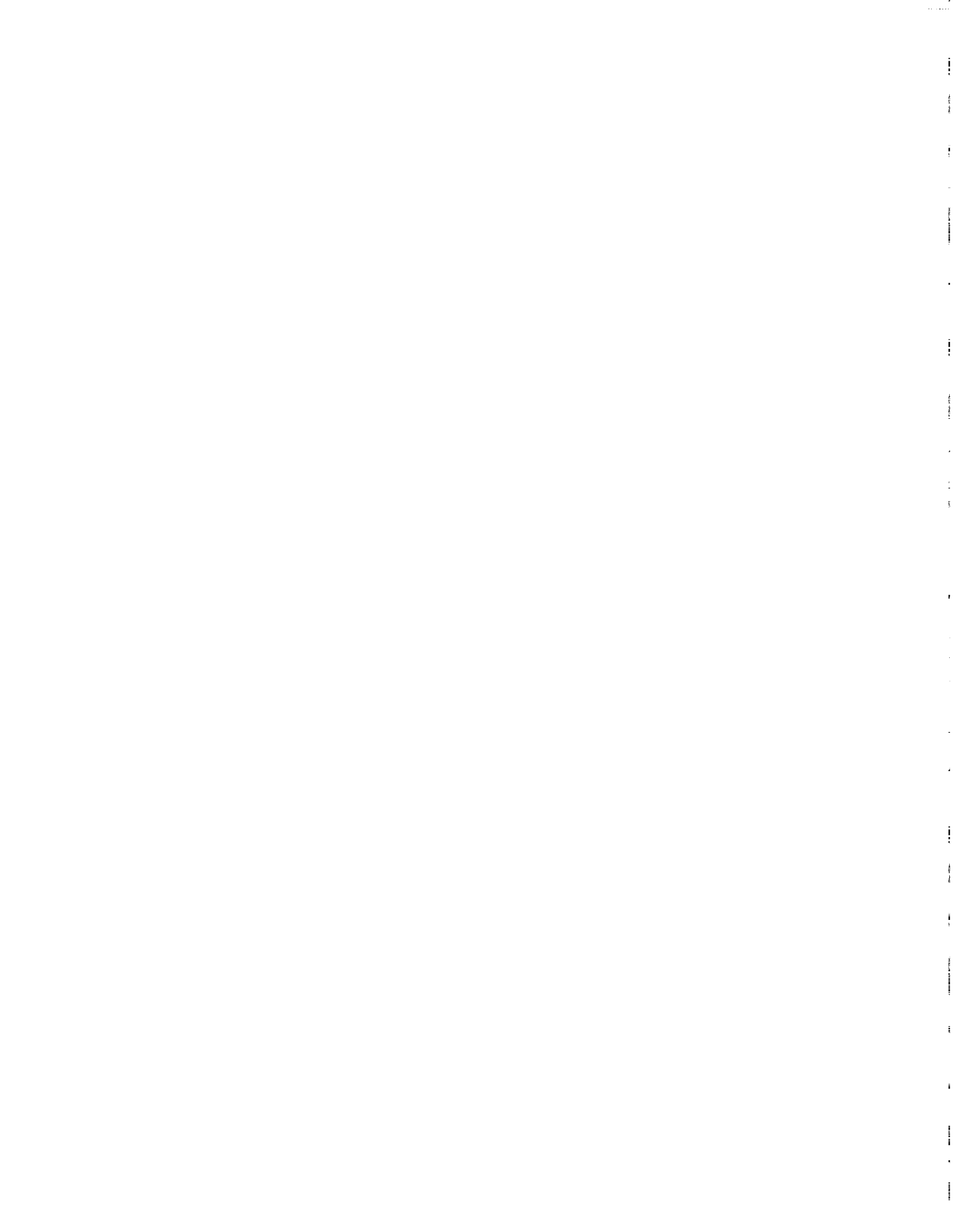
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May 1994

# BANK REGULATORY STRUCTURE

## The Federal Republic of Germany







United States  
General Accounting Office  
Washington, D.C. 20548

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General Government Division

B-257089

May 9, 1994

The Honorable Charles E. Schumer  
House of Representatives

Dear Mr. Schumer:

Proposals to consolidate U.S. banking regulatory agencies have raised questions about how other countries structure and carry out their various bank regulation and central bank activities. You have asked us to provide you with information about the structure and operations of regulatory activities in The Federal Republic of Germany (Germany), the United Kingdom, Canada, and France. This report presents the information you requested for Germany, which was presented to your staff in an April 29, 1994, briefing. Our objectives were to describe (1) the German bank regulatory structure and its key participants, (2) how that structure functions, and (3) central bank responsibilities that affect the banking industry.

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## Results in Brief

The German bank regulatory and supervisory structure consists of both public and private participants—with two federal agencies sharing certain responsibilities with external auditors and private banking associations.

The two federal agencies are the Federal Bank Supervisory Office (FBSO), and the Deutsche Bundesbank (Bundesbank), the independent German central bank. There is a sharp contrast between the legal responsibilities assigned to these agencies individually and the de facto sharing of regulatory responsibilities.

De jure, the FBSO is the primary German bank regulatory and supervisory authority. For example, only the FBSO may issue banking regulations with few exceptions, issue or revoke bank licenses, and take enforcement actions against banks. As a government agency reporting directly to the Ministry of Finance, the FBSO is held accountable for its actions to the German parliament.

Despite the difference in their legal responsibilities, the FBSO and the Bundesbank work closely together and are considered partners in the formulation of regulatory and supervisory policies. The influence of the Bundesbank on bank regulation arises from its detailed knowledge about banks in Germany, certain legal requirements that it be consulted before enforcement action is taken by the FBSO, and the general perception that

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the monetary policy and other basic functions of the central bank and those of banking supervision are interconnected. For example:

- The Bundesbank is involved with the FBSO in developing regulations. German banking law states that the Bundesbank must approve regulations involving liquidity and capital requirements and changes to banks' monthly reporting requirements. It must also be consulted about all other regulations. We were told by officials from both agencies that the FBSO has never issued regulations with which the Bundesbank strongly disagreed.
- The Bundesbank through its district offices, the Land Central Banks, is the central clearing, data collection and analysis point for most of the information used in bank supervision. The Bundesbank Land Central Banks forward to the FBSO monthly report information that they receive directly from banks as well as their analyses of the reported information.
- The Bundesbank Land Central Banks have the most active role in day-to-day bank supervision. They hold a key supervisory position with respect to operational and reporting issues affecting banks. In fact, representatives of the Bundesbank also said that, because the Bundesbank does not have legal enforcement authority, it is easier for banks experiencing problems to approach the Bundesbank rather than the FBSO.
- The Bundesbank Land Central Banks are very influential in determining the enforcement action that is taken by the FBSO because of their detailed knowledge of the banks they supervise. The more important the case, the less likely that the FBSO would take action without Bundesbank agreement.
- Generally, the FBSO and Bundesbank are both represented in international regulatory or advisory organizations and share the responsibility for developing German positions in these forums.
- The Bundesbank and FBSO also work together in managing individual bank crises, with the Bundesbank tending to take the lead role to divert possible systemic consequences.

In addition to its role in bank regulatory matters, the Bundesbank has responsibilities in other bank-related activities —such as liquidity provision, payments clearance, and currency delivery—that it does not share with the FBSO.

External auditors play a supporting but clearly important role in the German regulatory structure because they carry the primary responsibility for conducting bank examinations. German banking law requires annual audits. These audits are done by accounting firms of the banks' choice and at the banks' expense with the reports sent directly to both the FBSO and Bundesbank. Accounting firms are also tasked with conducting special examinations of banks, at the bank's expense, when requested by the FBSO. Detailed audit requirements are set in laws and regulations, which require accounting firms to examine and assess critical aspects of bank operations and condition, such as capital, asset quality, management, earnings and liquidity. If, during the course of their audits, auditors discover serious problems within a bank they must immediately report them to both the FBSO and Bundesbank. While the auditors have extensive responsibilities, their legal liability is limited to \$300,000 for each audit.

In Germany, deposit insurance is not a federal government responsibility; instead, it is provided by the private banking associations, which also have a role in developing laws and regulations and resolving failed banks. The lender of last resort function is also privately provided by the Liquidity Consortium Bank (LKO).

The top officials of the two regulatory agencies, bank associations and external audit organizations told us they are satisfied with the regulatory system and how it operates. Both also said they consider the relationship between the Bundesbank and FBSO to be excellent, characterized by cooperation and collegiality. They attribute the quality of cooperation to the fact that each agency understands its role, that the legal responsibility for taking action is clearly defined and that a united front helps contain outside criticism. Finally, they said that communication is fluid, personality conflicts are rare, and turf battles virtually nonexistent.

Figure 1 illustrates the bank regulatory functions served by the major players in the German bank regulatory structure.

**Figure 1: Responsibility for Bank Regulatory and Related Functions in Germany**

Key participants	Developing laws	Developing regulations	Issuing regulations	Licensing/chartering banks	Bank information reporting and analysis	Bank supervisory oversight	Bank examinations	Developing enforcement actions	Enforcement authority	Failure resolution	Liquidity provider	Crisis management	Payment/clearance system	International forum representative	Deposit insurance	Lender of last resort
<b>Public</b>																
Ministry of Finance	•	•	•													
Federal Bank Supervisory Office	•	•	•	•	•	•		•	•	•				•		
Bundesbank	•	•			•	•	•	•	•	•	•	•	•	•		
<b>Private</b>																
External auditors							•		•							
Banking associations	•						•							•		
Liquidity Consortium Bank																•

Source: GAO analysis.

## Scope and Methodology

To accomplish our objectives, we reviewed laws, documents and statistics provided by officials of the FBSO located in Berlin, and the Bundesbank at both the Frankfurt headquarters and two Bundesbank Land Central Bank locations in Frankfurt and Berlin. We also interviewed several senior

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executives of German banks and accounting firms and obtained information from the Federal Association of German Banks, the association's accounting firm, and the German Institute of Certified Public Accountants. (App. IV has more detailed information about our objectives, scope, and methodology.)

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We are sending copies of this briefing report to interested congressional committees, the President of the FBSO, and the President of the Bundesbank. Copies will also be made available to others on request.

Maja Wessels, Evaluator-in-Charge, and Mark Gillen, Assistant Director, were the major contributors to this briefing report. If you have any questions about the material in this briefing report, please contact me at (202) 512-8678.

Sincerely yours,



James L. Bothwell,  
Director, Financial Institutions  
and Markets Issues



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### Abbreviations

BCCI	Bank of Credit and Commerce International
FBSO	Federal Bank Supervisory Office
LIKO	Liquidity Consortium Bank
SMH	Schroeder, Muenchmeyer, Hengst and Co.

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# German Bank Regulatory Structure

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Figure I.1: Evolution of German Bank Regulatory Structure

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## GAO Evolution of German Bank Regulatory Structure

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- Before 1961: State-level supervision and central banking
  - After 1961: Federal bank supervision and unified independent central bank
  - Regulation and supervision focus on safety and soundness
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### Evolution of the German Bank Regulatory Structure

The German bank regulatory structure, which consists primarily of two federal agencies, the Federal Bank Supervisory Office (FBSO), located in Berlin, and the Deutsche Bundesbank (Bundesbank), domiciled in Frankfurt, was created in the late 1950s and early 1960s. Before 1961, bank supervision was carried out at the state (Laender) level. And until 1957,

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the central banking system, which was modeled after the U.S. Federal Reserve System, was divided into two tiers: (1) 10 independent Land Central Banks operating as central banks in each of the 10 states of the occupied western zone and the West Berlin Central Bank and (2) the Bank Deutsche Laender, a joint subsidiary of the Land Central Banks responsible for issuing bank notes, policy coordination, and certain other central functions.

In 1957, the two-tier central bank was abolished and replaced by a unified independent central bank, the Bundesbank; the 10 Land Central Banks along with the Berlin Central Bank lost their structural independence and became main offices of the Bundesbank but retained their designation as Land Central Banks. On July 10, 1961, the German Banking Act was passed, creating a federal bank regulatory agency, the Bundesaufsichtsamt fuer das Kreditwesen or FBSO. Because of concerns at the time about creating a large federal regulatory bureaucracy and duplicating expertise already developed in the accounting profession and at the central bank, the FBSO was initially provided with only 70 staff to oversee all German banks. To assist the FBSO and to take advantage of information already being collected by the Bundesbank for monetary policy and liquidity lending purposes, the Banking Act gave the Bundesbank certain supervisory responsibilities that it could carry out through its nationwide branch system of over 250 offices (183 as of April 1, 1994). The act also required external accounting firms to provide bank audit information to the FBSO and Bundesbank—thus relieving those two agencies of most examination responsibilities—and required audit reports for all banking organizations in Germany. The number of Bundesbank Land Central Banks was reduced to 9 in 1992 after German reunification. As a result, several of these banks are now responsible for more than 1 of the 16 German states (11 old states and 5 new states).

Banks in Germany are regulated and supervised almost exclusively to ensure the safety and soundness of individual banks and of the system as a whole. The FBSO may address issues such as bank clearance practices to ensure that credits and debits are being cleared without lags in crediting accounts for payments received. However, the German banking laws do not deal with issues such as fair lending practices or community reinvestment records.

## GAO Bank Activities

- Universal banking
- 3,860 financial institutions with \$3.5 trillion in assets

### Bank Activities

Any bank licensed in Germany may conduct a universal banking business that can include deposit, lending, discount, securities, safe custody, guarantee, and checking activities. For example, U.S. securities firms operating in Germany are considered banks and may conduct a universal banking business. Savings banks, which are owned mostly by municipal governments, are similarly unrestricted. Major categories of banks include commercial banks, savings banks, mortgage banks, and credit cooperatives.

As of December 31, 1993, there were 3,860 financial institutions in Germany reporting to the Bundesbank (of which 146 were foreign branches or subsidiaries) with total assets of approximately \$3.5 trillion. Commercial banks made up 28 percent of bank assets, with the largest three banks in Germany sharing 11 percent of the total.

Table I.1 provides information on German credit institutions by type.

**Table I.1: German Credit Institutions, by Type, as of December 31, 1993**

Dollars in millions			
Type of institution	Number of institutions	Assets <sup>a</sup>	Percent of total assets
Commercial banks	328	\$981,277	28%
Regional giro <sup>b</sup> and cooperative <sup>c</sup> banks	17	833,062	24
Cooperatives	2,778	463,697	13
Savings banks	704	806,570	23
Mortgage banks	33	459,234	13
<b>Total</b>	<b>3,860</b>	<b>\$3,543,840</b>	<b>100</b>
Three largest banks <sup>d</sup>	3	\$374,558	11
Foreign subsidiaries and branches <sup>e</sup>	146	\$179,082	5

<sup>a</sup>DM 1.65= \$1.00.

<sup>b</sup>Serve as central banks for the savings institutions in their respective regions.

<sup>c</sup>Serve as central banks for the cooperative banks in their respective regions.

<sup>d</sup>Also included in commercial bank category

<sup>e</sup>Foreign subsidiaries and branches are also included in other bank categories. This number does not include institutions, such as U.S. or U.K. investment banks, which are counted as banks in Germany but not in their home countries.

Source: Deutsche Bundesbank data (excludes credit institutions with special functions, such as the Post Office Bank).

# GAO Participants in Bank Regulation, Supervision, and Examination

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## Public:

- Bundesbank
- FBSO

## Private:

- External auditors
  - Banking associations
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## Key Participants in Bank Regulation, Supervision, and Examination

The German bank regulatory and supervisory structure consists of both public and private participants with two federal agencies sharing certain responsibilities with external auditors and private banking associations. The two federal agencies are the FBSO and the Bundesbank, the independent German central bank.

The Bundesbank is an independent federal corporation whose profits flow to, and whose \$170 million in capital is held by, the federal government. Nevertheless, the Bundesbank has full control over its own budget. It is headed by a Central Bank Council that includes all nine Land Central Bank presidents and seven other members, including the Bundesbank President, who are nominated by the federal government to 8-year terms and appointed by the federal President. The Directorate of the Council excludes the Land Central Bank presidents and is responsible for

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implementing the decisions made by the Council in its biweekly meetings. Of the Bundesbank's almost 18,000 staff, approximately 350 to 400 are directly involved in bank regulation and supervision. Approximately four-fifths of Bundesbank staff are employed outside of its Frankfurt headquarters in its nationwide network of offices.

The FBSO is a federal agency whose President is nominated by the federal government and, after consultation with the Bundesbank, appointed by the federal President. The President of the FBSO reports directly to the Ministry of Finance. As a result, the FBSO is accountable to the German Parliament. Unlike the Bundesbank, the FBSO is subject to the federal budgetary process, even though it receives only 10 percent of its funding from the federal coffers. By law, the banking industry must refund 90 percent of the FBSO's expenses, which is done through annual assessments based on a bank's size and through special billings. The FBSO has no substructure of branch offices, so its regulatory staff of 252 plus 166 support staff is located entirely in Berlin.

Although there are several thousand accounting firms in Germany, only a fraction conduct bank audits. These include about 500 small and medium firms and about 10 large accounting firms. The large firms, which encompass affiliates of the "big six",<sup>1</sup> generally audit the larger commercial banks. In addition, the savings and cooperative banking associations conduct bank audits through their audit offices, as does the deposit protection system of the Federal Association of German Banks.

German banks are represented by 14 banking associations; the 3 largest are those for commercial banks (Federal Association of German Banks), savings banks (German Savings Bank and Giro Association), and cooperative banks (Federal Association of German Cooperative Banks).

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<sup>1</sup>The big six international accounting firms are Ernst & Young, Arthur Andersen & Company, Deloitte & Touche, KPMG Peat Marwick, Coopers & Lybrand, and Price Waterhouse.

## GAO Regulation, Supervision, and Examination Are Shared

- FBSO has legal responsibilities but needs information
- Bundesbank is equal partner and primary day-to-day supervisor
- External auditors are key to examination function
- Banking associations are responsible for deposit insurance

### Bank Regulation, Supervision, and Examination Are Shared Responsibilities

The responsibilities for bank regulation and supervision are shared between the FBSO and the Bundesbank.<sup>2</sup> External auditors have an important support role because they are primarily responsible for conducting bank examinations. Bank associations also play a support role because of their deposit insurance responsibilities.

The FBSO has the responsibility for taking all formal actions involved in bank regulation and supervision and for obtaining the information necessary to take those actions, including issuing regulations, issuing bank licenses, and taking enforcement actions.

<sup>2</sup>Banking Act of the Federal Republic of Germany §§ 10,10a, 11, 24 and 25. Deutsche Bundesbank Special Series No. 2, 4th edition, July 1993.



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The Bundesbank has no responsibilities for such legal actions, but in practice it is an equal partner in the formulation of important FBSO regulatory and supervisory activities. Furthermore, the Bundesbank has a more active role in day-to-day bank supervision than the FBSO.

External accounting firms have no regulatory or supervisory decisionmaking responsibilities, but they are the key to the examination function which they carry out through various audits. The audit information these firms are required to submit to the FBSO and Bundesbank is essential to the regulatory and supervisory decisionmaking processes.

Banking associations are solely responsible for deposit insurance. As part of that function, they may help in assisting troubled banks or resolving failed banks. In addition, banking associations must be consulted by banking regulators on banking laws and regulations and before bank licenses are issued.

## GAO FBSO Has Primary Regulatory and Enforcement Responsibility

- Issues orders, regulations, legal opinions, and licenses
- Receives bank information from banks, Bundesbank, and auditors
- Raises questions about bank activities and operations
- Relies principally on Bundesbank and auditors for supervision and examination

### FBSO Has Primary Regulatory and Enforcement Responsibility

Under the Banking Act of 1961, the FBSO, with few exceptions, is given sole responsibility for issuing orders, regulations, and written opinions on banking issues. And only the FBSO can issue or repeal bank licenses or take any direct supervisory actions against a bank such as to (1) stop the conduct of unlawful business, (2) rectify cases of inadequate capital or liquidity, or (3) protect creditors and the safety of a bank's assets.<sup>3</sup> The FBSO is also required to

<sup>3</sup>Regulatory tools available to the FBSO include cease and desist orders, orders to restrict or eliminate dividend payments, orders to prohibit the continuation of a bank's ownership in other entities, and orders to restrict future acquisitions.

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“counteract undesirable developments in banking which may endanger the safety of the assets entrusted to credit institutions, adversely affect the orderly conduct of banking business or result in serious disadvantages for the national economy.”<sup>4</sup>

Such action could include (1) preventing banks from entering a new line of business that is deemed to be dangerous or may have unknown consequences or (2) ordering all banks to change certain operating procedures.

To carry out these responsibilities, the FBSO receives and assesses information and reports provided by banking institutions, their external auditors, and the Bundesbank. Included are monthly reports with very specific data on a bank's assets and liabilities, annual and special external audit reports, audit reports conducted by deposit insurance funds, and bank reports on such issues as changes in management, commercial or financial acquisitions, excessive losses, office relocations, changes in branch offices, intentions to merge, or the appointment of auditors. The FBSO is also authorized to request certain additional reports, such as a list of large loans or loans to managers, from specific institutions. Generally, the Banking Act also specifies that this information be provided concurrently to the Bundesbank, which then provides analyses of the reports to the FBSO.

If questions are raised by any of these reports, the FBSO may follow up with written or oral requests for more information from the bank or its auditor and request meetings with the bank's management or auditor. The FBSO is also given the authority by the Banking Act to use its own staff or staff from other institutions such as external accounting firms or the Bundesbank to conduct audits of financial institutions, even if there is no special reason for them. Information gained through such channels must be shared with the Bundesbank.

In practice, the FBSO does not have the staff to review and follow up on all of the information it receives or to conduct bank audits. Consequently, the FBSO relies to a great extent on the reports of the banks' auditors as well as on the Bundesbank to screen and analyze bank-specific information and to raise issues of importance.

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<sup>4</sup>Banking Act of the Federal Republic of Germany, § 6. Deutsche Bundesbank Special Series No. 2, 4th edition, July 1993.

## GAO Bundesbank Is Influential in Bank Oversight

- Conducts day-to-day bank supervision
- Serves as collection point for bank information and provides analysis
- Raises bank operational and reporting issues
- Recommends enforcement actions
- Participates in rulemaking

### Bundesbank Is Influential in Bank Supervision and Regulation

The Bundesbank and its Land Central Banks are very involved in the day-to-day supervision of banks as well as in the decisionmaking process that leads to regulatory and supervisory actions taken by the FBSO. Consequently, the Bundesbank's role in and influence on the German bank regulatory and supervisory process are much greater than might be gleaned from the 1961 Banking Act. This influence has developed from the Bundesbank's detailed knowledge about banks in Germany, its close communication with the FBSO, certain legal requirements that it be consulted before action is taken, and because of the general perception that the monetary policy and other functions of the central bank and those of banking supervision are interconnected.

The Bundesbank Land Central Banks are the central collection and analysis points for most of the information used in bank supervision. For

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instance, the monthly bank statistical reports are first submitted to and analyzed by the Land Central Banks before they and the analyst's reports' are sent to the FBSO. In addition, the Bundesbank or the Land Central Banks receive other required bank reports and external audit reports concurrently with the FBSO, analyze them, and send these analyses to the FBSO. The Bundesbank also conducts bank foreign exchange examinations that provide it firsthand information on some bank operations in at least all of the larger banks. It was given this responsibility after the Bankhaus I.D. Herstatt failure in 1974<sup>5</sup>—which was caused primarily by foreign exchange losses—because its staff had an expertise in this area that could not be matched by the accounting firms that normally do bank audits. If, as a result of their analysis, the Land Central Banks or Bundesbank believe that there are problems in a specific bank they are to notify the FBSO and recommend the action they think the FBSO should take to remedy the problems.

Primarily because of their role in the analysis of monthly and other reports, the Land Central Banks play the key supervisory role in Germany with respect to operational and reporting issues. They frequently contact banks in their regions—for additional information or clarification—and consequently have a more detailed knowledge of these banks than the FBSO. Furthermore, since the Bundesbank is located in Frankfurt, the headquarters of most of Germany's major banks, there are many formal and informal contacts between bank management and the Bundesbank. Representatives of the Bundesbank feel that the Bundesbank's lack of legal authority to take enforcement action against banks makes it easier for banks to communicate with the Bundesbank than with the FBSO.

While the FBSO has sole responsibility for taking any enforcement actions, the Bundesbank and its Land Central Banks play a significant role in the decisionmaking process that results in those actions. For example, the FBSO gives serious consideration to recommendations made by the Land Central Banks with respect to supervisory problems, and basically any enforcement action planned is discussed with the Land Central Banks before it is taken. The more important the case to the stability of the bank or banking system, the more likely the FBSO would be to get agreement from the Bundesbank.

Additionally, the Bundesbank is involved with the FBSO in rulemaking, even though only the FBSO or the Ministry of Finance may adopt regulations. Generally, the Ministry of Finance delegates rulemaking authority to FBSO. The Bundesbank must approve certain regulations, such as those that deal with liquidity and capital requirements.<sup>6</sup> Legally, if no agreement can be reached between the FBSO and the Bundesbank on such issues, the FBSO would be blocked from acting. To prevent a stalemate, the Finance

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<sup>5</sup>At the time it failed, Herstatt was one of Germany's largest foreign exchange dealers. Its closure had a global effect because it was closed during the middle of the trading day in the United States and consequently caught many banks with uncompleted foreign exchange transactions with Herstatt. The episode caused great disruption to the Clearing House International Payments System and resulted in losses for banks and Herstatt creditors.

<sup>6</sup>Bank Act of the Federal Republic of Germany, §§ 10, 10a, 11 24 and 25. Deutsche Bundesbank Special Series No. 2, 4th edition, July 1993.

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Ministry is given the authority to act in such cases and to adopt a regulation, but such action has never been necessary. In most other instances, such as when the FBSO wants to make certain exemptions to regulations or some reporting requirements, the FBSO is only required to consult with the Bundesbank. In practice, even in these areas, the opinions of the Bundesbank carry significant weight. We were told that the FBSO has never issued regulations with which the Bundesbank strongly disagreed. This effort toward consensus can partially be attributed to a recognition of the importance of a united Bundesbank-FBSO position if particular regulations were to be challenged by the banking industry in the strong German administrative court system.

The Bundesbank is also involved in the development of legislation. It testifies before the German legislature and also comments informally. Although technically the Finance Ministry is responsible for developing banking related legislation, it often draws on both the Bundesbank and the FBSO to help draft legislation.

## GAO Relationship of FBSO and Bundesbank Is Excellent

- Agencies are required by law to communicate
- Bankers and regulators describe excellent relationship

### Working Relationship Between FBSO and the Bundesbank Is Considered Excellent by Banks and Regulators

The FBSO and Bundesbank are required, by law, to “communicate to each other any observations and findings which may be of significance for the performance of their respective functions.”<sup>7</sup> Consequently, written communications that involve one agency but not the other are sent to the agency not involved. Information from meetings and telephone discussions that are of importance are also generally shared. In addition to day-to-day contacts, the senior leadership of the Bundesbank, its Land Central Banks, and the FBSO meet twice a year to discuss all important cases.

Although good relations cannot be legislated and some regulators acknowledged minor conflicts and turf battles, overall the relationship and

<sup>7</sup>Banking Act of the Federal Republic of Germany, § 7. Deutsche Bundesbank Special Series No. 2, 4th edition, July 1993.

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communication between the two agencies were described as excellent by the top officials of the two regulatory agencies, bank associations and external audit organizations we interviewed. They characterized the relationship as cooperative and collegial on the part of both agencies. Regulatory officials told us that any problems were likely to be short term and were not likely to seriously affect the quality of bank regulation and supervision.



## GAO External Auditors Are Responsible for Examinations

- Assess banks' operations, controls, and financial condition
- Legal responsibility to report serious problems immediately to FBSO and Bundesbank
- Legal liability of auditors is limited

### External Auditors Are Responsible for Bank Examination Function

In Germany, external auditors, not the regulatory agencies, perform the examination function through various audits. All banks licensed in Germany, with the exception of branches of European Union banks not headquartered in Germany, must be audited annually. Auditors were assigned these responsibilities under German law because, when the 1961 Banking Act was passed and the FBSO established, they already had expertise in banking. The auditors' role has evolved from checking banks' compliance with regulatory requirements to assessing a bank's operations and controls as well as its financial state.

External auditors' legal responsibility consists of providing regulators with specified information and immediately reporting information that might result in a qualification of the auditors' report. External auditors may qualify their reports if they feel that the bank has not met some concerns

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that they may have raised during the audit. While qualifications do not occur frequently, their frequency has risen in tandem with the increased responsibilities of auditors. The external auditors' legal responsibility also involves immediately reporting information that might "endanger the existence of the credit institution or gravely impair its development, or which indicate that the managers have seriously infringed the law, the articles of association or the partnership agreement"<sup>8</sup>. Such formal action is relatively rare, but informal discussions with the regulators are more frequent.

Although bank auditors carry a heavy legal responsibility, this is made somewhat easier to bear by legally limited liability for their work. Because bank audits are required by law, the auditors are liable up to only approximately \$300,000 for each audit, even if more than one party sues the accounting firm over the same audit. While the annual audit is not made public, the auditor's certificate is published which presents the auditor's opinion. Creditors or others may sue on the basis of that published opinion. Individual auditors in an audit firm are not financially liable. Although lawsuits are relatively uncommon, they are becoming more frequent as auditor responsibilities increase and banking becomes more complex. However, the FBSO has never sued an accounting firm and would be unlikely to do so in the future, primarily because it does not suffer monetary losses from a bank failure because insured losses to depositors are covered by the private deposit insurance systems.

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<sup>8</sup>Banking Act of the Federal Republic of Germany, §§ 25-27. Deutsche Bundesbank Special Series No. 2, 4th edition, July 1993.

## GAO Regulators Rely on External Auditors' Reports

- Annual audits assess safety and soundness
- FBSO may request periodic audits of bank operations
- Bank associations conduct audits for deposit insurance purposes

### Regulators Rely on External Auditors' Reports

German regulators rely primarily on three types of audit reports for qualitative information on the banks they regulate: (1) annual audits conducted by the bank's auditor, (2) periodic audits generally conducted every 3 to 6 years by an auditor chosen by the FBSO, and (3) audits conducted every 2 to 4 years by the bank deposit insurance organizations.<sup>9</sup>

Annual audits of bank safety and soundness are conducted by a firm chosen, and paid for, by the bank. German banking law requires that these audits include information that is described in detail in about 85 pages of regulatory guidelines. In general terms, audit firms are required to examine

<sup>9</sup>German banking law also requires annual audits of banks' custody (securities) businesses. Banking Act of the Federal Republic of Germany, § 30. Deutsche Bundesbank Special Series No. 2, 4th edition, July 1993. These auditors are appointed by the FBSO but are generally the banks' annual auditors.

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and assess critical aspects of bank operation such as capital, asset quality, management, earnings, and liquidity. This means that, in addition to conducting financial audits, German auditors must also check, among other areas, a bank's internal control and audit functions; its electronic data processing systems; its compliance with reporting requirements, the quality, diversification and country-risk of its loan portfolio and its loan procedures; and its derivatives business and procedures. More specifically, an auditor would be expected to check a bank's loan documentation on its largest loans, insider loans, and a sample of small loans. It would also be expected to assess the adequacy of a bank's loan loss reserves and request that the bank revise these reserves if necessary. An auditor might also discuss with bank management or other employees specific derivatives transactions that appear extremely complex. As a result of these detailed requirements, audit reports for large banks may exceed 500 pages and require a team of 30 to 50 auditors, many working year-round. An audit team for a small bank with an uncomplicated banking business, on the other hand, may consist of a team of only three or four auditors and take 3 to 4 weeks to complete.

Under section 44 of the 1961 Banking Act, the FBSO may request additional periodic audits of specific banks' operations. Such audits are commonly conducted at all banks at 3-to 6-year intervals and cover specific areas of the bank's operations such as derivatives, foreign exchange activities, the bank's internal audit function, or lending activities. In addition, an audit may be requested if the regulator suspects a problem at a specific bank.

Section 44 audits are always done by an audit firm that is not the bank's regular auditor. The bank is informed of the audit and the scope of the audit on very short notice and must pay for the audit. The bank normally does not receive a copy of the audit report from the FBSO until several weeks after the regulators have received it. The FBSO and Bundesbank will request that a bank answer questions about anything that they find unusual about the audit report or about any other concerns. In addition to providing information about the banks, these reports are also a check on the work of the banks' annual auditors.

The bank deposit protection systems for commercial, savings, and cooperative banks also conduct audits of their member banks at 2-to 4-year intervals, or more frequently if necessary, to make certain that the deposits they insure are safe. These audits are supplied to the bank regulators, the bank, and the bank's annual auditor, who must comment in writing on the audit to the regulators. In principle, these audits are similar to year-end audits and use the same audit procedures. The audits are likely, however, to focus on specific areas of a bank that are more complex or about which the insurance provider may have some concerns. The deposit insurance audit reports are considered to be quite rigorous by the bank regulators and are also a check on the work of the banks' annual auditors.

## GAO FBSO and Bundesbank Satisfied With External Auditors

- Regulators can disapprove a bank's external auditor
- Regulators appreciate quality of external auditors' work
- Dissatisfaction usually discussed and resolved

### FBSO and Bundesbank Are Generally Satisfied With External Auditors

The FBSO and Bundesbank do not qualify specific audit firms for bank audit work, but they do require that firms auditing banks be experienced in such audits. In addition, the FBSO has the right to disapprove the bank's choice of auditor. While such disapproval is infrequent, the FBSO is more likely to informally tell a bank that its audit firm selection would not be approved.

The bank regulators feel that they have a very good appreciation of the quality of bank auditors on the basis of their familiarity with the work these auditors do and discussions they have with bank management. In general, the FBSO and Bundesbank felt that the information from annual bank audits was satisfactory. They acknowledged that auditors may have a conflict between their examination responsibilities and their interest in serving their clients' needs but felt that the quality of audit work was not materially affected by this conflict. Since auditors may be barred from

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conducting bank audits by the FBSO, it is in their interest to supply the regulators with high-quality reports.

If bank regulators are dissatisfied with a specific audit report, they may react in several ways. It is common procedure for the Bundesbank Land Central Banks to fill out audit evaluation forms on all audits and send them to the FBSO to inform it of any concerns with the reports. Minor concerns may be brought to the attention of the auditors in future meetings. If the Land Central Bank's reservations are serious, it may meet with senior management of the audit firm or send a letter to the auditor—or ask the FBSO to send one—requesting that an auditor improve its report in the next year and possibly suggesting that in the absence of such improvement a reappointment of that auditor by the bank may be discouraged. Finally, and more infrequently, the top management of the FBSO and Land Central Bank may request a meeting with the bank and its audit firm to express their severe dissatisfaction with the work performed. Ultimately, as noted previously, a regulator may block a bank's selection of an auditor.

## GAO Banking Associations Provide Deposit Insurance

- Three deposit insurance systems; bank membership is optional
- Deposit protection is very high
- Deposit insurance systems assist and resolve troubled banks
- Associations also influence laws and regulations

### Banking Associations Provide Deposit Insurance

The German deposit insurance systems are private and membership is optional. There is no federal deposit insurance program and no federal guarantee of the private systems. With very few exceptions, all banks in Germany are members of a deposit insurance system. Banks that are not members of a deposit protection system must provide bank clients with this information.

Three separate deposit insurance systems are administered by the banking associations of the three major banking sectors: commercial banks, savings banks (owned mostly by municipal governments) and cooperative banks. The protection systems operated by the savings banks and credit cooperatives are aimed at protecting the solvency of the institutions, thus indirectly guaranteeing deposits. Savings banks also enjoy the backing of the municipal governments that own them. Only the commercial bank

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deposit insurance system directly protects deposits. None of the protection systems will intervene in the event of a general crisis in the banking industry.<sup>10</sup>

Deposit protection coverage of the commercial bank deposit insurance system is very high—nonsecuritized liabilities of each nonbank depositor are protected up to 30 percent of the bank's liable capital.<sup>11</sup> This means that a depositor in one of Germany's largest banks could be protected for almost \$1 billion. This high level of coverage, adopted in 1976 in the wake of bank failures in 1974, particularly that of Herstatt, was meant to ensure that commercial banks would be able to compete against banks that were owned by the public sector and to head off a possible legislated deposit insurance solution. The system is funded by an annual assessment based on a bank's deposit liabilities. Additional assessments may be made if necessary to discharge the fund's responsibilities, as has been done in the past.

The deposit insurance fund is not simply limited to paying off depositors when a bank fails. It also has the power to intervene and attempt to resolve a member bank's difficulties. Thus, the banking industry generally resolves its own problems. For example, in 1983 a relatively large bank—Schroeder, Muenchmeyer, Hengst and Co. (SMH)—failed as a result of its poor lending practices.<sup>12</sup> During this crisis, the regulators relied on, and even pressured the banking associations, to resolve the failed bank.<sup>13</sup>

Banking associations can also be quite influential in terms of affecting proposed banking laws and regulations. For example, banking associations, by law, must be consulted when changes to banking law or regulation are being considered and before banking licenses are issued.

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<sup>10</sup>"Deposit Protection Schemes in the Federal Republic of Germany" monthly report of the Deutsche Bundesbank, July 1992.

<sup>11</sup>Liable capital is defined as the paid-up endowment capital and the reserves plus up to 25 percent of tier 2 capital—which includes undisclosed reserves, asset revaluation reserves, general provision/general loan loss reserves, hybrid (debt/equity) capital instruments, and subordinated term debt.

<sup>12</sup>SMH failed in 1983 primarily as a result of excessive lending to a building machinery group and its affiliates. The banking community agreed to support SMH partially because it was involved in significant international transactions through a Luxembourg subsidiary, and German banks were consequently concerned about their international reputations. The bank's securities and other profitable operations were sold to Lloyd's Bank while the rest of the bank was wound down.

<sup>13</sup>For additional information about deposit insurance in Germany, see Deposit Insurance: Overview of Six Foreign Systems (GAO/NSIAD-91-104, Feb. 22, 1991)



## GAO Other Bundesbank Responsibilities

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- Liquidity Provider
  - Active in providing short-term liquidity needs
  - Extends short-term secured loans
  - Liquidity handled through Bundesbank Land Central Banks

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### Liquidity Provider

The Bundesbank is very active in providing solvent banks with loans to help them smooth out short-term liquidity needs through discount and Lombard lending. Discounting involves the sale of commercial bills of exchange to the Bundesbank at a fixed discount rate, generally lower than interbank rates. The low rates encourage borrowing from the Bundesbank up to a rediscount quota that is fixed by the Bundesbank. Because banks must provide the Bundesbank with financial information to obtain these loans, this provides another important source of information for the Bundesbank in carrying out its supervisory responsibilities.

The Bundesbank also provides short-term loans to banks secured by specified securities held by the bank obtaining the loan. The granting of these loans, called Lombard loans, depends on monetary policy because they are used as tools in determining the money supply. Lombard lending

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has been suspended in restrictive monetary environments, and the Bundesbank has granted special Lombard loans that can be discontinued from one day to the next.

Both discount and Lombard lending are conducted through the Land Central Banks and are considered normal liquidity borrowing without any negative market connotations.

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## GAO Other Bundesbank Responsibilities

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- Crisis Management
  - Significant role
  - Negotiates solutions to bank problems

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### Crisis Management

In the past, and as recently as the failure of the Bank of Credit and Commerce International (BCCI) and the closure of two BCCI branches in Germany, the Bundesbank has played a significant role in crisis management involving financial institutions. The extent of the Bundesbank's influence in crisis situations is apparent from its handling of the SMH bank failure in 1983 discussed previously. SMH bank had developed serious financial problems as a result of making large loans to several companies, which the bank did not report to the regulators as being affiliated. When one of these companies defaulted, the whole group failed. Bank management went to the Bundesbank when they realized the extent of the problem. The Bundesbank then notified the FBSO, and the two agencies called together the senior management of the bank and the bank's creditor banks to resolve the problem. The Bundesbank played a very influential role in persuading the creditor banks to forgive some of

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their debts and to delay repayment on other debts, thereby giving SMH bank the opportunity to dissolve in an orderly fashion. The Bundesbank feels that its independence and lack of legal enforcement responsibilities in disciplining banks helps it negotiate solutions to such problems and also makes the communication of problems easier than to the FBSO.

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## GAO Other Bundesbank Responsibilities

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- Payments clearance and currency delivery
- Bundesbank Land Central Banks are involved
- Three largest commercial banks and regional savings and cooperative banks also have a role

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### Payments Clearance and Currency Delivery

The Bundesbank Land Central Banks are also heavily involved in payments clearance and currency delivery at the local level. Checks, bills of exchange, foreign currency transactions, and transactions with foreign banks are all cleared from the individual payment systems of the commercial, cooperative, and savings banks and the clearance systems of the three largest German banks. Each Land Central Bank clears transactions in the region for which it is responsible. In 1991, 3.2 billion credit transfers, checks, and direct debits passed through Bundesbank facilities—one-third of the transfers and collection orders handled by German banks.

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## GAO Other Bundesbank Responsibilities

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- Participation in international organizations
- FBSO and Bundesbank share representation and coordinate positions on issues

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### Participation in International Organizations

The Bundesbank also plays a significant role in international organizations such as the Organization of Economic Cooperation and Development, the European Union, the International Organization of Securities Commissions, and Basle Committee on Bank Supervision, even though the FBSO has the superior legal regulatory status. Generally, the FBSO and Bundesbank are both represented in international forums and will have worked out joint positions before meetings of such groups.

## GAO LIKO Bank Serves as Lender of Last Resort

- A private bank is lender of last resort
- Credit decision committee has Bundesbank representative
- Troubled banks either liquidated or assisted by bank associations
- "Too big to fail" policy not advocated

### LIKO Bank Serves as Lender of Last Resort

The Bundesbank does not officially function as lender of last resort. This function is provided to some extent by the Liquidity Consortium Bank, or LIKO Bank. The LIKO Bank is a private bank that was jointly capitalized by the Bundesbank, which contributed 30 percent of the capital, and the German banking industry following the Herstatt failure in 1974. It is designed exclusively to help sound banks meet short-term liquidity needs on an emergency basis, rather than to sustain banks with more substantial financial difficulties.

Credit decisions are made by a four member committee comprised of representatives from the Bundesbank, the commercial bank, the savings bank, and the cooperative bank associations. Its facilities have been used by only seven banks since its founding. The infrequency of use can be attributed to the fact that most banks suffering a serious liquidity crisis are

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also experiencing extensive credit problems and would not qualify for LIKO Bank lending. Even though one of the seven banks failed and others suffered further difficulties, the LIKO Bank has not lost any money because the banking associations of which the borrowing banks were members took responsibility for ensuring that the loans were repaid. If necessary, the LIKO Bank may call on the initial capital subscribers for more funds, and it has access to a Bundesbank rediscount line of credit.

Banks in serious financial difficulties are either liquidated or assisted by the banking associations of which they are members. Deposits in failed banks are repaid by the private deposit insurance protection systems administered by the banking associations. Officials of the Bundesbank insist that they do not advocate a "too big to fail" policy. Indeed, the Bundesbank is prohibited by the Bundesbank Act from buttressing banks that have become insolvent. If a decision to rescue a large bank were made, it would be a political one. Nevertheless, the Bundesbank would play a significant role in advising on such a decision.

In cases where "there is reason to fear that credit institutions may encounter financial difficulties which warrant expectations of grave danger to the national economy," the 1961 Banking Act allows the Federal government to take action to "grant a credit institution an extension of time to fulfill its obligations,"<sup>14</sup> and order that credit institutions or the stock market be temporarily closed. Before taking such action the Federal government must consult with the Bundesbank and it is likely that the opinion of the Bundesbank would carry significant weight in the government decisionmaking process.

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<sup>14</sup>Banking Act of the Federal Republic of Germany, §§ 47. Deutsche Bundesbank Special Series No. 2, 4th edition, July 1993



# Summary of German Bank Regulatory Structure

Federal Bank Supervisory Office

De jure the FBSO is the primary German bank regulatory and supervisory authority. It alone has the authority to take legal action involving credit institutions. Such actions include: chartering, closure, the issuance of regulations, ordering special audits, and taking supervisory actions against banks.

De facto it shares much of its authority with the Bundesbank (see below). For example, it generally would not take a legal action with which the Bundesbank disagrees and is in communication with the Bundesbank on all important issues and decisions. Usually, it is not as involved in the day-to-day information gathering and supervision as is the Bundesbank. Close collaboration between the FBSO and the Bundesbank is a hallmark of the German regulatory system and carries over into joint memberships in international forums.

Deutsche Bundesbank

While the Bundesbank possesses none of the legal responsibility for bank regulation and supervision, beyond its authority to veto certain regulations, for all practical purposes it is an equal partner with the FBSO. Its responsibilities include:

- the collection and analysis of monthly bank data that it then forwards to the FBSO,
- the analysis of external audits, and
- for all intents and purposes, equal input as the FBSO in important decisions involving legislation, regulation, and supervisory actions, and veto authority over certain types of regulations.

With a larger supervisory staff than the FBSO, it is viewed as more of a day-to-day supervisor. It has also played a major role in crisis management and it is felt that it benefits in this role from its relative lack of legal responsibility in bank regulation and supervision.

External auditors

External auditors perform the examination function in the German supervisory system. Private accounting firms have a legal responsibility under German banking law to submit their annual bank audits to the FBSO and the Bundesbank. These audits must be conducted in accordance with regulations developed jointly by the FBSO and Bundesbank and promulgated by the FBSO. Auditors must inform the FBSO and the Bundesbank immediately of any significant findings.

External auditors are also used to perform special examinations ordered by the FBSO in areas such as derivatives activities, internal controls, or the credit portfolio. Most of these audits are routine, although some may be ordered because problems are suspected. Special audits are conducted by auditors other than the bank's normal auditors but are paid for by the bank.

Banking associations

Banks in Germany are represented by 14 banking associations that must be consulted by the Finance Ministry and the bank regulators on the development of banking laws and regulations.

The three largest of these associations—the commercial, savings, and cooperative bank associations—also administer three separate deposit insurance systems. In this context, the banking associations also have the power to intervene and attempt to resolve member bank difficulties.

# Structure and Independence of the Deutsche Bundesbank

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## Structure

The Bundesbank has a nationwide substructure consisting of 9 Land Central Banks each responsible for the territory in up to 3 of the country's 16 states (leander) and, as of April 1, 1994, 183 branches in larger towns and cities. In determining the location of the Land Central Bank offices, particular emphasis was placed on locating the office in the most important banking center of the area because direct contacts with the banking industry were deemed important for implementing monetary policy.

The territories of the 9 Land Central Banks are divided into (1) the Land of Baden-Wuerttemberg, (2) the Free State of Bavaria, (3) the Lands of Berlin and Brandenburg, (4) the Free Hanseatic City of Bremen and the Lands of Lower Saxony and Saxony-Anhalt, (5) the Free and Hanseatic City of Hamburg and the Lands of Mecklenburg-Western Pomerania and Schleswig-Holstein, (6) the Land of Hesse, (7) the Land of North Rhine-Westphalia, (8) the Lands of Rhineland-Palatinate and Saarland, and (9) the Free State of Saxony and the Land of Thuringia. At year-end 1993, the Bundesbank employed a total staff of 17,632, of which 2,828 were in its Frankfurt headquarters, 5,074 in Land Central Banks, and 9,730 in branch offices.

The governing bodies of the Bundesbank are the Central Bank Council, the Directorate, and the managing boards of the Land Central Banks. The Central Bank Council is composed of the 7-member Directorate (this may be expanded to 8 members) and the 9 presidents of the Land Central Banks and is the supreme policymaking body of the Bundesbank. It meets every 2 weeks and its decisions are made by simple majority votes.

The Directorate of the Council, which consists of the President, the Deputy President and up to six other members, who must all have special professional qualifications, is responsible for implementing these decisions. The members of the Directorate are nominated by the federal government and, after consultation with existing members of the Council, appointed by the federal President, normally for 8 years. They generally cannot be removed from office before completing their terms.

The Presidents of the Land Central Banks are proposed by the governments of the states over whose territory they have responsibility and are nominated by the Bundesrat (the Chamber of Parliament representing the states). The Central Bank Council is also consulted on these nominations, but in general they tend to be political and opposition by the Council is not sufficient to block a nomination.

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The Land Central Banks are each headed by a managing board, which include a president, a vice-president and one more member for the larger Land Central Banks. The Land Central Banks also have advisory boards, which consist of representatives of the banking sector, industry, agriculture and labor. Their purpose is purely one of consultation. The Land Central Banks, themselves, even though they are part of the Bundesbank, are the equivalent rank as the FBSO, one step below ministry level.

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## Independence

The primary task of the Deutsche Bundesbank, set forth in the Bundesbank Act, is not bank regulation and supervision, but the protection of monetary stability. To ensure that the Bundesbank would be able to accomplish this task, the Bundesbank Act made the central bank independent of instructions from the federal government. The basic obligation contained in the act for the Bundesbank to support the general economic policy of the federal government is expressly linked to the condition that this does not create insoluble conflicts with the primary task to be performed by monetary policy i.e., price stability. As a result, the Bundesbank is generally considered to be one of the most, if not the most, independent central banks in the world.

# Objectives, Scope, and Methodology

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At the request of Congressman Charles E. Schumer, we examined various aspects of the German bank regulatory system. Specifically, our objectives were to describe (1) the German bank regulatory system and its key participants, (2) how that system functions, and (3) other Deutsche Bundesbank responsibilities that affect the banking industry.

Much of the information presented in this report is based on interviews with and documents and statistics provided by the Senior Director of Bank Supervision and two other officials of the FBSO, the Director of Bank Supervision and his deputy of the Deutsche Bundesbank headquarters, and the Directors of Bank Supervision and their deputies at the Land Central Banks in Frankfurt and Berlin. Documentation included copies and descriptions of the monthly reports that banks submit to the Bundesbank, the draft audit guidelines that are expected to be issued by the FBSO in the fall of 1994, reports that cover recent changes to banking and Bundesbank law, and statistics on the banking industry.

In addition to our interviews with the regulatory agencies, we met with several senior executives at German banks and accounting firms. We also obtained information from the Federal Association of German Banks, and the accounting firm it owns, and from the Institute of Certified Public Accountants.

Finally, we reviewed the Banking Act of the Federal Republic of Germany and the Deutsche Bundesbank Act, the two laws that relate most directly to bank regulation and supervision and related documents.

We conducted our review from January 1994 through April 1994 in accordance with generally accepted government auditing standards. We discussed a draft of this briefing report with senior regulatory officials of the FBSO and Bundesbank, who generally agreed with the facts as presented.

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