

# “The German Banking System. A possible model for prospective new EU-members”

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# THE GERMAN BANKING SYSTEM. A POSSIBLE MODEL FOR PROSPECTIVE NEW EU-MEMBERS

Klaus F. Bröker

## Abstract

A substantial number of new members joined the EU recently. The list of prospective new EU-members is growing at a rapid rate. A crucial aspect in joining the EU, is a banking system that is up to par with all relevant EU-regulations. Aside from the implementation of EU-regulations, the most important issue is a well-regulated banking system that operates efficiently, is reliable and trusted. The German banking system has an extensive history that dates back centuries. Being in compliance with the essential EU-regulations, the German Banking System could very well be a guideline for prospective new EU-members. Germany might also be well considered a country to establish a banking subsidiary.

**Keywords:** German Banking System, EU-banking regulations, banking license, banking supervision, credit institutions, compliance, rules of conduct, record keeping, deposit guarantees.

**JEL classification:** G21, G28

## 1. Introduction

In recent years the EU with currently 25 members<sup>1</sup>, a population of nearly 460 million and the largest gross domestic product in the world<sup>2</sup> appears to be more attractive for new members to join. The list of prospective new EU-members is growing at a substantial rate<sup>3</sup>. EU-membership provides privileges, such as free trade, provision of free cross-border services, one currency, one market and the individual rights of choice in employment<sup>4</sup>. These are among a few of the reasons that makes joining the EU very appealing.

With more states joining the EU, one has to consider that regulations will increase and implementation of new rules will not only be slower, but more complicated and certainly more expensive for every member of the EU<sup>5</sup>.

A major issue in becoming a new EU-member is the status of the banking system in the prospective new member-state. The banking system has to be in accordance with EU standards, its rules and regulations, as well as with the national standards. The banking system must be well regulated, operate efficiently, be reliable and trusted by its clients<sup>6</sup>.

It is essential that clients have confidence in a banking system that is operated properly. Despite some regulatory and financial problems in the past, such as the bankruptcy of Herstatt Bank in 1974<sup>7</sup> or the most recent scandal of Phoenix Kapitaldienst GmbH in 2005<sup>8</sup>, the German Banking System has proven its stability and reliability.

The client's confidence in the German Banking System is stellar, therefore, the German Banking System in its set-up might be a guideline for prospective new EU-members.

## 2. German Banking

German Banking is not defined in one specific law, nor it is regulated in one single aspect. It is regulated by a large number of laws and ordinances.

The system of German Banking is based on the universal banking principle<sup>9</sup>, which includes but is not limited to services, such as: consumer and business checking and savings accounts, personal and commercial lending, home mortgages, paycheck and equity lending as well as services in investment banking, not limited to the purchase and/or sale of investment funds, exchanged traded financial instruments (i.e. shares, bonds, mutual funds, warrants, options, futures and other derivatives), cross-border services, money transfers, underwriting, depository services, etc.

German Banking is structured on a dual system<sup>10</sup>: The credit institutions<sup>11</sup> and the European Central Bank (Europäische Zentralbank or EZB) with the German Federal Bank (Deutsche Bundesbank) and its subsidiaries<sup>12</sup>.

The German Banking System has – due to EU-regulations<sup>13</sup> – two different types of commercial enterprises. The credit institutions, which are regulated by Section 1, Subsection 1 German Banking Act (Kreditwesengesetz or KWG), and the financial services institutions, which are regulated by Section 1, Subsection 1 a KWG<sup>14</sup>.

In this article the focus will be on the credit institutions, their structure and basic regulations.

### **2.1. Credit Institutions**

The 12 different types of credit institutions are defined in Section 1 Subsection 1 German Banking Act (KWG). Credit institutions are enterprises which conduct banking business on a commercial basis. Banking business is any commercial activity listed in Section 1 Subsection 1 No. 1-11 KWG<sup>15</sup>.

The following is the definition of credit institutions under German law.

#### **Section 1, Subsection 1 KWG**

*Credit institutions are enterprises conducting banking business commercially or on a scale which requires a commercially organized business. Banking business comprises*

- 1. The acceptance of funds from others as deposits or of other repayable funds from the public unless the claim to repayment is secured in the form of bearer or order debt certificates, irrespective of whether or not interest is paid (deposit business).*
- 1a. The business specified in Section 1, Subsection 1, sentence 2 of the Act on Mortgage-Bank-Bonds (Mortgage-Bank business).*
- 2. The granting of money loans and acceptance credits (lending business).*
- 3. The purchase of bills of exchange and cheques (discount business).*
- 4. The purchase and sale of financial instruments in the credit institution's name for the account of others (principal brokering services).*
- 5. The safe custody and administration of securities for the account of others (safe custody business).*
- 6. The business specified in Section 1 of the Act on Investment Companies (investment fund business).*
- 7. The incurrance of the obligation to acquire claims in respect of loans prior to their maturity.*
- 8. The assumption of guarantees and other warranties on behalf of others (guaranty business).*
- 9. The execution of cashless payments and clearing operations (giro business).*
- 10. The purchase of financial instruments at the credit institution's own risk for placement in the market or the assumption of equivalent guarantees (underwriting business).*
- 11. The issuance and management of electronic money (e-money business).*

This list does not define, but rather describes what is regarded as banking business under German laws. The classic banking business is listed under No. 1 and No. 2, the deposit business and the lending business. A bank that is licensed to conduct these types of businesses is referred to as a licensed bank (Vollbank).

A licensed bank is required to have a special set-up in its organizational structure to be in compliance with Sections 32, 33 KWG. Its minimum capital has to be no less than 5 Million Euros (Section 33, Subsection 1, No. 1 d KWG).

This article refers to the licensed banks or credit institutions as categorized above.

Banks or Credit Institutions conducting activities other than specified in Section 1, Subsection 1, No. 1 KWG, are referred to as special banks (Spezialbanken)<sup>16</sup>.

Section 1, Subsection 1a KWG, is listing a description of the eight different Financial Services Institutions that require licensing<sup>17</sup>.

## **2.2. Types of German banks**

Germany has an extensive history in banking which dates back many centuries<sup>18</sup>. German banks appear in different structures, but have in common their primary business focus, which is generating profit<sup>19</sup>.

The different types of banks<sup>20</sup> are:

- ◆ Private or Merchant Banks
- ◆ Savings and Loans Institutions
- ◆ Cooperative association banks

The types of banks mentioned above, conduct banking business for retail and institutional clients on a national and international basis.

The difference between these three different types of banks is in the institution's set-up, organizational structure, shareholders and rules and regulations, which are in addition to the basic rules and regulations outlined in the German Banking Act (KWG) and the German Securities Trade Act (Wertpapierhandelsgesetz or WpHG) and require mandatory compliance.

The functions of the different types of banks are as follows:

## **2.3. Private or Merchant (Commercial) Banks**

### **2.3.1. Definition/Function**

Private Banks<sup>21</sup> are organized under private laws, namely as privately organized and mostly privately owned corporations such as limited liability companies (GmbH or Gesellschaft mit beschränkter Haftung), general partnerships (oHG or Offene Handelsgesellschaft), limited liabilities (or closed) corporations (GmbH or Gesellschaft mit beschränkter Haftung), limited liability partnerships (GmbH & Co KG or Kommanditgesellschaft mit beschränkter Haftung) or corporations (by shares) (AG or Aktiengesellschaft).

Private banks are not state owned. The shares of private banks are usually owned by individuals or other corporations with all privileges and risks of such a structure.

Aside from supervision and regulation, neither the state or any local government nor governmental body has an interest in private banks.

Private banks are the primary global players in the markets, like the largest German bank, Deutschen Bank AG.

Private banks serve retail clients, however, their strongest focus is on institutional and international banking aspects.

### **2.3.2. Major regulations**

The major regulations of private banks are, on one hand, the regulations about their corporate structure. This structure is set forth in the German Commercial Act (Handelsgesetzbuch or HGB), the German Act on Limited Liability (closed) Corporations (Gesetz über Gesellschaften mit beschränkter Haftung or GmbHG), and the German Corporations Act (Aktiengesetz or AktG).

On the other hand, privately owned and structured banks have to comply with the rules and regulations of banking licensing and supervision, set forth in but not limited to the German Banking Act (Kreditwesengesetz or KWG) and the German Securities Trade Act (Wertpapierhandelsgesetz or WpHG), as well as a large number of other acts, ordinances, rules and regulations.

Private banks have their own rules and regulations, called General Terms of Business (Allgemeine Geschäftsbedingungen der Geschäftsbanken), in dealing with customers which vary from those of the other types of banks<sup>22</sup>.

### *2.3.3. Number of private and/or merchant banks in Germany*

The annual report of the regulatory body of banking supervision by the BaFin shows that at the end of 2004 there were 67 private banks regulated<sup>23</sup>.

## **2.4. Savings- and Loan Institutions**

### *2.4.1. Definition/Function*

Savings and Loan Institutions<sup>24</sup> are organized under specific public laws in every of the sixteen German States and owned by public entities such as municipality (the local community government). The Savings and Loan Institutions date back to the early nineteenth century<sup>25</sup>. The first "municipal bank" was incorporated in 1801 in the town of Göttingen in the state of Lower Saxony<sup>26</sup>. The basic idea of incorporating this kind of credit institution was to give the general public with low or little income access to banking services, such as depositing money safely, the ability to own a (small) and secure savings account as well as the ability to borrow money<sup>27</sup>.

### *2.4.2. Major regulations*

The major regulatory framework of the Savings- and Loan Institutions are the acts which are part of the public law in each of the 16 German States (Sparkassengesetze der Länder)<sup>28</sup>. Additionally Savings and Loan Institutions have to comply with all rules and regulations that are in effect with respect to banking supervision, etc. (like KWG, WpHG) just as the private or merchant banks do.

Savings and Loan Institutions are limited in their way of investing their funds, due to the fact that they are considered the small man's banking institution, and therefore, have restrictions on safeguarding<sup>29</sup>. In the past these credit institutions were guaranteed by the local municipality, and its shares were not for purchase and/or sale<sup>30</sup>. This was to protect the small banking business and its customers (mostly local retail and local businesses/small companies) from facing the risk of their (community) bank to have to file for bankruptcy due to (unnecessary) financial exposure or mismanagement.

Just like the private or merchant banks the Savings- and Loan Institutions have their own rules and regulations or general terms of business (Allgemeine Geschäftsbedingungen der Sparkassen), which differ from those of the private or merchant banks<sup>31</sup>.

### *2.4.3. Number of Savings and Loan Institutions*

The annual report of BaFin shows that at the end of 2004 there were 477 Savings and Loan Institutions regulated<sup>32</sup>.

## **2.5. Cooperative association banks**

### *2.5.1. Definition/Function*

Cooperative association banks (Genossenschaftsbanken)<sup>33</sup> are organized under a specific act; the Cooperative Association Act (Genossenschaftsgesetz or GenG) which, as a partly public but also partly private act, regulates various types of cooperative associations<sup>34</sup>.

The purpose of this act was to enable small business owners to establish various cooperations<sup>35</sup>. In respect to that, the cooperative association banks are regionally structured (small) local banks (credit institutions), which mainly focus on local retail and small business clients. Cooperative association banks are owned by the members of the cooperative association only. Their shares are not traded.

### *2.5.2. Major regulations*

The major act regulating the legal structure of cooperative association banks is the Cooperative Association Act (Genossenschaftsgesetz or GenG) that does regulate not only (small) credit institutions, but other types of cooperative associations as well. This specific act is partly a regulation aspect of public law. Such are the limited privileges under which a cooperative association can be established. It also consists of private law aspects regarding the individual structure and set-up of a cooperative association<sup>36</sup>.

Like any of the above described credit institutions, cooperative association banks have their general terms of business with respect to customer relations, which are different from any of the above mentioned credit institutions<sup>37</sup>.

### *2.5.3. Number of Cooperative Associations Banks*

The annual report of BaFin shows that at the end of 2004 there were 1,339 Cooperative Association Banks regulated<sup>38</sup>.

## **2.6. Other banks/credit institutions**

The three types of credit institutions mentioned above are the major types of banks in Germany. Additionally there are many more, such as Postbank (Postal Bank with as many as 9,707 branches at the end of 2004), Bausparkassen (Buildings and Loan Associations or Building Societies with 27 institutions at the end of 2004), Hypotheken- und Schiffshypothekenbanken (Mortgage and Ship Mortgage Banks with 22 institutions at the end of 2004) and various types of special banks<sup>39</sup>. All of which are regulated by a specific act regarding their structure, and all of which must be in compliance to the rules of KWG (German Banking Act) and WpHG (German Securities Trade Act) as well as all other rules and regulations for licensing and supervision.

The number of credit institutions regulated by BaFin at the end of 2004 was a total of 2,316<sup>40</sup>.

## **2.7. Deposit Guarantees**

A banking system is only as good as its structure, regulations and supervision. Additionally, the customer's confidence in the system is essential. In order to maximize customer confidence, it is vital to implement regulations to protect the customer's assets deposited in a bank. The customer's assets must be safe and secure at all times and should not be affected by any kind of problem or threat (i.e. financial problems, fraud etc) a credit institution or a financial services institution might encounter. Therefore, European law<sup>41</sup> requires every EU-member to have specific regulations in place to protect customers assets.

Based upon EU-regulations Germany has implemented (in addition to its already existing deposit guarantee system<sup>42</sup>) the Deposit Guarantee and Investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz or EAEG). Any institution in Germany, whether it is a credit institution or a financial services institution, has as a legal requirement to join this compensation scheme in order to offer protection of customer assets. That act requires a minimum protection according to EU-rules, which is limited to the maximum amount of 20,000 Euros per customer (Sec. 4 EAEG).

In addition, Germany has various types of compensation schemes for private banks, savings and loan institutions and cooperative association banks that offer more customer asset protection than the minimum required by EAEG<sup>43</sup>.

## **2.8. List of credit institutions and other regulated businesses**

The German Banking Authority (Bundesanstalt für Finanzdienstleistungen or BaFin) as the regulatory and supervising governmental body, lists every licensed credit institution in Germany on its webpage at [www.bafin.de](http://www.bafin.de). This list can be obtained from their webpage under the link "Data-bases" and then continued to "Institutions search", including every German credit institution, as

well as every foreign bank (foreign credit institutions), branches, subsidiaries, financial services institutions, investment companies etc.

### **3. Banking Supervision by the Federal Financial Supervisory Authority**

#### ***3.1. Definition/Function***

The Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht or BaFin) is the supervisory body.

BaFin was established on May 1, 2002, based upon the Act Establishing the Federal Financial Supervisory Authority (Finanzdienstleistungsaufsichtsgesetz or FinDAG) and now combines the three former Federal Supervisory Offices for banking, insurance industry and securities trading under one roof<sup>44</sup>.

BaFin is an independent body governed by public law and part of the German Federal administration<sup>45</sup>. Its major task is the supervision of credit institutions and financial services institutions as well as insurance companies and securities trading to ensure that the German financial system continues to function properly, remains competitive and that its integrity is preserved<sup>46</sup>. BaFin also ensures that the trust of customers, investors and insurance policy holders in the system is maintained and that the market operators conduct their business in accordance with all relevant rules, regulations and on a fair basis<sup>47</sup>.

As of September 2005 BaFin employs 1,500 people, and supervises about 2,300 credit institutions, 800 financial services institutions, 630 insurance companies and 6,200 investment funds.

#### ***3.2. Major regulations***

As set forth above, under 3.1., the major act regulating BaFin is the FinDAG which also sets up the current BaFin-structure (see 3.3. next). Regulations on BaFin can also be found in Sections 6 to 9 KWG and in various sections throughout KWG and WpHG.

Sections 6 and 6a KWG list the functions and tasks of BaFin as described under 3.1.

Section 7 KWG regulates the cooperation with the German Federal Bank (Deutsche Bundesbank). Section 8 KWG specifies basic rules for cooperation with other bodies (governmental and others). Section 9 KWG is the essential secrecy provision.

#### ***3.3. Structure***

The current BaFin structure consists of three separate units, namely “directorate for banking supervision”, “directorate for insurance supervision” and “directorate for Securities and asset management supervision”, each of which is headed by a chief executive director<sup>48</sup>. Each directorate is responsible for solvency and market supervision<sup>49</sup>. Functions extending across more than one area of supervision are assumed by the cross-sectoral departments<sup>50</sup>.

The current president of BaFin is Mr. Jochen Sanio. Second in charge is the vice-president, Mr. Karl-Burkhard Caspari<sup>51</sup>.

Directly attached to the President’s office is the Press and Publicity/Internal Information Management Office, as well as the President’s Private Office, the Strategic Planning and Controlling Office, the Project Management Office, the Organizational Development Office and the Internal Audit and Anti-Corruption Office<sup>52</sup>.

### **4. Banking license and conduct of business**

Banking supervision in Germany is divided into 2 phases<sup>53</sup>. Phase one is the authorization process, the granting of the license and phase two is the ongoing (on a daily basis) supervision<sup>54</sup>. The basic regulation for the application process is specified in the German Banking Act (KWG), especially in Sections 32, 33 KWG. The basic regulation for ongoing supervision, once a license is granted,

is set forth in the German Securities Trade Act (WpHG), especially in the rules of conduct and structure in Sections 31 to 34 a WpHG.

#### **4.1. Requirements for obtaining a banking license**

The basic requirements for obtaining a banking and/or financial services license are stated in Sections 32 and 33 of the German Banking Act (KWG) and read as follows:

##### **Section 32 KWG Granting the license**

*(1) Anyone wishing to conduct banking business or to provide financial services in Germany commercially or on a scale which requires a commercially organized business undertaking requires a written license from the Federal Financial Supervisory Authority; Section 37 (4) Administrative Procedure Code applies. The application for the license must include the following:*

- 1. Suitable evidence of the resources needed for business operations.*
- 2. The names of the managers.*
- 3. The necessary information for assessing the truthworthiness of the applicants and of the persons specified in section 1 (2) sentence 1.*
- 4. The necessary information for assessing the professional qualifications, as required for managing the institution, of the proprietors and of the persons specified in section 1 (2) sentence 1.*
- 5. A viable business plan showing the nature of the planned business, the organizational structure and the planned internal monitoring procedures of the institution.*
- 6. If qualified participating interests are held in the institution:*
  - (a) the names of the holders of the qualified participating interests,*
  - (b) the amount of these participating interests,*
  - (c) the data required for assessing the trustworthiness of these holders or the legal representatives or of the general partners,*
  - (d) if the holders are required to draw up annual balance sheets: their annual balance sheets for the last three financial years, along with the auditor's report compiled by an independent external auditor if such reports are to be prepared, and*
  - (e) if the holders belong to a group: particulars of the group and, if such balance sheets are to be drawn up, the consolidated group balance sheet for the last three financial years, along with the auditor's reports compiled by an independent external auditor if such reports are to be prepared.*
- 7. The facts indicating a close relationship between the institution and other natural persons or other enterprises.*

*The reports and documents to be submitted pursuant to sentence 2 shall be specified in detail by ordinance in accordance with section 24 (4). The requirements under sentence 2 (6) (d) and (e) do not apply to financial services institutions.*

*(2) The Federal Financial Supervisory Authority may make the granting of the license subject to conditions which must be consistent with the purpose pursued by this Act. It may limit the license to certain types of banking business or financial services.*

*(3) Before granting the license, the Federal Financial Supervisory Authority shall consult the guarantee scheme appropriate for the institution.*

*(3a) On being granted the license, the institution, if it is liable to pay contributions under Section 8 (1) of the Deposit Guarantee and Investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz), shall be informed of the compensation scheme to which the institution is assigned.*

*(4) The Federal Financial Supervisory Authority shall publish the granting of the license in the electronic Federal Gazette.*

In more detail Section 33 KWG regulates the refusal of the license and reads as follows:



**Section 33 KWG Refusing the license**

*(1) The license shall be refused if:*

*1. The resources needed for business operations, in particular adequate initial capital within the meaning of section 10 (2a) sentence 1 numbers 1 to 7, are not available in Germany; the initial capital which must be available is as follows:*

*(a) in the case of investment brokers, contract brokers and portfolio managers who in the course of providing financial services are not authorized to obtain ownership or possession of funds or securities of customers and who do not trade in financial instruments for their own account, an amount equivalent to at least fifty thousand euro;*

*(b) in the case of other financial services institutions, which do not trade in financial instruments for their own account, an amount equivalent to at least one hundred and twenty-five thousand euro;*

*(c) in the case of financial services institutions which trade financial instruments for their own account and in the case of securities trading banks, an amount equivalent to at least seven hundred and thirty thousand euro;*

*(d) in the case of deposit-taking credit institutions, an amount equivalent to at least five million euro;*

*(e) in the case of e-money business institutions, an amount equivalent to at least one million euro.*

*2. Facts are known which suggest that an applicant or one of the persons specified in section 1 (2) sentence 1 is not trustworthy.*

*3. Facts are known which warrant the assumption that the holder of a qualified participating interest in the institution or a general partner or legal representative of the enterprise concerned is not trustworthy or for other reasons failed to satisfy the requirements to be set in the interests of the sound and prudent management of the institution; Section 2 b (1a) sentence 1 number 1 sub-sentence 2 applies.*

*4. Facts are known which suggest that the proprietor or one of the persons specified in section 1 (2) sentence 1 does not have the professional qualifications necessary for managing the institution and if no other person has been assigned as manager in accordance with section 1 (2) sentence 2 or 3.*

*4a. Facts are known that if a license is granted the institution will become a subsidiary of a financial holding in the meaning of Section 1 (3a) sentence 1 or of a mixed activity financial holding in the meaning of Sentence 1 (3a) sentence 2 and that facts are known that a person in the meaning of Section 2c is not trustworthy or does not have the necessary professional qualification for managing the business of a financial holding or a mixed activity financial holding.*

*5. A credit institution or a financial services institution which, in the course of providing financial services, is authorized to obtain ownership or possession of funds or securities of customers or that is, due to a certificate issued by the Federal Financial Supervisory Authority in accordance with Section 4 (1) number 2 of the Act on Certification on Pension Plans, licensed to offer certified pension plans, does not have at least two managing directors who work for the institution not merely in an honorary capacity.*

*6. The institution has its head office outside Germany.*

*7. The institution is not prepared or incapable to make the organizational arrangements for the proper operation of the business for which it is seeking a license.*

*8. The applicant is a subsidiary of a foreign credit institution and the foreign authority responsible for the supervision has not consented to the incorporation of the subsidiary.*

*An investment broker or a contract broker who, in the course of providing financial services, is not authorized to obtain ownership or possession of funds or securities from customers and who does not trade in financial instruments for his own account shall not be refused a license in accordance with sentence 1 (a) if, instead of the initial capital, he can demonstrate that he has taken out appropriate insurance for the protection of customers.*

*(2) A pre-requisite of the professional qualifications for managing an institution needed by the persons specified in subsection (1) sentence 1 number 4 is that they have adequate theoretical and practical knowledge of the business concerned, as well as managerial experience. A person shall normally be assumed to have the professional qualifications necessary for managing an institution if he can demonstrate three years managerial experience at an institution of comparable size and type of business.*

*(3) The Federal Financial Supervisory Authority may refuse the license if facts are known which warrant the assumption that effective supervision of the institute is impaired. This is especially the case if:*

- 1. Facts are known that the institution is tied to other persons or enterprises or in a close relationship to those which due to its structure of participation or lack of commercial and financial transparency impair the effective supervision of the institution.*
- 2. Facts are known which warrant the assumption that the effective supervision of the institution is impaired due to rules and regulations of a non EEA (European Economic Area)- state applies on such persons or enterprises.*
- 3. Facts are known which warrant the assumption that the institution is a subsidiary of an institution domiciled abroad that is not effectively supervised in the state where it is registered or has its head office or whose appropriate supervisory body is not prepared to co-operate satisfactorily with the Federal Financial Supervisory Authority.*

*The Federal Financial Supervisory Authority shall refuse the license if, contrary to section 32 (1) sentence 2, the application does not include adequate information or documents.*

*(4) The license may not be refused for reasons other than those specified in subsections (1) and (3).*

The regulations in sections 32 and 33 KWG are only the basic requirements for granting a license. The webpage of the BaFin offers a detailed document on how an application should be made and what the essential requirements are in addition to the ones listed above<sup>55</sup>.

#### **4.2. Requirements for conduct of business and basic compliance regulations**

Like sections 32 and 33 KWG state the basic requirements for granting a license to conduct banking business or to provide financial services one can find the same basic requirements for the conduct of business and compliance once a license is granted.

Unlike Section 1 KWG the WpHG does not mention credit and financial services institutions rather than naming all institutions requiring a BaFin-license "investment services enterprises" (Section 2 Subsection 4 WpHG) because the scope of the rules and regulations in the WpHG is broader than the one in the KWG<sup>56</sup>.

The basic requirements for conduct of business and organizational structure (compliance) are stated in sections 31 to 34 a WpHG and reading as follows:

##### **4.2.1. Section 31 WpHG General rules of conduct<sup>57</sup>**

*(1) Investment services enterprises shall be required:*

- ♦ to provide investment services and non-core investment services with the requisite degree of expertise, care and diligence in the interests of their customers, and*

- ◆ *to avoid conflicts of interest wherever possible and to ensure that, in the event of unavoidable conflicts of interest, customers' orders are executed with due regard to customers' interests.*

*(2) They shall further be required:*

- ◆ *to demand from their customers, details concerning their experience or knowledge of transactions intended as the subject of investment services or non-core investment services, of the aims pursued with those transactions and about their financial situation, and*
- ◆ *to furnish their customers with all pertinent information, insofar as this is necessary to protect their customers' interests and with regard to the type and scope of the intended transactions. The customers are not obliged to furnish information requested pursuant to sentence 1 number 1.*

*(3) Subsections (1) and (2) shall also apply to enterprises domiciled abroad which provide investment services or non-core investment services for customers having their ordinary residence or registered office in Germany, provided that the investment services or non-core investment services and related ancillary services are not provided exclusively abroad.*

The general rules of conduct include the core rules which are as follows:

- ◆ Acting with expertise (called “know-your-products”), care and diligence<sup>58</sup>
- ◆ Acting in the interest of the customer
- ◆ Request at least the following information from the customer:
  - His/her experience or knowledge
  - His/her investment aims
  - His/her financial situation

The information about the customer is also called the “know-your-customer” principle<sup>59</sup>.

#### *4.2.2. Section 32 WpHG Special rules of conduct<sup>60</sup>*

*(1) Investment services enterprises or affiliated enterprises shall be prohibited from:*

- ◆ *advising customers of the investment services enterprise to purchase or sell financial instruments if and to the extent that such advice does not conform to the customers' interests;*
- ◆ *advising customers of the investment services enterprise to purchase or sell financial instruments in order to cause the prices to move in a specific direction for the purpose of transactions for the account of the investment services enterprise or an affiliated enterprise; or*
- ◆ *concluding transactions for own account based on knowledge of an investment services enterprise customer's buy or sell orders relating to financial instruments, which could prove detrimental to the principal.*

*(2) The proprietors of an investment services enterprise operated in the form of a sole proprietorship, in the case of other investment services enterprises the persons empowered by law or by the partnership agreement or articles of association to manage the business of and to represent the enterprise, and the employees of an investment services enterprise who are entrusted with executing transactions in financial instruments, conducting financial analysis or giving investment advice, shall be prohibited from:*

- ◆ *advising customers of the investment services enterprise to purchase or sell financial instruments under the conditions of subsection (1) number 1 or in order to cause the prices of financial instruments to move in a specific direction for the purpose of concluding transactions for own account or on behalf of third parties; and*

- ◆ *concluding transactions for own account or on behalf of a third party, based on knowledge of an investment services enterprise customer's buy or sell orders relating to financial instruments, which could prove detrimental to the principal.*

*(3) Subject to the conditions set out in section 31 (3), subsections (1) and (2) shall also apply to enterprises domiciled abroad.*

Violations of core rules have substantial consequences, resulting in fines and additional strict supervision of the violator.

#### *4.2.3. Section 33 WpHG Organizational obligations<sup>61</sup>*

*(1) Investment services enterprises*

- ◆ *shall be obliged to effectively maintain and utilize the resources and procedures required for the proper conduct of the investment service and non-core investment service;*
- ◆ *must be organized in such a way that, in providing the investment service and non-core investment service, conflicts of interest between the investment services enterprise and its customers or between different customers of the investment services enterprise are kept to the unavoidable minimum; and*
- ◆ *must have adequate internal controlling procedures capable of preventing any contravention of the requirements set out in this Act.*

*(2) Areas which are important for the provision of investment services or non-core investment services may only be outsourced to another undertaking if this neither adversely affects the proper conduct of such services, nor the performance of the duties pursuant to subsection (1), nor the respective investigation rights and monitoring powers of the Supervisory Authority. In particular, the investment services enterprise is required to secure itself by way of contracting the necessary directing powers and to include the outsourced areas in its internal controlling mechanisms.*

Section 33 WpHG (and its corresponding but more detailed regulation in Section 25a KWG) is setting the basic structure for the compliance system of any credit institution and financial services provider or investment services enterprise<sup>62</sup>.

#### *4.2.4. Section 34 WpHG Requirements for record keeping and retention<sup>63</sup>*

*(1) In carrying out investment services, investment services enterprises shall be obliged to keep a record of the following:*

- ◆ *the order and pertinent instructions of the customer as well as the execution of the order;*
- ◆ *the name of the employee who accepted the customer's order and the time at which the order was given and executed;*
- ◆ *the commissions and fees charged to the customer for the order;*
- ◆ *the instructions given by the customer as well as the placement of the order with a third party, to the extent that asset management within the meaning of section 2 (3) number 6 is concerned; and*
- ◆ *the placement of an order for own account with a third party investment services enterprise, insofar as the transaction is not subject to the reporting requirement pursuant to section 9; orders for own account shall be expressly indicated.*

*(2) The Federal Ministry of Finance may, by ordinance not requiring the approval of the Bundesrat and after consulting the Deutsche Bundesbank, require investment services enterprises to keep additional records, as such records are necessary for monitoring by the Supervisory Authority of compliance with the requirements imposed on investment services enterprises. The Federal Ministry of Finance may, by ordinance, delegate this authority to the Supervisory Authority.*

*(3) The records specified in subsections (1) and (2) shall be retained for a minimum period of six years following their date of creation. Section 257 (3) and (5) of the Commercial Act shall apply accordingly to the retention of the records.*

Section 34 WpHG is regulating documentation and record keeping in order to have everything properly documented and on the books. Records and documents have to be kept for six years<sup>64</sup>.

#### *4.2.5. Section 34a WpHG Segregation of assets<sup>65</sup>*

*(1) Investment services enterprises which are non deposit-taking credit institutions within the meaning of section 1 (3d) sentence 1 of the Banking Act shall immediately segregate clients' money held in safe custody which they accept in connection with an investment service or non-core investment service and which they use in their name and for the account of their customers from the money of the enterprise and from other clients' money in a trustee account with a credit institution authorized to conduct deposit-taking business in Germany or a suitable credit institution domiciled abroad and authorized to conduct deposit-taking business. Before placing the funds into safe custody, the investment services enterprise shall disclose to the credit institution that the funds are deposited for the account of a third party. The investment services enterprise shall immediately inform the customer of the account in which the client's money is deposited and as to whether or not the credit institution holding the client's money is a member of a scheme designed to protect the claims of depositors and investors as well as the extent of which the client's money is protected by in such a scheme.*

*(2) Investment services enterprises not authorized to conduct deposit business within the meaning of section 1 (1) sentence 2 no. 5 of the Banking Act shall immediately pass on for safe custody, securities, which they accept in connection with an investment service or non-core investment service to a credit institution authorized to conduct safe custody business in Germany or to a credit institution domiciled abroad which is authorized to conduct safe custody business and with which the customer is granted a legal status equivalent to that under the Safe Custody Act. Subsection (1) sentence 3 shall apply accordingly.*

*(3) The Federal Ministry of Finance may, by ordinance not requiring the consent of the Bundesrat, issue more detailed provisions on the extent of the obligations pursuant to subsections (1) and (2) in order to protect the client's money or securities entrusted to an investment services enterprise. The Federal Ministry of Finance may, by ordinance, delegate this authority to the Supervisory Authority.*

Banking laws are in effect to ensure a stable banking system, to protect consumers and provide confidence in a safe, stable and working banking system.

In order to support this, Germany implemented the Section 34a WpHG to protect the clients of investment services enterprises (i.e. their assets) from fraud and/or bankruptcy of the investment services enterprises. Section 34a WpHG applies only to companies which are not licensed to accept deposits in the meaning of Section 1, Subsection 1, No. 1 KWG<sup>66</sup>. The strict segregation of assets for investment services enterprises (except deposit-taking banks) is regarded to as the vital core rule in customer protection.

To ensure maximum customer protection, the segregation of assets works in two ways:

- ◆ customer assets must be segregated from corporate assets,
- ◆ customer assets must be segregated from each other.

## **5. Summary and outlook**

The German Banking System is based upon the so-called universal banking system even though Germany has a substantial number of special banks and financial services institutions. With the exception of regulation, the German Banking System is independent of political or governmental influence and is largely based on private equity with a high standard of transparency, qualification

of its managers and substantial financial background. Over the years the German Banking System has proven to be efficient in its regulatory framework and constant supervision and monitoring. The relevant standards to meet the Basel II Solvency Directive requirements are mostly implemented<sup>67</sup>. In general the German Banking System is in compliance with all relevant EU rules and regulations. Based upon this information and the long lasting history of independent, well-regulated and efficient banking, the German Banking System could very well be a model for prospective EU-members to adopt and modify to their specific national needs.

## References

1. EU members are: Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, The Netherlands, United Kingdom, see: <http://europa.eu.int>.
2. See <http://de.wikipedia.org>, Europäische Union.
3. On May 1, 2004 ten new members joined the EU: Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Malta, Cyprus (Greek part only), see <http://de.wikipedia.org>, Europäische Union; Prospective new members are Bulgaria, Croatia, Macedonia, Romania, Turkey, see <http://europa.eu.int>.
4. See for example Art. 2, 3, 17, 18, 23, 39, 43, 49, 56 EU-Treaty.
5. See <http://de.wikipedia.org>, Europäische Union.
6. Claussen C. P., Bank- und Börsenrecht. – München: Beck, 3. Edition 2003. – pp. 78.
7. German Supreme Court, BGH or Bundesgerichtshof, Judgement dated July 9, 1979, case no. II ZR 118/77 in BGHZ 75, 99 and NJW 1979, 1823. The Herstatt Bank insolvency affected about 52,000 customers with 78,000 accounts and 15,000 Safe Custody customers, see Schuhmacher at [www.agrarverlag.at](http://www.agrarverlag.at), Die Herstatt-Pleite.
8. See BaFin-Press release of March 14, 2005 at [www.bafin.de](http://www.bafin.de) with about 600 million euros in damages.
9. Claussen at <sup>6</sup> above, -pp. 32 - 33; Fischer R., T. Klanten. Bankrecht. – Köln: RWS, 3. Edition 2000, – 2 p.
10. Claussen at <sup>6</sup> above, – 18-19 pp.
11. Büschgen H. Banklexikon. – Düsseldorf: Handelsblatt, 1992, – 960-963 pp. and Section 1, Subsection 1, German Banking Act, KWG or Kreditwesengesetz.
12. Claussen at <sup>6</sup> above, – 18-19 pp. and Art. 105 ff EU-Treaty; German Act on The Federal Bank (Bundesbankgesetz).
13. EU-Directive on Securities Services of May 10, 1993 (93/22/EWG), ABl. EG of June 11, 1993 Nr. L 141, 27ff and EU-Directive on Capital Requirements of March 15, 1993 (93/6/EWG), ABl. EG of June 11, 1993 Nr. L 141, 1ff.
14. For more details on Financial Services Institutions see Boos K., R. Fischer. H. Schulte-Mattler, KWG-Kommentar. – München: Beck, 2. Edition 2004, Section 1 Notes 117 to 150.
15. Boos pp. at <sup>14</sup> above, Section 1 Notes 4 to 116.
16. Claussen at <sup>6</sup> above, – pp. 35 - 49; Fischer R., T. Klanten at <sup>9</sup> above, – p. 2.
17. Boos at <sup>14</sup> above Section 1 Notes 117 to 150.
18. Claussen at <sup>6</sup> above, – p. 19; the oldest German private bank which is still in operation is Joh. Berenberg, Gossler & Co KG in Hamburg, established 1590.
19. Claussen at <sup>6</sup> above, – p. 18.
20. Claussen at <sup>6</sup> above, – p. 18.
21. Claussen at <sup>6</sup> above, – pp 26-28; Fischer R., T. Klanten at <sup>9</sup> above, – p. 3.
22. Claussen at <sup>6</sup> above, – pp. 95-99; Fischer R., T. Klanten at <sup>9</sup> above, – pp. 113-156 and –pp. 459-473.
23. BaFin Annual Report 2004, page 89, [www.bafin.de](http://www.bafin.de), using the following links “English Version”, “Press & Publications”, “Publications”, “Annual Reports”, “2004”.
24. Claussen at <sup>6</sup> above refers to Savings and Loan Institutions as credit institutions governed by public law, -pp. 20-26.

25. Büschgen at <sup>11</sup> above, – pp. 1434-1442; Fischer R., T. Klanten at <sup>9</sup> above, – pp. 6-14.
26. Büschgen at <sup>11</sup> above, – pp. 1437.
27. Büschgen at <sup>11</sup> above, – pp. 1437-1438.
28. Claussen at <sup>6</sup> above, – pp. 20-25; Fischer R., T. Klanten at <sup>9</sup> above, – p. 6.
29. Claussen at <sup>6</sup> above, – pp. 23-24; Fischer R., T. Klanten at <sup>9</sup> above, – pp. 7-8; Büschgen at <sup>11</sup> above, – pp. 1435-1437.
30. Claussen at <sup>6</sup> above, – pp. 23-25; Fischer R., T. Klanten at <sup>9</sup> above, – pp. 6, 8-10.
31. Fischer R., T. Klanten at <sup>9</sup> above, – pp. 475-490.
32. BaFin Annual Report 2004, – p. 89, see <sup>23</sup> above.
33. Claussen at <sup>6</sup> above, – pp. 28-31; Fischer R., T. Klanten at <sup>9</sup> above, – pp. 3-4.
34. For more details see Beuthien V. Genossenschaftsgesetz – Kommentar. – München: Beck, 14. Edition 2004, Section 1 Notes 1 to 115.
35. Beuthien at <sup>34</sup> above Section 1 Notes 2 to 37.
36. Claussen at <sup>6</sup> above, – pp. 28-29.
37. Fischer/Klanten at <sup>9</sup> above, – pp. 3-4.
38. BaFin Annual Report 2004, – p. 89, see <sup>23</sup> above.
39. BaFin Annual Report 2004, – p. 89, see <sup>23</sup> above.
40. BaFin Annual Report 2004, – p. 89, see <sup>23</sup> above.
41. EU-Directives on Deposit-guarantee and investors compensation schemes of May 30, 1994 (94/19/EG), ABl. Nr. 135 and Investment Compensation Scheme of March 3, 1997 (97/9/EG), implemented in Germany by EAEG on August 1, 1998.
42. Claussen at <sup>6</sup> above, – pp. 145-149; Fischer R., T. Klanten at <sup>9</sup> above, – pp. 23-37.
43. Fischer R., T. Klanten at <sup>9</sup> above, – pp. 25-37.
44. BaFin – Responsibilities and objective, [www.bafin.de](http://www.bafin.de), “English Version”, “Responsibilities and objectives”, – pp. 1-2.
45. See<sup>44</sup>.
46. See<sup>44</sup>.
47. See<sup>44</sup>.
48. BaFin – Organizational Structure, [www.bafin.de](http://www.bafin.de), “English Version”, “About Us”, “Tasks and Objectives”, “Responsibilities and objectives”, page 4; to view the organizational diagram go to “About us”, “Organization”, “Organizational diagram”. The English version on the web is showing the old organizational BaFin-structure. The current structure is available only on the German webpage.
49. See<sup>48</sup>.
50. See<sup>48</sup>.
51. See<sup>48</sup>, to see the c.v. of the president, vice president and the 3 chief executive directors of BaFin go to [www.bafin.de](http://www.bafin.de), “English Version”, “About us”, “Organization”, “The Executive”.
52. See<sup>48</sup>.
53. See<sup>48</sup>, – p. 6.
54. See<sup>48</sup>, – p. 6.
55. [www.bafin.de](http://www.bafin.de), “English Version”, “For Providers”, “Investment Services Enterprises”, “General Information and notices” and a publication dated August 2002 will come up, reading: Notice on granting of a license to provide financial services pursuant to Sec. 32 <sup>1</sup> KWG. Also available on the German webpage “Notice on granting a license to conduct banking business pursuant to Sec 32 (1) KWG” dated February 25, 2005.
56. Assmann H.-D., U. Schneider, Kommentar zum Wertpapierhandelsgesetz. – Köln, OVS, 3. Edition 2003, Section 2 Notes 77 to 94.
57. The English translation of the Sections of WpHG cited in this article are taken from the official website of BaFin, then revised by the author. To review BaFin’s translation of the relevant Sections, see [www.bafin.de](http://www.bafin.de), go to “English version”, “Legal foundations & Official announcements”, “Laws & Regulations”, “Securities Trade Act”.
58. Assmann H.-D., U. Schneider at <sup>56</sup> above, Section 31 Notes 1 to 7; Bröker K., Compliance. – Wiesbaden, Gabler, – pp. 24-25, 58-65; BaFin-Directive of August 23, 2001 to specify Sections 31 and 32 WpHG.

59. Assmann H.-D., U. Schneider at <sup>56</sup> above, Section 31 Notes 80 to 95a, Bröker K., Compliance, – pp. 25, 58-65; BaFin-Directive of August 23, 2001 to specify Sections 31 and 32 WpHG.
60. See <sup>57</sup>.
61. See <sup>57</sup>.
62. Bröker K., Compliance, – pp. 26-29, 35-40.
63. See <sup>57</sup>.
64. Bröker K., Compliance, – p. 40; Assmann H.-D., U. Schneider at <sup>56</sup> above, Section 34 Notes 1 to 5.
65. See <sup>57</sup>.
66. Assmann H.-D., U. Schneider at <sup>56</sup> above, Section 34a Notes 1 to 19; Bröker K., Compliance, –pp. 77-79.
67. BaFin Annual Report 2004, – pp. 48-52 and 90-100, see<sup>23</sup> above.