

# “The German System of Financial Services Institutions”

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# THE GERMAN SYSTEM OF FINANCIAL SERVICES INSTITUTIONS

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## Abstract

The financial industry is a global market where tough rules, regulations and constant supervision are a necessity. The German regulatory system on financial services institutions is based on EU-directives but presents a number of unique aspects. Understanding the general EU-standards and their implementation into the German financial system lays ground for reviewing the chances of operating a financial services institution in Germany or doing business with German financial service providers.

**Key words:** German System on financial service institutions, EU-regulations on financial services, financial services license, financial services supervision, financial services companies, financial instruments, brokerage, portfolio management, compliance, rules of conduct, guarantee scheme.

**JEL Classification:** G24, G28.

## 1. Introduction

The EU, by its directives, is widely influencing the national rules and regulations of its member-states. In order to provide a unified financial market with an EU-wide standard of basic rules and regulations all EU-members have to comply with a substantial number of laws, rules and regulations with respect to the financial industry. A major change took place when the EU-directives no. 93/22//EWG<sup>1</sup>, 93/6/EWG<sup>2</sup> and 95/26/EG<sup>3</sup> came into effect in Germany on January 1, 1998. From this time on Germany implemented its own rules and regulations on financial services companies and – for the first time in its history – based brokerage business as one aspect of financial services on solid legal grounds.

Of course brokerage and other financial services business had long since existed in Germany, but because these specific types of business were not regulated by law until January 1, 1998, they were regarded as unregulated financial business, also called “the grey market area”<sup>4</sup>.

Because of their unregulated nature they were misused and there was no confidence in that part of the German financial market.

Germany finally decided to implement these rules and regulations once the EU enforced that all of its member-states adopt the directives on the financial services providers and enforced its implementation in national laws. This was a major step in Germany’s financial industry. For the first time ever, banks were not the only institutions that were allowed to provide financial services.

Now a substantial number of financial services providers started to compete with the already established banks with provision of financial services. This was another major step towards breaking up the universal banking principle<sup>5</sup>.

EU-directives set the minimum standard of regulations to be implemented by each EU-member state. Additionally, each member-state can add national restrictions to these EU-standards. Germany did just that when implementing these directives.

This article presents the general regulations of the German System of Financial Services Institutions and highlights some very unique aspects.

## 2. German Financial Services Regulations

The Sixth Act Amending the German Banking Act (6. KWG-Novelle)<sup>6</sup> and the Fourth Act on Supporting the German Financial Markets (4. Finanzmarktförderungsgesetz)<sup>7</sup> are the basic regulations that established the financial services industry in Germany.

Both acts set major changes in the German banking laws such as German Banking Act (Kreditwesengesetz or KWG), German Securities Trading Act (Wertpapierhandelsgesetz or WpHG) and German Exchange Act (Börsengesetz or BörsG).

### 2.1. Financial Services Institutions

The German Banking System has – due to EU-regulations – basically two different types of commercial enterprises in the regulated financial markets: The credit institutions are regulated by Section 1, Subsection 1 of German Banking Act (Kreditwesengesetz or KWG) and in general referred to as “banks”<sup>8</sup>, and the financial services institutions, which are regulated by Section 1, Subsection 1a, KWG.

This article’s focus is on the financial services institutions, their structure and basic regulation.

The 8 different types of financial services institutions are defined in Section 1, Subsection 1a of German Banking Act (KWG). Financial service institutions are enterprises that provide financial services to others on a commercial basis and are not credit institutions. Financial service is any commercial activity listed in Section 1, Subsection 1a, No. 1-8 KWG.

The following is the definition of financial services institutions under German law.

#### *Section 1, Subsection 1a, KWG<sup>9</sup>*

*Financial services institutions are enterprises providing financial services to others commercially or on a scale which requires a commercially organized business undertaking, and which are not credit institutions. Financial services are:*

- 1. The brokering of business involving the purchase and sale of financial instruments or their documentation (investment broking);*
- 2. The purchase and sale of financial instruments in the name of and for the account of others (contract broking);*
- 3. The administration of individual portfolios of financial instruments for others on a discretionary basis (portfolio management);*
- 4. The purchase and sale of financial instruments on an own-account basis for others (own-account trading);*
- 5. The brokering of deposit business with enterprises domiciled outside the European Economic Area (non-EEA deposit broking);*
- 6. The execution of payment orders (money transmission services);*
- 7. Dealing in foreign notes and coins (foreign currency dealing); and*
- 8. Issuing or administering credit cards or traveler’s cheques (credit card services) unless the credit card issuer is also the provider of the service underlying the payment.*

### 2.2. Types of German Financial Services Institutions/Providers

According to German law entities providing banking or financial services are called “institute” or “institution” (Section 1, Subsection 1b, German Banking Act or KWG)<sup>10</sup>. The major areas of financial services are in brokerage business and in portfolio management<sup>11</sup>.

#### 2.2.1. Brokerage business

The German legal language is not using the term “broker” or “brokerage business”. In Section 1, Subsection 1a of KWG the two major types of brokerage business are described as investment broking and contract broking. In the international financial industry both terms are rarely used because both are “brokerage” activities.

In the international financial industry a broker is a person or a firm that acts as an intermediary between buyer and seller, charging a commission or fee. A broker is an agent rather than a principal<sup>12</sup>. This international definition does not make a distinction between “investment broking” and “contract broking”.

Under German law “Investment broking” covers the activities of a documenting broker within the meaning of Section 34c of the German Industrial Code (Gewerbeordnung or GewO) to the extent that they relate to financial instruments<sup>13</sup>.

“Contract broking” covers the purchase and sale of financial instruments in the name of and for the account of others<sup>14</sup>.

Consequently, when referring to “brokerage business” one has to determine what type of brokerage services is referred to under German law, because each type requires a financial services license specifying the scope of business.

Unlike in other countries, i.e. the U.S.A. and the U.K., German brokerage entities are not allowed to operate customer accounts. All brokerage accounts must be with a bank licensed for deposit-taking business<sup>15</sup>.

### 2.2.2. Portfolio management

To qualify as a portfolio management entity the person or company must have the discretion to make the investment decisions<sup>16</sup>. The account holder provides the portfolio management company with a power of attorney to make all necessary investment decisions. This power of attorney is usually limited to investment decisions only. That means the portfolio manager is not able to initiate any money transfers from or into the client’s account.

The German portfolio management institutions are not banks, therefore these entities are not allowed to operate customer accounts. All accounts must be with a bank licensed for deposit-taking business.

### 2.3. Other types of Financial Services Providers

Institutions providing **own-account trading** are institutions that act as a purchaser or seller, rather than as a commission agent towards its customers<sup>17</sup>.

**Non-EEA deposit broking** is a business that is taking deposits in Germany and forwards the deposits to other counterparties outside the EEA<sup>18</sup>.

**Money transmission services** is related to the giro-business (a banking business) and means the commercial transfer of funds as a service for others<sup>19</sup>.

**Foreign currency dealing** is the exchange of (physical) banknotes and coins (legal tender). It also includes the purchase and sale of traveler’s cheques. Example: Foreign Exchange Bureaux<sup>20</sup>.

**Credit card services** cover only the “tripartite systems” where the card issuer, the card holder and the service provider (acceptor of the card) are different entities<sup>21</sup>.

### 2.4. Financial instruments

The above listed services are financial services, if these services are related to financial instruments.

Financial instruments are defined in Section 1, Subsection 11, German Banking Act (KWG)<sup>22</sup>:

*Financial instruments within the meaning of this Act are securities, money market instruments, foreign exchange or units of account and derivatives. Securities are the following, irrespective of whether they are evidenced by certificates:*

*1. Shares, certificates representing shares, debt securities, participation certificates, warrants, and*

2. Other securities that are comparable to shares or debt securities if they can be traded on a market; securities also comprise share certificates issued by an investment company or a foreign collective investment company.

Money market instruments are claims that are not covered by sentence 2 and which are customarily traded in the money market. Derivatives are outright forward transactions or option contracts whose price depends directly or indirectly on

- ◆ the stock exchange or market price of securities,
- ◆ the stock exchange or market price of money market instruments,
- ◆ the exchange rate of foreign exchange or units of account,
- ◆ interest rates or other income streams, or
- ◆ the stock exchange or market price of commodities or precious metals.

### **2.5. Structure of a financial services institution**

A financial services institution can be an individual, a sole proprietorship, a partnership, a limited partnership, a limited liability company, a corporation or any other legal entity under German law according to Section 2a, Subsection 2, German Banking Act. A financial services institution must have (at least) one managing director (Section 33, Subsection 1, No. 5 KWG).

The corporate structure of a financial services institution is based on the legal entity chosen. If the institution is a limited partnership (Kommanditgesellschaft or KG), the German Commercial Code (Handelsgesetzbuch or HGB), Sections 161 pp. applies. For a limited liability or close corporation the German Act on Limited Liability Corporations (Gesetz betreffend die Gesellschaften mit beschränkter Haftung or GmbHG) applies. On corporations the German Act on Corporations (Aktengesetz or AktG) applies.

The operational obligations of a financial services institution are basically regulated by Section 25a of German Banking Act (Kreditwesengesetz or KWG)<sup>23</sup> and Section 33 of German Securities Trading Act (Wertpapierhandelsgesetz or WpHG)<sup>24</sup>.

### **2.6. Guarantee Schemes**

To protect the customers of financial services institutions Germany has implemented the Deposit Guarantee and Investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz or EAEG)<sup>25</sup>. This guarantee scheme is based upon the EU-Directive on Deposit-guarantee and investors compensation scheme (94/19/EG)<sup>26</sup> and the Investment Compensation Scheme (97/9/EG)<sup>27</sup>.

Every German and European financial services institution has to be a member of such a guarantee scheme. The customers of a financial services institution must be informed in detail and in writing by the financial services institution about the guarantee scheme the company is a member of and its terms and conditions according to Section 23a of German Banking Act. A written warning notice must be issued to all customers if the financial services provider is not a member of any such guarantee scheme<sup>28</sup>.

The guarantee scheme covers a maximum amount of up to 20,000 Euros per investor. It does not cover any other currency than the Euro. This means, investments in US-Dollars are not protected under the German/European guarantee scheme<sup>29</sup>.

### **2.7. List of Financial Services Institutions**

The German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht or BaFin) as the regulatory and supervising governmental body, lists every licensed financial services institution on its webpage at [www.bafin.de](http://www.bafin.de). This list can be obtained from their webpage under the link "Databases" and then continue to "Institutions search".

This list unfortunately does not list the type of license and the scope of business each financial services institution has or provides.

### **2.8. Number of Financial Services Institutions**

When the new laws regulating the financial services companies came into effect on January 1, 1998, about 7,141 institutions providing financial services existed and applied for a license<sup>30</sup>. At the end of 1998 only 3,460 licensed financial services institutions were left<sup>31</sup>.

At the end of 1999 only 1,413 financial services institutions were left<sup>32</sup>.

At the end of 2000 the number of financial services institutions declined to 1,111<sup>33</sup>.

At the end of 2001 only 904 financial services institutions were left<sup>34</sup>.

At the end of 2002 only 757 financial services institutions were left<sup>35</sup>.

At the end of 2003 the number increased to 773 financial services institutions<sup>36</sup>.

At the end of 2004 the number increased again to 806 financial services institutions<sup>37</sup>.

At the end of 2005 the number declined to 743 financial services institutions<sup>38</sup>.

The majority of these financial services institutions are conducting investment broking and/or contract broking business<sup>39</sup>.

## **3. Financial Services Supervision by the Federal Financial Supervisory Authority<sup>40</sup>**

The Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht or BaFin) is the supervisory and regulatory body. It is an independent entity, governed by public law and a part of the German Federal administration. It is headquartered in Bonn and Frankfurt<sup>41</sup>.

The BaFin was established on May 1, 2002 and since then it has combined the three former supervisory agencies for banking, insurance industry and securities trading<sup>42</sup>.

As of September 2005 BaFin employs about 1,500 people, and supervises about 2,300 credit institutions, 750 financial services institutions, 630 insurance companies and 6,200 investment funds<sup>43</sup>.

The major act regulating and structuring the BaFin is the Act Establishing the Federal Financial Supervisory Authority (Finanzdienstleistungsaufsichtsgesetz or FinDAG). According to its history, the BaFin structure consists of three separate units, namely the "directorate for banking supervision", "the directorate for insurance supervision" and the "directorate for securities and asset management supervision". The BaFin is headed by a president and a vice-president. Each directorate has a chief executive director<sup>44</sup>.

More about the structure of the BaFin can be viewed on the homepage at [www.bafin.de](http://www.bafin.de).

## **4. Financial services license and conduct of business**

Financial services supervision in Germany is divided into 2 phases, just like the banking supervision. Phase one is the authorization process, the granting of the license. Phase two is the ongoing supervision once a license is granted<sup>45</sup>.

### **4.1. Financial services license**

The basic regulation for the application process is specified in the German Banking Act (KWG), especially in Sections 32 and 33. The German Federal Bank (Deutsche Bundesbank) has published helpful information and a booklet on "Notice on the granting of a license to provide financial services pursuant to Section 32, Subsection 1 of the German Banking Act" in English on their homepage at [www.bundesbank.de](http://www.bundesbank.de)<sup>46</sup>.

Section 32 of KWG grants licensing to conduct financial services. The applicant must submit a complete application including to the documents listed in Section 32, Subsection 1 of KWG<sup>47</sup>.

Section 33 of KWG states grounds to refuse the license. It also includes requirements for the minimum capitalization. The minimum capitalization starts at the amount of 50,000 Euros for investment brokers, contract brokers or portfolio managers<sup>48</sup>.

The applicant can choose, for which type or types of license(s) he or she applies. For example: It is possible to apply for the license for investment brokering and contract brokering at the same time. The applicant can also choose if his or her license should be restricted to certain types of financial instruments, for example to commodities only.

#### ***4.2. Conduct of business<sup>49</sup>***

The basic regulation for ongoing supervision is set forth in the German Securities Trading Act (WpHG), especially in the rules of conduct and the structure of an institution in Sections 31 to 34a of WpHG.

Section 31 of WpHG refers to the general rules of conduct and includes important regulations about “know-your-products” and about “know your customer” principles<sup>50</sup>.

Section 32 of WpHG refers to the special rules of conducts and includes a list of prohibitions<sup>51</sup>.

Section 33 of WpHG refers to the organizational and structural requirements a financial services enterprise has to fulfil<sup>52</sup>.

Section 34 of WpHG refers to record keeping (a minimum of six full years is required) and retention<sup>53</sup>.

Section 34a of WpHG refers to segregation of customer funds. This section states that customer funds must be segregated from each other and from company funds immediately. This section also prohibits any omnibus account business for all institutions that are not deposit-taking institutions (banks)<sup>54</sup>.

### **5. Unique aspects of the German regulations on financial services institutions**

#### ***5.1. Prohibition of operating customer accounts***

A very unique aspect of the German laws, rules and regulations on financial services institutions is that none of them can operate a customer account. Under German law the operation of customer accounts is regarded as deposit-taking business and requires a banking license.

It is the general understanding that the funds a customer is willing to invest, for example into the stock market, are investment funds, because the general purpose of these funds is the investment in financial instruments.

This is different under German law. Under German law, irrespective to what nature these funds are or what purpose these funds are for, they are regarded as deposits.

The reason behind this unique way of defining all investments as deposits is in the best interest of the customer: Customer protection. Because banks are much more regulated and as they have much higher financial requirements to meet, customer funds are more secure at a bank with a minimum of at least 5 million euros capital compared to a financial services institution that only requires a minimum capitalization of 50,000 Euros.

It is quite clear that this way of defining funds as deposits benefits the banks as the only licensed deposit-taking institutions and limits the abilities of all financial services institutions in Germany to compete with the banks on an equal level.

#### ***5.2. Prohibition of accepting customers funds***

In general, financial services institutions are also not allowed to accept any customer funds. If they are allowed to do so, these specific financial services companies need a special license, at least two managing directors and a minimum capitalization of 125,000 Euros. Even these few financial ser-

vices institutions have to immediately transfer any and all customer funds into a bank account at a deposit-taking institution. According to Section 34a of WpHG these funds have to be segregated from any other customer funds and corporate funds immediately.

### ***5.3. Prohibition of operating omnibus accounts***

According to Section 34a of WpHG customer funds which are with any institution that is not a deposit-taking institution (a fully licensed bank) have to be segregated from each other and from corporate funds. Consequently no German financial services institution is capable of conducting omnibus business or operating an omnibus account.

### ***5.4. Requirement to be a member of a guarantee scheme***

Section 23a of KWG requires a written disclosure to the customer of what guarantee scheme the financial services institution is a member of and all relevant details of said guarantee scheme. A financial services institution based outside the EEA and doing business in Germany with German (retail) customers must use a written disclosure stating that no such guarantee scheme under German/European law exists.

### ***5.5. Special risk disclosures for financial futures transactions***

Another unique part of the German rules and regulations is the risk disclosure for financial future transactions. If a customer wishes to conduct this kind of activity, the customer must be informed in writing about the specific risks involved in financial futures trading. Section 37d of German Securities Trading Act (Wertpapierhandelsgesetz or WpHG) requires specific wording to be used. This risk disclosure has to be signed and dated by the customer prior to any trading. The problem herein is that the law in Section 37d of WpHG only states a few aspects on this risk disclosure. The German Supreme Court (Bundesgerichtshof or BGH)<sup>55</sup> ruled that only a risk disclosure form that complies with more requirements than stated in the law is sufficient.

### ***5.6. Prohibition of arbitration***

Another very unique aspect under German law is arbitration. According to Section 37h of German Securities Trading Act (Wertpapierhandelsgesetz or WpHG) arbitration agreements are not valid unless both parties, the financial services institution on one side and the “customer” on the other side, are commercial enterprises. The consequences are that any arbitration agreement between a financial services institute and a retail client/customer (consumer) is unbinding and invalid.

## **6. Summary and outlook**

The German System on financial services institutions is based upon the relevant EC-directives. Additionally, Germany implemented a substantial number of unique or specific regulations. These specific regulations are restrictions of the general EC-rules and a national speciality of Germany. It must also be considered that the German rules and regulations are very abstract and include a large number of general terms and broad descriptions rather than detailed definitions. This requires substantial knowledge in understanding and operating a financial services institution in Germany. Once a basic understanding of those EU-regulations and its specific German amendments is reached the operation of or the business-relationship with a financial service institute in Germany remains no mystery.

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49. Bröker at <sup>4</sup> above, – pp. 13-15 and Bröker at <sup>28</sup> above.
50. For a translation of Sections 31 to 34a of WpHG see Bröker at <sup>4</sup> above, – p. 12-15 and [www.bafin.de](http://www.bafin.de), “English Version”, “Legal Foundations & Official Announcements”, “Laws & Regulations”, “Securities Trading Act”.
51. See 50.
52. See 50.
53. See 50.
54. See 50.
55. German Supreme Court, BGH or Bundesgerichtshof, Judgement dated February 14, 1995, case no. XI ZR 218/93 in WM 1995, 658 and NJW 1995, 1554 regarding the old risk disclosure form according to Section 53, Subsection 2 of German Exchange Code. This ruling has to be adopted to Section 37d of WpHG, Assmann at <sup>15</sup> above Section 37d Notes 4-88.