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POLITICS AND RHETORIC IN BANK REGULATION AND SUPERVISION: THE GERMAN EXPERIENCE

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Politics and Rhetoric in Bank Regulation and Supervision:

The German Experience[1]

Abstract

The paper discusses the politics of bank regulation from the 1930s to the present time. It also uses the German experience to illustrate the intricate politics of bank supervision in a federal system in which the sub-units own banks.

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1. Politics and Rhetoric

To understand the reality of bank regulation and supervision, one must disentangle the politics from the rhetoric. Bank regulators and supervisors often claim that they promote the "safety and soundness of banks". Once when I asked high-level regulators how and why the rules that they set and the actions they take would actually promote this objective, I was told: "You must understand: This is about politics!" The "Safety and soundness of banks" often just means financial repression, ensuring plentiful and cheap funding for the government. The rhetoric involves double talk using the same words to communicate different things to different people.

The politics of bank regulation and of bank supervision depend on the institutional and legal environment. The resulting heterogeneity presents an obstacle for systematic analysis. In bank regulation, the numbers of relevant objectives and instruments are small enough so that some general insights are nevertheless available. In bank supervision, however, in day-to-day activities of surveillance and rule enforcement, the combinatorics of political constellations, banks' activities

[1] Paper presented at the workshop *Markets for Regulation* in Gerzensee, Switzerland, May 25-28, 2026. I am very grateful for comments from the discussants, Katharina Pistor and Rainer Haselmann, and from the other participants. In view of space constraints, I only give sparse references. More complete documentation is given in Admati and Hellwig (2024), Hellwig (2013, 2017, 2018), and Hellwig and Schick (2022). Parts of the analysis are based on personal experience in several official committees, German and European, in the years 2008-2019.

and supervisory interventions are too complex for a general analysis. In an attempt to disentangle the politics from the rhetoric, this paper will present a general overview over the politics of bank regulation and a case study of the politics of bank supervision, The case study concerns the experience of Germany, which is interesting because it shows how intricate the politics can be.

For a long time, bank regulation and supervision were national activities. Since the late1980s, however, international bodies such as the Basel Committee for Banking Supervision (BCBS) have pushed for cross-country harmonization. This harmonization has left little room for jurisdiction-specific politics in bank regulation, but has not much restrained jurisdiction-specific politics in bank supervision. In the European Banking Union, since 2014, the single supervisory mechanism has also promoted harmonization of bank supervision. These developments have had profound effects on the politics of bank regulation and supervision.

2. From the "Safety and Soundness of Banks" to the "Need for a Level Playing Field"

In many countries, statutory regulation and supervision of financial institutions were introduced in response to the financial crises in the Great Depression. The professed aim was to promote "the safety and soundness of banks" but most of this regulation served as a tool for *financial repression* in the interest of ample and cheap funding to governments, and to politically important clienteles.

The tools of regulation differed across countries. Many countries imposed bounds on interest rates for deposits, some countries also on interest rates for loans. sometimes explicit or implicit cartels served as substitutes for interest rate regulation. Many countries also subjected the assets that banks were allowed to invest in and the scope of institutions' activities, across space and across lines of business, to regulation and supervision. There also were restrictions on cross-border transactions and investments.[2] A government that limits capital exports as well as bank lending to non-financial firms can expect to obtain plentiful funding from banks; this funding will also be cheap if the banks' own funding costs are low. Low interest rates can also be used to benefit politically important groups such as homeowners and farmers.[3]

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[2] For the United States, see Conti-Brown and Vanatta (2024), for European countries, see the essays on Italy, Portugal, and Spain in Dermine (1990), and the session on *Deregulation of Banking* in the Papers and Proceedings issue of *European Economic Review* 34 (1990), 383-411. Some countries in southern Europe prioritized government funding and used quantitative limits on other kinds of lending, as well as interest rate regulation.

[3] Thus, in the United States, regulation of depository institutions served to make home buying widely affordable. In Switzerland, rent control was indexed to the interest rate on residential mortgage debt, and the cartel of the banking industry catered to the polity's desire for low rental rates by keeping home mortgage rates low.

Beginning in the 1970s, substantial changes in economic and political environments undermined this system. Increases in the intensity of competition put pressure on margins. The ensuing reduction in profits lowered the banks' ability to absorb risks even as risks increased when market rates of interest and exchange rates became much more volatile. Shocks to these variables contributed to serious crises in the 1980s and 1990s. Some of the very measures that had previously been introduced to promote the safety and soundness of banks had become sources of systemic risk. For example, in the US, interest rate regulation hampered the depository institutions' ability to compete with money market funds. When interest rates were deregulated, this difficulty disappeared but then these institutions had profitability and even solvency problems because the fixed interest rates on the long-term loans they held were lower than the interest rates on their current funding.

By 2000, most of the old rules were gone. In the United States, the deregulation was driven by industry lobbies complaining that regulation impeded them in their business. In European countries, it was driven by an awareness that the old system was incompatible with the opening of borders mandated by the spirit of the time or, more specifically, the plans for an Internal Market for financial services in the EU.[4]

Since the second half of the 1980s, the Basel Committee for Banking Supervision (BCBS), an international body of supervisors from different countries, has engaged in a form of re-regulation by by means of harmonized rules. Participating countries were not obliged to adopt these rules. However, there was an understanding that, if a country's regulation and supervision were at least as strict as the Basel rules, the banks of this country would be allowed to operate in the other participating countries without supervision in the host countries.

The BCBS has focused on bank equity requirements, setting rules for the portions of banks' assets that must be funded by the banks' own money and the portions that may be funded by borrowing. The more a bank funds with equity, the more losses it can bear without becoming insolvent. Equity requirements had always been in place but were not very prominent. Following the decline of other modes of regulation, they became prominent, not least because they were the one regulatory instrument where international harmonization was not obviously nonsensical. In the course of these discussions, the mantra of "the safety and soundness of banks" has been replaced by "the need for

[4] In some countries, e. g., Finland, there also was an awareness that regulation of bank lending to non-financial firms had become a major source of inefficiency.

level playing fields" for banks, regardless of where their headquarters may be. For the members of the BCBS, this new mantra often just means promoting the interests of "their" banks.

3. Regulatory Capture by Sophistication: The Debate about Risk Weights

A key question for the BCBS is how to take account of the riskiness of the banks' assets. European countries had a long tradition of conditioning equity requirements on asset risks. Treating government debt as riskless, and residential mortgage loans as almost riskless, makes it easier to serve political biases. The US did not have such a tradition but gave in to the Europeans, so in 1988 the first accord of the BCBS, "Basel I", in 1988, had a crude classification of credit risks in the European tradition.

After 1988, the BCBS worked on extending this regulation to other risks. In 1993, it came up with a proposal to extend capital requirements to market risks. At that time, the industry was fully prepared and proceeded to what we may call regulatory capture by sophistication. The large, internationally active banks derided the proposal for its crudeness, asserting that it would force them to adopt low quality risk management. The BCBS quickly gave in. The 1996 extension of Basel I to market risks allowed the banks to use their own quantitative models to estimate their risks and determine the implied equity requirements. Basel II, concluded in 2004, extended this approach to credit risks. The usefulness and reliability of the banks' risk models for supervisory purposes were hardly questioned.

Beginning with the 1996 Amendment to Basel I, the new regime induced a vast expansion of bank borrowing. Whereas in 1998, hardly any major European bank had equity below 4% of total assets, by 2008, hardly any one of these banks had equity above 4%, and many had equity below 2% of total assets.[5] In the global financial crisis of 2007-2009, the banks that had extremely low equity funding were hardest hit, often by risks that their models had not even considered.[6]

Since then, the role of risk weights has been a perennial subject of controversy. "Basel III", the 2010 reform of Basel II that the BCBS negotiated after the global financial crisis, supplemented the risk-based approach with a "leverage ratio" rule whereby equity funding must be at least 3% (!) of total assets, but it did not question the approach as such. or the reliance on the banks' own risk

5 ASC (2014).
6 See Ch. 11 in Admati and Hellwig (2024) and the references given there.

models. The mantra is: “Surely a bank that incurs greater should be required to have more funding by equity.” In practice, this means: “If a bank claims that it is incurring hardly any risks at all, it should be allowed to get away with having hardly any equity funding at all.”

Banks and their lobbyists talk about risk as something that is objectively measurable. Problems of overconfidence and of poor incentives in “measuring” are not mentioned. Yet it is clear that such problems had much impaired the quality of the banks’ risk modeling before 2008 and that modeling practices did not much improve thereafter.[7] In an attempt to reduce the effects of flawed modeling, in 2017, the BCBS agreed on a “completion of Basel III”, which introduced a limit on the extent to which banks could use their models to lower their risk assessments and equity requirements. The industry has lobbied fiercely against legislation implementing this agreement. As yet, the US, the UK, and the EU have not fully adopted it. The European Commission (2026) has just proposed that, like the US and the UK, the EU should also delay its adoption since otherwise the “Competitiveness of the EU Bank Sector” might be harmed.

An evergreen in these debates is the phrase “But the Americans…!” For example: “The Americans have not even implemented Basel II!” Indeed, US authorities had considered Basel II to be too soft and limited its application to large, internationally active banks and to investment banks. For domestic banks, they stuck to the traditional “leverage ratio” tule that bank equity must not be less than 5% of total assets.

Europeans like to point out that European banks have higher equity ratios than US banks, without mentioning however this is only true for core equity relative to risk-weighted assets. For core equity relative to total assets, the reverse is true. European banks use risk-weighting much more radically than their US counterparts. For large, internationally active banks in Europe, risk-weighted assets are about 28% of total assets, for their counterparts in the US about 50% of total assets.[8]

[7] See Chapter 14 in Admati and Hellwig (2024) and the references given there.

[8] For large, systemically important banks, the ratio of core equity to total assets is 4% in Europe, versus 6% in the US. See Table 2 in Saurina (2026).

4. The Intricate Politics of Bank Regulation and Supervision in Germany and the Landesbanken

According to Peer Steinbrück, the German Minister of Finance in 2005-2009, the global financial crisis of 2007-2009 was caused by the United States and Germany was only its victim.[9] Mr. Steinbrück did not comment on why German banks were so strongly affected, much more than, e.g., French banks.[10] In the decade 2007-2017, German banks were seriously affected by all major crises. Bank bailouts cost German taxpayers some 80 billion euro.[11]

Before he became Federal Minister of Finance in 2005, Mr. Steinbrück had been finance minister and head of the regional government of North Rhine-Westfalia (NRW), one of the Länder (regions) of the Federal Republic of Germany. In these previous roles, he had had control over West LB, a public bank that was jointly owned by NRW and the NRW association of local public savings banks.[12] In 2011, one of his successors stated that the cost of West LB to taxpayers would amount to 18 billion euro.[13] The different Landesbanken together accounted for at least 50 out of the 80 billion euro of bailout costs to taxpayers.[14] Mr. Steinbrück's claim that Germany was merely the victim of a crisis caused by the United States diverted attention away from this problem.

In the multi-layer political system of Germany, bank regulation and supervision are tasks of the Federal Government. However, the regional governments are politically important at the federal level because they have a say in federal legislation.[15] They also have a stake in the regulation and

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9 Testimony before the Bundestag Committee of Inquiry on the Hypo Real Estate bailout; Deutscher Bundestag (2009).

10 Franco-Belgian bank Dexia had a similar business model and a similar fate as the German bank Hypo Real Estate, but other French banks suffered much less than their German counterparts.

11 In addition to the US crisis of 2007-2009, German banks were involved in the crisis in global container shipping and in the various real-estate, banking, and sovereign debt crises in European countries. In addition to bailouts by German taxpayers, they also benefited from the bailouts of AIG in the US and of banks in Ireland and Spain, as well as the ECB's provision of liquidity that enabled Southern European banks to repay their money market debts to German banks.

12 I use the terms "public" and "private" to indicate whether a bank is owned and controlled by the government or not. This distinction should not be confused with the US distinction between corporations whose shares are traded in public markets and corporations whose shares are privately held. Thus, in this paper, Deutsche Bank, a joint-stock corporation whose shares are traded in public markets, is designated a private bank.

13 Statement in the context of the decision of the NRW regional parliament to wind West LB down. The number refers to losses since 2005. The period 2000-2005, when Steinbrück was in the NRW government, had seen additional losses on the order of 4-5 billion euro from the burst of the tech bubble and a costly failure of an attempt to set up a presence in London.

14 In addition to the 18 billion for West LB, 15 billion for HSH Nordbank (Hamburg and Schleswig-Holstein), 10 billion for Bayern LB, 5 billion for LBBW (Baden-Württemberg), 3.6 billion for Nord LB (Lower Saxony and Saxony-Anhalt), 2 billion for Sachsen LB (Saxony). For documentation, see Hellwig (2018).

15 In contrast to the United States and Switzerland, the second legislative chamber is made up of the regional government rather than elected representatives.

the supervision of the Landesbanken. Given their importance in federal politics, the Federal Government does not want to incite their wrath for something as unimportant as bank supervision.

Supposedly, the Landesbanken had been created to provide politically desired services of general economic interest ("Daseinsvorsorge").[16] In fact, they have been used by regional governments to fund expenditures with going through regular budget procedures. For example, in January 1998, Gerhard Schröder, the head of the regional government of Lower Saxony, used his Landesbank, Nord LB, to buy Preussag Stahl, the steel subsidiary of the conglomerate Preussag. The parent Preussag had made arrangements to sell Preussag Stahl to the Austrian steel maker VOEST-Alpine. Preussag Stahl was located in Salzgitter in Lower Saxony and its submission of to "untrustworthy foreigners" was expected to harm the reputation of Mr. Schröder.[17] By averting this sale to the Austrians, he became a hero and triumphantly won the regional election in Lower Saxony. After that, he became the Social Democratic Party's candidate for Federal Chancellor, and went on to beat Mr. Kohl in the Federal Election.

Control over banks enables governments to direct money to their own purposes, without parliamentary procedures and without public discussions of costs and risks. Principles of parliamentary control, transparency, and accountability are treated as fairy tales for Sunday School kids. In this spirit, the German regional governments had created the Landesbanken around 1970, out of what used to be regional giro centers for the associations of local savings banks.

Unlike the giro centers, the Landesbanken went into large-scale funding of industry, until then a domain of private banks. However, the Landesbanken have always relied on government support. Their returns on assets were poor.[18]As latecomers in a fully developed financial system, they got many bad credit risks. Moreover, the regional governments using them for "structural-policy",

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[16] The German term *Daseinsvorsorge* comprises all services that contribute to the material basis for living in the country. Under the European Treaties, member states are free to specify such services and to designate companies to provide them, but these companies are subject to the Treaty's competition rules, including the rules for state aid, *unless* the European Commission finds that the application of these rules would obstruct the intended public services.

[17] Preussag, the seller of Preussag Stahl, was controlled by West LB, the Landesbank of NRW. According to testimony before the Committee of Inquiry of the NRW regional parliament that investigated the saga of West LB, Gerhard Schröder had talked to his NRW counterpart about the transaction. The Preussag Steel CEO, who was strongly opposed to the the sale to VOEST-Alpine, suggested that the CEOs of West LB and Preussag gave in once they realized that a special examination would uncover manipulative accounting involving cross-subsidization of subsidiaries in the period 1996/97. See NRW (2017).

[18] Expertenrat (2011) shows that over decades the average reported rates of return of the Landesbanken were near zero, significantly below the large private banks and even more below the local savings banks.

wanted them to support old and declining companies, rather than focus on profits.[19] They could only survive because public guarantees lowered their funding costs and bailouts covered their losses.

5. Why were German Banks so Exposed?

Around 2000, the European Commission indicated that it considered the regional governments' guarantees for the Landesbanken to represent a form of state aid that was incompatible with the competition rules of the European Treaties.[20] The German government threatened that it would contest a prohibition of the guarantees in the European Court of Justice. In 2001, they agreed on a compromise under which the Commission delayed the implementation of its ruling until 2005 and Germany did not go to court. (On the German side, Peer Steinbrück, who at that time was NRW finance minister, had been one of the leading negotiators.)

Between 2001 and 2005, the Landesbanken raised some 250 billion euros in additional state-guaranteed debt. A large part of this money went into asset-backed securities in the United States. The Landesbanken also used special purpose vehicles (SPVs) for substantial additional investments in such securities, funded by money market borrowing. They provided the SPVs with liquidity guarantees without showing either the SPVs or the liabilities from the guarantees in their balance sheets. Thus, they funded a substantial part of the US securitization and real-estate bubble. They did so, however, without understanding the risks.[21] A large part of the losses listed above came from these investments.

HSH Nordbank and Nord LB also lost large amounts from lending to fund container ships. Here they did not understand that credit risk were correlated as they depended on market conditions in shipping. Aggregate over-investment in ship capacity induced a shipping crisis in 2008-2020, with

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[19] According to NRW (2017), NRW finance ministers exerted tight control over the preparation of decisions and over the information provided to members of the administration council. Moreover, they considered "structural-policy" objectives to be paramount, including the keeping of company headquarters in NRW. Participations in nonfinancial companies were justified as a means of ensuring the companies would use the bank's banking services; for companies got in trouble, maintenance of such participations was justified as a means of protecting the bank's loans to the companies. However, this was done without a clear strategy for any one of these companies.

[20] The Commission rejected the claim that the guarantees were necessary for the Landesbanken to contribute to *Daseinsvorsorge*, services of general economic interest. It argued that the guarantees covered all debt funding and therefore all activities, most of which involved standard banking services. It did allow government guarantees for promotional banks that would specialize on subsidized funding for politically determined objectives.

[21] When Lewis (2010, p. 67) talks about "the folly of subprime mortgage investors, some large number of whom seemed to live in Düsseldorf, Germany", the reference is mainly to West LB, located in Düsseldorf. Industriekreditbank, also located in that city, was involved on a smaller scale. Dunbar (2011) gives further examples of Landesbanken exhibiting shocking ignorance about their investments.

freight rates depressed to such an extent that shippers could not service their debts. The regional government of Hamburg had seen prominence in ship finance as a means of maintaining Hamburg's role as an administrative center for the global shipping industry.

There may have been a sense of panic. Until the mid-1990s, the *ancien régime* in the German banking system had held up reasonably well. In the early 1990s, there was not even a counterpart to the banking crises that many countries experienced at this time. Yet, the lending boom associated with reunification was hardly less pronounced than the real estate and SME lending booms in other countries. The German banks merely dissolved hidden reserves or created negative hidden reserves to cover up the associated losses, expecting to make up for losses later.

Beginning around 1994, however, several developments eroded the profitability of German banks, private as well as public. Deregulation in the insurance sector, admission of money market funds, disintermediation of corporate borrowing, new information and communication technologies, new scale economies in security creation – all these developments raised the intensity of competition and turned the expectation of profits making up for earlier losses into an illusion. The decline of market rates of interest also contributed to this erosion.[22]

Yield panic also induced the large *private* banks to gamble for survival. Deutsche Bank aspired to become a global leader in investment banking by acquiring Bankers Trust. Acceptance of the morals of the Bankers Trust investment bankers, as well as their bonus claims ended up costing the bank dearly, including some 20 billion dollars in sanctions and fines.[23] With similar aspirations, Dresdner Bank acquired investment banks Kleinwort Benson in the UK and Wasserstein Perella in the US but, when they tried to impose control, the most competent investment bankers left. After that, the remaining Dresdner Kleinwort could do no better than buying buy asset-backed securities. In 2008, they recorded large losses and Dresdner Bank had itself taken over by Commerzbank. Commerzbank itself had expanded its covered-bond business, taking on significant liquidity risks. Competition in the covered-bond sector was so intense that the bank had to use short-term borrowing to fund bonds in warehousing as well as the excess of collateral over the covered bond that it issued, which was mandated by regulation. Even so, margins were close to zero, and large quantities were needed to earn significant profits. In the general market breakdown after the

[22] For lack of price competition, deposit rates had previously not risen along with wholesale market rates, so the decline in market rates reduced margins directly.

[23] See chapters 14 and 17 in Admati and Hellwig (2024).

Lehman bankruptcy, all banks with significant covered-bond businesses had severe liquidity problems and had to be bailed out.[24]

6. Where were the Supervisors?[25]

When money market funding of SPVs broke down in the summer of 2007, the liquidity guarantees came due, and the sponsoring banks had to take the SPVs into their accounts. When this was done, the SPVs' losses caused Sachsen LB, the Landesbank of Saxony, and Industriekreditbank (IKB) to become insolvent right away. Immediately the question was asked why the supervisors had tolerated the use of SPVs outside the sponsoring banks' accounts.

Supervisors claimed that they had no power to interfere. Legally, the SPVs were distinct from the banks sponsoring them, which is why they were not in the banks' accounts. The liquidity guarantees were ignored because they had maturities below 365 days. Guarantees with longer maturities would have been prohibited under large-exposure regulation but this regulation did not cover guarantees with shorter maturities.

This literal interpretation of the law was grotesque. A teleological interpretation would have paid attention to the fact that the assets held had much higher maturities and that the guarantees would have to be renewed to ensure continued funding. The supervisors should have recognized that SPVs served to circumvent regulatory requirements and prohibited such practices, perhaps invoking other legal norms that ask supervisors to ensure banks' professionalism. In the case of Sachsen LB, asset-backed securities in SPVs amounted to more than 40 billion dollars; equity was between 2 and 3 billion euros and on-balance-sheet assets around 70 billion euros. Maturity transformation and leverage on such a scale can certainly be regarded as unprofessional banking. Basel II had actually

[24] In addition to Commerzbank, two other private banks, Aareal Bank, Hypo Real Estate (HRE), were also affected, as was West LB. Aareal Bank had repaid the government by 2014; on this bank, the government earned 237 million euro in interest and fees. By contrast, Commerzbank cost the government something between 2 and 5 billion euro, depending on the price at which the remaining shares are sold. HRE cost the government 20 billion euros. (This number, which exceeds the 14 billion assessed in Hellwig (2018), was given by the government itself in another answer to a parliamentary interpellation in 2018.) The government also lost close to 10 billion euro on Industriekreditbank (IKB), which had heavily invested in asset-backed securities. HRE and IKB were private banks, but government-owned Kreditanstalt für Wiederaufbau owned 33 % of it. HRE was a 2003 spin-off from Hypovereinsbank (HVB), itself the result of a 1998 shotgun wedding of Bayrische Hypotheken- und Wechselbank and Bayrische Vereinsbank, in both of which the regional government of Bavaria held large stakes (together with the insurer Allianz).

[25] For a more extensive account of the material in this section, see Hellwig and Schick (2022).

prohibited the use of SPVs to circumvent equity requirements, but, as of 2007, Germany had not yet implemented this prohibition.

Supervision is shared between the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) and the Deutsche Bundesbank.[26] Both institutions have a right to participate and speak in meetings of supervisory/administrative boards of banks. Answers of the Federal Government to an interpellation of the parliamentary party of the Greens show that, in the years before 2008, both institutions participated in all in board meetings of banks but hardly ever spoke up.[27] In board meetings of Sachsen LB, mentioned above, they never spoke at all.[28]

On the use of SPVs, the government's answers to the interpellation indicate that the supervisors never questioned the banks' assessments that risks were minimal.[29] The supervisors were incompletely informed about the full extent of the guarantees but they did not question the information they were given. In proceedings before the Federal Constitutional Court, the supervisors themselves stated that relations between them and the banks had to be friendly and cooperative because that was the only way they could do their job.[30]

Supervisors were also inactive on other occasions: In 2007, a whistleblower alerted BaFin to the involvement of West LB in *cum-ex* tax fraud and offered to provide evidence. Violating the rules for whistleblower protection, BaFin passed the alert on to the bank. Ehen the bank denied the accusation, BaFin did nothing. They appreciated that this might be a criminal case but informed

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[26] Hartmann-Wendels at al. (2009) provide a detailed account of the division of tasks between the two institutions. In principle, BaFin was in the driver's seat, but the actual supervision *in situ* was carried out by Bundesbank employees. The Bundesbank seems to have had a habit of poviding BaFin only with filtered versions of the reports of its empoyees' inspections.

[27] The interpellation was submitted in 2010. A first answer, given in 2011, contained only statements about aggregates, on the grounds that any statement about specific banks would endanger the bank's reputation and/or financial stability. In 2017, the Federal Constitutional Court ruled that in view of the *ex post* nature of the facts involved, the government's excuse could not be accepted. A second answer, given in 2018, then also addressed questions concerning the supervisors' behaviours towards individual banks.

[28] Similarly, they never spoke in the meetings of IKB, Commerzbank and Dresdner Bank. In the meetings of HSH Nordbank, they spoke twice in 2008 and not in any other year. They intervened more often in the meetings of West LB (14 interventions) and Bayern LB (8 interventions).

[29] In one example, the supervisors were satisfied with the statement that liquidity guarantees of Bayern LB to money market lenders did not impose any *direct* liability on the Free State of Bavaria (my emphasis).

[30] They made this claim made in the oral proceedings before the Federal Constitutional Court mentioned in Fn. 26. The notion that the supervisor's task is to force banks to engage in a behaviour that they would not choose voluntarily never appeared in their testimony. See Hellwig and Schick (2022).

neither the tax authorities nor the public prosecutors.[31] Had they done so, the damage from *cum-ex* tax fraud (12 billion euros) might have been much smaller.

The supervisors also failed to speak up when Bayern LB acquired a majority of shares in the Austrian bank Hypo Group Alpe Adria (HGAA) in 2007. The bank's procedure in this acquisition was shoddy, with a conflicted due diligence assessment, a neglect of the issues raised by this assessment, and a vote by written procedure. In its answer to the interpellation of the Greens, the Federal Government declared that in this case BaFin and the Bundesbank had remained silent because they feared that by speaking up, they would violate the entrepreneurial freedom and independence of Bayern LB. The bank's losses from the acquisition ultimately amounted to about 5 billion euros.[32]

7. The Politics of Lax Supervision

Until the creation of the European Banking Union in 2014, German supervisors were subordinated to the Federal Ministry of Finance. In 2006, a leading official of the ministry had publicly argued in favour of German participation in the development of securitization and the use of SPVs for holding the products of securitization. Toleration of the use of zero-equity SPVs may have been ordered by the ministry. Or anticipatory obedience preempted the need for an explicit order.[33]

According to Thiemann (2012), differences in treatments of SPVs across countries reflected differences in attitudes to the international roles of banks. SPVs were tolerated by governments that wanted "their" banks be successful in international competition and were not tolerated by governments that did not have such ambitions. The cited declaration of a German official fits this pattern. In 2004, Chancellor Schröder had admonished the financial sector to create a national

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31 In another *cum-ex* tax fraud case in 2014, BaFin again violated the rules for whistleblower protection. It only woke up to cum-ex in 2015, when Maple Bank became insolvent due to the government's claims for repayments of unlawfully obtained refunds.

32 The Austrian committee of inquiry about the HGAA scandal documents the shoddiness of procedures, including the 2009 sale to the Austrian government, see Griss-Bericht (2014).

33 The subordination encompassed the Bundesbank's participation in banking supervision. Much of the work, in particular, *in situ* inspections in the banks, was carried out by Bundesbank employees, but in the actual decisions, BaFin was in the driver's seat, in principle under directions from the finance ministry. Hartmann-Wendels et al. (2009) provide a detailed account of the division of labour between the two institutions and the procedures used.

champion in banking.[34] Supporting German companies in becoming "champions" in global markets had been a declared objective of his government from its beginning in 1998.

The toleration of SPVs may also have been intended to help the Landesbanken. If BaFin had prohibited the use of SPVs when the Landesbanken were enthusiastic about them would have been a sure way to antagonize the regional governments. As mentioned above, this is something the Federal Government does not want to do.[35] Because of the intricacies of German federalism, bank supervision, a federal concern, ended up catering to the regional governments.

Traditionally, the regional governments also selected most members of the Governing Council (Zentralbankrat) of the Bundesbank. A typical example was Franz-Christoph Zeitler, with a civil-servant career close to the leading figures of the CSU, the Bavarian version of the Christian Democrats. In 1995, the government of Bavaria made him President of the Bavarian division of the Bundesbank; as such he was also a member of the board of the Bundesbank. When the Bundesbank was reorganized in the creation of European Monetary Union, he remained on the board, becoming Vice President in 2006. When the above-mentioned acquisition of HGAA by Bayern LB took place, he was in charge of bank supervision. From the perspective of the Bavarian government, he was the ideal person for supervision of this transaction.

In 2005, love for the Landesbanken and love for national champions were joined in federal legislation that liberalized access to the covered-bond sector. Besides catering to the Landesbanken, the government hoped that this law would turn Germany into a European hub for covered-bond finance.[36] German covered-bond institutions acquired large amounts of real-estate mortgages and government bonds all over Europe and issued bonds secured by these assets. However, liberalization caused competition to become even more intense than before. In 2008, all banks with substantial covered-bond businesses needed government bailouts.

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[34] Monopolkommission (2004) warns of of such a policy on the grounds that due to recent changes in the financial sector, financial stability could no longer be taken for granted and that financial crises "are likely to be more frequent and more serious if banks assume that they are 'too big to fail' and expect their governments to bail them out." In its reply to this report, the government acknowledged the scope for moral hazard but suggested that supervision by BaFin and the Bundesbank would prevent any major crisis.

[35] The political importance of the regional governments appears also in the fact that many of them end up as federal ministers. Of the five finance ministers that Germany has had in the period 1982-2009, four were previously heads of regional governments; the fifth one (Waigel) was President of the CSU.

[36] See Expertenrat (2011).

8. Crisis Interventions: Universal Bailouts, no Assumption of Control

In the crisis after the Lehman bankruptcy, German governments supported banks with guarantees and with equity injections. The regional governments took care of their Landesbanken, the federal government (mainly) of the private banks. In some cases, newly created "bad banks" took over assets in order to wind them down.

Through these bailouts, *all* debts of German banks were protected, not only bank deposits but all other kinds of debt as well, including subordinated and even hybrid debt that for purposes of regulation had been treated as a kind of "equity". Losses on problem assets assigned to bad banks were attributed to taxpayers.[37] In the case of Hypo Real Estate (HRE), bailing out investors and debt instruments unrelated to deposits and the payment system was justified with systemic concerns from the exposures of other financial institutions, such as Deutsche Bank and the insurer Allianz,[38] In this case, even the shareholders got €1.30 per share when the government used a squeeze-out to obtain full control.

Apart from HRE, the federal government did not take control of the banks it supported. Recapitalizations mostly took place through silent participations, a hybrid between debt and equity that regulators had recognized as equity.[39] Thus, in the case of Commerzbank, out of the 18.2 billion euros that the Federal Government put in, 16.4 billion went into a silent participation without any control rights. The remaining 1.8 billion gave the government a blocking minority, 25% of the equity plus one share, but nothing like the more than 75% the government would have obtained if the 18.2 billion had all been equity.

In public discussion at the time, free-market doctrinaires warned against a nationalization of banks and expropriation of owners as steps on the road to socialism. They failed to appreciate that bank resolution is a substitute for an insolvency procedure and that, in an insolvency procedure, the receiver acts as an agent of the government. They also failed to see that concerns for systemic

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37 For West LB and HRE, this was done by having "bad banks" take over the assets at nominal values and taking write-downs later. In the case of HSH Nordbank, the values at which the "bad bank" took over the assets were already depreciated, with write-downs covered by the regional governments' loss guarantees to the bank. The very large costs of these three banks to taxpayers, as listed in Section 5 above, reflect these losses.

38 An interview given by Hannes Rehm, the CEO of the German Financial Market Stabilization Fund (SoFFin), suggested that the bailouts also protect other important investors, such as the established churches, public television, municipalities and pension institutions.

39 Holders had a claim to a coupon of 9% of nominal value, payable in any year in which the bank's "profit" under German commercial-law accounting rules was positive. If losses required writing down the nominal value of equity, the nominal value of the silent participation would be written down in parallel.

repercussions of bank failures bear some similarity to the concerns that allow the fire brigade to infringe private property by breaking and entering a house if there is a fire that threatens to spread to neighboring houses. The warnings of socialism did however provide the government with a convenient excuse for not assuming responsibility.[40]

The free-market doctrinaires who warned against the Federal Government's taking control were strangely silent about the Landesbanken, where the issue would have been one of "federalization" of banks under regional-government control, rather than nationalization. Such a federalization of these banks would have caused not only a constitutional conflict, but also an intra-party conflict inside Angela Merkel's Christian Democratic Union, to which most of the affected heads of regional governments belonged. By providing support without taking control, the Federal Government avoided these conflicts, as well as a public discussion about the contribution of the Landesbanken in the crisis. The regional governments were adamant in resisting change. For them, control over a Landesbank is worth every euro of taxpayer money.

There were also claims that universal bailouts without assumptions of control were needed to avoid legal challenges as the interventions sidestepped existing rules for dealing with problem banks, which were deemed impractical.[41] However, the Bank Restructuring Act of 2010, which was supposed to eliminate the problems with the old rules, was just as impractical. Whereas this law had been introduced with a promise that the authorities would never again be as helpless as they had been in the fall of 2008, just a month after this law had been passed, the Federal Ministry of Finance told a committee of which I was a member that, if it followed the committee's recommendation to wind down HRE, there would be another run and the authorities would again be helpless![42] Make believe rhetoric had been a substitute for effective reform.

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[40] The four banks that received recapitalizations from the Federal Government, among them HRE and Commerzbank, were all involved in the covered-bond sector, where excess capacity had induced intense competition and excessive liquidity risks. The federal institutions claimed that imposing some consolidation would violate the rights of shareholders. Yet, the HRE bailout had been justified, i. a., with the need to maintain the brand name of the German-law covered bond! See Expertenrat (2011).

[41] Rules for dealing with problem banks did allow for supervisory intervention even before a violation of equity or liquidity requirements had occurred, but they had creditor protection as their main purpose. By analogy to insolvency law, this was interpreted as a mandate to freeze asset holdings, without concern for systemic repercussions.

[42] The Bank Restructuring Act had failed to account for the liquidity needs of a bank in a recovery and resolution procedure. Against the ministry's objections, Expertenrat (2011) argued that, if necessary, continued funding of HRE by the government would be covered by the 2008 bailout law.

9. After the Crisis: Politics as Usual

The view that Germany had only been a victim of a crisis created in the US was convenient for many, and there was little willingness to address shortcomings of the German financial system, its regulation and supervision. Under the leadership of Mr. Zeitler from the Bundesbank, the German delegation to the BCBS negotiations about regulatory reform, strongly resisted anything that would make life harder for the Landesbanken and their owners. Together with the French and the Japanese, they managed to restrain the tightening of equity requirements in Basel III to such an extent that the Financial Times commented: "Basel: The Mouse that Did Not Roar".

Mr. Zeitler also worked hard to abort proposals to identify core equity with common stock. He wanted to ensure that German public banks could continue to use "silent participations", rather than common stock. Having achieved partial success in the BCBS, he shifted his lobbying to the European Commission, which duly designed legislation in which equity is not defined as common stock but as anything having a list of properties satisfied by silent participations as well as common stock.[43] The resulting EU legislation violated the principle that Basel rules define a lower bound for the strictness or rules enacted by participating jurisdictions.

Supervisory practice did not much change after 2008.[44] For a long time, BaFin was wilfully blind to fraud and embezzlement at Wirecard, initiating criminal proceedings against investigative journalists instead of checking their accusations against Wirecard. Along with the German government, BaFin seems to have been entranced by the idea that Wirecard was a "champion" in modern transactions technology, never mind the money laundering involved.[45] The supervisors were also blind to the crisis in container shipping that had began in 2008 and lasted until the Covid pandemic. This crisis caused huge losses for several German banks but, even in a special examination of ship loans in 2013, the supervisors saw no serious problems.[46]

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[43] See item 53 in BCBS (2010) and Art. 28 of the Capital Requirements Regulation, Regulation (EU) *575/2013* of the European Parliament and the Council (CRR) of June 26, 2013. Tboth documents contain the list of requirements, but in BCBS (2010), this list only provides necessary conditions for something to be regarded as common equity. For joint-stock companies, BCBS (2010) allows only common equity, a term that does not appear in Articles 27 and 28.

[44] The discussion here is again based on Hellwig and Schick (2022).

[45] In contrast to the 2008 crisis, the Wirecard scandal led to a change of personnel at the top of BaFin. Remarkably, this change was triggered by revelations of insider trading by BaFin employees, rather than revelations of supervisory failures.

[46] The severity of this crisis could have been predicted already in 2009. In that year, Hapag-Lloyd, the German "national champion" in shipping, applied for government support. The committee advising the Federal Government on such applications from non-financial companies, of which I was a member, reported that the shipping crisis would last much longer than the overall recession because many new ships that were still in the construction

10. Europe as a Game Changer?

The German attempt to maintain the symbiosis of governments, supervisors and banks as if the crisis had not happened was defeated by the EU Commission. The Commission used the crisis to assert and to expand its powers. It had to approve all bailout measures under the rules for state aid. It conditioned these approvals on substantial adjustments. West LB had to be wound down, HSH Nordbank had to privatized as well as shrunk; its successor has assets of about 30 billion euros, a far cry from 200 billion in 2008. Other approvals bailouts were also conditioned on substantial downsizing. In particular, the Commission imposed exits, or at least substantial reductions, from covered-bond activities and from ship finance. The Commission's thus destroyed all dreams of turning Germany into a global hub for covered bond issues or for ship finance.

The Commission also declared that the global financial crisis had done so much damage because up to then there had been "too little Europe" in banking and finance. To remedy this perceived deficit, it introduced legislation creating new institutions to coordinate supervisory activities across member states. Other legislation created a "single rule book", transferring most equity requirements from an EU Directive, in need of being implemented through national legislation, into a directly applicable EU Regulation. Moreover, the Bank Recovery and Resolution Directive introduced common rules for dealing with banks in difficulties.[47]

For members of the euro area, the most important change came with the 2014 creation of the Single Supervisory Mechanism (SSM), a common bank supervisor under the auspices of the European Central Bank. The SSM cooperates with national supervisors but has authority over decisions. Importantly, the EU Regulation creating the SSM stipulates that all supervisors must be independent of government interference. I suspect that this independence was a major reason why, in the years following the creation of the SSM, the supervisors got the banks to recognize losses on non-performing loans and deal with them, including the ship loans of German banks.

Before one begins to idealize these developments, however, one should recall that, in drafting the Capital Requirements Directive, the Commission gave in to German demands to weaken Basel III

pipeline, whose orders could not be rescinded, would add to capacity make and delay the time when container shipping would again earn the funding costs of the ships. For a public version of the argument, see Hellwig (2013).

[47] Like the German Bank Restructuring Act of 2010, which it superseded, however this directive made no provisions for bank liquidity in a resolution procedure, which is also impractical. See Ch. 16 of Admati and Hellwig (2024) and the references given there.

by treating silent participations as core equity for all banks, rather than merely those that do not have access to the stock market. I suspect that this was the price the Commission paid for the agreement of Germany to the transition of European law from the status of a directive to the status of a regulation. The current initiative of the Commission, which calls for also moving the remaining rules from the directive to the regulation, may give rise to similar deals, this time involving a weakening of the "completion of Basel III". The Commission's stance towards bank regulation seems to have been driven by considerations of power as well as considerations of merit.

11. Concluding Remarks

In the ongoing debate about bank regulation in Switzerland after the breakdown of Credit Suisse, the remaining Swiss mega-bank UBS has threatened to move abroad if the government's proposals were implemented. With a move to another country, however, the bank would lose the familiarity and friendliness of its relations with supervisors and the polity. Rebuilding such political capital in another country would be costly and would take time. Whereas Ireland or the Cayman Islands may provide useful tax havens or anonymity havens, by and large a bank's home country tends to be its most convenient supervision haven. The details may differ as the politics differ, but the kind of symbiosis of banks, supervisors and governments that is apparent in the German experience has its analogues in other countries. The various reports on the run-ups to the 2023 breakdowns of Credit Suisse and Silicon Valley Bank indicate that this is also true for Switzerland and California.

The symbiosis of banks, supervisors and governments reflects a tradition that is epitomized by the saying "banks are where the money is". As in the era of financial repression, from the 1930s to the 1980s, governments think of statutory power over banks as a source of funding for desired purposes. The internationalization of capital markets since the 1970s has added the notion that successes of a country's banks in international markets are a source of pride and potentially a source of additional income. Some countries have tried to generate economic growth by becoming financial hubs that attract funds from foreign countries and invest them in yet other foreign countries; this was the story of Cyprus before the Greek debt crisis.

There may however be a tendency to underestimate competitive pressures and risks. When the risks realize, the above saying becomes "governments are where the money is". There may be substantial damage for the country, but responsibility is hard to establish. The crisis was just due to bad luck –

or it was the fault of the Americans…. Memories recede quickly, and the politics of bank supervision return to their normal mode.

It is not a coincidence that, after 2008, the most pronounced changes in bank regulation and supervision occurred in the EU where supranational institutions used the crisis to gain an advantage in competition with national institutions. In particular, the SSM has thoroughly changed the interplay of banks, supervisors and governments. It remains to be seen how the symbiosis of institutions in the European Banking Union will evolve over the years.

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