War of the Worlds

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BY KLAUS C. ENGELEN

Reforming world financial regulation is about to get nasty. Berlin, call your office!

On both sides of the Atlantic, the worlds of finance and politics expect that the next twelve months could bring about the most dramatic changes in financial services regulation in decades. After talking for months about the reasons that led to the financial meltdown and after agreeing on the outline of a solution, political leaders will begin to come up with concrete proposals. From that point on, behind the scenes and in the open, the power grabs between the United States and Europe, and within the European Union, will start to get nasty.

From a German perspective, this could be bad news. Key supervisors, regulators, and experts in the field of international financial diplomacy see a real danger that Germany could be distracted during negotiations by its upcoming elections. The consequence could be that Berlin won't come up in time with the strategy and clout it needs to defend its vital financial and economic interests during dealmaking on the EU and global levels. "Sorry to say, neither government nor legislators nor the private sector has the looming fights about securing German interests in the coming reform battles on their radars," laments a Bundestag financial market expert.

Absorbed in rescue efforts for ailing enterprises and banks—which in return are hoarding ever-cheaper funds while cutting loans to corporations and the politically important "Mittelstand"—the Berlin government is only focusing on the September 27 national election.

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But the 0.3 percent growth in the German economy for the second quarter of 2009, after four consecutive quarters of negative growth, has boosted Angela Merkel's bid for re-election as chancellor. The €85 billion ($121 billion) in economic stimulus measures passed by the Berlin coalition government in two major stages prevented the slump, helped by Germany's €5 billion car-scrappage scheme. "The government can claim part of the credit for this recovery, for stabilizing the banks and implementing the short-term plan," says Goldman Sachs economist Dirk Schumacher.

German Chancellor **Angela Merkel** *is hitting back. "With us, dear friends, Wall Street or the City of London won't dictate again how money should be made only to let others pick up the bill."*

In early summer, the coalition government of Chancellor Merkel and foreign minister Frank-Walter Steinmeier began drifting apart. Cabinet members are walking in different directions. This was dramatized by recent do-it-alone actions by Germany's new economic minister Karl-Theodor zu Guttenberg. This aristocrat from the Bavarian CSU has become an overnight political star. Despite membership in the Merkel cabinet, zu Guttenberg received a lot of political mileage from opposing Merkel's rescue concept for Opel and talking about it publically. Recently, he single-handedly even put forward new legislation to restructure failing banks, although his ministry has no responsibility in this area. He simply adopted an alternative insolvency law concept from the international law firm Linklaters. The Linklaters plan would make it easier to restructure even big banks and thus prevent situations such as that of the failed mortgage financier Hypo Real Estate, where the German government had to amend the insolvency laws in order to have the option of expropriation included.

Germany's financial sector—in particular its "three-pillar" banking system comprising private commercial banks, public sector Landesbanks, and savings banks and cooperative banks—has been severely damaged by the financial crisis. German banks, represented at the EU level through the European Banking Industry Committee, may face major power struggles on a broad range of financial market reform proposals. Some see as helpful the fact that a German banker, Karl-Peter Schackmann-Fallis, is presently heading EBIC. Schackmann-Fallis is executive member of the board of the German Association of Savings Banks.

The problem of overlapping supervision agencies was not resolved in the United States because of powerful vested interests.

MANY DISPUTES BUT SOME COMMON GROUND

Chancellor Angela Merkel and Finance Minister Peer Steinbrück have found some common ground on reforming financial market supervision and regulation. They did a lot of finger-pointing at Wall Street and the City of London bankers who produced and distributed those toxic financial products that are now bringing down major European banks. Preparing for the G20 Washington financial summit in November 2008—in particular the forty-seven–point "Action Plan" and the "Declaration of Financial Markets and the World Economy"—the chancellor's office and the ministry of finance worked closely together. This is not surprising, since both were deeply involved in the rescue operations for failing banks beginning last year (IKB and KfW, WestLB, SachsenLB, HRE, and Depfa). After the Lehman Brothers demise with its systemic fallout, Merkel and Steinbrück were forced to go to Parliament and ask for major budget increases and guarantees to put in place a more comprehensive rescue structure: the Financial Market Stabilization Fund, or SoFFin. This new vehicle was immediately used to support Commerzbank AG as it faced huge writedowns in the assets of Dresdner Bank AG that it had taken over a few months before from the insurance giant Allianz AG.

Both Berlin governing coalition partners agree broadly that there is an urgent need to push through long-overdue repairs of the international financial architecture. High on that repair list is getting rating agencies, as well as unregulated entities such as hedge funds and private equity firms, under supervision. Other reform priorities include cleaning up offshore centers, changing the compensation incentives for bank managers, making sure that banks retain an interest in the securitized products they issue, and finally, streamlining European financial market supervision structures. There, the EU Presidency agreement of June 2009 is an important step. Legislative proposals for a new EU regulatory framework—as it was decided—should be in place in the course of 2010.

The British, trying to defend their competitive position as the world's second-largest financial center, are already stepping on the brakes.

THE LOOMING "BATTLE OF THE BIG BEASTS"

Looking at the unfolding drama of rewriting "new rules of the road" for financial markets, *The Economist* in its July 23, 2009, print edition talks of a looming "battle of the big beasts" and of "mutual suspicion and national interests" that "underlie European rows over financial regulation." However, judging by the noisy and partly hostile opposition to the new rule changes that U.S. President Barack Obama is proposing in his financial white paper, some "battle of the big beasts" is also raging on the other side of the Atlantic.

In broad terms, the United States and Europe seem to be in agreement that they want better global cooperation, better systemic oversight, tougher bank regulation, and more supervision of unregulated entities and products such as hedge funds and derivatives. But the room for regulatory convergence across the Atlantic remains limited, in spite of the fact that the newly enlarged Financial Stability Board was given the G20's mandate to streamline the global regulatory framework with the lessons of the present financial meltdown in mind. This would mean, in particular, tougher supervision of systemically important "large complex financial institutions" and higher global standards on capital requirements.

But as key European supervisors and other experts admit, "There is not much evidence of U.S.-EU coordination at the level of discussing concrete reform proposals." They see the focus of Obama's reforms as bank regulation and consumer protection. They are disappointed that the problem of overlapping supervision agencies was not resolved in the United States because of powerful vested interests. In their view, hotly contested issues remain. For instance, the EU directive on alternative investments would not be acceptable to the Obama administration and the U.S. Congress since it would go much further than just requiring registration. The European Commission has put forward an alternative investment directive that would force hedge funds and private equity funds to seek regulatory authorization, report their strategies, and set aside capital against losses. Regulators would be able to set limits on borrowings.

European supervisors also see a problem in how, under the new U.S. regulations, banks would be required to retain an interest in securitized asset-backed securities. The European Union is opting for a much broader requirement, forcing banks to keep an interest in loans that are securitized and then sold.

European supervisors and regulators note major differences between the United States and European Union in how credit rating agencies will be supervised and how regulated derivative products and customized derivatives should be handled. They realize that the Obama administration, in order to get its regulatory regime change through Congress, must take the powerful commercial interests of Wall Street into account.

THE BATTLE WITHIN EUROPE

With a backdrop of such looming transatlantic regulatory battles, Europe itself also seems to be on the brink of an internal "battle of the big beasts." Going by the newspaper headlines, some old fights between London and the Continent's heavyweights, Germany and France, have resurfaced. After all, it was French President Nicolas Sarkozy and German Chancellor Merkel who have long led the charge against hedge funds and private equity funds. In Germany, hedge funds and private equity funds have been politically demonized as "locusts" since the spring of 2005. The head of the SPD party, Franz Müntefering, also used this metaphor. In

Pity the Social Democrats

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Should the Social Democrats not win enough votes on September 27, 2009, to form another coalition government with Chancellor Angela Merkel and her conservative Christian Democratic and Bavarian Christian Social Union camp, an eleven-year reign of Social Democrats at the top of the Ministry of Finance will come to a politically bitter, if not tragic, ending. It remains to be seen whether a new coalition between the CDU/CSU and another party—the Liberals, the Free Democrats, or the FDP—could do a better job.

Driven by an ever-more-powerful German financial services industry and by big export-oriented German corporations, the Social Democrats under Chancellor Gerhard Schröder pushed for "modernizing" Germany's financial services market—meaning deregulation in order to stay competitive within Europe and globally.

After Oscar Lafontaine left his position as finance minister and SPD party head in a row with Schröder in March 1999, Hans Eichel, a former governor of the state of Hesse, continued implementing his financial sector policy of modernization, deregulation, and financial innovation. As in the case of consolidating banking, securities markets, and insurance under a Federal Financial Supervisory Authority (BaFin), Eichel and the SPD met formidable conservative opposition forces in the Bundestag and in the CDU/CSU governed states. I recorded Eichel's efforts to "modernize" Germany's financial sector in *TIE* ("The Little Bang Approach: Germany keeps reforming its financial sector bit by bit," March/April 2001) and his subsequent highly successful push to streamline European financial market supervision together with Gordon Brown, then Chancellor of the Exchequer ("Central Bank Losers: The inside story of how the ECB and the Bundesbank are being pushed aside as financial regulators," Summer 2002).

When Merkel formed the present Grand Coalition of CDU, SPD, and CSU in November 2005, former finance minister and governor of North Rhine-Westphalia, Peer Steinbrück, took over the finance ministry. Formerly involved in the state supervision of today's failing WestLB, Steinbrück is having a hard time as Germany's top crisis manager after the government was forced to save failing banks, starting with IKB, WestLB, and SachsenLB, followed by HRE and its Dublin subsidiary Depfa. In accordance with OECD, G20, and EU policy resolutions, Steinbrück resumed the fight to clean up offshore tax havens and used undiplomatic language against Lichtenstein, Switzerland, and Luxembourg because of their resistance to shedding bank secrecy.

Pity the Social Democrats. They have not been able to get much political mileage out of taking on the larger and more difficult part of the crisis management, especially the bank rescue operations. It is easy for the opposition to paint the Social Democrats as the main villains for state failings in supervision because they have been in government for more than a decade. Those accusing the Social Democrats today of pushing securitization and allowing REITs and hedge funds were often those who a few years were demonizing the governing them for not deregulating "Finanzplatz D" quickly enough.

—K. Engelen

addition, Sarkozy and Merkel have campaigned to "clear up" offshore centers and tax havens. To American and British ears, such attacks were coded swipes against the "Anglo-Saxon" capitalism responsible for the economic and financial disaster through greed, regulatory capture, and collective irresponsibility.

Therefore it is not surprising that the British, in trying to defend their competitive position as the world's second-largest financial center, are already stepping on the brakes. Paul Myners, British financial services minister, is warning the Continent that the European Union's draft regulations for hedge funds and private equity funds need "major surgery," because while 80 percent of European hedge fund assets are managed in London, only 3 percent are managed in Paris. Myners asserted that it was easy for certain European countries to make "political capital by demanding intrusive regulation of an industry of which they have little or no experience."

The Asmussen Complex

Jörg Asmussen

ARMIN LINNARTZ, CDU/CSU

Jens Weidmann

"Those who really govern us have more power than ministers, deciding the fate of banks, companies and billions: This pair of public servants steers Germany almost single-handedly through the crisis." This is how the German magazine *Stern* talks about Jörg Asmussen, state secretary of the Ministry of Finance, and Jens Weidmann, economic advisor to German Chancellor Angela Merkel. Whether it is establishing the €480 billion Financial Stabilization Fund, saving Commerzbank AG from going under, or rescuing Hypo Real Estate, Opel AG, or the retail giant Arcandor, Berlin's power duo has been pulling the strings. Both are in charge of a "shadow" cabinet leading the billion-euro rescue operations after huge losses from the subprime mortgage disaster brought down German banks at huge costs to the taxpayers.

Berlin watchers are talking about the "Asmussen Complex." Before joining the German ministry of finance in 1996, Asmussen studied economics at the University of Bonn at the same time his friend Weidmann was writing his doctoral thesis on European monetary policy. One of the professors in Bonn looking over Weidmann's thesis then was Axel Weber. At the ministry under Theo Waigel (CSU), Asmussen, who had joined the Social Democratic Party, worked closely with the Waigel's speechwriter, Walther Otremba (CDU), now state secretary of the Ministry of Economy.

Like U.S. Treasury Secretary Timothy Geithner, Asmussen also has a massive problem of credibility. Both meet the description of arsonists who are called to lead the firefighter's squad.

When Hans Eichel (SPD) took over the finance ministry, he brought in Asmussen as his personal adviser, a lucky strike for Weber's career. First, Asmussen persuaded Eichel to appoint Weber to the "Council of Economic Experts" (Sachverständigenrat) and, two years later, to the presidency of the Deutsche Bundesbank. A year earlier, Weber's predecessor, Ernst Welteke, had lured Jens Weidmann from the German Council of Economic Advisors to head the Bundesbank's monetary policy research department. After joining the International Monetary Fund in 1997, Weidmann held the position of General Secretary of the Council of Economic Advisors from 1999 to 2003, a task that gave him a key role in German economic analysis. When Chancellor Angela Merkel was looking for a head for the economic department in the Chancellery, Weber suggested Weidmann for this key position. This way a "gang of four" from University of Bonn now wields enormous influence over Europe's largest economy.

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For many years, Asmussen worked hard to position Frankfurt as an internationally competitive financial center—for instance, fighting "unnecessary reporting and documentation burdens," pushing "asset-backed securities," and allowing German banks to shift ever-larger parts of their international investments in so-called complex structured products from bank balance sheets into conduits and special purpose vehicles in the shadow banking system in offshore centers like Dublin. Asmussen also made enemies when he was caught asleep on his watch as a member of the IKB board and the board that supervises Germany's watchdog BaFin. All this did not slow his move to the top. When—as many predict—the Social Democrats lose the chance to stay in government, Asmussen could care less. With his experience and connections he can make millions in the private sector. "I wouldn't be surprised if he joins Deutsche Bank, a bank that owes him a lot," says a disgruntled SPD member of parliament: "There he can join his former boss Caio Koch-Weser in London, so he won't have to pay German taxes." Koch-Weser held the same position as Asmussen under former Chancellor Gerhard Schröder.

—*K. Engelen*

The British also have caused an impasse over EU bank supervisors. EU finance ministers failed to reach an accord on whether EU bank supervisors should be given the power to impose decisions that risk placing a burden on national budgets and taxpayers. UK Prime Minister Gordon Brown is also fighting plans for the president of the European Central Bank (to which the United Kingdom does not belong) to chair a new Systemic Risk Board, one of two pillars of the proposed new EU regulatory framework.

This European Systemic Risk Board would continuously assess the stability of the financial system as a whole. Where necessary, it would issue risk warnings and recommendations to policymakers and supervisors, and monitor their follow-up. The second proposed pillar is the European Supervisory Authorities, dealing with the banking, insurance, and securities industries and working in a network with national supervisors in preparing technical standards, ensuring the consistent application of EU law, and resolving disputes between national supervisors.

As the list of British objections to EU regulatory reform proposals gets longer, German Chancellor Merkel is hitting back. "With us, dear friends, Wall Street or the City of London won't dictate again how money should be made only to let others pick up the bill," she told a party convention of the Christian Social Union, the Bavarian sister party of her Christian Democrats. "People rightly expect that a crisis like this will never happen again."

FRENCH-GERMAN *ENTENTE CORDIAL* ON SHAKY GROUND

On closer look, the French-German *entente cordiale* that works impressively in attacking Anglo-Saxon capitalists rests on shaky ground. Old rivalries about different approaches to regulating financial markets still run deep among German supervisors, regulators, and experts with respect to *La Grande Nation*. They see their suspicions confirmed when the present occupant of the Élysée Palace is celebrated in the *Financial Times* for his "overarching ambition" to make Paris the Continent's financial center, challenging New York and London.

The France of Nicolas Sarkozy is no longer content with financial services employing only 4.8 percent of its workforce compared to 7.6 percent in the United Kingdom. In asset management, France claims a leadership role with a 21 percent share of total European funds under management, or €5.181 billion ($7.290 billion). The United Kingdom and Germany trail with 17 percent and 18 percent shares respectively. According to Paris Europlace, the financial markets organization, French banks are emerging from the crisis with fewer losses in the downturn than their major competitors: €20 billion for France, €35 billion for Germany, €180 billion for the United Kingdom, and €350 billion for the United States. French finance minister Christine Lagarde told the *Financial Times*, "I don't want to run down another city, another system, another supervisory scheme, but I do think Paris is well-positioned to play a key role in what will be a rejuvenated and re-invigorated but certainly disciplined financial sector."

Even before they read about Sarkozy's "overarching ambition," some well-connected insiders in Germany and in some smaller EU countries draw attention to certain stunning developments in Europe's response to the worst financial crisis in memory.

They express amazement at how quickly and effectively Sarkozy's France used the crisis to form a close partnership with the EU Commission in making key strategic decisions on how the European supervision structures should be strengthened and how key positions in such a European modernization process could be filled with highly qualified French personnel. And they make

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another observation: Before the Élysée sent France's most illustrious elder finance statesman, Jacques de Larosière, to put together a "High-Level Group on Financial Supervision" tasked with repairing regulation and supervision, a secret deal was struck between Sarkozy and UK Prime Minister Gordon Brown that, "Whatever the outcome of the EU Commission's new EU regulatory framework, Paris would get the capital market supervision and London the rest, meaning supervision of banking, insurance, and pension funds," allege these insiders. They see the Merkel government as "absent from these key French-led moves in an embarrassing way with damaging consequences for the future competitiveness of Germany's financial services industry." They predict Merkel, soon probably in her second term in office, making all kind of excuses about "why Germany and Frankfurt lost out."

Some see David Wright, deputy director-general for the internal market and services in the European Commission, "at the center of the European strategic decision-making process on regulatory and institutional regime changes." A British national, Wright has held a range of posts at the Commission, including adviser in the cabinet of President Santer and member of cabinet for chief Treasury Secretary Leon Brittan. "David Wright is not only physically a giant, but also intellectually in the field of financial markets," says a Brussels insider. "It was a brilliant move by Wright to let his Directorate experts write a script for EU regulatory reform and have some top names in high finance sell it to politicians, legislators, and the public."

WHAT'S IN THE GERMAN REFORM PACKAGE FOR PITTSBURGH

The United States, United Kingdom, Germany, and others had to mount unprecedented rescue operations to ward off the threat of systemic financial collapse. By way of comparison, last year Germany already was running in third place after the United States and Great Britain in announced losses, write-downs, and recapitalizations. To fight the meltdown, Berlin established a "Special Financial Market Stabilization Fund" (SoFFin) with an endowment of €480 billion ($672 billion) to help the financial sector with guarantees and loans, sometimes even taking stakes in ailing institutions. The German government also came up with a €30 billion stimulus package and a €100 billion support fund for enterprises, in particular medium-sized companies. However, estimates of so-called "toxic securities" or "non-core assets" in German bank balance sheets run from about €600 billion up to €800 billion.

Landesbanks are using protection by powerful regional politicians to block investigations and requests for information.

These bank rescues pose dilemmas for the politicians in charge and have unintended—if not pervasive—consequences.

The Social Democrats, after eleven years in control of the Ministry of Finance, are seen as handing out state aid in staggering amounts to banks whose managers took home millions in bonuses and are now letting taxpayers pick up the bill. "For the party of Willy Brandt, it is bitter to be seen in the forefront of privatizing bankers' profits and socializing bankers' losses," laments an SPD member of the Bundestag.

Fear of angry taxpayers caused the Berlin government to drag its feet with its two "bad bank" schemes. The "detoxification structures" that eventually were put on the law books were designed to minimize costs to the taxpayer. "One is designed as a special-purpose vehicle," explains Katharina Barten of Moody's, "that can assume structured credit products, whereby likely future losses on such products are calculated upfront and have to be paid, in installments over twenty years, out of any future net profits of the transferring bank as far as these would be paid out of as dividends to shareholders. The other is "a public sector vehicle to which banks would be able to offload not only structured credit products but also whole portfolios of non-core or non-strategic assets. If used by a public sector bank, this vehicle would need to be guaranteed by the bank's public sector owners, which would have to absorb future losses to the degree that these cannot be covered out of profits of the transferring bank." Moody's concludes, "The German bad bank plan fails to adequately deal with the toxic assets held by those banks." As a result, so far German banks have not been using the "bad bank" schemes, and toxic securities continue to burden German bank balance sheets and tie up capital which should be used to make more loans. It was not surprising that the first public sector bank to use the public sector vehicle "bad bank" scheme was WestLB. This is the Landesbank that Peer Steinbrück, Germany's top rescue manager, knows well. As North Rhine-Westphalia's former economic minister (1998–2000), finance minister (2000–02), and head of state government (2002–05), Steinbrück oversaw the Dusseldorf banking giant—once Germany's second largest bank.

REGULATORY CAPTURE BY CRISIS MANAGEMENT

In Germany as in other countries hit by the financial meltdown, regulatory capture—in the sense that the financial services industry is telling political leaders, supervisors, and central bankers what to do—has reached incomprehensible dimensions. I tried to shed light on how the disease of regulatory capture led to massive regulatory failures in the United States in the run-up to the subprime crisis (see "Barely Contained Outrage" *TIE*, Fall 2008). As it turned out, from July 2008, when Deutsche Bank head Josef Ackermann informed BaFin President Jochen Sanio that IKB was in trouble, to the present behind-the-scenes rescue of Sal Oppenheim, Europe's leading independent private banking group, Ackermann played a key role in the German government's bank rescues. Some critics accuse Deutsche Bank—as a global force in securitizations and issuing toxic paper—of having poisoned the public sector-dominated German banking system while minimizing its own losses by starting early to speculate against the toxic products they were selling to not-so-smart Landesbankers.

But how does one keep a private banking sector afloat if two out of four large institutions need state support, while another is under foreign control, and the country has only one large private bank to assume a rescue role with its own financial resources? Here's another dilemma: the private banks' Deposit Protection Fund of the Association of German Banks lost a large part of its financial resources when Commerzbank, having bought its rival Dresdner Bank from the insurance giant Allianz, itself needed state help. All eyes turned to Deutsche Bank, which did not accept state support and then became an even more dominant solvent contributor to the Deposit Protection Fund. This gave Deutsche Bank head Josef Ackermann added clout when "advising" the Berlin crisis managers how to structure the "burden sharing" in the bank rescues. Supported by the politically well-connected insurance giant Allianz, Deutsche Bank was able to convince the Merkel government to protect bondholders and institutional creditors invested with hybrid and subordinated debt in the failing banks, thus putting the full rescue burden on taxpayers.

Hans-Joachim Dübel, an independent financial sector expert, qualifies Deutsche Bank's crisis management strategy as a combination of "superb management and sheer unbelievable luck." "Deutsche not only managed to successfully hedge herself through the crisis by selling or shorting toxic assets and buying protections from corporations, governments, and insurers worldwide. She also maximized political bang for the buck by fear-mongering the German finance ministry into a massive public bailout of the private deposit insurance system backed by them when Hypo Real Estate went belly up. A Hypo Real Estate insolvency could have easily destroyed Deutsche Bank's capital base via her obligations to the deposit insurance fund, as would have AIG's as a main protection seller for Deutsche's assets. Now Deutsche Bank—with double-digit billions in capital provided courtesy of German and American is going on a buying spree among her competitors and is one of the clear winners of the financial crisis."

One of the perverse effects of the still-smoldering financial crisis is that credit rating giants like Moody's, Standard & Poor's, and Fitch have become more powerful.

ONLY BRUSSELS CAN KEEP THE LANDESBANKS IN CHECK

Rescue operations also contribute their share of competitive distortions in Germany. The timing, shape, and implications of the German government exit strategies from private sector support actions remain highly uncertain.

Only one thing is for sure. Matters would be much worse if the public banking sector, representing almost half of total German banking assets and plagued by polarization, conflict of interests and—in the Landesbank sector—by a lack of sustainable business models, were not held in check by Brussels. The need for obtaining approval from EU competition commissioner Neelie Kroes, a former Dutch politician, has evolved as a mitigating factor. EU regulators have ordered Commerzbank and WestLB to sell off nearly half their balance sheets in return for state bailouts. And the EU Commission made clear that it will come down hard on the Landesbanks to consolidate and restructure toward profitable business models as quickly as possible. In Germany's "three pillar" banking structure, the Landesbanks have the biggest losses and will need most of the public support funds. This could undermine fair competition. "After having played a large role in the investment casino," admits a high government official, "some Landesbanks may be beyond repair with mind-boggling costs to the taxpayer." No wonder that, for instance, the cooperative banks who pursued more conservative traditional lending policies and avoided major investments in toxic financial instruments through offshore structured investment vehicles and conduits are crying foul.

THE FIGHT ABOUT MORE TRANSPARENCY IS HEATING UP

In financial reform speeches, Chancellor Merkel and her finance minister talk about the importance of more transparency in financial markets and financial institutions. But when it comes to shedding light on the failures of supervisors, politicians, bank managers, and their supervisory boards, Germany's governing coalition is still unwilling to find out who was responsible. Not letting the public know who is protected in the major rescue operations seems to be the official policy. Compared to the United States and the United Kingdom—where major investigations and official reports looked into bank and supervision failures—Germany is missing a unique chance restore confidence in markets and with investors and make sure that in the future similar dismal failures in management and supervision can be avoided.

In particular, the Landesbanks are using protection by powerful regional politicians to block investigations and requests for information. Thus, failure followed by taxpayer rescue is not used as a chance to improve corporate and public sector governance. This failure probably will damage "Finanzplatz D" for years to come.

Typically, German Finance Minister Peer Steinbrück, at the meeting of finance ministers in Luxembourg in June 2009, rejected making any stress tests of (German) banks public: "We are in favor of a stress test as regards the system as a whole, not with a view to the specific capital situation of individual banks, and not for publication."

As I explained in my earlier *TIE* piece on Germany ("Denial, Coverup, and the Blaming of Others, Summer 2008), when German authorities came to the rescue of IKB, WestLB, and Sachsen LB after these institutions got hit hard in their subprime mortgage portfolios last year, the rescue missions were shrouded in secrecy. Although the opposition parties in the German Bundestag—the Free Democrats, the Greens, and the Left Party—tried hard to push the ruling parties to vote for an investigation committee, they did not succeed. There was a broad consensus among the country's dominant political class to shift the huge losses of the banks to German taxpayers.

At that time the German authorities thought they could handle the bank problems "case by case." Nobody predicted that Lehman Brothers with its broad-based business in the German financial services market could go bankrupt. Only after the demise of Lehman Brothers in September 2008 triggered a bigger run on key funding markets did the German government look for a "comprehensive solution" to rescue its financial sector.

But Gerhard Schick, the opposition Green Party's financial spokesman, and his colleagues from the liberal Free Democratic Party and the Left Party, had more success in setting up a parliamentary fact-finding commission to investigate the huge rescue operation of Hypo Real Estate and its Dublin subsidiary Depfa. Hypo nearly collapsed in September 2008 when Depfa failed to get short-term funding after the Lehman Brothers bankruptcy. In a first rescue effort, the Munich-based bank received a €35 billion ($49 billion) guarantee under a bailout plan agreed upon in the early hours of September 29, 2008. Since then, the mortgage lender has received a total of €102 billion in debt guarantees and credit lines. Under pressure from the Berlin government, German banks came up with €8.5 billion in guarantees for Hypo Real Estate. Opposition lawmakers contend that the government negotiated poorly and should have made private banks take on a higher share. Key witnesses before the committee, including Deutsche Bank head Josef Ackermann, BaFin President Jochen Sanio, and

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Bundebank President Axel Weber, supported the government's view. "A collapse of Hypo would have meant the end of the financial world," Sanio said.

In view of these parliamentary hearings and major leaks of protocols and sensitive information, in particular from the rescue fund SoFFin, key German officials reject the notion that not enough information is flowing to the public and to taxpayers. "What has happened recently in the case of Sal Oppenheim has caused huge economic damage and makes one speechless," laments an official.

ARE RATING AGENCIES EVEN MORE POWERFUL THAN BEFORE?

One of the perverse effects of the still-smoldering financial crisis is that credit rating giants like Moody's, Standard & Poor's, and Fitch have become more powerful. Since central banks have started to acquire structured securities or use them as collateral in their huge support operation to put liquidity in the banks and the economy, they have become more dependent on credit ratings. At the same time, rating agencies like Moody's sends shock waves through banks by abruptly and systematically downgrading its ratings for structured securities by "too many notches," thus forcing banks to adjust for the subsequent downgradings and inject fresh capital under very difficult circumstances.

Central bankers are becoming more aware of the problem. "Central banks must rethink their reliance on credit ratings to assess financial products' suitability for open-market operations," Mervyn King, governor of the Bank of England, told British lawmakers. And he cautioned: "We don't allow anyone with a given credit rating automatic access, we always do a second check, but actually there is a good deal to be said for downplaying the role of credit ratings in its entirety. Rating agencies moved into areas where they did not have the appropriate expertise. There were conflicts of interest."

In Europe, up to the highest political levels, there is the realization that dependence on the almighty U.S.-regulated rating oligopoly has reached a stage where the wellbeing of even big national economies is threatened. A less-discussed outcome of the financial meltdown is the realization that the major credit rating giants—as bastions of American global economic power—were given the status of "too big to be prosecuted for wrongdoing." Some would put it stronger, calling them "above the law." Oltmann Siemens, an international lawyer and veteran of the International Finance Corporation, asks the pertinent question: "How can we advance global governance in financial markets if an Attorney General of the State of New York, Andrew Cuomo, was able to stop all criminal proceedings against the major credit rating agencies before any serious investigation has even started and after Congressional hearings brought to light extensive serious wrongdoings?"

The governments of the major financial centers, especially the United States and the United Kingdom—are drawing the line against tougher regulations.

THE BIG FINANCIAL CENTERS DEFEND THEIR COMPETITIVE EDGE

As the next G20 summit approaches, the governments of the major financial centers, especially the United States and the United Kingdom—are drawing the line against tougher regulations. Contrary to the high-flying resolutions made at the highest political level at the previous G20 financial summits in Washington and London, the officials representing Wall Street and the City are withdrawing from reform commitments and defending the competitive advantages of their financial service industries in world finance.

In this respect, the testimony of two key German supervisors before the Finance Committee of the German Parliament on December 17, 2008, is useful for leaders such as Merkel and Sarkozy. Hermann Remsperger, then a member of the Bundesbank's board, warned: "If we (Europeans) try to pass too many reform proposals—not only regulatory but also institutional—through the window (of opportunity) that might not work." And BaFin president Jochen Sanio argued with respect to the powerful economic interests vested in financial centers like New York and London: "There always will be the risk that someone will try to gain competitive advantages by regulatory arbitrage. Will the hedge funds that are under heavy pressure be put under regulatory control? Would the United States and London, where the management companies are located, lose a major competitive advantage? This would be the real test."

Looking at what has been achieved since the G20 leaders proclaimed their forty-seven–point "Action Plan," Gerhard Hofmann, a former top banking supervisor of the Bundesbank and now member of the managing board of the BVR, Germany's central organization of the cooperative banking group, draws alarming conclusions: "There is a great danger that the big picture gets totally lost due to political activism. The number of regulatory initiatives is overwhelming, if not amazing. The whole thing looks uncoordinated and may lead to inconsistencies. Moreover, the focus is too much on nitty-gritty details. One key issue behind all regulation should be given much more attention: the incentive structures which strongly influence risk appetite and risk controls for banks and investment firms. Here, compensation schemes are critical, but not because high bonuses may be viewed as unethical. From a financial stability point of view the core issue is that bonuses are still by and large based on short-term, not longer-term, results. Even more importantly, bonuses are asymmetric by allocating profits to the accounts of managers and traders, but losses onto taxpayers' shoulders."

Hofmann thinks that "there is still a chance—albeit small—that regulation might not change so dramatically considering that some titans of the financial industry have seemed to recover much faster than expected (Goldman Sachs, Deutsche Bank, and others). As the association that represents the major global financial service firms, the Institute of International Finance has pointed out it seems that the strong (banks) get stronger and the weak (banks) get weaker. Overall, policymakers will be under even greater pressure to address the "too-big-to-fail" issue due to heightened concentration on the banking sectors around the world."

Hofmann also thinks that the issue German economic minister zu Guttenberg raises, namely of putting on the law books a new bank restructuring regime, has not been dealt with for years and should be high on governments' priority list. "Zu Guttenberg's initiative on new restructuring rules for banks may not be welcome from a political perspective as the issue is outside his responsibility, but the truth is that he points to an issue which has so far not been dealt with properly. If the government continues to rescue systemically relevant banks at all costs, the next crisis will be more likely and could be much deeper due to massive moral hazard created on the part of large banks' management. Policymakers should resist the temptation to regulate too many details, yet not neglect the big picture on how a market economy operates."

As someone who was in charge of banking supervision for the Bundesbank for a decade, Hofmann points to the urgent need "to adjust incentives in a way to get the banking and capital markets in Germany functioning again." In this context, he strongly agrees with the EU Commission that in Germany the rehabilitation of the Landesbank sector will be critical. "The prospects for reforming Germany's banking market will—to a large extent—depend on how the Landesbank issues are resolved. Here, the pessimistic view is that regional governments will want their Landesbanks to survive without much regard for the costs to the taxpayer. The political influence on these banks has become very strong during the crisis, especially as the game behind the scenes is a serious dispute between finance minister Steinbrück who rightly asks for substantial consolidation and the regional political leaders who want to keep their Landesbanks."

In Europe, up to the highest political levels, there is the realization that dependence on the almighty U.S.-regulated rating oligopoly has reached a stage where the wellbeing of even big national economies is threatened.

At the forthcoming G20 summit, Chancellor Merkel, having been sharply criticized initially for not doing enough to boost consumption while relying too much on exports, can point to the positive economic growth numbers and also to the fact that Germany is progressing with important new rules.

Beginning January 1, 2010, as recommended by the Basel Financial Stability Board, Germany will tie bank managers' bonus payments to longer-term profitability so that short-term profits can no longer determine bonuses. As the German watchdog BaFin has informed the banks, bonuses have to be repaid if deals prove too risky in retrospect. "There must be no more pay excesses and wrong incentives for exaggerated risk," warns Finance Minister Peer Steinbrück. ◆