Promoting long-term investments under changing regulatory framework conditions

The case of Germany's KfW Bankengruppe[1]

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Abstract:

As a consequence of the severe financial crisis of 2007-2009, legislators and regulatory authorities started to enhance the supervision of financial markets and institutions. The recently proposed, discussed or finalized initiatives often try to combine a high-level of harmonization with a more binding set of rules. Especially in the regional context of the European Union, this approach has implications not only for the still heterogeneous national banking sectors, but also for particularly long-term oriented institutions, like promotional banks. In this article we discuss the institutional setup, the current regulation, and possible changes in the regulatory framework of one specific long-term lender: Germany's national promotional bank KfW.

JEL classification: L32, L50, G28

Keywords: promotional banks, prudential regulation, Basel III

1. Introduction

Five years after the outbreak of the financial crisis in mid-2007 and three years after the global recession of 2009, the economic situation remains worrisome. Many industrialized countries witnessed uneven recoveries and currently face problems of persisting high deficits and demanding overall levels of public debt combined with a subdue growth outlook – phenomena that are typical for periods after severe financial crises (Rogoff and Reinhart (2008))[3].
At the same time, the regulatory process initiated at the G20 level as a response to the collapse of financial institutions and markets reaches a critical phase as the new minimum capital and liquidity requirements for banks are currently finalized within the European Union (EU) and will be implemented presumably from 2014 onwards. Further substantial changes to the practice of prudential regulation in Europe can be expected by the recently proposed Single Supervisory Mechanism; a piece of EU legislation by which core supervisory powers over Eurozone bank's will be transferred from national regulators to the European Central Bank.[4]
Although being neither directly nor indirectly linked to the underlying causes of the last financial and economic downturn, long-term investors/lenders are closely affected by both the ongoing economic challenges and the pronounced changes in their regulatory environment. KfW is, as many other long-term investors, a very specific institution with characteristics which cannot be assumed to be known. In order to discuss the impact and application of the current regulatory changes to KfW and its clients, we have chosen the following structure for this article: At first, we start with a short overview of KfW's history, followed by a discussion of its traditional tasks, its mission and its principal business model. Afterwards, we briefly illustrate KfW's role within the German financial system and outline more recent tasks assigned to KfW. Having set out the institutional background, we analyse the current regulatory regime of the promotional bank and the foreseen changes to it, also discussing it in the context of the regulatory regimes of other European long-term investors. The last section sums up and concludes.

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[3] Despite a fiscal situation roughly comparable to its "peers", the crises in Euro area currently dominates the headlines, reflecting partly underlying problems in the political and economic setup of the union, see Gros and Mayer (2010), Sinn and Wollmershäuser (2011) and Pisani-Ferry (2012) for alternative diagnosis.

[4] While the new capital and liquidity requirements represent only two of the many recent regulatory initiatives, CRD IV and CRR (in the EU context one directive and one regulation) are intended to be a cornerstone of the post-crises banking regulation. The single supervisory mechanism is one important pillar of the EU plans for the establishment of a genuine "banking union". The corresponding draft proposals of the EU Commission were published in September 2012 and shall be adopted in mid-2013. For an overview on current regulatory changes at an EU level, see e.g. EC (2012a) and EC (2012b), pp. 39-50. For a detailed discussion on the EU banking union, see Becker (2012).

2. More than 60 years of operating experience: A short history of KfW

As in the case of most promotional banks, KfW's corporate history[5] is closely interconnected with the economic history of its owners.[6] It was founded in 1948, six months before the official foundation of the Federal Republic of Germany, as a central loan institution through which Germany's share in the *European Recovery Program* (typically known as "Marshall Plan") should be passed through to the final beneficiaries. KfW's very name, with KfW being the acronym for *Reconstruction Loan Corporation,* still refers to its early task of financing the rebuilding of destroyed residential buildings, infrastructure and enterprises.

The rebuilding of Western Germany proceeded surprisingly fast and the Federal Republic entered in the early 1950s a period of high growth rates, expanding social incomes and low unemployment, typically known as the *economic miracle* ("Wirtschaftswunder").[7] Following this economic transformation process, KfW's main field of activity changed to the financing of small and medium sized enterprises (SMEs), the financing of environmental protection and export finance – tasks which still represent core tasks of KfW today.[8]

The fall of the iron curtain and the peaceful reunification of the two separate German states in 1990 again brought substantial changes to KfW's activities, including major programmes for the economic reconstruction of Eastern Germany, financing housing for the Soviet Armed Forces as well as transition programmes for Central and Eastern Europe. Within the domestic promotional business, housing renovation and modernisation became more and more important during that period – a trend that continued after 2000, with an emphasis on energy efficient construction and refurbishment.

Together with the promotion of renewable energies, investments in climate and environment protection are a major field of activity for KfW today, with 40 % of new commitments devoted to this area in the most recently finished business year.[9] As further aspects of KfW's activities, promotional programmes for higher education and demographics can be mentioned.

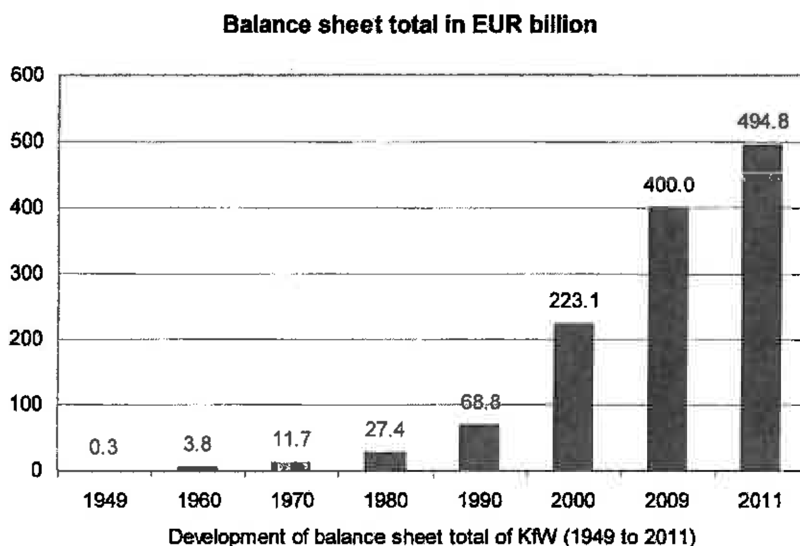

Figure 1: Balance-sheet total of KfW

Looking at KfW's history over the last 60+ years, three points can be mentioned: First, a remarkable growth both in terms of its balance sheet total (figure 1) and in terms of the multitude of promotional tasks assigned to KfW. As outlined by Gál et al. (2006), this trend towards an institutional concentration of promotional activities can be observed not only in Germany but internationally.[10]

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[5] Unless otherwise indicated, all information concerning KfW's history up to the late 1990s are from Harries (1998). A short historical overview can also be found on KfW's homepage:
http://www.kfw.de/kfw/en/KfW_Group/About_KfW/Identity/History/index.jsp.

[6] 80 % of KfW is owned by the Federal Republic of Germany and 20 % by Germany's Federal States.

[7] Although the ultimate economic contribution of the Marshall Plan is controversial among economic historians, it had a widely agreed positive psychological effect on Germany. See Wehler (2008) for a discussion on the magnitude and the underlying causes of Germany's post-war boom.

[8] KfW's experience in international loans and the public ownership made the bank an ideal implementing partner for Germany's development cooperation, which became more and more important during the 1960s. The trend towards an internationalization of business was to some extent reversed during the 1970s when two subsequent oil crises led to a refocusing on domestic promotion.

[9] KfW, press release, KfW promotion provides stability in a difficult financial and economic environment, 30 January 2013.

[10] Formerly separated institutions which are now part of KfW include *Staatsbank Berlin* (mid 1990s), *Deutsche Investitions- und Entwicklungsgesellschaft* (in 2001) and *Deutsche Ausgleichsbank* (in 2003).

Second, despite the fact that some promotional tasks remained considerably stable over time (e.g. promotion of SMEs), KfW reacted throughout its history to all major economic challenges of its time.[11] The ability to rapidly adapt to changing economic conditions rests on KfW's business model and its unique position within Germany's financial system – thus allowing finance programmes to be funded via the capital market, with a decreasing share of budget sources in the balance sheet of KfW.

Finally, on the institutional side, it has to be mentioned that the overall structure of KfW remained relatively stable. KfW continues to operate under its own act of Parliament ("Law Concerning KfW") dated 5 November 1948.[12] Its legal form as public-law institution ("Anstalt des öffentlichen Rechts"), its location (headquartered in Frankfurt) and its public ownership structure (Federal Republic of Germany: 80 %, Federal States: 20 %) have remained unchanged since its foundation in 1948.

3. Traditional tasks, mission and business model

As an institution, KfW can be understood from many different, though interconnected perspectives: From a pure economist's perspective, KfW is a government instrument to reduce adverse effects of different forms of market failure. In most cases, it does that by providing credit at attractive conditions to its final beneficiaries through the principle of *on-lending.* From the perspective of its main client base, KfW offers financial solutions for SMEs, private households and municipalities in Germany, using the local banking sector as main distribution channel. Looking at the liability side of the balance sheet, KfW refinances its business by issuing debt instruments on international capital markets, being one of Europe's largest issuers. Finally, from an institutional perspective – due to its experience in the banking sector and at international capital markets – KfW can also be seen as a "bridge" between the government and the financial sector, acting to some extent as a gateway between both spheres.

To explain how KfW[13] promotes long-term investments we take a more nuanced look at KfW's operations and the underlying principles of its business, focusing on i) operational efficiency, ii) incentives and conditionality of promotional programmes and iii) limits of activities.

Operational efficiency

Financing SMEs, municipalities and households is a local business, as asymmetric information make it hard to take well-informed lending decisions over great distance with changing clients. Responsible risk management would make it necessary either to create and maintain a comprehensive network of local branches to overcome these problems[14] or to concentrate on a subset of highly collateralized customers and/or highly standardized products, thereby limiting the access to and the scope of promotional programmes.

KfW operates instead under the principal of *on-lending,* where the final customers can apply for a promotional programme at their local (house) bank. The risk assessment, the final lending decision and the handling of the loan is performed by this bank that refinances the loan via KfW and earns a margin for its services. To minimize possible conflicts of interest, credit risk stays to a large extent or completely with this bank.[15] By working through this *principal of on-lending,* inefficient parallel structures are avoided, a decentralized decision making process is ensured, and geographically broad access to promotional programmes is guaranteed.

Incentives and conditionality

As mentioned earlier, KfW offers promotional loans[16] to target different forms of market imperfections. The ability to offer promotional loans at attractive conditions rests on an explicit, direct and unconditional guarantee from the Federal Republic of Germany[17]. This guarantee, together with KfW's good reputation in international capital markets, provides access to long-term refinancing at favourable conditions, as capital markets regard KfW as a Bund substitute.[18]

To prevent a crowding out of private investments and to ensure a prudent use of internal and public resources, access to KfW's promotional programmes is dependent on certain conditions. Within a given programme, applicants have to verify their eligibility (innovative nature of investment projects, certain type of start-up, investments in energy efficiency) and are subject to ex-ante and/or ex-post audits. Furthermore, KfW often finances only part of the total investment costs and is thereby a co-lender or a co-investor alongside its on-lending partner.

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[11] Quite naturally, the most recent financial and economic crisis had a considerable impact on KfW and its business, which will be briefly discussed in chapter 5.

[12] The Law concerning KfW has received only two important amendments in recent years. In April 1998, a direct and unconditional guarantee from the Federal Republic went into effect which supplements the existing *maintenance obligation* ("Anstaltslast"). The second amendment was a consequence of an accord reached with the European Commission in 2002 concerning state aid ("Verständigung II").

[13] To remain focused, we exclude KfW *Entwicklungsbank* - specialized on promotional cooperation - and *KfW IPEX Bank* - KfW's private - sector arm from the analysis.

[14] The very origin of banks can be traced back to the need for institutions to overcome these transaction costs and asymmetric information, see Benston and Smith (1976) or Diamond (1984) as reference.

[15] Within specific promotional programmes, KfW also assumes a higher percentage of credit risk, e.g. up to 80 percent in case of the financing of certain start-ups.

[16] Besides promotional loans, KfW provides also equity capital, securitization, and mezzanine capital.

[17] § 1 a KfW Law. KfW is also exempt from paying (corporate) taxes and has no obligation to pay out dividends (currently under discussion: see agreements of the coalition parties November, 4th 2102). After paying for its administrative costs, reserves and fees for its on-lending banks, all funds available can be used for promotional purposes.

[18] Authorities can use budgetary funds to further enhance the attractiveness of specific programmes.

Limits of activity

Due to an accord reached with the European Commission ("Verständigung II"), functions and business as defined in § 2 of KfW's law are well defined. The law stipulates the functions of KfW in performing promotional tasks, each specified in a body of rules. Other functions, such as granting loans and other forms of financing to territorial authorities and special purpose associations under public law, financing measures with purely social goals as well as for the promotion of education, and granting other financing in the interest of the German and European Economy are also mentioned in KfW's law.[19] The core of KfW's business is:

"1. performing promotional tasks, in particular financings, pursuant to a state mandate in the following areas:
a) SMEs, liberal professions and business start-ups, b) Risk capital,
c) Housing, d) Environmental protection,
e) Infrastructure, f) Technical progress and innovations,
g) Internationally agreed promotional programmes, h) Development Cooperation,
i) Other promotional areas specifically stated in laws, regulations or published guidelines on state economic policy that are assigned to the Institution by the Federal Republic or one of the Länder (Federal States)."

This allows a stable business model, with only two weak points: (1) The concentration on the German economy and the German banking sector makes this model vulnerable if an important partner on the asset or liability side fails. (2) The stable income situation may create a political environment where the bank may be asked to fulfil functions it is not designed for.

4. The role of KfW within Germany's financial system

Every institution has to be understood in the light of its working environment. For the overwhelming part of its lending business, KfW's direct counterparty is the German banking sector. Table 1 compares some characteristics of Germany's "three-pillar" structured banking sector,[20] including a fourth category of so called *special purpose banks* to which the two German promotional institutions at federal level (KfW and *Landwirtschaftliche Rentenbank)* as well as the promotional institutions at regional level *(Landesförderinstitute)* belong.

Table 1: Characteristics of the German banking sector (November 2012)

t	Commercial sector	Cooperative sector	Public sector	Special purpose banks excl. KfW*	KfW*
Number of banks	275	1104	433	17	1
Employees**	176.5	163.3	283.7	10.3	4.0
Balance sheet total	3293.3	1042.7	2482.3	472.8	510.8
└ of which: Share of loans to MFIs (asset side)	30.4 %	33.7 %	28.1 %	45.2 %	57.3 %
└ of which: Share of deposits and loans of non-MFIs (liability side)	36.9 %	55.3 %	47.4 %	15.2 %	3.4 %

Sources: Deutsche Bundesbank / Comments: Balance sheet total in billion EUR, * KfW in this context means KfW without KfW IPEX bank, ** employees in 1000. Latest figures available from 2011, MFIs: monetary financial institutions.

First, it can be mentioned that KfW is – in terms of its balance sheet total[21] – a large institution. This is true not only in comparison to Germany's other special purpose banks but also in comparison to the whole sector and most foreign and/or multilateral promotional institutions.

However, one has to keep in mind that the horizontal grouping in Table 1 and the comparison to other banking institutions is to some extent misleading, as KfW is not a direct competitor and can be thought of as an institution operating through its on-lending partners (figure 2).[22]

[19] Certain limits are included in KfW's law and by-laws. KfW has also an obligation to care for assets (Vermögensbetreuungspflicht). Broadly speaking, a new product has to be bankable to be approved.

[20] The German banking sector is often characterized by its *"three-pillar structure"* with commercial banks, a cooperative sector and a public banking sector, see Brunner et al. (2004).

[21] Current figures partly reflect one-off effects, namely i) KfW's role in the implementation of two stimulus packages of the Federal government after the economic downturn of 2008/2009 and ii) slower asset growth on side of the German banking sector due to the financial market and economic crises.

[22] An interesting point in this regard is that KfW cooperates not only with commercial, cooperative and public banks, but also with regional promotional banks, for whom KfW is important source of refinancing.

The second main point exemplified in Table 1 is the clear difference in the business model of the different institutions. The principal of on-lending at KfW is reflected in a high ratio of 'loans to MFIs' to 'balance sheet total' which is almost twice as high as the commercial, cooperative or public banking sectors and the largest single item on the asset side of KfW's balance sheet. On the liability side, the negligible share of credits and deposits from 'non-MFIs' reflect KfW's strict capital market orientation. Finally, the relatively favourable ratio of employees to balance sheet total can be used as a rough proxy of the already mentioned operational efficiency.[23]

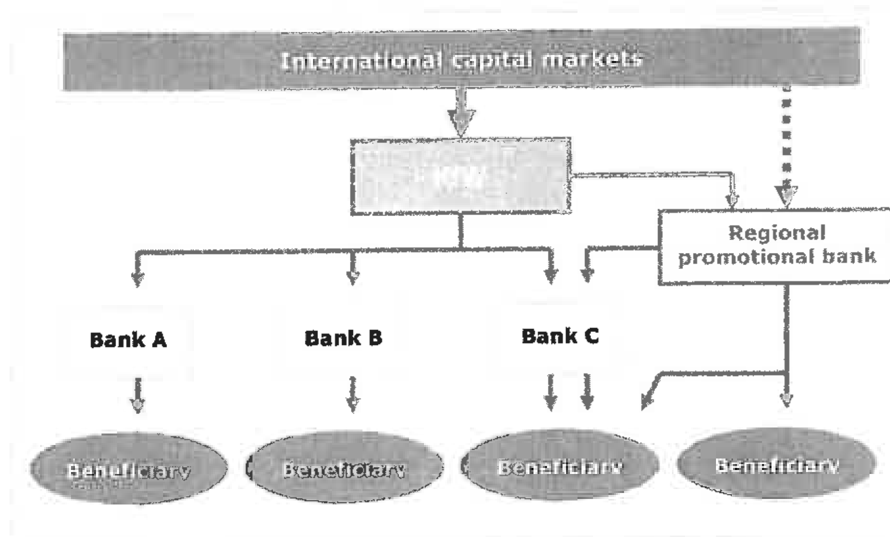

Figure 2: Flow of promotional funds to final beneficiaries

The outlined specific characteristics of KfW's business model and its position "behind" the German banking sector have the following implications on the regulatory side: First, the special business model of KfW is clearly reflected in the way the institution is currently regulated (chapter 6.2). Second, despite KfW's special status, the institution is indirectly impacted by regulatory changes through its interconnectedness with the German banking sector.

5. Special tasks

In addition to its classical promotional tasks outlined in chapter 3, KfW performs special tasks on behalf of the Federal Government. These range from the privatisation of German state- owned companies to the settlement of outstanding financial burdens of the former German Democratic Republic. These special tasks can inter alia be capital market or service related. The legal basis is § 2 (4) of KfW law, which states:

"The limitations of Paragraph 3 do not apply insofar as an operation is involved in which the Federal Republic of Germany has a state interest and which, in each case, is assigned to the Institution by the Federal Government."

Insofar two requirements have to be fulfilled: (1) a state interest and (2) an assignment letter (in German: *Zuweisungsschreiben).* The common features of the assignment letters by the Federal Government include the description of the task, reporting requirements and a guarantee by the Federal Republic to cover the risks involved. Three examples[24] may be enough to describe the special tasks:

Privatisation of Deutsche Telekom and Deutsche Post
As part of the privatisation process in Germany, KfW had been buying shares from the Federal Government and selling some of them in various capital market transactions. This special task started in 1997 and will be continued in the long term. In this area KfW may be qualified as a Long Term Investor and acts closely to the role model of the French *Caisse des Dépôts* and the Italian *Cassa Depositi e Prestiti.*

KfW Special Programme 2009
A special programme launched at the end of 2008 and expanded in March 2009, it was designed to ensure that companies could secure financing after the financial and economic crisis of 2008. This commitment made an important contribution to mitigating the worst effects of the crisis and thus restoring confidence in the industrial sector. In economic terms this type of programme is orientated to mid-term goals and is thus an instrument of economic stabilisation policy. Consequently, the programme was closed as planned at the end of 2010.

Financial support measures for Greece

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[23] According to Standard & Poors, a rating agency, the ratio of administrative costs to net interest income in 2010 stood at 26 % for KfW compared to 75 % ratio for a typical German bank.

[24] For details see KfW annual report 2010, p. 34, p. 102.

In order to ensure Euro area financial stability, the Euro members agreed in 2010 to offer Greece financial support in form of coordinated bilateral loans, given strict terms for these transactions. The part taken by the German Federal Government within the first rescue package for Greece is handled by KfW. Thanks to the capital market expertise, KfW was in a position to execute this challenging transaction swiftly. For this type of operation the special knowledge of a bank with regular actions on international capital markets is required.

6. Searching for an appropriate regulation

The combination of promotional tasks in the different areas of KfW's activities and the special tasks make it difficult to regulate KfW in the same way as other banks in Germany, including other promotional banks like *Landwirtschaftliche Rentenbank* or promotional banks of the German Länder. All these banks are subject to the German Banking Act.[25]
KfW is like the French *Caisse des Dépôts* and the Italian *Cassa Depositi e Prestiti* not subject to the EU banking regulation, a decision that is reflected in the German Banking Act, which states that only a few rules of the German banking act have to be respected:

"The Reconstruction Loan Corporation (i.e. KfW - the authors) is subject to §§ 14, 22a-o and to action taken by virtue of §§ 47(1)2 and section 48;..."[26]

To design an appropriate regulation for KfW we will, in the first paragraph draw the picture of how big promotional banks are currently regulated in a broader sense of regulation, then we will focus on the existing prudential regulation, mainly citing the reasons why KfW is not subject to the German Banking Law. Changes in regulation were required after the financial and economic crisis of 2008. By comparing the different solutions designed for the French *Caisse des Dépôts*, the Italian *Cassa Depositi e Prestiti* and the *European Investment Bank* (EIB) we will offer some best practices.[27] The current legislative initiative on the new framework for KfW's prudential regulation is presented in the final paragraph.

6.1 Regulation of big promotional banks

Even if all the institutions mentioned in Table 2 (below) are not subject to European Banking Directives and/or national banking laws, none of these institutions are free to choose activities and market behaviour. As we have shown in chapter 3, KfW's activities are strictly limited by KfW-Law, which was amended in 2003 to fulfil the requirements of the Law on the Restructuring of Promotional Banks of the Federal Republic - Promotional Bank Restructuring Act[28] and thus to be in line with the European Competition and State Aid policy. This set of existing regulations may be expanded by a mandatory application of some or all rules of prudential regulation, either described in the Accords of the Basel Committee, i.e Basel II or Basel III, the existing directives and regulations of the European Union, i.e. the existing capital requirements directive and the banking directive or the national law, i.e. in Germany the Banking Act (KWG).

Table 2: Different types of regulation to be accepted by promotional banks

Regulation type	Accepted by
European State Aid policy	CDC, CDP, KfW
Governance and Code of Conduct Rules	CDC, CDP, EIB, KfW
International Accounting Standards	CDC, CDP, EIB, KfW
Control by the Court of Auditors	CDC, CDP, EIB (partly), KfW
Contracts with external Rating Agencies	CDC, CDP, EIB, KfW

Sources: own research

As a general pattern for Europe, norms are disseminated in the following way: new norms are put forward by decisions of the Basel Committee, where regulators of the most important countries meet to design rules for international active banks. In a second step the European Union takes the Basel accords and transforms the rules into European directives or regulations applicable to all credit institutions in the EU and the European Economic Area. Directives then have to be transposed into national law.
As a response to financial and economic crises this process should be streamlined to allow a level playing field – at least in the European Union[29]. That explains why even Savings or Cooperative Banks try to influence the decisions of the Basel Committee and that the European Commission tries to design a single rulebook.

[25] Gesetz über das Kreditwesen (KWG)
[26] § 2 (2) German Banking Law (KWG), translation based on the non official translation by Deutsche Bundesbank. These rules cover the reporting of loans of 1.5m Euro or more, the rules of a refinancing register and two sections of a moratorium and the resumption of banking activities.
[27] We owe many arguments to a working group, set up by the institutions mentioned to discuss proper solutions in prudential regulation and accounting, for examples see: http://www.ltic.org/IMG/pdf/LTI_Contrib_and_concl_on_banking_supervision_3.pdf.
[28] BGB1 I, p.1657
[29] For an overview on financial crisis related regulation at EU level see Lannoo (2011), annex 2.

We have to admit that whatever solution may be designed, typical information will be required by different regulators, either in the same way as the Basel II rules would broadly require for accounting and regulation purposes[30] or in slightly different forms. An example of the last pattern may be the different requirements on "own funds" for regulatory purposes, for different accounting standards or the adjustment of the rating agencies to define equity. Generally, these requirements are closely linked and sanctioned by the different regulators in a predictable way, but we may show some cases where not only tradeoffs may occur but also conflicts of objectives. This question is not to be neglected, as the information and reporting requirements ask for a stable data basis and appropriate IT solutions[31].
Even if we only focus on national regulation, we have to admit that the scope of prudential regulation, which basically covered the protection of depositors and the solvency of individual banks as shown in the following quote is subsequently enlarged:

"Eine effiziente Aufsicht über die Finanzmärkte schafft Vertrauen bei Anlegern und Marktteilnehmern. Das Sicherstellen der Solvenz der Finanzinstitute und der Schutz der Kunden sind Leitbilder eines modernen Aufsichtsrechts."[32]

Since the beginning of the century these basic goals ("Schutzzwecke") of prudential regulation were subsequently enlarged to cover also specific goals of money laundering (see §§ 25 b-h, 53 b KWG), consumer protection (see for instance § 45 a KWG) and even remuneration of the directors (see § 45 (2); 6 KWG) or special restructuring rules for credit institutions (see §§ 48 a ss KWG).
To avoid any misunderstandings: we do not argue that these goals should not be covered by any type of prudential regulation for credit institutions. For the following contributions we just want to remember that the prudential regulation for the financial sector has moved a long way from simple per-se rules to a set of more and more complex rules in order to protect new goals and – in a macroeconomic view – the stability of the financial sector. This type of "rule of reason-regulation" needs a detailed and specified set of rules, specified towards different actors, for example banks on one side and insurance companies on the other side.
If we agree that this type of regulation is state of the art[33], we need a more economic approach in prudential regulation as well. First examples of the efficiency and the effectiveness of this policy can be found in the EU competition policy. By summing up this experience in a typical German tradition we would argue that a set of per-se rules supplemented by a predictable economic analysis are needed to give a fair and consistent guideline to the management of financial institutions acting in different business models. Thus the idea of the business model may be a general principle for at least prudential regulation and accounting[34] and may allow – depending on our knowledge – to design rules with different approaches towards different subjects. This permits the creation of a set of clusters in which decisions are predictable. In our view, this would be a preferred solution compared to ad hoc decisions ("Einzelfallentscheidungen").[35]

6.2 Existing prudential regulation at KfW

KfW is subject to legal supervision by the Federal Ministry of Finance in consultation with the Federal Ministry of Economics and Technology. The supervisory authority is authorized to adopt all measures necessary to ensure that KfW operates its business activities in accordance with the By-Laws and other rules and regulations.
One reason why KfW is exempted from most rules of German Banking Act (KWG)[36] is the special supervision described above and legally defined in § 12 KfW-Law. Other reasons are that the business activities of KfW are strictly limited to fulfil promotional activities in the public interest. Last, but not least, there is no need to protect depositors, as KfW may not collect deposits[37], conduct current account business or deal in securities on the account of third parties.
Thus KfW respects the principle of subsidiarity in its relevant market: there is no competition with commercial banks. In a vertical view, KfW respects the principle of non-discrimination under European Community law in carrying out its operations with regard to credit institutions or financing institutions. The basic rule "same business, same risks, same rules", therefore requires an appropriate interpretation.
Even if KfW is not subject to the German Banking Act it does apply the relevant norms, particularly the minimum requirements for risk management (Pillar II in Basel language) and the German solvency regulation (Core of Pillar I). Exemptions are documented and for a new type of regulation a project was designed (so called KAJAK) and discussed with various parties.
To draw a complete picture, we have to mention that within the KfW group other types of prudential regulation exist: The group company KfW IPEX Bank GmbH, which carries out all other financings not explicitly covered by § 2 KfW-Law is fully subject to the provisions of the German Banking Act. The main activities of this entity are project and export finance. Another group company, DEG (Deutsche Investitions- und Entwicklungsgesellschaft mbh) has a special derogation by §

[30] Even in the 3rd pillar of Basel II "prudential filters" may be applied to convert accounting data into prudential regulatory data.
[31] To our knowledge these projects are the most expensive current projects in all credit institutions.
[32] Jahresbericht der BaFin 2002, p. 11, see BFS-KWG/Fischer on Einf KWG, Munich, 3rd ed. 2008, p. 25.
[33] Against this approach, see Reichmut (2008).
[34] For examples see: http://www.ltic.org/IMG/pdf/LTI_Contrib_and_concl_on_banking_supervision_3.pdf.
[30] BGBl I, p. 1657.
[35] This approach is described by Schwalbe (2009), pp 61-77.
[36] We cited and described these arguments, to be found in the rationale of German Banking Act (KWG), several times, for details see BFS-KWG-Schäfer on § 2 KWG, op. cit. p 149 and in a last version Lob (2011), pp 119-150.
[37] § 2 (3) last sentence KfW-Gesetz.

2 (4) German Banking Act[38] due to the special tasks: DEG promotes private-sector development in developing and transition countries.

6.3 Prudential regulation (of big promotional banks) in Europe

The effects of the financial and economic crisis in 2008/2009 and poor decisions made in the field of operational risk encouraged a view that more regulation might also be helpful for KfW. This idea is to be found in 'Growth. Education. Unity. The coalition agreement between the CDU, CSU and FDP':

"We will ensure the KfW complies as necessary with the regulations of the German Banking Act (KWG). We want to significantly streamline the administrative and supervisory structures of the KfW. This will require corresponding amendment of KfW-Law."[39]

By starting from this political decision we have to ask how a concept can be designed in a proper way to combine rules, procedures and institutions to achieve the intended goals[40].
As these questions also occurred at the same time for our partners in France, Italy and Luxemburg we can try to find the best concept by comparing best practices in the different institutions[41]. Starting from the basic rule "same business, same risks, same rules", we have first to admit that the institution most comparable to KfW is the *European Investment Bank* (EIB).
EIB has found a solution in its statues (By-Laws), amended in 2009. Article 12 states:

"1. A Committee consisting of six members, appointed on the grounds of their competence by the Board of Governors, shall verify that the activities of the Bank conform to best banking practice and shall be responsible for the auditing of its accounts."...
2. The Committee referred to in paragraph 1 shall annually ascertain that the operations of the Bank have been conducted and its books kept in a proper manner. To this end, it shall verify that the Bank's operations have been carried out in compliance with the formalities and procedures laid down by this Statute and the Rules of Procedure.
3. The Committee referred to in paragraph 1 shall confirm that the financial statements, as well as any other financial information contained in the annual accounts drawn up by the Board of Directors, give a true and fair view of the financial position of the Bank in respect of its assets and liabilities, and of the results of its operations and its cash flows for the financial year under review.
4. The Rules of Procedure shall specify the qualifications required of the members of the Committee and lay down the terms and conditions for the Committee's activity."

Thus, the EIB has found a solution adapted to its specific position. As a multilateral development bank, EIB cannot be subject to decisions of the Luxemburg banking authority[42]. By choosing members for the Committee on the grounds of their competence, EIB has access to the knowledge of national banking supervisors and/or experts in accounting.
EIB's statutes do not limit the application of prudential supervisory rules. The Committee may decide the type of analysis that should be carried out. We define this type of a regulation as a *carve in approach*. A *carve out approach* would apply all given rules without some well defined norms. Furthermore the EIB approach combines prudential regulation and auditing of its accounts. The independent Committee which members are not members of other EIB boards gives advice – the ultimate decision is made by the board of directors.
Given its uncontested authority the Committee's advice is – to our knowledge – followed by appropriate decisions of the board of directors.

French CDC has even more experience. The legal basis is a law which was amended in 2008[43]. The mission of CDC is to support the economic development of France and to fulfil public interest in supporting public policies pursued by the state and local governments. CDC's supervisory board (*Commission de Surveillance*) consists of thirteen members, including inter alia representatives of the French Parliament, the Court of Auditors, the Banque de France, and the Trésor Public. The supervisory board controls the general management, the strategy of CDC and gives advice on important risk and investment decisions which are prepared by specialized committees (e.g. *Comité d'examen des comptes et des risques*). Concerning prudential regulation France also uses a carve in approach. The decisions on which fields have to be analysed are taken by the supervisory board. The supervisory board asks the National Banking Supervisor to give advice. *L'Autorité de contrôle prudentiel* (ACP) is the French Supervisor for credit institutions and insurance companies[44].

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[38] (4) Die Bundesanstalt kann im Einzelfall bestimmen, dass auf ein Institut die §§ 2c, 10 bis 18, 24, 24a, 25, 25a, 26 bis 38, 45, 46 bis 46c und 51 Abs. 1 dieses Gesetzes insgesamt nicht anzuwenden sind, solange das Unternehmen wegen der Art der von ihm betriebenen Geschäfte insoweit nicht der Aufsicht bedarf;...
[39] Growth. Education. Unity. The coalition agreement between CDU, CSU and FDP, 2009, p. 28, final translation by the authors.
[40] See i.a. Lob (2011), pp 119-150.
[41] The normal disclaimer applies: these views are just the ideas of the authors and do not bind KfW.
[42] The Luxemburg banking authority acted as an advisor to EIB for the implementation of an IRB-Approach to measure credit risk.
[43] For a detailed analysis see Lob (2011), p. 145.
[44] In 2008 this task was given to the Banking Authority.

As for the EIB, the French rules focus on banking regulation and even give clear hints to the methodology of the Basèl Committee, mentioning own funds, liquidity and pillar II- items. The advice given by ACP is not public. The final decisions are taken by the supervisory board of CDC.

Cassa Depositi e Prestiti (CDP) is a joint-stock company under public control, with the Italian government holding 70 % and a broad group of bank foundations holding the remaining 30 %.[45] CDP collects savings from retail investors through the Italian Postal Office and primarily finances local authorities, infrastructure projects and economic support oriented initiatives, it is also the main shareholder in a number of major Italian companies operating in Italy and abroad.
According to a rating report from Standard and Poor's from September 2011[46] CDP has an 'integral' link with the Italian government. The government is legally required to be the majority owner of CDP, and it provides an explicit guarantee of most of CDP's obligations. The Italian government also exercises operational and management control and tight supervision over CDP.
Article 5 of Law Decree No 269 dated 30 September 2003 *Cassa Depositi e Prestiti* states that:

"The provisions of Part V of the Consolidated Banking Act, referred to in Legislative Decree No. *385* dated 1 September 1993, applicable to intermediaries registered in the special list of Article 107 of the said Decree apply to CDP S.p.A., taking into consideration the characteristics of the supervised body and of the special provisions relating to the separate management referred to in paragraph 8."

Italian legislation provides several means by which the Italian government and other public authorities can exercise control over CDP. CDP's board of directors includes the chief accountant of the state, the director general of the Ministry of Finance Treasury department, and three experts on financial matters appointed by the ministry, which has the power to define criteria for lending and funding by decree in the main section of CDP ("segregated activity"). It also dictates the criteria for determining the general and economic conditions for the lending and funding in this section. The Ministry presents an annual report to parliament on CDP's activities and results, while the Italian Court of Accounts supervises CDP's accounts and prepares its own report to parliament. Finally, a parliamentary commission prepares an annual report to parliament on CDP's performance.

6.4 New prudential regulation for KfW

On 2013, March, 13th the Federal Government published a draft of the new KfW law in order to design the framework of the new prudential regulation. In a public hearing[47] German banking authorities, business associations and KfW gave comments to the draft. BaFin and Bundesbank agreed with the ideas of the law and the technique used. In whole they argued for a concept to apply the rules of the German banking act as far as possible.[48] Some banking associations asked for a similar supervision of KfW as for commercial banks or promotional bank subject to KWG[49] und thus to include KfW in the German Banking Act. BaFin cleary pointed out the need for more adaption in this case.[50]
Insofar a majority of the invited experts supported the draft of the law and the expert of German chamber of commerceDIHK underlined the relevance of KfW's promotional activities for the real economy in Germany.[51]
It was for KfW to explain the different models in Europe.[52]
As the majority in the German parliament (Bundestag) drafted a similar version, the law may be finished in a fast track procedure before summer 2013.[53]
In fact the new law will only offer a large framework for a statutory instrument. This instrument will be drafted by the Federal Ministry of Finance, in consultation with the Federal Ministry of Economics and Technology. The two German prudential supervisory authorities will be consulted. In difference to US-rulemaking the statutory instrument has not to be designed in a given timetable. So the final scope of application may vary from a non-use of the statutory instrument – a solution that is not to be expected - via a tailor-made regulation as applied for the Abwicklungsanstalten[54] to a regulation very close to the existing regulation of promotional bank subject to KWG.

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[45] In a recent change to CDP's articles of association, banking foundations will remain as preferred shareholders of CDP only until 2012 and their entitlement to a minimum 3 % real annual dividend has been scrapped. A mandatory automatic conversion of preference shares into ordinary shares on Jan. I, 2010, unless a foundation exercised its right to withdraw from the company, has now been postponed for three years. By law, minority shareholders may only be banking foundations, banks, and other supervised financial intermediaries, none of which are permitted to own more than 5 % of CDP's shares.
[46] http://www.cassaddpp.it/content/groups/public/documents/ace_documenti/010846.pdf
[47] See Deutscher Bundestag, 17. Wahlperiode Protokoll Nr. 17/134
[48] See also the written comment of Deutsche Bundesbank
[49] See the written comment of Bundesverband Deutscher Banken et al., against: Bundesverband öffentlicher Banken.
[50] See Deutscher Bundestag, 17. Wahlperiode Protokoll Nr. 17/134, p. 4
[51] Ibid, p. 10
[52] Ibid, pp. 7 and 17
[53] Cf. Annex and http://dip21.bundestag.de/dip21/btp/17/17231.pdf, pp. 231-235 for further information..
[54] § 8a Abs. 5 S. 2 und 3 FMStFG :"Auf die Abwicklungsanstalten sind die §§ 3 und 6 Absatz 2 und 3, die §§ 6a, 7 bis 9, 14, 22a bis 22o, 24 Absatz 1 Nummer 6, 8, 11 bis 14 sowie Absatz 1a, 2 und 4, die §§ 25, 25a Absatz 1 Satz 1 und Satz 8, die §§ 25b bis 25h, 26 Absatz 1 Satz 1 bis 3, § 29 Absatz 2 Satz 1 und Absatz 3, die §§ 37, 39 bis 44a, 44c, 47 bis 49, 54, 55a, 55b, 56, 59, 60 und 60a des Kreditwesengesetzes sowie die §§ 9 und 10 des Wertpapierhandelsgesetzes entsprechend anzuwenden..."

Insofar the starting point is the same as for the French Modernisation Law and CDC in 2008:

- The law shall not affect Section 2 Paragraph 2 of the Banking Act, so KfW will still be exempted from the German Banking Act as well as from European Banking Regulations CRR/CRDIV (the same European exemption applies for CDC, CdP, ICO, MFB ...).
- designing a large framework to apply parts of the French Banking Law for CDC and German and European Banking Law for KfW
- allocating institutional tasks for supervising compliance with these rules to the banking authority, i.e. in France Autorité de contrôle prudentiel and in Germany BaFin and Bundesbank.

Due to German Requirements the draft of the law goes further than the French example. § 12 (a) 1 covers the existing German Banking law, the appropriate statutory instruments and the European regulations. Even the non-existing supervision banking laws and regulations are covered by this empowerment. As in the French law a filter is included: Laws and regulations shall apply accordingly in whole or in part. This filter will not be set by the supervisory board but by the Federal Ministry of Finance in consultation with the Federal Ministry of Economics and Technology.
When determining the banking supervision laws and regulations to be applied accordingly, it should be taken into account that KfW is a promotional bank with the tasks assigned to it pursuant to § 2. A simple rule could be: promotion first, regulation second – or as a different option: as far as possible. The extent of the empowerment covers the existing structure of KfW group as well as all potential changes, for example if KfW acquires companies and thus creates a financial conglomerate. This is not to be expected.
The draft has no limits as the French Law, limiting the supervision of Autorité de contrôle prudentiel only to banking activities of CDC, as KfW owns no insurance company and if, this will be covered by the financial conglomerates directive and the Supervision of Financial Conglomerates Act. Non-banking activities in KfW group are identified and can be treated in a proper way. Furthermore the draft does not include any type or parliamentarian control after the Bundestag has enacted the law. This type of control could be guarantied – as for CDC – via the Supervisory Board or an appropriate committee.
An important difference to the French model is a lack of a second filter at the end of the process. Whereas the French practice allows the Supervisory Board to overrule the recommendations of the French Autorité de contrôle prudentiel the draft of the German Law has no such provisions: "BaFin may issue all directives and take all measures ...". The allocation of these tasks to BaFin is in line with the respective roles of BaFin and Bundesbank. If the special business model of KfW should be more highlighted by the Board of Supervisory Directors and its Audit Committee and the legal supervision by the Federal Ministry of Finance in consultation with the Federal Ministry of Economics and Technology, defined in § 12 KfW-Law can overrule the recommendations.
Given the large framework of the empowerment the room for designing an appropriate new regulation for KfW is very large:
In the own wording of the prudential supervisory authorities the German Banking Act lays down rules for banks which they have to observe when they are being established and when they are carrying on their business. These rules are designed to prevent unwelcome developments that might disrupt the smooth functioning of the banking system. How closely banks are supervised depends on the nature and scale of the business, i.e. on the risks incurred. BaFin calls this risk-based supervision. As a matter of principle the German regulator concentrates most heavily on whether institutions maintain adequate capital and liquidity and have installed appropriate risk control mechanisms. [55]

"Laws and regulations shall apply accordingly in whole or in part" can mean that there will be no change for the rules to be applied. In the current practice KfW applies on a voluntary basis different laws and regulations. The change will be that these laws and regulations should be applied on a compulsive basis and this practice will not only be controlled by the accountant and the supervisory authority (within the limits of § 12 KfW Law) but also by the prudential supervisory authorities BaFin and Bundesbank.

A different solution might be that a core of provisions of the German Banking Act is defined to respect the provisions of the coalition agreement: "We will ensure the KfW complies as necessary with the regulations in the German Banking Act (KWG)." In this solution there will be a change in the rules to be applied (as necessary) and the institutions: This model may take the results of the KAJAK-project for the rules to be applied and design the institutional roles according to Prüfungsberichtsverordnung. The accountant and the supervisory authority (§ 12 KfW Law) and the prudential supervisory authorities BaFin and Bundesbank have to find out an appropriate design of their respective roles.
The law also offers a much wider solution where a carve out approach may be applied. As KfW is not permitted to take deposits[56] all rules for a non deposit bank (a non-CRR bank in the terms of European regulation) may be compulsory. The carve out exemptions should thus be the deposit insurance system and the operations assigned via § 2 (4) KfW Law as far as they can not be conducted according to the German Banking Law and especially MaRisk and the provisions for large exposures– and as KfW has no banking licence all provisions of the revocation and expiry of authorisation can not be applied.
The right balance has to be found by applying a consistent concept. In a pure microeconomic view there is a clear trade-off between KfW's ability to run its promotional business and increasing transaction costs of regulation. These transaction costs can be justified via a case by case analysis or a pattern prediction which type of regulation may be appropriate for KfW's business model.

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[55] See http://www.bafin.de/EN/Supervision/BanksFinancialServicesProviders/banksfinancialservicesproviders_node.html

[56] For details see § 2 (3) KfW Law

7. Concluding remarks

As one main policy instrument of the Federal government, Germany's national promotional bank KfW has adapted throughout its history to changing economic framework conditions whilst at the same time keeping its focus on its main mission to promote SMEs, climate and environmental protection, building sector and education.

This article raised the question of how KfW is impacted by the current regulatory changes. To answer this question, we first outlined the institutional setup of KfW, focusing on its principal business model and the specific differences between KfW and typical banks or banking groups in Germany.

Afterwards we discussed the current regulatory framework of KfW also in the context of other European long-term investors (the *European Investment Bank, French Caisse des Dépôts* and Italian *Cassa Depositi e Prestiti)* and the foreseen changes to it; namely the political decision to ensure that KfW complies accordingly in whole or in part with the German banking act (KWG).

By following a best practice approach using the regulatory setup of the institutions mentioned above, we asked how a possible solution for KfW might look like. As one potential solution we briefly discussed the alternative using German banking supervision authorities and/or the group auditor as a possible institution to partly monitor / control KfW's compliance with the German Banking Act.

Progress in optimizing the business model of the different institutions should also be made by a peer group review and the exchange of best practices in Risk Management, Governance and Accounting,

Table 3: Overview of (planned) regulatory regime of selected promotional institutions

	CDC	CdP	EIB	KfW
Legal Basis	Law	Law	By-laws	Law, Decree and/or By-laws
Type of Regulation	Carve in	Carve-in" from a CRD point of view, approach of the national banking supervisor resembles more to a "Carve-out" approach	Carve in	Carve in
Institutions involved	Supervisory Board and National Banking Supervisor	Ministry of Economy and Finance (MEF), Parliament, Parliamentary Commission, National Banking Supervisor (Banca D'Italia),), External Auditor	Board of Directors and independent Audit Committee	Supervisory authority (§ 12 KfW law), BaFin/Bundesbank, Auditor audit committee as part of the Supervisory Board
Decision making by	Supervisory Board (5,)	Board of Directors	Board of Directors and 6	Supervisory Authorities (1, 8 or 8, 5)
Practical Experiences	Since 2010	t.b.d.	Since 2010	t.b.d.

Sources: own research
For figures designing institutions see Table 3

Annex

§ 12a
Power to issue statutory instruments; authority to issue directives

(1) The Federal Ministry of Finance is empowered, acting in consultation with the Federal Ministry of Economics and Technology, by statutory instrument, which shall not require approval by the Federal Council, to determine that the following banking supervision laws and regulations, which do not already apply to the Institution, shall apply accordingly in whole or in part to the Institution and the group of institutions, financial holding group or mixed financial holding group to be formed, to guarantee the conduct of orderly business of the Institution:

1. the Kreditwesengesetz (Banking Act),
2. the Finanzkonglomerateaufsichtsgesetz (the Supervision of Financial Conglomerates Act),
3. the statutory instruments enacted to enforce the laws specified at 1 and 2, and
4. the regulations of the European Union;

This shall not affect Section 2 Paragraph 2 of the Banking Act. The empowerment shall encompass in particular the banking supervision laws and regulations concerning

1. the trading book
2. securitisations
3. own funds
4. consolidation
5. liquidity
6. the modified balance sheet capital ratio
7. lending business
8. cashless transactions
9. the prevention of money laundering or financing of terrorist activities, or the prevention of other criminal offences that could lead to the Institution's assets being jeopardised
10. the particular, and especially the organisational, duties of the institutions, the directors, the management bodies of financial holding companies and mixed financial holding companies, and the supervisory and administrative bodies, and the requirements placed on these persons and their representatives
11. the remuneration systems of the institutions and other institutions that are part of the group for their directors and staff and members of the relevant supervisory and administrative bodies
12. auditing and appointment of the auditor and the particular duties of the auditor
13. financial conglomerates.

When determining the banking supervision laws and regulations to be applied accordingly, it should be taken into account that the Institution is a promotional bank with the tasks assigned to it pursuant to § 2.

(2) Through the statutory instrument pursuant to (1) above the Federal Financial Supervisory Authority (BaFin) may be assigned authority for supervising compliance with the banking supervision laws and regulations, and in that connection it may be determined that BaFin shall cooperate with the Deutsche Bundesbank pursuant to Section 7 of the currently valid version of the Banking Act.

(3) Through the statutory instrument pursuant to (1) provisions may also be introduced concerning disclosure, reporting and submission duties of the Institution, the group of institutions, financial holding group or mixed financial holding group to be formed, and the respective members of bodies

and employees, as well as information, access and auditing rights of BaFin and the Deutsche Bundesbank.

(4) Furthermore, through the statutory instrument pursuant to (1) provisions may be introduced concerning obligations of secrecy incumbent on employees of BaFin and persons in the service of the Deutsche Bundesbank.

(5) BaFin and the Deutsche Bundesbank shall be consulted before the statutory instrument is enacted.

(6) As part of the tasks assigned to it through the statutory instrument pursuant to (1), BaFin may issue all directives and take all measures that are appropriate and necessary to prevent or eliminate infringements of banking supervision laws and regulations, toward

1. the Institution
2. the directors and boards of the Institution
3. the companies that are part of the group of institutions, financial holding group or mixed financial holding group to be formed, and if applicable the conglomerate, and
4. the bodies of the companies that are part of the group pursuant to item 3, and toward the members of these bodies.

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