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A Lost Game of Bank Bargains: West Germany and International Banking Regulation between Bretton Woods and Basel I (1972–1988)


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Abstract: Current theories of financial regulation suggest expanding rules-based formal state intervention to promote international banking stability. Such policy solutions should then be global in scope. This article instead argues that principles-based informal co- and self-regulation through domestic (gentlemen’s) agreements underpinned West German bank internationalisation until the 1980s. The analytic narrative approach allows the tracing of the social dynamics of the German politics of regulation, drawing on unused primary sources: Coalitions between the German regulating and regulated actors were bolstered by a liberal domestic framework and bespoke national policies. In contrast, regulatory harmonisation through international prudential standards came with high domestic adjustment costs for the German banking sector. Thus, domestic makeshift solutions to deal with and internalise cross-border financial risks proved most workable.

JEL-Codes: G 15, G 18, G 21, G 28, L 51, M 48, N 24, N 40, N 44, N 84

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1 Introduction

The international business of banking is heavily defined by its regulatory and policy environment. Any cross-border financial activity is affected by a variety of jurisdictions. Naturally global competition in banking creates (and spreads) financial risks across borders, begging the question of how to balance the costs and benefits of international financial intermediation. Banking regulation theory posits that banks either learn caution on their own (self-regulation; principles-based) or should be given a set of guidelines by which to abide (state intervention; rules-based). If there is an interplay between the public and private sector, that process may more adequately be described as “conditioned self-regulation” or “co-regulation”. To fix global finance after the Global Financial Crisis of 2007–2008, ever more complex rules-based formal state intervention and regulation at supranational level seem to be the order of the day.

In this vein, Dirk Schoenmaker prominently suggested that financial stability, international banking, and national financial policies are incompatible (financial trilemma). Policymakers could only choose two of these. In compromising on national autonomy, Schoenmaker thus made the case for joint sovereignty and global governance to mitigate potential fallbacks from international banking instability.

Historically, though, this article demonstrates instead how principles-based informal co-regulation at arm’s length and non-statutory national supervision underpinned sound international banking, whilst creating both commercial success and financial stability. The article examines the evolution of the regulatory and supervisory framework of West Germany (hereafter: Germany), spanning the period from the terminal phase of the Bretton Woods monetary system (early 1970s) until the adoption of minimum capital requirements with the Basel I Accord (1988). Amid renewed globalisation after World War Two, the post-Bretton Woods era was characterised by unprecedented international financial instability. It was in this period that German universal banks embarked on rapid internationalisation, (belatedly) following the patterns of foreign peers in Europe and elsewhere. Yet despite the iconic fall of Bankhaus Herstatt in 1974 as well as the near-collapse of Schröder, Münchmeyer, Hengst & Co. (SMH) in 1983, Germany enjoyed financial stability relative to other industrialised economies. But what were the regulatory underpinnings of German bank inter-

nationalisation? How did this regulatory regime evolve? And what are the policy implications for the governance of international banking at large?

Instead of detailed legislation and compliance codes, the extant literature claims that Germany’s banking system relied on self-regulation by keeping the state at a distance, reflecting a liberal approach to industrial policy in general.10 Compared to the fragmented US system, it is argued that Germany avoided overlapping jurisdictions and duplicative agencies by operating with substantially fewer regulations and rules.11 Also, German banks are found to have played a more powerful and autonomous role in producing regulatory solutions than, for example, Japanese or French banks.12 German banking regulators and supervisors thus pursued “a liberal philosophy based on free-market concepts”, with Germany operating a highly liberalised banking system earlier than other countries.13 Importantly, Andreas Busch observed that regulating actors across the US, UK, Switzerland, and Germany built on national routines in response to changes in banking spurred by globalisation.14

Such earlier research has, however, been unable to explain the intimate dealings with and coalition-forming dynamics between the German regulating and regulated actors. This article therefore employs a new set of archival sources (government, regulatory, central bank, and commercial bank files), which allow the opening of the black box of the German “game of bank bargains” – that is, a game in which the players (national interest groups) bargain over how to structure and regulate banks. Charles Calomiris and Stephen Haber demonstrated that the regulation and design of national financial systems are the result of histori-

cally explainable and changeable formations of coalitions between national interest groups (governments, financial supervisors, central banks, commercial banks, depositors etc.).\textsuperscript{15} The rules according to which this game is played depend in turn on the respective political system.

Applying this framework to the Bonn Republic of the 1970s and 1980s, the players included the Bundesbank, members of the federal government, ministry officials, the Länder central bank boards, and bank representatives from across the three-pillar German banking system. These representatives were united in their respective banking associations (private banks, savings banks, credit cooperatives) to rally behind a common strategy in negotiations and decision-making processes vis-à-vis policymakers. During that period, the private commercial banks accounted for nearly 25 percent of the average business volume of the entire German banking system.\textsuperscript{16} The foreign or international assets made up about 30 percent of the big private sector bank balance sheets (Deutsche Bank, Dresdner Bank, Commerzbank), with the state-owned Westdeutsche Landesbank (WestLB) developing an equally international outlook. These banks therefore lend themselves to an analysis of German’s regulatory regime.

Unlike in other larger member states of the European Community (EC), especially the UK, statutory banking supervision in Germany was not exclusively subordinate to the central bank. Direct financial (or prudential) supervision was instead the responsibility of a separate authority, the Federal Banking Supervisory Office (\textit{Bundesaufsichtsamt für das Kreditwesen}, BAKred), which was founded in 1962. The Supervisory Office was first an arm of the economics ministry before being transferred to the finance ministry in 1972 as part of a wider reshuffle of competencies. The German Banking Act (\textit{Kreditwesengesetz}, KWG) from 1961 stipulated that the dependent BAKred and the independent Bundesbank were obliged to cooperate in regulatory and supervisory matters. This created a division of labour, with the Bundesbank however enjoying greater power thanks to its autonomy.\textsuperscript{17}

The article finds that German regulators mainly governed through discretionary (gentlemen’s) agreements with commercial banks to smooth over conflicts of interest, in the absence of more formalised alternative solutions. Such agreements proved transactions cost-saving, legally non-binding, and flexible

\textsuperscript{15} C.W. Calomiris/S.H. Haber, Fragile by Design. The Political Origins of Banking Crises & Scarce Credit, Princeton 2014.
\textsuperscript{17} Becker, Banking Supervision.
tools to cope with recurrent issues in banking markets while not straitjacketing German market participants. Importantly, such agreements were voluntary. Public officials and private financial institutions regarded each other as partners. In this setting, the peril of regulatory capture was inherent, that is, the possibility that regulatory agencies advanced the interests of financial institutions, rather than acting in the public interest.\footnote{O. Issing, Einführung in die Geldpolitik. 6th rev. ed., Munich 1996, p. 136; D. Carpenter/D.A. Moss (Eds.), Preventing Regulatory Capture. Special Interest Influence and How to Limit it, Cambridge 2013.}

The article further demonstrates that the German “game of bank bargains” reflected a traditional preference for liberal market principles, pronounced accountability of banks, and ad hoc discretion. In addition, despite the existence of a statutory framework (the KWG), domestic non-statutory particularities in financial accounting were salient throughout: In contrast to many international competitors, German banks were allowed to tap hidden reserves to offset losses; making large-scale provisions was in large part tax-deductible (which improved bank income statements); and the banks were encouraged to manage international risks themselves in concert with their preferred external auditing firms. Competition policy considerations further softened external regulatory intervention, paving the way for continued (sectoral) self-regulation. Germany was therefore able to unilaterally internalise negative externalities of cross-border banking activities (such as financial instability).

While international financial governance constitutes a global public good, it need not be distributionally neutral and may impose net costs on individual economic agents (i.e., banks) within countries.\footnote{J. Frieden, The Governance of International Finance, in: Annual Review of Political Science 19, 2016, pp. 33-48, here: p. 39. Financial supervisors must negotiate with other states multilaterally, while also responding to domestic polities. This creates a “two-level game” (Putnam), see E.B. Kapstein, Architects of Stability? International Cooperation among Financial Supervisors, in: C. Borio/G. Toniolo/P. Clement (Eds.), The Past and Future of Central Bank Cooperation, Cambridge 2008, pp. 113-152, here: p. 123.} Hence, regulatory harmonisation through adopting international prudential standards would have come with high domestic adjustment costs for the German banking sector, i.e., large-scale intrusion and unknown policymaking territory.\footnote{See L. Quaglia/A. Spendzharova, Post-crisis Reforms in Banking: Regulators at the Interface between Domestic and International Governance, in: Regulation & Governance 11, 2017, pp. 422-437. In contrast, D.A. Singer, Regulating Capital. Setting Standards for the International Financial System, Ithaca, N.Y. 2007, pp. 3-4, argues that regulators should have an interest in harmonising international standards to bolster domestic bank stability.} Despite repeated calls to enforce stricter regulation and supervision, the majority of German policymakers...
found it difficult to implement such measures, not least thanks to complicated
domestic legislative processes. In consequence, the well-functioning informal and
non-statutory domestic framework made Germany a (partial) foot-dragger in de-
vising formal transnational supervisory policies such as balance sheet consoli-
dation and capital adequacy ratios by the late 1980s.\footnote{The 20\textsuperscript{th} century saw a secular trend towards ever more formal bank supervision, see E. Hotori/M. Wendschlag/T. Giddey, Formalization of Banking Supervision. 19\textsuperscript{th}-21\textsuperscript{th} Centuries, Singapore 2022.}

The case of German bank internationalisation between Bretton Woods and
Basel I corroborates the argument that preserving national prerogatives usually
formal domestic makeshift solutions, rather than accelerating a formalised gov-
ernance of international banking. Expanding on institutionalist (though rather static) explanations, the story thus uncovers the internal dynamics and the
evolution of the German game of bank bargains. Finally, the article provides a
historical test case for the financial trilemma.\footnote{On combining a historical narrative with an analytical approach in banking history, see C.L. Colvin, The Past, Present and Future of Banking History, in: A. de Jong et al. (Eds.), The Routledge Companion to Business History, London 2017, pp. 89-106.}

The article is organised as follows: Part 2 explains how monetary concerns
informed Germany’s approach to addressing the cross-border activities of Ger-
man lenders through the Luxembourg off-shore marketplace. Part 3 demon-
strates how from the mid-1970s prudent concerns on how to supervise the
international business of German banks spurred the conclusion of gentlemen’s
agreements. Part 4 details German financial practices to address international
lending risks until the 1980s, followed (part 5) by Germany’s reluctance to es-
tablish international banking standards during the negotiations of the Basel
Committee. Part 6 concludes.
2 Monetary Concerns: Luxembourg Looming

Germany, in line with other Group of Ten (G10) member countries, witnessed no major policy debates about the burgeoning Euromarkets until the late 1960s. The federal government indeed adopted a highly liberal regulatory approach that ruled out capital controls in principle. However, following a bout of market volatility and distrust in several major Western currencies such as sterling or the US dollar, the Bundesbank began to castigate the Euromarkets as a “monetary subsidiary government” \((\text{monetäre Nebenregierung})\). The German central bank was adamant that the Deutsche Mark (DM) should under no circumstances become an international investment and reserve currency, fretting that such a status would entail unprecedented obligations and burdens. As a prospective international lender of last resort, the German central bank might then be expected to backstop and restabilise the international financial system. In response, the Bundesbank embraced tight credit and liquidity policies (such as high minimum reserves).

But these efforts were frustrated, given the Bundesbank’s inability to access (and control) the growing Euro-DM money supply held off-shore. Conversely, domestic monetary tightening was the main reason why German banks sought access to off-shore Euromarket centres to engage in regulatory arbitrage, mainly in Luxembourg. Here, minimum reserves had been completely abolished in 1967, in addition to various tax advantages compared to the Federal Republic. German banks were thus able to fund themselves more cheaply in Luxembourg and gain greater leeway for their lending conditions, treasury, and liability management. That practice, however, was increasingly taking its toll on German domestic credit control.

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24 The G10 were formed in 1962 when the General Agreements to Borrow (GAB) were established. They included Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. In 1964, Switzerland joined the group as an eleventh member, though the name G10 remained.


In September 1972, Bundesbank director Helmut Schlesinger informed his board colleagues that the number of Luxembourg subsidiaries and their business volume had “skyrocketed”, with the Bundesbank facing a severe loss of oversight. The Bundesbank felt thus forced to order all Luxembourg subsidiaries in which German banks had a majority interest to henceforth submit monthly balance sheet data. The decision was fiercely contested, however, given that it was especially pertinent to the big banks and WestLB. Luxembourg officials were alarmed, too. Press reports even raised memories of a troubled war-ridden past, as the Bundesbank blueprint was perceived as an encroachment on Luxembourg sovereignty. Whereas the Luxembourg banking commissioner Albert Dondelinger and the German commercial banks merely offered to provide information on the total size (or so-called global data) of all German banking activities in Luxembourg, the Bundesbank insisted on receiving detailed individual reports. Dondelinger at first signalled cooperation. Joint efforts between Germany and Luxembourg, he said, were a necessity as a result of European economic and monetary integration. Soon, however, he began to argue that Luxembourg rules on banking secrecy constrained the reporting of data to parent banks, i.e., those German banks holding a majority stake in Luxembourg entities. Dondelinger’s argument clearly indicated a strong desire in Luxembourg to maintain regulatory advantages. Since the German banking subsidiaries represented a cornerstone of Luxembourg’s economic policymaking (and tax revenues), it was unthinkable to unnerve them.

Tensions escalated, however, as German authorities insisted that Luxembourg provide German bank data to German public bodies. Helmut Schmidt, the German finance minister, balked at the “uncontrolled practices” of the Luxembourg subsidiaries of German banks. Such conduct, Schmidt urged in February 1973, would demand a quick and thorough analysis by the German government and the central bank. Schlesinger was tasked with redoubling efforts to develop a common framework with Luxembourg regulators. Meanwhile, an infor-

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28 Central bank council minutes, 07.09.1972, Historical Archives of the Deutsche Bundesbank (HA BBk), B 330/6174/2.
30 Bundesbank directorate minutes, 28.03.1973, HA BBk, B 330/5800.
32 Central bank council minutes, 15.02.1973, HA BBk, B 330/6703/1.
33 Central bank council minutes, 01.02.1973, HA BBk, B 330/6702/1.
mal bargain was in the air: Franz Heinrich Ulrich, the head of Deutsche Bank, hinted that he “would be ready for any sort of Gentlemen’s Agreement”. Likewise, Dresdner Bank’s chief Jürgen Ponto was said to support the disclosure of data from Dresdner’s Luxembourg subsidiary “in a strictly confidential manner”. Yet Ponto would only provide such information as the head of the subsidiary’s board of directors, and not as an employee of the parent company. These were rather peculiar suggestions for solving major technical issues in cross-country financial regulation and corporate governance. They document that, in the 1970s, financial regulation in Germany was still perceived to rely on personal bonds and informal dealings between bankers and officials.

In the event, Dondelinger promised Schlesinger that he would engage in a “pragmatic and confidential collaboration” with German officials. The Luxembourg government finally relented in early April 1973, exacting concessions from all subsidiaries of German origin on the sharing of data. The deal represented a relative victory for German financial and monetary policymakers: Luxembourg subsidiaries of German origin would submit detailed balance sheet data to their parent institutions, which would then transfer such data to the Bundesbank. Crucially, because this scheme was meant to protect Germany’s balance of payments, it would only include ongoing business between Luxembourg residents and residents domiciled in Germany. In consequence, the business between the Luxembourg subsidiaries of German banks and their foreign clients (e.g., the operations of a US company residing outside Germany) or non-resident entities (other off-shore banks or non-bank financial holdings in Luxembourg or elsewhere) would be exempt from the stipulations. Most importantly, the Luxembourg subsidiaries were committed to this code for “general monetary policy purposes”, the Bundesbank stressed.

By contrast, direct banking supervision to contain credit risk only played a minor role. The new scheme was moreover embedded in the debate on how to rein in Euromarket growth, which some authorities (especially in the Bundesbank) believed was a consequence of loose policies. Other European countries such as France and the UK also put pressure on Luxembourg to better regulate its burgeoning financial marketplace. But their primary concern was that Lux-

34 Quotes in central bank council meeting verbatim protocol, pp. 9-10, 01.02.1973, HA BBk, B 330/6702/1.
35 Quote in central bank council minutes, 12.04.1973, HA BBk, B 330/6705/1.
36 Bundesbank directorate minutes, 10.04.1973, HA BBk, B 330/5800.
embourg’s financial centre would take a bigger share in the Eurodollar market at the expense of Paris and London.  

Therefore, the German initiative was specifically motivated by domestic monetary considerations and not EEC-wide prudential concerns.

The 1973 agreement allowed a papering over of underlying frictions because it internalised a conflict between regulators and bankers through pragmatism. While perhaps imperfect, it served to accommodate the pressing needs of officials without putting German off-shore banking entities at a competitive disadvantage against foreign houses. But for the same reason, the conflict was not solved for good, and debates over more widespread monitoring would re-emerge by the late 1970s.

3 Prudential Concerns: Contours of Consolidation

Until 1973 German regulators were primarily concerned with monetary stability. Shortcomings of banking stability and prudential supervision first became apparent as a result of the petrodollar recycling that followed the oil price crisis in 1973, as well as the Herstatt bankruptcy in the summer of 1974. In the aftermath of Herstatt, Germany’s new chancellor Helmut Schmidt (1974-1982) reinforced his commitment to the governance of global capitalism. Schmidt clearly stood out in the international debate. He advocated greater global transparency (including the publication of detailed banking statistics) and called for common international principles in banking supervision.

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38 Memo by Vo 422 (Hartenstein), Luxemburg als Finanzzentrum (Entwicklung, Verwaltung und Organisation), 09.05.1973, HA BBk, B 330/27118.
39 The implications of Herstatt’s fraudulent exchange rate dealing for German banking supervision are not examined here because they are covered elsewhere, see Schenk, Summer in the City; E. Mourlon-Druol, “Trust is Good, Control is Better”: The 1974 Herstatt Bank Crisis and its Implications for International Regulatory Reform, in: Business History 57, 2015, pp. 311-334.
Similarly, the Bundesbank urged restraint in central bank support operations, putting the primary responsibility for Eurobanks on their host countries. In September 1974, the G10 governors in Basle – in a deliberately vague statement on the Euromarkets – recognised “that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary.” For German central bank officials, that statement was only meant to accommodate the liquidity needs of markets in general. It did not indicate any intention to intervene in the event of liquidity or even solvency problems of individual financial institutions. To Otmar Emminger, the Bundesbank’s vice president (1970-1977), any neglect of prudent banking standards ruled out central bank support for banks in difficulties, and he felt this message had been effectively imparted to all international lenders. Further, the Bundesbank eschewed ultimate responsibility for banking entities of German origin that were operating in foreign jurisdictions. German commercial banks were forced to develop a cautious approach to Euromarket operations given the unambiguous communication of the Bundesbank. They could not expect any backstop or bailouts for reckless behaviour.

Among German regulators, there seemed to be no acute need for stricter Euromarket regulation. At the beginning of 1975, a high-level working group of representatives from the finance ministry, the Bundesbank, and the BAKred called on Helmut Schmidt to refrain from reiterating his public criticism of the Euromarket. They pointed to (1) the “obvious hopelessness” of such efforts, (2) the generally positive assessment of the Euromarkets by deficit countries, and (3) the much more cautious business policy of the banks after the Herstatt crisis. By

43 Quoted in Goodhart, Basel Committee, p. 40.
44 Memo by Hans W. Gerhard to the Managing Director and deputy Managing Director, International Banking – Staff Visit to Europe, 09.04.1976, International Monetary Fund Archives, European Department-EURAI Subject Files Box 70.
45 Memo by Klein (I24) for Emminger, Verantwortung der Notenbanken für die an den Euromärkten operierenden Auslandstöchter und -filialen einheimischer Banken, 14.06.1977, HA BBk, N 2/1058.
46 Memo by B10 (Bundesbank), Probleme des Euromarktes, hier: Deutsche Haltung gegenüber Maßnahmen und Institutionen zur Absicherung des Euromarktes im internationalen Bereich,
the mid-1970s, the Bundesbank and the German government were agreed that
the Euromarkets had, on balance, proved beneficial.

The German discussion on international banking supervisory issues regained
momentum from summer 1977, following a phase of rapid growth in German for-
eign subsidiaries. Once again, Luxembourg, which proved to be largely unco-
operative, came under scrutiny. In response to fresh requirements from the
Bank of England in late 1974, German banks using the Euromarket had succes-
sively issued letters of comfort for their overseas subsidiaries or pledged to vouch
for them in an emergency.\(^{47}\) But, as Deutsche Bank’s Wilfried Guth emphasised,
these were only moral commitments, with no direct effects on bank balance
sheets.\(^{48}\) Ironically, the self-commitment of the parent institutions even com-
pounded the challenges for German supervisors. Audit reports comparable to the
requirements of the German banking legislation did not exist in Luxembourg. Yet
in the case of solvency controls, the BAKred argued that the Basel Concordat of
1975 – though legally non-binding – stated that “parent authorities must take
account of the exposure of their domestic banks’ foreign subsidiaries […] because
of those parent banks’ moral commitments to those foreign establishments.”\(^ {49}\)

Furthermore, it was unclear to what extent Principle I of the German Banking
Act (KWG) would be undermined through Luxembourg, that is, if German banks
actually exceeded the legal lending limit of 18 times their own funds. Banking
supervisors cautioned that German lenders were using the same capital several
times, building so-called equity capital pyramids. Monitoring capital adequacy
was unviable, since the German Banking Act applied only to German parent
institutions, but not their independent overseas entities.\(^ {50}\) The latter indeed
tended to be undercapitalised: as the German finance minister Hans Apel was
warned in early November 1977, loans extended by Deutsche Bank’s Luxembourg
subsidiary in 1976-1977 amounted to 40 times its capital, while Bayerische
Landesbank or Bayerische Vereinsbank had issued loans worth 25 times its capi-

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02.04.1975, HA BBk, N 2/1056; Müller-Uri (BMF Referat VII A1), Besprechung am 26.03.1975
47 Controlling the euro-markets, Bank of England Quarterly Bulletin, 01.03.1976, pp. 74-77, here:
p. 75; “Growing supervision by central banks”, Financial Times, 08.03.1976; Schenk, Summer in
the City, p. 1149.
48 Bankenverband, Niederschrift über die Sitzung des Ausschusses für Fragen der Außenwirt-
schaft und der Europäischen Gemeinschaften, p. 3, 25.01.1975, Historical Archives of Deutsche
Bank (HADB), V25/x307.
49 Goodhart, Basel Committee, p. 117.
50 Memo by Knapp (VII B 1), Euro-Markt und Bankenaufsicht, 18.04.1978, German Federal
Archives/Bundesarchiv (BArch), B 126/70502.
tal. In practice, therefore, German banking supervision was only “fully effective” for those banks without subsidiaries in Luxembourg. German regulators discussed three theoretical options to respond:

1. bilateral agreements with Luxembourg, new laws in the Federal Republic, or regulations by the EEC;
2. regulations on a voluntary basis adopted by German credit institutions;
3. (domestic) restrictions that only the Bundesbank could impose.

The first option was discarded for political reasons. No short-term change seemed feasible. Alterations to Luxembourg law were unlikely thanks to Luxembourg’s fiscal reliance on the finance industry and its goodwill. The EEC, meanwhile, had reached a political impasse. Unlike Germany, most member states, especially the UK, were indifferent to their currency’s use for Euro-transactions. In addition, a swift revision of the German Banking Act (KWG) looked unworkable in the near future. Despite Helmut Schmidt’s persistent grievances against the Euro-markets, the archive record suggests that the finance ministry was not pushing the item to the top of the legislative agenda. In mid-December 1977, finance state secretary Manfred Lahnstein (who reported directly to the finance minister) told F. Wilhelm Christians and Helmuth Cammann (the president and the general secretary of the association of German private-sector banks, Bankenverband, respectively) that formal supervision of the foreign subsidiaries was unlikely to materialise. In particular, Lahnstein was doubtful that “such a difficult set of issues” lent itself to statutory regulation at all. Instead, Lahnstein and his staff sought to devise a fresh informal gentlemen’s agreement from the very outset. The objective was to ensure that the Luxembourg subsidiaries at least broadly observed German lending standards. Lahnstein also hoped to avoid any diplomatic rows with Luxembourg that might result from formal legislation.

51 Memo by Gamerdinger (VII A 1) for the finance minister, Bedeutung des internationalen Finanzplatzes Luxemburg, p. 8, 02.11.1977, BArch, B 126/70502.
52 Memo by B22, Gründe für die Errichtung von Töchtern deutscher Kreditinstitute in Luxemburg und hieraus resultierende Probleme, p. 15, 23.08.1977, HA BBk, B 330/9075/2.
53 Memo by Gamerdinger (VII A 1) for the finance minister, Bedeutung des internationalen Finanzplatzes Luxemburg, p. 11, 02.11.1977, BArch, B 126/70502.
56 Memo by Knapp (Referat VII B1), Gentlemen’s Agreement, Bezug: Besprechung bei StS Lahnstein am 16.08.1978, BArch, B 126/70502.
The second option (a voluntary agreement) depended on the willingness of German financial institutions to cooperate. Yet the banks cited Luxembourg’s strict banking secrecy as an obstacle to disclosing local business data to the Bundesbank. The Bundesbank officials felt that this was a disingenuous argument. After all, banking secrecy in the Federal Republic itself was affected given the corporate structures of the banks. Technically, the governance structure of the banks did in fact allow disclosing data to the German authorities.

As a third option (strict domestic restrictions), the Bundesbank envisaged the possibility of no longer discounting bills of exchange, or of recommending that the BAKred create “negative special ratios” for Principle I. In other words, the authorities considered imposing heavy sanctions on the banks. The Bundesbank wished to receive constant notifications (preferably monthly) about the complete status of the foreign offices. While a multilateral solution was considered desirable (though unattainable), the German central bank favoured “voluntary agreements” (the second option) with the leading associations of the banking industry. Alternatively, to increase pressure on the banks, the Bundesbank leaders threatened a much tighter KWG.57

Meanwhile, Inge Lore Bähre, the charismatic BAKred president (1975–1984), pondered new legal foundations to gain access to the material requested from the Luxembourg subsidiaries.58 She hoped that the technique of balance sheet consolidation in particular would provide supervisors with a comprehensive picture of a bank’s worldwide business and risk exposure.59 But the Bundesbank’s goal to (partially) amend the KWG as quickly as possible could not be realised, Lahnstein and Bähre said in early 1978. A swift consolidation was off the cards.60 One reason was certainly that German discussions were superseded by simultaneous progress at the Basel Committee, which since 1974-75 had been headquartered at the Bank for International Settlements (BIS) in Basel. It served as a forum for G10 members to address banking supervisory matters. Beginning in October 1977, discussions in Basel on how to mitigate fallouts from equity capi-

57 Central bank council minutes, 17.11.1977, HA BBk, B 330/9075/2. The suggestion for a voluntary agreement came from Claus Köhler, a Bundesbank director.
tal pyramids were re-invigorated by Dutch initiatives, resulting in two reports for central bank governors in September 1978 and March 1979 that advocated consolidation as soon as possible.  

Finally, the private-sector banks relented. As part of their concessions, they agreed to devise a common formula that would help analyse the Luxembourg data, though under the proviso that this came without additional costs. Importantly, Christians even somewhat opened the door to future consolidation, provided that this did not entail producing aggregate balance sheet items. In other words, the numbers should not just be added up. Christians stressed that such balance sheet data should not serve consolidation purposes. Moreover, applying German domestic rules on capital and liquidity to Luxembourg entities was “unacceptable”, regardless of the consolidation or further separation of balance sheets. In the end, such concerns were assuaged by the Bundesbank’s reassurance that it would take a predominantly monetary policy view.

The German bank representatives, meanwhile, were surprised by the ambivalent behaviour of Luxembourg. While the Grand Duchy insisted on banking secrecy and sovereignty, it looked in principle “positively disposed towards far-reaching supervision” by the BAKred. Given these developments, the German private commercial banks by July 1978 concluded that a gentlemen’s agreement with the BAKred was “inevitable”. It soon became clear that the new agreement was not meant to materialise through a “contract” to be signed by all parties (the BAKred, the Bundesbank, and the three banking associations). Instead, the associations were to declare their approval while keeping the matter strictly confidential.

In early December 1978, following several months of negotiations, the final version of the gentlemen’s agreement was drawn up. In the future, the German parent institutions would submit audit reports to the BAKred and the Bundes-

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62 Memo by B, Aktivitäten deutscher Banken in Luxemburg, pp. 3-4, 10.04.1978, BArch, B 126/70502; quote in Köhler/Bürger (Direktorium Bundesbank) to the finance ministry, Aktivitäten deutscher Banken in Luxemburg, 18.04.1978, ibid.
64 Knapp to Lahnstein, Euro-Marktgeschäfte deutscher Kreditinstitute über Töchter in Luxemburg, hier: Angestrebtes Gentlemen’s Agreement zwischen BAKred und Verbänden, 13.06.1978, BArch, B 126/70502.
bank on those foreign institutions in which the parent banks held a stake of more than 50 percent, i.e. those which they effectively controlled. Information on single borrowers was to be redacted or encrypted. A consolidation of bank balance sheets was off the table for the time being, however. The latter marked a partial victory for the private-sector banks which, particularly for competition reasons, had strongly opposed consolidation. The Bundesbank, considering its demands for permanent reporting of monthly or quarterly data as well as balance sheet consolidation, emerged as the relative loser from the negotiations. It considered the agreement merely “a first step”.66

From autumn 1978 the Bundesbank again sought to address consolidation in the domestic discussions, but also in international fora. Amongst international (especially European) regulators, the trend towards consolidation accelerated, with the most important BIS reporting countries beginning to create legal bases for obtaining consolidated balance sheets from their home banks. Germany was a latecomer here, in spite of all the Euromarket criticism it had voiced in the past.67 There was consensus between the Federal Government and the Bundesbank that the experience with the gentlemen’s agreement should first be evaluated before discussing the details of any amendment to the German Banking Act (KWG). Tackling consolidation “as a matter of urgency” and not just in the new legislative period (beginning in autumn 1980) now became the unanimous aim of the German authorities, although the Länder central banks and the finance ministry were still bickering over the time schedule.68 The report of a study commission (also named the Gessler commission) “Fundamental Questions of the Banking Industry” (Grundsatzfragen der Kreditwirtschaft), published in May 1979, already advocated quota consolidation. This was to rule out the possibility of parent institutions using the same equity capital more than once through their

66 Memo by B10 (Bundesbank), Konsolidierung als Mittel der Bankenaufsicht, p. 2, 15.01.1979, BArch, B 136/11546.
67 Letter from the Bundesbank to Matthöfer, Konsolidierte Rechnungslegung deutscher Kreditinstitute, 03.07.1979, HA BBk, N 2/1062; Drach, Globalization Laboratory, pp. 664-666.
68 Central bank council minutes, 09.08.1979, HA BBk, B 330/10143; Wertz to Köhler, Novellierung des Gesetzes über das Kreditwesen, 05.07.1979, HA BBk, B 330/10143; Assmann (i.V.) to Matthöfer, Konsolidierte Rechnungslegung deutscher Kreditinstitute, 01.02.1980, BArch, B 136/11547.
For other G10 countries, meanwhile, it was staggering to hear Emminger lamenting the “relative powerlessness” of the Bundesbank when it came to supervising the Luxembourg subsidiaries. Foreign observers were further surprised to see that the Gessler commission sidestepped an issue as pressing as the pace of international German bank expansion and the role German authorities should play in oversight.

The 1978 gentlemen’s agreement, while certainly a makeshift solution, underscored the prevalence of liberal thinking in German bank regulation. It was, after all, based on a high level of mutual trust between German regulators and regulated parties. The agreement corresponded to a concept of conditioned self-regulation that echoed earlier instances of cooperation. Even so, the 1978 agreement also coincided with the beginning of greater formalisation of international banking supervision. The German commercial banks were indeed aware that they could not escape more statutory control in the long run. From 1979 German banks felt pressured into disclosing ever more detailed figures in ever shorter time intervals.

Clearly, regulatory discussions in Germany and elsewhere were often caught in a “trade-off between enforcing national supervisory measures at the worldwide level and maintaining domestic banks on a competitive footing.” German authorities indeed became wary of weakening their home banks by imposing ever more requirements on their international business. Likewise, the Bankenverband warned that “over-zealous efforts to supervise the Euromarkets” posed a threat to West German exports and jobs and hindered the recycling of the surplus funds of oil producers. The perception that German banks should be able to compete internationally may thus have informed Germany regulatory restraint, in spite of a palpable rhetoric of restriction.

A further complication was that banking regulation in Germany was divided between the BAKred and the Bundesbank: The BAKred only saw itself as responsible for individual institutions and their risks, especially credit risks (creditworthiness, etc.). Market risks or systemic issues were dealt with by the Bun-

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70 Quote in central bank council minutes, 15.02.1979, HA BBk, B 330/9660/2.
71 “Panic over”, The Economist, 26.05.1979, p. 82.
73 Pecchioli, Internationalisation, p. 111.
desbank. The Bundesbank was essentially concerned with obtaining more and better data in order to pursue its credit policy. These different remits prevented a more uniform approach and coherent strategy in international fora. In consequence, Germany lagged behind other countries with regard to the harmonisation of banking law, particularly in the EC, and the setting of global banking standards from the late 1970s.  

As a case in point, a highly self-critical internal Bundesbank briefing from February 1980 noted that “despite all efforts of the Bundesbank and benevolent declarations of intent by the Federal Minister of Finance, the Federal Republic is one of the few countries in which the desired improvement of international banking supervision is currently not making any progress”. Before the end of 1981, it was highly unlikely that the “extremely poor transparency” of the foreign subsidiaries of German parents would substantially improve. Likewise, prospects for consolidated balance sheets and group-wide supervision to be applied across entire banking groups were very remote, barring a catastrophe that might prompt adjustments in supervision and spur legal changes. In bilateral discussions, too, Germany’s foreign partners were hinting at such shortcomings. It thus became necessary to resolve these issues first before engaging in ever more ambitious projects.  

Even so, Bundesbank president Karl Otto Pöhl reassured chancellor Helmut Schmidt in March 1980 that the Bundesbank was making headway with the introduction of consolidated monthly statements for German banking concerns. Although Pöhl argued that such regulations were a prerequisite for proper financial regulation and sound international banking, he pointed out that national measures would only help to a limited extent. Pöhl highlighted the necessity for internationally active German banks. Uncoordinated measures would by contrast lead to distortions of international competition. Schmidt suggested discussing persistent credit risks, the necessity to rein in international credit expansion, and the “lender of last resort” problem among the G7. Schmidt’s persistent concern

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77 Letter from Pöhl to Schmidt, 03.03.1980, and Annex Bessere Kontrolle der Euromärkte, BArch, B 136/11548.
was based on his impression of how badly international authorities handled the Euromarket, and he was privately irritated that they had “not lived up to their responsibility to ensure the functioning and security of global capital markets”.79

Urging the Bundesbank leadership and the finance ministry to take action, Schmidt expressed his unease at incalculable credit risks, lax balance of payments practices and the undermining of national monetary policy.80

The G10 governors indeed concluded in April 1980 that international banking should be monitored more systematically. This further galvanised talks on bank balance sheet consolidation.81 Before the onset of the debt crises in Poland (1981) and Mexico (1982), however, the Basel Committee proved unable to close the gaps in statistical information, to reconcile macro- and microeconomic issues in banking or to dampen the growth of international bank credits.82 Meanwhile, the German banks hoped for a drawn-out domestic solution that would give them plenty of time to phase in new directives on consolidation.

Following informal exploratory talks that began in 1980, German private-sector banks finally concluded a new gentlemen’s agreement on consolidation with the BAKred in late summer 1981. The agreement was supposed to bridge the gap until the KWG could be overhauled, with first drafts being expected by late 1982. Importantly, the banks acknowledged that consolidation would bring about more transparency. But they were concerned about losing competitiveness relative to foreign banks should strict domestic German capital and liquidity ratios be applied to consolidated group balance sheets. The banks nevertheless agreed to provide consolidated quarterly data to the BAKred and the Bundesbank from September 1981, though only for foreign entities which they fully owned or for which they could claim close to 100 percent ownership.83 Mean-

79 Memo by the federal chancellery, Kurzprotokoll über die 7. Sitzung des Kabinettsausschusses für Wirtschaft (geheim), 25.01.1980, HA BBk, N 4/1.
80 Memo by Schulmann, Gespräch des Bundeskanzlers BM Matthöfer und Präsident Emminger über Fragen der Xenowährungsmärkte am 5.02.1979, 07.02.1979, BArch, B 126/70322.
81 Pecchioli, Internationalisation, p. 117. On the emergence of consolidation see Goodhart, Basel Committee, pp. 100-103; Drach, Liberté Surveillée, pp. 70-78.
82 Drach, Liberté Surveillée, pp. 163-193.
while, they pushed back against Bähre’s wish to include minority holdings of 25 percent. Wilfried Guth (Deutsche Bank) explicitly warned authorities that the banks' goodwill “should not be spoiled through dogmatic regulations that would be evaded anyway”. Deutsche Bank, though welcoming consolidated balance sheets in principle, said that full consolidation meant its group capital would shrink from nearly DM 8.5 billion to just over DM 6.5 billion, implying the need to raise equity or reduce lending once the new rules were in place. German legislation was nevertheless spurred by the revised Basel Concordat in June 1983 and the new consolidation guidelines of the EC decreed the same month.

In addition to pressure from international standard-setters, the near-collapse of the Hamburg-based private bank Schröder, Münchmeyer, Hengst & Co. (SMH) in early November 1983 further speeded the KWG amendment. With just DM 110 million in equity, SMH had used its domestic parent company and its Luxembourg subsidiary to lend DM 900 million to the construction equipment group IBH. Under existing German bank law, SMH would have been allowed to lend 75 percent (instead of 8 times) of its capital to IBH. While Luxembourg indeed proved a loophole, the incident also demonstrates how German regulators failed to notice that SMH had over-extended itself, despite the transparency that had been achieved since the 1981 gentlemen’s agreement. SMH’s “partially incomplete and misleading” reporting practices left the Bundesbank with few rescue options, the central bank noted internally. Given such fraudulent or unsound practices, there was at least some truth to the Bankenverband’s argument that SMH was an “isolated” case that did not justify far-reaching legal changes. SMH was finally rescued by other banks (including the British bank Lloyds) and through the German private banks’ deposit insurance fund, thus mitigating repercussions on the interbank market.

As the KWG amendment was finalised in November 1984, the BAKred was indeed told by finance state secretary and German G7 sherpa Hans Tietmeyer that the supervisory office should show “flexible behaviour” during the transition...
period before full consolidation would be phased in by the late 1980s.\textsuperscript{90} Consolidation would be required for all subsidiaries in which German banks held a stake of more than 40 percent, in addition to fresh capital rules governing the extension of large credits to a single customer. The Bundesbank was happy to declare that the “liberal approach” of the KWG would be retained, which simply provided a general framework and held bank managements accountable in the first instance.\textsuperscript{91} To illustrate the special meaning of accountability to German actors, the next section details Germany’s approach and practices to deal with problem foreign loans. Such loans posed the biggest risks during the Eastern European and Latin American debt crises of the 1980s.

4 Accounting, Audit, and Accountability

While aggressiveness was the order of the day in the 1970s, German banks cut back on international lending in the early 1980s, with Deutsche Bank leading the pack.\textsuperscript{92} German banks were comparatively little affected by the Eastern European and Latin American debt crises. While they had a disproportionately large exposure to Poland relative to other OECD banks, their risks in Mexico, Brazil or Argentina were quite low. Of all claims of BIS reporting banks on the 25 largest debtor countries (USD 400 billion), German financial institutions accounted for just USD 35 billion or up to 9 percent by 1984. And some 40 percent of these claims were covered by government guarantees, the \textit{Wall Street Journal} reported.\textsuperscript{93} By and large, German banks were in a solid position, with far lower financial risk in Latin America than US banks, which had loaned several times their own funds. Deutsche Bank, as the German market leader, had made excellent risk provisions, with the exposure to its six most vulnerable debtor countries amounting to 75 percent of its equity. By contrast, the exposure of the

\begin{itemize}
  \item \textsuperscript{90} BMF VII B 1, Gespräch M mit führenden Vertretern der deutschen Kreditwirtschaft am 22.11.1984 („Bristol-Gespräch“), p. 3, 26.11.1984, BArch, B 126/123843.
  \item \textsuperscript{91} Deutsche Bundesbank, Geschäftsbericht 1984, p. 85.
  \item \textsuperscript{92} P.A. Wellons, Passing the Buck. Banks, Governments and Third World Debt, Boston/Mass. 1987, pp. 189-196.
\end{itemize}
ten major US banks to their six most critical debtor countries averaged 169 per-
cent of their capital.94

Figure 1 below shows the unguaranteed exposure to Poland of select Ger-
man banks on the eve of the Polish crisis in 1981. Deutsche Bank was the most
stable of these, with an unguaranteed exposure of 11 percent of its equity. In
contrast, public banks like Hessische Landesbank/Helaba (20 percent) or Bank
für Gemeinwirtschaft (45 percent), but also Commerzbank (25 percent) faced
seeing a substantial portion of their capital being wiped out, also because their
risk provisioning (thanks to dismal profits in the early 1980s) was far worse than
Deutsche Bank’s.

Fig. 1: Selected German banks’ total unguaranteed exposure to Poland in DM million (bars, left-
hand-side axis) and as a share of bank capital (line, right-hand-side axis), June 1981. Source:

The figures illustrate that despite the relative stability of German banks, they
were still faced with a substantial amount of problem foreign loans. For banks,

94 K. Lissakers, Banks, Borrowers, and the Establishment. A Revisionist Account of the Inter-
national Debt Crisis, New York 1991, pp. 212-213; A. Nützenadel, Between State and Market, in:
W. Plump/ A. Nützenadel/ C.R. Schenk, Deutsche Bank. The Global Hausbank 1870-2020, Lon-
don 2020, pp. 212-459, pp. 509-516; Direktorensitzung: Verschuldungskrise – Internationales
Geschäft, p. 5, 30.03.1983, HADB, V25/x769.
there were theoretically three options on the table to deal with the debt crisis. They could lend more to borrowers (fresh money approach); they could swap debt to equity; or they could recognise more provisions and take larger write-downs. German banks clearly favoured the last option because provisions against possible non-payment were in part tax-deductible, following an extensive German policy debate since the mid-1970s.95

A key early tool under discussion to mitigate negative repercussions from losses in foreign lending were so called Sammelwertberichtigungen (SWB) or overall valuation allowances made by banks. Such allowances were meant to cover prospective latent risks in foreign loans. Rather than addressing past credit losses, they were to protect against future defaults, stretching beyond individual credit risks (which were covered by individual valuation allowances, Einzelwertberichtigungen).96 A lingering issue since the late 1970s was whether such SWB should be recognised for tax purposes. The tax division within the finance ministry rebuffed suggestions to revise the SWB scheme because such changes would lower the tax burden of banks, despite them already being able to claim plenty of other allowances. In contrast, the ministry’s money and credit division (Abteilung Geld und Kredit) was strongly in favour of expanding the scheme to help banks bolster their balance sheets. The BAKred and Inge Lore Bähre in particular supported the idea as well.

A specifically pressing issue was whether country risks should be included in the scheme. The Bankenverband lobbied heavily for widening the scope, with Klaus Mertin, head of accounting on Deutsche Bank’s board, promoting the idea in public.97 Understandably, Deutsche Bank had an interest in gaining recognition for its newly developed country risk management system. Bähre, citing a threefold rise of foreign loans by German banks between 1974 and 1977, welcomed Mertin’s idea in 1978.98 Yet an official appeal from the Bankenverband in autumn 1978 was rejected by policymakers thanks to an impasse between tax and supervisory authorities inside the finance ministry. Finance state secretary Manfred Lahnstein opted to procrastinate, not least because he surmised that a wider SWB scope might be part of a new package to control the Euromarkets in

97 K. Mertin, Bewertung von Auslandsrisiken, Zeitschrift für das gesamte Kreditwesen, 01.02.1978, pp. 100-104.
98 Wichert to Lahnstein, Sammelwertberichtigungen in den Bilanzen der Kreditinstitute, 21.06.1978, including several annexes, BArch, B 126/81063.
future legislation or a revamped banking act (KWG). Furthermore, drawing up official lists of “good and bad debtor countries cannot be done for political reasons”, Lahnstein was warned by his staff.

The issue was hence put on hold for another three years before Bundesbank officials raised it again in early June 1981. Total foreign lending by German banks, they said, was “a growing concern” owing to estimates that their foreign business (including subsidiaries) accounted for a fifth of total credit volume. The BAKred had requested the Institute of Public Auditors (Institut der Wirtschaftsprüfer) in January 1980 to delineate in their reports the scale of country risks and risk management tools used by the German finance industry. In contrast to foreign supervisory offices, the BAKred was merely entitled – but not obliged – to monitor the country risks of German financial institutions. In collaboration with the banks, the auditors reviewed bank country risk management models when they examined and audited year-end results. But since the country risk management systems varied considerably across all German banks it was unclear how such systems informed actual lending decisions. Quantifying the risks was equally difficult. For the auditors, it proved indeed challenging to give clean audit opinions when they felt unable to oversee country risks based on the information provided by the banks. Yet questioning bank financial statements by pointing to inadequate risk management would, on the other hand, have damaged the (public) standing of the banks, Inge Lore Bähre feared. Finding a solution was critical.

By late 1981, early 1982, Bähre was massively concerned about the increase in country risks. To her, it was “untenable” that loans extended to foreign public borrowers were still not part of the SWB scheme (i.e., implying they were risk-free). She therefore doubled down and solicited support from the finance ministry to rethink the negative decision from 1978. The core argument Bähre put forward was that adequate risk provisions “would, in the end, be cheaper than using budget funds for support measures”. Bähre played down potential tax privileges for the banks, arguing that more provisioning was indeed “in the

99 Memo by Knapp (VII B1) for Minister Matthey, Bildung von Sammelwertberichtigungen für Auslandsrisiken, 30.11.1978, BArch, B 126/81063.
101 Memo by Kaulbach (BMF VII B 1) to state secretary Schulmann, Länderrisiko, 23.07.1982, BArch, B 136/22766.
102 Memo by B11, Länderrisiken, 26.05.1981, forwarded by Köhler and Bauer to the boards of Länder central banks on 09.06.1981, BArch, B 126/81058.
interest of the wider economy”. Her warnings should also be seen against the backdrop of bank resolution in Germany more widely. A working party of the finance ministry warned in January 1982 that Germany lacked a proper bank resolution mechanism that would avoid wide-spread repercussions on the German financial system. In turn, pre-emptive action and provisioning seemed most advisable.

Importantly, though, it was stressed that country risks did not qualify as credit risks. In other words, a new risk category (country risk) developed by the banks themselves troubled policymakers who could not yet agree on a definite regulatory response. Country risks in particular encompassed political risks or transfer risks which were not dealt with directly in the KWG. The KWG merely addressed risk dispersion. Unchartered regulatory territory made it more difficult for policymakers to agree on a metric. Right as the Mexican crisis unfolded in September 1982, the money and credit department argued that SWB in essence amounted to “necessary value adjustments to claims”, with the aim to cover “latent, but actually existing risks”.

In the event, a ruling by a fiscal court in Kassel (Hesse) removed the obstacle. As a trailblazer, the German subsidiary of the National Bank of Detroit had earmarked doubtful Polish loans to be value-adjusted by 50 percent. The local tax authorities in Frankfurt refused to allow such practices at first. The fiscal court eventually ruled that such adjustments were indeed permissible, however. German supervisors welcomed the decision, on the argument that, following rescheduling agreements with Western creditor banks, Poland would defer principal payments on 95 percent of the debt due in 1982 by four years, with a portion of the interest payments also being delayed until 1983.

By December 1982, the finance ministry, the BAKred, and the Bundesbank had agreed on guidelines and criteria that allowed creditor banks to adjust the value of problem country loans. A major problem emerging in country risk assessment was transfer risk, and the German finance ministry accepted that this entailed granting banks some leeway in their adjustments. But although senior policymakers were agreed that German banks should enjoy relative freedom when handling distressed loans, the tax authorities grew more exercised over lax practices in the banking industry. It was felt that the banks exploited the wiggle room they were given, since value adjustments for Polish loans ranged between 6 and 75 percent by summer 1983. This created the impression that, for most banks recognising provisions, financial performance and their tax situation mattered first, and not the value of specific claims on countries on their balance sheets.

In any event, the federal finance ministry advised Länder tax authorities in December 1983 that Polish loans could be adjusted in value by up to 50 percent, thus cementing the practice of most banks since 1982. Similarly, it did not object to adjustments of between 30 and 40 percent on loans to other problem borrowing countries such as Mexico, Brazil or Argentina. The practice was thus implicitly approved and became a cornerstone of liberal German bank balance sheet management throughout the 1980s. If a German bank established provisions, it would suspend tax payments on that amount. Such provisions would later either be used for actual write-downs or booked (and ultimately taxed) as an extraordinary profit. The German arrangement thus provided clear tax deferral benefits.

As German taxpayers rather than bank income statements bore the burden, the lenders enjoyed favourable ratings from rating agencies (which in turn lowered bank funding costs). A seminal OECD study rightly stressed the increasing importance of provisioning policies in the 1980s and their implications for a bank’s standing in the marketplace. The archival record suggests that the Bundesbank welcomed the practice of socialising losses from international lending when comparing German banks to their US peers in particular. In contrast to Germany, additional reserves in the US were often taken from taxed income or

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111 Letter by Tietmeyer to Köhler, 10.03.1983, BArch, B 126/324442.
112 Finanzamt Frankfurt am Main-Börse to Oberfinanzdirektion, Wertberichtigung bei Auslandskrediten, 12.07.1983, BArch, B 126/324442.
114 Pecchioli, Supervision, pp. 111-112.
post-tax earnings. The same applied to Japanese banks. The Bundesbank leadership noted in May 1984 that US institutions would by contrast suffer if data on their problem loans, scale of provisioning, and capital base were exposed, since they had not yet taken many write-downs. US banks therefore sought to avoid a deterioration in the value of problem loans.115

It was thus not until May 1987 that Citicorp became the first US bank to substantially increase its reserve for possible loan losses in relation to the third world debt crisis, followed by Chase Manhattan and other large US banks.116 In effect, it took US banks five years from the beginnings of the debt crisis in 1982 to emulate the debt management practices of their German rivals.117 But even compared to rules in the UK, France, or Canada, the German approach proved highly flexible. It gave banks’ managements and their auditors exceptional freedom. And this was clearly built upon the mutual trust enshrined in the German financial system, reflecting the consensual tradition of Germany Inc (Deutschland AG).118

Also, unlike US commercial banks, hidden reserves allowed German universal banks to incur some inevitable losses and to take write-downs without visible dents to their balance sheets. German bank annual reports therefore remained “miracles of non-disclosure” throughout the 1980s, without truly reflecting profits (or losses) in proprietary trading or shareholdings.119 While the accounting technique of hidden reserves was also used in other banking systems (such as the Netherlands), the Bundesbank considered it a mainstay of German banking.120 There was indeed much truth to F. Wilhelm Christians’ remark in 1980 that the “secret reserves might be one of the most difficult things for us to give up.”121 This “active exploitation of hidden reserves”, Richard Dale observed, was “therefore

115 Central bank council minutes, 30.05.1984, HA BBk, B 330/12051/1.
120 Drach, Liberté Surveillée, p. 86.
closely linked to the German conception of universal banking”. Nevertheless, the European bank accounting directive of 1986 limited the use of such secret reserves, and their abolition could only be delayed until the early 1990s as support for their use dwindled.

5 From Gentlemen’s Agreements towards Global Standards

The previous sections showed that the notion of accountability was prevalent among German authorities. As the Latin American debt crisis struck in 1982, both the Bundesbank and the BAKred were agreed that German banks should not face an “over-reaction” from supervisors because that would harm their ability to provide fresh credit to borrowers in arrears. This implied drawing a fine line between support, guidance, and outright pressure. The Bundesbank declined to purchase any non-performing assets from banks in case of a deeper credit crisis, echoing its previous stance that Western central banks “should take care not to weaken the basic responsibility of commercial banks for their lending business”.

Conversely, the Bundesbank leadership was concerned that a general increase in (international) responsibilities for central banks (or the BIS, for that matter) would reinforce views amongst foreign colleagues (namely in the UK) that monetary authorities should widen the scope of their lender of last resort function. The monetary officials in Frankfurt instead took the view that the Basel Concordat of 1975 provided a suitable guideline for the regulation and supervision of international banking. This was because the Concordat called for national approaches, allowing for a monetary policy aimed at the domestic stability of the Deutsche Mark while giving the Bundesbank ample scope to

intervene whenever it thought appropriate. The Bundesbank was adamant that while the Concordat might be redesigned in a more precise fashion (“which in itself is unnecessary”), there should only be a review of its existing boundaries.

In November 1982, the Bundesbank forcefully reiterated that it would be “unacceptable” if the BIS (instead of the IMF) were thrust into the role of an “aid agency” to buy the distressed debt of a growing number of countries. This might affect central bank competencies and place central banks themselves as lenders of last resort “under an implicit or customary obligation to regulate risky exposures of the finance industry.”126 And indeed, “in particular at the request of the Bundesbank”, the revised Concordat of June 1983 did not touch upon lender of last resort functions.127

Meanwhile, the BAKred insisted that German banks disclose their country risks for 140 countries.128 The finance ministry found that Germany’s capacity to supervise its banks was “limited” given the lack of information on the exposure of foreign subsidiaries. German lenders should therefore redouble efforts to diversify risk and make more provisions, the finance ministry said, arguing for improved transparency and balance sheet consolidation. The consensus in Germany was that sovereign risk should not be limited by default. Rather, risk assessment and provisioning should remain entirely with the banks. Bank supervisors were only to check that banks’ internal auditing sufficed, that their loan portfolio was diversified, and that they were adding funds to provisions. This less intrusive view was also shared by the Basel Committee.129

Still, in order to expand the Gentlemen’s Agreement on consolidation in light of recent signs of increased sovereign risk, the BAKred urged the banks in September 1982 to “immediately” submit their consolidated volume of foreign credit broken down by debtor countries.130 Criticism was, moreover, raised by international regulators. Alexandre Lamfalussy, the assistant general manager of the BIS, complained that German banks lacked consolidated figures on sov-

126 Quotes in Bundesbank directorate minutes, 10.11.1982, HA BBk, B 330/11363.
128 Bundesbank directorate minutes, 06.10.1982, HA BBk, B 330/11362.
ereign risk. Gordon Richardson, the governor of the Bank of England, confided to the British chancellor Geoffrey Howe in December 1982 that, while central bank governors had long accepted the principle of consolidation, it was “particularly regrettable that Germany and Italy [had] failed to take the necessary action when the matter was first raised in the mid-1970s.” Whereas the Italians were now moving towards appropriate legislation, Germany stood out for its “lack of legal powers and its problems in obtaining them.” Clearly, the debt crisis had exposed German regulators’ tardiness in implementing formal accounting rules which met international standards.

Crucially, however, the Bundesbank noted that it was facing a dilemma over how to contain country risks using national measures while at the same time stabilising the international monetary system and securing cross-border payments. Prudential measures looked partly at odds with monetary concerns. In other words, the Bundesbank’s goal was now to realign international bank lending and capital flows with the necessity to reduce sovereign risk. Yet the roadmap would only prove workable if, as the IMF demanded, commercial banks were involved. In late November 1982, Claus Köhler, a Bundesbank director, drafted an agreement that set out the major elements of this strategy. The Bundesbank would, first, not interfere (kein Hineinreden) with the business policies of commercial banks. Second, the self-responsibility of the banks was to be maintained. Finally, concerning prudential supervision, the Bundesbank doubled down on the proposal to amend the KWG (consolidated balance sheets; see section 3). Importantly, the Bundesbank explicitly decided against assuming any “advisory role” for the banks. It would not tell them how to steer foreign lending or what level of impairments they should recognise for their loan books or new credits.

With the Bundesbank practising more lenience, Bundesbank president Karl Otto Pöhl (1980-1991) was increasingly annoyed by the BAKred, which he felt was throwing its weight around. Indeed, it appeared that the Bundesbank was siding with German banks. The Berlin supervisors meanwhile wanted to play hardball, increasing the formal power of their bureaucracy as they weathered the debt crisis. Scrutinising banks now became more of an issue in Germany as prudential concerns were heightened by banks that failed to make adequate provisions. In November 1982, for instance, BAKred officials asked Dresdner Bank to scrap its dividend payout for 1982 and instead add more funds to provisions.

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131 Bundesbank directorate minutes, 10.11.1982, HA BBk, B 330/11363.
133 Bundesbank directorate minutes, 01.12.1982, HA BBk, B 330/11363.
134 Central bank council minutes (verbatim protocol), p. 6, 06.01.1983, B 330/11601/1.
in a clear signal that regulators were dissatisfied with how Dresdner was managing country risks. This irritated the Dresdner management, who argued that each bank should manage risks free from regulatory intervention and also that it was necessary to keep credit lines open.\(^{135}\) The tussle over adequate provisions continued for several years as Dresdner failed to meet the requirements of German supervisors. By December 1983, the BAKred made clear that they still regarded Dresdner’s country risk provisions to be rather “modest”.\(^{136}\) With only DM 287 million in provisions to tackle sovereign risks at the end of 1983, Dresdner needed to close a gap of up to DM 213 million to reach the target of DM 500 million. Dresdner thus scrambled to relocate funds from various parts of its group. Even Commerzbank, while also beset by lousy profits in the early 1980s, was doing better.\(^{137}\)

The BAKred in 1984 decided to turn the screw on more sluggish banks such as Dresdner, confronting their inadequate provisions with average figures from better performing peers. Such reprimands emerged as a standard tactic for encouraging German banks to ramp up provisions.\(^{138}\) The urgency and “massive pressure” by Germany’s financial watchdog came as a surprise to the more permissive Bundesbank, however.\(^{139}\) Despite concerns in the central bank council that some lenders would stumble over higher refinancing costs or the need for additional capital, the BAKred initiative proved successful.\(^{140}\) Dresdner now made much more effort to please regulators, vowing to vastly increase its provisions to DM 1.84 billion by January 1985. The bank management sarcastically referred to “an amount which for the time being should also be acceptable to the federal supervisory office”.\(^{141}\) Overall, total German bank provisions and write-offs for foreign loans showed a clear upward trend, rising from DM 5.4 billion (1980) to DM 9.1 (1981) and DM 12.1 billion by 1982. Within these figures, Deutsche Bank clearly stood out.\(^{142}\) Credit risk reserves would receive another boost of 17 percent

\(^{135}\) Excerpt from Dresdner Bank, Sonderprotokoll der Gesamtvorstandssitzung, 23.11.1982, Historical Archives of Commerzbank (HAC) 500/3-148.


\(^{137}\) See ibid. and excerpt from Dresdner Bank, Sonderprotokoll der Gesamtvorstandssitzung, 31.10. to 01.11.1983, HAC-500/3-148.

\(^{138}\) Lissakers, Banks, Borrowers, and the Establishment, p. 213.

\(^{139}\) Memo by Nölling (president LZB Hamburg) to the central bank council, Stellungnahme des Zentralbankrats zur Länderrisikovorsorge, 17.10.1984, B 330/12056/2.

\(^{140}\) Central bank council minutes, 18.10.1984, B 330/12056/2.

\(^{141}\) Excerpt from Dresdner Bank, Sonderprotokoll der Gemeinschaftssitzung, 29.01.1985, HAC-500/3-148.

in 1983, with pre-tax profits of all German banks nevertheless totalling a record-high of USD 6.75 billion.\textsuperscript{143} There was no indication that higher provisions threatened profits. And, compared to other European banks, Deutsche Bank was even regarded as a standard setter in terms of adequate provisioning.\textsuperscript{144}

As a result, the need to reform and rethink the regulation of German banking in the wake of the debt crises was much less pressing than in other countries, especially the US. The US already maintained a relatively formal and transparent regulatory regime by the early 1980s.\textsuperscript{145} This was a result of its extremely fragmented banking system, with a plethora of state and federal elements and institutions. The International Lending Supervision Act (ILSA) passed in 1983 imposed new rules on US banks for their country risk management, but simultaneously set in motion a policy spiral that would lead to the Basel capital standards adopted in 1988.\textsuperscript{146}

The Basel Committee on Banking Supervision (BCBS) was hardly influenced by politics until 1983. The Committee viewed itself as a purely technical advisory body making unanimous recommendations for soft law.\textsuperscript{147} The Americans, however, and in particular Fed chairman Paul Volcker, began to exert more influence on the BCBS through the Group of Ten from 1984 onwards, with Volcker pushing for multilateral regulatory convergence.\textsuperscript{148} The prize was a capital adequacy standard for all internationally operating banks (at least within the OECD). Amongst European regulators there had already been discussions on common European banking ratios since the mid-1970s.\textsuperscript{149} Stricter rules for US banks alone, which were chided most for their over-lending prior to the debt crises, would have put them at a competitive disadvantage vis-à-vis competitors from Japan, France, the UK or Germany. This was undesirable for US policymakers.\textsuperscript{150}

\textsuperscript{143} “West German Banks Boosted Credit-Risk Reserves in 1983”, \textit{Wall Street Journal}, 17.08.1984.
\textsuperscript{144} Lissakers, Banks, Borrowers, and the Establishment, pp. 212-213.
\textsuperscript{146} H. James, International Monetary Cooperation since Bretton Woods, Washington, D.C. 1996, pp. 405-406.
\textsuperscript{149} Drach, A Globalization Laboratory, pp. 668-669.
\textsuperscript{150} E.B. Kapstein, Supervising International Banks: Origins and Implications of the Basle Accord, Essays in International Finance, no. 185 (Princeton, N.J): International Finance Section,
sum, the “shrinking win-set” (Andrew David Singer) faced by US regulators eventually gave rise to the idea of creating an international level playing field for cross-border lending.\textsuperscript{151}

In the Basel Committee negotiations, jolted into life by the Americans and the British in mid-1986, the French and particularly the Germans were soon considered as outliers.\textsuperscript{152} Germany, which “saw no need of standardization among the G-10 countries”, favoured a very narrow concept of equity capital to avoid dilution, thus preserving the rigorous German capital requirements.\textsuperscript{153} Both the UK and the US, by contrast, advocated a broader concept that would potentially include many more downstream forms of capital. This was at odds with the German position.

The Bankenverband wrote to Pöhl that the UK-US proposals would give rise “to the concern that decisions with far-reaching consequences for the German banking industry are being taken here”.\textsuperscript{154} The Bundesbank subsequently warned in its monthly report that a “common standard based on different national definitions of capital would lead to a serious distortion of competitive positions.”\textsuperscript{155} Germany only wanted to recognise share capital, open reserves and, if necessary, equity “surrogates” such as participation rights (\textit{Genussrechte}).\textsuperscript{156} Importantly, the KWG even prohibited German banks from using other surrogates. Germany was adamant about retaining the basic Principles of the KWG, opposing the inclusion of subordinate debt in the definition of own funds.\textsuperscript{157}

To Germany, apart from the broad definition of capital, the critical flaw was the one-size-fits-all 8 percent capital ratio based on a bank’s risk-weighted assets that was to become the cornerstone of the Basel I framework.\textsuperscript{158} The Bundesbank argued that countries with a narrow concept of capital (such as Germany)
should be allowed to adopt a lower level of capital given its better quality. In consequence, the Bundesbank suggested that binding standards be set by national banking supervisors. By contrast, it proposed that ratios developed within the Basel Committee be harmonised with EC standards, but only used for monitoring purposes. To the displeasure of the finance ministry and the Bundesbank, the new capital rules were finally adopted in July 1988. In the Group of Ten, Bundesbank President Karl Otto Pöhl was prodded to agree to the recommendations, although Germany “n’est guère convaincue de la pertinence prudentielle du nouveau ratio.”

Within Germany, however, the KWG and its previous principles were not discontinued but continued to apply until 1993. The reason for the acquiescence in 1988 was that the internationally active German banks would “exclude themselves from important international developments unless they participated in the voluntary implementation” of the BCBS recommendation, the BAKred said. The Basel recommendations, the supervisors noted, were “of only secondary importance from a supervisory point of view, but of the utmost importance for the international standing of German banks”. The bankers in return stressed that they needed the “backing” (Rückendeckung) of German supervisors to maintain their international standing. Clearly, as co-regulation remained an important component of their regulatory system, German banks and regulators were only reluctant participants in what evolved into a global standard for international banking regulation. But time-honoured German financial practices finally had to go.

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160 Drach, Liberté Surveillée, p. 281.
163 Kapstein, Resolving the Regulators’ Dilemma, p. 346.
6 Conclusion

The regulatory framework governing the foreign activities of German banks throughout the 1970s and 1980s represented a stable bank-government nexus which no stakeholder wanted to upend. In Germany, the regulation of international banking often occurred in an informal and de-institutionalised fashion, particularly when critical and sensitive issues were discussed and resolved. Outstanding individual personalities and informal administrative action contributed significantly to galvanising, delaying, or bringing about decisions. The very lack of financial transparency (reflected in hidden reserves and the tax-deductibility of allowances) often facilitated bank performance and financial stability because it came with a large room for manoeuvre. Yet such national characteristics also slowed down the pressure to adapt to international developments. As the European and global regulatory initiatives presaged a new policy scaffolding, German banks and policymakers were forced to comply with the convergence of international regulatory standards.

Starting from the 1970s, ever freer international financial markets tended to produce ever more transnational rules. Liberal German co- and self-regulation eventually had to give way to more formalised external regulation and state intervention to comply with new level playing fields. German banks could no longer capitalise on a propitious domestic regulatory environment. German regulators had to abandon bespoke national supervisory policies. With bank management leeway limited and regulatory sovereignty reduced, the late 1980s marked the unwinding of a long-time successful regulatory framework that had displayed both efficiency and stability.

The story of Germany’s informal regulatory model seems to (partially) invalidate the current one-sided argument for external state intervention to stabilise the global financial system. Rather, the German case suggests that supervisors may want to consider promoting internal self-responsibility and self-discipline across the finance industry. Historically, grand bargains, while predicated on the primacy of national German politics, were indeed possible. That does not necessarily imply a revision, but perhaps a restatement of Schoenmaker’s trilemma. Put differently, the German case presented here echoes Forrest Capie’s observation that “if trust goes, regulation takes its place”. As this article has sought to

demonstrate, regulation may serve as a substitute for trust, but not necessarily an improvement.

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Bionote

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