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Independence Day for financial regulators in Europe?

Katja Langenbucher: The EU Commission proposes more leeway for bank supervisors. A comparison between regulatory bodies in the U.S. and Germany shows why it is important to discuss the proposal



Among the many things gone wrong in the lead up to Wirecard, the regulatory architecture of the German Federal Financial Supervisory Authority (BaFin), supervised by the German Ministry of Finance (MoF), has received much attention. If BaFin had not been as deeply embedded in the Finance Ministry's lines of reporting, so some claim, there would have been less political influence and more accountability on the side of BaFin. Neither a fast-track peer review by the European Securities and Markets Authority (ESMA) nor the final report of the German parliament's Committee of Inquiry found concrete evidence of the MoF trying to influence BaFin on actions taken in the Wirecard case. Still, ESMA is concerned by a "heightened risk of influence by the MoF, given the frequency and detail of reporting to the MoF, in the Wirecard case" and notes that this "could have opened the possibility for the MoF to influence BaFin had they disagreed".

ESMA guidelines on financial information have since 2014 stressed that "enforcers should ensure adequate independence from government." For banking supervision, the EU Commission intends to go down a similar path. Its proposal for amending the Capital Requirements Directive 2013/36/EU (CRD IV) of October 2021 holds that "recent developments showed the need for clearer and more operational provisions on the principle of independence of competent authorities." Art. 4 CRD IV will be reframed to require member states to "provide all the necessary arrangements to ensure that those competent authorities (...) can act independently and objectively, without seeking or taking instructions, or being subject to influence from supervised institutions, from any government of a member state." The European Banking Authority (EBA) will issue guidelines on independence of competent authorities, "taking into account international best practices".

Exploring independence of financial regulators

For Germany, this will require careful examination of the current regulatory architecture. In a SAFE White Paper, we have provided a short overview of five countries, exploring independence of financial regulators from governmental and legislative bodies. While we found that coordination between the ministries of finance and the financial regulators happens to a certain extent in the area of rulemaking, we did not see a financial regulator under direct supervision of that country's ministry of finance (with a limited exception for the U.S. Office of the Comptroller of the Currency (OCC), which is understood as an independent bureau of the U.S. Department of the Treasury). Instead, financial regulators are typically accountable to the national parliamentary body.

Assessing international best practices requires, first, a working definition of what is to count as independence. We can measure and compare several elements contributing to an independent body. To name just a few: there is (i) the appointment procedure for who will head the agency, (ii) the protection of its head against removal for political reasons rather than for cause, (iii) the supervision of the agency's daily work, both of a more formal or a more substantive kind, (iv) the reporting obligations of the agency to the executive or the legislative branch, and (v) the budget of the agency, who decides on the amount of funding and who contributes to it.

Assessing best practices

Second, an assessment of best practices will be on the lookout for international benchmarks. Unsurprisingly, the U.S. Securities and Exchange Commission (SEC) is often held out as a model for capital market oversight. The U.S. President appoints the Commissioners, after advice and consent of the Senate. It is a multi-member commission with staggered terms, where three members will be of the President's party and two of the opposition. The chair can only be removed by the President "for cause", which is understood as

inefficiency, neglect, malfeasance, or abuse of office. The SEC reports to the House Financial Services Committee as well as to several other committees. SEC action is held accountable under the Administrative Procedure Act to a standard of “arbitrary and capricious”. Financially, the SEC is dependent on the Congressional appropriations process.

It follows from the SEC's mandate targeting securities markets that a number of additional regulatory authorities fulfill tasks which in Germany are in part taken over by BaFin. The Commodity and Futures Trading Commission (CFTC) is under the Commodity Exchange Act in charge of protecting commodities and futures markets from fraud, manipulation, abusive practices, and systemic risk in the context of derivatives. The OCC takes over some supervisory and licensing tasks in the context of banking supervision over national banks and federal savings associations.

The Consumer Financial Protection Bureau (CFPB) is an agency established under the Obama administration, entrusted with the task of ensuring efficient retail investor protection on capital markets. It has one director, appointed by the President with consent of the Senate. The CFPB Director serves for a term of five years and can be removed only for “inefficiency, neglect of duty, or malfeasance in office”. The CFPB does not rely on annual appropriations for funding but receives funding directly from the Federal Reserve. The Director requests an amount he deems “reasonably necessary”. The Federal Trade Commission (FTC) was originally conceived as an antitrust authority (“trust-buster”). This mandate was later broadened to unfair and deceptive acts or practices which include the financial services area. One example is provided by the FIC overseeing the Equal Credit Opportunity Act, an element of U.S. fair lending laws. It is composed of five members, no more than three from the same political party. It also has staggered terms of membership. However, the U.S. President can remove its head at will, for instance for political reasons.

The third requirement for a best practice exercise is the most complicated one. Regulatory bodies exercise state power and are, as such, an integral part of the constitutional architecture.

Regulators as constitutional elements

Countries such as the U. S. distinguish between “political” and purely technical “administrative” agencies. The latter are typically embedded in the governmental structure. For the former, their independence from the government is a characteristic feature. The goal of having an agency which does not report to government is to allow for more robust enforcement. For these countries, the constitutional benchmark is the principle of separation of powers. Building the SEC in 1934 to supervise financial markets is often understood as a compelling example. The CFPB provides a counterexample, illustrating incompatibility with these principles: The U.S. Supreme Court held in a recent decision that its leadership by one single individual with broad removal protection violates the separation of powers.

Germany, by stark contrast, understands all regulatory agencies as an extension of government. Against this background, its constitutional test is democratic accountability. The German Constitutional Court (Bundesverfassungsgericht) has in a 2019 decision on the banking union stressed the principle of democratic accountability. The Court accepts independent agencies only in a few cases.

EU bodies have long pushed in a different direction than the German understanding and the final report of the Bundestag's Committee of Inquiry on the Wirecard case is well aware of the ensuing tension. So far, a pragmatic solution for BaFin has taken the form of oversight principles issued by the MoF. They stress that BaFin acts independently and that the MoF limits itself to general questions of appropriate organizational structure and procedures. It remains to be seen whether this approach will comply with the EU Commission's plans for independence. In our SAFE White Paper, we have suggested a novel understanding of democratic accountability via parliament. The European Commission's proposal provides a good reason to continue this discussion.

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