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# Why the initial Regulation of Financial Innovations is decisive – Regulatory Arbitrage and off-balance-sheet Leasing in Germany

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# Why the initial Regulation of Financial Innovations is decisive – Regulatory Arbitrage and off-balance-sheet Leasing in Germany\*

## Abstract

*This policy letter provides evidence for the crucial importance of the initial regulatory treatment for the further development of financial innovations by exploring the emergence and initial legal framing of off-balance-sheet leasing in Germany. Due to a missing legal framework, lease contracts occurred as an innovative social practice of off-balance-sheet financing. However, this lacking legal framing impeded the development of this financial innovation as it also created legal uncertainties. This was about to change after the initial legal framing of leasing in the 1970's which eliminated those legal uncertainties and off-balance-sheet leasing entered into a stunning period of growth while laying the foundation of a regulatory resiliency against efforts that seek to abandon the off-balance-sheet treatment of leases. As the initial legal framing is crucial for the further development of a financial innovation, we propose the French approach for the initial vindication of new financial products in which the principles-based rules are aligned with the capabilities of regulators to intervene, even when a financial innovation complies with the letter of the law. In this way, regulators could regulate the frontier of financial innovations and weed out those which are entirely or mainly driven by regulatory arbitrage considerations while maintaining the beneficial elements of those products.*

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Why does the process towards a regulatory framework for financial innovations tend to institutionalize a regulatory treatment which allows for the persistence of regulatory arbitrage? Why do they maintain this beneficial treatment in the aftermath and how could regulatory interventions obstruct this tendency? This raises important questions regarding the emergence and initial legal vindication of financial innovations as, for example, current debates on the regulation<sup>1</sup> of cryptocurrencies show. Economists have long known that financial innovation will tend to get

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\* SAFE policy papers represent the authors' personal opinions and do not necessarily reflect the views of the Research Center SAFE or its staff.

<sup>1</sup> e.g. M. Goldmann and G. Pustovit. "Governing Cryptocurrencies through Forward Guidance?", SAFE Policy Letter No. 68, March 2018, <http://safe-frankfurt.de/policy-center/policy-publications/policy-publications/publicationname/governing-cryptocurrencies-through-forward-guidance.html> accessed 7 April 2018

structured in such a way to avoid regulatory costs, achieving transactions in economic substance, which avert burdensome regulatory costs.<sup>2</sup> Doing so, they tend to put at peril regulatory frameworks, intended to provide stability to the system. How could such undermining of the safety valves be limited? To inquire into this question, this policy letter investigates a financial innovation, leasing, which emerged in Germany as an off-balance sheet financing technique in the 1960's and maintained this beneficial accounting treatment over the course of the last 50 years.

Lease contracts are typically structured so that they provide an off-balance-sheet effect for the lessee as the assets as well as the corresponding liabilities only appear in the notes of the lessee. Up to date, lease contracts account for nearly 3 trillion USD of off-balance-sheet debt – only under IFRS.<sup>3</sup> However, even the recent revision of lease accounting by the IASB will only partially bring leases on balance sheet as the new standard IFRS 16 includes regulatory loopholes that enable the leasing sector to keep certain lease agreements off balance sheet. Given the tendency of financial innovation to maintain their beneficial regulatory frame, one easily overlooks, however, that the political struggle may have started when those financial products have been legally vindicated for the first time. The initial regulation of financial innovations exerts a strong influence on further debates as it represents legal fact that is hard to overcome, while also facilitating the further growth of those instruments. The emergence and further evolution of off-balance-sheet leasing in Germany is a good example for a financial innovation which developed a resiliency against regulatory interventions in the aftermath of its initial legal vindication in the early 1970's.

In the year 1962, leasing emerged in Germany as a financial export from the US. Due to a missing legal frame and its ambiguous character between an on-balance-sheet loan and an off-balance-sheet rent, lease contracts were drafted in accordance with the beneficial German rental law, constituting a new social practice of off-balance-sheet financing. However, this legal treatment also strongly hampered the business of the first leasing firms in Germany as it created legal uncertainties, which led the market share of leasing in Germany to initially remain insignificant. Fiscal authorities perpetually raised questions regarding the recognition of lease contracts as the balance-sheet treatment of a lease (Who is the owner of the leased asset? Who has to depreciate the asset? What about the deduction of interest expenses?).

Due to this link to issues of taxation, the first legal framing of leasing in Germany was a verdict of the German fiscal court (BFH) in 1970. This verdict was the first official regulation of lease agreements in Germany and vindicated this new financial instrument, albeit in a way not desired by the leasing

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<sup>2</sup> c.f. E. Kane. "Interaction of Financial and Regulatory Innovation". The American Economic Review, 1988, 78(2), Papers and Proceedings of the One-Hundredth Annual Meeting of the American Economic Association, 328-334.

<sup>3</sup> FAZ (Frankfurter Allgemeine Zeitung). „Erst verkaufen, dann nutzen: So einfach ist das nicht mehr“. 01.02.2016, Wirtschaft, p. 16.

industry as it stresses the financing character of leases<sup>4</sup>, threatening its off-balance-sheet effect. The court determined that the economic ownership of a lease contract, not solely its legal form had to be the crucial criteria for on-balance sheet recognition while it also required a case-by-case review, depending on the concrete design of the lease. Furthermore, the court decision also represented the legal basis for the upcoming and decisive tax decrees<sup>5</sup> which should finalize the legal framing of leasing in Germany. After this challenging judgement of the BFH and the unabated willingness of the German financial authorities to bring leasing on-balance sheet<sup>6</sup>, the German leasing industry decided to affect the origination process of the subsequent regulation, directly co-authoring<sup>7</sup> the four decrees<sup>8</sup>, which from 1971 onwards were successively released.

Those decrees specified and, most importantly, quantified the abstract requirements of the BFH decision as they established sharp bright-lines for the balance sheet treatment of lease agreements.<sup>9</sup> In this way, the industry managed to confine the issue of the economic substance of a lease contract to clear, quantitative boundaries – which could be easily circumvented through a smart drafting of a lease contract. For example, one crucial bright-line is the so called “90-40 rule”, fixed in the first tax decree from 1971 which determines that the lessor shall recognize the lease if the basic lease accounts for less than 40 % and exceeds more than 90 % of the economic lifetime, creating an off-balance-sheet effect for the lessee. Hence, the initial legal vindication of leasing institutionalized the off-balance-sheet effect of lease agreements as it enabled the leasing industry to engage in regulatory arbitrage techniques and to design off-balance-sheet lease contracts. Furthermore, the legal framing of this financial innovation removed legal uncertainties while the German state certified<sup>10</sup> this financial innovation as a valid off-balance-sheet tool, providing the basis for the stunning growth of leasing in Germany in the following years (see figure).

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<sup>4</sup> BFH, 26.01.1970 - IV R 144/66, Available at: [https://www.jurion.de/urteile/bfh/1970-01-26/iv-r-144\\_66/](https://www.jurion.de/urteile/bfh/1970-01-26/iv-r-144_66/)  
[https://www.jurion.de/urteile/bfh/1970-01-26/iv-r-144\\_66/](https://www.jurion.de/urteile/bfh/1970-01-26/iv-r-144_66/)

<sup>5</sup> H. Fittler, „40 Jahre Leasing-Verband: Entstehung und Entwicklung des Bundesverbandes Deutscher Leasing-Unternehmen“. In H. Fittler and M. Mudersbach (eds.) Leasing-Handbuch für die betriebliche Praxis, 2012, Frankfurt am Main, Fritz Knapp Verlag, 34-58.

<sup>6</sup> Ibid.

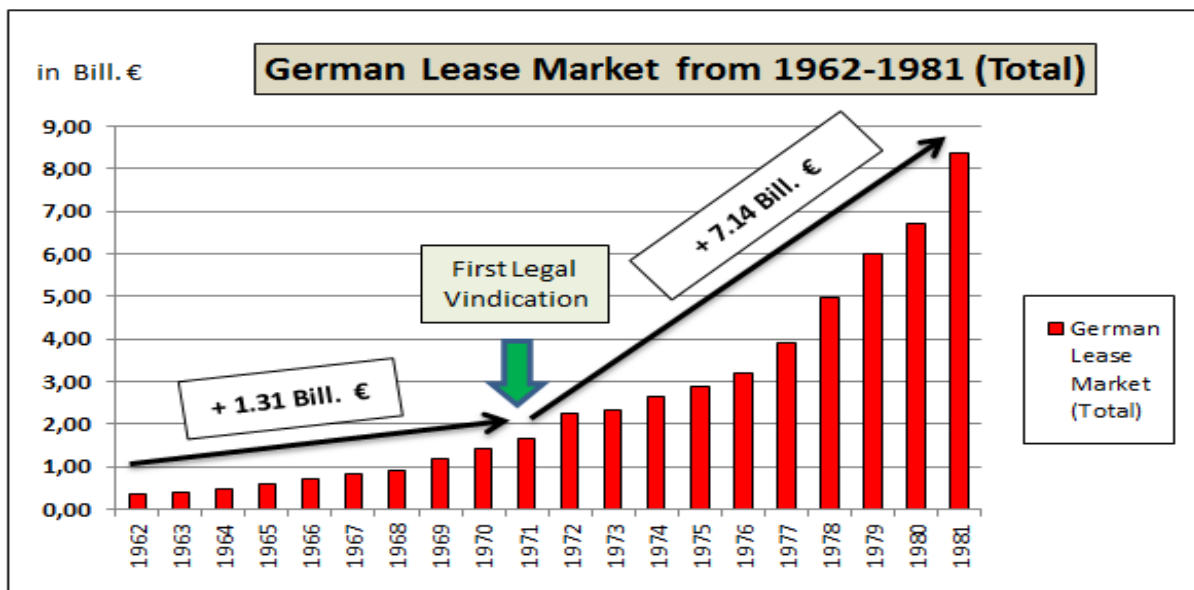
<sup>7</sup> W.-D. Hoffmann, „Eigentümer und Schuldner als Bilanzierungssubjekte im BilMoG- Entwurf (Gastkommentar)“, Der Betrieb, 2008, 31, 1.

<sup>8</sup> Known as the four “Leasing-Erlasse” of the German Ministry of Finance. Available at: <https://bdl.leasingverband.de/leasing/leasing-erlasse/>

<sup>9</sup> M. Vossler, „Leasing im Steuerrecht“. In H. Fittler and M. Mudersbach (eds.), Leasing-Handbuch für die betriebliche Praxis, 2012, Frankfurt am Main, Fritz Knapp Verlag, 133-165.

<sup>10</sup> D. McAdam, S. Tarrow and C. Tilly, “Dynamics of Contention”, 2001, Cambridge University Press.

Figure 1: The Development of the German Lease market (1962-1981)



Source: unpublished market data of the ifo Institute.

But in how far does this initial regulation affect current regulatory debates? Firstly, today, every fourth equipment investment in Germany is financed through off-balance-sheet leases.<sup>11</sup> Hence, leasing has become one of the most important sources of external funding, in particular for German SMEs. Thus, the growing economic importance of financial innovations such as leasing represents a crucial pillar of its regulatory resiliency. Any regulatory attempt which seeks to bring leases on balance sheet faces significant practical and political obstacles due to the sheer size of off-balance-sheet leasing today. As off-balance-sheet leases have become a crucial source of external funding in Germany, the certifying state authority becomes a natural ally of the industry to maintain the status quo. Secondly, the process towards an initial regulation established important direct ties between a newly emerging financial sector and the certifying authorities which may become a crucial source of the financial industry in subsequent regulatory debates. Thirdly, the ambiguous character of financial innovations like leasing allows financial engineers to game the rules in order to maintain off-balance-sheet structures or to create new structures, even in case of a new regulation as the new IFRS 16 shows.<sup>12</sup> Even if an unfavorable legal frame is implemented, market actors may circumvent those new regulatory requirements by means of regulatory arbitrage – constituting another pillar of the regulatory resiliency of financial innovations.

<sup>11</sup> Bundesverband Deutscher Leasingunternehmen, „Leasingmarkt 2016“, <https://jahresbericht.leasingverband.de/leasing-markt-und-umfeld/leasing-markt-2016/index.html>

<sup>12</sup> c.f. M. Thiemann and J. Friedrich, “Drawing the line: The political economy of off-balance-sheet financing”, economic sociology\_the european electronic newsletter, 2016, 17(2), 7-16, Available at: <https://www.econstor.eu/bitstream/10419/156068/1/vol17-no02-a2.pdf>

Thus, the initial legal framing is crucial for the further development of financial innovations which are based on the maintenance of cost advantages due to evasion of certain classification. But which lesson can be learned from this case? The intentional non-regulation of such instruments is perhaps a way forward in some cases<sup>13</sup> as regulations may only vindicate a new financial tool while creating clear categories or bright-lines which can be exploited through regulatory arbitrage techniques. However, such an approach also bears the risk that a financial innovation becomes economically or systemically so important on its own that regulators can only subsequently institutionalize a given market practice – as for example the case of off-balance-sheet swap derivatives in the US has shown.<sup>14</sup> This creates a dilemma for regulators. On the one hand, they may see the necessity to act and to provide a regulatory framework. On the other hand, there is also the potential threat that this regulation may only enable regulatory arbitrage while fueling the growth of a financial innovation.

To deal with this tension, the French approach for the regulation and supervision of financial innovations is probably a suitable means for certifying institutions. In France, the establishment of principles-based rules is aligned with the capabilities of regulators to intervene to correct compliance decisions – even when the regulatory treatment of a financial transaction by the regulated *prima facie* meets the requirements of the legal framework. In contrast to other jurisdictions, it is not the French regulator who has to prove e.g. whether an accounting decision also reflects the economic substance of a transaction but the regulated financial institution in conjunction with its auditor, shifting the burden of proof to the latter.<sup>15</sup> Such a reversal of the burden of proof from the certifying authority to the innovating financial industry provides an important leeway for regulators to influence the development of these financial innovations.<sup>16</sup> It is thereby an approach worth considering for the initial legal framing of financial innovations as well as for regulation later on. Such an approach would entail that the company issuing the financial innovation could be forced to justify their accounting decisions in front of the regulator. Issuers would have to explain why and under which conditions this new product shall be classified and treated in certain way, *based on the economic substance of the financial innovation*. By involving both auditors as well as regulatory advisors, the regulator could indicate in his decision-making, which arguments he views as justified and which ones he deems unjustifiable.

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<sup>13</sup> For the regulation of cryptocurrencies, see J. P. Krahen, “Think Twice Before Regulation Bitcoins”, SAFE-Policy Blog, 8 March 2018, <http://safe-frankfurt.de/policy-blog/details/think-twice-before-regulating-bitcoins.html> accessed 7 April 2018.

<sup>14</sup> R. J. Funk and D. Hirschman “Derivatives and Deregulation Financial Innovation and the Demise of Glass–Steagall”, 2014, *Administrative Science Quarterly* 59(4), 669-704.

<sup>15</sup> M. Thiemann and J. Lepoutre, “Stitched on the Edge: Rule Evasion, Embedded Regulators, and the Evolution of Markets”, 2017, *American Journal of Sociology* 122(6), 1775-1821.

<sup>16</sup> S. T. Omarova, “License to Deal: Mandatory Approval of Complex Financial Products”, 2012, *Washington University Law Review* 1, 63-140.

Such an approach would significantly reduce the information asymmetries between regulators and regulated and limit possibilities for regulatory arbitrage. It would allow a certain degree of flexibility to the regulatory framework while creating legal certainty for those buyers and sellers of financial contracts that follow the approved path. In this way, the economic benefits of a financial innovation would persist, while legal uncertainties are created in the grey areas of the law where they are useful. In order to limit their workload, regulators should focus on a few exemplary cases that either regard the newest form of financial contracts, the fastest expanding and/or large segments of the market. Given the degree to which all of these financial engineers operate in a common field of practice, principles-based decisions taken by regulators will quickly spread (Interview with a Banker, June 2011). A way to further that effect is to force all auditors to take those decisions into account, as they are obliged to evaluate financial contracts anyway. Making that observation an important part of their professional duties, including the possibility for sanctions, will lead to a widespread effect without involving a 100% in depth supervision of all financial contracts in the market.

Regulators could in this way regulate the frontier of financial innovations and weed out those which are entirely or mainly driven by regulatory arbitrage considerations. In case these innovations only make sense if they successfully evade regulatory costs, reintroducing doubts over the capacity to achieve this evasion already would limit that behavior. The reactive behavior of the regulated is an unchangeable fact of life and financial innovations will aim at achieving such regulation related cost evasion. Such behavior is favored by clear rules-based regulatory frameworks. Coupled with the impossibility for supervisors to intervene in these practices based on economic substance, it is an institutional setting that favors the spread of such innovations. On the contrary, principles-based regulations and the capacity for intervention by regulators, engenders a regulatory dialogue that is, in principle, able to keep such innovations at bay.