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BaFin

Foreword

Dear Readers,

Three months after taking up office, the new President of BaFin, Dr Elke König, sets out her position on the challenges facing Germany, Europe and the world in an interview on page 27 of BaFinQuarterly. She addresses matters including European regulatory proposals such as CRD IV and Solvency II, the cooperation between BaFin and the new European Supervisory Authorities and the need to regulate the shadow banking sector.

One of BaFin's most important functions is to identify at an early stage developments that could damage the financial system. Such a potential effect is currently attributed to Exchange-Traded Funds (ETFs). Critics warn of risks that may result from product structures becoming ever more complex. In a new study, BaFin has examined the ETF market and drawn some valuable conclusions. These are presented in detail in the article on page 5.

Lessons from the financial crisis will also continue to dominate discussions in international bodies in 2012. The market reaction to the collapse of Lehman Brothers demonstrated that the global market for OTC derivatives could be a source of systemic risk. This is not only due to the size of this market, but also to its lack of transparency. For this reason, the G20 States have agreed on new rules for all standardised OTC derivatives that are to come into force by the end of the year. The EU wishes to implement these rules, inter alia, under the European Market Infrastructure Regulation (EMIR). The report on page 16 outlines the most important principles of the proposal.

Transparency is also the aim of the notification and publication requirements applicable for holders of net short positions in certain shares. They were extended considerably at the end of March 2012 by the coming into force of section 30i of the Securities Trading Act (Wertpapierhandelsgesetz – WPHG). There is now an electronic notification procedure, as outlined in the article on page 12.

As a Supervisory Authority open to dialogue, BaFin holds regular events to promote interdisciplinary exchange on important issues. Two and a half years after the first conference on Islamic financial services, which was very well received by market participants, the media and the supervisory authorities of Muslim partner countries, BaFin will be hosting another international Conference in May 2012. For details, see page 3.

Happy reading!

Dr Sabine Reimer, Head of Press and Public Relations

Current regulation

SUPERVISORY PRACTICE

Second Islamic Finance Conference

Two-and-a-half years after the first Islamic Finance Conference, which received a very positive response from market participants, the media and supervisory authorities of Muslim partner countries, BaFin will now be hosting another meeting on the subject.

The conference, which will focus on practical aspects of Islamic finance from an international perspective and will be held in English, will be presented by high-ranking representatives of financial supervisory authorities, businesses and universities.

The main item on the conference agenda is the sharia-compliant capital market. The aim is to inform the market of the opportunities and challenges of Islamic financial products and to stimulate an exchange of information and views among experts.

Limited capacity

The conference will be held at the Frankfurter Hof hotel in Frankfurt am Main on 10 May 2012 and will start at 10.00 a.m. The agenda may be viewed on BaFin's website .

Since capacity is limited, those who would like to attend must first complete an expression of interest form. BaFin will then inform them all whether they have been successful or not.

www.bafin.de » Events

BaFin sees need for better quality of product information sheets

Since 1 July 2011 investment services enterprises, when providing investment advice, are required to inform their customers clearly and concisely about the essential features of the financial instruments they recommend. In a representative sampling, BaFin has looked at the information sheets used for this purpose and has found a need for corrections.

"What we see is that the purpose of the new information sheet pursued by the legislator, i.e. to inform customers clearly and concisely about the products recommended as part of the investment advice provided, in many cases is not yet being achieved", emphasised Karl-Burkhard Caspari, Executive Director of Securities Supervision at BaFin. "Unless they have sufficient and comprehensible information, investors are not able to decide appropriately between different investment alternatives."

Review in summer of 2011

BaFin began its review in the middle of June 2011. The objective was to clarify how the new provisions of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG) on product information sheets for financial instruments were being implemented. For this purpose, BaFin assessed 120 to 130 production information sheets each for shares, bonds and a certificate with a broad stock exchange index as its underlying. A significant number of these were found to have shortcomings.

What BaFin discovered is that, although many information sheets complied with the draft structure that had been developed by the German Banking Industry Committee (GBIC), the quality of the content provided in the individual items of this structure varied widely.

Many product information sheets too general

BaFin sees a need for improvement especially when it comes to itemising the information sheets. In many cases, investment services enterprises had not described their products and the related risks in sufficient clarity. It was also often the case that only a very generalised description of the costs was provided – consisting, for example, in a reference merely being made to the institution's schedule of fees and services. The assessment also revealed that many information sheets contained phrases and statements that were either difficult to grasp or not comprehensible at all. Some examples of this are specialised terms for which no explanation was provided, compound word structures and unknown abbreviations. Moreover, institutions frequently tried to exclude liability for the correctness of their information sheets.

BaFin presented the findings of its assessment to the associations of credit and financial services institutions. Some institutions have already responded and, for example, deleted exclusions of liability for correctness from their information sheets. In the annual review pursuant to section 36 of the WpHG, BaFin will conduct a follow-up review to determine whether all institutions have taken suitable measures to improve the quality of their information sheets.

www.bafin.de » Pressemitteilungen (only available in German)

Internet sweep: many online credit offers unlawful

In many cases the websites and online credit offers of businesses in Germany do not comply with the legal provisions governing the advertising of consumer credit loans and the information that should be provided. This is the finding of a consumer protection Internet "sweep" in the Member States of the European Union (EU) and the European Economic Area (EEA) in which BaFin took part for the first time in the autumn of 2011, together with the Federal Office of Consumer Protection and Food Safety (Bundesamt für Verbraucher-schutz und Lebensmittelsicherheit – BVL) and the Centre for Protection against Unfair Competition (Wettbewerbs-zentrale – WBZ). The EU Commission coordinated the sweep by the Consumer Protection Co-operation Network (CPC) in the participating countries.

In Germany, the Internet sweep unearthed infringements of the relevant legal obligations in 20 out of 26 sites investigated. For example, some businesses offering loans on the Internet failed to meet the requirement to state the total cost of a credit, that is, not only the mere amount of the loan but also the interest as well as the arrangement fee and sales costs. In addition, in their advertising businesses offering such loans must provide representative examples that are actually available to at least two-thirds of interested consumers. Sometimes this representative example was missing altogether, or was not clear and concise, or the interest rate quoted was not available for a large proportion of target consumers. Furthermore, in some cases the actual business offering the consumer credit could not be identified. The consumer must, however, be able to tell straightaway who is offering the loan and where that business is based. The businesses involved were thus in breach of the obligations of the Telemedia Act (Telemedien-gesetz) and the Regulation relating to Price Quotations (Preisangabenverordnung) in particular.

Infringements on 70 percent of websites

All told, the CPC examined 562 websites in the 27 Member States of the EU and in Norway and Iceland, with particular regard to how far the businesses comply with the requirements of the Consumer Credit Directive. Infringements were detected in around 70 percent of cases, that is to say: 393 websites. The most frequent irregularities included the absence of prescribed standard information (46 percent of cases) or of facts that are essential to enable consumers to make an informed decision (47 percent) and misleading statements on costs (20 percent).

National supervisory authorities have now been asked to instruct the businesses to make the necessary clarifications or corrections and, if necessary, to take legal action against the infringements on the basis of their respective national legislation. They will report to the EU

Commission in autumn 2012 on the progress that has been made by then.

BaFin has already appraised the infringements identified, in consultation with the BVL and the WBZ, and asked the German umbrella banking associations to urge their members to comply with the legal framework conditions on the advertising of loans. At the same time the Wettbewerbszentrale has also looked into a number of infringements. BaFin will in future examine compliance with the requirements governing the advertising of consumer credit loans at regular intervals.

Exchange Traded Funds: opportunity or risk for the financial markets?

A few months ago, the Swiss bank UBS received a painful lesson in the risks associated with trading in Exchange Traded Funds (ETFs, see information box).

Frank Brings, BaFin

At that time, the arrest of a UBS investment banker was headline news. The bank had charged the staff member, who was responsible for ETF trades, with fraud. The bank lost USD 2 billion in the unauthorised trades and was then forced to issue a profits warning. It also caused immense reputational damage.

This incident served to ignite existing debate about the possible systemic risks of ETFs. Critics increasingly warn that ETFs are not as safe as issuers promise and even issuers give some credence to the allegations as market product structures become ever more complex. By the end of 2011, around 36% of European ETFs were synthetic – ie. based on swaps.[1] Experts fear that significant risks could arise from index variations and warn of the counterparty credit risk from swaps. Niche providers are also trying to jump on to the ETF bandwagon with innovative products.

National and international supervisory authorities are also increasingly turning their attention to ETFs as an asset class. The ETF industry is currently attracting substantial criticism, in particular from the Financial Stability Board (FSB), the Bank of International Settlements (BIS) and the International Monetary Fund (IMF).[2]

Exchange Traded Funds (ETFs) are index funds traded on stock markets. They may include national or international share indices, commodity and real estate indices and also pension indices. In contrast to a traditional investment fund, an ETF offers investors a cost-effective investment instrument with which they can rapidly buy and sell positions in certain asset segments. Other advantages from the investor’s point of view are the transparency of this investment form and the security offered by the legal form of special fund assets. Investors use ETFs to structure and diversify their portfolio. In addition to classic ETFs, there are also similar products such as Exchange Traded Commodities (ETCs) or Exchange Traded Notes (ETNs). However, the terms are not always clearly defined. Whilst ETFs have special fund assets, ETCs and ETNs are debt securities; ETCs are normally secured and ETNs are normally unsecured. ETCs allow investors to have quick and transparent access to value development of commodities without having to buy physical products.

Market developments

In recent years, ETFs have attracted much higher influxes of capital than traditional funds. At the end of 2011, the global investment volume in ETFs was USD 1,350 billion, of which around USD 270 billion was for funds registered in Europe. This meant that global investment volume had almost doubled since the end of 2008 (see figure 1, p. 6).

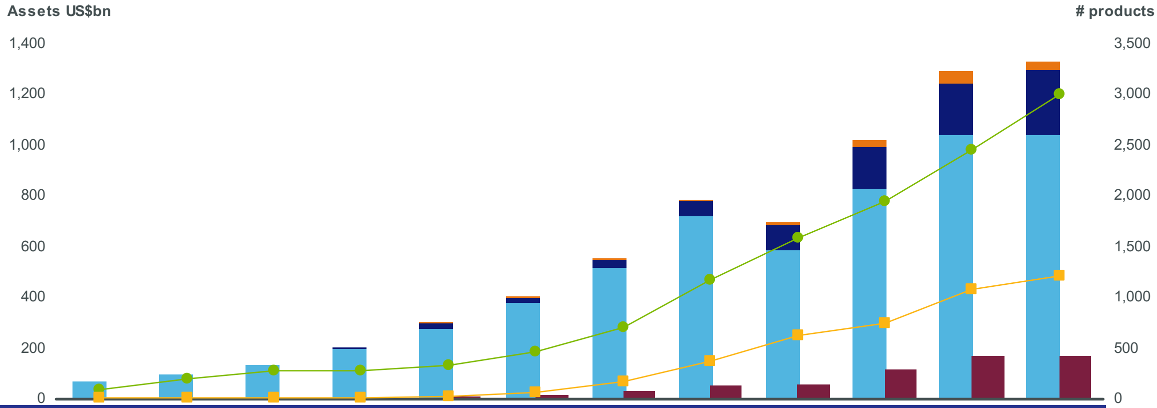
High demand for ETF products from both institutional and private investors cannot only be explained away by low transaction and administrative costs. The fact

[1] See BlackRock ETP Landscape (Annual Report 2011).

[2] See FSB, ‘Potential financial stability risks arising from recent trends in ETFs’, 29 March 2011; BIS Working Paper No. 343, ‘Market structures and systemic risks of ETFs’, April 2011; IMF ‘Global Financial Stability Report’, April 2011.

Fig. 1: Development of global ETF market

- The 10-year CAGR for ETP AUM is 30.2%. For ETFs, 78% of AUM is invested in equity products, 19% is invested in fixed income products and 2.3% is invested in commodity products. Other ETPs (excluding ETFs) are primarily invested in commodities – 82.3%.



Assets (US$bn)	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
ETF total	**74.3**	**104.8**	**141.6**	**212.0**	**309.8**	**412.1**	**565.6**	**796.7**	**711.1**	**1,036.0**	**1,311.3**	**1,350.9**
ETF equity	74.3	104.7	137.5	205.9	286.3	389.6	526.5	729.9	596.4	841.6	1,053.8	1,057.4
ETF fixed income	0.1	0.1	4.0	5.8	23.1	21.3	35.8	59.9	104.0	167.0	207.3	257.7
ETF commodity	–	0.0	0.1	0.3	0.5	1.2	3.4	6.3	10.0	25.6	45.7	31.1
Other ETPs total	**5.1**	**3.9**	**4.1**	**6.3**	**9.3**	**15.9**	**32.5**	**54.6**	**61.2**	**119.7**	**171.3**	**173.5**
# ETFs	92	202	280	282	336	461	713	1,170	1,595	1,944	2,460	3,011
# Other ETPs	14	17	17	18	21	63	170	371	625	750	1,083	1,210

Note: CAGR = Compound Annual Growth Rate. AUM = Assets Under Management. Global ETP flows are approximated by combining flows available for the United States, Europe, Canada and Latin America (excludes Asia, Middle East and Africa). Data as at year end 2011 or where updated data is not available, we utilise the most recent period available.

Quelle: BlackRock ETP Landscape (Annual Report 2011).

that exchange trading also normally allows for quick and cost-effective entry and exit from the market also plays an important role.

Replicating performance

ETFs aim to replicate as accurately as possible the returns of a diverse reference portfolio – usually an index. This replication of a target index may be physical or synthetic. Where there is physical replication, the ETF manager invests on the spot market in the securities held in the index. In the synthetic replication variety, which is particularly widespread in Europe, the fund can hold a securities portfolio that varies significantly from the target index. In order to rebalance differences in the performance of these portfolios and the performance of the reference index, management also concludes additional agreements with swap counterparties. The result is intended to synthetically replicate the performance of the target index.

In addition to classic ETFs, there are also other similar products such as Exchange Traded Commodities (ETCs) or Exchange Traded Notes (ETNs), although the terms are not always clearly defined (see Fig. 2 on p. 7). While ETFs comprise special fund assets, ETCs and ETNs take the legal form of debt securities. ETCs are usually secured and ETNs are usually unsecured. ETCs give investors quick and transparent access to value development of commodities without having to buy physical products directly.

An ETF provides investors with an investment instrument that costs less than traditional investment funds and allows them to buy and sell positions in certain investment segments for short periods. As compared with traditional investment funds, the advantages from the investor's point of view are the transparency of this investment form and the security provided by the legal form of special fund assets. Investors can use ETFs to structure and diversify their portfolio.

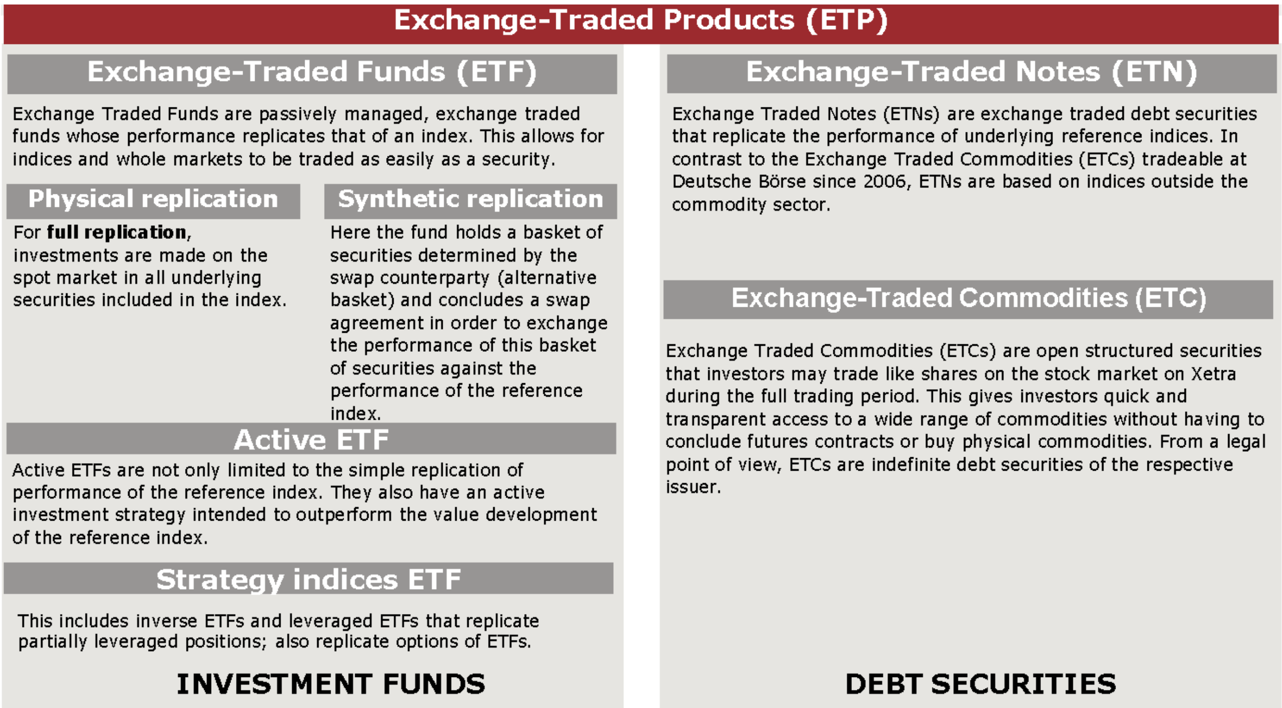
Risks of ETFs

BaFin has taken note of the criticism from international supervisors as an opportunity to set up a study to examine the market for Exchange Traded Funds. This included interviews with important market participants.

The study revealed that there are diverse practices in connection with the variations of index replication:

- Above all, physical replication provides ETF issuers with incentives to lend out the largest possible

Fig 2: Variations in Exchange Traded Products



Source: www.deutsche-boerse.de/BlackRock

number of acquired securities in order to generate additional profits. According to industry information, income from securities lending typically makes up around one third of total earnings. With securities lending, there is a risk of increased demands for sale or buyback by investors that can lead to liquidity problems at those banks that have implemented onward lending of the securities. This can mean that there is a possibility that they may not be able to meet the liquidity demands of the fund or investor, depending on the collateral of the ETF issuer. In concrete terms, this would mean that investors wishing to cash in their units with the fund would not be able to have the transactions honoured with immediate effect. Furthermore, securities lending and the involvement of another business partner creates additional counterparty credit risk.

- With synthetic replication, there is additional counterparty risk from the counterparty for swaps; these are often banks associated with the ETF issuer. This can result in concentration of counterparty credit risk if a default of the counterparty cannot be compensated in that other swap parties are involved and there is insufficient corresponding (over-) collateralisation.

- There can also be liquidity shortfalls. A bank acting as swap counterparty and market maker for the ETFs of its Group's investment companies may be overstretched to meet the risks of swaps and provide market liquidity, particularly if investors cash in large volumes of ETF units.

- There can also be more conflicts of interest, particularly if several or almost all functions are located within a Group. For example, there is a high risk of conflicts of interest if the issuer is a bank subsidiary and the parent bank also acts as depot bank, swap counterparty and index sponsor. Within the Group this could result in a relaxation of risk management standards, such as through falling qualitative requirements as regards assets used as collateral. This could result in problems for the convertibility of assets.

- The collateral structures of ETFs also present further risk potential as investor trust, particularly for swap-based ETFs, depends on the creditworthiness of the principal bank and securities provided.[3] Investor trust in ETFs could be lost, for example, if inferior collateral is provided. In periods of increased counterparty credit risk and raised levels of market mistrust, there is also a danger that investors will cash in more ETF units. Other risk factors for the collateral structures of ETFs lie in the valuation of collateral,

[3] See BIS Working Paper, April 2011.

the ability of swap partners to provide further collateral where there is a loss in value (replacement obligations) and the quality of collateral management.

With synthetic ETFs, collateral provided may vary from the replicated index. This is particularly the case with a fully funded swap structure, where the assets of the ETF, such as shares or pensions, are all sold; in an extreme case the special fund assets will in the end consist only of cash.

In a further step, the ETF issuer concludes a standardised derivatives contract for a fully funded swap with the Group parent. The Group parent acts as swap counterparty, collects the funds of the ETFs and in return deposits collateral with the depot bank that is compliant with the UCITS Directive and can be pledged in favour of the ETF.

Requirements of risk management

The BaFin study concluded that the financial institutions operating in the ETF market must counter the risks resulting from the interactions with counterparties with sophisticated risk management.

With respect to the requirements of risk management of ETFs, supervisory focus is currently mainly concentrated on the following issues:

- With which risk measures and in which risk management processes are ETF-specific market risks, counterparty credit risks and liquidity risks of the departments of the relevant financial institution (swap department, trading department, financial department) measured, reported, limited and managed?

- What is the exact structure of the collateral? Is the quality of collateral sufficiently valued (inclusion of discounts)?

- How and how often is compliance with collateral criteria monitored for onward lending of the securities by swap counterparties?

- Are there adequate minimum capital requirements with respect to ETF-induced risks, and how are they determined?

- Does risk management include appropriate ETF-specific stress scenarios for risk management that, for example, assume that investors might withdraw high volumes from ETFs at short notice (ETF run)?

The study shows that the industry is developing increasingly complex structures and less transparent underlyings. The progressively non-transparent oversupply of products is unsettling private investors. More complex structures could also endanger the original simple character of ETFs. Therefore, it is particularly important that ETF issuers provide investors and supervisors with all relevant information about product characteristics in a timely manner.

ESMA draft guidelines

On 30 January 2012, the European Securities and Markets Authority (ESMA) published draft proposals for guidelines to regulate investment funds. Fund issuers are invited to submit responses to the consultation paper before the end of March, before ESMA publishes its final guidelines, probably in the summer. The most important proposals in the ESMA consultation paper refer to transparency and securities lending:

- Transparency: One part of the transparency initiative is that in future ETFs should carry the identifier ‘ETF’ in their name so that they are more clearly recognisable as such. UCITS-Directive compliant investment funds that track indices will generally be subject to extended transparency requirements in prospectuses with respect to index features and index composition. Furthermore, the prospectus should also state the replication methodology, (such as synthetic, full physical replication or sampling) and the resulting risks. UCITS that employ swaps must also specify the counterparties and the amount and type of accepted collateral in the prospectus. Similar transparency requirements should also apply to securities lending transactions, although the disclosure of the identity of the securities lender is only supposed to be made ex-post in the annual reports.

- Securities lending: Until now there have been no absolute limits for securities lending transactions. From a legal point of view, a fund could lend out the majority of its securities. At a European level, until now the minimum proposed standard for UCITS has been that the value of securities lent to a borrower (less retained collateral) should not exceed 20% of the value of special fund assets. The current paper includes consideration of how lending transactions could be limited in the future. Either the amount of securities lent to individual borrowers is to be capped, or the total share of securities that may be lent out from fund assets is to be limited. The ESMA draft does not go into any more detail – it just calls on fund issuers to comment on this issue. The ESMA proposal also suggests that in the future issuers should normally include additional earnings from lending activities in fund assets. Any fee sharing agreements should be expressly disclosed. Further standards address acceptable collateral and limit the investment possibilities for cash collateral.

Financial stability risks

With an eye to financial stability, the synchronisation of fluctuations in financial market prices and their impact can only be partly explained by increased uncertainty and volatile markets. The phenomenon is also due to endogenous mechanisms stemming from the financial system itself that have an aggravating effect in that they trigger a downward spiral in financing and market liquidity. Stress amplifiers tend to be pro-cyclical amendments to loan conditions, such as margins or discounts on collateral provided, as in the interbank markets or on the part of prime brokers of hedge funds.

A further reason behind the marked synchronicity of the prices of risky financial assets may be that there has been an increase in the importance of derivatives and passive investment strategies that (like ETFs) are based on broad financial market indices. Changes in futures prices on share indices generally have an equalising effect on the prices of the individual index values on the spot market in excess of their signalling effect and trading activities of index arbitragers. A highly uncertain environment can favour trade in index products and increase synchronicity of prices. Arbitrage strategies in high frequency trading (HFT) can have a similar effect. Security mechanisms in automated HFT can also lead to rapid withdrawal of liquidity and amplify share price falls.

With an eye to financial stability, it is therefore important to pay careful attention to the extent to which banks may be financing illiquid parts of portfolios with their associate ETFs and may be subject to liquidity risks due to cash outflows for ETFs.

BaFin represents German interests

BaFin keeps a close eye on, and sometimes takes an active part in, discussions in international bodies and other market and products developments. For example, BaFin is contributing to the development of standards by ESMA and the International Organization of Securities Commissions (IOSCO). It also represents German interests in the ETF Group of the FSB Senior Supervisors Group that started work in January 2012.

These international bodies are currently considering the proposals for risk reduction and increasing transparency that are outlined here. It is hoped that they will be implemented as soon as possible. An analysis of the stability risks by the competent supervisory authorities as outlined above takes as long as the specified examination of appropriate risk management infrastructures. Joint standards for the ETF industry, particularly with respect to the publication of detailed disclosures about investment policy and interconnections with other market participants would also require expansion of the existing discussions with supervisory authorities.

Differentiated view

The BaFin study concludes that ETFs allow investors simple diversification of their portfolios by providing liquid and cost-effective instruments to invest in indices. A large number of issuers and asset classes offer investors flexibility for their investment strategy. However, the study also showed that the risks addressed by international supervisors exist and are pertinent.

Nevertheless, a relativist perspective that takes account of the context should be adopted. The study identifies the main risk as possible feedback against individual financial institutions and Groups, such as liquidity risk or counterparty credit risk. However, the existing legal framework already addresses and limits most risks, particularly for German products.

The ETF market is also not yet so large that there can be fear of a direct systemic risk. However, there could already be a danger that ETFs could act as an ‘accelerant’ during market crises. A greater danger for financial stability may then arise if current growth rates are maintained and ETFs become systemically important in certain less liquid sections of markets.

Finally, market interventions must always balance the advantages of financial innovations with their risks. With lower transactions costs under normal market conditions, ETFs offer investors the possibility of making significant cost savings. However, this must not lead to the development of a system that accepts higher systemic risk.

Ceremony marking the appointment of Dr Elke König as president of BaFin.

The ceremony marking the appointment of Dr Elke König as the new president of BaFin, held in Frankfurt on 24 January 2012, was an exercise in contrasts. Surveying past and future challenges facing the world of financial supervision, the speakers, among them Federal Finance Minister Dr Wolfgang Schäuble, struck not only celebratory but also thought-provoking, even critical, notes.

Federal Finance Minister Dr Wolfgang Schäuble

Music plays at the banks

Addressing Jochen Sanio, the long-serving BaFin President and known music lover, Minister Schäuble paraphrased Finnish composer Jean Sibelius (1865 1957), noting that "bank directors are the only people one can chat to about music because artists only talk about money..." He added: "In your 37 years as a banking supervisor, you built such a reputation for toughness that I cannot imagine music being the only subject you ever broached in your exchanges with bank directors."

Reflecting on Mr Sanio's career, Minister Schäuble reminded the more than 100 high-ranking representatives of financial institutions, supervisory authorities and associations assembled at BaFin's new premises in Frankfurt about the "many crises you had to tackle and the countless milestones in the history of Germany's financial markets you witnessed while acting as a supervisor." The minister commanded Mr Sanio's leading role, at the climax of his career, in implementing a new global financial architecture.

Beyond his tribute to Mr Sanio's work, Minister Schäuble touched on a number of challenges currently facing financial markets. Banks should be well capitalised, he said, bemoaning the increasing decoupling of the financial services industry from the real economy. "This is why the new capital and liquidity standards being introduced with Basel III are a crucial – and necessary – response to the crisis," Schäuble said. "In order to stop and reverse this steady divergence and to steer financial markets back towards their primary function – namely, to serve the real economy – we need the pace of markets to slow down."

Regulation – a difficult balancing act

Dr Elke König, the New BaFin President, said that financial services providers not only needed strong and effective supervision but that they, in fact, secretly welcomed it. BaFin, she said, would "supervise with a sense of proportion in the future as well" and "continue to push for regulation with a sense of proportion internationally". "Regulation is a difficult balancing act, but one which I am convinced can also continue to succeed," König added.

Although the supervisory authority had to be fast in its reaction to market developments, she said, it also had to be dependable. "A supervisory line must be identifiable for the financial services industry to take its lead from." Supervision had to be predictable, and BaFin would abide by this imperative. "BaFin is going to be an effective, prudent and dependable supervisory authority in the future, as well as one that is respected nationally and internationally," Ms König summed up.

For Minister Schäuble, Ms König is the right person in the right place at the right time: "In times like these, in which financial markets are going through turbulences and many radical changes are taking place, it is particularly important that we once more have an experienced person with a proven track record at the head of the Federal Financial Supervisory Authority. This also increases confidence in the German financial marketplace," the Minister said.

König thanked Minister Schäuble for his "kind words and the great confidence" he had placed in her. She also thanked her predecessor: "Herr Sanio, you have passed over to me a well-run institution, a highly skilled and highly committed team that does a vital job: ensuring the proper functioning, stability and integrity of the German financial market. German integrated financial supervision is in good shape."

New BaFin President Dr Elke König and her predecessor Jochen Sanio

Sanio's critical closing remarks

Prior to this, Mr Sanio had taken critical stock of the situation as he retired from BaFin. "Almost my entire working life has been spent in times of a fundamental revolution in the financial services industry. Driven by politically-led worldwide deregulation of the financial markets, a banking system which had been predominantly committed to the real economy became an oversized, highly complex organism that proved too much for financial supervisors to control. The subprime crisis made these abnormal structures apparent to everyone." But to date the necessary deconstruction and reconstruction of the financial system had not yet fully taken place.

In his farewell address Mr Sanio also addressed his successor directly. "You are assuming the Presidency of BaFin in the midst of another serious crisis." This was something that BaFin had got used to by now. Sanio wished his successor much luck in the tasks that lay ahead. May Fortune smile on her, he said. "After all, Lady Luck owes us big time."

BaFin President Dr Elke König: "Banks managing capitalisation"

In early February around 60 business journalists accepted BaFin's invitation to the New Year Press Reception in the supervisory authority's new building in Frankfurt's Mertonviertel business quarter. "For me this occasion is a first: today I am talking to you for the first time as the President of BaFin", Dr Elke König told representatives of print media, press agencies and radio and TV broadcasters. Among other things, in her speech König argued for better bank capitalisation.

"The financial crisis and also the current sovereign debt crisis clearly show how important it is for banks to have an adequate and solid capital base and to ensure that they have stable sources of funding", König said. The new Basel III capital requirements were therefore a confidence-building and indispensable measure. For that reason the introduction of the new rulebook should not be deferred either. "During the Basel III negotiations my predecessor Jochen Sanio successfully fought for transitional periods. The banks therefore have sufficient time to adapt", König continued.

Recapitalisation plans of German banks analysed

König was confident on the capital situation of German banks. For instance, the German banks for whom the recapitalisation survey conducted by the European Banking Authority (EBA) last year had revealed a need for additional capital had submitted their recapitalisation plans on time by 20 January 2012. "In these plans they tell us how they are proposing to achieve the required adequate hard core capital ratio by the middle of this year", the BaFin president explained.

It emerged from these plans that the German banks should succeed in achieving the recommended capitalisation without outside assistance. "I think this is very positive news," König said. She welcomed the fact that some banks were shedding "one or two burdens". For banks this deleveraging – the reduction of risk positions – was a "sensible way to maintain or regain their stability", she made clear.

Solvency II still too complex

The dominant topic in insurance supervision was Solvency II, König said. She described the target date of 1 January 2014 for applying the new

European rulebook in full as very ambitious. In the BaFin President's opinion, Solvency II also requires further improvement: "The new supervisory system is still very – if not too – complex."

BaFin would therefore also be trying to persuade the European Insurance and Occupational Pensions Authority (EIOPA) to further reduce the complexity – when developing technical standards and guidelines for Solvency II, for instance. "One of the main reasons for our doing this is to make life easier for small and medium-sized undertakings", said König.

New BaFin President Dr Elke König giving her speech

BaFin's active role at the European level

In her speech König also discussed the European supervisory system that has been in operation for more than a year now. She pointed out that BaFin played an active role in it. For instance, the three European Supervisory Authorities (ESAs) were charged with drafting a large number of technical standards, and BaFin was closely involved in the development of these. "For us, 'technical standards' could become the Word of the Year for 2012", König said.

As an example, she mentioned the implementation of Basel III in Europe: in the coming months and years the EBA was scheduled to draft more than 100 such standards for the planned EU Regulation alone. "BaFin will contribute its know-how and do its utmost to ensure that the standards are developed with a sense of proportion and take due account of the – legitimate – interests of the German market", König declared.

With regard to securities supervision, König regretted the delay in the plans for regulating derivatives trading: "In September 2009 the G20 Heads of State and Government had agreed that by end 2012 all derivatives trades should be cleared centrally, reported to trade repositories and, if appropriate, traded on organised platforms", she said. This deadline could probably no longer be met. This was due not only to the great complexity of the subject but also to the fact that national implementation measures were difficult to coordinate in cross-border matters.

More staff for international regulation

On the other hand, the President was pleased that BaFin had been allowed 30 new posts for the 2012 budget. "We will use them primarily to perform functions on the European and global regulation stage", she said, and immediately engaged in some self-promotion: "Of course we are competing with other attractive employers. But where else do you have the opportunity to help shape European and even global regulation?", she said. A number of highly-qualified BaFin staff were already taking advantage of this opportunity. "They will be pleased to get some support."

SUPERVISORY LAW

Expanded notification and publication requirements for short selling

Marie Christine Geilfus, BaFin

Verena Ludewig, BaFin

In Germany, short-selling transactions are regulated by two mutually complementary approaches. The first approach prohibits naked short selling in certain shares, government debt securities as well as credit default swaps (CDSs), and the second provides for transparency requirements for holders of net short positions in certain shares.

These transparency requirements were considerably expanded on 26 March 2012 with the entry into force of section 30i of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG) dealing with notification and publication requirements.

Section 30i WpHG replaces General Decree on transparency requirements

The new provision replaces the General Decree on transparency requirements of BaFin for the shares of ten selected companies[1] of 4 March 2010. The notification and publication requirements now pertain to all shares admitted to trading on the regulated market of a German stock exchange. Section 30i of the WpHG thus covers several hundred shares.

However, the new provision not only expands the scope of existing notification and publication requirements but also revises the provisions on the reporting channel as well as the manner of publication. Moreover, BaFin may now also sanction violations of notification and publication requirements committed wilfully or negligently with fines of up to 200,000 euros.

A **net short position** in a share exists when netting all of a holder's financial instruments, such holder's economic exposure in the company's shares in issue is equivalent to a short position in shares. As a rule, this calculation includes all types of financial instruments whose performance is dependent on the performance of the respective share, and thus in particular short positions in the share itself, option transactions, swaps and financial instruments that are based on indices and baskets and at least partly include the specified shares, as well as corresponding shares in exchanged traded funds (ETFs).

Previous provision

Under the General Decree, market participants were required to notify BaFin if their net short positions reached, exceeded or fell below 0.2% of the shares in issue of the ten selected companies.

[1] Aareal Bank AG, Allianz SE, Generali Deutschland Holding AG, Commerzbank AG, Deutsche Bank AG, Deutsche Börse AG, Deutsche Postbank AG, Hannover Rückversicherung AG, MLP AG and Münchener Rückversicherungs-Gesellschaft AG.

Such notifications had to be submitted using a standard form to be sent via fax by the end of the next trading day. Any notified net short positions reaching, exceeding or falling below 0.5% were published by BaFin in anonymised form on its website (only available in German).

Two-tier transparency system to be maintained

With section 30i of the WpHG, the two-tier transparency system is maintained. The holder of net short positions (person or entity subject to the notification requirement) must therefore notify BaFin by the end of the next trading day at the latest if its net short position reaches, exceeds or falls below the threshold of 0.2% of a company's shares in issue (first tier) if the shares are admitted to trading on the regulated market of a German stock exchange. If the net short positions exceed, reach or fall below a threshold of 0.5%, the person or entity subject to the notification requirement must itself additionally publish these positions in the electronic Federal Gazette (second tier). This publication, too, must take place by the end of the next trading day.

Unlike the provision under the General Decree, the holder of the net short position subject to the notification and publication requirements is now itself responsible for having the publication effected in the electronic Federal Gazette. This replaced the anonymised publication on the BaFin website. In addition to information about the issuer and the net short position, the publication in the electronic Federal Gazette must contain details on the person or entity subject to the publication requirement itself. In the case of natural persons, such particulars will for example include their name and the country in which they have their principal place of residence, and in the case of legal persons the name of the company as well as the location and country of its headquarters.

Further notification and, where applicable, publication requirements apply when such positions reach, exceed or fall below a further 0.1 percentage point in each case. Investment services enterprises or equivalent enterprises domiciled abroad are exempt from the notification and publication requirements if they satisfy the conditions of exemption pursuant to section 30i (4) of the WpHG (market maker exemption).

Details clarified by Regulation

The technical details on the calculation as well as notification and publication of net short positions are clarified by the Regulation on Net Short Positions (Netto-Leerverkaufspositionsverordnung – NLPosV). The NLPosV introduced an electronic notification and publication procedure for net short positions. For this purpose, BaFin has made available an electronic notification procedure by means of a reporting and publishing platform accessible via the Internet. The notifications themselves are to be submitted via the reporting and publishing platform in a specialised procedure.

Electronic notification procedure

To transmit a notification to BaFin electronically, the person or entity subject to the notification requirement (or a third party authorised by such person or entity) must first register on the reporting and publishing platform and then apply for the specialised procedure for net short positions. Since 26 March 2012, persons and entities have been able to apply for the specialised procedure and simultaneously submit a notification of a net short position. Notifications are deemed to be preliminary until BaFin verifies the identity of the notifying person or entity.

For notifications to be clearly attributed to the person or entity subject to the notification requirement, each person or entity subject to the notification requirement and each contact person must identify itself to BaFin once, at the latest when the first notification is submitted. For this purpose, the application for the specialised procedure is to be printed out after having been transmitted electronically, and then signed and sent to BaFin by fax or post with further documents required for identification. Once the written documentation has been received, BaFin compares the data provided electronically with the documents submitted. In the event of successful verification, it activates the notifying party’s account for the procedure. From that point in time, the notifications are no longer deemed preliminary. BaFin informs both the notifying person or entity and the person or entity subject to the notification requirement of such account activation.

Already before this verification is completed – i.e. immediately after the registration for the specialised procedure – the person or entity subject to the notification requirement receives temporary access by means of which preliminary notifications can be submitted, such access being applicable until (possible) revocation of the notification authorisation by BaFin. However, notifications are recorded in the internal database of BaFin only after the notifying person or entity has been positively identified.

In addition to the Frequently Asked Questions (FAQs) on notification and publication requirements pursuant to section 30i of the WpHG, BaFin has published an IT information sheet that explains how to successfully submit a notification.

Short-selling transactions to be regulated at European level from November 2012

Section 30i of the WpHG will apply only for just over seven months, since already on 1 November 2012 the European Regulation on short selling and certain aspects of credit default swaps will enter into force. This EU Regulation also provides for transparency rules on net short positions that will replace section 30i of the WpHG.

The scope of the provisions of the EU Regulation will go beyond the German rules. They will expand notification and publication requirements to include additional financial instruments. The European transparency requirements will thus pertain not only to all shares admitted to trading on the regulated market but also to all shares traded on the European markets. They will thus also cover securities traded on multilateral trading facilities (MTF) and on the regulated unofficial market. In addition, the EU Regulation will introduce notification requirements for government debt securities of the EU, the EU Member States and their federal states as well as the European Financial Stability Facility (EFSF) and similar bodies or authorities.

International

REPORTS

ESMA urges investors to exercise caution in forex transactions

The European Securities and Markets Authority (ESMA) has issued an investor warning in which it is calling on investors, before entering into foreign exchange transactions, to check whether the provider is an authorised firm.

ESMA also urges investors not to invest any money that they cannot afford to lose, and points out that the ultimate loss may turn out to be greater than the initially invested amount. Investors should also be aware, ESMA continues, that certain product or service offerings may not be straight-forward. "Be aware of the inherent risks", reads the fourth core message which, according to ESMA, is addressed above all to private investors.

Increasing number of unauthorised firms operating in EU

The European supervisory authority bases its warning on the rising number of cases it has registered within the European Union (EU) in which unauthorised firms had offered transactions or trading platforms in foreign currency derivatives. By way of example, it mentions contracts for difference (CFDs), forward exchange transactions (FX forwards) and rolling spot contracts.

In the ESMA warning, the most important risks that trading in foreign currency derivatives pose to retail investors are listed. They are summarised under the headings of "Complexity", "Volatility", "Leverage", "Marketing campaigns" and "Internet trading". In cases of doubt, the authority recommends investors to seek advice from independent, trustworthy financial advisers.

In the event of any questions or doubts it also recommends contacting the respective national regulatory authority. For example, BaFin provides Tips for Investors (only available in German) on its homepage.

EU-wide survey on bank recapitalisation: Results for German banks

The EU-wide survey on bank recapitalisation of the European Banking Authority (EBA) has found that the 13 participating German banks have a capital shortfall totalling 13.1 billion euros. It is attributable to six of the 13 credit institutions, with around 65 per cent of the national capital shortfall being accounted for by two of them: Commerzbank with a capital requirement of 5.3 billion euros, and Deutsche Bank with a capital requirement of 3.2 billion euros. Moreover, Norddeutsche Landesbank, Landesbank Hessen-Thüringen, DZ Bank as well as WestLB all report capital shortfalls.

According to Raimund Röseler, Chief Executive Director of Banking Supervision at BaFin, the results have to be viewed against the backdrop of the current market distortions as they affect government bonds and the concurrent increase in capital requirements. The current recapitalisation survey does not pre-empt Basel III, and is also without prejudice to a waiver of the zero weighting of EEA countries' sovereign bonds.

The sharp increase in German banks' recapitalisation requirements compared with the initial survey conducted in October is essentially attributable to the fact that the EBA moved the reporting date for risk-weighted assets (RWA) and regulatory capital back from 30 June 2011 to 30 September 2011. Furthermore, in the second survey the RWA effects from implementation of the EU Capital Requirements Directive (CRD III) were no longer approximated using a scaling factor of 2.5 but instead calculated on the basis of nuanced CRD III rules. In some cases, this leads a marked increase in risk-weighted assets. A further change is the restriction of offsetting options with respect to fair value gains and losses for credit claims on EEA countries.

For more information as well as a complete overview of the results for German banks, please visit the BaFin website.

EMIR: New rules for trading OTC derivatives

Dr Christian Sigmundt, BaFin

The smouldering financial crisis since 2008, and in particular the market reaction to the collapse of Lehman Brothers, has demonstrated that the global market for OTC derivatives[1] can be a source of systemic risk. The lack of information about the interconnections between major market participants heightened the loss of trust between banks. As well as the low level of transparency in the OTC derivatives market, the size of the market is also of systemic importance.[2]

Against this background, in 2009 the G20 States reached agreement in Pittsburgh that by the end of 2012 all standardised OTC derivatives would be traded on stock exchanges or electronic trading platforms and would be cleared by a Central Counterparty (CCP). OTC derivatives contracts would be registered with trade repositories. Contracts that are not cleared centrally would be subject to higher capital requirements.

[1] OTC means 'over the counter'. OTC derivatives are derivatives that are not traded on a stock exchange or other trading platform, but bilaterally between buyer and seller. Agents are often involved. OTC trading is not regarded as particularly transparent.
[2] In June 2011, according to the Bank for International Settlements (BIS) the global nominal volume was USD 700 trillion.

Implementation in the EU

In the European Union (EU), moving trade in OTC derivatives onto the regulated markets or electronic platforms is now taking place as part of the revision of the Markets in Financial Instruments Directive (MiFID) (see BaFinQuarterly 04/11). The clearing of derivatives via a central counterparty that is to be mandatory for certain market participants and the requirement for OTC derivatives contracts to be reported to a trade repository is to be regulated within the EU by the European Market Infrastructure Regulation (EMIR). In September 2010, the European Commission published a first draft proposal. After negotiations between the member states' delegations and further discussions between the European Council and the European Parliament it is expected that EMIR will enter into force in the second half of 2012. As the final version has not yet been published, this article discusses the main points of EMIR without referencing individual Articles of the Regulation.

Central counterparty bears counterparty credit risk

The CCP will be the counterparty on both the buyer's side and the seller's side for clearing of trades in financial instruments. The involvement of the CCP means that the contractual parties must no longer bear the counterparty credit risk. In return, it asks for margins (as collateral). One of the functions of this collateral is to cover the market risk until maturity of the contract. As the functioning of CCPs is of great importance from a systemic point of view, there are usually additional procedures in place to protect the CCPs from e.g. the default of a clearing member (i.e. a direct participant).

These safeguards include, for example, the establishment of a clearing fund that all clearing members pay into and that may be accessed if the collateral of a defaulting clearing member is insufficient. Risk management procedures depend on the respective financial instruments to be cleared. Risk management is particularly difficult for some derivatives, such as credit default swaps (CDS), as the jump-to-default risk must be taken into account. This is where the value of a derivative can suddenly fall to zero, such as when there is default of the reference entity.

Bilateral clearing

For bilateral clearing, the contractual parties merely confirm their trades and then effect clearing between themselves. Calculation and provision of collateral depends on the individual assessment of the creditworthiness of the contractual partner. If one party is a company from the real economy that seeks to hedge against foreign exchange risks or commodity price risks, the current position is that collateral is not always provided.

Concentrating clearing of derivative trades on CCPs increases their risk for the financial markets. For this reason, EMIR will include qualitative and quantitative requirements for the CCP and impose requirements for approval and supervision by the national authorities. These requirements will apply to CCP regardless of what kind of financial instruments they clear and whether these financial instruments are traded on or off exchange..

The regulatory content of EMIR can be divided into three parts:

- Regulation of mandatory clearing of certain derivatives via a CCP, and requirements for bilateral clearing of products not subject to mandatory clearing;
- Regulation of the approval and supervision of CCPs in the EU and
- Regulation of the approval and supervision of trade repositories in the EU.

Mandatory clearing for certain companies

Regulated companies in the financial sector (banks, insurers, UCITS[3] etc.) and companies outside the regulated financial sector, whose derivative trades exceed thresholds that are still to be determined, will only be allowed to clear certain derivatives via a CCP. The determination of the thresholds for unregulated companies is to be regulated in technical standards. The intention is that derivative positions that only serve to hedge business risks should not be included in the calculation of thresholds for these companies. This should minimise the consequences of mandatory clearing as regards the provision of collateral and the costs for an economically legitimate hedging against price risks and foreign exchange risks by such companies.

The clearing obligation not only means that the companies have to be directly or indirectly bound to one or more CCPs, but also that the companies have to provide the necessary collateral. This requires a rethink for companies in the real economy in particular as, unlike banks, they do not usually hold reserves of cash or highly liquid financial instruments that CCPs can accept as collateral.

No mandatory clearing for certain trades

However, there will also be exceptions with regard to mandatory clearing. Certain players, such as central banks, are not subject to mandatory clearing, nor are intra-group trades, provided that certain conditions are met. This is intended to ensure that it is possible to have uniform management of risk at group level.

There is also mandatory clearing if the counterparty is not subject to EMIR, but would be subject to EMIR if its registered office was in the EU. This leads to overlaps, such as with regulation in the USA under the Dodd-Frank Act. The extensive implementing legislation (equivalent to level 2 in the EU) for the Dodd-Frank-Act is not yet complete. The European Commission is currently negotiating with US authorities with respect to the numerous delimitation issues.

Extent of mandatory clearing

The question which OTC derivatives should be subject to mandatory clearing under EMIR mainly depends on whether the respective product is cleared by a CCP in the EU or a CCP from a third country that is recognised in the EU (bottom-up approach). If a CCP is already approved under EMIR and it seeks to extend its product range, or if the CCP wishes to commence business operations for the first time, it must seek approval from its national competent authority. The competent authority's decision will be based on how it values the CCPs risk management and also on the forecast of whether the CCP can technically cope with the anticipated volume.

After approval by the national competent authority, the European Securities and Markets Authority (ESMA) must decide within six months if and when all affected market players within the EU need to clear the approved OTC derivatives centrally. ESMA will draw up technical standards for these purposes that will then be submitted to the European Commission.

Depending on the product, the ESMA technical standards can impose mandatory clearing for trades that were concluded after EMIR came into force but

[3] Undertakings for the Collective Investment of Transferable Securities.

before the European Commission made clearing mandatory (front loading).

The Criteria have to be defined further in the Technical Standards

Criteria that should be considered in any event are the liquidity of the contract, the availability of reliable price information and the degree of standardisation. However, all further details are to be developed in the technical standards ESMA is due to submit by the end of September 2012.

One additional aspect is the question to which extent the level of competition between individual CCPs is to be included in the decision. If there is only one CCP in Europe for a certain group of derivative contracts, this CCP will have a monopoly. This monopoly could be countered by a transitional period until clearing becomes mandatory that also allows other CCPs to offer corresponding clearing.

Possible conflicts of interest

Such competitive considerations could lead in individual circumstances to conflicts of interest with the basic policy of having as much OTC derivatives as possible subject to centralised clearing as soon as possible. It will be interesting to observe ESMA administrative practice in this respect. In any case, there will be a consultation of the draft technical standards later this year.

This market-driven solution raises the question of what would happen if a product is rated as particularly risky and which – perhaps for that particular reason – cannot find a CCP that wants to or is able to clear the trades. Under such circumstances, EMSA may intervene and notify the European Commission as to which classes of derivative contracts, in its opinion, should be subject to mandatory clearing (top-down approach). The European Commission can then request ESMA to call on the CCPs to clear such products. This procedure is designed to investigate why a product is not being cleared. Further measures, such as a ban on products, are not addressed by this draft.

Reporting obligations

EMIR is based on the assumption that it is essential to give the competent authorities a comprehensive overview of the markets and the exposures of the markets participants. Thus, EMIR requires that the main elements of each trade in OTC derivatives in Europe are to be reported to a trade repository no later than the working day following the trade day. This allows for a micro and macro-prudential evaluation of the positions of individual players. The reporting obligation applies to both parties involved, but may be delegated. The exact content of the reporting obligation will be set out by ESMA in technical standards that must then be approved by the European Commission.

The US Dodd-Frank Act also envisages mandatory reporting to a trade repository. As derivative markets are organised globally, it is important that the respective reporting obligations are standardised where possible in terms of content and format so that competent authorities are able to aggregate the positions of market players. This is the only way that the authorities can have a complete picture of the exposure of market participants. Various international committees are currently discussing the necessary standardisation of reporting obligations. However, there are also issues of confidentiality of data and data protection to be discussed.

Exception: customised OTC derivatives

Central clearing is not possible for all OTC derivatives. For different asset classes there is a need, particularly with respect to maturity, to trade and hold customised OTC derivatives. Such non-standardised products cannot be cleared by a CCP on grounds of effectiveness, as the market does not have sufficient liquidity. Such customised derivatives are used in particular by companies in the real economy in order to hedge against commodity price risks or foreign exchange risks for imports or exports. International accounting standards determine how derivative positions are to be recognised on balance sheets.

If a derivative exactly covers a business risk, this trade has no balance sheet effect under so-called hedge accounting. However, a precondition of International Accounting Standard IAS 39 is that the maturity of the derivative must exactly match that of the risk. For this reason, standardised products cannot usually be used within the scope of hedge accounting.

Such bilateral contracts are still allowed under EMIR, but the framework conditions are being tightened. There are minimum requirements for risk management and the timely, electronic confirmation of trades plays an important role. Financial and other companies subject to mandatory clearing also have to ensure that there is adequate collateral for trades and that they are valued at market value.

The details, particularly with regard to the amount of collateral, are to be defined in technical standards.

Other obligations

Products subject to EU mandatory clearing are to be included in a central repository maintained by ESMA.

In order not to interfere with competition by erecting barriers to access between CCPs and between possible trading centres that offer OTC products, such as electronic platforms, CCPs and trading centres should allow non-discriminatory access to relevant data (trading feeds) in line with an ordered process and in compliance with deadlines.

Standardising supervision

A central part of regulation is supervision of CCPs as they can be systemically relevant. Their importance for the derivatives market will increase with the introduction of mandatory clearing. Until now, the EU has not had a uniform structure for the supervision of CCPs. In Germany, CCPs are subject to banking supervision. Many other countries have their own sui generis supervision system.

EMIR unifies supervision structures and takes account of the fact that once mandatory clearing is introduced; there will no longer be an assumption that CCPs only serve just one national market.

Approval of CCPs

EMIR envisages that the national competent authority will decide if a CCP is to be approved for a specific product class. However, a supervisory college, whose members will include other competent authorities and central banks, must give a joint opinion as to how far the decision of the national competent authority will be supported. The college will also comment on major changes to models and parameters of CCPs.

As regards the composition of the college, a balance must be found between the participation interests of the competent authorities and central banks and functionality. The current EMIR approach is that CCPs that currently have national approval would have to apply to their national competent authority for an approval within six months of the technical standards applicable to them coming into force.

Discussions also continue about the supervision or recognition of CCPs from third countries. The EU basically follows the approach that such CCPs could be recognised by the European Commission provided that the supervision is at least comparable.

Due to the relevance of the CCPs for the whole internal market, EMIR also regulates the cooperation between the competent authorities and central banks, particularly in emergencies.

Qualitative and quantitative requirements

Due to their systemic importance, it is vital that CCPs are subject to robust qualitative and quantitative requirements. In many cases, EMIR just provides an outline and leaves the details to be filled in by ESMA, which is to provide the technical standards that must then be approved by the European Commission. As regards content, the details will be based on the Standards for Financial Markets Infrastructures of the CPSS[4] and IOSCO[5] that have not yet been agreed.

In addition to risk-based requirements, EMIR also includes requirements of the CCPs as regards transparency of their cost and fee structures. This issue also highlights the possible prominence of a CCP in European mandatory clearing.

Specification of regulatory capital requirements

One important issue is the specification of CCP regulatory capital. The regulatory minimum capital must already be available when the CCP submits its application for approval. Additionally, the CCP must also already have sufficient capital, reserves and profits to be in a position to maintain operations during a transition period in order to permit restructuring or an orderly winding down. Details are included in the technical standards.

From a qualitative viewpoint, there will be requirements for the governance of CCPs. In particular, a risk committee is to be set up, and will include clearing members of the CCP and independent parties. Its function will be to advise the CCP on issues of risk management.

Other important issues regulated by EMIR are the requirements for the removal or disclosure of conflicts of interest by the CCP and operational requirements as regards business continuity in crisis situations so that the business can be restarted quickly after a disaster.

[4] Committee on Payment and Settlement Systems.
[5] International Organization of Securities Commissions.

Segregation of collateral

One new aspect is that a CCP may segregate the collateral of clearing members from other collateral. A similar obligation should also be placed on clearing members vis-à-vis the customer. This segregation, that the CCP may offer as one of several models of holding collateral, is intended to help customers to quickly access paid-in collateral if its clearing member defaulted and if necessary transfer the clients' entire position plus collateral to another clearing member.

The technical standards will also include requirements as to the amount of collateral required from CCPs and the composition of the clearing funds they manage. This is intended to provide uniform criteria to make CCPs more robust against a default of clearing members. In addition to these mechanisms, CCPs should still keep back other financial resources in order to hedge against possible losses. From a risk point of view, the order of priority by which the individual mechanisms come into play upon default of a clearing member is important, as this also creates incentives for risk minimisation.

In this context the definition of highly liquid assets that can be accepted by the CCP as collateral is also of importance. The requirements of CCPs are rounded off with rules affecting the processes upon default of a clearing member and requirements for risk modelling and stress testing of CCPs. These are central elements that guarantee security against default of CCPs.

Interoperability

Interoperability is the technical connection between two CCPs so that their clearing members can carry out trades with each other and those trades can be cleared via the two CCPs. Such a process can prevent a market participant from being a clearing member of several CCPs and having to fulfil the necessary technical conditions for each. However, risk management is much more complex with interoperability, as the CCP risk models can be very different.

Interoperability may be required from an efficiency standpoint but may not always appear to make sense from a risk standpoint. Therefore, interoperability of CCPs is not initially to be possible for derivatives but is to be limited to cash equities.

Interoperability models are subject to increased requirements for risk management of the CCPs involved. Any approval of interoperability regimes requires the involvement of the respective colleges of the affected CCPs.

Supervision of trade repository

Access to data on a trade repository is important for supervisory purposes. Furthermore, aggregated data should also be made public. Therefore, trade repositories in the EU need to be approved or, if domiciled in third countries, they need to be recognised.

However, in contrast to the supervision of CCPs, as with rating agencies, the competent authority for supervising trade repositories is ESMA itself. A trade repository should have the necessary operational reliability to store and manage the data.
EMIR also regulates which public authority in the EU may access the data on a trade repository and under what conditions. Such public authorities may include, for instance, banking supervisory authorities, securities regulators or macro-prudential competent authorities such as the European Systemic Risk Board.

Outlook

At the moment, we can only give an initial overview of the regulation. The effects and challenges can only be subject to deeper analysis when the necessary technical standards have been developed.

Even now, it looks as if EMIR, in conjunction with the US Dodd-Frank Act, will have a significant effect on the derivatives markets. The debate in the international bodies will also likely be how to implement the G20 aims in other jurisdictions and how in the end the worldwide mechanisms will interact.

EIOPA assesses equivalence of other supervisory systems

Dr Harald Eschmann, Thorsten Arhold, BaFin

Switzerland's supervisory system can be rated as equivalent overall compared with the new European framework for insurance supervision, Solvency II. That is the finding reached by an equivalence assessment carried out by the European Insurance and Occupational Pensions Authority (EIOPA), on which BaFin employees also collaborated.

The assessment also found that Japanese supervision of reinsurers is equivalent to the new European regime "with certain caveats"; by contrast, the supervisory system in the British overseas territory of Bermuda was found to be "not equivalent" in respect of captive insurance undertakings and "equivalent with certain caveats" as regards the supervision of commercial insurers. The EU Commission decides on the equivalence of the supervisory regimes based on the assessment made by EIOPA.

Assessment of systems of Switzerland, Japan and Bermuda

On the basis of a Call for Advice of the EU Commission, EIOPA had been requested to assess the equivalence of the supervisory regimes of Switzerland and Bermuda in terms of Article 172 (reinsurance), 227 (group solvency) and 260 (group supervision) as well as Japan in respect of Article 172 of the Solvency II Framework Directive (2009/138/EC). The assessments were conducted by the Equivalence Committee of EIOPA.

The findings of the equivalence assessment have an impact on the solvency requirements for European primary and reinsurance undertakings entering into contracts with reinsurers from third countries, as well as for (re)insurance groups operating both in the EU and in third countries. The assessment is thus of decisive financial importance for the companies concerned.

Assessment method

The Committee initially drew up comprehensive questionnaires relating to the respective supervisory regime and sent these to the aspirants. The questions were evaluated by the country teams of the Committee. A further Q&A session took place prior to the supervisory visit in June 2011.

In the overall result of the assessment reports, a distinction is made between "equivalent", "equivalent with certaincaveats" and "not equivalent". If the finding is "equivalent with certaincaveats", the supervisory regime is initially treated as equivalent, but the points of objection are examined once again at a later time.

The Commission's requested public consultation of the draft assessment reports with the decision proposals of EIOPA took place in August of this year. The result of the consultation was included in EIOPA's final answer to the Call for Advice. The Commission is expected to decide on the equivalence of the supervisory regime at the end of 2013 on the basis of the EIOPA proposals.

Criticism of supervisory systems in Switzerland and Japan

EIOPA qualifies the supervisory regime of Switzerland overall as "equivalent" to Solvency II. There are minor caveats with regard to the companies' disclosure obligations that fall short of the standard under Solvency II. Also regarded as a problem by the Committee is that the Swiss Financial Market Supervisory Authority (FINMA) may exempt smaller insurers from the obligation to establish an internal control function and a compliance function. There is no provision in statute for co-operation on group supervision, even if the practice in this area is to be regarded as equivalent to Solvency II.

EIOPA assesses the supervision of reinsurance undertakings in Japan as "equivalent with certain caveats". The supervisory authority in Japan, the Japan Financial Services Authority (JFSA), has all relevant supervisory powers. However, the availability of qualified specialist personnel, particularly with regard to the transition to a fully risk-based supervision, is considered by the Committee as borderline. It moreover criticises that licensing can cover the authorisation of non-insurance business to a considerable extent. Although the disclosure and information obligations are provided for very comprehensively in the supervisory guidelines of the JFSA, they have no formally binding character in law. Overall, the capital requirements for insurers are less risk-sensitive than under Solvency II.

Differentiated classification in Bermuda

The supervisory regime in Bermuda appears to be "not equivalent" in respect of captive insurance undertakings and "equivalent with certain caveats" in the area of supervision of commercial insurers. Overall, the licensing regulations fall short of the standard under Solvency II, give the supervisory authority broad discretionary scope and are not comprehensively laid down in statute. There is no requirement for a business plan similar to Article 23 of the Solvency II Framework Directive. Shareholder control is possible only to a limited extent for the supervisory authority in Bermuda. In the corporate governance area, there are numerous exemptions that apply to captive insurance undertakings. In particular, no key functions for risk management, internal auditing, compliance and actuarial function are required as under Solvency II. Moreover, the extensive possibilities of outsourcing (even in the area of executive board functions) can lead to quasi-virtual companies in this segment, according to the analysis of the Committee.

There are also differences between captive and commercial insurance undertakings in terms of solvency requirements. The assessment of the supervisory regime of Bermuda moreover revealed the fundamental problem that decisive legal provisions are still in the development stage. The assessment finding for commercial insurers is therefore subject to the reservation of a review following entry into force of the statutory provisions relating to the solvency regime.

Further actions and transitional provisions for other third countries

The Board of Supervisors of EIOPA adopted the Advice on the equivalence assessments of Switzerland, Bermuda and Japan on 20 October 2011 and then sent it to the EU Commission. The Committee is to assess the development of the supervisory regimes after entry into force of the binding Level 2 equivalence criteria. The EU Commission is then expected to make the decision on equivalence based on this result in 2013.

Transitional measures

In 2012, EIOPA will assess the legal provisions of those third countries which can be considered for the Equivalence Transitional Measures for third countries as part of the solvency calculation. This is a kind of "light version" of the first equivalence assessments that are conducted in the form of a gap analysis. The EU Commission has drawn up a list of candidates, most of which have already been contacted.

In principle, a third country's participation in the procedure is voluntary. However, the Commission can and presumably also will subject those third countries providing only limited co-operation to a gap analysis based on publicly available information.

Relevance for German groups

For German insurance groups, what is important with regard to the future calculation of group solvency is:

- whether they intend to use, in one of the advised third countries for the supply of data of the subsidiary there, the deduction and aggregation method, with the result that Article 227 of the Solvency II Framework Directive would apply,

  and

- whether there are other third countries in which it has subsidiaries for whose data supply the group in future would like to use the deduction and aggregation method, but which so far are not on the list of the EU Commission and which are important for the group in respect of their risk capital in the respective country.

Based on the currently available knowledge, the vast majority of cross-border insurance groups will use the consolidation method for calculating group solvency under Solvency II. An equivalence assessment or gap analysis would then not be imperatively required for the assessment of group solvency according to Article 227 of the Solvency II Framework Directive.

Relevance for German primary insurers and reinsurers

In the case of a positive equivalence decision

- reinsurance contracts concluded with primary or reinsurance undertakings having their head office in a third country shall be treated in the same manner as reinsurance contracts concluded with undertakings having their head office in the EU or the European Economic Area (EEA) (Article 172 (3)),

- Member States may not require such primary or reinsurers to cover unearned premiums and outstanding claims provisions by depositing assets (collateral) with primary or reinsurers having their head office in the EU or the EEA (Article 173),

- Member States may not require such primary or reinsurers to hold assets in the amount of their liabilities under reinsurance contracts concluded with primary and reinsurers in the EU or the EEA (Article 134).

Experience report

Currently, the Equivalence Committee is preparing a paper on the experiences gained from the three assessments. The most important realisation will be that the work involved must not be underestimated: in the 8-month procedure, up to 1,000 pages of input from third countries had to be processed by the assessors parallel to their normal work.

This calls for not only quantitatively adequate assessment teams but also personnel assistance by EIOPA and experienced assessment leaders. The information provided by the third countries on their supervisory regime must be sufficiently detailed. The assessment teams should articulate their expectations clearly already at the start of the assessment. What is important is for the reports to be consistent both in their language and in the evaluation of the results.

New Supervisory Regime for Financial Conglomerates

Sina Weinhold-Koch, BaFin

Seven German companies are classified as financial conglomerates and, as such, are subject to supplementary supervision in accordance with the German Insurance Supervision Act (Versicherungs-aufsichtsgesetz – VAG) and the German Banking Act (Kreditwesengesetz – KWG): Allianz Deutschland AG, Debeka Group, Deutsche Bank AG, DZ Bank AG, Inter Versicherungsgruppe, Signal Iduna Group and Wüstenrot & Württembergische AG. The corresponding German supervisory regime is based on the Financial Conglomerates Directive of 16 December 2002 (Directive 2002/87/EG). This was most recently modified by an amending directive (2011/89/EU), which also amends the Insurance Groups Directive (98/78/EG), the Capital Requirements Directive (2006/48/EG) and the Solvency II Directive (2009/138/EG).

The amending directive came into force on 9 December 2011, from which date the EU member states have 18 months to transpose the European rules into national law. However, they must also deal with the problem that some of the proposals for CRD IV (Capital Requirements Directive IV) and the Solvency II Directive (Directive 2009/138/EG) modify the same supervisory provisions.

Gaps in the rules

After the Financial Conglomerates Directive came into force on 1 January 2005, it became clear that the rules did not achieve their objectives in certain cases or that they contained gaps. In its "Advice to the European Commission" dated 30 October 2009, the JCFC – formerly the Joint Committee on Financial Conglomerates, and since 1 January 2011 the Joint Committee's Sub-Committee on Financial Conglomerates[1] – identified several points as being in need of improvement. Additional modifications were also resolved in the course of the legislative process.

Based on these recommendations, the European Commission published its proposal for a revision of the Financial Conglomerates Directive in August 2010. In addition to the suggestions by the JCFC, the revised directive contains other new rules for the supervision of financial conglomerates. Together with the Omnibus I Directive (2010/78/EU), it ensures that the Financial Conglomerates Directive is adapted to match the new European supervisory structure. For example, common guidelines and technical standards for some rules can be issued by the Joint Committee of the three European Supervisory Authorities (ESAs).

Group supervision versus financial conglomerate supervision

Under the original Financial Conglomerates Directive, a serious problem arose in cases where the financial holding or insurance holding companies in the financial conglomerate become a "mixed financial holding company", for example due to the purchase of a company. Previously, in such cases the supervisory authorities had to decide at the level of

[1] The abbreviation "JCFC" was retained.

the holding company between sectoral group supervision and supplementary supervision under the Financial Conglomerates Directive.

The amending directive means that both supervisory regimes can now be applied in parallel. This is made possible by additions to the Insurance Group, Solvency II and CRD Directives. The amending directive ensures that these sectoral directives now define a "mixed financial holding company" and incorporate it into the directive's scope in each case. To avoid the duplication of identical obligations in the case of equivalent supervisory requirements, the amending directive also allows the authority responsible for supplementary supervision to decide, after consulting the other competent authorities, to apply only the supplementary supervisory regime.

New rules for identifying financial conglomerates

Supplementary supervision under the Financial Conglomerates Directive is designed in particular for large, complex groups and the resulting risks. To do justice to this intention, the amending directive modifies in particular Article 3 of the Financial Conglomerates Directive. This provision governs the thresholds for identifying financial conglomerates. In order to meet the requirement for risk-based, proportionate group supervision, asset management companies and alternative investment fund managers under the AIFM Directive (Directive on Alternative Investment Fund Managers – 2011/61/EU) in particular have been brought within the scope of the Financial Conglomerates Directive, and the exemption options for small, non-complex groups have been amended appropriately.

Following completion of the national identification processes based on the relative and absolute thresholds under Article 3(2) and (3) of the Financial Conglomerates Directive, it became clear that small groups whose insurance and banking/investment services activities are of a comparable size would also fall under the definition of financial conglomerates. There can be no question of any exemption from supplementary supervision in such cases because they do not fall below the ten per cent threshold under Article 3(2) of the Financial Conglomerates Directive. This undesirable situation has now been remedied by a new paragraph 3a in Article 3. Small, heterogeneous groups that exceed the ten per cent threshold but do not exceed the EUR 6 billion absolute threshold may be exempted from supplementary supervision.

A new subparagraph c) was also inserted into Article 3(4) of the Financial Conglomerates Directive. This allows one or more investees in the smaller sector in which the conglomerate is active to be excluded from the calculation of the thresholds if these investees are decisive for the identification of a financial conglomerate, but are collectively of negligible interest with respect to the objectives of supplementary supervision.

Annual review of exemption

If the competent authorities decide to exempt a group from supplementary supervision, they must now reassess their decision every year. This is stipulated by the new paragraph 9 in Article 3 of the Financial Conglomerates Directive.

A new Article 8 also allows the new and old rules for the identification process to be adapted by common guidelines.

Finally, two new subparagraphs inserted into Article 3(2) of the Financial Conglomerates Directive ensure that asset management companies and alternative investment fund managers under the AIFM Directive are included in the process of identifying financial conglomerates. To calculate the relative and absolute thresholds, they are allocated either to the sector to which they belong or to the smallest financial sector in the group.

Stress tests and supervisory colleges

Stress testing of financial conglomerates is now permitted, but not required. A new Article 9b in the Financial Conglomerates Directive gives the EU member states the option to require the competent supervisory authority (the "coordinator") to perform stress tests.

In accordance with the third paragraph of Article 5 of the amending directive, however, the European Commission is required to examine in its review report on the application of the Financial Conglomerates Directive to be submitted by

31 December 2012 whether mandatory stress testing for financial conglomerates should be introduced.

The amending directive expressly mentions supervisory colleges for financial conglomerates for the first time in the new paragraph 4 of Article 11 and in the recitals.

The recitals clarify that a (separate) college should only be set up for the financial conglomerate if neither a banking nor an insurance sector college is in place.

More transparency

The amending directive introduces a comprehensive new rule to ensure more transparency by revising Article 9(4) of the Financial Conglomerates Directive. Regulated entities must now provide the competent authorities with details on their legal structure and their governance and organisational structure. The overview must include in particular all regulated entities, non-regulated subsidiaries and significant branches, and must be updated annually.

Additionally, a list of all identified financial conglomerates must be published. Under the new Article 4(3) of the Financial Conglomerates Directive, however, the Joint Committee of the ESAs, rather than the European Commission, is now responsible for this list. The list should also be available to download on the websites of the European Supervisory Authorities.

Far-reaching reform on the cards

The amending directive results in more changes to the Financial Conglomerates Directive than were originally proposed by the JCFC. Nevertheless, the rules do not result in far-reaching changes to the supplementary supervision of financial conglomerates, and concentrate instead on closing existing gaps.

However, the amending directive does hold out the prospect of far-reaching reform in the foreseeable future: Article 5 instructs the European Commission to examine by 31 December 2012 whether a number of far-reaching changes should be made. These address in particular the question of whether the scope of the Financial Conglomerates Directive should be extended further, for example by including entities such as special purpose vehicles (SPVs), special purpose entities (SPEs), pension funds and Pensionskassen in the calculation of the thresholds.

Solvency II: Group-wide supervision in flux

Petra Faber-Graw, BaFin

The present contribution is a continuation of the report by Petra Faber-Graw from the BaFinQuarterly Q4/11. In it she summarises the most important issues that were discussed in the committee headed by her up to October 2011, namely the Insurance Group Supervision Committee of the European insurance supervisory authority EIOPA.

Definition of lead supervisor

The concept of lead supervisor was already introduced with Solvency I. For a clear pan-European definition of lead supervisor, the Insurance Group Directive established a number of criteria which, inspired by the Financial Conglomerates Directive, are found among the provisions of Solvency II.

The aim is to define, for each group operating on a pan-European basis, a single authority vested with certain co-ordination and decision making powers. These criteria were supplemented under Solvency I by the legally non-binding Helsinki Protocol. It assigns to the lead supervisor all supervisory colleagues having legal responsibility for certain entities within the group. The lead supervisor headed what at that time was the Co-ordination Committee (“CoCo”).

Clear division of supervisory powers

It was from this idea that the concept was born under Solvency II to introduce and define with legally binding effect the concept of a “college”, and to vest such bodies with specific supervisory powers that are delineated at the group and solo level. The intended aim of the college is to gain better overall knowledge of the group, to strengthen co-operation amongst the supervisors concerned and to be better able to identify, assess and measure the risks of the group both nationally and worldwide.

Ultimately, the solo supervisor is also to be better informed overall about the group and to make his contribution towards ensuring that the information procured provides a group picture. The principle applying here is that the group supervisor is responsible for co-ordination and has the final say on certain key issues. For example, he approves internal models for calculating group solvency.

Nonetheless, the group supervisor is always required to consult the college prior to any of his decisions.

Mediation at EIOPA

The college itself does not have any legal decision making power. However, its members may have deviating opinions on certain group issues recorded in writing and initiate a mediation process with EIOPA. If the outcome of the mediation process does not result in a common ground allowing for a consensus to be formed within the college, the national supervisor has the possibility of applying a capital add-on for the group entities supervised by him so as to reflect the risk profile. Capital add-ons applied by solo supervisors must be included at the group level, i.e. "netted".

Moreover, the group supervisor may require a capital add-on if the group fails to satisfy the risk profile and the governance provisions for a protracted period.

Possible transitional provisions

At Level 2, there are currently discussions among other things about various possibilities of introducing sensible transitional provisions to make the transition to Solvency II easier for the insurance undertakings. Under one proposal, insurers are to be given greater freedom when it comes to choosing between the consolidation method and the deduction and aggregation method. Such transitional provision would alleviate concerns that, according to Article 220, all groups would immediately have to calculate on a consolidated basis.

Another possibility relates to regular reporting on the solvency capital requirement (SCR), which under the Directive must take place "at least annually". If shorter reporting periods are decided for on Level 2, the provision for annual reporting could apply for a transitional period until such time as the requisite processes have become established at the undertakings concerned. However, ad hoc calculations provided for outside regular reporting obligations should not be affected by this provision.

No disadvantaging of third-country branches

One of the purposes of Solvency II is to provide EU-wide protection of policy holders. At the same time, policy holders of (re)insurance undertakings in third countries in principle should not be put at a disadvantage. In the Level 3 discussion on group supervision currently being conducted at EIOPA, overarching issues are being dealt with in this regard: of particular concern is the question of how the Level 1 and Level 2 texts are to be applied to European branches of third country (re)insurance undertakings as well as whether and to what extent supervision for branches of third country (re)insurers in the EU can best be harmonised. Article 174 of the Solvency II Directive provides that no provisions shall be applied to third-country reinsurance undertakings taking up or pursuing reinsurance activity in the territory of a Member State where such provisions result in a more favourable treatment than that granted to reinsurance undertakings having their head office in that Member State.

In many countries it is currently not permitted by law to liquidate a branch in isolation and without a court decision in countries in which the group has its headquarters. The solvency calculation of the group is "indivisible" with respect to the branches included. That in turn means that the supervisory authority cannot view the solvency of a branch in isolation from the solvency of a group. To sufficiently protect policy holders of branches of third-country undertakings, the way in which certain requirements are to be dealt with at the undertaking/group level has to be clarified to the extent these requirements affect policy holders of the branches within the EU.

Discussion examples

The following examples provide an overview of the issues currently being discussed at Level 3.

- Own funds: Article 166 (2) requires the eligible amount of basic own funds required to cover the Minimum Capital Requirement (MCR) of the branch and the absolute floor of such MCR to be constituted in accordance with Article 98 (4) whereby the share of Tier 1 items in the eligible basic own-fund items is required to be higher than half of the sum of the basic own funds. By contrast, Article 166 (3) stipulates that the eligible amount of basic own funds may not be less than half of the absolute floor of the MCR of the branch. This provision initially appears incompatible with the requirement under Article 166 (2).

- SCR: In view of the fact that an undertaking's solvency calculation in practice is not divided up quantitatively among the branches, the question is raised – for the reasons mentioned above – whether Member States should perhaps require a higher "proportionate" SCR amount for the branch of the third-country insurer.

- Governance: Unlike the SCR provisions, Article 162 (2i) requires the governance requirements to be fulfilled by the undertakings themselves and not by the branch. To date there is no provision that would limit the application of the governance requirements to activities within the Member State of the branch or even within the Community.

- Reporting and disclosure requirements: Article 35 requires the (re)insurance undertakings to submit to the supervisory authorities the information which is necessary for the purposes of supervision. The explicit requirements for branches of third-country (re)insurers according to the Solvency II Directive as well as the requirement for a "non-favourable" treatment of third-country (re)insurers would mean that Article 35 also applies to branches of third-country (re)insurance undertakings. The requirement for a "non-favourable" treatment might also mean that the Solvency II disclosure obligations as set out in Chapter IV Section 3 also apply to third-country (re)insurance undertakings. But the Solvency II Directive is silent on the details regarding the nature and extent of the disclosure obligation for third-country (re)insurance undertakings. No more is it clear at present which of the individual reporting formats, if any, are to apply to branches of third-country (re)insurers.

- Colleges: Various group supervisors of large Member States currently see advantages in a participation in colleges, particularly where Article 167 is considered. An informal involvement in the colleges would not fall within the scope of the Solvency II Directive, which could mean that the requirements for the colleges stipulated in Title III Chapter III, including the binding mediation process of EIOPA, would no longer be applicable here.

- Extraterritoriality questions: At Level 3, discussions are also currently revolving around responsibilities in connection with extraterritoriality in the application of solvency or governance standards at the level of the undertaking or in the imposition of fines on branches.

Outlook: Omnibus II Directive

The transformation of the former Committee of European Insurance and Occupational Pensions Supervisors into the new EU supervisory authority EIOPA will also have an impact on the text of the Solvency II Directive. These changes will take place as part of the Omnibus II Directive. Articles 7 and 7e of this Directive currently define the rights and obligations of EIOPA which among other things include issuing EU-wide binding technical standards and recommendations.

For group supervision, two subject areas are the focus of interest in this connection: firstly, setting binding standards and conditions for co-operation and exchange of information between supervisory authorities, and secondly, defining the conditions for applying the disclosure regulations that are relevant at the group level.

Issue

INTERVIEW

BaFin President Dr Elke König: "We want to be regarded internationally as a benchmark"

BaFin President Dr Elke König

Dr Elke König has been President of BaFin since early January 2012. Around 100 days after she took office, BaFinQuarterly spoke to her about the challenges that will have to be overcome in Germany, in Europe and internationally in the months ahead.

Dr König, your predecessor Jochen Sanio called for supervision with teeth. How do you think BaFin should act towards the financial industry?

BaFin will continue to be a strong and effective supervisory authority that fulfils its functions with a due sense of proportion and deals with the institutions under its supervision on an equal footing. In banking supervision, in which we collaborate very well with the Bundesbank, the banking industry should view both institutions as a dynamic single whole.

My objective is for BaFin to be regarded as a benchmark in Europe and in international bodies. After all, Germany is a major financial market. For that reason we want to participate closely in the shaping of European and global supervisory standards. A lot of new things are currently coming together. We should look on that as an opportunity.

What topics are you thinking of in particular, and where do you see the biggest challenges in the months ahead?

First of all would come the three European Supervisory Authorities[1]. We must be careful to adopt the right position in the new European System of Financial Supervisors. At the same time we are faced with the implementation of various regulatory packages such as, for example, Basel III by CRD IV[2] and Solvency II. In addition, in no circumstances we must lose sight of regulation of the shadow banking sector.

Let us just take a closer look at the first item. What does it mean for BaFin to adopt the right position in mutual relations with the EBA, EIOPA and ESMA?

Let us be clear about one thing: there is no alternative to the European System of Financial Supervisors. Europe is a common economic area for which we will in due course need a common rule book. This is also in the interests of the German financial industry. When I say "adopt the right position", I mean above all participating in the formulation of the European rules for the financial sector. In this connection it is important for us to bring our influence to bear in all ways and to contribute our expertise: for example in the Boards of Supervisors, through working together in the working groups in which the technical standards are developed, by occupying top positions and by providing the best possible advice to the chief political negotiators in the Council.

BaFin will assist the work of the ESAs and the ESRB[3], but will also keep a critical eye on them. The EU Commission will present a first experience report on the activity of the three authorities in early 2014. The ESAs' founding Regulations might then have to be improved upon here and there.

Especially since everything did not run smoothly at the EBA last year.

I file that under the heading of start-up difficulties. You also have to recognise that the EBA had to take on a huge job from a standing start in 2011. Since the next stress test is not scheduled to take place until 2013, there is now sufficient time for it to take a new direction, for example beyond focusing on the potential need for more capital to analysing how and in what areas banks are reacting to adverse market situations. BaFin will make its views on this issue very clear in the EBA.

You had just mentioned the CRD IV regulation package.

Yes, that is currently one of the most important topics in banking supervision. In the years ahead the EBA will be having to draft technical standards for all the supervisory requirements and processes – for the Capital Requirements Regulation alone, there will be more than 100 of these. We must ensure that legitimate German interests remain safeguarded here.

What other topics will be keeping banking supervisors particularly busy in the months ahead?

Maybe the question of how we supervise systemically important banks. By now, 29 institutions have been classified as G SIBs[4]. Special rules will apply to such institutions in future. For example, there will be a capital surcharge. The next thing we will have to sort

[1] The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), known collectively as the European Supervisory Authorities (ESAs).
[2] The EU is bringing in the CRD IV package, consisting of a Directive (the Capital Requirements Directive – CRD IV) and a Regulation (the Capital Requirements Regulation – CRR) because it wants (among other things) to implement the Basel III decisions, which provide for stricter capital and liquidity requirements.

[3] European Systemic Risk Board.
[4] Global systemically important banks and banking groups.

out is the question of how we deal with the banks that are systemically important at the national level. How are they to be defined? What requirements are to be imposed on them? That is a fascinating discussion, which is still only just beginning, though.

How should we deal with national banking giants?

Unlike G-SIBs, with domestics the focus cannot be on higher capital requirements alone. In my opinion, in this case the intensity of supervision is critical: for certain important banks we need particularly intensive supervision. By concentrating on the whole subject of capital, sight is frequently lost of the fact that risk management, the nature of the business that an undertaking conducts and the organisational set-up put in place for this are far more important. Capital must always be the last line of defence – but not the only one.

There is also much discussion internationally of the question of how in emergency situations large institutions can be helped to recover, or even be resolved, across national borders. When do you expect agreement to be reached on this?

The subject of cross-border restructuring is a very complicated one. Although our German Restructuring Act means that we do not need to fear comparison at the moment, the effect of national legislation simply ends at national borders, which is a problem when it comes to G SIBs. For that reason, in October 2011 the FSB[5] adopted principles for the recovery and resolution of G-SIFIs[6]. They are meant to facilitate the orderly resolution of such institutions. A significant component of the FSB requirements is recovery and resolution plans. The FSB is keeping a very close eye on whether national supervisory authorities have been presented with such plans for their G-SIFIs. BaFin is responsible for the two German G SIFIs, Deutsche Bank and Commerzbank.

The question of burden-sharing is also playing a prominent role. National interests very quickly manifest themselves at the international level: every country wants to protect its taxpayers and its depositors. We need to be realistic here.

How is the EU dealing with this?

A Crisis Management Directive is planned. Consideration is being given not only to implementing the FSB requirements and introducing a burden-sharing scheme. There is also talk of a creditors loss-sharing scheme, commonly referred to as debt write-down[7]. By the time we have such a Directive at the latest, the recovery and resolution of institutions should be easier to plan and to manage, for the European area at least.

In order to prevent things getting that far at all, the FSB is closely examining the recapitalisation plans which six German banks (among others) have submitted following the EBA recapitalisation survey. Are you expecting any unpleasant surprises?

On the contrary. It is clear from the plans of the German banks involved that not one of them will have to call on the State to manage their recapitalisation. In principle, the EBA has already accepted the plans. The respective international supervisory colleges have discussed the plans. In my eyes, that is also the only proper process for informing the host country supervisors of these plans in good time and adequately. It now remains to be seen whether they work out.

What will change for the banks if or when the plans are put into effect?

Our analysis of the plans has revealed that none of the German institutions involved will change its behaviour in its core business. The fact that banks are reducing their risk positions, also known as deleveraging, is not a bad thing in and of itself. It’s just that deleveraging is one of the instruments available for recapitalisation. A supervisory authority can find nothing wrong in that, in the sense of a return to core competences and business. It would become dangerous only if it took on excessive

[5] Financial Stability Board.
[6] Global systemically important financial institutions.
[7] Debt which at the supervisory authority’s instigation can be either converted into capital or written down.

proportions and resulted in a credit squeeze. But that is not the case in Germany at present.

Are you afraid that the criteria that the banks must meet might be eased again?

I don't think so. We will of course have to discuss in due course whether the sovereign buffer[8] introduced in the course of the survey needs to be applied. One might even hope that the idea may be dropped some time. But I cannot imagine that we will deviate from a capital requirement that has only just been decided in the very near future. Furthermore, Basel III – and CRD IV – do not require any lower capital resources in the final expansion stage in 2018 than the EBA's recapitalisation recommendation. The EBA's recommendation can therefore also be interpreted as a major intermediate step towards Basel III and CRD IV.

While a lot has been done internationally on the regulation of banks since the outbreak of the financial crisis, the same cannot be claimed regarding the shadow banking sector. You have already mentioned the subject as one of the biggest challenges.

It is very important that we don't get bogged down on this. So far the various FSB working groups have merely been gathering the facts. In so doing, we are defining quite wonderfully everything there is, in order then to continually identify and add new points. But we urgently need to move from description to action on this subject. Otherwise we'll be regulating the banking market while the risks are being created next door.

The next step must therefore be to make the connections between regulated banks and shadow banks transparent. We must then regulate these connections if need be. But the regulation of shadow banks themselves is also something we should push ahead with straight away. That's the only way dangerous arbitrage can be stopped.

[8] Capital buffer that takes into account the default risks on government (sovereign) bonds.

Why do you think it is that the negotiations are faltering?

The problem is that by now national interests are diverging relatively widely again. Unfortunately, a good many countries appear to be focusing more on short-term market advantage than on long-term stability. I also have the impression overall that the enthusiasm for this topic is waning. During the financial crisis the pressure to do something was very high.

Attention was focused on developing new capital and liquidity rules. Although at that time there were fears that funds might shift into the shadow banking market, the problem itself was not tackled at first. Now that it is possible to tell in which direction the markets are changing, we must on no account take even more time on regulating shadow banks. If we don't make significant progress soon, it is only a question of time before we are hit by unpleasant surprises from this area.

How do you intend to ensure that the topic is given renewed impetus?

By keeping on raising it in international bodies, by trying to win support for it and by finding allies so as to form majorities. Of late, I have gained the impression that some countries who have up to now been stonewalling are shifting ground a little. In any event, I remain optimistic – after all, I am a Rhinelander.

We have spoken a lot about banking matters, but there is also a project of great importance in insurance supervision: the European rulebook Solvency II.

We and also EIOPA are being asked to take on quite a lot with the development of the technical standards for this rulebook. My biggest concern is that proportionality is preserved. Small and medium-sized insurers cannot be asked to meet the same requirements as large ones.

I'm not particularly concerned about the capital requirements – in principle the basic model applies to all, although smaller insurers will hardly want to devise internal models because the cost is simply too great. But the reporting and disclosure requirements will need to be looked at closely, to see who really needs what information.

Solvency II is supposed to come into effect in 2013 and to be applied in full from 1 January 2014. In view of the discussions on the supplementary Omnibus II Directive, is this timetable still realistic?

I think so, even if it is very challenging. There must be no further delays, though, otherwise it will become a problem for supervisors and undertakings to prepare for the changes in good time. Many of the rules that we need in practice have simply not yet reached a point where undertakings can align their organisational processes with them and adapt their IT systems. And we also need a certain lead-time in order to prepare ourselves for analysing the data.

I am generally of the opinion that one must set oneself ambitious deadlines. There are of course still some things that need to be improved in Solvency II. But a start must be made on the implementation some time. But then in three or five years' time we should also have the courage to say: "That's worked out well and that hasn't, so that's where improvements need to be made." After all, we're not creating a system that's got to remain exactly as it is for the next 30 years. What is certain is that we need a reform now. At present we have a solvency system for insurers that urgently needs to be put on a new footing.

Small and medium-sized insurers in particular are rather sceptical on this issue.

For many smaller undertakings the switchover to Solvency II is a major challenge. The big insurers are coping better with the whole process because they have the appropriate resources. We take the concerns of small insurers very seriously and are arguing in EIOPA for a further reduction in the complexity of the rulebook in the interests of proportionality. But in my opinion, an association such as the GDV[9] is also playing a major role in preparing undertakings for Solvency II. I'm sure small insurers in particular can make good use of the support of the Association.

Let us turn from small to really large insurance undertakings. Do you think it is also possible to identify global systemically important institutions in the insurance sector, as in the banking sector?

There you are opening another important line of questioning. I believe that the considerations that apply to banks cannot simply be transferred to insurers. The risks of a run or domino effects are unlikely in the insurance sector. Quite different mechanisms come into play there. Life insurance is a mainstay, a primary pillar, so to speak, of pension provision. If this pillar wobbles, that is a social problem on a national scale.

But there is hardly one single undertaking that would bring the whole pillar tumbling down. The danger that I see lies rather in the largely similar structure of the investments of all life insurers. If one of the building blocks that go to make up the investments falls dramatically in value or is lost altogether, then it won't be just one insurer that collapses – many may fall. This means that just one issue – not one undertaking – causes the whole pillar to teeter on the brink without the undertakings being directly linked to each other. For that reason capital alone will not help in these circumstances either.

Instead, our focus must be on risk management, on (among other things) the most appropriate mix and diversification of investments. This also applies under the Solvency II regime.

Another major difference from the banking system is that if problems arise in the insurance sector there is more time to restructure, transfer portfolios or find other solutions. Although it is repeatedly argued that the US insurance group AIG had to be rescued in the

[9] Gesamtverband der Deutschen Versicherungswirtschaft (= German Insurance Association).

financial crisis, the reason for this lay not its insurance business but in the fact that the company also provided financial guarantees, i.e. ultimately it was operating in the shadow banking sector.

BaFin's low interest rate enquiry recently revealed that German insurers are well placed. Does that mean that there is no reason to fear any problems?

The results of the enquiry don't mean that we can now sit back and take it easy. If interest rates remain low for a long time, this will have a severe impact on undertakings in the medium term. The next few years will weigh heavily on insurers because they will have to build up an urgently needed addition to their premium reserve. That will have to be financed first. Even if insurers have made preparations – that won't be good enough without support from changed framework conditions. For that reason we welcome the fact in the government's Bill for the Amendment of the Insurance Supervision Act the arrangements governing sharing in valuation reserves are being amended, something we have been calling for for a long time. This is a first step in the right direction.

What are the main items still high on the agenda in 2012?

Above all, there would be the international regulation of derivatives trading. This subject is making slower progress than hoped. I think this is due, firstly, to the fact that things are enormously complex. More and more very different players are involved in such transactions. Secondly, the industry must of course be given the chance to implement everything that is agreed, and there the devil is in the detail.

But we need this regulation urgently; I see no alternative – even though there will of course never be a completely watertight solution. The subject will raise entirely new questions: What happens if a Central Counterparty fails? Or how can we make it possible for supervisors to have access to data available on global transactions registers? But transparency in this market, which is after all closely linked with the shadow banking sector, is absolutely imperative.

Dr König, thank you for granting us this interview.

Agenda

DIARY

08.05.	**ESRB** Advisory Technical Committee, Frankfurt
08./09.05.	**IAIS** Technical Committee, Washington
14.-17.05.	**IOSCO** Annual Conference, Peking
18.05.	**FSB** SCSRC, London
29.05.	**FSB** Plenary, Hong Kong
05./06.06.	**IOPS**, Paris
06./07.06.	**EBA** Board of Supervisors, London
14./15.06.	**EIOPA** Board of Supervisors, Frankfurt
18.-21.06.	**IAIS** Triannual Meetings
19.06.	**ESMA** Board of Supervisors, Kopenhagen
19./20.06.	**BCBS**, Stockholm
21.06.	**ESRB** General Board, Frankfurt
26./27.06.	**Joint Forum**, Amsterdam
02.07.	**Joint Committee**, Paris
11./12.7.	**EBA**, Board of Supervisors, London

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