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President's Statement

The Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin) is the guarantor of the continuing stability, competitiveness and integrity of the German financial system. It would be fighting a lost cause, however, were its voice audible only in that territory lying between Flensburg and Passau. Today's financial markets are interwoven with one another worldwide. Regulators must therefore think and act internationally – and they do.

BaFin nurtures close contacts with other regulatory authorities – including those beyond Europe's borders. We develop our regulatory practice in large part in concert with our foreign colleagues in international bodies. The foundations of German supervisory law are laid down in the institutions of the European Union. In the EU committees of the CESR, CEIOPS and CEBS, BaFin sings in the choir of European regulatory authorities.
But when it comes to making European harmonisation consonant with German interests, it can also sing with a powerful solo voice.

Things have been happening on the international supervisory stage over the past year: the Market Abuse Directive, for example, has been promulgated. This is intended to set Europe-wide uniform standards for combating insider trading and market manipulation. Solvency II, the future European system for supervising insurance companies, is taking shape and "Basel II", the new capital accord for banks, is approaching completion. Both projects represent a new supervision of solvency - a supervision that is oriented towards individual risks assumed by banks and insurers and that maintains scrutiny of their internal risk management systems at all times. Here in Germany, we are already taking great strides forward along that path.

Jochen Sanio
President

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Advantages of integrated supervision.

The advantages of integrated financial market supervision clearly manifested themselves in BaFin's first full financial year. Solvency supervision and customer protection issues were resolved more quickly than before due to BaFin's role as the main point of contact for all market participants.

Merged supervision also proved a plus because most of the institutions and companies supervised faced similar problems. They were all affected equally by unstable developments on the financial markets, for example. The high volatility that marked the beginning of the year was followed by a substantial recovery in prices as the year progressed.

Integrated supervision also proved its worth in moulding the international regulatory environment. Opinion shaping has become considerably easier now that supervisors can speak "with one voice" in all international bodies. The merger has not only given German regulators a stronger voice in international discussion forums. BaFin's comprehensive approach to supervision enables knowledge transfer and synergies that make it much easier to set a regulatory course. In the insurance arena, for instance, "Solvency II" is developing a new risk-oriented regulatory framework influenced primarily by the banking supervision rules contained in "Basel II".

Basel II in the home stretch.

The capitalisation rules imposed on credit institutions with regard to assumed risks (Basel II) have been undergoing fundamental reform since 1999. In 2003, the Basel Committee on Banking Supervision took a number of decisions that considerably advanced this process. In the first half of 2004, the Committee will be seeking to reach a fundamental consensus on how the new accord will look. The presentation of these "Framework Agreements" will be followed by a series of national consultations.

Solvency II enters the next phase.

In 2001, the Insurance Committee of the European Commission proposed an initial series of research studies as part of the new "Solvency II" project aim at improving on current practices with regard to accounting for insurance undertaking risks. In 2003, the Commission concluded the first phase of the "Solvency II" project. The result of this first phase is a three-pillar approach inspired by "Basel II" but tailored to the insurance industry. A discussion draft for an EU framework directive based on this approach should be submitted by early 2005.

Stress tests in the media.

The stress tests to which BaFin subjected insurance undertakings attracted a great deal of attention in 2003. The tests are one of BaFin's early warning instruments. A stress test simulates the effects of hypothetical crisis developments in the capital markets on an insurance undertaking's (IU) balance sheet. The simulation is designed to demonstrate whether, even in an ongoing crisis situation (= stress scenario), the IU would still be in a position to meet its obligations without having to resort to counter measures.

The results of the tests were frequently misinterpreted by the media in 2003. Failing the stress test is first and foremost a signal that the IU in question needs to improve its ability to bear risk. This is the only way problems can be avoided if a crisis actually surfaces on the capital markets in the future.

Protektor goes into action.

In 2003, Protektor Lebensversicherungs-AG, the rescue company for the life insurance industry formed in the previous year, went into action for the first time. When Mannheimer Lebensversicherung found itself in a financially precarious position and no outside investor could be found for the troubled company and its shareholders to fill the financial gap, BaFin was obliged to order the company to transfer its entire insurance portfolio to Protektor. This allowed the claims of life insurance customers to be protected and the policies to remain effective.

Medicator is brought to life.

Since last summer, health insurers have had their own rescue company. On 3 July 2003, the eight largest German health insurers

formed Medicator AG. If a private health insurance finds itself in financial distress, Medicator will ensure that its insurance policies are continued. Currently, unlike Protektor Lebensversicherungs-AG, the corporation is purely a holding company.

Reinsurers under supervision.

Developments on the international insurance markets prompted the legislature to once again consider further strengthening the supervision of reinsurance companies in 2003. It resolved not to wait for the EU to adopt the relevant directive, which was under preparation at the time. The preliminary work for the new national legislative project has been underway since October 2003 and is oriented along the lines of the EU's draft directive. Under the new supervisory provisions, the regulations applicable to primary insurers are to be adopted and applied to reinsurers to the maximum extent possible. At the core of the new supervisory system is the requirement that reinsurers obtain a licence to conduct business and that they are subject to solvency rules in the future. The new rules, together with further amendments to the Insurance Supervision Act (*Versicherungsaufsichtsgesetz – VAG*) are expected to come into force no later than the beginning of 2005.

Crackdown on market manipulation.

2003 was the first full year in which BaFin's duties included analysis of stock exchange and market price manipulations. This responsibility was allocated to the integrated supervisory authority in July 2002. Since then, market analysis has covered both the monitoring of insider activities and targeted searches for price manipulations. In an official move taken in the Spring of 2004, the Federal Justice and Finance Ministries drafted two statutes intended, among other things, to implement the objectives of the German government's 10-point programme and improve corporate integrity and investor protection. Both legislative drafts – the Balance Sheet Control Act (*Bilanzkontrollgesetz – BilKoG*) and the Act on the Improvement of Investor Protection (*Anlegerschutzverbesserungs-gesetz – AnSVG*) affect securities supervision activities.

Two-stage control procedure for enforcement.

The BilKoG is designed to counteract irregularities in financial statements and reports. The statute will affect issuers whose securities are traded in Germany on the official or regulated market. At the heart of the draft law is the establishment of a two-stage control procedure (enforcement): a private auditing agency shall be put in place to conduct fundamental examinations in order to check that the accounting policies of the companies in question comply with regulations. According to the plan, BaFin will use public law remedies to enforce an audit if a company fails to cooperate with the auditing agency.

New prospectus obligation for the grey capital market.

The aim of the planned law to improve investor protection is to strengthen the rights of investors and promote their trust in the integrity of the capital markets. The obligation to publish a sales prospectus is to be extended to include what are known as "grey market" products – such as uncertificated equity participations.

BaFin will continue to act as a depository and reviewer for prospectuses pursuant to the Act on the Prospectus of Securities Offered for Sale (*Wertpapier-Verkaufsprospektgesetz – VerkProspG*).

Investment Modernisation Act comes into force.

The Investment Modernisation Act (*Investmentmodernisierungs-gesetz- InvmG*), which came into force on 1 January 2004 represents the German government's legal implementation of two amending directives to the EU Investment Directive – the "OGAW Directive". The German government took this as an opportunity to liberalise and modernise German investment law. The revision has brought with it new tasks for BaFin. The legislature's decision to tread into new territory and allow hedge funds has received considerable media coverage. Moreover, investment companies with variable capital have now become a possible vehicle for this type of fund. BaFin reacted by establishing a new section for hedge fund and investment stock corporation supervision at its Frankfurt am Main office. The new section will be responsible for issuing licences and authorisations, as well as for the ongoing supervision of domestic hedge funds. In addition, it shall monitor the distribution of foreign hedge funds in Germany.

Important steps taken towards adopting International Accounting Standards.

With the adoption of its Fair Value Directive, the IAS Regulation and the Modernisation Directive, the EU has set the course for the introduction of International Accounting Standards (IAS): BaFin has been working on the development of accounting standards with the International Accounting Standards Board (IASB) at both national and international level for some time now. In 2003, the discussion focused on Exposure Draft 5 (Insurance Contracts) as well as IAS 32 (Financial Instruments: Disclosure and Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement). While Exposure Draft 5 is still at the discussion stage, the revised Standards IAS 32 and IAS 39 have already been issued. Both standards will have a considerable impact on accounting by banks and insurers.

1 Financial stability in Germany

The macroprudential perspective is becoming more important for regulators ...

Financial stability in Germany can only be assured with effective and credible financial supervision. Since the end of the 1990s, the realization has taken hold worldwide that national regulators can only properly accomplish their mission if they extend their horizons beyond domestic economic aspects. This change of heart was consummated under the pressure of financial crises, turbulence on the stock markets, financial innovations and the increasing globalisation of money flows. Today, because of greater economic and financial integration, risks can not only be traded better, but can also be transferred more quickly than in the past. It is not only national borders that are becoming more open – there are also close ties between the individual branches of the German finance industry. Credit institutions, insurance undertakings and investment firms are becoming more and more close-knit in terms of both business and competitive relationships on the capital markets. Last but not least, there is increasing interaction between the finance industry and the real economy.

… and complements domestic economic perspectives.

This means that the German financial system is not immune to developments in other countries and in the other sectors of the German economy – something that regulators cannot ignore.

Analysis of the national and international environment in which financial enterprises do business both complements and supports the conventional supervision model, which is closely linked to individual institutions. If this broad perspective can enable the timely recognition of looming threats to the financial sector, regulators can adjust their instruments in order to act more effectively and head off crisis developments. There is also an international and European dimension to this overarching approach to supervision. The international Financial Stability Forum and the economy networks of the European supervision system regularly study potential threats to financial stability. The country-specific studies conducted by the International Monetary Fund – the "Financial Sector Assessment Program (FSAP)" – add weight to the macroprudential approach[1]. This means that financial market and financial stability analysis represents an important multi-sector mission for BaFin.

1.1 In retrospect: developments in the financial markets

A bumpy ride on the international financial markets.

2003 was a year of what were often abrupt changes in direction on the international financial markets, many of which caught market participants unaware. During periods of heightened uncertainty, there were drastic temporary increases in the volatility of price movements. Over time, however, the situation on the markets calmed perceptibly.

Financial institutions benefit from rising share prices.

At the beginning of last year, leading stock indices fell to multiyear lows. The S&P 500, for example, lost as much as 49% on its all-time high of March 2000, while the DAX was down as much as 73%. Technology stocks tumbled even more. Sentiment did, however, pick up shortly after the first wave of military action in Iraq, fuelled by expectations of a quick end to the conflict. Low interest rates favoured higher stock prices and investors were again prepared to move funds out of safer investments to seek better returns in riskier positions.

After the Spring of 2003, the stock markets made major gains and recuperated a large part of the losses they had suffered. The German financial sector clearly profited from the higher valuation level.

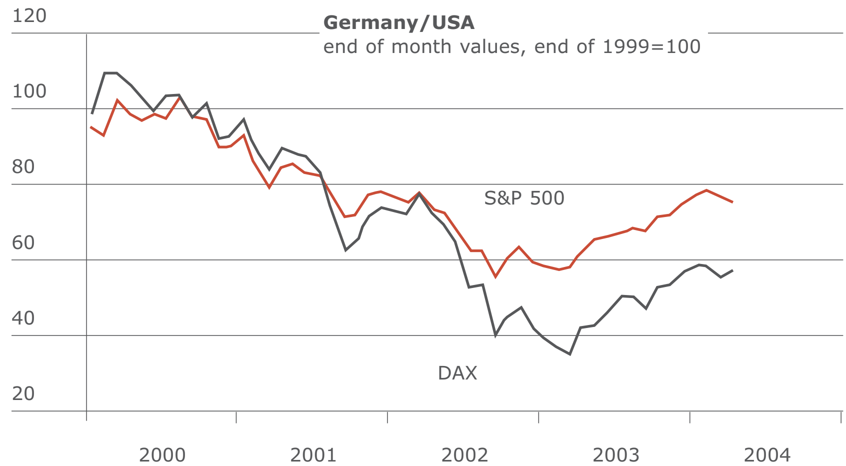
The unrealised hidden liabilities burdening banks and insurers – insofar as these had not already been written down anyway – were markedly reduced. This stabilised the earnings position of many financial services providers. What matters now is how well advances in the stock markets can be sustained by advances in the real economy.

The economic situation has improved worldwide.

Although it was primarily the US economy that overcame weak growth on the global economy and lent support to the worldwide recovery in the Spring of 2003, many developing countries in Asia also came through with their own strong upward surges. By

[1] cf. Chapter I 2.1.

Fig. 1
Stock markets in comparison



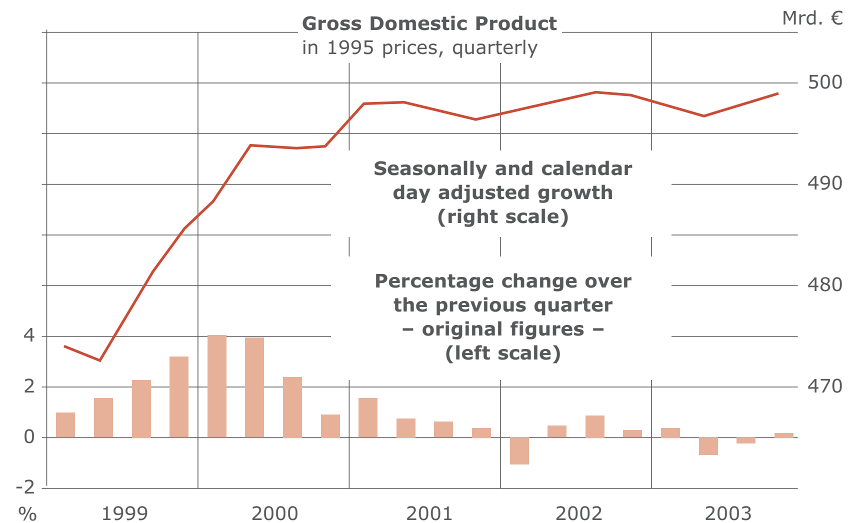
Source: Deutsche Börse AG, Standard&Poor's, own calculations

comparison, the recovery in the euro zone was rather subdued, despite low interest rates and stable prices. Growth rates should accelerate somewhat this year if the spark from the export-driven economies can ignite growth on the domestic economy. The global upswing is having a direct impact on internationally active German financial services providers, providing them with an opportunity to expand their business.

The German economy is slowly awakening from stagnation …

The German economy ought to profit from the upward trend on the global economy. Up until now, however, it has had a hard time freeing itself from a phase of persistent stagnation. It was only in the second half of 2003, when world geopolitical risks ebbed and some reform projects were initiated in Germany, that the forces of growth gradually got the upper hand. It is still too early, however, to speak of a broad-based, self-sustaining recovery.

Fig. 2
Economic growth in Germany



Source: Federal Statistics Office, Deutsche Bundesbank

... ... with stabilizing effects on the financial sector.

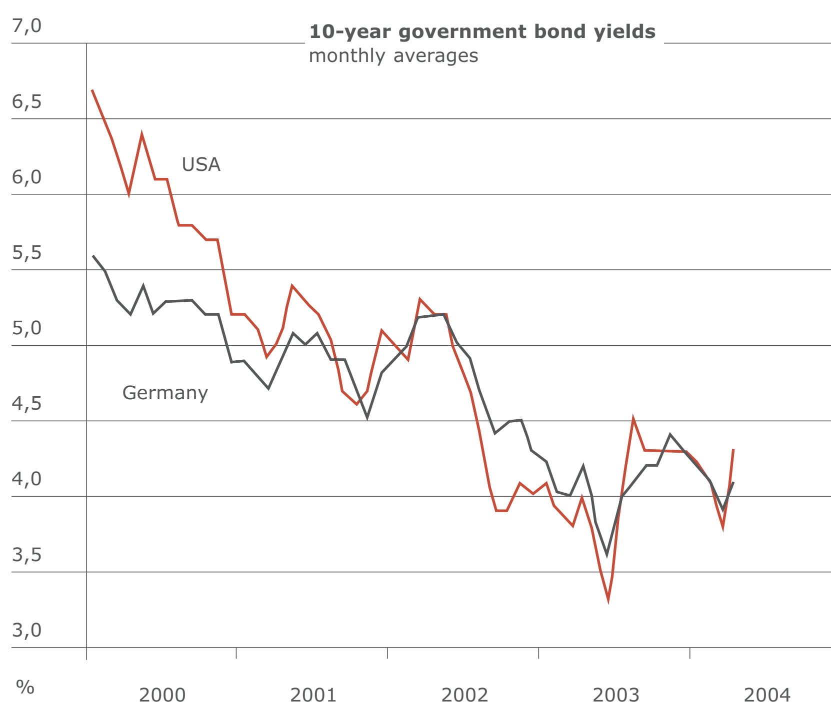
The modest economic improvement appears to have created a little breathing room for German financial services providers. Although the 40,000 company insolvencies in 2003 – again almost exceeding the record levels of the preceding year – produced a large amount of defaults that had to be absorbed, the value of unpaid receivables fell appreciably because fewer large businesses became insolvent. In addition, there were increasing signs towards the end of the year to suggest that company failures had finally peaked. Given a more stable German economy, financial services providers can limit their loan loss risks and start to expand their business activities again. Together with their own cost reduction initiatives and more robust financial markets, this will take some of the burden off financial sector balance sheets.

After some turbulence, the bond markets are again on track.

The fear of global deflationary tendencies and expectations that the American Federal Reserve would react by buying government debt pushed interest rates on the bond markets down to historic lows in the early Summer of 2003. As this scenario became increasingly less likely and as economic prospects improved, yields in June rose sharply within a few weeks, with developments in Europe more restrained than in the United States.

Overall interest rates initially continued to rise, albeit unsteadily. Despite growing confidence in economic improvement, the continuation of a relaxed monetary policy in the world's major economic regions, the accompanying generous money supply, the continuing favourable inflation outlook and the massive purchases of US treasury bonds by Asian central banks ultimately resulted in falling yields towards the end of the year. In the first few months of

Fig. 3
Capital market rates



Source: Deutsche Bundesbank, Federal Reserve Bank

Table 1

Overview of the German economy and financial sector*)

Selected economic figures	Unit	1999	2000	2001	2002	2003
Economic growth[1]						
World economy	%	3.7	4.7	2.4	3.0	3.9
USA	%	4.4	3.7	0.5	2.2	3.1
Euro zone	%	2.8	3.5	1.6	0.9	0.4
Germany	%	2.0	2.9	0.8	0.2	- 0.1
Company insolvencies	Number	26,476	28,235	32,278	37,579	39,320
DAX (end 1987 = 1000)[a]	Points	6,958	6,434	5,160	2,893	3,965
Money market rate[2]	%	2.97	4.39	4.26	3.32	2.33
Capital market rate[3]	%	4.53	5.28	4.86	4.81	4.08
Euro-Dollar exchange rate	1 €=...$	1.07	0.92	0.90	0.94	1.13
Gross sales of fixed interest securities[4]	€ billion	571	659	688	819	959
Credit institutions						
Credit institutions[a]	Number	3,168	3,006	2,726	2,521	2,296
Branches[a]	Number	58,546	56,936	53,931	50,867	47,406
Employees (per KWG)[a]	Number	732,950	733,800	728,950	710,650	...
Loans to domestic non-banks[a]	€ billion	2,905	3,004	3,014	2,997	2,996
Administrative costs	€ billion	70.2	77.7	81.3	78.3	...
Market price write-downs of fixed interest securities	€ billion	4.8	1.4	3.3	0.9	...
Net interest income	€ billion	77.8	76.9	80.0	85.6	...
Net interest margin[5]	%	1.28	1.14	1.13	1.20	...
Commisssion income	€ billion	22.5	28.1	25.4	24.3	...
Risk provisions	€ billion	11.5	15.9	19.8	31.5	...
Cost-income ratio (4 large banks)	%	77.4	79.0	83.8	77.9	73.0**
Capital ratio (4 large banks)[6]	%	10.2	10.9	11.1	11.1	12.0
Insurance undertakings						
Life insurers						
Hidden reserves in the investment portfolio (IP)[7]	€ billion	74.4	62.9	50.0	1.1	...
As a percentage of IP book value	%	14.4	11.4	8.6	0.2	...
Portion of fund units in IP[8]	%	18.9	21.4	22.5	23.0	23.5**
Portion of borrower's notes and loans in IP[8]	%	16.7	16.6	17.1	18.1	19.6**
Net rate of return on IP[9]	%	7.5	7.4	6.0	4.4	-
Net technical provisions as % of balance sheet	€ billion	451.0	484.6	511.6	528.5	-
totals	%	83.1	83.7	83.7	83.8	-
Surplus[10]	€ billion	18.7	20.3	13.4	5.0	-
as % of gross premiums earned	%	32.4	33.1	21.5	7.7	-
Eligible own funds (A+B+C)	€ billion	38.8	42.9	44.2	39.8	42.2 p.
Solvency margin[11]	€ billion	19.2	20.5	22.2	23.3	23.7 p.
Coverage of solvency margin[12]	%	201.8	209.5	199.0	170.4	178.0 p.
Reinsurers						
Hidden reserves in the investment portfolio (IP)[7]	€ billion	83.6	101.8	89.2	35.8	-
as % of book value	%	67.0	75.9	54.2	18.5	-
Combined ratio[13]	%	110.5	102.9	122.4	98.3	-
Net technical provisions as % of balance sheet	€ billion	79.1	84.6	94.8	101.8	-
totals	%	58.3	57.4	52.3	47.4	-
Net profit for the year[14]	€ billion	1.44	2.17	0.31	5.37	-
Available capital[15]	€ billion	23.9	25.1	31.5	40.2	-

Sources: BaFin, Deutsche Bundesbank, IMF; figures for 2003 are only partially available.
*) Annual totals or average values, unless stated otherwise. **) third quarter. p.) preliminary results.
a) As of year end; Credit institutions and branches incl. Postbank; KWG definition excludes Postbank among others.
1) Change in real gross domestic product y-o-y.
2) 3-month Euribor.
3) 10-year government bond yields.
4) Domestic issuers.
5) Net interest income as a percentage of balance sheet totals.
6) At the banking group level, average end of quarter values.
7) Fair values – book values of investments (IP) valued at cost.
8) As a percentage of total IP without deposits with ceding undertakings.
9) (Income from IP less expenditures for IP) / arithmetical average of IP (beginning and end of the year).
10) Net profit for the year + gross expenses for premium refunds.
11) Minimum level of free, unencumbered own funds.
12) Eligible own funds / Solvency margin.
13) Gross expenses for insurance claims and insurance operations / gross premiums earned.
14) Corresponds to items II.14 Formblatt 2 RechVersV.
15) Total capital less outstanding capital contributions.

2004, German capital market interest rates had reached a level which was extraordinarily low by historical standards. Low interest rates have squeezed the profitability of many German financial services providers, but the relatively steep yield curve should now make it easier for banks to achieve interest income.

Improved situation for German banks.

Although the operating results recorded by banks in financial year 2003 turned out to be better than in the previous year, they were still not satisfactory. They reflected not only the cyclical economic environment, but also the structural problems within the industry. In addition to value adjustments and write-downs that stagnated at a high level, it was primarily the continuing low profitability of German banks that caused their business results to suffer in international comparison. The banks have begun to address their costs and earnings in order to improve their overall key figures.

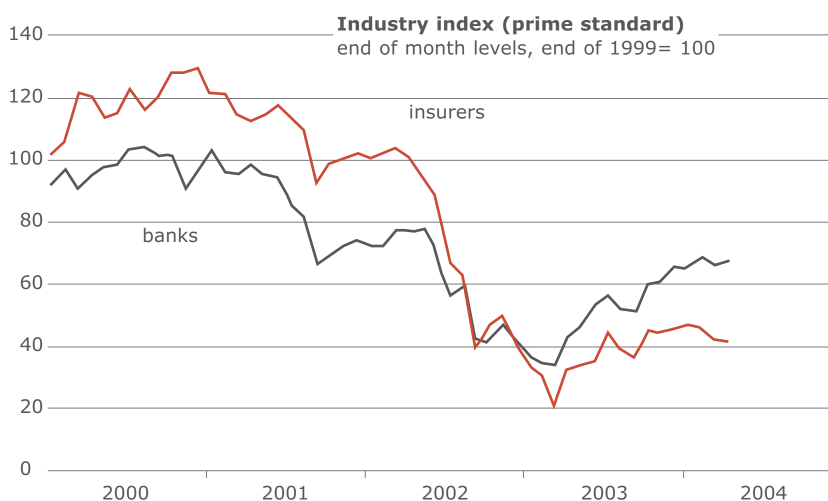
Progress has been made on the cost side: German banks have closed branches, combined core business areas, out-sourced tasks and reduced staff. The cost reduction measures have borne fruit: cost-income ratios fell again in 2003, even if they still remained above the average for comparable countries.

Key bank income figures are largely dependent on overall economic developments. Economic stabilisation has a positive effect on hidden reserves, and after being hit hard in the previous years, most banks should have again seen improved developments in their commission income.

Although many institutions have taken action to improve their plight by reducing their activities in vulnerable business sectors, German banks have an income problem that reflects deeper-rooted structural difficulties. While the five largest banks in Germany have a cumulative market share of just over 20%, the five largest British institutions have a market share of around 75%. This high degree of market fragmentation has led to strong competition between banks.

Fig. 4

Stock indices of the German financial sector



Source: Deutsche Börse AG, own calculations

Although price wars have meant favourable interest terms for bank customers, it has become almost impossible for banks to make a profit in interest rate-dependent business. Since mid-2002, however, interest rate spreads have started to improve again for the first time since the beginning of the 1990s. It would appear that circumstances have forced German banks to assess their credit risks more precisely and make better price adjustments to reflect risk.

Progress in the insurance sector – despite a first case for Protektor.

In 2003, the image of the insurance industry was damaged by the near-insolvency of Mannheimer Lebensversicherung AG. On average, however, financial year 2003 went better for the industry than many expected. Premium income rose and hidden liabilities were off-loaded.

Both life insurers and health insurers have strengthened their hidden reserves. Although all of the problems faced by the industry are far from being solved, positive developments on the stock exchanges have resulted in lower than expected equity portfolio write-downs.

Declining investment income has recently made it difficult for some insurers to achieve the maximum interest rate ("guaranteed rate"). As of 1 January 2004, the Federal Finance Ministry adjusted the rate to bring in into line with the capital markets, lowering it from 3.25% to 2.75%. The profit margins of many life insurers, however, continued to narrow, with current market interest rates remaining very low compared to the higher guaranteed rate applicable to old policies.

The fact that life insurers are investing more and more in debt instruments and loans means that they becoming increasingly important as financial intermediaries on the credit markets. This represents an important development for the German financial sector as a whole.

After two weak years, the situation of reinsurers has also improved. Like all reinsurers operating worldwide, however, leading German reinsurers have had to endure a downgrade of their credit ratings – something that is especially disadvantageous for a primarily internationally oriented business. Reinsurers are frequently the victims of their insufficiently risk-oriented pricing policy. There have been signs of a turnaround since 2001. Unfavourable claim developments and the difficult economic situation have since prompted reinsurers to become more risk conscious and to reject price concessions.

1.2 Outlook: possible risks for the German financial sector

Global imbalances could prove unsustainable …

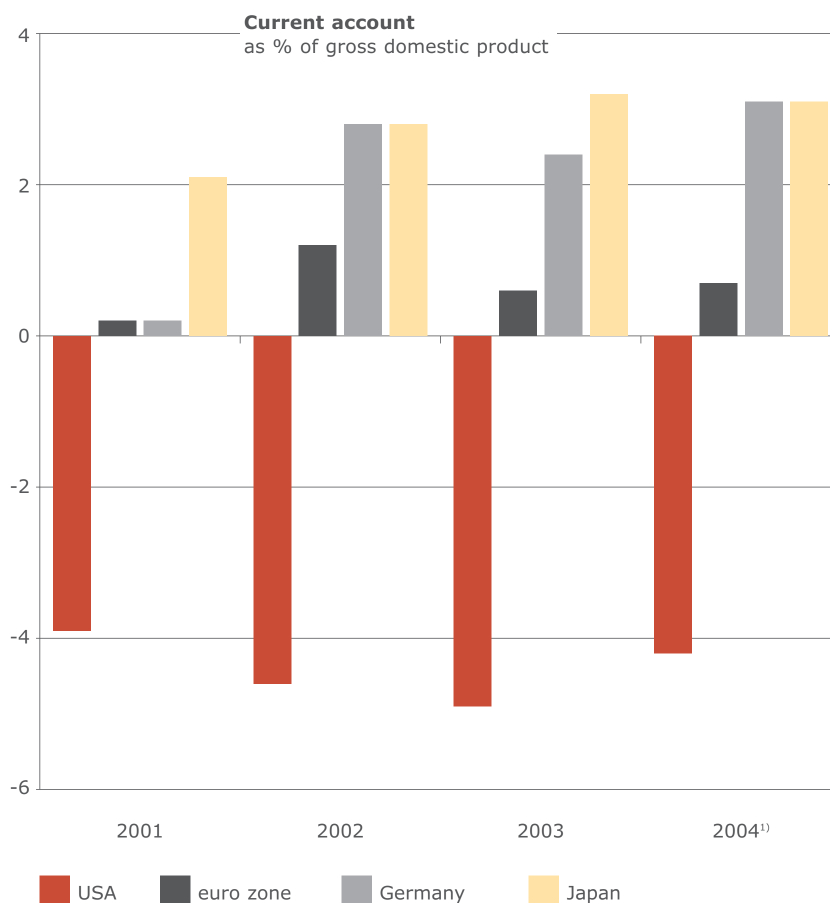
One threat to financial stability currently lies in a possible disruption of the economic upturn. Such an extreme shock could be triggered if the imbalances that have been accumulating on the global economy increase further. Doubts as to the sustainability of the high US current account deficit, for instance, have grown as the public sector requires more and more imported capital to finance the burgeoning budget deficit.

… and could destabilise exchange rates.

As a result, abrupt exchange rate movements to the detriment of the US dollar could have destabilising effects. A further drastic appreciation of the euro with the latent danger of overshooting would slow Germany's nascent economic recovery and have painful effects on the German financial sector.

Changes in exchange rates could have a direct effect on the balance sheets of banks and insurers, particularly those with heavy exposure to markets outside of Europe. This type of situation could arise if, for example, a higher euro rate were to cause assets acquired abroad to be devalued and offsetting positions were unable to neutralise exchange rate risks. Many institutions would have to set up greater risk provisions than originally planned. A continued significant increase in the euro could dampen Germany's already weak economic upturn and produce a trend towards higher default rates. Nonetheless, premiums for "credit default swaps" (CDS), which serve as an indicator of the probability of loan defaults, suggest that the market does not see any specific dangers for the large German financial services providers at present.

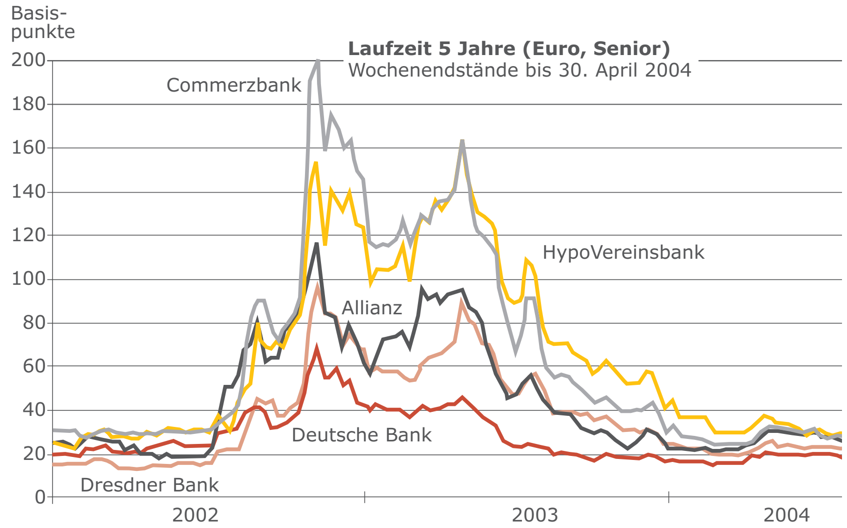
Fig. 5
Foreign trade imbalances



1) IMF forecast
Source: IMF, World Economic Outlook, April 2004

Fig. 6

CDS-Premiums* for selected German financial institutions

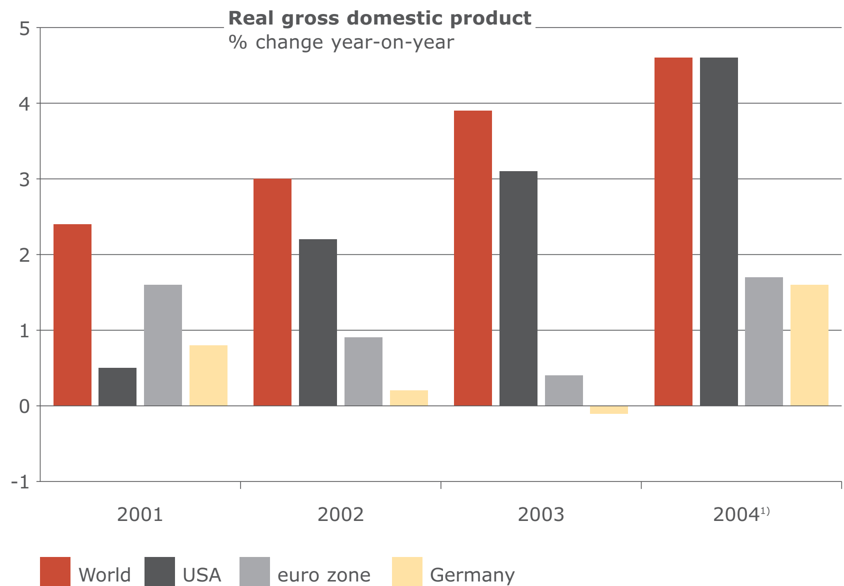


*) Credit Default Swap Premiums

Source: Bloomberg

Fig. 7

Economic growth in selected regions of the world



1) IMF forecast
Source: IMF, World Economic Outlook, April 2004

If the economic situation worsens unexpectedly, this will have a significant impact on the equity markets as well. Cautionary voices note that current price levels on many exchanges already reflect expectations of a substantial climb in company profits. Any renewed weakness in growth could very quickly disappoint such expectations. Any subsequent price corrections would then recreate new hidden

liabilities on the balance sheets of banks and insurance companies, both of which recently started to build up their equity portfolios again.

Do credit risk transfers create financial stability risks?

The past few years have seen strong growth on the global credit risk transfer market. New and sometimes very complicated financial instruments are being created at a swift pace. These instruments all have the following relationship in common: one institution (protection buyer) would like to hedge its credit risks, and one or more institutions assume the risk (protection seller/investor). The reference assets are the credit risks of a third party – either those of a single borrower or of a pool of loans or bonds. Regulators are interested in the risks that such arrangements could produce for the financial system and market participants.

The tradability of credit risks plays a key role in credit risk transfers. In the past, banks have been able to reduce their credit risks by issuing large volume loans in consortium with other banks, for example. There are now new types of instruments that allow credit risks to be transferred to the capital markets.

As a result, the spectrum of potential market participants has widened significantly and now ranges from banks to primary and reinsurers and on to investment companies. In principle, the term "credit risk transfer" has included well known instruments such as credit sales or traditional certificated securities (asset backed securities/mortgage backed securities). The current focus, however, is on innovative instruments ranging from derivative products, like credit default swaps, to structured products, like certificates issued on entire loan portfolios (e.g. collateralised debt obligations, credit linked notes). The latter enable investors to assume credit risks in the form of tranches classified by risk content, whereby the instruments being offered are sometimes very complex. Moreover, index products are being offered on the market that allow hedging against, or assumption of, the risks of credit default by large firms in "a package".

These instruments give the financial industry greater flexibility in risk management and can reduce bulk risk, for example. In addition, certificating credit risks represents an additional financing possibility. Investors, on the other hand, get access to another asset class that can help improve the risk diversification in their portfolios. Analogously to other derivative markets, banks also play the role of intermediary on this market – primarily with the aim of realising commission income.

Thus, the advantages of the credit risk transfer market consist in the redistribution of credit risks to a larger number of market participants both inside and outside the banking sector. It is possible, however, that this will create new risks for the financial system. One of the current main concerns is that it is very difficult to identify the amount of risk transfer actually taking place and the party ultimately responsible for assuming that risk. In addition, concentrated exposures could play a larger role than on other derivative markets. Various initiatives at international level, most notably the Joint Forum and the network of European supervisory authorities, are currently dealing with the effects this market could have on the stability of the financial system.

Interest conditions could change.

Interest rates are currently unusually low. Sooner or later, however, excess liquidity worldwide could induce the world's leading central banks to increase their key interest rates in order to head off inflationary tendencies. A more restrictive monetary policy and higher inflation expectations could drive capital market interest rates up considerably, braking investment and economic growth. The German financial industry would be affected directly and not just by way of real economy channels. Since the prices of fixed interest securities fall when interest rates rise, this would diminish the value of bond portfolios. This effect is particularly relevant for those financial services providers that have recently shifted their portfolios out of equities and into fixed interest securities. In the medium term, however, banks and above all insurers that traditionally maintain large fixed income portfolios could possibly even benefit from increasing yields, because this would allow them to increase their interest income, meaning that freed up cash could then be reinvested on better terms.

A reversal in interest rates would pose a particular threat to emerging markets and companies with lower creditworthiness.

High liquidity on the markets has made investors more willing to accept risk in a quest for higher yields. At times, investors have made hardly any risk differentiations. The credit risk spreads for the bonds of lower rated issuers have declined steadily, reaching an all-time low in the Spring of 2004. More risk-conscious behaviour now seems to be gradually asserting itself. Any significant change in direction on the global bond markets would drive the spreads for emerging market and corporate bonds up sharply. If such a scenario were to arise, investors – including many financial services providers – would have a strong incentive to quickly withdraw their invested capital. Some debtor nations would then have difficulties gaining access to the international capital markets.

Balance sheets of German banks and insurers are still vulnerable to setbacks.

In recent years, the German credit industry has been systematically pursuing cost reduction programmes. Nevertheless, structural problems persist. The German credit industry maintains the highest number of branch offices in Europe, for example. Over capacity thus needs to be reduced. Economies of scale have been achieved only in individual cases. The mortgage banking and transaction banking sectors provide clear examples of how larger units can reduce costs. The Landesbanks, too, are just beginning to make structural changes. New business models have to be designed by 2005 when *Gewährträgerhaftung*[2] and *Anstaltslast*[3] will be abolished. This is one of the areas that banks will have to devote particular attention to in future. One example of new initiatives is the "true sale" initiative of the Kreditanstalt für Wiederaufbau, in which all three pillars of the German credit industry participate. The initiative aims to ease and optimise the transfer of credit risks in order to improve credit offerings. The "true sales" initiative will not lead to a "bad bank" and, since it will not be backed by state guarantees either, it is competition neutral.

Life insurers are also faced with some uncertainties. It is possible that endowment policies will lose their tax privileges as of 2005.

[2] Gewährträgerhaftung = guarantor's liability (the shareholders of public sector banks are referred to as Gewährträger, i.e. guarantors)
[3] Anstaltslast = liability assumed by a public-law entity for the debts of a corporation incorporated under public law

What consequences would this have for the new business of these companies? The legislature, at any rate, has not yet spoken the final word. The adjustment of statutory minimum interest will also have an impact on new business. Given that capital market interest rates have remained at extremely low levels for a longer period of time, the question could be posed as to whether insurers should abandon their tradition of guaranteed rates when writing new policies. A decision on this matter will be probably determined by developments on the capital markets.

2 Highlights

2.1 Financial Sector Assessment Program – IMF

The audit work of the International Monetary Fund (IMF), which subjected Germany to minute scrutiny as part of its Financial Sector Assessment Program (FSAP), played an important role in BaFin's work. The FSAP audit, which Germany opted to undergo, received a large amount of media coverage. BaFin was then able to use the results of these tests as further proof of the integrated supervisory authority’s ability to assert itself even in difficult times. The goal of the FSAP, in which 50 nations had already participated, is to identify potential weak points in the financial sector of IMF member countries where the IMF might, if necessary, suggest recommended action. On the German side, the Federal Ministry of Finance was responsible for conducting the FSAP.

Stability under close scrutiny.

The IMF examined the stability of the German financial system thoroughly. This was done partly using a comprehensive questionnaire that the German side was required to answer. In addition, there were two audit visits from the FSAP audit team, whose members typically comprised not only IMF employees but also representatives of national supervisory authorities and central banks. Experts from the UK, Canada, Sweden, Switzerland and the USA supported the team during its audit visits in February and in May/June 2003. Comprehensive audit discussions were held with financial regulators, industry and professional association representatives, as well as with academic institutions. During the first visit alone, the ten-member team met more than 120 appointments in just two weeks. Their focus was on meetings with the Bundesbank and BaFin.

The IMF conducted stress tests with a representative group of banks and insurers in parallel to the audit visits. The aim was to test whether or not the stability of the German financial sector could withstand even major simulated shocks.

In conducting the stress tests, important key parameters such as equity prices, interest rates, exchange rates and loan default probabilities were altered and the possible effects of these changes on the German financial system were then analysed. The IMF used base values from the end of 2002 and studied banks and insurers separately.

Results for the banking sector.

The results for the banking sector showed that even with extreme changes to key parameters, the solvency ratio did not fall below the prescribed 8% minimum level. The biggest effect was a 60% increase in the probability of loan defaults. This mainly affected smaller institutions, where capitalisation fell by as much as 22%. Large banks showed changes of up to 18%. A 30% collapse in global equity prices had the most pronounced effect on large banks, producing a change in capitalisation of as much as 21%.

Landesbanks, savings banks and cooperative banks had the greatest exposure to interest rate risks. A simultaneous upward movement of the yield curve in the EU, the USA and Japan led to capital losses of up to 12%.

Results for the insurance sector.

The stress tests for the insurance industry indicated above all a vulnerability to equity price developments. A 35% collapse led to portfolio losses of up to 6% at life insurance companies, only one of which came in below the solvency threshold. A 10% drop in bond values produced losses of up to 2%. Casualty insurers lost up to 18% of their investments under the stock price scenario. The stress tests for reinsurers demonstrated that the sector was able to handle up to three natural catastrophes on the scale of hurricane “Andrew".

BaFin was also audited.

Barely one year after its formation, BaFin found itself under examination by the international body. The IMF reviewed its activities and its legal framework. In its concluding report[4] published in November 2003, the IMF expressly praised the German decision to adopt an integrated supervision model and to bring the Bundesbank into the banking supervision process. One fixed component of FSAP is to test adherence to international codes and standards[5] for the financial sector. In this regard, the IMF gave the German financial system very high marks. The Fund found a slight need for improvement only in certain sub-categories of banking supervision, for example, in the classification of impaired and restructured loans, in notice and authorisation obligations for intended acquisitions of equity participations by banks, and in the granting of loans to related persons and institutions.

IMF proposals concerning securities supervision

As far as securities supervision was concerned, the Fund's recommendations included the suggestion that BaFin be given additional regulatory competence. This would, for example, improve the supervision of investment services enterprises and strengthen the independence of listed company auditors. In addition, the Fund believed it was necessary to reconsider the division of responsibilities for exchange supervision between the federal states and the national government and review the ongoing supervision by state exchange regulators.

[4] Further details may be found at www.imf.org.

[5] These include, in particular, the IMF Code of Good Practices on Transparency in Monetary and Financial Policies, the Basel Core Principles for Effective Banking Supervision, the Objectives and Principles of Securities Regulation of the International Securities Supervision Organisation IOSCO, the Core Principles for Systematically Important Payment Systems of the IOSCO and the Bank for International Settlements as well as the Insurance Core Principles of the International Association of Insurance Supervisors).

… concerning insurance supervision

In the area of insurance supervision, the IMF criticised the lack of authorisation rules and solvency regulations for reinsurers. Parallel to the work on an EU directive, preliminary work for a corresponding national legislative project started in October 2003.
The auditors also concluded that BaFin's supervisory system for combating money laundering and financing terrorism was both comprehensive and effective. At the same time, the IMF urged BaFin to undertake more money laundering audits on its own initiative.

… and concerning the battle against money laundering.

The IMF awarded BaFin good marks for its practical work. The auditors expressly supported BaFin's risk-oriented approach to supervision for the banking and insurance industries. The auditors suggested that BaFin increase its employee numbers and further improve its expertise in banking and insurance supervision.

2.2 Financial Conglomerate Directive

…for the stability of the financial system.

In February 2003, the Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate[6] came into force. The Directive is aimed at increasing both the stability of the financial system and the protection of depositors, policyholder and investors. The directive from Brussels calls for a new quality of supervision. A central element is solvency supervision at conglomerate level. For the first time, solvency assessments will be made at group level, thus extending to different branches. This will involve using a uniform regulatory approach to assess risks from banking and insurance transactions. The current multiple use of capital to cover risks, between the banks and insurers of a group, for example, is no longer possible. Moreover, conglomerate level supervision is to take particular account of risk concentrations, intra-group transactions, internal control mechanisms and risk management. The Directive also regulates the jurisdiction of supervisory authorities.

The merger of the three former supervisory authorities to form BaFin means that Germany already conforms to the integrated supervision approach underlying the new Directive, which will be incorporated into German law by 11 August 2004. BaFin is working with the Federal Ministry of Finance on adjusting the national statutes and their implementing regulations.

Eight German financial conglomerates.

Among other things, BaFin is represented in the Mixed Technical Group, one of the groups of experts set up at the European Commission to ensure the uniform implementation of the directive. The Directive provides for the appointment of one coordinator from among the competent supervisory authorities for every financial conglomerate. For this purpose, a sub-group from the Mixed Technical Group acted as the central collection point for data concerning the financial conglomerates operating within the European Community. In Germany, BaFin has written to 38 groups requesting information on their multi-sector activities. BaFin has

[6] Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

secured the firm involvement of the respective industry associations in this preliminary identification process. A preliminary analysis of the data received shows eight groups in Germany that meet the directive's definition of financial conglomerate, based on annual financial statements as of 31 December 2002.

2.3 International Accounting Standards – IAS

The way has been cleared for international accounting standards.

With the adoption of its Fair Value Directive, the IAS Regulation and the Modernisation Directive, the EU has set the course the introduction of International Accounting Standards: this means that the way has been cleared for an international harmonisation of accounting practices. Uniform standards are especially appropriate for companies that operate worldwide, since they make it easier to compare different firms within the same industry.

International Accounting Standards (IAS/IFRS)
The IAS provide a system of accounting principles. In contrast to the German Commercial Code (HGB), however, this system is not based on statutorily established principles but rather on standards that elucidate individual accounting issues in detail. This shows the extent of the Anglo-American influence on the International Accounting Standards Committee Foundation (IASC) since it was formed in 1973. The IASC Foundation comprises 19 trustees from a whole range of different geographic and professional backgrounds. A number of these trustees are then elected as members of the highest accounting body, the International Accounting Standards Board (IASB). As a private association, its legitimacy is supported by its “due process” – a public standard setting procedure which enables anyone to submit suggestions and criticism.

As of 2005, the IAS Regulation will require capital market-oriented parent companies to prepare group financial statements in accordance with IAS. BaFin is proceeding under the assumption that the German legislature will also require only capital market oriented companies to prepare group financial statements under IAS in the first instance. Despite this limitation, it is expected that accounting will play an important role in supervision, too: broad categories of users are called upon to familiarise themselves with the proposals and concepts of the IASB. Besides regulators, these users include banks, insurers and analysts. Accordingly, BaFin is involved in developing IASB accounting standards at national and international level.

International Accounting Standards Board (IASB)
The IASB is the highest body responsible for promulgating accounting standards. It strives to develop uniform, high quality and understandable accounting principles. The IASB currently has twelve full-time and two part-time members. Besides Germany, the Board includes representatives from Japan, France, Canada, the USA, Australia and the UK. Five members of the Board are accountants, three are analysts and a further three are accounting practitioners.

2003 was marked by the discussions on Exposure Draft 5 (Insurance Contracts) as well as IAS 32 (Financial Instruments: Disclosure and Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement).

Requirements on the insurance industry – Phase 1.

The IAS ED 5 – Insurance Contracts project is divided into two phases. Phase 1, which essentially retains national accounting standards, is set to begin on 1 January 2005.Among other things, however, data on the fair value of insurance contracts must be disclosed for the first time after 31 December 2006. In addition, the assets and liabilities that result from insurance contracts, as well as items on the income and cash flow statements must be explained. Moreover, uncertainties associated with cash flows must be disclosed. Last but not least, the obligation to provide explanations on particular items also applies to the principles and goals of the risk management system. In light of the long transition period, the IASB is satisfied that a policy of small steps will suffice to achieve a high degree of acceptance for the new rules. This is intended to allow the insurance industry to make a step-by-step transition to the new rules.

Phase 2 – a comprehensive system.

The IASB is currently evaluating numerous comments on the proposed draft. A comprehensive accounting system for insurance contracts will not be drafted until Phase 2.

IAS 32 and 39.

By contrast, the final versions of the revised standards IAS 32 and IAS 39 have been available since 17 December 2003.

IAS 32 concerns the disclosure of financial instruments and their classification as equity or debt capital. In Germany, the classification of the capital shares of cooperatives has been met with particularly strong reservations. Classification as debt capital is based on the legal form of the capital shares, which grant the purchaser of cooperative shares the right to terminate at any time. Under the IAS accounting system this leads ineluctably to classification as debt capital. Although no change in supervisory treatment is planned – capital shares of co-op members continue to be classed as regulatory capital – the cooperative banks fear that the classification of their capital shares as debt capital under IAS will have a negative impact on their business environment. The ongoing negotiations with the IFRIC (the interpretation committee of the IASB) appear close to reaching a mutually satisfactory solution. Such a solution could allow the cooperative banks to limit the options for termination.

IAS 39 provides details on the accounting treatment and valuation of financial instruments, as well as the treatment given to hedging transactions. Financial instruments are grouped into five categories with three different accounting methods:

1. Assets and liabilities held for trading, as well as all derivatives that have no hedging function will be reported in the balance sheet at fair value. Gains and losses will be recorded as profit-neutral.
2. Loans and receivables will be carried at cost, just like liabilities.
3. Securities held to maturity will be carried at cost.
4. All other financial assets will be classified as available for sale and valued at their fair value. Gains and losses will be taken directly

to equity. Gains and losses will not effect income until they are realised.

5. The so-called fair value option permits every financial asset item or every financial liability to be stated at fair value.

In addition, special rules have been set up for recognising hedging transactions. The key issues for the banking industry with regard to hedge accounting in connection with interest rate risks (macro hedge accounting) were again offered for discussion in a separate draft paper[7]. BaFin's involvement in the working groups could help to improve the situation considerably.

Consequences for the financial industry and regulators.

These standards will have a considerable impact on banks and insurers. The rules on hedging transactions and derivatives are becoming increasingly important, because banks and insurers are both struggling with the same type of accounting problems. In addition, it is clear that international accounting is tending ever further in the direction of fair value accounting.

Fair value accounting

Fair value is the amount at which an asset could be exchanged or a liability settled between knowledgeable, willing and independent parties (market or fair value). In contrast to the German Commercial Code (HGB), fair value accounting allows gains to be reported as soon as the fair value increases. These gains need not – as the HGB prescribes – also be realised. This kind of accounting demands not only complex models for computing market and/or fair values, but also requires the integration of modern risk management systems.

Fair value accounting reflects the IAS accounting philosophy, which aims to communicate information relevant to decision making. Priority is given to the interests of those who provide equity capital. By contrast, the German HGB's valuation at cost and its imparity principle (lower of cost or market principle and recognition of expected losses from firm commitments) follow the principle of caution that tends more towards creditor protection. The trend towards convergence with IAS accounting therefore represents a significant change for German businesses.

Boundaries between sectors are blurring.

Another new development is the fact that the accounting rules no longer make sector-specific distinctions between banks and insurers but instead give primacy to product orientation.

This means that the new accounting rules are another reason why the traditional boundaries between individual sectors are blurring. As an integrated financial supervisor, BaFin is well equipped for this kind of trend.

[7] "Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk".

The consequences for capital.

The effect is on capital is by far the most pronounced. Accounting that is more oriented towards fair values considerably increases the importance of valuation results, and most notably "unrealised gains". Furthermore, under IAS, new asset items are reflected on the balance sheet (such as, for example, derivatives), increasing the weight of intangible assets.

New approaches to risk provisions.

The way in which appropriate risk provisioning is calculated will also change. Among other things, the IASB is discussing approaches that will apply to risk provisioning and value adjustments. A central question in this regard is the concept of a more future-oriented approach to provisioning. Until now, the concept of risk provisions and value adjustments was based on the past. In addition, the provisions of the HGB, which are guided by the prudence principle, allowed for the creation of hidden reserves. The IAS concept, however, largely discloses these reserves through fair value accounting. Market or fair values are subject to constant fluctuations that can influence capital.

Regulators focus on fair value.

The question posed to regulators is thus whether or not supervisory rules can continue to rest on balance sheets or whether modifications – for example, in the case of capitalisation requirements – are required. Irrespective of the accounting standards, regulatory norms have, until now, been oriented more towards the prudence principle. In the near future, regulators will be faced with the pressing task of seeking ways of maintaining principles heretofore classified as central in a new accounting environment. At the same time, appropriate risk provisioning must be discussed. Moreover, the effects on the management of institutions and firms need to be examined.

3 International Cooperation

Because many of the firms under supervision operate internationally, the activities of financial supervision do not stop at national borders. BaFin is represented in well over 100 international working groups. Even today, large parts of its regulatory framework are based on European legal provisions and the next few years will bring even more harmonisation at European level.

In the past, the three supervisory authorities performed their international tasks independently of one another. They coordinated a joint German position only in those matters that touched on obviously common points. One of the reasons why the legislature amalgamated the three authorities into one integrated financial supervisor was to enable them to coordinate their public stance in all regulatory areas.

Although BaFin's individual departments still have the option of taking different positions from one another at international level, this only happens where there is an industry-specific need.

3.1 Global Cooperation

3.1.1 Financial Stability Forum (FSF)

The FSF is where finance ministers and representatives of national supervisory authorities and central banks meet. Based in Basel, it is regarded as the lynchpin of the network of international organisations. This body was formed in 1999, among other things in response to the Asian crisis. Its mission is to monitor the international financial system for its vulnerability to risk, identify any required action and to promote coordination and the exchange of information between the various authorities responsible for financial stability. The FSF has put together a collection of twelve standards of conduct[8] that it regards as the essential elements of a functional financial system.

Regional meetings in Latin America, Asia and Eastern Europe, as well as telephone conferences, supplement the FSF's semi-annual meetings. The following subject areas have been the focus of the three FSF meetings held since the beginning of 2003: The weak points in the international financial system, the bases for corporate control and off-shore financial centres (OFC):

Weak points in the international financial system.

The assessment of possible problems for the international financial markets stemming from the war in Iraq was a key issue. Particular attention was devoted to unexpected interest and exchange rate changes that could lead to considerable volatility on the financial and, in particular, on the stock markets. The Forum examined the possible negative effects of such changes on the balance sheets of banks and insurance undertakings, which would worsen the financing conditions for businesses and consumers.

In addition, attention was focused on emerging markets and capital flows into these markets. The heavier exposure of institutional investors in these countries raised questions about adequate risk assessment, particularly in relation to yields and diversification.

Other subjects included credit risk transfers and stronger collaboration in supervising globally-active reinsurance firms[9]. The members of the FSF agreed that the Forum should aim to achieve better data and greater transparency with respect to credit risk transfers. Accordingly, the FSF drafted a working plan on this subject together with the Forum on Financial Conglomerates (Joint Forum), which is aimed at improving collaborative efforts and enhancing information exchange between supervisory authorities. The market for risk transfers is enjoying continuously strong growth[10].

In early 2004, the FSF dealt intensively with the interim report prepared by the Joint Forum, which studied market participants, market developments and risk factors. At the forefront of the discussions was the question as to whether or not there was an undesirable concentration of credit risks in the market. The Forum

[8] Code of Good Practices und Core Principles – cf. also www.fsforum.org/compendium/key_standards_for_sound_financial_system.html.
[9] Concerning IAIS and reinsurers, cf. Chapter I 3.1.4.
[10] concerning credit risk transfer, cf. Chapter I 1.1.2.

was in favour of a more in-depth analysis of this issue. The final report of the Joint Forum is expected to be submitted in time for the FSF's next meeting in September 2004.

Basis for corporate control.

The Forum also issued an official declaration concerning its support for other international institutions striving to strengthen accounting transparency and establish international auditing and conduct guidelines for accountants, as well as international accounting standards. The starting point of discussion was the Parmalat case – an example of a situation in which international corporate control failed. Debate also focused on ways of improving the rating processes used by rating agencies and making them more efficient by increasing transparency and avoiding conflicts of interest[11].

Offshore financial centres.

The Forum paid particular attention to progress in the treatment of OFCs, which has been a key issue since the FSF was formed. In May 2000, the Forum approached the IMF to develop a programme for OFCs. The programme was realised in 2003 and was expanded with the support of the Forum. It was agreed that supervisory and regulatory standards were to be improved, and cooperation programmes with OFCs intensified. The IMF has since reached agreements with all the centres concerned. The Forum will continue to address this subject and urge the centres to make ongoing improvements in the area of regulation, monitoring, cooperation and information exchange. If necessary, this will also include direct contact with individual OFCs. An FSF press release from April 2004 includes a short description of the situation of the various centres and, to the extent they have not already done so, information concerning their willingness to publish the IMF reports[12].

3.1.2 Joint Forum

The Joint Forum on Financial Conglomerates was formed at the beginning of 1996 and comprises representatives from the banking, insurance and securities regulators. They represent the three international organisations affiliated with the Joint Forum: the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO). The Joint Forum has representatives from Australia, Belgium, Germany, France, the UK, Italy, Japan, Canada, the Netherlands, Sweden, Switzerland, Spain and the USA. Germany is represented by BaFin. The goals of the Joint Forum are to:

- improve supervisor understanding of the other sectors,
- develop a basis for supervising the regulated companies of a financial conglomerate, and
- prepare and analyse those financial industry issues that are relevant to multiple sectors.

[11] for a discussion of the work of the competent IOSCO committee, cf. Chapter I 3.1.1.
[12] www.fsforum.org/press/OFC_pressrelease.pdf; 11 further information may be found at www.bis.org/bcbs/jointforum.htm.

The Joint Forum consults with the Basel Committee on Banking Supervision, the IAIS and IOSCO, to set up workings groups for special issues. In 2003, BaFin representatives participated in the work of both the "Working Group on Enhanced Disclosure" and the "Risk Assessment and Capital" working group[13].

Joint Forum Working Group on Risk Assessment and Capital.

The working group "Risk Assessment and Capital" submitted two reports in the Summer of 2003. Its report "Trends in Risk Integration and Aggregation" examined the significance of "economic capital" models in the three sectors. The group queried 31 financial groups with predominantly international operations and found that use of these models within large financial groups has recently been on the increase. The models aim at quantifying the various risks of a financial conglomerate (e.g. credit and market risk, actuarial risks) and optimising the relationship between risk and return on capital employed. The prerequisite is that the individual risks in the firms of a financial group be analysed, consistently sub-classified and permanently monitored. This type of "economic capital" model might thus lead to improved risk management within a financial conglomerate. In addition, the working group was sceptical with regard to the models' underlying assumption that diversification would reduce capital requirements. The financial industry will have to study this matter in greater detail.

The report "Operational Risk Transfer across Financial Sectors" examines, in particular, the conditions required to make cross-sector transfers of operational risks effective. An example of operational risk is the risk of business interruption caused by a catastrophe. Reducing capital backing for these risks is generally inconceivable without an effective risk transfer. The report examines this problem from the perspective of both the policyholder and the insurer. A key issue is that relating to the conceptual prerequisites under which insurance undertakings offer insurance coverage for operational risks.

Examining the subject of credit risk transfer.

In the Autumn of 2003, the working group "Risk Assessment and Capital" was commissioned to study the issue of "Credit Risk Transfer" (CRT). The focus was on determining current market developments, the importance of CRT investments for financial markets and/or the supervised firms, and the possibilities and problems associated with them. In addition, the group is to analyse supervisory concepts such as reporting obligations, restrictions on authorised investments and quantitative limits.

Work on the first point was largely completed in 2003. The second point was suggested by BaFin representatives and will dominate the work of the group in 2004.

[13] Further information concerning the Joint Forum may be found at www.bis.org/bcbs/jointforum.htm.

3.1.3 IOSCO

IOSCO Core Principles supplemented.

The International Organization of Securities Commissions (IOSCO), based in Madrid, remains the most important international forum in which securities regulators can set standards and issue recommendations on measures to be taken. Its goal is to constantly adjust the supervisory framework in order to reflect rapidly changing conditions on the national and international securities and derivatives markets. IOSCO has 181 members from more than 100 countries. The IOSCO's most influential tools are its resolutions and standards.

At its annual conference in October 2003, the IOSCO issued its "Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation"[14]. This document supplements the IOSCO Core Principles, which prescribe and elucidate thirty principles for the proper establishment of a securities supervision system. While IOSCO's Core Principles remain abstract in many ways, the Methodology contains a system for each of the thirty principles which can be used to determine whether or not the principle in question has been implemented completely, largely, partially or not at all in any given country.

Methodology is used for IMF and World Bank audits.

The IMF and the World Bank are using this Methodology in their Financial Sector Assessment Programmes (FSAPs) for conducting audits in the securities area. Currently, IMF audits for the securities sector consist solely of ascertaining the implementation status of the IOSCO Core Principles at national level. The application of the Methodology should further advance the convergence of national securities supervision systems. An earlier version of the Methodology has already been used – during the FSAP audit in Germany.

Rules of conduct for securities analysts

During the period under review, the IOSCO's Technical Committee drafted principles relating to securities analysts and the conflicts of interest that are sometimes associated with their work[15].

Investors must be able to trust the independence and objectivity of analysts.

Securities analysts provide international securities markets with an important channel of information for investors. This means that their work is important not only in order to ensure that the securities markets function properly, but also from an investor protection point of view. Since their work inevitably involves selecting and processing information, it is important that investors are able to trust the independence and objectivity of analysts. This trust is, in turn, an indispensable prerequisite for a smoothly functioning market.

In addition to recommendations, the IOSCO principles and implementation measures contain various prescriptions and proscriptions directed at both analysts and investment firms. The aim is to ensure that analysts perform their analytical work without being influenced by their own interest, or those of a third party, and

[14] www.iosco.org/pubdocs/pdf/IOSCOPD155.pdf.
[15] www.iosco.org/pubdocs/pdf/IOSCOPD152.pdf.

without seeking to derive an illegitimate advantage for themselves or the companies they work for.

The IOSCO'S primary requirements are:

- Analysts may not trade in the securities being analysed or related derivatives prior to publication of the analysis.
- Investment firms may not promise or guarantee any advantages to the analysts they employ in connection with the firm's investment banking transactions.
- Analysts, or firms that employ analysts, must disclose the material advantages they have been granted in connection with any of their reports. They may not promise any favourable analysis to the issuers that form the subject of the analysis.

In addition, the Technical Committee published a report concerning analyst conflicts of interest. The report is based on an international study conducted by the securities analysts project group.

Rules of conduct for rating agencies

The integrity of rating procedures is to be strengthened.

In 2003, the Technical Committee of the IOSCO also drafted principles governing the activities of credit rating agencies[16]. These principles aim at strengthening the integrity of the rating process. The ratings of international rating agencies in particular are becoming increasingly important to the financial markets, trading members, issuers, investors and, not least, to the supervisory authorities. Credit institutions, for example, can use “external ratings” for bank regulatory purposes; insurers use the ratings issued by recognised agencies as a criterion for assessing the security of a financial investment.

In the wake of recent large company scandals, rating agencies have attracted not only the public's attention but also that of regulators. As a result, IOSCO set up its Credit Rating Agency Task Force to study the way in which rating agencies operate in the IOSCO's member countries and to identify possible problems. The IOSCO’s new credit rating principles are aimed at strengthening the independence of the agencies and improving ratings quality. The principles, which are to be implemented at national level, set forth standards with respect to the

- quality and integrity of the rating process,
- independence of rating agencies and rules governing possible conflicts of interest,
- transparency of rating decisions and their timely publication and
- confidentiality of information made available to them.

In light of the public importance of these issues, the IOSCO recently decided to specify these general principles in a catalogue of good practice rules for credit rating agencies. BaFin is also represented on the task force for this new mission. The objective is to issue specific rules before the end of 2004.

[16] www.iosco.org/pubdocs/pdf/IOSCOPD151.pdf.

The IOSCO's standing working groups

The "Disclosure and Accounting" working group.

BaFin's also has representatives on the IOSCO's five standing working groups. The work of the following working groups is particularly worth mentioning:

The "Disclosure and Accounting" working group deals with international auditing and accounting standards and prospectus information requirements. It has also collaborated on developing a supervisory body that is to supervise the standard setter for international auditing standards.

The new supervisory structure is to be independent of the professional regulatory organisation, IFAC: The draft reform that the IFAC coordinated with IOSCO provides for the establishment of a "Public Interest Oversight Board (PIOB)" as an independent supervisory body within the IFAC. The PIOB is to begin its work in 2004 and will be responsible for monitoring the audit standard-setting process and influencing the appointment of the IASB chairman, among other things. Practicing accountants shall not be admitted to the PIOB. All members of the PIOB shall be required to act only in the public interest and the IOSCO will appoint four of the ten PIOB members and its chairman.

The "Investment Management" working group.

In 2003, the IOSCO working group "Investment Management" completed its report entitled "Risk Assessment of CIS Operators"[17]. The report contains an overview of risk management at investment companies ("CIS Operators"). The work of the group also focuses on the issue of "Fees and Commissions within the CIS and Asset Management Sector"[18]. A "best practices" paper is expected in 2004.

Multilateral Memorandum of Understanding

Given that cross-border capital market transactions are increasing, international collaboration between supervisory authorities at bilateral level are becoming more and more important. The IOSCO's Multilateral Memorandum of Understanding (MMoU) has created a new basis for this collaboration. The supervisors who have signed the agreement can use improved information exchange to pursue violations of securities law more effectively. To date, 24 supervisory authorities worldwide have signed the IOSCO's MMoU. It is expected that many more of the over 100 member authorities will add their names. BaFin signed the MMoU in early November.

3.1.4 Basel Committee on Banking Supervision

Third consultative paper

In April 1999, the Basel Committee on Banking Supervision began its fundamental reworking of capitalisation rules for credit institutions. A number of key decisions advanced the process considerably in the year under review. In April 2003, the Committee

[17] "Risk Assessment of CIS Operators".
[18] "Fees and Commissions within the CIS and Asset Management Sector".

made its third presentation of reform proposals for consultation. The results of the impact studies that had been conducted were reflected in the Committee's decisions.

More than 200 commentaries were received in the 3rd consultation phase.

The Basel Committee received more than 200 commentaries on its third consultative paper. Critical comments on individual issues aside, there was general approval of the reform approach. At its October 2003 meeting, the Committee identified four fundamental areas in need of further work:

- Recalibration of capital requirements solely on unexpected losses,
- simplification of the treatment of securitisations (asset-backed securities),
- the rules concerning credit card exposure and associated matters
- some weighting modalities in the area of credit risk mitigation techniques.

In future, only unexpected losses will be calibrated.

The most far-reaching decision was the decision to cushion only unexpected losses (UL) and not expected losses (EL) with future regulatory capital requirements.

UL calibration also has far-reaching consequences for tier 2 capital and risk provisioning.

The decision to impose capitalisation requirements on only unexpected losses has consequences that are not limited to risk weighting. The composition of tier 2 capital is also affected, particularly since it concerns the recognition of provisions. General provisions can no longer be applied to tier 2 capital. If capital is only used to back unexpected losses, then those capital components used to back EL must be eliminated from capital.

Even in the case of a pure UL calibration, banking supervision cannot disregard adequate risk provisioning for expected losses. The Committee ruled in favour of setting up strong incentives for the establishment of adequate risk provisions. In the IRB approach, provisions are compared with the amount of expected losses.

- If the expected losses are higher than the provisions (general and specific provisions) there is a coverage shortfall. Such a shortfall shall then result in a corresponding adjustment to capital. Half of the difference should be deducted from tier 1 and tier 2 capital respectively.
- Concomitantly, the institutions are to be permitted to add the amount by which provisions exceed expected add to their tier 2 capital (the excess). Nonetheless, the addition of a provisions excess is to be limited to a maximum percentage of risk-weighted assets, in order to prevent an excessive increase.

Advantages of pure UL calibration.

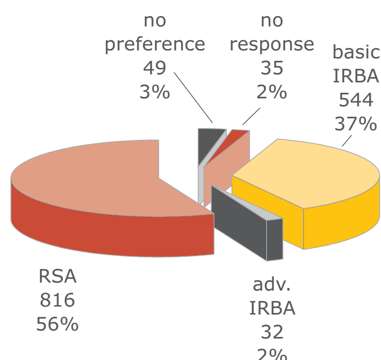
The pure UL calibration decision issued by the Basel Committee corresponds to the negotiating position that BaFin and the Bundesbank have taken from the outset. It offers several advantages:

- Considering only unexpected losses for capitalisation requirements corresponds to the risk management methodology used by banks.
- Excepting general provisions from tier 2 capital brings the definitions of capital used by the Basel Committee and the EU closer together.

- Even when only unexpected losses are to be backed with capital, the risk provision policy of the institution is included in the equation. Considering the effects of a shortfall or excess on capital creates incentives for following an adequate risk provision policy.
- Banks do not have to alter their forecasting methods and computational procedures. According to the computational methodology described in the third consultative paper, an unexpected loss is derived by simply deducting the product of default probability and amount of losses in the event of default. These risk parameters are already estimated by banks anyway.

The decision of the Basel Committees to require recalibration also means, however, that the original Basel II publication schedule will have to be postponed.

Fig. 8
Procedure for measuring credit risk to be in place by 31/12/2006



Poll of credit and financial services institutions

BaFin is continuing to prepare for the tasks inherent in the legal and practical implementation of Basel II in Germany. In this regard, it conducted a poll of all German credit and financial services institutions in July 2003 with the support of the Bundesbank. The poll was conducted before the Committee decided to lengthen the obligation to conduct the advanced procedure for parallel measurement of capital requirements for credit risk and operational risks to two years. The goal was to obtain an overview as to which procedures German institutions intended to use in future to measure capital requirements for credit and operational risks. The questionnaire was sent to a total of 2,400 institutions and 1,476, or 61.5%, responded (as of 19 August 2003).

Of the 1,476 banks that responded to the questionnaire, 39% were aiming to implement the internal ratings based approach (IRBA), 2% of which were eyeing the advanced IRBA. In contrast, more than half of the banks (56%) were initially planning to start with the revised standard approach (RSA). The response "indifferent" includes all of the responses from institutions that had not yet decided whether to use the revised standard approach (RSA) or the IRBA.

Those banks that stated a preference for the IRBA in the pool wanted to apply it predominantly to corporate lending and/or retail banking. Only relatively few banks were in favour of introducing the application of the IRBA to the "sovereign" and "bank" classes of receivables. If the EU actually provides for the option of permanently exempting these areas from the IRBA under certain conditions, many institutions would take advantage of it (see also Table 5). The distribution of receivables classes and banking groups is shown in Table 2. The fact that the total figures for the various receivables classes differ also reflects the fact that not all institutions do business in every segment.

Assessment of responses by bank group.

BaFin has also evaluated the responses to its poll broken down by bank group. According to its analysis, all large banks and central cooperative institutions are in favour of the IRBA. The same applies for more than three quarters of the savings banks and two thirds of the Landesbanks. Cooperative banks were the only group that

Table 2

Procedure for measuring capital charges by asset classes and bank groups to be put in place by 31/12/2006

	Corporate			Sovereign			Banks			Retail business				Total no. basic IRBA banks	Total no. adv. IRBA banks	Total no. IRB banks
	basic IRBA	adv. IRBA	*RSA or basic IRBA*	basic IRBA	adv. IRBA	*RSA or basic IRBA*	basic IRBA	adv. IRBA	*RSA or basic IRBA*	res. mort. e exp.	qualif. revolv. retail exp.	other retail exp.	*RSA or basic IRBA*			
Large banks	1	3		1	3		1	3		4	4	4		1	3	**4**
Regional banks and other lending banks	29	18		14	8		22	9		25	33	42		36	18	**54**
Landesbanks / Girozentralen	6	2		6	2		7	1		3	3	3		5	3	**8**
Savings banks	334			1			1			312	311	311		334	0	**334**
Central cooperative institutions	1	1		1			1							1	1	**2**
Cooperative banks	132	1	*48*	9	1	*1*	9	1	*1*	84	83	80	*45*	146	1	**147**
Mortgage banks	5	3		3			4			8	3	4		7	3	**10**
Building societies	1	1			15			1		12	1	12		11	1	**12**
Credit institutions with special functions	1													1		**1**
Total	**510**	**29**	*48*	**35**	**15**	*1*	**45**	**15**	*1*	**448**	**438**	**456**	*45*	**542**	**30**	**572** *)

Although securities depositories, housing enterprises with savings schemes and investment companies were included in the poll, none of the firms questioned intends to use the IRBA.

Total number of responses: **1476**

*) Two branch offices of foreign banks and two branch offices of subsidiaries of German institutions abroad also would like to apply the IRBA but are not listed here. This results in the discrepancy shown when compared to Fig. 8.

expressed considerably reservations in the poll. BaFin assumes, however, that some institutions in this group will change their minds, especially now that the Bundesverband der deutschen Volksbanken und Raiffeisenbanken e.V. has set up a rating project. This would then considerably increase the overall number of IRBA banks, too.

Table 3

Portion of IRBA banks by bank groups as of 31/12/2006

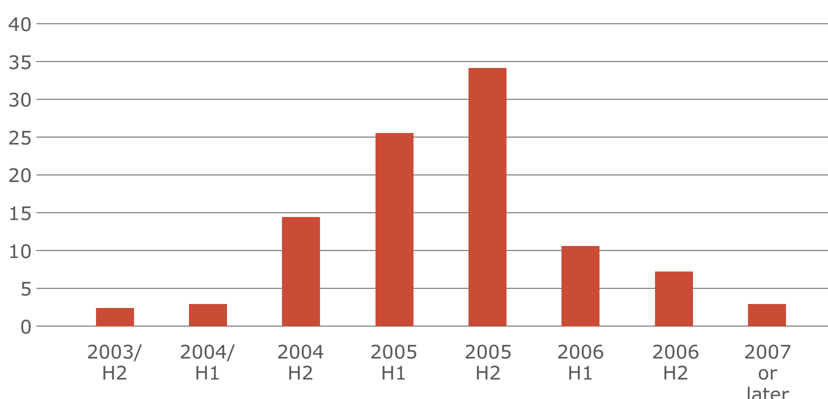
	Total IRBA banks	Total responses	Portion IRBA banks
Large banks	4	4	**100 %**
Other lending banks	54	131	**41 %**
Landesbanks / Girozentralen	8	12	**67 %**
Savings banks	334	437	**76 %**
Central cooperative institutions	2	2	**100 %**
Cooperative banks	147	811	**18 %**
Mortgage banks	10	16	**63 %**
Building societies	12	23	**52 %**
Credit institutions with special functions	1	10	**10 %**
Average			**39 %**

Just under 20% of institutions intend to comply in 2004 and a solid 60% in 2005.

What interests regulators is not only how many institutions are working towards implementing the IRB approaches. The question as to when the institutions expect to have their systems ready to pass regulatory inspection is equally important. The poll shows that just under one fifth of institutions believe they will comply with the system by 2005. The bulk of IRBA acceptance audits – or 60% – will be performed in 2005. These numbers, however, are of limited significance because less than half of the banks that said they wanted to use IRBA from the outset indicated when they intended to apply to be inspected for compliance.

Fig. 9

Expected distribution of compliance inspection applications for the IRB approach



Proceedings for equity portfolios and specialised lending.

Almost 90% of the 576 IRBA banks would like to choose the simple risk weight method for their equity portfolio. Only a few (3.1%) said they were in favour of the IRBA-related PD/LGD approach and fewer still (1.2%) wanted to opt for internal market models. In addition, most institutions intend to temporarily exclude the equity portfolio from the IRBA.

Table 4

Procedures for measuring capital charges for equity exposures preferred by IRBA banks as at 31/12/2006

			of which are planning temporary exceptions to IRBA	
	Percentage	Percentage	Number	Percentage
Simplified risk weighting method	511	88.7 %	490	96 %
Internal market models	7	1.2 %	6	86 %
PD/LGD approach	18	3.1 %	12	67 %
Indifferent	1	0.2 %		
No response	39	6.8 %		
Total	**576**	**100.0 %**		

The overwhelming majority of banks engaged in specialised lending (80%) want to use supervisory classification criteria (“slotting”) for measuring own funds requirements for that business.

Partial exception to the IRB approach,

BaFin is also interested in the extent to which institutions are contemplating a – temporary or permanent – partial exception to the IRBA ("partial use"). Here, the analysis is restricted to the basic IRBA. Only 42 IRBA banks – a small percentage – will include all asset classes in the IRBA from the outset. Of the 534 institutions preferring partial use, one quarter plan to eventually include all asset classes. The other credit institutions, on the other hand, are aiming at permanent partial use of the IRBA. The majority of these institutions plan to permanently exclude sovereign and bank exposures. Only 39 of all of those banks that prefer permanent "partial use" justify their decision on the basis that one or more of their portfolios are immaterial.

Fig. 10

Procedure for measuring operational risk to be in place by 31/12/2006

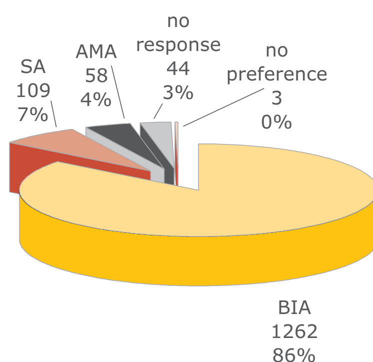


Table 5

Extent of partial exemption from the basic IRBA when Basel II/CAD III comes into force on 31/12/2006

IRBA banks	Number
without partial use	42
with partial use	534
of which: permanently	399
of which:	
sovereign exposure	364
bank exposure	362
due to immateriality	39

Preferred procedures for measuring operational risk.

The vast majority of banks (86%) initially plan to use the basic indicator approach to measure capital charges for operational risk. 58 institutions have chosen advanced approaches (see Fig. 10). 13 of them will initially apply "partial use". A breakdown of the procedures preferred by type of institutions is provided in Table 6.

This shows that even before the definitive international framework had been agreed upon, a large number of German institutions had already decided to use the advanced procedures for measuring their capital charges. BaFin welcomes their decision, because it demonstrates that an important segment of the German banking industry is determined to adjust to the requirements of the future by improving risk management. Many smaller and medium-sized institutions will only be able to implement this process with the active support of their peak associations, which can help them to overcome data and resource problems.

At the same time, the survey results should also encourage those institutions that have had reservations about the new approaches in the past to rethink their position. These institutions should bear in mind that when conducting the supervisory review process, BaFin will be checking whether or not the institution's risk management system is appropriate in relation to its particular business focus. The audit procedure could be more involved for those institutions which do not use any of the regulator-approved internal procedures for calculating capital requirements for credit risk. In some cases, BaFin will also have to impose an adjustment to bring risk management into line with the risk content of the business structure in question.

Table 6

Planned procedure for measuring operational risk

	Basis indicator approach (BIA)	Stan-dard approach (SA)	Advanced measurement approach (AMA)	No Data	Indifferent	Total
Large banks	0,0 %	0.0 %	75.0 %	0.0 %	25.0 %	4
Other lending banks	57.3 %	26.7 %	13.7 %	1.5 %	0.8 %	131
Landesbanks/Girozentralen	8.3 %	66.7 %	25.0 %	0.0 %	0.0 %	12
Savings banks	83.3 %	6.6 %	4.6 %	5.3 %	0.2 %	437
Central cooperative institutions	50.0 %	50.0 %	0.0 %	0.0 %	0.0 %	2
Cooperative banks	96.3 %	1.7 %	0.9 %	1.1 %	0.0 %	811
Mortgage banks	62.5 %	12.5 %	18.8 %	6.3 %	0.0 %	16
Credit institutions with special functions	90.0 %	10.0 %	0.0 %	0.0 %	0.0 %	10
Securities depositories	0.0 %	0.0 %	100.0 %	0.0 %	0.0 %	1
Building societies	43.5 %	52.2 %	4.3 %	0.0 %	0.0 %	23
Housing enterprises with savings schemes	50.0 %	0.0 %	0.0 %	50.0 %	0.0 %	4
Investment companies	55.6 %	11.1 %	11.1 %	22.2 %	0.0 %	9
Branches of foreign banks	*23.1 %*	*30.8 %*	*7.7 %*	*38.5 %*	*0.0 %*	*13*
Subsidiaries of German banks abroad	*33.3 %*	*66.7 %*	*0.0 %*	*0.0 %*	*0.0 %*	*3*
Total						**1476**

Constructive collaboration is particularly important.

The national implementation of the new own funds requirements is a formidable challenge, not only for institutions but also for the banking supervisory authorities. This means that the constructive and confident collaboration of institutions, associations and regulators will continue to be particularly important in the future, too. Accordingly, in autumn 2003, BaFin established a working group comprising two representatives from the associations of the Central Credit Committee (Zentraler Kreditausschuss – ZKA), two representatives from credit institutions, and employees of both the Bundesbank and BaFin.

The aim of the working group is to perform the technical preparatory work for the national implementation of Basel II and the European legal guidelines that will accompany it. This body will provide regulators with a forum in which to discuss practical issues and develop practical solutions with industry representatives.

A working group and several sub-committees assist in shaping opinions.

To ensure that the working group can function as efficiently as possible, it enjoys the support of specialist sub-committees that comprise experts from industry and supervision. Specialist sub-committees have been set up for IRBA, collateral, ABS, operational risk, the supervisory review process and disclosure requirements. The working group decides whether or not the solutions developed in the sub-committees should be pursued further, or resubmitted for further discussion. The interim decisions of these sub-committees are published on BaFin's Internet site[19] , which means that even those institutions and lending industry associations that are not participating directly in the discussion have access to the same information.

3.1.5 IAIS

The International Association of Insurance Supervisors (IAIS)[20] was formed in 1994 and represents more than 100 insurance supervisory authorities. The IAIS was established in order to

- promote cooperation between insurance regulators,
- establish international standards for insurance supervision,
- offer training to its members and
- coordinate its work with supervisory authorities in other financial sectors and with international financial institutions.

In 2003, the IAIS completely revised and expanded its "Insurance Core Principles and Methodology". These principles cover all aspects of insurance supervision and offer effective guidance for insurance regulators worldwide. The IAIS presented its 28 Insurance Core Principles at the 10th IAIS Annual Conference, which took place from the end of September to early October.

Some 400 representatives from member countries and insurers attended the conference and the following papers were passed:

- the revised standards for supervising insurance firms[21],
- a standard for supervising reinsurers[22],
- a guideline paper on controlling the solvency of insurance companies[23]
- a paper on the use of actuarial methods in insurance supervision[24]
- a guideline paper on the application of so-called stress tests to insurance firms[25].

In 2003, the IAIS again organised seminars for emerging nations, some of which were supported by BaFin experts. Collaboration with other international organisations was strengthened further.

Joint IAIS and FSF working group produces its first results.

The "Task Force on Enhancing Transparency & Disclosure in the Reinsurance Sector (Task Force Re), which was formed by IAIS and the Financial Stability Forum (FSF) in autumn 2002, developed its initial proposals for improving transparency on the global reinsurance market. A database has been developed that will allow regulators, financial authorities and, to some extent, the public, to keep abreast of developments on the global reinsurance market. A standard for extended public disclosure obligations[26] was adopted at the meeting of the Technical Committee in December. The working group is preparing two additional standards on the subject of capital investments and life insurers.

[19] www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Fortentwicklung des Aufsichtsrechts > Arbeitskreis Umsetzung Basel II.
[20] Further information may be found at www.iaisweb.org.
[21] Insurance Core Principles & Methodology.
[22] Standard on Supervision of Reinsurers.
[23] Solvency Control Levels Guidance Paper.
[24] Use of Actuaries as Part of a Supervisory Model Guidance Paper.
[25] Stress-Testing by Insurers Guidance Paper.
[26] Standard on Disclosures concerning Technical Performance and Risks for non-life Insurers and Reinsurers.

3.1.6 FATF

Established in 1989, the "Financial Action Task Force on Money Laundering" (FATF) is the foremost international body responsible for combating money laundering and terrorism financing. The 33-member body is housed at the headquarters of the Organisation for Economic Cooperation and Development (OECD). Last year, Russia and South Africa joined as new FATF members. Germany, represented by the President of BaFin, held the rotating presidency of the FATF for the year ending in June 2003.

The FATF revised the core international standards for anti-money laundering efforts.

During that term, the FATF's 40 recommendations were completely overhauled for the second time since 1996. These recommendations form the core international standards for anti-money laundering efforts. They set uniform standards for the first time, most notably for the entire financial sector and for all persons and professional groups active in it. The overhaul takes into account the latest findings and developments in the area of anti-money laundering. Over the past year, the FATF has also adopted a variety of principles and "best practice" papers to add to its eight "special recommendations" for combating the financing of terrorist activities.

3.2 European Cooperation

In 2000, the European heads of state and government agreed on an action plan to create a single market for financial services by 2005. According to the ninth Progress Report from the European Commission, the Financial Services Action Plan (FSAP) is nearing completion: 36 of the 42 measures provided for by the FSAP have been implemented. Because of the elections for the European Parliament in 2004 and the European enlargement process, those key points on the FSAP agenda that have not yet been implemented are to be addressed in the course of this year. With the adoption of its Market Abuse and Prospectus Directive, the EU made significant progress in 2003 towards achieving its aim of integrating the European financial and securities markets. In addition, an agreement was reached within ECOFIN on 7 October 2003 with regard to the Investment Services Directive.

In light of the directive projects pursued by the European Commission – Prospectus, Market Abuse and Investment Services Directives – BaFin has focused primarily on its involvement in the law-making process at European level during the year under review. Besides supporting the Federal Ministry of Finance, its work in the Committee of European Securities Regulators (CESR), of which BaFin is a member, is particularly worth mentioning.

Financial Stability Table formed.

Further progress was also made in the organisation of the European supervisory process. Meetings of the Economic and Financial Committee (EFC), which provides preparatory advice to ECOFIN on economic and financial issues and also reports on financial stability, now take place twice a year as Financial Stability Tables (FST). This represents a new development in the sense that these meetings are now attended by representatives of industry-specific supervisory

bodies, and that these representatives now report directly to the FST. To accomplish this new mission, the supervisory bodies in the insurance and investment sectors have followed the example of the banking supervisory bodies and have formed groups to analyse industry-specific risks and developments in the area of financial stability. One special task relates to evaluating the risks that can arise from risk transfers. The group has also been given the job of clarifying how to detect risk concentrations more effectively and more regularly in the future, which means that it complements the work performed by the Joint Forum in this same area.[27]

3.2.1 Regulations and Directives

In 2004, the Act on the Improvement of Investor Protection will implement the Market Abuse Directive into German law.

On 12 April 2003, the Directive of the European Parliament and of the Council on Insider Dealing and Market Manipulation (market abuse) was promulgated as the first directive drawn up using the Lamfalussy process. The member states must integrate the Market Abuse Directive into national law within 18 months, i.e. by October 2004. The Directive replaces the existing European regulations on insider trading and ad-hoc disclosure requirements and, for the first time, creates prescriptions for prohibiting market price manipulation and establishing rules of conduct for securities analysts. The idea is to create pan-European common standards to combat market abuse and bolster investor confidence in the markets. Up until now, the technical implementing provisions – “Stage 2” of the Lamfalussy process[28] – came in the form of two Commission directives and a Commission regulation passed in December. The CESR submitted proposals for the technical implementation provisions. In 2004, the Act on the Improvement of Investor Protection will implement the Market Abuse Directive into German law.

Prospectus Directive

Prospectus Directive must be implemented into national law by 1 July 2005.

The Directive of the European Parliament and the Council on the prospectus to be published when securities are offered to the public or admitted to trading – the Prospectus Directive – came into force in December 2003. The Directive must be implemented into national law by 1 July 2005. It will allow businesses to offer securities publicly, or apply to register them for trading on a regulated market, EU-wide provided that the responsible home country authority has approved the prospectus. This will make it easier and cheaper to raise capital. For investors, the Directive brings a qualitative improvement in information and will ease access to prospectuses by providing for a central repository. The Directive affects only prospectus requirements. Existing European and national laws will continue to apply for admission to exchange listing. In November 2003, the Commission submitted a first draft of a regulation that built on the preliminary work of the CESR working group. The European Commission had tasked the CESR to advise the Commission on the minimum requirements for a prospectus. In addition, the CESR advised the European Commission with regard to

[27] cf. Chapter I.
[28] cf. Fig. 11, p. 50.

the issue of further implementation measures concerning the Prospectus Directive, particularly concerning the incorporation of data by reference and advertising.

Directive creates a European passport for investment firms.

Investment Services Directive

ECOFIN reached a political agreement on the draft directive on markets for financial instruments, which is intended to replace the existing Investment Services Directive, in Luxembourg on 7 October 2003. At the end of March 2004, the European Parliament approved the proposed directive.

The new directive provides a pan-European legal framework for the execution of investor orders by stock exchanges, multilateral trading systems and intra-bank trading. It creates a European “passport” for investment firms that will permit companies to do business EU-wide once they obtain authorisation in their home country. The draft directive thus governs the authorisation and business activities of investment firms. Moreover, it contains comprehensive provisions for regulated markets and the work of the responsible authorities. In December 2003, the Commission provided the CESR with mandates to develop the implementing provisions for this directive. The working groups established have begun their work and are expected to complete it by the end of January 2005.

Transparency Directive

On 30 March 2004, the European Parliament approved the proposed directive concerning transparency requirements for securities issuers. The Council of Economic and Finance Ministers had already approved the proposal informally on 25 November 2003. The Council is expected to pass the directive formally in the first half of 2004.

Under the principle of home country control, the proposed directive aims to eliminate the requirement for issuers to meet different transparency requirements. It focuses on three areas: regular financial reporting, ownership transparency and disclosure, and the provision of information on exchange-traded companies. The aim of ownership transparency is to inform the public more quickly and comprehensively on the significant participating interests of major shareholders. The varying implementation of the existing regulations in the individual member states is to be replaced by a harmonised regulatory framework.

After hearing from market participants and member states, and after considering the recommendations of the CESR, the Commission will lay down detailed implementation measures and will task the CESR with developing the Directive’s implementing regulations.

Policyholders will be better protected and the principle of home country control will be introduced.

Reinsurance Directive

In 1998, the Insurance Committee of the European Union set up the Reinsurance Subcommittee and gave it the task of preparing a reinsurance directive[29] In 2003, the subcommittee continued its

[29] Directive of the European Parliament and of the Council on supervision of reinsurance and amending Council Directives 73/239/EEC, 92/49/EEC and Directive 98/78/EC and 2002/83/EC.

intensive work on the draft directive. In parallel to this effort, the individual member states carried out solvency simulations for reinsurers that will allow the Committee to review whether or not, under the solvency rules under consideration, reinsurers would already be sufficiently capitalised. The goal of the directive is to better protect policyholders and to introduce the principle of home country control to reinsurers as well. The Commission published the draft directive in the spring of 2004.

The intention is to submit the draft to the Council after the European Parliamentary elections. The plan is to prepare the directive using an accelerated, “fast-track” solution, i.e. the Commission plans to borrow as much as possible from the regulations applicable to primary insurers and adjust them only where specific reinsurance matters are involved.

The original plans aimed to pass the directive at a far earlier stage. Consequently, Germany prepared a draft (Referentenentwurf) for a revision of the Insurance Supervision Act that anticipated many of the regulations contained in the planned Reinsurance Directive. The key points of the draft include minimum own funds requirements and an authorisation requirement for the reinsurance business.

Pension Funds Directive

Occupational retirement provision will have to meet minimum European standards.

On 3 June 2003, the European Parliament and the Council passed the directive on the activities and supervision of institutions for occupational retirement provision – the Pension Funds Directive – which must be implemented into national law by 23 September 2005. Strict supervisory standards aim at ensuring a high degree of security for future pensioners. In addition, the directive is intended to provide efficient administration of occupational retirement provision.

The scope of the directive’s application covers occupational retirement provision institutions and, optionally, life insurers if they are direct insurers. It does not apply to government-sponsored social security institutions. Among other things, the directive sets out the prerequisites for operating such a vehicle, the informational obligations of these vehicles vis-à-vis future and present beneficiaries, the determination and coverage of technical provisions, investment principles, asset management and custodial rules, cross-border activities and the collaboration between member states and the European Commission.

Directive on the Creation of a new Committee Structure in the Financial Services Sector

On 5 November 2003, the European Commission submitted six orders and a proposed European Parliamentary directive aimed at creating a new committee structure for the financial services sector. These proposals are intended to put the EU in a position to react quickly and efficiently to developments in the financial services sector and to guarantee that regulations are implemented quickly and in a uniform manner throughout the EU.

The Lamfalussy process will now be extended to the banking and insurance sector.

They also aim at extending the use of the "Lamfalussy process"[30] – previously applicable only to the securities sector – to the banking and insurance sector, as well as to collective investment funds (UCITS).

As in the securities sector, two committees will be set up for both the banking and insurance sectors: a committee of national regulatory authorities – Level 1 and 2 of the "Lamfalussy process" – and a committee of national supervisory authorities – Level 3 of the "Lamfalussy procedure". Competence for UCITS will be transferred to the corresponding committees in the securities sector.

Comitology functions for the new regulatory authority committees.

Both new committees of the regulatory authorities – "Level 1 and 2" – namely the European Banking Committee (EBC) and the European Insurance and Occupational Pensions Committee (EIOPC), will replace the Banking Advisory Committee and the Insurance Committee. The proposed directive aims primarily at adjusting the existing directives in the financial services sector to bring them into line with this new arrangement. To this end, comitology functions were transferred to both new committees. In addition, the UCITS Contact Committee's regulatory committee authority was moved to the European Securities Committee (ESC). The Council tasked a working group to work on the directive. This working group met for the first time on 8 December 2003, discussed the directive in detail and requested that the delegations provide written feedback. The directive is scheduled to be passed at some point prior to the European Parliamentary elections.

Planned directive for insolvency protection systems

The European Commission is planning a directive on insolvency protection systems to protect policyholders from the financial consequences of an insolvent insurance firm. Corresponding insolvency protection systems are to be established at national level. These will complement the protection provided by the so-called "Winding-up Directive". Priority is to be given to compensating policyholders as quickly as possible in the event of insolvency. The protection systems will kick in if the investments of an insolvent insurer are inadequate to satisfy all policyholder claims.
Following a suggestion by the EU Insurance Committee, a working group comprising all member states has been working since the beginning of 2002 on a report concerning the status of all national protection systems and their experiences, as well as areas for future harmonisation.

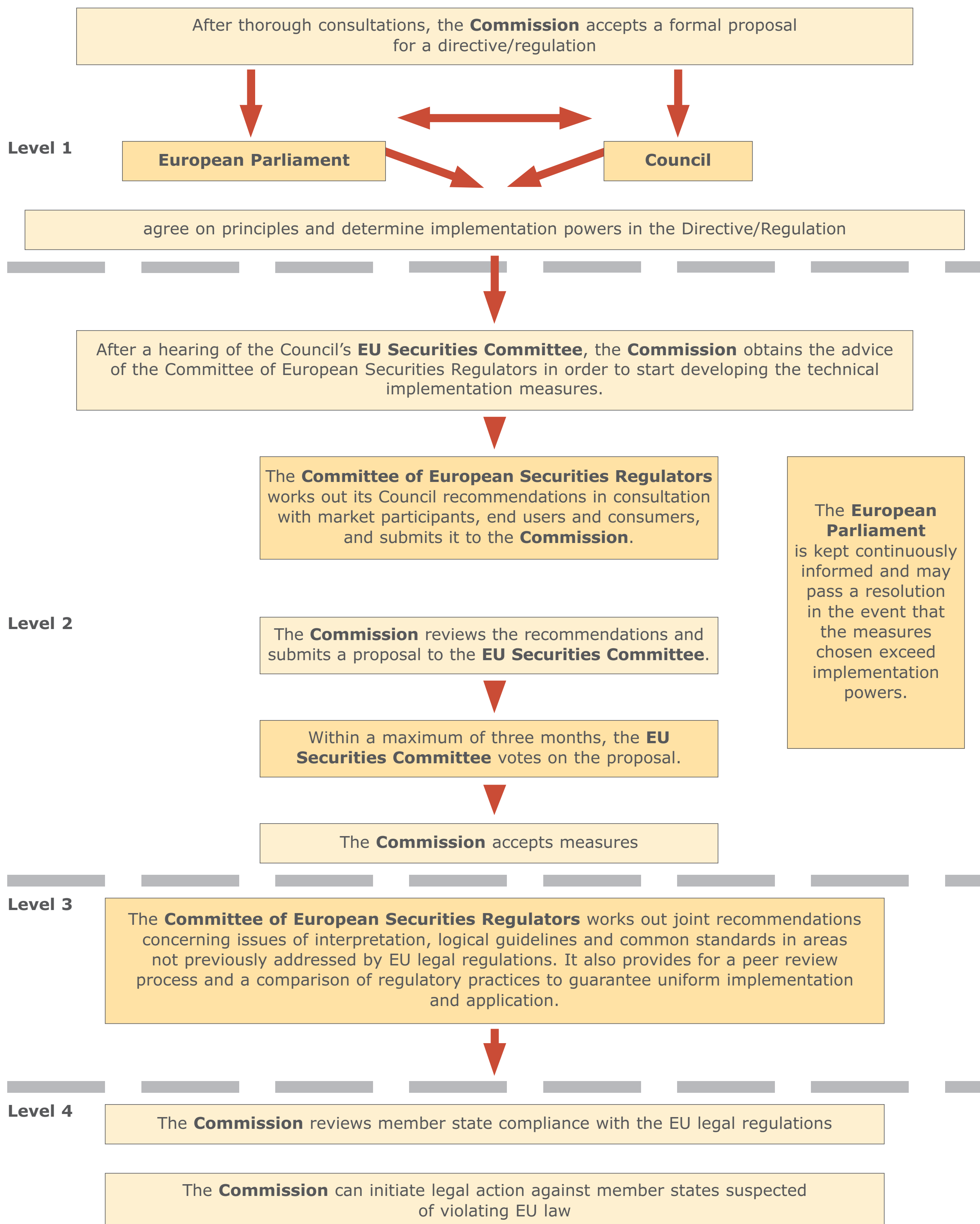
Germany has three protection institutions.

Up until now, Germany has had three protection institutions: Verkehrsopferhilfe e.V. for motor vehicle liability insurers, Protektor Lebensversicherung AG (Protektor) for life insurers and Medicator AG for private health insurers.

Protektor's charter allows it to assume the portfolios of distressed life insurers, thereby enabling policyholders to keep their insurance cover. There is no risk that these policyholders will be either unable to obtain insurance coverage or forced to obtain only limited or

[30] cf. Fig. 11, p. 50.

Fig. 11
The Lamfalussy process in the securities sector[31]



[31] Taken directly from the final report of the Committee of the Wise Men concerning regulation of the European Securities Markets dated 15 February 2001, p. 10. europa.eu.int/comm/internal_market/en/finances/general/lamfalussyde.pdf.

considerably more expensive coverage elsewhere. This contrasts with what a compensating institution does in the event a life insurer is liquidated. Unlike Protektor, Medicator is purely a holding company.

There are no plans to transfer the portfolios of distressed health insurers to Medicator.

BaFin is currently working to obtain recognition for its existing national protection systems, such as Protektor.

3.2.2 CESR

In the CESR, BaFin can participate in the shaping of European supervision law.

As a body of the European Supervisory Authorities, the Committee of European Securities Regulators (CESR)[32] continues the work of the Forum of European Securities Commissions (FESCO). It began its work as a formal European committee in June 2001. For BaFin, the CESR is an important vehicle for participating in shaping supervision at European level. In addition to FESCO's previous fields of endeavour, the CESR also has the task of counselling both the European Commission and the newly formed Securities Committee when it comes time to fill in the framework.

Permanent working groups

CESR-Pol

The CESR-Pol is a permanent body of the CESR which discusses current cases from supervisory practice. In addition, the CESR-Pol is concerned with improving and advancing cross-order information exchange[33] between securities supervisory authorities. The CESR-Pol's 2003 activities were marked by working mandates to address such matters as "Risk Based Enforcement", joint guidelines in the area of cooperation and information exchanges, relationship to uncooperative jurisdictions from non-EEA states and Internet monitoring. Another of its responsibilities involved preparing for the integration of new EU member candidates into the body, as well as having these states sign the MoU.

CESR-Fin

The CESR-Fin is a working group that develops proposals for a harmonised supervision of compliance with accounting standards in Europe. During the reporting period, the group released several papers for final publication or consultation. The aim of its work has been to prepare the EU securities markets for the application of international accounting standards (IAS/IFRS) to the group balance sheets of exchange traded companies, and to prepare the uniform application of these standards across Europe. Pursuant to EU regulation 1606/2002, IFRS accounting is binding for all financial years that begin on or after 1 January 2005.

CESR Standard No.1 on Financial Information.

In this regard, "CESR Standard No. 1 on Financial Information", published in April 2003, provides the EU-wide harmonised basic structures for the national "enforcement" of accounting standards. It enables the responsible administrative agencies to audit the annual

[32] Further information may be found at www.cesr-eu.org.
[33] Pursuant to the multilateral "Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities" (MMoU).

and interim financial statements of listed companies. This will include unscheduled audits – subject, of course, to certain selection criteria.

Administrative units, or the agencies required to report to them, are also to be put in a position to intervene in the event that accounting regulations are violated.

CESR Standard No.2.

Moreover, the draft of a "CESR Standard No. 2", published in November 2003, proposes a system in which national enforcement activities are coordinated Europe-wide. The draft provides for more than just the creation of a forum in which all agencies with responsibility for implementing accounting standards discuss the specific application of standards on a regular basis. It also provides for the formation of a database at the CESR containing the decisions of these agencies.

Comitology of working groups ("Level 2")

Market Abuse Directive.

The European Commission used two different mandates to commission the CESR with the preparation of proposals for implementing the Market Abuse Directive. After comprehensive public consultations, the CESR delivered its proposals to the Commission at the end of 2002 and in August 2003. In December 2003, the European Commission then passed two formal directives and a regulation with implementing provisions for the Market Abuse Directive. The other implementation directive is scheduled for passage in early 2004.

Prospectus Directive.

In 2003, the European Commission issued the CESR with another mandate to provide suggestions for implementation measures for the Prospectus Directive. In 2003, the CESR continued and broadened the consultation process it had already begun in 2002. The recommendations were transmitted to the European Commission in three parts, in July, September and December 2003. This advice was given full consideration in the European Commission's proposed measures for implementing the Prospectus Directive. The European Commission proposes that these implementation measures be issued in the form of a regulation.

Investment Services Directive.

The CESR has already set up three working groups to develop measures for the implementation the Investment Services Directive. The CESR's work is expected to be completed by January 2005.

3.2.3 CEIOPS

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)[34] was established as a formal European committee by order of the European Commission on 5 November 2003. The EU thus followed the resolution passed by the EU Economics and Finance ministers to extend the four-stage fast-track legislative process (Lamfalussy process[35]) as originally developed for the securities sector to the entire financial sector. The CEIOPS is the

[34] Additional information may be found at www.ceiops.org.
[35] cf. Fig. 11, p. 50.

successor to the former Conference of EU Insurance Supervisors and began its work on 24 November 2003.

The committee comprises high-ranking representatives of supervisory authorities for insurance and occupational retirement provision from the EU and EEA member states. Until 1 May 2004, the EU candidate countries had observer status.
The CEIOPS assumes the Level 3 functions of the Lamfalussy procedure. Its task is to advise the Commission, either upon request or on its own initiative. Above all, the committee supports the Commission when it is working on implementing provisions that affect insurance and reinsurance matters. In addition, it is expected to contribute to coordinating supervision practices within the Community. Finally, the CEIOPS offers supervisory authorities a forum for collaboration and the exchange of information on regulated institutions.

Before the committee submits its views to the EU Commission, it consults with market participants, consumers and end users. To this end, the CEIOPS established an advisory panel of accountants, actuaries, insurance professionals and consumers in February 2004. The CEIOPS has already set up a working group on financial stability, which met for the first time in January 2004. Other working groups on occupational retirement provision and Solvency II[36] have also been established.

In addition, the CEIOPS formed a steering committee known as the "Bureau". The Bureau has a total of five members, each elected for two years. Dr. Thomas Steffen, BaFin's Chief Executive Director of Insurance Supervision is the deputy chairman of the committee. The committee is assisted by a secretariat that will begin its work under the supervision of a general secretary on 1 July 2004 at its future headquarters in Frankfurt am Main.

3.2.4 CEBS

The Committee of European Banking Supervisors (CEBS)[37] was established for the banking sector in January 2004, thereby extending the four-stage fast-track legislative process (Lamfalussy procedure[38]) to the entire financial sector. Like its sister committees, the CEBS assumes the Level 3 functions in the Lamfalussy procedure. Unlike both the other committees, however, the CEBS has representatives not only from supervisory authorities but also from the central banks.

The CEBS will advise the European Commission in banking supervision matters.

The CEBS will advise the European Commission before it issues implementing regulations and, in this context, will consult with market participants, consumers and end users. It develops common recommendations for the interpretation and application of the

[36] There are five working groups for Solvency II: Life and Non-life Insurers, Supervisory Review Process, Transparency and Accounting, as well as Cross-sector Issues.
[37] Further information can be found at www.c-ebs.org.
[38] cf. Fig. 11, p. 50.

directive texts. The members of the body will compare and improve their supervisory practices and harmonise them, thus making the CEBS a platform for supervisory information exchange, too.

The CEBS met for the first time at the end of January 2004 to decide on its rules or procedure and work schedule for the year. The core elements of this program will be the implementation of Basel II into European law and accounting. Sub-working groups have been established in both areas. The CEBS's main working group is the "Groupe de Contact".

Germany has a presence on the CEBS.

The EU candidate countries have participated in CEBS meetings from the beginning; as observers before 1 May 2004 and as full members thereafter. As far as Germany's representation is concerned, the Bundesbank and BaFin each have one representative on the committee. Helmut Bauer, BaFin's Chief Executive Director of Banking Supervision works on the steering committee that advises and assists the CEBS chairman. The CEBS is also supported by a secretariat in London, where BaFin wants to be represented by one local member.

3.2.5 Groupe de Contact

At the multilateral level of the European Economic Area (EEA), BaFin is a member of the Groupe de Contact (GdC). Established in 1972, the GdC allows members to exchange confidential information on credit institutions with the purpose of identifying potential crises at banks with pan-European operations. Furthermore, the exchange of information is also aimed at aligning the various different supervisory approaches and activities in order to create a level playing field within the banking sector.

The GdC is the CEBS's main working group and permanent working committee.

In the future, the GdC's activities will include acting as the main working group and permanent working committee of the CEBS at Level 3 of the comitology process. In so doing, it will be entrusted with essential basic tasks: it will work out recommendations for interpreting EU directives and draft standards for banking supervision not covered by the provisions of EU law.

The GdC has focused on the work surrounding the SRP.

As in the preceding year, the GdC focused on the work surrounding the Supervisory Review Process (SRP) of the Basel accords in 2003. Various sub-groups, which deal with the individual components of the future SRP, were formed within the GdC for this purpose. These working groups develop concepts for shaping the SRP. They are guided by previous drafts of a directive that were developed by the EU for the new bank capital requirements. BaFin participates in all sub-groups. The groups work on a number of issues including the future design of the intra-bank "Assessment Process", the "Supervisory Evaluation Process", the supervisory system for assessing risks within banks, the "Risk Assessment System", and other issues relating specifically to "Corporate Governance" at banks, with particular reference to the SRP.

Among other things, they analyse comparative studies and hold regular meetings with bank representatives. In the course of its fundamental work, the GdC has developed a pan-European, common

understanding of the new supervisory rules. In addition, the GdC has made a substantial contribution to the further development of the texts of the directive, which will provide a model for the implementation of "Basel II" into national law.

3.2.6 Insurance Committee of the European Commission – Solvency II Project

The EU intends to establish a new solvency system.

In December 1998, a "solvency sub-committee" was set up by the Insurance Committee of the European Commission. One of the key objectives of this sub-committee is to establish a new solvency system that reflects the risks of insurance undertakings more accurately. The analyses conducted by the sub-committee will form the basis of a future directive. The Solvency II Project is divided into two phases. During the first phase, which ended in April 2003, the member states and the Commission offices drew up the general structure of the future EU solvency system. The result is a Basel-inspired "three pillar" approach, adjusted to the needs of insurance supervision. In the second phase, the work of the committee will focus on the following five sub-areas:

Technical provisions and investments - life insurance.

1. In the case of life insurance, the European Commission intends to harmonise the basis for setting up technical provisions. International accounting developments will play a decisive role. Requirements for investments are to be based on the "prudent person" principle, and the relationship between the asset and liability sides of the insurer's balance sheet shall be monitored.

Technical provisions - non-life insurance.

2. The Commission offices have recommended that quantitative specifications be drawn up for property and casualty insurers for those technical provisions relevant for supervisory purposes. In addition, the intention is to develop a standard for technical provisions. The techniques and procedures should be compatible with those used in international accounting (IFRS, IAS).

Life and non-life, target capital and minimum capital.

3. The problem with Pillar I is how to find methods that can determine the overall solvency of an insurance firm. Overall solvency should depict the financial solidity of a company, taking particular account of the risks of its business and its environment.

   There are two factors that will determine the own funds requirements for insurance companies: target and minimum capital. Target capital should correspond to the economic capital that a business needs to be adequately equipped for fluctuations in its business. The working groups responsible for dealing with this problem have yet to propose a solution for determining which ruin probability will be used as a basis for this calculation. The European Commission is striving to develop a standard model for the calculation of target capital.

   Nonetheless, firms have the option of using internal risk models in order to calculate their target capital level. The prerequisite for this, however, is that the respective supervisory authorities approve these internal models. The criteria that must be met in order to obtain this approval must be developed at EU level. Solvency II will also accept models for use in specific areas, in

order to ease the introduction of internal models. Minimum capital requirements must be met. Since some member states need a court order before they can take supervisory measures, it should be a figure that can be simply and objectively calculated. Whether the minimum capital level should be calculated as an independent absolute figure or as a percentage of target capital has yet to be clarified.

Pillar II requirements.

4. The Solvency II sub-committee agreed that principles had to be developed for orderly administration, internal control systems and effective risk management in a business. In addition, the committee agreed that important aspects of the supervisory review process had to be harmonised at EU level. These include, for example, a common framework for evaluating corporate governance, for early warning indicators and for stress testing reference scenarios.

   Finally, intervention powers and the scope of the competences of the supervisory authorities have to be specified more clearly. In individual cases, regulators should be able to issue regulations that exceed the standard requirements, or demand more detailed disclosure in order to more clearly ascertain the risk profiles of insurance companies.

Market discipline and disclosure.

5. Transparency and disclosure can strengthen market mechanisms and meet the needs of risk-oriented supervision. Which informational obligations should be placed on companies under the third pillar of Solvency II, however, depends on the procedures that are chosen for Pillars I and II. Consequently, the EU wants to define the third pillar more precisely at a later time. The member states and the Commission offices are of the view that developments in IASB, IAIS and Basel II work should be observed attentively in order to coordinate disclosure obligations and to reduce the administrative burden on businesses. In addition, the EU must decide whether or not certain regulatory information should be published. In BaFin's view, this is particularly problematic in situations where companies do not comply with regulatory requirements. The mere publication of such information could worsen the situation of the affected business considerably.

First comprehensive discussion paper expected by mid-2004.

The European Commission wants to complete work on an initial comprehensive discussion paper for a draft framework directive by the middle of 2004. The Commission has chosen the codified version of the present Directive 2002/83/EC for life insurers as the basis for the structure of the future directive. The aim is to make the regulations and other rules of the new directive as compatible as possible with the globally applicable IAIS standards.

Five working groups at the CEIOPS.

As part of the Lamfalussy procedure, the European Commission intends to transfer certain work to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The CEIOPS has set up five working groups for this purpose. These groups will develop standard procedures for determining target capital in life and non-life insurance (Groups 1 and 2). In addition, they will address the requirements placed on the “Supervisory Review Process” (Group 3) of Pillar II and transparency and/or

disclosure (Group 4). There will also be a group for cross-sector issues (Group 5).

BaFin preparing for Solvency II.

To advance the European Solvency II Project, BaFin is planning to work with businesses and associations on proposals for solutions that reflect the peculiarities of the German market. In a first key step, BaFin sent out a comprehensive questionnaire to 635 companies in October 2003. This gave supervisors an up-to-date and comprehensive picture of how German insurers, pension funds and reinsurers have further developed their valuation and risk measurement methods and what they are planning for the future. Among other things, BaFin is interested in how well smaller and medium-sized businesses are equipped for Solvency II.

In addition, insurance supervisors are currently setting up an external advisory panel for the Solvency II project that is aimed at aligning BaFin's work on the project with associations, business and academia. The deliberations of this advisory body will become part of the international discussion concerning Solvency II.

3.3 Bilateral cooperation with supervisory authorities

BaFin has a tightly woven network of agreements and contacts within Europe and with major supervisory authorities across the globe. This bilateral collaboration is based on the common positions contained in memoranda of understanding (MoU)[39]. These allow for intensive exchange of information and audits by the German supervisor in other countries.

BaFin signs agreement with IOSCO.

In November 2003, BaFin signed the IOSCO multilateral MoU (MMoU), which creates a new framework for worldwide information exchange between securities supervisory authorities. The signing of the agreement was preceded by an intensive examination of the German authorities. The strict examination of potential signatory authorities is designed to allow IOSCO to ensure, among other things, that the respective national rules prevent the unauthorised release of information. Currently, 24 of IOSCO's more than 180 members have signed the MMoU.

A special agreement governing the supervision of the Clearstream Group was negotiated with Luxembourg's Commission de Surveillance du Secteur Financier and came into force on 9 January 2004.

Regular meetings enhance information exchange.

Regular bilateral meetings with partner regulators are used to discuss general supervisory issues and exchange information relating to supervisory matters. There have been 54 such meetings with partner authorities from the EU or worldwide in the area of banking supervision alone. Moreover, the respective BaFin supervisors collaborate with the employees of foreign supervisory authorities in a large number of cases involving common regulatory subjects.

[39] A list of the MoUs signed with different countries may be found in Appendix 6.

BaFin had several opportunities to explain the German supervisory system in detail to US American insurance supervisors (NAIC) and parliamentarians. This was important because a prerequisite for creating international standards is mutual awareness and the recognition of supervisory systems. The aim is to reduce the deposit requirements placed on foreign reinsurers doing business in the USA. The final report of the NAIC working group for Germany – which has since been submitted – now accurately portrays the German supervisory system.

Integrating the EU accession states

In 2003, BaFin continued its engagement in the Working Group on Effective Financial Services Supervision in Accession Countries (EFSSAC). In the past, this working group had examined whether or not the EU accession states had implemented the key elements of the EU's financial market supervision system, and which measures still had to be taken. The countries in question used the results of these examinations to draw up their own action plans. During the year under review, the EFSSAC was now examining whether or not the accession countries had taken the action planned. The results were included in the Commission's final reports and demonstrate that, on the whole, the accession countries were very successful in implementing the European regulations.

BaFin also gave delegations from Poland and the Czech Republic the opportunity to broaden their knowledge of German regulatory practices. Moreover, a BaFin employee is assisting the Czech insurance supervisory authority in implementing the EU regulations as part a twinning project.

European Integration using the EU passport.

BaFin offered the supervisory authorities of the accession countries the chance to gain an insight into the practical implementation of EU “passport” rules in Germany. Institutions from EEA states must express their desire to offer cross-border services or establish a branch in one of the other EEA states. The home country supervisory authority, i.e. the supervisory authority from the country in which the institution has its registered office, certifies that the institution is subject to supervision in that country, and that the correct notice procedures are in place. The institution then receives certification which, in addition to its home country licence, allows it to engage in the certified business areas in other EU countries. This confirmation is also known as the EU “passport”.

As of 1 May 2004, these EU passport regulations are also applicable to the 10 new EU member states. BaFin's offer to provide information on the practical implementation of the EU passport regulations was broadly accepted. Between October 2003 and March 2004, bilateral meetings were held with Slovakia, the Czech Republic, Slovenia, Hungary, Latvia, Estonia, Lithuania and Poland. Where these countries used integrated financial supervisory authorities, the meetings were set up to offer guidance covering all three pillars. The British FSA and BaFin have initiated the establishment of a network of experts on EU passport issues, which will begin work in September 2004 with its first meeting in Bonn.

4 Consumer complaints

In the course of 2003, a total of 24,260 customers of insurance, credit institutions and financial services providers brought their complaints to BaFin. This was 5% below the comparative number of 25,648 received in 2002.

Customer complaints are a source of information for possible abuses at supervised businesses. They offer an opportunity to examine whether or not a company has violated its conduct obligations, and even whether supervisory remedial measures should be taken.

BaFin acts solely in the public interest.

Of course, when compensatory damage claims are involved, many consumers hope to obtain legal assistance from BaFin. Since BaFin acts solely in the pubic interest, it may not assist individual customers in disputes over the interpretation of contractual or statutory provisions. Neither may BaFin review a civil suit's prospects for success.

Complaint management project.

In 2003, BaFin began its complaint management project with the aim of applying uniform standards to handling complaints in the area of insurance, banking and securities trading. Procedures will be streamlined and accelerated using information technology. Among other things, complaints forms will be available online at BaFin's homepage for all sectors in the future. This will make it easier for customers to submit complaints and comments to BaFin, and will provide BaFin with the necessary information on the facts underlying the criticism.

The complaints management system will also allow the immediate and detailed recording of the grounds for the complaint. This is an important means for the early detection of abuses. When the system is introduced, BaFin will release a quarterly report on the number and grounds for complaints on its homepage.

4.1 Complaints in the insurance sector

The number of complaints has fallen.

Most of the items received and processed by BaFin – 19,778 compared to 21,132 in the prior year (-6.4%) – again came from the insurance sector. 17,667 of these items were complaints, 975 were general non-complaint enquiries and 119 were petitions that came to BaFin via the German Bundestag (Lower House of Parliament). In addition, there were 1,017 items that did not fall within BaFin's realm of responsibility, and around 11,000 telephone enquiries.

Because of the changeover to an improved evaluation system for complaint statistics, a year-on-year comparison of the number of complaints in 2003 is only possible to a limited extent. For technical reasons, some counting deviations occurred during the changeover phase. In the medium term, however, the new system will provide additional evaluation possibilities. Moreover, only the fully processed correspondence from citizens will be included in the statistics. At the end of 2003, around 2,000 items that had been submitted to BaFin in 2003 had yet to be resolved.

Overall, 26.71% of proceedings (prior year: 24.5%) had a favourable outcome for the correspondent; 68.15% of complaints were unfounded, and in 5.14% of the cases, BaFin was not the competent authority.

Table 7

Complaints received - by insurance class

Year	Life	Motor	Health	Accident	Liability	Legal Expenses	Building/ Household	Other classes	Other complaints[40]
2003	5548	2758	3408	1416	1565	1300	1948	467*	1368*
2002	5504	3151	2765	1770	1671	1499	1600	-----	-----
2001	5320	3130	2919	1759	1487	1347	1504	-----	-----
2000	4584	2897	2748	1779	1329	1248	1567	-----	-----
1999	4107	3392	3046	2663	1839	1715	1978	-----	-----

(* No comparative figures available for prior year due to statistical changeover.)

As in the prior year (2002: 36%) most of the complaints (30.1%) submitted in 2003 continued to relate to claims settlement in life and non-life insurance. These were followed by complaints regarding the handling of insurance policies: 28.77% (25%), contract termination: 18.68% (31%) and business conduct when negotiating contracts: 11.2% (13%). In addition, 11.3% fell into the "other" category. The main underlying grounds stated (more than one is possible) are shown in the following table:

Table 8

Grounds for complaints

Category:	Number:
Coverage questions	1854
Other	1443
Changes and adjustments of premiums	1433
Amount of benefits	1412
Liability issues (grounds/percentage share)	1285
Policy changes – extensions	1212
Manner of claims processing/delays	1207
Termination without cause	1193
Termination for cause	1192
Advertising/advice/application recording	1187
Bonus/credit	958
Withdrawal/contest/revocation/objection	812

Selected cases within the insurance sector

Bonus forecasts are not guaranteed.

In the area of life insurance, the most frequent questions related to bonuses. It was often not clear to insurance company customers that the future values quoted for the bonus development are normally only non-binding forecasts and are not guaranteed. BaFin is working towards ensuring that firms clearly distinguish between guaranteed and non-guaranteed benefits both at the time the contract is concluded and in their annual statements on bonus developments.

[40] Broker complaints, wrong address, etc.

The guaranteed rate is the maximum rate.

In addition, confusion arises time and time again with regard to the term "guaranteed rate". Many customers think this refers to a minimum rate of return. In fact, however, it is the maximum rate for computing the premium. Customers frequently misunderstand the insurer's statements concerning the contract rate. The customer often assumes that the quoted rate applies to the total of premiums paid. In fact, however, only a portion of the premium – the so-called savings portion – is invested with interest.

Revocation of insurance contracts.

A large number of customers requested assistance in revoking their insurance policies pursuant to section 5a of the Insurance Contract Law (*Versicherungsvertragsgesetz – VVG*). Sub-section 2 of that provision stipulates that the revocation period does not begin until the policyholder has received the insurance certificate and the complete documentation. The insurer bears the burden of proving receipt. Citing non-receipt, the customer can demand rescission of the contract and reimbursement of premiums already paid. In such cases, it must first be determined whether or not premiums have been paid for at least one year since conclusion of the contract. If so, then the right of revocation is generally excluded. Otherwise, investigations are carried out on a case-by-case basis to check whether or not there is any evidence indicating receipt. BaFin will not assist insurance brokers that try to get contracts cancelled so they can earn a commission selling a customer a different insurance policy.

Health insurance premium adjustments generated complaints.

As far as health insurance is concerned, most complaints revolve around premium adjustments. These generally challenge the legal propriety of procedures and the amount of the premium adjustment. In such cases, BaFin's powers to intervene are limited to examining whether or not the trustee for premium adjustments gave his/her consent to the adjustment.

Motor vehicle liability insurance and claims settlement.

In the area of motor vehicle liability insurance, the year under review saw a number of complaints relating to the calculation of theoretical economic damages stemming from the total loss of a used passenger vehicle. Under the new regulations contained in section 249 (2) sentence 2 of the BGB, introduced by the 2nd Amendment to the Law of Damages Act (*2. Schadenrechtsänderungsgesetz*), the amount of money required by sentence 1 only includes value added tax (VAT) if and to the extent it is actually incurred. As a result of this statutory revision, insurers deduct 16% from the gross amount of replacement cost shown in the expert's report when they settle claims. However, in the case of the commercial sale of used vehicles, section 10 and section 25a of the Value Added Tax Act (*Umsatzsteuergesetz – UStG*) provide for two different tax rates depending on how the dealer purchased the car. If the dealer bought the vehicle from a business that enjoys the right to a credit for VAT paid, e.g. a lawyer, the dealer deducts the amount of VAT shown on that business's invoice as a credit against his own VAT obligation. When he resells the vehicle to the future claimant, section 10 of the UStG requires the dealer to charge 16% VAT and pay it to the tax authorities. If, however, the dealer gets the vehicle as a trade-in from a consumer, he pays no creditable VAT on that transaction. When that vehicle is later sold to the future claimant, section 25a of the UStG states that the dealer does not have to show any VAT on the invoice, but instead must only turn

over 16% VAT on the profit made from the transaction (so-called "mark-up taxation"). Thus, given the usual profit margin of 15-20% and the application of section 25a UStG, the amount of VAT contained in the overall purchase price is usually only 2-3%.

Mark-up taxation criticised.

The main criticism here is that when the claimant procures a replacement used car, he must absorb a portion of his damages: the insurer has deducted the 16% from the estimated replacement cost, but when the claimant submits the invoice, he is reimbursed only for the 2% "mark-up tax". BaFin's position is that when used vehicles are damaged, only 2% should be deducted. The ombudsman for the insurance industry has decided in favour of that view.

No legal protection for gambling.

A flurry of complaints were made in the first half of 2003 concerning legal expenses insurance, because insurers were refusing to assume cost coverage for suits brought to enforce promised winnings (under section 661a of the BGB). This subject matter proved difficult, and it was often unclear whether it involved a contractual promise (*Gewinnzusage*) or gambling (*Gewinnspiel*). The standard terms and conditions for insurance exclude coverage for gambling. In the overwhelming majority of cases, it is also unclear who is responsible for the mailing. Furthermore, there is often no address to which to issue a summons, since the companies in question tend to be letterbox firms, particularly based in Austria, Great Britain and the Netherlands. In such cases, the consumer can only be advised to ignore the solicitation flyers in their letterboxes. Some legal expenses insurers have already reacted to the introduction of section 661a of the BGB. The latest terms and conditions exclude insurance coverage for suits brought to enforce promised winnings.

4.2 Complaints about credit institutions and financial services providers

This area, which does not include complaints about securities transactions, saw 3,565 complaints submitted in 2003 (prior year: 3,317), as well as 356 general enquiries (prior year: 573). In addition, there were 5,291 telephone enquiries. BaFin submitted 40 official statements to the German Bundestag's Petition Committee (2002: 67).

Most complaints were unsuccessful. Customers were successful in only 251 cases (7.04%), after BaFin called upon the institution to respond. In 112 cases (3.14%), BaFin criticised the conduct of the particular institution.

Selected cases within the banking and financial services sector

On the whole, the number of complaints concerning the "account for everyone" ("*Konto für jedermann*") remained low in 2003. For no apparent reason, however, enquiries during the fourth quarter increased substantially. Banks had either refused to open a current account or had terminated an existing one. In such cases, unless it was clear that maintaining the account would place an unreasonable burden on the institution, BaFin would approach the bank on the complainant's behalf.

Financing "junk property".

For complaints concerning the financing of so-called "junk property", customers expect the banking supervisory authorities to assist them in rescinding purchasing and lending agreements. In 2003, no judgements were passed that could clarify the legal position of those affected. According to the decisions of the European Court of Justice dated 13 December 2001[41] and that of the Federal Court of Justice dated 9 April 2002[42], the loan contract may be rescinded if the contract was concluded in a door-to-door sales situation and if the sales representative failed to provide the required advice concerning the right of revocation. The property purchase agreement, on the other hand, can only be rescinded if the lending agreement and the purchase agreement are related transactions. In certain cases, it turned out that individual banks accommodated customers with interest rate reductions or partial debt forgiveness if they encountered financial difficulties as a result of entering into such financial arrangements. Such assistance is granted on the condition that the customer clearly substantiates his financial emergency.

The perennial problem of early redemption penalties.

The number of complaints concerning premature repayments of fixed interest loans increased again in the year under review. Several institutions are not prepared to allow early pay-offs. According to section 490 (2) of the BGB, they are obliged to do so only if it is in the customer's legitimate interest; for example, in the event of a sale of the financed property. Customers also object to the early redemption penalties, which they regard as disproportionately high both in their absolute amount and in relation to the amount of the loan.

BaFin only had to contact a small number of banks. It transpired that the institutions in question had consistently fulfilled the requirements imposed by the Federal Court of Justice in its decisions dated 1 July 1997[43] and 7 November 2000[44].Where a dispute relates to the penalties calculated in accordance with these requirements – because the amount of the risk cost savings for early repayment is not prescribed by the BGH, for example – only the courts can decide them.

Loan principal pay-offs using life insurance.

The number of complaints received by BaFin concerning combination financing (*Kombinationsfinanzierungen*) has increased. Under this financing arrangement, banks and customers agree that a loan will be repaid in a lump sum upon maturity of a life insurance policy. If, at the time the contract is concluded, calculations have been made using only the guaranteed maturity value, the amount of insurance proceeds will suffice to retire the loan obligation in full. When calculations are made using estimated maturity value, i.e. to include bonuses, the insurance proceeds may turn out to be lower than the loan principal if – as bonuses have caused them to do in recent years – the maturity value lags behind the amount forecasted. BaFin has called on insurance companies to inform affected customers of these coverage gaps early on and show them how the gaps can be

[41] case no.: C- 481/99.
[42] case no.: XI ZR 91/00.
[43] case nos.: XI ZR 197/96 and XI ZR 267/96.
[44] case no.: XI ZR 27/00.

filled. Some lending institutions, for example, have asked their customers to fill the financial gap by making special repayments. Since banks must insist on reasonable principal payments, regulators do not object to this. Customers frequently accuse the institutions involved of giving them bad advice. Besides repayment via an endowment policy, repayment can also be made using mortgage savings contracts (*Bausparverträge*). The tax savings provided by the insurance contract and the fixed interest rates in a mortgage savings contract can make such combinations advantageous to the borrower. On the other hand, they also require higher current payments. The contract relationships are complex and therefore more difficult to deal with in the event of disruptions. Only the courts can make a final decision as to whether or not there has been defective advice in any individual case.

Securities are often no longer adequate collateral for securities loans.

Various institutions extended credit to their customers to enable them to purchase securities. As a result of market losses since the end of 2000, the value of these securities no longer provided sufficient collateral to secure repayment of the loans. After they were sold, customers were often faced with remaining debt that sometimes exceeded their financial means. BaFin cannot, however, do anything for these customers. For one thing, the institution is required to monitor collateral for its loans in its own interest only. Furthermore, it is within customers' power to sell and limit their losses. In all of the cases dealt with by BaFin, the customers were knowledgeable and experienced. In other words, they should have been aware of the risks they were taking.

Interest rate adjustments tied to changes in key rates.

Complaints about interest adjustments almost always involve the customer's assumption that the interest rate on their loan will fall following any drop in key interest rates.

Such a reduction is, however, only automatic if the interest rate on the customer's account is contractually linked to key interest rates. The complaints that BaFin receives always refer to interest rate agreements that are not linked to such key rates but rather, to general interest rate trends. There has been no substantiated case, however, of a bank adjusting its rate too slowly.

Some individual institutions increased the interest rates charged on account overdrafts in order to ensure that their pricing made adequate provisions for the higher risk of default compared to other loans. They justified the increases by telling their customers that market interest rate levels had changed – which, at that particular time, they had not. Even if the increase in interest rates were justifiable from the standpoint of risk, false justifications can lead to loss of customer trust. Even though such conduct does not violate supervisory standards, BaFin called on these institutions to tell their customers the real reason for the increase.

Delayed fund transfers.

BaFin received a great deal of correspondence in which bank customers complained about money transfers taking too long. Follow-up inquiries revealed no grounds for objecting to the conduct of the banks in question. The three banking days requirement was not exceeded and there was no evidence to indicate that banks had delayed transfers.

Cross-border fund transfers within the EU.

The EC regulation concerning cross-border payments[45] obliged institutions to execute certain cross-border payment transfers within the European Union on the same conditions as a domestic transfer. For the regulation to apply, the following prerequisites must be met:

- the payments must be in euros,
- the transfer must not exceed €12,500,
- the transfer must be directed to a recipient in a member state of the European Union,
- the party making the transfer must include the International Bank Account Number (IBAN) and the Bank Identifier Code (BIC) of the recipient on the transfer form and
- the party making the transfer must pay the fee he is charged.

From the complaints received, BaFin was able to discern that banks were adhering to these rules. Several customers believed that all cross-border payments within the European Union had to be settled this way. This is not, however, true for payments by cheque and for bank transfers that do not meet all of the prerequisites of a standard EU bank transfer.

Charges for return of direct debit.

The number of complaints concerning charges for returned cheques and direct debits has dropped considerably. The Federal Court of Justice has ruled that flat charges for returned cheques and direct debits are impermissible because instead of providing a service, the banks are acting in their own interest.

Accordingly, they may not charge a fee for informing a customer of the return. The decision of the Federal Court of Justice dated 21 October 1997[46] failed, however, to clarify whether or not it was permissible to assert damages for customer conduct that was in breach of contract. Some institutions – in particular, savings banks – are using this as a justification.

Fees in inheritance matters.

Besides the question as to what documentation an institution may demand to prove heirship status, complaints relating to the settlement of inheritances included the issue of fees charged by institutions. Banks may charge a fee to the extent that such fees are for services requested by the customer, such as copies of documents sent to the decedent. Nonetheless, they may also be charged if the conduct of the heirs requires a greater expenditure of effort. BaFin has protested charges levied on transactions that unavoidably accrue in inheritance matters.

Deceptive advertising.

Bank customers turned to BaFin for help because they believed that advertising by institutions was either deceptive or entirely impermissible. Some complaints affected investment offers that expressly specified a limited term of validity. The institutions, however, cancelled the offers early. Even if most advertising documents contained the remark “offer subject to change” (*Angebot freibleibend*), this was not always sufficiently apparent to reasonably informed interested parties. After BaFin intervened, the institutions agreed to design their offers more transparently in the future.

[45] EC Regulation (No. 2560/2001) of the European Parliament and the Council dated 19 December 2001.
[46] case no.: XI ZR 5/97 and XI ZR 296/96.

Objections were also raised against credit offers directed towards persons who were either not creditworthy or ineligible for credit; for example, highly indebted persons or minors. Inquiries revealed that the institutions had hired other companies to do the advertising. These companies, in turn, had purchased addresses from address list publishers who received parameters from the bank concerning the selection criteria. The bank did not receive the addresses. If this kind of advertising is undesirable, the addressees have a right to object to it. Should they do so, the bank will then instruct the company they hired to cease using their addresses.

4.3 Complaints regarding securities transactions

561 complaints about securities transactions by banks.

In 2003, 561 (prior year: 559) communications were received from customers complaining about private credit institutions, savings and cooperative banks and relating to the investment services offered by these institutions. In some cases, the complaints prompted particular scrutiny during the annual review of that institution’s reporting obligations and rules of conduct, or the scheduling of a special audit.

The past year once again saw many complaints relating to investment performance in the banking sector – even though the markets did relatively well in 2003. Since the positive market developments did not make up for all prior-year losses, customers continued to lodge complaints concerning the performance of securities investments, as well as the quality of advice and explanations.

Warrants and certificates.

As in previous years, the warrants and certificates market was a particularly rich source of complaints. Many complainants objected primarily to the design of new products (e.g. “knock-out certificates”), a pricing structure that was very difficult for investors to grasp, and the less than transparent suspension of trading systems. This was partly due to the fact that many customers failed to familiarise themselves thoroughly with the documentation, e.g. the sales prospectus. Furthermore, they sometimes lacked the necessary information. The mistrade rules, which some investors in off-exchange trading were unaware of, were also criticised. A mistrade is a transaction resulting from erroneous order entry that can be cancelled. It is often difficult for investors to judge against whom they should assert their damage claims. Privity of contract normally exists only between issuers and the customer's bank and/or between the bank and the customer but not, however, directly between the issuer and the bank customer.
Some of the complaints concerned investment funds that were wound up or transferred to other investment funds. Since contractual terms and conditions usually allow funds to be liquidated and transferred, the complaints were legally unfounded. Likewise, many investors continued to criticise the fees charged by banks for such things as securities account administration, account transfers or partial executions of securities transactions. These complaints were normally unfounded.

Complaints about financial services providers.

During the reporting year, 100 written complaints were received concerning financial services providers. Numerous concerns were communicated by complainants by telephone. The complaints did not focus on any one particular area. The subjects ranged from general complaints concerning the poor performance of investments, to concrete descriptions of violations of the Securities Trading Act (*Wertpapierhandelsgesetz – WpHG*). As in the previous year, many investors complained that their investment objectives were ignored, and that the financial services provider also failed to take their financial resources into account. In one case, 26 customers of an investment services enterprise were encouraged by a former employee of the institution to complain to BaFin about purportedly poor or false advice. The majority of the complaints were unjustified, because the financial portfolio had been managed within the scope of the agreed investment contracts. BaFin is nevertheless investigating the possibility that unauthorised financial services were provided, and is looking into cases of "cold calling".

5 Combating money laundering and unauthorised transactions

5.1 Combating money laundering and the financing of terrorism

Money laundering, terrorism financing and fraud against banks, financial services providers and insurance firms can endanger stability and Germany's reputation as a financial centre. As a result, BaFin established the Money Laundering Prevention Group, which bundles all of the functions relating to the prevention of money laundering or criminal abuse of the financial system, in early 2003. This not only provides synergies: the group's bundled powers also increase the impact of BaFin's fight against money laundering and terrorism financing.

BaFin requires the institutions it supervises to prevent money laundering themselves by establishing security measures appropriate to their respective risk situation. Using both its own and external audits, it determines whether or not the institution has complied with its money laundering obligations. In addition, the Money Laundering Prevention Group is responsible for the ongoing supervision of financial transfers, foreign currency and credit card transactions, because these are associated with a high risk of money laundering.

BaFin's circular on non-cooperating states.

BaFin also keeps the institutions under its supervision informed about international developments in combating money laundering and terrorism financing. Its publications last year included the current versions of the list of non-cooperating states[47], prepared by the Financial Action Task Force on Money Laundering (FATF). Two

[47] cf. BaFin Circular 1/2003 (Q), 2/2003 (GW), 6/2003(GW) and 8/2003 (GW).

states, St. Vincent and the Grenadines and Grenada, were removed from the list during this period. Since then, the FATF has closely monitored the reforms which both countries agreed to implement. In February 2003, BaFin announced[48] that the sanctions imposed by the FATF against Ukraine at the start of the year could be lifted after Ukraine took steps to improve its anti-money laundering efforts. In November, BaFin implemented an FATF resolution and called upon banks and insurers to monitor transactions to and from Myanmar (Burma) more carefully. After the Republic of Nauru and Ukraine[49], this was the third admonition directed against a state. Finally, BaFin released its Money Laundering Typology Report for 2002/2003[50], in which the FATF provided examples of current money laundering cases and highlighted international trends in the financing of terrorism.

Combating money laundering in the banking sector

"Private banking" gets special attention.

In 2003, many banks made significant progress in implementing the statutory provisions. A number of institutions, however, continue to exhibit substantial shortcomings in the way they are implementing the money laundering obligations. This pertains primarily to preventive security measures and organisational structures. Some of the institutions' internal departments for combating money laundering were also understaffed. Many institutions have yet to install the correct internal, EDP-supported early warning systems. These are of critical importance in allowing institutions to meet their obligations under the money laundering laws.

EDP-supported research systems prevent losses.

During the year under review, BaFin directed special attention to institutions operating in areas fraught with an enhanced money laundering risk, especially in the area of "private banking". Here too, some banks had still failed to implement the appropriate money laundering prevention measures. Creating uniform standards for the prevention of money laundering that apply to all institutions of a group has proved crucial for preventing money laundering both in Germany and abroad. The intention is to include those group institutions that do not carry out financial transactions themselves. This could also include businesses that offer purely asset management and advisory services, for example.

During 2003, many institutions combined their risk management in the areas of anti-money laundering, preventing terrorism financing and fraud. They concentrated these previously separate tasks in the hands of their anti-money laundering officer as a central competence centre. This close meshing of money laundering, terrorism financing and fraud prevention within the meaning of section 25a (1) sentence 1 No. 4 of the Banking Act (*Kreditwesengesetz – KWG*) and section 14 (2) No. 2 of the Money Laundering Act (*Geldwäschegesetz – GwG*) contributes to the active prevention of greater damage to the institutions.

[48] cf. Urgent Circular 2/2003 (GW).
[49] cf. Annual Report BaFin 2002, p. 20.
[50] cf. Circular 3/2003 (GW).

Selected cases

During the year under review, there were specific cases in which not only damage to the reputation of individual institutions, but also material losses, were prevented. One institution, for example, was able to avoid hundreds of millions in damages to its own interests in connection with money laundering and fraud. Consequently, BaFin continued to press for the introduction of legally required risk management, including the required EDP research security systems, in 2003. It is particularly important to adjust these systems to the respective business and risk structure.

Relief for smaller institutions.

In 2003, some smaller institutions outsourced their anti-money laundering functions to larger institutions with BaFin's consent. BaFin expressly welcomes this development if, in addition to the synergies offered, it enables smaller institutions to meet their responsibilities under the Money Laundering Act. A new audit concept agreed with BaFin brings some relief to the outsourcing institutions: auditors of annual financial statements have to report on whether or not the provisions of the Money Laundering Act are complied with and implemented. The auditors must review this aspect only once, namely at the institution assuming the outsourced duty. As a result, this aspect of the audit no longer applies to the outsourcing institution.

23 special audits resulted in new findings.

BaFin commissioned auditors to conduct 23 special bank audits in 2003. Two cases were audits for cause which, because of their significance, included auditors from BaFin's Money Laundering Prevention Group. The results of the audits reconfirmed how important it is that auditors keep an institution's money laundering potential in view and focus their audit accordingly. As a result, BaFin will be conducting audits with its own staff or having them accompany teams of external auditors more often in the future.

Preventing money laundering in the financial services industry

Some smaller financial services institutions, in particular, continue to exhibit considerable deficiencies in implementing the statutory standards. In many cases, the audit reports of their annual financial statements, which are assessed by BaFin, also leave much to be desired. These reports are often incomplete and lack clarity.

Growing interest in the financial transfer business.

During the reporting period, there was a growing interest on the part of international financial transfer firms in opening branch offices or establishing a presence in Germany. BaFin provided the interested companies with detailed information concerning the supervision standards. In 2003, two institutions were licensed to engage in the financial transfers business. In two cases, BaFin revoked the authorisations of licensed institutions after it found serious violations of reporting and other duties under the Banking Act.

Also, in September 2003, BaFin published a fact sheet setting forth the prerequisites that firms must fulfil in order to engage in the credit card business[51].

[51] www.bafin.de Rechtliche Grundlagen & Verlautbarungen >> Sonstiges >> Merkblatt über die Voraussetzungen für die Erteilung einer Erlaubnis zum Betreiben des Kreditkartengeschäftes (Fact Sheet concerning the Prerequisites for Issuance of a Licence to Engage in Credit Card Transactions) (section 1 (1a) sentence 2 no. 8 KWG).

Combating money laundering at insurance firms

BaFin is reviewing Money Laundering Act compliance by those insurance firms subject to its provisions. In so doing, it mainly reviewed the reports of such firms' internal auditors and the suspicious activity reports filed by them pursuant to section 11 GWG in the year under review.

Particularly susceptible transactions in the insurance sector.

The assessment revealed that single deposit accounts, the payment of sizeable single premiums or transactions involving broker or intermediary accounts are areas that could be misused for the purpose of money laundering. All national and international money laundering typologies support this finding. In 2003, the section 11 suspicious activity reports of insurance firms primarily involved precisely this type of transaction.

Other cases mainly involved contracts relating to foreign countries, as well as cash deposits of more than €5,000, where the insurance firms are required to undertake special security and monitoring measures.

Prosecuting "Underground Banking"

201 new proceedings for unauthorised financial transfers or foreign currency transactions.

The battle against what are known as shadow banking systems ("underground banking") was also a focal point of BaFin's work during the reporting year. "Underground banking" involves persons or firms executing fund transfers or foreign currency transactions without a permit. National and international sources indicate that such shadow banking systems are strongly suspected of being misused for money laundering and terrorism financing. The reason lies in the fact that transactions in this area are carried out, in the main, without written receipts and thus do not leave a "paper trail". The aim of financial supervision is to steer as much of those payment streams as possible into appropriate individual enterprises that are subject to BaFin's ongoing supervision. During the reporting year, the Money Laundering Prevention Group also took part in several international initiatives to combat underground banking.

In 2003, BaFin opened a total of 201 new cases against unauthorised fund transfers and/or foreign currency transactions. In 14 cases, it conducted a local audit of the suspect company. On 17 occasions, it issued formal prohibitory injunctions against companies which, despite demands to cease and desist, had continued to engage in unauthorised transactions. BaFin also simultaneously filed criminal complaints with local prosecutors against those firms. BaFin continued to discover several international organisations that were using local agent networks and transmitting transfer orders via fax or the Internet in 2003. BaFin used more in-depth Internet research and local audits to add to its knowledge about how these kinds of multinational networks conduct such transactions, as well as about other participants. A prohibitory injunction was brought against a transfer system headquartered in Malaysia that settled transactions over the Internet.

BaFin informs local business registrars about licensing requirements.

In the past, financial transfer firms operating without a licence have often claimed that when they registered their business they were not informed about the licence requirement. Accordingly, BaFin sent a circular to business registrars informing them of the licence

requirements set out in the KWG in 2003. The circular was accompanied with the request that BaFin be informed about the commencement of business activities and that the applicant be expressly informed before starting a business that requires licensing.

Automated access to account information

The procedure introduced by the 4th Financial Market Promotion Act (*Finanzmarktförderungsgesetz – FMFG*) for automating access to account information pursuant to section 24c of the KWG has been in use since 1 April 2003. Since then, every bank has been required to make available a current file of all cash and securities accounts that it manages in Germany.

This file is to include the names and birth dates of each account holder and co-signer, as well as the names and addresses of beneficiaries. Account balances and account activities, however, are not recorded. BaFin is entitled to access information from these files to answer legitimate external inquiries – for example, from prosecutorial officials – or to fulfil its own statutory supervisory mission.

Test phase with more than 11,000 inquiries.

Following a test phase in which BaFin handled over 11,000 inquiries, the system went into operation on 24 November 2004. In the first seven weeks after its launch, regulators processed about 2,200 inquiries including just under 1,600 inquiries directed to BaFin by prosecutors and the police. 425 inquiries came from BaFin itself, mainly relating to cases of unauthorised financial transfer transactions. BaFin was able to provide information on a total of more than 9,600 accounts in response to internal and external inquiries. To obtain this information, BaFin accessed the data of participating credit institutions about 5.5 million times.

In several instances, and with the help of account information from BaFin, investigating officials were able to seize previously unknown assets of persons charged. It was also possible to determine quickly whether or not suspected terrorist organisations had accounts in Germany. In addition, BaFin answered numerous inquiries from banks, computer centres and authorised officials, and ruled on exemption applications from about 150 institutions, in the year under review.

Freezing of accounts suspected of having a terrorist background.

Section 6a of the KWG came into force on 6 November 2003. It allows BaFin to prohibit an institution from allowing a person resident in the EU to access an account held with them. In order to do so, there must be grounds to suspect that the account serves terrorist purposes. Even before section 6a of the KWG was introduced, an EU regulation[52] authorised imposition of financial sanctions against suspected terrorists resident outside the EU. This regulation was the EU's implementation of UN Security Council Anti-terrorism Resolution 1373/2001. The EU, however, has no authority to promulgate similar rules for persons resident within the EU. Section 6a of the KWG has now closed this gap for Germany, allowing it to seize money belonging to EU residents.

[52] R (EC) No. 2580/2001.

5.2 Prosecuting unlicensed banks, financial services providers and insurers

Black capital markets are thriving.

In 2003, the black capital market, in which unlicensed banks, financial services providers or insurers transact business, continued to thrive in Germany. By the end of the year, BaFin had investigated a total of 2,345 (prior year: 1,642) cases of unauthorised business including 822 (prior year: 619) new cases that were added in the course of the reporting year.

This rapid increase has two causes: firstly, the 4th Financial Market Promotion Act came into force in July 2002, enacting provisions that not only improved the tools available for combating the black capital markets, but also widened its scope of application. Secondly, BaFin has been strengthening its workforce since it was formed, which means that it can now take on a greater number of cases and pursue these cases more vigorously.

BaFin has been able to do this not least due to its close collaboration with German state police authorities, the Federal Office of Criminal Investigation (Bundeskriminalamt), Interpol and its foreign partner authorities.

BaFin's powers were extended.

Pursuant to section 37 of the KWG and section 83 of the VAG, BaFin may demand information and inspect business documents, conduct on-site audits, search business premises and seize evidence in order to pursue cases of unauthorised banking, financial service and insurance businesses. Since 2002, BaFin has also been allowed to investigate those persons and companies that are suspected of being accessories to the preparation, conclusion and settlement of such unlicensed transactions, without first requiring proof that they themselves are engaged in this type of transaction[53]. This could apply to trustees, attorneys or Internet service providers. BaFin generally has the same investigative and intervention rights vis-à-vis such firms as it does against those suspected of conducting the unauthorised transactions. These new powers allow it to shut down Internet sites and freeze bank accounts to ensure that investors' money is properly refunded.

203 information requests, 31 search warrants and 27 on-site audits and searches.

Among those providing BaFin with tips on unauthorised transactions are investors, employees of firms, competitors, associations, the Bundesbank and prosecutorial authorities. In 2003, BaFin launched proceedings against suspect firms in 203 cases using information and document requests. BaFin obtained 31 search warrants and conducted 27 on-site audits and searches. It assessed fines in 29 cases. These figures do not include cases of unauthorised financial transfers and currency transactions that were pursued in the battle against money laundering and terrorism financing.

If BaFin can prove the unauthorised conduct of banking, financial services or insurance business, it takes action to ensure that these undertakings immediately cease and unwind the transactions. Last year, BaFin issued 33 prohibitory injunctions and 35 unwinding orders. In 21 cases, BaFin appointed liquidators selected from a group of experienced insolvency administrators.

[53] section 37 (1) sentence 4 KWG, section 44c (6) KWG.

The focus was on unlicensed banking and financial service transactions.

With 756 new investigatory actions and a total of 2,185 open proceedings, the focus of the battle against the black capital market was on prosecuting unauthorised banking and financial services transactions. For investors, the deposit and principal broking business are especially dangerous when they are unlicensed and conducted without regulatory supervision. These often involve large deposits of customer money with a great danger of total loss.

Principal broking services requiring a licence

Transactions in equity participations, hedge fund products and certificates is flourishing.

Trading in equity interests in limited partnerships or civil-law partnerships, in hedge fund products and certificates such as profit participation rights and certificates, and in bearer notes flourished on the black capital markets in 2003. These investment offers are often linked with principal broking services. The proceeds investors are told they can expect from selling the participation or redeeming the security purchased are linked by contract to the performance of the financial instruments acquired with their invested capital. Accordingly, the investor – who is often unaware of the danger – bears the full risk of a total loss of the derivative or security acquired for him. Not infrequently, the offerors of such products advertise them by alluding to the security and professionalism that is associated with ordinary registered investment funds. They often operate in several countries, which can make prosecution of civil law claims very difficult.

In several instances, BaFin deemed transactions with such investment products to be principal broking services and the Administrative Court of Frankfurt am Main has – to the extent that it has dealt with the issue thus far – confirmed that legal opinion. Because of corresponding prohibitory injunctions and unwinding orders, some of the offerors were unable to continue business operations.

The parties against whom BaFin takes measures have legal recourse, which they frequently use. Experience shows that this involves long drawn out, legally complicated proceedings during which the case wends its way through all levels of the administrative court jurisdiction and, in individual cases, up to the Federal Constitutional Court (Bundesverfassungsgericht). In 2003, BaFin worked on a total of 260 contested cases in connection with unlicensed banking and financial services transactions. 124 objections were filed in the course of the year; 65 contested proceedings were concluded, 37 of which by rejection notice (*Widerspruchsbescheid*). There were 113 judicially contested matters in 2003, 54 of which were filed for the first time during the reporting year. 61 judicial proceedings were ended in 2003; 47 cases by a decision on the merits by the court, while in 14 cases, proceedings were settled on other grounds.

All judicial decisions were in favour of BaFin.

Prosecuting unauthorised insurance intermediation

In 2003, BaFin initiated 643 new administrative offence proceedings for unauthorised insurance intermediation. Within a half-year period, German insurance agents brokered the sale of around 10,000 life insurance policies to German customers without first checking whether or not the life insurance firm, which had its registered office

outside the EEA, had met the prerequisites for transacting business in Germany. Sometimes, the firm did not even have a licence in its country of origin. In such cases, this means that the insurance broker has acted culpably in endangering the interests of German policyholders, thus fulfilling the factual elements of an administrative offence as set out in the Insurance Supervision Act (VAG). A noteworthy aspect of the policies sold was that the brokers involved were receiving relatively high commission rates compared to industry norms, and the policies were frequently taken out for exceptionally long terms.

Audits and searches

When firms are suspected of engaging in unlicensed banking, financial services or insurance transactions, BaFin employees are authorised to take action within the offices of such firms. This means that regulators may conduct audits on, and search the premises of, suspect firms and seize evidence. This also applies if a firm is suspected of involvement but does not itself engage in unlicensed banking or financial services transactions. Searches must generally be authorised by judges of the court exercising local jurisdiction.

19 searches produced significant discoveries.

There is a large logistical expense associated with searches and seizures of evidence. They require prior coordination with participating officials such as the police and prosecutorial authorities, registration offices and the Bundesbank. There must be a judicially issued warrant and the documents seized must be evaluated as promptly as possible. In order to accomplish this task more efficiently and frequently, BaFin established a section responsible for on-site audits and searches throughout Germany at the end of 2002.

During the reporting year, BaFin took on-site action on 27 occasions. This included eight audits and 19 searches, with a marked increase in the number of premises searched – 27. This is attributable to the fact that BaFin frequently searches both the homes and offices of firm managers. In one complex investigation, parallel searches were carried out in four different German states. BaFin was assisted in this effort by employees of the Bundesbank and local police departments.

Documents and other items of evidentiary value were seized in nearly all audits and searches. The searches of the home and offices of one accused person allowed BaFin to prove that the individual claiming to work for a bank in Samoa was actually managing the business from Cologne and was personally receiving investor funds. BaFin enjoined the receipt of deposits and ordered the refund of investment capital received.

In another case, the target of a prosecutorial investigative proceeding filed a licence application with BaFin for a business he had already been operating without such authorisation. During the search, documents were found revealing that the accused had been advised by local officials of the requirement to obtain a licence as early as 1999. Consequently, BaFin denied his application for a licence.

Licence required or not?

BaFin also conducts preliminary reviews as to whether or not a planned business activity requires a licence in accordance with the KWG or the VAG. If this is the case, the firm needs to obtain the licence from BaFin before it commences business operations. During the reporting year, regulators rendered an opinion in 504 cases of proposed business activities. It was primarily new business concepts that were submitted to BaFin for review. This often called for reviews of extensive documentation and a detailed legal review of the concept. In the insurance sector, the focus was on legally difficult problems of differentiation. The prosecution of offerors acting with criminal intent was the exception.

Cross-border banking and financial services

For some years now, BaFin has observed that banking and financial services are being offered in Germany from non-EEA countries, or, especially in cases with a criminal background, that the false impression is being given that the offers are from abroad. In these cases, no physical presence in Germany is established. Consequently, BaFin redirected its administrative practice in September 2003, and published a fact sheet fixing the threshold beyond which cross-border banking and the provision of financial services would be subject to the licensing requirements of section 32 (1) sentence 1 of the KWG[54]. The fact sheet contained descriptions of typical fact situations that would require a licence from BaFin. Moreover, it identified the prerequisites that had to be met before BaFin would grant an exemption for certain business areas. The publication was preceded by several conferences with association representatives and institutions in order to give reputable offerors in the banking and financial services sector early notice.

BaFin fills in gaps in investor protection.

BaFin specified to which firms the licence requirement extended. Among other things, this was intended to fill gaps in investor protection and combat the black capital market in Germany more effectively. Whether or not a firm is physically present in Germany no longer plays a role in determining whether or not the firm in question is required to have a licence under the KWG.

BaFin now has the authority to intervene in cases where a foreign resident firm targets German residents with offers to enter into contracts for banking services and receive funds in the process. This is necessary in light of the growth in the cross-border provision of financial services since the 1990s. Among the things contributing to this phenomenon are Internet and telephone banking, which make it easier to carry out banking transactions and provide financial services online. The number of firms offering their services from abroad is steadily increasing, and these companies are using new media to target the German market. Some of these firms are not subject to supervision in their home countries. Whether or not customer funds are actually used as contractually agreed can generally be determined only at great expense, since the firms also claim, among other things, that they are (supposedly) exempt from

[54] www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Sonstiges.

the licence requirement. Some firms are established only briefly in non-EEA countries in which there is no supervision requirement in order to use targeted offers to get at German investors' money. Before the new administrative practice took effect, firms that had been prohibited by bank regulators from doing business in Germany frequently moved their domicile – actually or only apparently using post office box addresses – abroad, preferably to the Caribbean, to avoid supervision.

The new administrative practice works against competitive distortions.

Treating competitors equally is the prerequisite for fair competition in the banking and financial services sector. This can be realised by assuring, in particular, that all companies – regardless of their domicile – are subject to the same or materially equivalent rules of supervision. This has already been accomplished in the EEA by implementing various EU directives that apply to the banking and financial services sector. Thus, the task is to create uniform supervision standards for firms from the EEA and from non-EEA countries. Relaxing supervision is justified only for those firms that have convincingly effective home country supervision, meaning that no additional host country supervision is required in Germany.

In practice, however, BaFin's actions are limited even if it can deal directly with foreign companies. Because of the territoriality principle, it has no enforcement powers against foreign firms. Undertaking sovereign acts abroad is generally impermissible under international law. BaFin must therefore rely on assistance from the responsible foreign authorities. Should BaFin prohibit a foreign firm from doing business it can, however, announce this fact in press releases or on its Internet site.

Exemptions for institutions with effective supervision.

Institutions domiciled in non-EEA states such as Switzerland, the USA, Canada or Australia, for example, are subject to supervisory controls that conform to international standards. This means that certain business areas can be exempted from supervisory rules pursuant to section 2 (4) of the KWG.

As a result, BaFin is prepared to exempt cross-border transactions with banks and institutional customers, for example. The same applies to transactions resulting from the intermediary activities of a bank which is member of a group.

Other exemptions from supervision

At the end of 2003, and pursuant to section 2 (4) of the KWG, 219 institutions had been exempted from licensing requirements and the supervision provisions of the KWG with respect to their banking and financial services businesses. BaFin had received another 36 applications for consideration as of the reporting date. Regulators issued exemptions to six companies in the course of financial year 2003. Section 2 (4) of the KWG allows firms to be exempted from certain regulatory provisions in individual cases, provide that the nature and type of their businesses does not necessitate supervision. Typically, banking transactions that are only auxiliary or ancillary activities of minor significance or that provide a necessary link to other licence-free business activities, are eligible for exemption. This applies, for example, to the following: the assumption of default risk in the central regulatory area or purchasing cooperatives, payments

of advances on claims against statutory health insurers by pharmacy billing centres to their affiliated chemists, loans from municipal utilities to their customers for switching energy systems or loans from self-help institutions and student loans from charitable foundations, as well as deal opportunity brokerage (*Nachweismakelei*) in connection with advice on mergers and acquisitions.

Exemption for REWE supermarkets.

The exemption granted to the German supermarket partnership limited by shares, REWE, in 2003 is particularly worth mentioning. The REWE supermarkets that belong to this firm are permitted to engage in lending without a licence, albeit within a very narrowly circumscribed area. The supermarkets offer customers paying by EC card a short-term loan whose amount has been limited by BaFin: with a minimum purchase of €20, the supermarkets may pay out a maximum of €100.

6 Certification of pension products

BaFin does not examine Riester products for economic soundness.

"Certification" means that the terms and conditions of a private pension plan agreement comply with the requirements of the Act Governing the Certification of Contracts for Private Old-Age Provision (*Altersvorsorge-Zertifzierungsgesetz – AltZertG*). BaFin examines only their eligibility for tax favourable treatment using eleven statutorily specified criteria. On the other hand, it does not examine these contracts for economic soundness. Offerors of so-called "Riester" products are predominantly life insurers, banks and investment companies.

In 2003, BaFin awarded a total of 55 certificates, 54 of which were individual certificates – for the products of individual offerors – and one of which was applied for by an association. Since three offerors

Table 9

Types of certificate

Type of certificate	**Certificate for standard contract submitted by central organisation**	**Individual certificate for provider of services**	**Certificate for provider of services based on standard contract**	**Certificate for standard contract sub-mitted by central organisation as authorised representative**	**Total**
Processing fee	5,000 €	5,000 €	500 €	250 €	
Basis Applicant	section 4 (2) AltZertG	section 4 (1) AltZertG	section 4 (1) AltZertG	section 4 (3) AltZertG	
Life Insurers	6	342	0	0	348
Credit Institutions	12	6	0	3,238	3,256
Investment Companies	1	16	4	9	30
Housing sector	1	0	0	28	29
Total	**20**	**364**	**4**	**3,275**	**3,663**

As of: 02/01/2004

waived their rights to certificates, there were a total of 3,663 certificates at the end of the reporting year (prior year: 3,611 certificates).

During the reporting year, BaFin’s random sampling initiative checked a total of 218 banking and insurance products for compliance with the certified contract conditions. Overall, the sampling returned positive results. BaFin was obliged to object to violations in only a few individual cases.

BaFin called upon a life insurance company to start using only the certified conditions with immediate effect, and to revise any contracts concluded in the meantime. In another 21 cases, inaccuracies were discovered that did not, however, pertain to the eleven certification criteria and that were corrected for the future. Several offerors had inaccurate descriptions in their consumer information pointed out to them. This was primarily tax information and was not relevant for certification purposes.

II Supervision of credit and financial services institutions

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1 Solvency supervision

1.1 Basis for supervision

1.1.1 Implementation of the Winding-up Directive

The implementation of the directive on the reorganisation and winding-up of credit institutions also led to several amendments to the Banking Act (*Kreditwesengesetz- KWG*)

Authority for and recognition of insolvency proceedings.

From now on, only the government agencies or courts in the country of origin have the authority to open insolvency proceedings against a deposit-taking credit institution or electronic money institution domiciled within the European Economic Area. If insolvency proceedings against an institution are commenced in another member state, the Federal Republic of Germany must recognise these proceedings irrespective of the rules set forth in section 343 (1) of the Insolvency Code (see section 46e (1) KWG). Accordingly, the implementation of the Directive through section 46e (2) of the KWG blocks the conducting of territorial proceedings. This reflects the decision of EU lawmakers to follow the principle of strict uniformity and universality in insolvency proceedings, and to create special rules for credit institutions under insolvency law. By way of contrast, the EU regulation on insolvency proceedings provides for territorial proceedings, which cover only those assets situated in the state of opening.

Notification of other EEA member states concerning reorganisations.

The implementation has also given rise to a number of new informational obligations. If possible prior to, but in any case directly following the ordering of reorganisation measures, BaFin is required, pursuant to section46d of the KWG) to notify the competent authorities of the other EEA states in order that any required accompanying measures can be initiated for other entities under supervision. Moreover, such reorganisations must be made public to ensure that legal remedies can be sought in the event that the interests of third parties are impaired.

Additionally, comprehensive rights to information for creditors and informational obligations for courts and liquidators have been introduced in order to assure the enforcement of creditors' rights, particularly in connection with proceedings involving foreign entities. In this regard, the legislature took steps to ensure that language barriers in particular would not stand in the way of the enforcement of claims.

Furthermore, the EU legislature has also introduced obligations for the various supervisory authorities to inform each other in the event that an EEA branch office of an institution domiciled outside of the EEA encounters difficulties.

Imminent illiquidity.

The German legislature used the implementation of the Directive as an opportunity to introduce the concept of "imminent illiquidity" within the meaning of section 46b of the KWG, as grounds for insolvency. In this way, the KWG has been structurally aligned with the Insolvency Code (InsO), which, in addition to the general

grounds for opening insolvency proceedings – illiquidity and overindebtedness – also makes reference to imminent illiquidity (section 18 InsO) as grounds for opening insolvency proceedings.

In both the KWG and the InsO, "imminent illiquidity" is only applicable as a reason for the opening of insolvency proceedings in accordance with the will of the debtor. This means that the debtor must personally initiate the request by BaFin to the insolvency court or agree to such a request for the opening of insolvency proceedings. In this way, the new grounds for insolvency complement the range of supervisory instruments available to BaFin and brings the structure of insolvency provisions set forth in the KWG more in line with that of the Insolvency Code.

Additionally, the implementation of the Directive by lawmakers improves the position of BaFin. The agency must now be consulted prior to the appointment of the liquidator. The liquidator is also obliged to provide BaFin with information upon request.

1.1.2 Amendment of Mortgage Bank Act

On 15 August 2003, the German government proposed a draft of amendments to the Mortgage Bank Act (*Hypothekenbankgesetz-HBG*). These proposed amendments are designed to ensure that even in cases of insolvency, interest and principal payments will be made on the bank's *Pfandbriefe*. This is meant, in particular, to allay the concerns of international investors and rating agencies. The special laws of neighbouring European states display sometimes fundamentally more detailed rules in this regard. The increased precision of the German law will ensure, among other things, that the market-leading German *Pfandbriefe* will not diminish in attractiveness to issuers and investors. Still, there is ample reason to assume that the proposed legislation will remain mostly theoretical, as not one mortgage bank has become insolvent since the HBG came into force in 1900.

Court appointed custodian can transfer cover assets and Pfandbrief liabilities more easily.

As before, the cover pool is to be kept separate from the rest of the overall insolvent estate. Beyond this, the draft law provides for the introduction of a court-appointed custodian in cases of insolvency. The custodian's job will be the administration of the cover pool in the interest of *Pfandbrief* and derivatives holders, and the disposal of assets for this purpose. Additionally, the transfer of cover assets and *Pfandbrief* liabilities is to be made significantly less complicated. On the one hand, the custodian will be granted authority to transfer all of the cover assets and *Pfandbrief* liabilities to a separate mortgage bank. Alternatively, the draft also provides for the possibility to transfer only partial amounts of the Pfandbrief liabilities and cover assets. Both alternatives can be exercised by transferring full legal title or on a fiduciary basis. Every full or partial transfer of cover assets and *Pfandbrief* liabilities must be approved by BaFin. This rule provides an added measure of security for *Pfandbrief* holders. To secure cover assets, the custodian can employ these measures even directly prior to the commencement of insolvency proceedings. Additionally, the amendment sets forth a mandatory present value excess cover of 2% beyond the volume of *Pfandbriefe* outstanding to offset administrative costs and any unforeseen defaults. This excess

cover must be invested in highly liquid securities eligible as substitute cover within the meaning of the HBG.

Furthermore, the revised law states that any excess cover, including voluntary overcollateralisation, may only be transferred by the custodian to the liquidator of the credit institution if it is clear that it is not needed.

1.1.3 BaFin ordinances concerning the present value calculation of cover

On 19 December 2003, BaFin laid out rules for the calculation of present value and the simulation of interest and exchange rate variations in two ordinances[55]. These ordinances were promulgated on 24 December 2003[56] and took effect on 25 December 2003.

Present value calculation of cover and weekly stress test scenario modelling (minimum) improve international standing.

The ordinances are designed to ensure that the constant cover of the *Pfandbriefe* required by statute since 1 July 2002 is also calculated according to the present value method[57]. To this end, and in addition to the individual methods for present value calculation of cover, they define a stress scenario as a minimum measure of the adequacy of *Pfandbrief* cover. This stress test takes into account possible changes in interest and exchange rates and must be applied at least once per week. The institutions have the choice of three alternatives for the interest rate scenarios and two for the currency scenarios. The ordinance concerning the present value calculation of cover can play a significant role in further improving the standing of the *Pfandbrief* on the capital markets and therefore directly lessening the burden of refinancing.

1.1.4 Circular on the treatment of electricity derivatives

In 2003, BaFin held hearings on the draft of a circular aimed at defining the level at which electricity derivatives and derivatives on other underlyings not directly related to financial markets are to be taken into account in own funds requirements and large exposure regulations.

Electricity, like other forms of energy, is commonly regarded as a commodity. In this sense, derivatives that are priced based on the exchange or market value of electricity qualify as financial instruments within the meaning of section 1 (11) of the KWG. As a result, investment broking or, for instance, contract broking with

[55] "Ordinance on ensuring permanent present value coverage of mortgage *Pfandbriefe* and municipal bonds and the calculation of coverage by mortgage banks" ("Verordnung über die Sicherstellung der jederzeitigen Deckung von *Hypothekenpfandbriefen* und Kommunalschuldverschreibungen nach dem Barwert und dessen Berechnung bei Hypothekenbanken") (for the HGB) as well as the ordinance with identical substance "Ordinance on ensuring permanent present value coverage of *Pfandbriefe* and municipal bonds (*Kommunalschuldverschreibungen und Kommunalobligationen*) and the calculation of coverage by credit institutions under public law" ("Verordnung über die Sicherstellung der jederzeitigen Deckung von *Pfandbriefen* sowie Kommunalschuldverschreibungen und Kommunalobligationen nach dem Barwert und dessen Berechnung bei öffentlich-rechtlichen Kreditanstalten") (for the PfandbrG).

[56] Federal Law Gazette (Bundesgesetzblatt – BGBl.) 2003 I, p.2818 or 2815)

[57] cf. also BaFin Annual Report 2002|A, p.55.

electricity derivatives, constitutes banking business or financial services, and is consequently subject to the requirements of section 32 (1) of the KWG relating to the licensing of persons wishing to provide such services commercially or on a scale which requires a commercially organised business.

Standard own funds requirements inadequate due to the high volatility of electricity prices.

The unique physics of the commodity electricity, such as its "non-storability", give rise to price fluctuations on the market that are not comparable to other commodities markets. The enormous volatility of electricity spot prices, caused, for instance, by strong supply and demand fluctuations according to weather conditions and the time of day, holds substantial risks for market participants. The standard own funds requirements therefore have only limited suitability in this area.

The circular will also encompass rules for other market risks, such as those involved in weather derivatives, for example.

However, it is no longer only forward contracts on electricity that are in need of attention. Other derivative products with innovative underlyings not directly related to financial markets, e.g. weather or economic data, are moving into the market. These products are also subject to price risks, but since these risks are not directly comparable to risks from currency, commodity or interest rates and share prices, they are classified as "other market risks".

New system for the calculation of the amounts counting as own funds (capital charges) as part of the standard method.

BaFin is using the draft circular to introduce a new system for the calculation of capital charges on electricity derivatives and other innovative financial instruments. This effects the standard method for the calculation of capital charges on market risk positions. The ability of institutions to employ internal risk models that meet with banking-supervisory approval in accordance with Principle I, part seven, on the calculation of own funds requirements, remain unaffected by this change.

Own funds requirements for potential market risks are thus to be determined based on the standard deviation in relation to the daily change in value of the instruments held by the institution at the close of business (current portfolio). The changes in the value of the portfolio are to be calculated on the basis of the historical price movement of the individual instruments over a specified observation period. If no adequate price history is available for a given financial instrument, the institution must calculate suitable theoretical prices for that instrument.

The draft of the circular was discussed extensively with the financial services providers involved. BaFin will introduce the finalised regulation in a new section of the Solvency Ordinance (*Solvabilitätsverordnung- SolvV*) pursuant to section 10 of the KWG.

1.1.5 Minimum requirements for the credit business of credit institutions

On 20 December 2002, BaFin published the "Minimum requirements for the credit business of credit institutions" (*"Mindestanforderungen an das Kreditgeschäft der Kreditinstitute"- MaK*)[58] to define section

[58] Circular 34/2002 (BA).

25a of the KWG, which necessitates, for example, “an appropriate internal control system” within the institutions, in more detail for this key business area. BaFin cooperated closely with numerous experts from credit institutions, auditors and association representatives in developing the MaK. In the end, practical and flexible solutions were devised which were met with acceptance by the credit industry. As a result, the credit industry’s leading associations all welcomed the publication of the MaK.

MaK expert committee supports opinion shaping at the agency.

This comprehensive exchange of experiences with representatives of the field and the credit industry was continued by BaFin in 2003 as well. The rules set forth in the MaK are deliberately left open so that the institutions can flexibly implement the requirements regarding organisation and lending business. Nonetheless, or for precisely this reason, many questions arose during practical implementation by the individual institutions and later in the course of auditing. In order to clarify these questions in a manner compatible with the realities of the industry, BaFin created the MaK expert committee, which is made up of experts from the credit institutions, auditors and association representatives. Under the direction of BaFin, this body examines fundamental questions. The committee’s discussions on topics important to the industry lead to recommendations which BaFin can then utilise in its decisions relating to MaK-relevant concerns. Thus, the committee supports the opinion-shaping process of the agency.

Results from the expert committee are posted on the website.

The members of the committee met three times in the year under review. Among other things, they answered questions regarding credit risk strategy, the separation of functions, intensified loan management and the processing of problem loans, as well as risk classification systems. BaFin publishes the minutes of these meetings on the Internet[59]. In this way, the institutions are able to keep themselves informed about the issues clarified by the committee, and a uniform implementation of the MaK in auditing is assured.

1.1.6 Outsourcing

Increase in requests for information concerning outsourcing.

2003 also saw a large number of institutions continue to request information about the permissibility and organisation of various outsourcing solutions. The main reason was the impending close at year’s end of the transition period, during which older contracts were to be altered to comply with the stipulations set forth in BaFin’s outsourcing circular. Additionally, a growing number of requests were submitted for information concerning new, complex forms of outsourcing that not only relate to individual functions of banking or financial services, but encompass entire operational areas, particularly back office services. One area of focus in the year under review was lending business, especially the outsourcing of loan processing and approval to external providers specialising in the processing of loans, so-called “credit factories”. In principle, it is possible to transfer such operational areas or functions to a “credit

[59] www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Fortentwicklung des Aufsichtsrechts > Mindestanforderungen an das Kreditgeschäft (MaK) > Fachgremium.

factory" within the limits provided by section 25 (2) of the KWG. BaFin has reacted to the growing market trend towards outsourcing and the need of the institutions for specific information regarding the scope within which outsourcing services can be used in the area of lending.

BaFin more closely defines requirements for credit factories.

With the publication of its statement in December, BaFin defined the supervisory requirements for the outsourcing of loan processing and approval functions to "Credit factories" more closely.

In addition to the outsourcing possibilities already in existence for standard retail business, institutions can also outsource activities that are part of lending business, which is presently deemed not to be fully standardisable. Nonetheless, the management and managerial control functions of the outsourcing institution, which carries full responsibility for the operational areas outsourced, may not be impaired. Additionally, even when a "credit factory" is engaged, the institutions must continue to comply with the guidelines concerning the separation of functions and voting set forth by the agency in the MaK. Finally, the regulations regarding the limiting and monitoring of risks also apply to the outsourced business.

With these supplementary guidelines, BaFin has provided a framework for the structuring and implementation of this special form of outsourcing, so that planning can take place on a reliable supervisory basis.

1.1.7 Proceedings before the ECJ: Financial supervision only a matter of the public interest?

Bank customers have no right to demand that BaFin take specific supervisory measures, and as a result, have no legal recourse for damages incurred if their bank should become insolvent, causing them to lose money. This is the conclusion arrived at by the Advocate General of the European Court of Justice, Christine Stix-Hackl, in her opinion[60] concerning the case based on the submission by the German Federal Court of Justice. Though it often abides by it, the opinion of the Advocate General is not binding on the European Court of Justice. A decision can be expected in 2004.

The plaintiffs in the original case were customers of BVH Bank für Vermögensanlagen und Handel AG, which filed for bankruptcy in 1997. The institution was not a member of a deposit guarantee scheme and was obliged to inform customers of this fact. From 1987 to 1992, the bank unsuccessfully attempted to gain membership of the private deposit guarantee fund of the Association of German Banks. The former Federal Banking Supervisory Office (Bundesaufsichtsamt für das Kreditwesen – BaKred) performed special audits of the bank in 1991, 1995 and 1997. Following the last audit in 1997, the supervisory authority filed a bankruptcy petition and revoked the institution's banking license. In consequence, the plaintiffs claimed damages from the Federal

[60] Opinion of Advocate General Stix-Hackl in Case C-222/02 of 25 November 2003, Peter Paul and Others v Federal Republic of Germany, published at www.curia.eu.int.

Republic of Germany on the grounds that it failed to implement the European Directive on deposit-guarantee schemes promptly enough. Additionally, the plaintiff alleged that the supervisory authority was late in closing the bank. The plaintiffs were awarded 20,000 euros each based on the delayed implementation of the Deposit-Guarantee Directive (94/19/EC). This is the amount up to which deposits must be insured in the event of bank illiquidity pursuant to the Deposit-Guarantee Directive. The claim to damages beyond this amount based on alleged misconduct by the supervisory authority was, however, rejected by the Cologne Higher Regional Court of Appeal (Oberlandesgericht) based on section 6 (4) of the KWG former version without a court examination of the misconduct on the part of the banking supervisory authority averred by the plaintiffs.

The regulation – now section 4 (4) of the Act Establishing the Federal Financial Supervisory Authority (*Finanzdienstleistungs-aufsichtsgesetz- FinDAG*) – stipulates that financial supervision is only a matter of public interest. Whether or not this rule conforms with European law is now up to the ECJ to decide. The opinion of the Advocate General of the ECJ is clear on this point: neither the Deposit-Guarantee Directive nor the other banking-supervisory directives give depositors the right to demand specific measures from the competent supervisory authority or to claim damages in the event of misconduct. Banking supervisors should primarily be responsible for ensuring that credit institutions comply with regulations and for maintaining a functioning banking sector. These responsibilities, so she asserts, excludes the individual consideration of depositors' interests. Moreover, the Deposit-Guarantee Directive sets forth a final special rule to be applied in the event that deposits are no longer accessible. The Advocate General also doubts that the banking supervisor could have prevented the insolvency of BVH Bank and the related loss of deposits through measures based on a timely implementation of the Deposit-Guarantee Directive. In this, she follows the line of reasoning used in court not only by Germany, but also by the EU Commission, United Kingdom, Ireland, Italy, Portugal and Spain.

Other liabilities cases against BaFin.

In the period under review, the courts rejected damage claims in other cases brought by depositors against BaFin. The courts could not conclude misconduct by the agency in any of these cases.

The Berlin Higher Regional Court of Appeal (Kammergericht) and the Bonn Regional Court (Landgericht) declined to hear 35 cases, including several class actions, brought by investors against BaFin following the bankruptcy of Hanseatische AG. The former Federal Banking Supervisory Office had previously forbidden the company from continuing to conduct deposit business without a licence. The company was already at the point of insolvency when the prohibitory injunction was handed down. Following the bankruptcy, numerous investors attempted to claim compensation for their lost investments. The amounts claimed ranged from € 5, 000 to 500,000. The courts determined that, in all cases, the banking supervisory measures employed were within the law.

On the same grounds – i.e. a lack of misconduct by the supervisory authority – the Berlin Regional Court rejected claims against BaFin in the amount of € 80,127 asserting breach of official duties. The

plaintiffs in this case were investors in the Berlin-based Spree Capital GmbH. In 1998. the former Federal Banking Supervisory Office forbid the company from continuing to conduct deposit business without a license and ordered the liquidation of the business. The GmbH did not possess the financial resources to pay out the deposits, and depositors levelled charges at BaFin for not having acted against the institution earlier. At the same time, other investors maintained that BaFin did not have the authority to intervene against the company at all. The Berlin Regional Court expressed doubt that the plaintiffs were entitled to damages from BaFin, since the agency is only active in the public interest. In the end, however, this was not the decisive issue, because the courts were unable to determine any misconduct on the part of the former banking supervisory authority.

1.2 Statistical information

At the end of the year, 2,385 credit institutions with 47,406 branch offices were under BaFin supervision. 10,648 of these branch offices belonged to Deutsche Postbank AG alone.

Table 10

Credit institutions by type of institution

	Number
Lending institutions (complex groups): *of which Landesbanks*	67 11
Savings banks	489
Cooperative banks	1,399
Branches of foreign banks	79
Mortgage and ship mortgage banks	22
Building societies	27
Other private, regional and surety banks	142
Housing enterprises with savings schemes	42
Investment companies	80
Securities trading banks	38
Total	**2,385**

In the year under review, BaFin granted banking licenses to three credit institutions – one of which is an investment company. Six licenses expired (not counting mergers between savings banks and cooperative banks or the discontinuation of banking business by semi-public cooperative banks).

The number of severe breaches of supervisory law by credit institutions rose slightly in 2003. In all, 369 (2002: 333) such violations of the KWG and other supervisory rules occurred, which required sanctioning by BaFin.

BaFin took action against managers in 51 cases.

Based on the severe breaches discovered, the agency took action against the managers of institutions in 51 cases. The actions taken included warnings and, in extreme cases, the dismissal of the managers from their positions.

Table 11

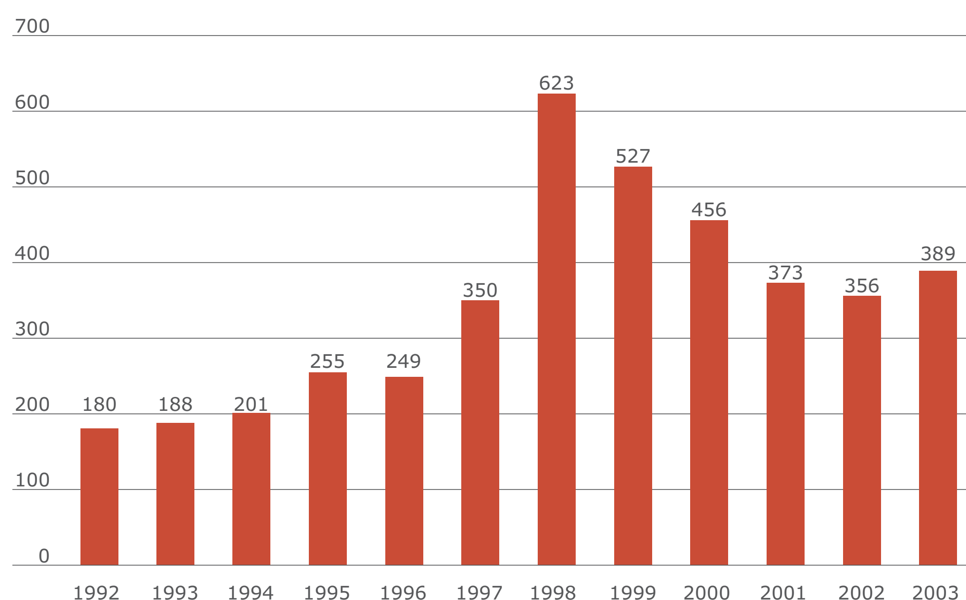
Breaches of supervisory law and sanctions imposed

Type of institution	Severe breaches of supervisory law	Actions		
		against managers	Administrative fines	Emergency (pursuant to section 46 KWG)
Foreign banks and complex groups	6	0	1	1
Other private banks	19	3	0	9
Savings banks	87	9	0	0
Cooperative banks	255	37	0	0
Mortgage banks	2	2	0	0
Building societies	0	0	0	0
Total	**369**	**51**	**1**	**10**

In accordance with section 44 (1) of the KWG, BaFin is entitled, even without special cause, to subject supervised institutions to special audits, carried out or commissioned by BaFin, in order to gain a better insight into the financial state of affairs of the individual institutions. In 2003, 389 such audits were ordered, encompassing mainly lending business and the proper organisation of this business area, as well as the adequacy of risk provisioning. Additionally, BaFin audited the cover of mortgage *Pfandbriefe* and public-sector at five mortgage credit institutions.

Fig. 12

Auditing pursuant to section 44 KWG



BaFin primarily engaged auditing firms to carry out the special audits. Audit teams from the regional offices of the Bundesbank and BaFin staff were also active as auditors in the areas of risk modelling, unlicensed financial services and money laundering.

European passport

The European Union has set forth rules for the cross-border provision of financial services , including the establishment of branches within the EU, in two Directives: the Banking Directive (Directive 2000/12/EC or BD) and the Investment Services Directive (Directive 93/22/EEC or ISD). These Directives were incorporated into German law through the enactment of sections 24a and 53b of the KWG. According to these provisions, institutions from EEA member states must report the provision of cross-border financial services or the intention to establish a branch in another state of the European Economic Area. If approved, the institutions receive a letter of confirmation from both the host country and the home country supervisors. When the report is forwarded to the host country supervisor, this means that the institution is subject to supervision in the home country and that the reporting procedure was properly executed.

This letter of confirmation is also referred to as the European passport, because it provides the institution with a certification of the existing license to conduct banking business issued by the home country, with which it can also conduct business in other member states in the specified areas. The host country supervisor merely informs the institution of the rules that are specific to the host country, so-called general good.

In 2003, German credit institutions submitted 72 such reports to BaFin in order to provide financial services in other EEA member states in accordance with the rules on cross-border provision of services set forth in article 21 of the BD. In turn, 26 institutions from EEA member states commenced cross-border business within Germany. German institutions established nine new branches within the EEA. Eight EEA institutions set up branches in Germany.
13 German investment firms submitted 37 reports in the year under review in order to become active in cross-border business within an EEA member state in accordance with article 18 of the ISD. BaFin received 85 reports pursuant to the ISD from European supervisory agencies. Of these, 77 reports related to the first-time commencement of cross-border provision of services in Germany in accordance with article 18 of the ISD. Eight of the reports concerned the establishment of a branch pursuant to article 17 of the ISD. In all, there were 1,201 investment firms within the meaning of the ISD active in Germany with a European passport at the end of 2003. These companies were from 15 European countries, with more than two-thirds from the United Kingdom. By the end of 2003, more than 200 reports had been submitted by German investment firms for the cross-border provision of services or the establishment of branches within the European Economic Area.

1.3 Ongoing solvency supervision

1.3.1 Complex groups

In 2003, BaFin had 67 lending institutions under supervision in the large banks segment, so-called complex groups, of which 11 were Landesbanks.

BaFin welcomes broad write-downs on shares.

In 2003, BaFin took up the issue of "hidden liabilities" in the investment portfolios of German banks for scrutiny. The books of German banks contain a not insignificant volume of investments that are to be reported at cost according to the German Commercial Code (*Handelsgesetzbuch- HGB*). However, pursuant to section 253 (2) of the HGB, a write-down must be performed to the so-called fair value of the position if the market price falls below the book value of the security and a sustained impairment is to be expected. The same applies under international accounting standards (IAS, IFRS or US-GAAP) which are currently already relevant, at least for the consolidated financial statements of large German banks. "Hidden liabilities" are considered to exist if the prevailing market price is lower than the book value and no value adjustment has taken place. Though the situation has become somewhat more relaxed due to the onset of the global market recovery in the second quarter of 2003, the rise in prices was not always sufficient to compensate for the sharp declines in value seen over the course of the previous three years.

Some institutions therefore began extensive write-downs on shares held in investment portfolios starting in the third quarter of 2003. BaFin welcomes this process unequivocally. It has markedly reduced the danger of losses stemming from the valuation of assets. Free of "hidden liabilities", the banks again have more latitude in their ability to act. Thus, investments that are deemed non-strategic can be more easily sold at a profit, which sets the stage for German banks to rebound.

In the year under review, BaFin ordered 22 special audits. The audits focussed on lending business, trading activities and risk provisioning.

Postbank is the leading provider of services for payment transactions.

Deutsche Postbank AG intends to begin processing a range of back office functions including payment transactions for other banks and savings banks. To this end, the bank set up the necessary technical and organisational structures in 2003. Together with software provider SAP, Postbank developed banking software with which it can process its own and other back office operations in large volumes and cost-effectively. Many of the processes were taken up by the SAP bank software as early as the Fall of 2003. At ten million a day, the bank processes more transactions than any other bank in Germany. Furthermore, the new banking software is client-compatible/supports multiple clients.

Deutsche Bank and Dredner Bank have both announced plans to outsource payment transactions to Postbank in 2004. Postbank will process payment transactions for Deutsche and Dredner Bank independently. To this end, Postbank will take over Deutsche Bank's DB Payments AG and Dresdner Bank's Zahlungsverkehrsservice

GmbH. This will make Postbank to one of the leading payment transaction processors in Germany. The related preliminary agreements have already been signed by the three banks. In this, the institutions see a significant step toward the realisation of their strategic goals, as well an important signal concerning the consolidation of the German banking market.

1.3.2 Landesbanks and savings banks

2003 was another year devoted to restructuring for all 11 Landesbanks and 489 savings banks, a process that will continue to occupy the agendas of banks and supervisors in the coming years. Moreover, the economic situation has worsened for some of the institutes. The Landesbanks are currently grappling – as are the large private banks – with poor earnings, which has led to losses for some of the larger institutions. The earnings situation for savings banks – with some exceptions – first saw some slight improvement at the end of the year under review. Given only a slight improvement in the interest margin, the focus, as in the previous year, remained on reducing costs, for instance through the formalisation and standardisation of loan processing.

Good rating only with new structures.

July 2005 will mark the end of the *Anstaltslast*[61] and *Gewährträger-haftung*[62] in the public-law sector. Consequently, the favourable ratings enjoyed up to now could deteriorate, giving rise to higher refinancing costs, if this is not completely or partially circumvented by means of radical restructuring. The public-sector institutions – some of which have already changed over to a private legal form – must therefore also make certain of their ability to compete in the market after 2005. The aim of the planned, and in part already implemented, measures is to achieve the best possible rating, at least a so-called A rating, even after the *Anstaltslast* and *Gewährträgerhaftung* have lapsed. This includes comprehensive cost-cutting measures. Additionally, the Landesbanks and savings banks are examining the performance outlook of the business areas in which they are active. Both types of institution are considering an expansion of trans-institutional cooperation, a restructuring of ownership, as well as mergers, in order to increase competitiveness. This involves cooperation both between savings and Landesbanks (vertical integration) and among either savings or Landesbanks (horizontal integration). This development, however, is only in the early stages. How broad cooperation will be, and how fast, is still unclear.

Some examples of vertical integration already exist.

The Braunschweigische Landessparkasse has been integrated into Norddeutsche Landesbank, the Berliner Sparkasse is now part of Landesbank Berlin and Südwestdeutsche Landesbank along with the commercial banking business of Landeskreditbank Baden-Würtemberg and the Landesgirokasse have merged to form Landesbank Baden Würtemberg. Thus, some examples of vertical integration between Landesbanks and savings banks already exist.

[61] *Anstaltslast* = liability assumed by a public-law entity for the debts of a corporation incorporated under public law.
[62] *Gewährträgerhaftung* = guarantor's liability (the shareholders of public sector banks are referred to as *Gewährträger*, i.e. guarantors).

The most recent example is that of Sachsen Finanzgruppe, which incorporates Landesbank Sachsen and several savings banks from the state of Saxony within a financial holding company. Additionally, cooperation agreements creating close-knit associations similar to, but not quite corresponding to, group structures are being considered, planned or implemented between Landesbanks and savings banks throughout Germany. The institutions involved have taken these steps in order to achieve better ratings in particular.

With such close integration between the Landesbanks and savings banks, the institutions must now develop a business model that provides the Landesbanks with separate areas of operation that are not in competition with the larger savings banks. This could encompass, for instance, participation in syndicated loans or meta loans. Other Landesbanks offer expertise for large projects in areas such as project finance and risk assessment. Furthermore, these banks can offer support to savings banks – which are still bound by the regional principle (*Regionalprinzip*[63]) – with portfolio risk diversification, e.g. through credit derivatives.

Bafin sees an opportunity in the strengthening of ties.

BaFin sees an opportunity in the strengthening of ties between Landesbanks and savings banks. The agency also recognises the fundamental goal of achieving a uniform rating on the basis of integration. Nonetheless, combined risk strategies are limited by the obligations set forth in the KWG regarding the responsibility to be taken by managers.

For example, these integration models must not result in the creation of "shadow boards" that are obscured from banking supervision. The legal framework within which the integration is based must therefore contain clear guidelines. All important decisions are to be made only by the competent executive bodies of the credit institutions themselves. In no case may the duties named in section 25a (1) of the KWG be transferred to bodies of the integrated structure.

HSH Nordbank as an example of horizontal integration.

With the exception of pre-existing participations, there is currently only one example of horizontal integration between Landesbanks: namely, the merger of Hamburgische Landesbank and Landesbank Schleswig Holstein to form HSH Nordbank AG. Existing participations in other Landesbanks are being examined, especially in the current climate, for their value to the parent, due to the fact that substantial amounts of equity are tied-up in investments often yielding only marginal profitability. A purchase of these participations, for example, by another Landesbank appears possible in this case. In all, the number of Landesbanks is probably too high at the present time. A consolidation by way of further horizontal integration will likely prove unavoidable in the long run.

In addition, some Landesbanks have begun limited forms of cooperation encompassing only individual business areas. For instance, Bayerische Landesbank is working together with Hessen

[63] *Regionalprinzip* = Each savings bank conducts business only in the area of its local *Gewährträger* (holder).

Thüringen Girozentrale. So far, this has led to a merger of the banks' subsidiaries in Luxembourg and Switzerland and to the establishment of a joint securities clearing bank.

EU state aid cases still pending.

The state aid action brought by the European Commission against the use of the state housing fund (Landeswohnungsbauvermögen) has not yet been settled. The decision of the Commission in regard to the assets of the Agency for Housing Promotion (Wohnungsbauförderungsanstalt- Wfa) in North Rhine Westphalia must be augmented by a decision from the ECJ. Some states have already reacted to this still pending process. The housing promotion agencies in some states are now being operated as separate credit institutions, if they hold the assets transferred to the Landesbanks. In North Rhine Westphalia, this is what has led to the establishment of Landesbank NRW as a housing promotion bank (*Förderbank*) and simultaneously a holding company for WestLB AG, the remaining commercial bank.

The number of savings banks dropped from 530 to 489.

The long-standing trend of savings banks forming larger and stronger entities continued in 2003. Consequently, the number of savings banks dropped from 530 to 489.

Joint liability scheme of savings banks continues to develop.

Following intensive consultations with BaFin, the German Savings Bank Association (Deutscher Sparkassen- und Giroverband- DSGV) decided in December 2003 to "further develop the joint liability scheme" of the Sparkassen Finanzgruppe guarantee schemes. In this, the DSGV remained committed to the idea of guaranteeing the existence of the institutions. It increased cover requirements and introduced a risk-based dues system. This is designed to promote risk awareness in the actions of the institutions. With the care and informational obligations imposed on the institutions, along with intervention rights of the guarantee schemes and uniform risk monitoring, the new system focuses on risk prevention.
The new articles of association are scheduled to come into force on 1 January 2006.

BaFin ordered special audits of 98 savings banks and five Landesbanks.

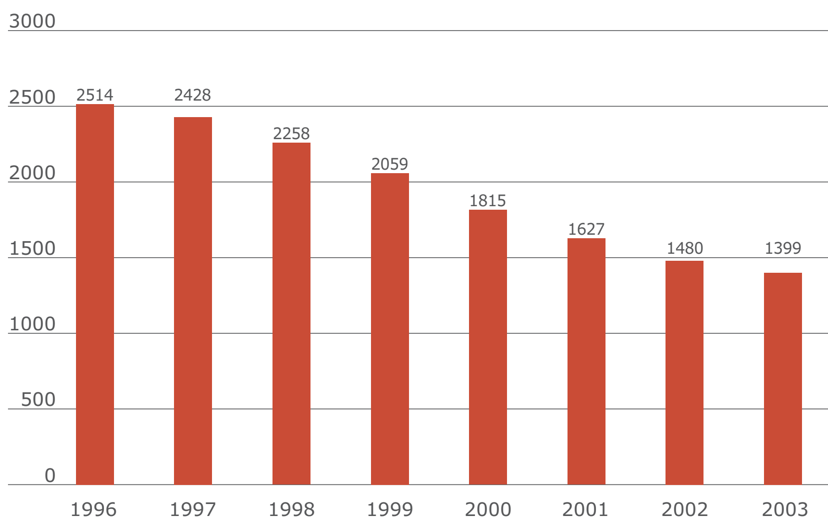
BaFin kept a keen watch over the restructuring processes in the public sector. During the year under review, the agency intervened in several cases, in particular concerning management issues at large institutions. BaFin ordered special audits of 98 savings banks and five Landesbanks in accordance with section 44 of the KWG. As in the past, the audits focussed on risk-bearing areas of business: lending business, organisation and trading business. There were also audits based on specific events. In 2003, BaFin issued one warning to an executive board member. Four similar cases were in processing, but not completed by the end of 2003. There 87 cases of severe breaches of supervisory law, as a consequence of which eight managers were required to step down.

As part of its hands-on and more individual approach to banking supervision, BaFin conducted several supervisory consultations with managers and board members of institutions. These conversations served for purposes of information and control, for the elimination of irregularities or to aid in the early prevention of irregularities. BaFin also plans to continue conducting such consultations as a supervisory instrument in 2004.

1.3.3 Cooperative banks

Despite initial signs of a slight upward trend, the economic environment for cooperative banks remained extremely difficult in 2003. The rate of decline in number of cooperative banks was slightly lower than in previous years, falling in 2003 from 1,480 institutions to 1,399.

Fig. 13
Number of cooperative banks



Cooperation within the cooperative sector.

The cooperative banks made efforts to increase cooperation within the cooperative sector. They continued working to implement the computer-supported whole bank controlling system “V Control” throughout the sector. This system is designed to improve business and risk diversification for the individual banks and, in so doing, to positively influence the earnings position of the institutions.

The economic situation is tense for many institutions.

Some cooperative banks were able to achieve slightly improved results through a moderate reduction of risk provisioning. In spite of this, however, many institutions are still under strain due to low operating income and high costs. Numerous institutions were only able to break even by releasing provisions and hidden reserves. Consequently, it is BaFin’s priority that the banks uncover deficiencies and risks quickly, so that suitable steps can be taken immediately to rectify them. In order to form as detailed a picture as possible of the cooperative banks, BaFin required nearly all of these institutions to submit the audit reports on their annual financial statements. Together with the pre-audit reports, the number of reports submitted totalled more than 2,500.

200 routine audits and 18 extraordinary audits offer more detailed insight.

Additionally, BaFin ordered general audits with a uniformly defined auditing task at 200 cooperative banks in accordance with section 44 of the KWG. The choice of institutions to be audited was based on a random sample. The examinations focussed on an impairment test of the different exposures in the banks' loan portfolios. In each case, the auditing firms engaged were responsible for determining whether or not, and to what extent value adjustments were needed or if preceding value adjustments were sufficient. The basis of the

audits was provided by documents concerning the financial position of individual borrowers and pledged collateral. Furthermore, the auditing firms reviewed the extent to which the institutions had suitable standards in place to quickly identify and control default risks in their lending business. The audited institutions displayed approximately one-third less additional need for risk provisioning this year than in the previous year. Current earnings were sufficient to fund provisioning. In addition to the above mentioned routine audits, BaFin ordered 18 extraordinary audits, in order to better comprehend the situation at troubled cooperative banks.

255 severe breaches of supervisory law, 37 warnings or dismissals of managers.

The evaluation of special audits and auditors' reports revealed various violations of the KWG with differing degrees of severity. As a result, 2003 also saw BaFin take a series of supervisory actions. Following severe violations, the agency wrote to 255 cooperative banks, demanding an explanation and the immediate rectification of the defects. BaFin also issued warnings to 37 managers, or ordered their dismissal.

Increased dues for the guarantee scheme.

In 2003, the guarantee scheme for cooperative banks once again had to deal with a large number of institutions in need of rescue. For this reason, membership dues were increased for 2004. From now on, dues for membership in the guarantee scheme are calculated based on the financial strength of the individual banks (90% to 140% of the individual annual membership fee). The system of classification developed for this purpose is also designed to lower risk costs for the entire cooperative sector. If the classification system allows economic deficiencies to be uncovered at an early enough stage, preventative measures can be implemented by the individual institutions, thus avoiding significant damage. Due to the importance of the guarantee scheme for the cooperative banking sector, BaFin maintains regular contact with the scheme and makes enquiries as to its financial position on a regular basis.

1.3.4 Foreign banks

Global and domestic economic developments had varying impacts on foreign-owned banks in 2003. Business volumes, and consequently the earnings situation of traditional foreign banks was affected by the slowing of the global economy and, for some, by the war in Iraq. In some cases, however, the institutions have moved into new business areas and have thus been able to compensate for lost earnings. The foreign-owned institutions focussing on the German market were, in this way, for the most part able to carry forward the successful development of the previous years. This was especially true of the foreign banks specialising in consumer credit.

The number of foreign banks drops from 89 to 79.

The total number of foreign banks operating within Germany decreased by ten compared with the previous year, from 89 to 79. This, however, should not be interpreted as a sign that Germany’s attractiveness as a location for banks is diminishing. Some institutions continue to operate within Germany and have merely changed their legal form and now have the status of branches within the meaning of section 53b of the KWG. Other foreign financial groups are now concentrating more on their home markets and have sold-off their banks in Germany to local investors. There were also a

number of newly established foreign banks in 2003. These foreign investors are active primarily in the areas of consumer credit and private banking.

Cross-border services offered in Germany from EEA member states increased strongly again this year. This increase may also be due to the modified administrative practices[64] of BaFin concerning the licensing requirements for the cross-border provision of services. Based on these changes, many foreign institutions from EEA member states closed their German offices and are now providing services on a cross-border basis, without physical representation in the country.

The regular and specific consultations conducted by BaFin with foreign banks, as well as supervisory inspections and audits were mainly of a preventative nature. Formal actions were rare.

1.3.5 Other private, regional and specialty banks

Continuing unfavourable economic conditions have varied impacts on private banks. Some institutions successfully colonise niche markets.

The 142 private, regional and specialty banks comprise a very heterogeneous group. In addition to traditional private bankers, the group only includes regionally active credit institutions and banks that have specialised in a specific business area and customer group. As a result of differing business focuses, the prolonged economic weakness also effected the institutions differently. The banks, which are primarily involved in the securities business, were adversely affected by the cautious climate on the stock exchanges.

In many cases, this meant that earnings goals were not even nearly met. Macroeconomic problems were reflected in lending business, in a repeat of high risk provisioning needs for the individual institutions. Nonetheless, there are some institutions in the area of private, regional and specialty banks that have been extraordinarily successful in positioning themselves within niche markets, and therefore showed good earnings figures in the year under review.

Some institutions required fresh capital.

In order to avoid reporting losses, the shareholders of some institutions were forced to implement capital protection measures. These measures took the form of direct income contributions and the pledging of collateral for high-risk loans. Consequently, BaFin was obliged to take a closer look into the financial position of the shareholders of these institutions.

Due to the poor state of the economy, only a few investors were interested in the founding of new institutions. Parties interested in acquiring a banking license were more apt to do so through the purchase of shares in an existing bank. Consequently, BaFin was obliged to carry out sometimes involved procedures to assay the ownership of institutions.

[64] cf. Chapter I 5.2, as well as the fact sheet on licensing requirements pursuant to section 32 (1) of the KWG in conjunction with section 1 (1) and (1a) of the KWG for cross-border banking business and/or cross-border provision of financial services of September 2003; www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Sonstiges.

BaFin conducted 22 special audits and issued three warnings to managers.

The focus of the 22 special audits initiated by BaFin was again an examination of the institutions' lending business and compliance with the particular organisational duties pursuant to section 25a of the KWG. In the majority of cases, the audits did not reveal any severe breaches of supervisory law. The managers were issued warnings by the agency. A special audit of BFI Bank AG, Dresden exposed significant risks in the lending business as well as massive organisational defects throughout the entire bank. As a result of this, BaFin closed the institution at the beginning of April 2003, at first temporarily. Since the bank was unable to compensate for these risks through capital support measures, and the organisational defects also excluded a continuation of business, BaFin revoked the institution's banking license in May 2003. In July 2003, at the request of BaFin, the Dresden Local Court (Amtsgericht) opened insolvency proceedings against the institution. Currently, the competent prosecution authorities are investigating the bank's officers for evidence of wrongdoing.

1.3.6 Mortgage banks

At the end of 2003, 20 mortgage banks and two ship mortgage banks (*Schiffspfandbriefbanken*) were under BaFin supervision. The process of concentration continued with the merger of Westfälische Hypothekenbank AG and Hypo Real Estate Bank AG. Additionally, HSH Nordbank AG acquired HKB Hypotheken- und Kommunalkredit-bank AG, which was then renamed HSH Nordbank Hypo AG.

In 2003, the total lending and bond volumes of mortgage banks increased slightly[65]. At the same time, the proportion of public-sector lending – to total lending volumes – retreated somewhat.

This, however, was more than compensated by mortgage lending growth. On the other hand, new loan approvals were down 3.2%. In mortgage lending business, the decline was 12%, while the approval rate for public-sector lending was up 0.8%. Bond volumes were also up slightly on the previous year. In this area, however, the number of approvals rose by 33.8%. This rise occurred mainly thanks to mortgage *Pfandbriefe*, up 26.3%, and in particular non-covered bonds, which saw approvals increase by 99.3%. Public-sector *Pfandbriefe* rose by 2.6%. As a result, uncovered bonds surpassed public-sector *Pfandbriefe*, which were previously the leading segment in terms of approval rates.

In 2003, the institutions remained mired in a difficult market environment. This was the result not only of problems in the property sector, but also of interest rate developments, in particular the persistently flat yield curve. In particular, institutions that had provided considerable financing for properties in eastern Germany in the past were faced with what were often high value adjustments. Moreover, inaccurate interest rate forecasts again weighed on the earnings of some institutions.

[65] VdH member banks in the January to November period (source: VdH).

Five audits of cover assets revealed no severe breaches of supervisory law.

BaFin audited the cover assets of mortgage *Pfandbriefe* and public-sector *Pfandbriefe* at five mortgage banks in 2003. These audits did not raise any fundamental concerns with regard to the security of cover pools. Nor did BaFin find evidence of any severe infractions of the cover requirements set forth in the Mortgage Bank Act. The value of individual cover assets only had to be adjusted downwards in one case, and this did not affect the overall value of the cover pool. BaFin also examined the lending business of five institutions with regard to compliance and the adequacy of risk provisioning. Most institutions had to increase their risk provisioning, often substantially. At five further institutions, BaFin commissioned audits of compliance with the “Minimum requirements for the trading activities of credit institutions” (*Mindestanforderungen an das Betreiben von Handelsgeschäften- MaH*). The violations revealed by these audits were mostly minor in nature. In one case, a further audit forced the agency to require that measures be taken against bank management.

1.3.7 Building societies

Following the merger of BHW Bausparkasse AG and BHW Allgemeine Bausparkasse AG to form BHW Bausparkasse AG, there were 16 private building societies and 11 regional building societies at the end of the year under review.

Exceptionally positive new business.

New business at building societies saw exceptionally positive growth in 2003, because many customers were made to feel unsure as a result of discussions concerning possible eliminations and cuts in housing subsidies. Beyond this, there are currently few other attractive investment options available. Non-collective business for building societies has been far more significant than collective business for several years now. As an example, building societies currently have an extensive involvement in lending business, which is more closely related to conventional banking than genuine savings and loan business (*Bauspargeschäft*).

This development has resulted from years of declining demand for contractually guaranteed mortgage savings loans due to strong competition from other lending institutions and low interest rates. This means that at the moment, substantial amounts of funds earmarked for such loans cannot be allocated. These funds are now being legally and rather successfully invested non-collectively. They are being used primarily for lending, particularly for prefinancing and bridging loans. In contrast to earlier years, fewer investments are being made in securities due to the fact that lower interest rates have made fixed-income securities less attractive.

Eight special audits found no substantial deficiencies.

While the risk involved in conventional collective lending business has remained at a relatively low level, the same is not entirely true of non-collective business. Consequently, BaFin focuses its audits on the lending business of the institutions involved. In all, the agency ordered audits of eight building societies in the year under review, and the deposit guarantee scheme – Entschädigungseinrichtung Deutscher Banken GmbH – audited three building societies. These audits did not reveal any substantial deficiencies.

BaFin changed practices concerning rate approval.

In 2003, BaFin approved 64 rate amendments and 15 new rates. The agency changed its practices concerning rate approval in the year under review. Previously, BaFin endorsed a rate if an institution adhered to a set of relatively simple, generally applicable rules laid out by the agency. Now, the supervisory authority requires capital budgeting, which is meant to allow an evaluation of the impact of the rate in question on the applicant institution. This process means that the institution in question must submit analyses of risks and returns, as well as simulations for various possible scenarios. This is the agency's way of updating the basis for its approval practices, and focusing more on the earnings components of the applicant institutions than in the past. When old rates are changed or new rates developed, BaFin monitors whether or not the interest rates for mortgage savings loans reflect low market interest rates. In order to offer low interest rates on loans, some building societies offer plans which require the customer to make relatively high and frequent savings deposits in return for low interest rates on loans. Other building societies are considering the introduction of variable interest rates. This would, on the one hand, call into question the basic idea of mortgage savings, namely a guaranteed interest rate determined in advance. On the other hand, it would allow building societies to reduce their typical risks and ensure the attractiveness of mortgage savings loans for customers, even in times of low market interest rates.

1.3.8 Financial services institutions

In its sixth year of supervision over financial services institutions, BaFin noted that financial services institutions have overcome the initial difficulties with regard to compliance with their organisational obligations and are now abiding by the rules in a more routine fashion. This applies in particular to the numerous notification and reporting requirements, which provide BaFin with an up-to-date insight into the state of affairs of the institutions and enable the agency to take prompt action when required. Furthermore, the quality and completeness of the new licensing applications submitted by institutions have improved considerably as compared to past years. This has allowed BaFin to accelerate the licensing process considerably.

In previous years, the number of institutions under supervision saw marked annual decreases. This was due in part to the prolonged weakness of the markets. A further reason for the declines was that many institutions already active before 1998 were unable to reorganise their operations to comply with statutory requirements, which caused them to shift parts of their business into areas that were not subject to licensing requirements.

The number of financial services institutions rose for the first time in 2003.

In 2003, the number of institutions licensed to provide financial services rose for the first time. While in 2002, 641 financial services institutions were subject to supervision by the agency (443 of which were portfolio managers), this number had risen to 773 institutions (447 of which were portfolio managers) by the end of 2003. Similarly, the number of financial services institutions licensed within another member state of the European Economic Area and active in

Germany based on the European passport system also increased. The number of branches of European financial services institutions totalled 34 at the beginning of the year, and 38 by year's end. The number of financial services institutions from other EEA member states that were active in Germany based on the European passport system without having established a branch rose from 960 to 986. BaFin conducted one special audit of a financial services institution in the year under review, and issued nine warnings to managers.

Market and solvency supervision for financial services providers are to be combined into "supervision under one roof".

Since 1 October 2003, BaFin's Frankfurt am Main office has been performing "supervision under one roof" of financial services providers from the federal states of Berlin, Brandenburg, Hamburg, Schleswig-Holstein and Mecklenburg-West Pomerania. This means that the processing agent exercises both solvency supervision in accordance with the KWG and market supervision in accordance with the WpHG over a single financial services institution. This enables the agency to form a comprehensive picture of the institution. In the past, these two areas of supervision were the responsibility of two different departments in two different locations. In April 2004, BaFin plans to organisationally combine the supervision of all financial services institutions.

Round table with eight associations of the financial services sector.

Financial services providers do not have a unified peak or umbrella association to represent the interests of the sector in dialogue with the financial supervisor. Thus, on 1 April 2003, a round table was convened with eight associations of the sector and BaFin. Among other things, the parties representing the interests of the sector expressed discontent with the burden placed on the institutions as a result of reporting procedures.

They objected in particular to the required submission of the auditor's report on annual financial statements, putting forward that most financial services institutions are only subject to auditing requirements for their financial services activities pursuant to the KWG. BaFin responded that, in the vast majority of cases, it has no other source of information for solvency supervision than the auditor's report on an institution's annual financial statements. Along with its own audits, the auditors' reports are the only option BaFin has of informing itself independently of the financial situation of the institutions. Moreover, BaFin has made frequent use of its statutory power to waive the requirement that an institution submit its audited annual financial statements in accordance with the Securities Trading Act (*Wertpapierhandelsgesetz – WpHG*).

1.3.9 Securities trading banks, exchange brokers and electricity traders

In the year under review, BaFin had 38 exchange trading banks, 37 exchange brokers and eight electricity traders under its supervision. The absence of an economic recovery and the continual advance of trading technology meant that these institutions were once again faced with substantial readjustments in 2003. Some institutions could or would not make these changes. Thus, four securities trading banks ceased doing business with customers in 2003. A subsidiary of a French institution shifted its operations to a German branch of its parent company. Additionally, eleven exchange

brokers or brokerage firms discontinued their business with customers. For the most part, this business was taken over by existing institutions or in some cases, newly established institutions. In particular, 2003 saw a clear increase in trading with securities subject to price determination by a particular broker[66]. By the end of 2003, BaFin observed that the rationalisation measures initiated by the institutions, along with the slight recovery of the markets, had begun to have an effect. The majority of companies were able to offset initial losses or even achieve positive earnings.

Four special audits and nine supervisory inspections.

BaFin ordered four special audits of these institutions in 2004. These audits focussed on risk management and controlling. The agency also conducted nine supervisory inspections. No warnings were issued and no dismissals of managers were required.

Revenue estimates of the EEX were not met.

Some electricity traders did not make use of their licenses to conduct banking business or provide financial services with electricity derivatives. For one, there is still a lack of interest in such transactions on the part of customers. The European Energy Exchange (EEX) in Leipzig, for instance, failed to meet its revenue projections. Secondly, it became clear that some institutions experienced severe difficulties in meeting solvency requirements set forth in supervisory law. This applies to companies that continue to conduct the majority of their business in areas that are not subject to licensing requirements, in addition to their licensed banking activities.

BaFin is currently working with these institutions to achieve a risk adequate treatment of these non-licensed transactions.

1.4 Review of risk models

Since the new version of principle I was introduced in 1998, credit institutions have been permitted to use their own risk models to calculate capital backing for market price risk as an alternative to the standard method. These models, however, may only be used to calculate own funds backing after approval by BaFin. A comprehensive on-site review is a precondition of this approval.

Uniform competence centre for all types of risk.

Group D, which is responsible for the review of these models, was reorganised by BaFin in 2003 to form a competence centre for all types of risk. This centre now conducts non-pillar-specific evaluations of the quantitative methods used for risk assessment. For the category of credit risks, this means that as of 2004, for example, the group, renamed “QRM”, will work together with colleagues from the various sections of the agency and the Bundesbank to evaluate, in advance, the statistical methods and processes employed in the implementation of the Advanced Approach[67]. The QRM Group will also play an important role in the future IRBA/IRBA inspections, at least with respect to all system-relevant institutions and institution

[66] The securities allocated to an institution for the determination of the exchange price.
[67] The advanced approach can be chosen by the institutions within the framework of the IRBA (Internal Ratings Based Approach) allowed by Basel II.

types. Additionally, the Group will assist the individual departments as and when required, by increasing the extent to which it shares its auditing experience with them for special audits, too.

At year's end, there were 15 banks with approved market risk models.

In 2003, BaFin approved the market risk model of one domestic bank. This brought the number of banks with approved market risk models up to 15. Although no new applications for approval were submitted in 2003, BaFin expects at least two institutions to hand in such applications in 2004. Since the financial supervisory reforms in 2002, the models have been reviewed for the most part by the Bundesbank. BaFin orders the reviews and participates through its own specialists. In some cases, the agency also conducts the reviews itself. Furthermore, BaFin makes a final evaluation of the review results and, based on this, issues the approval and the determination of the additional factor.

The reviews are not only to be conducted for first-time applications, but are followed up at regular intervals – if needed also on an event-specific basis – for institutions already in possession of an approval. These recurrent reviews are necessary because institutions regularly either expand their models to include new types of risk (transition to "full use") or adjust and modify the methodology or context of the models. In 2003, BaFin conducted 8 such reviews in cooperation with the Bundesbank. These were concerned primarily with the relatively difficult issue of measuring specific risks in the net interest position.

Prognosis quality of the risk models remains robust.

The prognosis quality of the 15 model banks' risk models remains encouragingly robust. This is highlighted, for one, by the fact that the number of cases in which the actual loss on a trading day was higher than the loss projected for that day by the model remains relatively low. There were 17 such exceptional cases at 14 model banks in 2002. In 2003, there were 20 such cases at 15 model banks. Secondly, the empirical study conducted by BaFin with regard to the prognosis quality of the 13 model banks in 2001 confirms the high quality of the risk models. This study revealed that the prognosis models used by German institutions can easily hold up in an international comparison. The same applies for comparisons with American model banks, which the US Federal Reserve subjected to a similar study. The high prognosis quality is all the more notable given the high price and rate volatility on the financial markets that followed the September 11 terrorist attacks. Although initially. the models were deliberately only tested for 2001 due to the events (September 11, Enron, the bursting of the "new economy" bubble) that exerted real stress on them (33 outliers at 13 model banks), the prognosis quality of the models will also be monitored by BaFin on a regular basis in the future.

The modifications to the additional factors in 2003 increased the gap between the individual banks compared to the previous year from 1.0 to 1.8 (see table 12). This is, however, solely attributable to the fact that the factor was raised considerably for one institution. Nonetheless, the median[68] in 2003 sank by 0.05 compared to 2002,

[68] The median is the 50% quantile of a distribution, meaning 50% of the total number of values is less than the median, and 50% greater.

to reach 0.2. This means that for half of the institutions reviewed, BaFin determined an additional factor of only 0.2 or less. This was mainly due to qualitative improvements to the models.

Table 12
Risk models and factor gaps

Year	New applications	Rescinded applications	Rejected	Number of model banks	Minimum additional factor	Maximum additional factor	Median
1997	5	0	2	3	-	-	-
1997	5	0	2	3	-	-	-
1998	15	2	4	9	0.1	2.0	1.45
1999	5	0	0	8	0.1	1.6	0.85
2000	2	0	0	10	0.0	1.6	0.30
2001	2	0	0	13	0.0	1.5	0.30
2002	1	0	0	14	0.0	1.0	0.25
2003	0	0	0	15	0.0	1.8	0.20

In the opinion of BaFin, the construction of a market risk model encompassing all significant market risk factors ("full use") has, as yet, only been completed by four institutions, although some slight corrections are still required in these cases as well. For the remaining institutions with partial models ("partial use"), BaFin is pushing them to complete the transition to "full use" as quickly as possible. The agency continues to ensure that the risk models are being implemented and constructed in this spirit, so that no regulatory arbitrage is possible.

With the help of the regular visits to the model banks, BaFin is working to maintain the closest possible contact with the institutions, extending beyond the official reviews. These visits, which can easily last several days, have already proved to be useful in many ways. They are especially valuable for increasing the efficiency of cooperation with the Bundesbank in the supervision of model banks. BaFin will expand the use of this instrument in the future.

2 Market supervision

After three difficult years that were dominated by losses on the markets, the year under review saw the onset of a recovery. For the most part, German securities exchanges returned to positive territory in 2003. Investors, on the other hand, remained uncertain following what had been a few difficult years on the markets. As a result, the supervisory authority was obliged to concentrate on implementing effective customer protection measures in order to restore investor confidence in the markets.

2.1 Basis for supervision

The groundwork for investor protection is provided by the rules of conduct for investment services enterprises set forth in the Securities Trading Act (*Wertpapierhandelsgesetz- WpHG*). Along with organisational requirements, these rules of conduct centre upon informational obligations. Familiarity with the ways in which products function, and the risks they incur, is the fundamental premise used to make investment decisions. Additionally, information about costs, collateral and conditions of use can be key factors for investment decisions. The organisational requirements are just as important. These include, for instance, obligations for companies to maintain the resources needed for the provision of services. Furthermore, the organisational requirements contain rules for addressing conflicts of interest. These are important, because investment services often entail conflicts of interest. The services should, however, be provided in the interests of customers, and should not motivated by outside interests.

A further fundamental component of market supervision is supervision in accordance with the Safe Custody Act (*Depotgesetz-DepotG*). This law mainly contains civil law rules for the protection of investors who have securities under custody with a credit institution or who commission a credit institution to purchase securities on their behalf.

The supervisory requirements are set out in a statement made by BAKred on 21 December 1998. In this statement, the former supervisor specified the requirements that companies must meet for custody business in order to be deemed lawful and for the fulfilment of securities delivery obligations[69]. This administrative regulation includes rules concerning the individual types of custody and the management of customers' securities.

BaFin monitors compliance with the rules of conduct and the Safe Custody Act. To this end, the institutions are required to undergo annual audits (performed either by *Wirtschaftsprüfer* or *vereidigte Buchprüfer*). The resulting audit reports are then evaluated by BaFin. Smaller institutions with a low volume of business can apply for a waiver of this auditing requirement.

2.2 Ongoing market supervision

2.2.1 Credit institutions

At the end of 2003, BaFin’s market supervision encompassed 155 private credit institutions, including foreign banks, 507 public-sector banks (mostly savings banks) and 1,432 cooperative banks.

In the year under review, 197 credit institutions applied for a waiver of annual auditing requirements pursuant to section 36 (1) of the WpHG. BaFin granted the waiver in 196 cases. It was refused in

[69] www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Verlautbarungen & Bekanntmachungen.

28 cases. Additionally, BaFin passed decisions on 176 applications for a waiver of required auditing of the institution’s safe custody business pursuant to section 29 (2) sentence 2 of the KWG. The agency approved the waiver in 101 cases, and refused it in 75.

Audits

Deficiencies in safe custody business.

In 2003, BaFin evaluated 152 audit reports on the securities business of private and foreign banks. In 78 cases, the agency required submission of a clarification by the institution. In the savings and cooperative bank segment, a total of 245 audit reports on securities business were evaluated. 142 reports gave evidence of deficiencies with regard to the provision of investment services. Consequently, in 54 cases, BaFin asked the institutions to provide a clarification of when and how the uncovered deficiencies were to be eliminated. The companies were also required to submit reports on the implementation of the measures announced. The results of these measures will be examined as part of the next annual audit. BaFin took supervisory action in five cases due to deficiencies in safe custody business.

In the area of savings and cooperative banks, BaFin determined a general focus for audits in the year under review. The purpose of the audits was to examine joint accounts or accounts for which a power of attorney had been granted in order to determine whether or not the identity of the order giver was verified in Internet or telephone orders. In some cases, the institution is not able to determine who is placing an order, since there is often only one identification number (PIN) assigned to each account. In order to examine whether or not an institution has complied with the supervisory requirements, BaFin must have know which party out of several possible order givers actually placed the order. By setting this as the focus of the audits, BaFin intended to determine whether this lack of identification was limited to individual banks or represented a wide-spread problem. Evaluation of the audits showed that the credit institutions were generally capable of identifying the order giver. The problems presented were limited to individual cases, and were solved individually.

There was no generally applicable focus for the audits of private and foreign banks in 2003. Depending on the particular supervisory needs, the following areas were examined in detail: the gathering of customer data and provision of information to customers, compliance with record keeping requirements and the review of deficiencies exposed through the internal auditing procedures of certain institutions.

Annual audits were monitored.

BaFin agents were dispatched to monitor the annual audits of credit institutions in 39 cases. Monitoring of audits at foreign branches was expanded. With regard to the branches of companies domiciled in other EU countries, the home country supervisor is responsible for ensuring compliance with the organisational requirements. Compliance with the rules of conduct, on the other hand, is the responsibility of the host country. In order to support this system, BaFin maintained dialogue with the supervisory authorities of the various countries involved. BaFin commissioned auditing firms to conduct three special audits of credit institutions in 2003.

Focuses of supervision

In the area of banking, BaFin paid particular attention to the resources of the compliance organisation, because those areas of business that contribute little to earnings are often impacted most by cost-cutting. The agency's observations show that compliance indeed suffered from cut backs, in the form of either staff reductions or decreased budgets. The compliance departments were also often assigned additional duties outside of their area of competence. Given that a fully functioning compliance organisation is indispensable, the 2004 audits will continue to focus on this area.

Fund platforms examined in more detail.

In addition, the so-called fund platforms were examined in more detail. These are banks with centralised safe custody and administration of fund units. The interesting thing here is the relationship between the fund platform, the external sales agent and the investor. Often, the fund platform focuses only on the execution of orders, without providing additional advisory services (“execution only”). In many cases, individual consultations are then performed by the sales agent.

In general, there can be no supervisory objections to such a separation of functions. This means that, depending on the way in which this is done, significant WpHG areas may be outsourced to the sales agent, e.g. the gathering of customer data or the provision of information to customers.

Global certificate for small, non-listed public limited companies.

Following the reform of the laws governing shares, non-listed “small” public limited companies (AG) can decide to amend the company’s articles of association to exclude the certification of their shares. These companies simply issue a global certificate representing all shares, signed by the management board. The certificates need not be tradable. The shares should be held in safe custody by the public limited company itself. BaFin has often been asked in which cases such public limited companies are required to obtain a licence for safe custody business in order to hold the global certificate. A license is required if there is a fee connected with the safe custody of the global certificate, or if it is held on the behalf of more than 100 shareholders.

Banks are required to forward an annual account statement to customers each year for account verification. The data transfer method used by institutions that communicate with their customers online was also made more straightforward. In such cases, it is possible to make the annual statement available to customers by placing it in an electronic mailbox. The preconditions of this are that the customers approve and that the channel is secure. If a customer does not acknowledge the electronic posting within a certain period, the annual account statements must be sent by mail.

In the year under review, BaFin had to examine whether or not bonds, which differ in their terms and conditions, may be held in collective custody. Only fungible securities of the same type may be held in collective custody. This means that securities representing different rights are excluded from collective custody. If every variation in bond conditions was to rule out collective custody, this would force the securities depository to conduct a comprehensive

review of the terms and conditions of the bonds held. BaFin decided that only those variations in bond conditions relating to core terms of the security, in particular maturity and interest rate, would preclude collective custody.

2.2.2 Financial services institutions

Number of “tied agent” continues to grow.

At the end of 2003, BaFin had 773 financial services institutions under its supervision. Additionally, 4,026 so-called “tied agents” were registered with the agency. These companies are active for the account and under the liability of another investment services enterprise. They themselves are not considered to be investment services enterprises, though they are indirectly subject to BaFin supervision, since their activities are accounted with the business of the liable investment services enterprise. The institution of “tied agency” makes it possible for individuals to provide investment and contract broking services without obtaining their own licence. Working as an agent under the liability of another institution is an attractive opportunity for many, as licensing entails costs and statutory requirements.

Consequently, the number of “tied agents” has grown steadily over the past few years (2002: 3,897, 2001: 1,168).

In the year under review, 107 financial services institutions applied to BaFin for a waiver of annual auditing requirements pursuant to the WpHG. The agency released 36 institutions from the auditing requirements. In 41 cases, BaFin rejected the application. At the end of the year, there were 21 applications for which a decision was still pending. Nine applications are no longer in need of processing.

Audits

In 2003, the securities supervisor evaluated 703 audit reports on the compliance of financial services institutions with the rules of conduct. No concentration was determined in relation to the deficiencies identified. In 116 cases, BaFin took supervisory action against companies based on the audit reports. In general, the agency orders the elimination of the deficiencies. The institutions involved are required to inform BaFin of how they have implemented these orders. The result is then examined as part of the next annual audit. In the event of severe violations of the rules of conduct, the licence may be revoked.

Monitoring of audits by BaFin creates opportunities for dialogue.

BaFin has the right to monitor the company audits. This allows the companies and the supervisor to discuss supervisory matters. BaFin’s agents can also gain a direct insight into the business operations of the institutions in question. The monitoring of audits also gives BaFin an opportunity to exchange views with the auditor on the matters to be audited and the expectations placed upon the audit report. In 2003, BaFin monitored 70 audits at financial services institutions.

Ensuring the quality of reports.

BaFin has the right to order the appointment of a different auditor where this is necessary in order to achieve the purpose of the audit. This is meant to ensure the quality of the audit reports. Since BaFin

does not generally conduct the audits itself, the quality of the reports is of the utmost importance for supervision. An auditor can be considered unsuitable, not only due to professional considerations, but also in the event of a conflict of interest on the part of the auditor. Such a case could arise, e.g. if the auditor provides other services for the institution in addition to conducting the audit. In the year under review, BaFin made use of its power to require appointment of a different auditor in a number of cases. On occasion, the investment services enterprises decided against the appointment of the originally named auditor after BaFin announced the possibility that it would reject the choice.

If a company fails to appoint an auditor for the annual audit of compliance with the rules of conduct, BaFin has the option of commissioning the audit itself at the company's expense. This occurred in a few cases. In some cases, BaFin audited the financial services institutions itself.

2.3 Rules of conduct for securities analysis

Securities analysts have an important intermediary function.

BaFin also monitors securities analysts, insofar as they are subject to the competency and disclosure requirements set forth in section 34b of the WpHG. Securities analysts play an important role on the capital markets as information intermediaries. They offer recommendations and forecasts for various types of clients, as well as for their own asset management departments. For instance, analysts compose research reports and issue recommendations for private and institutional investors (sell-side-analysis). They also offer reports and recommendations concerning optimum portfolio structure to portfolio managers (buy-side-analysis). Furthermore, bank analysts support asset and securities advisors, as well as the sales departments of their banks. The job of the analysts is to identify and evaluate those facts relevant to investment decisions out of the mass of available information. The resulting research reports or recommendations serve as the basis upon which investors make investment decisions. The securities analyses are composed by analysts employed by credit and financial services institutions or exchange information services. Analysts can also be independent.

The goal of market supervision in the area of securities analysis is to ensure the objectivity of securities research and the transparency of the market. This guarantees the confidence of investors in the capital markets.

Legal basis

Section 34b (1) of the WpHG regulates the obligations of investment services enterprises for the creation and distribution of securities analysis. The competency and disclosure requirements set forth in section 34b of the WpHG therefore apply exclusively to credit and financial services institutions. Individual analysts are not subject to these requirements, regardless of whether or not they are employed by an investment services enterprise or are independent.

A portfolio recommendation for a certain sector is not securities analysis within the meaning of the WpHG.

Securities analysis is information that serves to direct investment decisions and involves examinations of securities or the issuer of a security. In particular, company financial or market trading data are

evaluated and a recommendation is made concerning a security, e.g. "buy" or "sell" or a certain price target is given. Investment recommendations that do not contain detailed information on the security in question, e.g. "buy shares of XY", do not constitute securities analysis. Similarly, portfolio recommendations concerning a certain region or sector, or reports analysing macroeconomic, political or market environments are not considered securities analysis if no recommendations are made for individual securities.

Companies are obliged to exercise care.

Investment services enterprises are obliged to compose securities research reports with the requisite degree of expertise, care and conscientiousness. A fundamental rule is that research must be clear, understandable and unambiguous. The recommendations must be plausible to the customer. The information used should be as up-to-date and as complete as possible. Facts must be separated from opinion.

Additionally, the name of the analyst who compiled the report must be given. Analysts must have a sufficient background and training in the subject, and cannot make any promises to issuers that a favourable analysis will be made.

Conflicts of interest must be disclosed.

Furthermore, potential conflicts of interest in securities analysis must be disclosed. In practice, an analyst's value to a company frequently depends on the ability of the analyst to generate revenues for underwriting, investment banking and trading. The potential for conflicts of interest is thus inherent. These conflicts of interest are especially pronounced where a credit institution has taken over the placement of the securities that are the subject of an analyst's research. Further conflicts of interest can also arise from the other activities of a bank. For instance, a bank might also act as an M&A advisor or market maker for the company that is the subject of the research.

Pursuant to section 34b of the WpHG, a disclosure must be made if the investment services enterprise or an affiliated company holds at least 1% of the share capital in the company whose shares are the subject of the analyst's research. A disclosure is also required if the institution was a member of the syndicate that underwrote the most recent issue of the subject company's securities during the five years preceding the issuance of the research report, or if, on the basis of a contract concluded with the issuer, they act as a sponsor for the securities analysed in the research report.

Analysed securities held for trading could indicate a conflict of interest.

In its statement of 7 March 2003, BaFin mentioned three further cases which would require a disclosure. One of these is when the investment services enterprise, alone or together with affiliated companies, holds a net short position amounting to at least 1% of the subject company's share capital. Moreover, a conflict of interest subject to disclosure requirements is assumed to exist if the investment services enterprise or an affiliated company holds shares of the subject company for trading.

Practical solutions found for disclosure.

The practical implementation of these disclosure requirements gave rise to some uncertainties. After BaFin held hearings with the associations of the business sectors involved, it refined, in its statement dated 24 July 2003, the requirements for the disclosure of

a net short position amounting to at least 1% of the share capital and for shares in the subject company held for trading. Consequently, the disclosure requirement for net short positions is limited to spot transactions. BaFin offers institutions that regularly trade in the shares of companies for which they also conduct research the option of having their trading activities monitored by the agency for a representative period tailored to the situation of the individual institution. If the shares of subject companies are traded regularly, a general note to this effect is sufficient to satisfy the disclosure requirement. In addition to the standard cases described in the law and the further examples listed in the statement, a disclosure of potential conflicts of interest must also be made, unless organisational measures have been taken to avoid the development of such situations.

This can be achieved by creating spheres of confidentiality, so called "Chinese walls".

Annual Audit

Savings and cooperative banks favoured external analysts.

At the end of 2003, BaFin had 365 credit and financial services institutions under its supervision that made use of internal or external research, and that made the reports available to customers or to the public in their own name or in the name of third parties. Supervision focuses on the internationally-oriented private banks and other large credit institutions that conduct their own research and make it available to customers or to the public. On the other hand, financial services institutions, as well as savings and cooperative banks, put more emphasis on the use of external analysts, e.g. from the financial association (Finanzverbund), making the research available to their customers in their own name, or with reference to a third party analyst.

From the annual audit reports in investment services business, BaFin was able to gain an initial insight into the type and scope of research activities, e.g. sell-side or buy-side analysis, primary and secondary research, as well as the utilisation of research reports, i.e. target groups and distribution channels.

Research capacities noticeably reduced.

This confirms the impression that many institutions have either reduced or transferred their research capacities abroad, especially with regard to sell-side research. Moreover, a trend can be observed towards a concentration of securities research on large listed companies, or "blue chips". This has left investors with a markedly reduced supply of high quality analysis for small and mid-cap companies.

As a rule, the institutions under supervision differentiate between two target groups with respect to the type and scope of securities research: institutional investors and private investors. The often broad studies conducted for institutional investors are presented to retail customers in a compressed format. The securities research reports are either made available to customers or distributed to the general public on the institution's homepage and through other media outlets such as press and television.

Only isolated deficiencies uncovered.

BaFin determines whether or not the disclosure requirements have been met, and whether or not the organisational measures for the prevention of conflicts of interest are adequate, for the most part based on the audit reports pursuant to section 36 of the WpHG. Except for a few isolated instances of deficiencies, most companies under supervision had installed suitable organisational measures to ensure compliance with the competency and disclosure requirements pursuant to section 34b of the WpHG, e.g. reporting channels or separate spheres of confidentiality. Likewise, the disclosure requirements in the event of potential conflicts of interest were adhered to in most cases. That being said, the incidence of deficiencies was greater when affiliated companies had to be taken into account for the examination and disclosure of potential conflicts of interest. This places higher demands on the organisational measures and requires the implementation of group-wide solutions.

The more involved investigations required for multi-national companies also proved problematic due to the variation among national disclosure requirements. In practice, the different requirements sometimes lead to sweeping references concerning potential conflicts of interest in order to ensure that the securities research distributed worldwide meets with the various disclosure requirements.

Regular monitoring

BaFin evaluates the Internet with regard to research as well.

With regard to publicly distributed securities research, BaFin does not only use audit reports to monitor compliance with the requirements set forth in section 34b of the WpHG. The agency also evaluates publicly accessible media and the Internet. The goal of this is not to carry out a fully comprehensive inspection of analysis contents. At its core, securities research is a personal appraisal by the analyst, based on an informed evaluation of data. As such, it is impossible to categorise research reports as "right" or "wrong".

BaFin can, however, review whether or not adherence to the competency requirements has been maintained. These requirements are deemed to have been violated if the judgement of the analyst is based on false or insufficient information, or when the facts have been wrongly or inadequately evaluated. This also applies when misleading statements are made regarding the underlying facts or methods of evaluation.

Distribution of securities research through the media

BaFin meets with representatives of media associations.

A securities research report is an important source of information for the investor, often learned of through the media. Thus, the media plays a significant role as an information intermediary. Consequently, the transparency aimed for in the law with regard to potential conflicts of interest should also be ensured for this method of distribution. The statutory requirements in section 34b of the WpHG, however, only apply to investment services enterprises, not to the media.

The question of how conflicts of interest can be adequately disclosed in the case of research distribution through the media was met with uncertainty on the part of both media representatives and analysts.

Therefore, BaFin conducted intensive discussions with representatives of the sectors involved and various media associations. After these meetings, BaFin recommended the following course of action:

Due to the various forms of presentation in the media, a differentiation must be made between two types of research distribution: research distributed by the investment services enterprises and research distribution for which the media outlet is responsible. If the investment services enterprise is responsible for the content of the research (e.g. guest commentary, discussions of sample portfolios on shows dedicated to stock trading), it is subject to disclosure requirements. In other words, the facts from which a potential conflict of interest can be construed must be made clear during the media appearance itself.

On the other hand, if an investment services enterprise makes research available to the media outlet for the purpose of creating its own editorial content, e.g. short news items on published research or securities analysis, the institution is required to inform the media outlet concerning potential conflicts of interest. The media outlet itself, however, is not required to mention the reported potential conflict of interest in its broadcast.

Outlook

EU Directive expands the disclosure requirements.

With integration of the EU Market Abuse Directive, the requirements for the proper conduct of securities research and the disclosure of potential conflicts of interest are to be expanded in the future to include the individual analysts themselves. The requirements will then cover both employees of credit institutions or financial services institutions, as well as independent analysts.

Moreover, there will be greater demands concerning the prevention or disclosure of self-interest or potential conflicts of interest. The aim of the Market Abuse Directive is to create a level competitive playing field and to harmonise requirements across Europe.

IOSCO principles as a national guideline.

Further changes can be expected to result from incorporation of the principles passed by the IOSCO in September 2003 for addressing analyst conflicts of interest. These principles are meant to serve as a guideline for securities supervisory authorities and are to be incorporated by IOSOCO members. The principles set forth, for instance, that analysts’ salaries should be based on agreements designed to rule out conflicts of interest. Another aim is to prevent issuers, institutional investors and third parties from exerting undue influence on analysts. Moreover, analysts and their employers are to be forbidden from trading in the securities of the issuer being analysed or their related derivatives prior to publication of the research report. Companies will also be prevented from promising positive research reports for issuers against payment of a fee. Analysts are to be prohibited from reporting to the investment banking area.

3 Currency conversion of 1 July 1990 and allocation of equalisation claims

Pursuant to the Treaty on German Monetary, Economic and Social Union of 18 May 1990, the now defunct agency BAKred allocated equalisation claims and liabilities to monetary institutions and previous import/export operations in the territory of the former German Democratic Republic[70]. The allocations have been completed since 2001, with one exception based on a particular legal constellation. Still at issue is the amount of the equalisation claims made by two major banks. Both cases are still pending before the administrative courts.

The net liabilities of the Currency Conversion Equalisation Fund totalled approximately €2.3 billion at the end of 2003.

The monetary institutions and previous import/export operations were allocated equalisation claims in the amount of €45.565 billion and equalisation liabilities totalling €1.874 billion. The balance of both items is thus €43.691 billion. Taking into account the repayments made up to that point, the net liabilities of the equalisation fund as at 31 December 2003 still totalled €2.268 billion. If the situation develops more favourably than projected as at 1 July 1990 in the DM-denominated opening balance sheet, the credit institutions must, under certain conditions (sections 36 (4) and 43a et seq. of the *D-Mark Bilanzgesetz- DMBilG*) make payments into the equalisation fund for currency conversion. BaFin reviews the auditors' reports and, if necessary, conducts special audits to determine whether or not these obligations have been met.

Table 13

Calculation of payment amounts and payment obligations

Auditors' report extracts submitted in reporting year	640
• with deficiencies reported by the auditor	16
• with deficiencies addressed with the credit institution	22
Auditing pursuant to section 44 KWG	2
Amount paid into the equalisation fund for currency conversion by the credit institution	
• in 2003	0.287 Mrd. €
• since introduction of the payment obligation as at 31 December 2003	5.025 Mrd. €

As in 2002, the payment obligations pursuant to the DMBilG were top of the agenda again in 2003. In particular, these include the organisational requirements to meet obligations, the calculation of payment amounts, including interest, as well as the conditions under which payment obligations exist. Based on deficiencies reported by the auditor or due to its own evaluation, BaFin concluded in some instances that the payment obligations had not been met in full. In such cases, BaFin required the institution to make the delinquent payments and remedy any organisational deficiencies.

[70] Detailed explanation of the economic and legal basis for the allocation of equalisation claims and the payment obligation: AR BAKred 2000, Chapter VII.

Additionally, BaFin focussed on the possibility of replacing the payment obligations of the institutions with regard to a portion of their impaired old loan portfolios with equivalent one-time payments. In this regard, the agency had to clarify, among other things, the extent to which the statistical models used for the projection of default rates in ongoing risk assessment can be implemented for the present value calculation of expected principal payments on old loans. Particular attention was paid to the question of the amount of non-used provisions and other liabilities backed by equalisation claims to be paid into the equalisation fund.

Another area of discussion was the future requirements for the handling of old loans removed from the balance sheet by credit institutions. The rules governing these are to be reworked in the Agriculture Prior Debt Act (*Landwirtschafts-Altschuldengesetz*), which is currently still in legislation. Among other things, the proposed law is intended to enable debtors and the affected creditor banks to more readily arrange an early redemption of the old loans, for which subordination was to take effect as of 1 July 1990.

III Supervision of insurance undertakings and pension funds

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1 Basis for supervision

1.1 Amendments to the Insurance Supervision Act and the Capital Resources Ordinance

The revision of the Insurance Supervision Act (*Versicherungs-aufsichtsgesetz – VAG*) dated 10 December 2003[71], which was developed with the intensive involvement of the insurance supervisory authority, was enacted mainly in order to implement three EC Directives:

- the Winding-up Directive[72] dated 19 March 2001,
- the Life Insurance Directive[73] dated 5 November 2002 and
- the Solvency Ratio Directive[74] for non-life insurance undertakings dated 5 March 2002.

In addition, the legislature made some changes and clarifications to the content of other parts of the VAG and amended section 15 of the Act Establishing the Federal Financial Supervisory Authority (*Finanzdienstleistungsaufsichtsgesetz – FinDAG*).

[71] Act on the Implementation of Supervisory Provisions relating to the Reorganisation and Winding-up of Insurance Undertakings and Credit Institutions (BGBI. p. 2478, No. 59).
[72] Directive on the reorganisation and winding-up of insurance undertakings (D 2001/17/EC; OJ EC letter L 110 p. 28).
[73] Life Insurance Directive (D 2002/83/EC; OJ EC).
[74] Directive in amendment of Directive 73/239/EC as regards the solvency margin requirements for non-life insurance undertakings (D 2002/13/EC; OJ EC letter L 77 p. 17).

Implementation of the Winding-up Directive

The implementation of the Winding-up Directive means that the VAG now contains regulations on the mutual recognition of reorganisation measures and winding-up proceedings in the EU member states. It also provides statutory regulations governing the necessary cooperation between supervisory authorities. Furthermore, the VAG now obliges insurance undertakings to create what is known as the guarantee assets (*Sicherungsvermögen*) for all classes of insurance. These guarantee assets must be entered into a "list of assets". This means that the claims of the insured are to be met using the assets entered in this list before any claims from other creditors are met.

Recognition of insolvency proceedings.

Only the responsible authorities in the home member or signatory state are authorised to open insolvency proceedings. The other member and signatory states must recognise these proceedings. If insolvency proceedings are opened in another member or signatory state, Germany must recognise these proceedings without the restricting conditions of section 343 (1) of the Insolvency Code.

The commencement, conduct and closure of liquidation proceedings are categorically subject to the laws of the home country. The insolvency court must forward the order to commence insolvency proceedings to the supervisory authority without delay. In turn, the supervisory authority immediately informs the supervisory authorities of the remaining member and signatory states. The same procedure applies to the ordering of limits on free disposition pursuant to section 81b (4) of the VAG.

Guarantee assets for all insurance classes.

In the past, the VAG only required the privileged satisfaction of policyholder claims for those insurance contracts that had to be backed by a coverage fund (*Deckungsstock*). This applied to life insurance, health insurance operating in the same way as life insurance, accident insurance with premium refund and pension benefits from liability and accident insurance. No privileged settlement of claims was provided for health and other non-life insurance. Now, guarantee assets, the sum of which must be equivalent to the amount of the technical provisions at the very least, are provided for uniformity. The listed assets are to be used to satisfy insurance-related claims before those of the remaining insolvency creditors – albeit after the cost of the proceedings.

Now that the Winding-up Directive[75] has been implemented, a portion of the underwriting liabilities, which were previously backed by "remaining restricted assets", are now backed by the guarantee assets (section 66 (1a) VAG). The term "*übrigen gebundenen Vermögens*" ("remaining restricted assets") has been replaced by the new "sonstige gebundene Vermögen" ("other restricted assets"). This is intended to prevent misunderstandings that might otherwise result from the amended scope of the item.

[75] cf. Article 10 in conjunction with article 2 letter k of Directive 2001/17/EC.

Implementation of the Life Insurance Directive and the Solvency Directive for non-life insurers

Greater requirements with regard to solvency.

The implementation of the Life Insurance Directive[76] and the Solvency Directive for non-life insurance undertakings[77] led to changes to several provisions of the VAG and the Capital Resources Ordinance (*Kapitalausstattungsverordnung – KapVO*). The new provisions increase the requirements with regard to the solvency of insurance undertakings and improve BaFin's options for intervention within the framework of solvency supervision. Changes were made to the solvency requirements of mutual insurance associations, which are not subject to the solvency requirements of the directive due, among other things, to their small size.
Insurance undertakings that were actively conducting insurance business on 21 March 2002 must comply with the amended solvency requirements by 1 March 2007 at the latest. Pensionskassen and death benefit funds must implement the new solvency requirements by no later than 31 December 2007. BaFin may grant an extension of two years at the most. The remaining insurance undertakings have already been subject to the new requirements since 1 January 2004.

Solvency requirements must be maintained continuously and not just at the balance sheet date.

The VAG now explicitly states that insurance undertakings are to maintain the required levels of solvency continuously, and not just at the balance sheet date. To this end, life insurance undertakings are permitted, following approval by the agency, to credit the value of future surpluses to own funds until 2007. This option shall lapse after this transition period has ended. BaFin has already reacted very restrictively to applications for crediting future surpluses to own funds.

Certain assets that were previously fully eligible as own funds now require the written approval of the supervisory authority to be counted. These include half of the non-paid-up portion of the share capital for public limited companies (AG), or half of either the non-paid-up portion of an equivalent item for public law insurance undertakings, or of the initial fund for mutual insurance associations (VvaG). Property and casualty insurers that operate on the principle of mutuality also require BaFin's approval before crediting portions of supplementary contributions. Further amendments limit the ceiling up to which certain assets can be credited to own funds.

BaFin now has the power to require submission of a financial recovery plan.

Moreover, BaFin now has the power to require submission of a financial recovery plan. This plan must clearly set out how the insurance undertaking will achieve adequate solvency in the short term. This supervisory instrument can be used even in cases where no evidence exists to suggest either insufficient own funds or an imminent threat that minimum solvency requirements will not be met. BaFin can demand submission of the recovery plan when the facts support the assumption that the undertaking is in danger of defaulting on its policy obligations – i.e. at a sufficiently early point in time. In order to ensure prompt fulfilment of the solvency

[76] D 2002/83/EC; OJ EC, L 345 p. 1.
[77] D 2002/13/EC; OJ EC, L 77 p. 17.

requirements, BaFin can require that the insurance undertaking maintain a greater amount of own funds than is called for in the Capital Resources Ordinance.

The supervisory authority can also devalue all of the assets eligible as own funds in order to protect the interests of policyholders. Similarly, it is possible for the agency to limit the reduction in required solvency that usually accompanies the conclusion of reinsurance contracts if the type and quality of the contracts excludes their being accounted for in full.

Solvency I led to an increase in the minimum guarantee fund.

In the Capital Resources Ordinance, Solvency I primarily necessitated a marked raising of the amount of the so-called minimum guarantee fund, a minimum of own funds intended to cover losses of all types. The solvency requirements were also increased considerably for certain lines of non-life insurance that exhibit a risk profile particularly susceptible to volatility. Additionally, the threshold used to determine solvency requirements in accordance with the premium index and claims index was also raised. For insurance undertakings that conclude few, if any, new contracts, the solvency margin determined is one deemed to be adequate in order to address the remaining liabilities from existing business.

For insurance undertakings that do not fall within the scope of the above-named Directives, the solvency requirements were moderately increased in some cases. The solvency requirements of the Capital Resources Ordinance still do not apply to certain minor mutual insurance associations with minimal premium income. To the extent that application of the ordinance is contingent upon annual premium income, the previous threshold has been rounded up for the sake of ease following conversion to a euro-denominated amount.

Further amendments to the VAG

There were also several smaller changes made to the VAG in 2003 that were not based on an EU Directive:

- A person holding 10 mandates as trustee or responsible actuary is categorically barred from appointment as trustee pursuant to section 12b of the VAG.
- For life insurance, the so-called free provision for bonuses and rebates (*Rückstellung für Beitragsrückerstattung – RfB*) can now count towards "other restricted assets" (section 54 (5) VAG). The previously applicable exemption in section 54 (1) sentence 4 of the VAG (previous version) was not re-adopted by lawmakers. In this regard, a transition period is in effect until 31 December 2008.
- BaFin may commission external auditors for any and all audits of insurance undertakings. This is based on section 83 (1) sentence 1 no. 4 of the VAG.
- Pursuant to section 15 of the FinDAG, the costs of the audits are to be borne by the insurance undertaking in question. Until now, the requirement for separate reimbursement of these costs only applied to the banking and investment sectors.

- By 31 December 2006, the German government will inform the federal legislature concerning the risk-adequate own funds of insurance undertakings and their investment management status. The government will state its position on the suitability of the statutory provisions and submit its suggestions for improvement, which also take into account the developments at EU level.

Informational obligations for occupational retirement provision

The revision of the VAG in 2003 brought changes to the informational obligations of the undertakings in the area of occupational retirement provision.

Now, a differentiation is made between information to be submitted at the beginning of the contract relationship and that to be supplied by the undertaking over the course of the contract term.

In the area of occupational retirement provision, the pension funds are in direct competition with the *Pensionskassen* and life insurance undertakings, which perform direct insurance underwriting within the meaning of section 1b (2) of the Act to Improve Occupational Pension Schemes (*Gesetz zur Verbesserung der betrieblichen Altersversorgung – BetrAVG*). When the legal status of the employee in relation to a life insurance undertaking is equivalent to the relationship of the employee with a pension fund and *Pensionskasse*, the informational obligations of the provider must also be identical. This has not been the case up until now. The new regulations serve to close this loophole. At the same time, the corresponding requirements from the EU Pension Fund Directive[78] are being implemented. The informational obligations with respect to insured individuals now apply to all providers of occupational retirement provision, i.e. pension funds, *Pensionskassen* and life insurers offering occupational retirement provision benefits. The requirements are to be satisfied for every insured individual, regardless of whether or not they are policyholders (party to a contract with the provider). Pension plan reinsurance policies, which do not grant the current or future beneficiaries a direct claim right against the insurance undertaking, are not included.

According to the new regulations of the VAG, customers must be informed of the following at the beginning of the contract relationship:

- Name, address, legal form and registered office of the provider and any branch through which the contract is to be concluded;
- Terms and conditions of the contract, including rates, to the extent that these apply to the contract relationship;
- The law applicable to the contract;
- The term of the contract and the tax rules applicable for this type of pension.

During the contract period, the undertakings must inform customers of the following:

[78] Directive 2003/41/EC.

- Change of name, address, legal form and registered office of the provider and any branch through which the contract was concluded;
- The future beneficiary's expected benefits entitlement, on an annual basis with the first occasion being the start of the contract relationship;
- The investment options and the structure of the investment portfolio, as well as the potential risks, the costs of asset management and other investment-related costs, provided the future beneficiary bears the investment risk;
- Heeding of the obligations named in section 115 (4) of the VAG.

The undertakings are also obliged to submit their annual financial statements and management report from the previous financial year on demand.

The existing regulations concerning informational obligations proved too imprecise. They required "appropriate information on benefits and methods of payment". The new wording is oriented around the information required by the beneficiary in order to effectively enforce claims against the pension provider. For this reason, the requirement is restricted to the sections of the terms and conditions that apply to the contract relationship. Employees are still not allowed to demand complete submission of the contract documentation.

Changes in reinsurance supervision

In mid-2002, the Fourth Financial Market Promotion Act (*4. Finanzmarktförderungsgesetz – 4. FMFG*) took a first step towards expanding the supervisory rules for professional reinsurance undertakings. Practical experience, however, made supplements necessary, and these were included in the revision of the VAG 2003. In effect, the legislature expanded the scope of the standard ownership controls for primary insurers to include reinsurers as well. This clearly states that anyone intending to acquire a qualified participating interest in a reinsurance undertaking must notify BaFin immediately before doing so (section 104 VAG). In addition, BaFin is now allowed to engage a special commissioner at reinsurance undertakings. Moreover, reinsurance undertakings may only continue conducting their business in a legal form different to that admissible for primary insurers (e.g. as a GmbH) and operate outside the investment principles set forth in section 1a of the VAG until the end of 2004.

Planned changes in reinsurance supervision

Nonetheless, as early as 2003, primarily international developments had already prompted the legislature to once again consider a further reinforcing of supervision over reinsurance undertakings. The closing report of the IMF investigation (Financial Sector Assessment Programme = FSAP) in the first half of 2003 concluded that the absence of authorisation rules and solvency provisions for reinsurers is problematic.

German reinsurers in particular, says the report, carry substantial weight on the global reinsurance market and thus on the financial markets as a whole. The initial plan was to meet these concerns by way of a quick implementation of the EU Reinsurance Directive. After work on the Directive stalled in late summer 2003, however, the German legislature decided to act before the Directive was passed. Preliminary work on the new law began promptly in October 2003. The planned provisions are to follow along the lines of the aforementioned EU draft Directive. The new supervisory provisions are expected to allow the regulations for primary insurers to be transferred as far as possible. Deviations will occur wherever necessary based on the characteristics of the reinsurance business. Although reinsurers have no direct contractual relationships with policyholders, the principal aim of the revision is to indirectly protect policyholders by guaranteeing the ability of reinsurers to fulfil their obligations to the primary insurers. At the same time, the reinsurance market as a section of the German financial market will be strengthened by expanding the supervisory requirements and powers.

Reinsurers shall require authorisation in the future.

The new supervisory system will centre around the future requirement for reinsurers to obtain authorisation. The result will be an authorisation procedure with clearly-defined requirements and informational obligations for the commencement of business operations. The authorisation can also be revoked under certain conditions. Both of these measures represent a fundamental progression, as unsuitable companies can now be effectively kept from entering, or removed from the market.

In the future, the solvency provisions for primary insurers will apply accordingly for reinsurers.

A further key element of the new law is the applicability of the solvency provisions for primary insurers in the area of property and casualty for reinsurers as well. This means that, in the future, reinsurers will have to meet a minimum capital requirement of €3 million, regardless of business volume, in order to qualify for the authorisation of their business operations. The insurance supervisory authority had already been monitoring the capital resources of reinsurers. Without legally fixed (quantitative) provisions, however, it was difficult to sanction breaches of supervisory law.

The new rules are to come into effect together with further amendments to the VAG at the end of 2004. In the future, this will provide Germany with a supervisory system for reinsurance undertakings that not only corresponds to high international standards, but also meets the new challenges of the market.

1.2 Investments

Financing Protektor Lebensversicherungs AG

At the end of 2002, Protektor Lebensversicherung AG took over the in-force business of the financially hard-hit Mannheimer Lebensversicherung AG. The shareholders of Protektor, i.e. all life insurers organised within the German Insurance Association (Gesamtverband der Deutschen Versicherungswirtschaft – GDV), provided the financing for Protektor. They paid in capital according to their corresponding market shares and provided subordinated loans. BaFin monitored this process closely and affirmed the suitability of these investments for the shareholders' restricted assets. However, instead of the full nominal value, the value to be stated was that adjusted for the required write downs on the investments taken over from Mannheimer Lebensversicherung AG. This was because only this amount could reflect the economic substance and, in turn, ensure the investment security required by the investment protection provisions (section 54 (1) VAG).

The stress test – a qualitative element of investment management

Stress tests are an effective early-warning system for the investment management of insurance undertakings. They assist in financial supervision by identifying those insurance undertakings that do not operate an appropriate investment policy. In terms of method, stress tests also provide an important prerequisite to the appropriate future coupling of the own funds requirements of insurance undertakings as indicated by Solvency II with investment risk.

The new 2004 BaFin stress test.

BaFin changed its 2004 stress test substantially from the 2003 model. For instance, company-specific factors such as the hedging of investments and hidden reserves of all investments can now be taken into account in the stress test. Together with the accompanying explanations, the model has been made even more informative and easy to use.

Many questions arose last year with regard to fixed-interest investment ratings, which are required to calculate credit risks. The recognition and assignment of external ratings now follows the procedure used for Basel II.

Prevailing developments on the capital market are taken into account in the selection of market-adequate parameters. For this reason, BaFin has converted the two scenarios used for the 2003 stress test into three scenarios:

Stress test 2004 uses three scenarios.

Stress test scenarios 2003	Stress test scenarios 2004
A: equities -35% and bonds -10%	A 35: equities -35%
B: equities -20% and bonds -5%	B 10: bonds -10%
	BA 25: equities -20% and bonds -5%

As a result of the division, the original stress test A is to be calculated separately using two scenarios. The susceptibility of the undertakings' investments with regard to the risks of a stock market crash (new A 35) or an interest rate increase (new R 10) is now examined independently. The –35% discount selected in 2003 for equities, as well as the –10% for bonds were, however, left unchanged by BaFin. Similarly, the combined scenario of the original stress test B (new RA 25), was also left unchanged as a "worst case" scenario at –20% for equities and –5% for bonds. All of the 2004 stress test scenarios continue to include creditworthiness reductions contingent upon the investment rating. The increased detection of realised credit risk last year indicates just how important it was to keep watch over this risk category. This substantiates the approach taken by BaFin. The agency will continue to optimise the stress model in the future and require the undertakings to perform risk-adequate asset investment management.

Exemption for the handling of financial problems

In accordance with section 1 (3) of the Investment Ordinance (*Anlageverordnung – AnlV*[79]), BaFin also has the power to approve investment in assets that are not listed in the AnlV, that do not meet the requirements, or that exceed the specific limitations. BaFin approves such investments in order to support insurance undertakings that are having problems meeting the restricted asset requirements. In 2003, the agency granted such exemptions mainly in the area of real property investments. In most cases, the market value of properties is higher than the book value due to accounting rules. This creates hidden reserves. Properties are often held through real-estate companies (*Immobilien-Gesellschaften*), which in turn – unlike other investment vehicles – may own no more than three properties. If the undertaking transfers ownership of a property to a real-estate company within the meaning of the AnlV at the market value, the valuation reserves are realised and thus recognised on the balance sheet. Allowing real estate companies to hold more than three properties enabled undertakings to avoid costs, which in turn benefited their policyholders.

High-yield investments

In several cases, BaFin approved the addition of what are known as high-yield assets to investment funds, which constitute restricted assets. As a rule, the principle of investment security demands that, even for indirectly held assets such as funds, only securities with an investment grade rating are to be purchased. High-yield assets are high yield fixed income securities that are either unrated or rated as speculative grade and that harbour more risk.

[79] Ordinance on the Investment of Restricted Assets of Insurance Undertakings.

Circular 29/2002 (VA) means that for the first time, investment funds can not only invest in the securities of established issuers, but can also include a small proportion of high-yield assets. Depending on the composition of the remaining assets of the fund and direct investments, the term “small proportion” generally means 5% of the overall fund investments.

Additionally, for the first time in the period under review, BaFin approved investments in what are known as pure high-yield funds, provided that the purchase of such paper has been excluded in the other funds held by the insurance undertaking and thus, the proportion of such investments as part of overall fund investments is kept to a minimum.

Credit Risk Transfer

BaFin permitted insurance undertakings to purchase structured financial instruments, which are used to transfer certain default risks to investors, under the conditions set forth in circular 1/2002. The highly complex class of Asset Backed Securities (ABS) and Credit Linked Notes (CLN) may only be allocated to restricted assets if the undertaking can prove that it has fully analysed the products both legally and economically and if the financial instruments in question have an investment grade rating. Furthermore, such investments may not exceed 7.5% of restricted assets.

Life insurers put just 1.2% of invested assets in ABS and CLN.

BaFin has observed that, up until now, insurance undertakings have proceeded very carefully with regard to taking on credit risks. The life insurance sector, which made the bulk of investments at 62%, put an average of just 1.2% of its entire invested assets into ABS and CLN. The investments made by the property and casualty sector totalled 1.1%. In all, such investments have remained more or less marginal up to now. Nevertheless, BaFin will continue to monitor developments carefully.

1.3 Unisex rates

In the period under review, a “Proposal for a Directive implementing the principle of equal treatment between women and men in the supply of goods and services” was implemented at EU level. The proposal calls for a ban on rate variations based on gender. The basic idea behind this unisex rate is that it is not the gender of the individual that impacts their life expectancy and health risks, but factors such as lifestyle and health awareness.

Ban on gender-based rates under discussion.

A ban on gender-based rates would cause fundamental changes to private pensions, annuity insurance and private health insurance, for example. While the rates for women in the area of private pensions and health insurance would be lowered, the rates for annuity insurance would increase substantially due to the lower expected mortality among women.

1.4 Insurance selling

In the period under review, BaFin concluded two administrative offence proceedings brought against insurance brokers due to violations of the restriction on passing on commissions to customers (*Provisionsabgabeverbot*[80]). To the extent that the brokers were unwilling to pay their fines voluntarily, BaFin collected them by means of enforcement proceedings. Additionally, BaFin asked several insurance brokers to discontinue the practice of passing on commissions in order to win insurance contracts.

Reports of irregularities in field sales.

The insurance supervision again evaluated reports of embezzlement by the insurance undertakings in accordance with circular R 1/94. This led to numerous questions and sanctions. Many forms were filled out incompletely or incorrectly. Some reports did not state the point in time at which the misappropriation was discovered, although this information is crucial in order to attribute the act to a specific reporting period. The management of the insurance undertaking subject to the reporting requirements is responsible for the timely, omission-free and accurate completion of the reporting forms. Circular 1/94 contains comprehensive instructions in this regard.

[80] cf. sections 144a (1) no. 3, 81 (2) sentence 4 of the VAG in conjunction with the Anordnung des Reichsaufsichtsamtes für Privatversicherungen of 8 March 1934 with regard to life insurance – Number 58 of the official gazettes Deutscher Reichsanzeiger and Preußischer Staatsanzeiger of 9 March 1934.

2 Statistical information

2.1 Number of insurance undertakings and pension funds

In 2003, the number of insurance undertakings under BaFin supervision decreased by 23 to 668. Together with the nine public-law insurance undertakings under supervision at state level, whose data is included in the description of 2003 business trends, this total can be broken down by sector using the following table:

Table 14

Number of insurance undertakings under supervision

(Number of the previous year in brackets)

	Active insurance undertakings (IU)			Inactive IU
	Federal supervision	State supervision	Total	
Life IU	106 (110)	3 (4)	109 (114)	10 (18)
Pensionskassen	157 (154)	0	157 (154)	1 (4)
Death benefit funds	43 (45)	0	45	2(4)
Health IU	54 (55)	0	54 (55)	1 (-)
Property/casualty IU	235 (238)	6 (8)	241 (246)	10 (15)
Reinsurance IU	45 (43)	0	45 (43)	4 (5)
Total IU	**640 (645)**	**9 (12)**	**649 (657)**	**28 (46)**
Pension funds	23 (18)	0	23 (18)	0

2.2 Commencement of insurance business

Life insurance undertakings

Eleven foreign life insurers registered to provide services within Germany in 2003 (2002 figures in brackets).

In the year under review, BaFin authorised one public limited company to conduct life insurance business. The authorisation procedure was connected with a reorganisation.

In 2003, 11 life insurance undertakings from other EU countries registered to provide services within Germany pursuant to the Third Life Insurance Directive (92/96/EEC). These can be broken down by home country as follows:

Table 15

Life insurers from the EEA

Ireland	2
Austria	2
Luxembourg	2
Greece	2
United Kingdom	1
Spain	1
France	1

Additionally, one new branch of an EU life insurer from Greece was established in Germany in 2003.

Health insurance undertakings

In the year under review, BaFin authorised one public limited company to conduct health insurance business. The undertaking took over the portfolio of an existing mutual insurance association that is now defunct. One health insurer that operated only non-substitutive health insurance transferred the entirety of its portfolio within the insurance group.

Property and casualty insurance undertakings

In 2003, BaFin authorised two public limited companies and one mutual insurance association to start conducting property and casualty insurance business. At the end of 2003, six authorisations were pending, and several enquiries had been submitted that did not result in any authorisation procedure.

While no undertakings from the EC/EEA established branches within Germany in 2002, one branch in this category was set up in 2003.

37 foreign accident insurers registered to provide services in Germany in 2003.

In the period under review, 37 insurance undertakings (2002: 29) registered to provide services in Germany. These institutions came from the following home countries:

Table 16

Property insurers from the EEA

Country	Number
United Kingdom:	13 (of which 3 from Gibraltar)
Ireland:	11
France:	2
Spain:	2
Norway:	2
Sweden:	2
Denmark:	2
Belgium:	1
Liechtenstein:	1
Greece:	1

Additionally, insurance undertakings previously authorised to provide services also registered expansions of their business operations. The provision of compulsory insurances remains marginal. In 2003, too, several insurers discontinued operations in the Federal Republic of Germany.

Reinsurance undertakings

In 2003, two further undertakings began conducting reinsurance business. The number of pure reinsurance undertakings rose accordingly from 43 to 45.

Pensionskassen and pension funds

In the year under review, BaFin authorised five *Pensionskassen* and five pension funds, all of which are public limited companies, to conduct business. In one additional case, the authorisation procedure for a pension fund was aborted when the application was rescinded. At the end of the year, four applications were still pending for *Pensionskassen* and pension funds respectively. Two *Pensionskassen* merged with other undertakings.

2.3 Interim reporting

Since 1995, insurance undertakings have been reporting selected accounting and portfolio data to BaFin, or to its predecessor BAV, on a quarterly basis. Experience with the data from financial years 1995 to 2002 shows that, partly due to systematic reasons, the preliminary figures submitted to BaFin in the quarterly reports are often at variance with the final figures. Consequently, this chapter will compare the preliminary data for 2003 with the preliminary data from 2002. In the area of property/casualty insurance, BaFin also compares the preliminary figures from 1998 until 2002 with the final figures, and then projects the final data for 2003 based on the conclusions drawn from this comparison.

2.3.1 Business trend

Life insurance undertakings

New business down 14.3%.

In the area of direct life insurance, new business (i.e. policies with the first premium paid) decreased from 9.8 million to 8.4 million new contracts (-14.3%), falling back to the same level seen in 2001. The reason for this was the 30.9% drop in new retirement savings plans and other life insurance business (2002: +43.6%). At the same time, the underwritten amount of new insurance policies grew by 9.2% to €245,7 billion (2002: €225.1 billion).

Endowment insurance comprises a larger share of new business.

The share of “traditional” endowment insurance as a proportion of new contracts rose to 27.0% (2002: 20.3%). Term insurance accounted for 31.2% (2002: 27.9%). The proportion of retirement savings plans and other life insurance fell to 41.7% (2002: 51.8%). Endowment insurance comprised 22.2% of the underwritten amount of new insurance policies, up from 20.6%. Term insurance remained at the previous year's level of 30.7%, while the contribution from retirement savings plans and other life insurance fell to 47.1% from 48.6%.

Slight increase in early withdrawal.

A total of 3.5 million contracts were terminated early[81] in 2003 (2002: 3.1). The underwritten amount of such early withdrawals increased by 23.8% to €112.6 billion. In the area of retirement savings plans and other life insurance, the increase in early withdrawals was above average at 24.9%. With respect to the underwritten amount, this corresponds to an increase of 27.5%.

[81] Surrender, conversion into paid-up policies and other early withdrawal.

As a whole, direct life insurance business totalled 91.3 million contracts (+0.9%) at the end of 2003. The underwritten amount came to €2,139.1 billion (+4.4%). The proportion of this amount attributable to endowment insurance fell: the number of contracts dropped from 61.5% to 59.0%, with the underwritten amount falling from 53.3% to 50.8%. The annuity insurance portion remained almost constant at 16.5% in terms of the number of contracts, and 19.6% in terms of the underwritten amount. On the other hand, the share made up of retirement savings plans and other life insurance expanded: The number of contracts accounted for 24.5% (2002: 22.2%) , while the underwritten amount constituted 29.6% (2002: 27.5%). Gross premiums written in direct insurance business rose to €67.2 billion (+3.9%).

Health insurance undertakings

Gross premiums written in direct health insurance business in 2003 increased to €24.7 billion. This 7.2% increase was virtually on par with that of the previous year (6.0%).

Payments for claims incurred up 4.1%.

Payouts for insurance claims incurred from the 2003 and previous financial years was up 4.1% (2002:+6.9%) to €15.1 billion. Thus, the rate of increase for all claim payments was lower than the rate of premium growth in 2003.

Despite the instructions of the insurance supervisor calling for uniform counting and accounting of insured natural persons, the data offered in the various reports have been and continue to be persistently dissimilar. Consequently, an assessment of the stated interim figures would be fruitless.

Property and casualty insurance undertakings

In 2003, property and casualty insurance undertakings saw gross premiums written in direct insurance business of €57.8 billion, a 2.6% increase as compared to the previous year.

Gross claims expenditure from the accounting year was down 9.5% to €19.8 billion (2002: +14.0%), while gross expenditure for claims from previous years climbed 9.6% to €15.4 billion (+7.3%). Gross provisions relating to individual insurance claims from the accounting year finished 12.6% lower, at €13.9 billion (2002: -1.0%). Gross provisions relating to individual claims from previous years were up 4.4% to total €41.3 billion (2002: +3.9%).

By far the largest area was motor vehicle insurance, with gross premiums written totalling €22.4 billion. This represents an increase of 2.3%, following a 2.8% rise in 2002. Total gross payouts for insurance claims from the accounting year were down 3.2%, and payments made for previous years' claims fell by 4.5%.

2.3% increase in gross premiums written in motor vehicle insurance business.

Gross provisions relating to individual insurance claims from the accounting year sank by 3.3% after a 1.7% decline in the previous year. Gross provisions for individual claims outstanding from previous years were up 2.1% (2002: 2.1%).

Premium income increased 1.8% in general liability insurance.

In the area of general liability insurance, the undertakings took in €7.0 billion in premiums (+1.8%). For insurance claims from the accounting year, the undertakings paid out 7.5% less, and for previous years' claims, 4.5% more. The particularly important gross provisions relating to individual claims sank by 5.9% with regard to outstanding claims from the accounting year (2002: 20.0%) and remained unchanged in relation to outstanding claims from previous years (2002: +8.1%).

Premium deterioration halted in fire insurance.

Fire insurance business posted gross premiums written of €2.1 billion (+9.2%; 2002: +1.7%). This represents a halting of the premium deterioration experienced from 1995 to 2001, and is also reflected in the continued clear drop in the number of contracts (-4.2%; 2002: -3.6%). Gross expenditure for accounting year claims fell by 16.7%, while gross provisions for the individual claims dropped by 9.0%. For insurance claims from previous years, the undertakings paid out 15.8% less, with provisions nearing 2002 levels.

Insurance claim payouts sank by 24.7% in comprehensive residential buildings insurance and comprehensive household insurance.

Viewed together, comprehensive residential buildings insurance and comprehensive household insurance generated premiums of €6.2 billion (+2.3%). Payouts on insurance claims from the accounting year fell by 24.7% (2002: +56.8%). For insurance claims from previous years, the undertakings paid out 47.7% more than in 2002 (+0.8%). For claims from the accounting year, provisions were down 29.8% (2002: +41.6%) and provisions relating to previous years' claims increased by15.9% (2002: +0.1%).

Gross premiums written in general accident insurance rose by 1.5%.

At €5.8 billion, gross premiums written in general accident insurance were up 1.5% on the previous year. Gross expenditure for claims from the accounting year and previous years held steady, at +0.2% and -0.4% respectively. The gross provisions relating to individual claims outstanding from the accounting year increased 4.6%. Previous years' claims provisions were unchanged.

Extrapolation for financial year 2003

As in previous years, BaFin endeavoured to project the final figures for 2003 in the area of property and casualty insurance based on the data provided by means of interim reporting. Due in particular to divergent provisioning, the final results of the previous years deviated, sometimes significantly, from the projected figures. Nonetheless, there are clearly identifiable trends.

In its projections, BaFin measured how the fourth-quarter data related to the final figures for financial years 1998 to 2002, and then applied these ratios to the quarterly figures for 2003.

The simple methodology does not produce exact projections, but it does provide initial insights. Based on the data collected through interim reporting, the projection is limited to gross profit before premium refunds and changes to the equalisation provision.

Gross premiums earned rose slightly, while total claims expenditure sank.

Total direct business is likely to account for gross premiums earned of €57.9 billion in 2003, compared to €56.3 billion in 2002. Payouts for accounting year claims are projected to total €42.2 billion (2002: €48.1 billion) with a settlement result of €1.7 billion (2002: €5.9 billion). Total claims expenditure will thus decrease from €43.2 billion to €40.5 billion, with the claims ratio falling from 76.7% to 70.0%. The expense ratio will remain virtually unchanged at 26.8%. Taking into account the other underwriting items, the gross underwriting result will improve from a €2.5 billion deficit to a €1.1 billion surplus in 2003.

The following table details the projections:

Table 17

Extrapolation for financial year 2003

€ billion	Total direct insurance business		Accident insurance		General liability insurance		Motor vehicle insurance		Fire insurance		Compr. household and res. buildings insurance	
	2003 E	2002	2003 E	2002	2003 E	2002	2003 E	2002	2003 E	2002	2003 E	2002
Gross premiums earned	57.9	56.3	5.7	5.6	7.0	6.9	22.6	22.0	2.1	1.9	6.2	6.0
Expense												
for current year claims	42.2	48.1	2.5	2.4	4.9	5.3	20.1	20.4	1.3	1.5	4.3	5.7
Settlement result	-1.7	-5.0	-0.7	-0.6	-0.5	-0.8	-1.8	-1.9	-0.4	-0.2	0.3	-0.2
Gross claims expenditure	40.5	43.2	1.8	1.8	4.4	4.5	18.2	18.5	0.9	1.2	4.6	5.4
Gross administrative expenditure	15.5	15.1	2.1	2.1	2.4	2.3	4.1	4.0	0.5	0.6	2.1	2.1
Gross balance of other u.w. items	0.7	0.6	0.5	0.7	0.0	0.0	0.0	-0.1	0.1	0.1	0.1	0.1
Gross u.w. result (before premium refunds)	1.1	-2.5	1.3	1.0	0.2	0.1	0.2	-0.4	0.5	0.0	-0.7	-1.5
Claims ratio	70.0%	76.7%	31.4%	31.7%	62.7%	64.8%	80.8%	84.0%	44.9%	64.7%	75.1%	89.8%
Expense ratio	26.8%	26.7%	36.7%	37.3%	34.3%	33.7%	18.4%	18.0%	25.3%	29.3%	34.4%	34.1%
Gross profit ratio	1.9%	-4.4%	23.1%	17.6%	3.0%	1.6%	1.0%	-1.7%	23.2%	-0.6%	-11.2%	-25.6%

2.3.2 Investments

For the sector as a whole, total investments increased by 5.4% in 2003 (2002: +6.5%) to €1,059.5 billion (2002: €1,006.3 billion). Further details are provided in Table 18. In the following section, some selected aspects are examined in closer detail.

The book value of property investments declined by 3.5%. The proportion of properties sank further from 2.6% to 2.4%. The book value of shares in affiliated companies increased by 3.8%. The proportion of the entire investment portfolio comprised of such shares remained virtually unchanged at 11.1%.

The proportion of directly held shares continued to fall, from 2.0% in 2002 to 1.7% in 2003.

Following a 41.0% decline in 2002, the book value of directly held shares decreased by 8.8%, a reflection of the slow pace of recovery on the capital markets. The already small proportion of shares in relation to total investments sank further, from 2.0% in 2002 to 1.7%.

Investments in fund units increased by 2.8% (2002: +6.2%), though the proportion of these investments to total investments dropped slightly from 22.8% to 22.2%.

The book value of bearer bonds grew by 22.2% (2002: +5.4%), with their contribution to total investments rising from 8.4% to 9.7%. Notes receivable, which are "write-down-proof" by virtue of their valuation at par, increased to 12.9% (2002: +10.1%), and thus continued to grow as a share of total investments from 16.1% to 17.3%.

As was the case in the previous year, the growth in total investments for health insurance undertakings, at 10.6%, and for reinsurance undertakings, at 13.4%, was substantially higher than the sector average of 5.4%. Conversely, investment growth was below average for life insurance undertakings (2.9%), for property and casualty insurers (4.5%), and for *Pensionskassen* and death benefit funds (5.2% each). The considerable increase in investments at health insurers is attributable to the statutory requirement to build up reserves from surplus in order to lower premium increases after retirement. The higher investment levels of reinsurance undertakings were primarily the result of higher premiums and capital increases.

Table 18

Investments 2003

Total investments made by insurance undertakings	Balance as at 01/01/2003 €m	%	Additions in 2003 €m	%	Balance as at 31/12/2003 €m	%	Change in 2003 €m	%
Real property and equivalent rights and buildings	25,900	2.6%	2,590	0.6%	25,005	2.4%	-895	-3.5%
Shares in affiliated companies	113,038	11.2%	20,308	4.9%	117,362	11.1%	+4,324	+3.8%
Loans to affiliated companies	20,424	2.0%	11,587	2.8%	19,342	1.8%	- 1,082	- 5.3%
Participating interests	20,775	2.1%	5,670	1.4%	17,500	1.7%	- 3,275	- 15.8%
Loans to companies in which a participating interest is held	4,714	0.5%	2,444	0.6%	4,718	0.4%	+ 4	+ 0.1%
Shares	19,862	2.0%	10,962	2.7%	18,123	1.7%	- 1,739	- 8.8%
Fund units	229,172	22.8%	49,248	11.9%	235,512	22.2%	+ 6,340	+ 2.8%
Other variable yield securities	5,018	0.5%	1,698	0.4%	4,907	0.5%	- 111	- 2.2%
Bearer bonds and other fixed-interest securities	84,419	8.4%	123,250	29.8%	103,178	9.7%	+ 18,759	+ 22.2%
Loans secured by mortgages, land charges and capital annuity charges	71,164	7.1%	10,769	2.6%	73,067	6.9%	+ 1,903	+ 2.7%
Registered bonds	211,025	21.0%	62,563	15.1%	216,042	20.4%	+ 5,017	+ 2.4%
Debt certificates and loans	162,016	16.1%	73,024	17.7%	182,940	17.3%	+ 20,924	+ 12.9%
Loans and prepayments on insurance certificates	5,446	0.5%	1,760	0.4%	5,516	0.5%	+ 70	+ 1.3%
Other loans	8,067	0.8%	1,360	0.3%	9,879	0.9%	+ 1,812	+ 22.5%
Deposits with credit institutions	19,647	2.0%	33,613	8.1%	23,405	2.2%	+ 3,758	+ 19.1%
Other investments	4,271	0.4%	2,357	0.6%	3,015	0.3%	- 1,256	- 29.4%
Total investments	**1,004,958**	**100.0%**	**413,203**	**100.0%**	**1,059,511**	**100.0%**	**+ 54,553**	**+ 5.4%**
Life IU	592,342	58.9%	224,446	54.3%	609,338	57.5%	+ 16,996	+ 2.9%
Pensionskassen	71,844	7.1%	26,864	6.5%	75,554	7.1%	+ 3,710	+ 5.2%
Death benefit funds	1,400	0.1%	479	0.1%	1,473	0.1%	+ 73	+ 5.2%
Health IU	88,509	8.8%	28,972	7.0%	97,864	9.2%	+ 9,355	+ 10.6%
Property/casualty IU	103,904	10.3%	48,616	11.8%	108,621	10.3%	+ 4,717	+ 4.5%
Reinsurance IU	146,959	14.6%	83,825	20.3%	166,661	15.7%	+ 19,702	+ 13.4%
All IU	**1,004,958**	**100.0%**	**413,203**	**100.0%**	**1,059,511**	**100.0%**	**+ 54,553**	**+ 5.4%**

2.4 Solvency 2002

2.4.1 Life insurance undertakings

In 2003, the solvency sheets of 107 life insurance undertakings were submitted for financial year 2002. A review of these revealed a solvency margin of €23.348 billion to be covered. By far the greatest percentage of the amount to be covered was comprised of the mathematical provisions and capital at risk of the main insurance undertakings, while supplemental insurance and unit-linked insurance were fairly insignificant. Of the 107 undertakings, four were only obliged to cover the minimum guarantee fund as a result of the limited scale of their business.

107 life insurers maintained own funds of nearly €39.8 billion in 2002.

As a whole, the undertakings maintained eligible own funds of €39.775 billion, which represents a 170% coverage of the solvency margin.

The components of these own funds were:

Own funds	A, totalling	€ 6.870 billion (17.3%)
Own funds B,	totalling	€32.299 billion (81.2%)
Own funds C,	totalling	€ 0.606 billion (1.5%)

BaFin approved own funds C of 13 undertakings.

Own funds A consisted primarily of paid-up share capital, half of the non-paid-up share capital and reserves. Own Funds B is the portion of the provision for bonuses and rebates not yet allocated for bonuses, which, in accordance with section 56a sentence 5 of the VAG, can be used to cover extraordinary losses. Own Funds C represents the value of future surpluses, and can only be deemed eligible with BaFin approval. Future surpluses can be approved as own funds only to the extent that the own funds A and B leave a shortfall in coverage of the solvency margin. In financial year 2002, BaFin approved own funds C as eligible funds for 13 life insurance undertakings.

The own funds of 12.1% of the undertakings covered the solvency margin exactly because the use of own funds C in the required amount was approved. 64.5% of the undertakings maintained excess coverage of the solvency margin of up to 100%; 10.3% of the undertakings had surplus coverage between 100% and 200%; for 5.6%, the excess amount was between 200% and 300%, and 7.5% maintained surplus coverage of more than 300%.

Solvency regulations require undertakings to cover at least half of the guarantee fund through own funds A and B. All life insurance undertakings were able to fulfil this requirement.

Seven undertakings included capital represented by participation rights as eligible own funds.

Insurance undertakings may allocate a limited amount of capital represented by participation certificates to own funds in order to cover the solvency margin[82]. In financial year 2002, seven undertakings included participation capital totalling €19.3 million as eligible own funds. This was equivalent to 19.7% of these undertakings' paid-up capital. None of the undertakings exceeded the statutory upper limit[83] of 25%.

2.4.2 Death benefit funds

In 2003, BaFin evaluated the solvency sheets submitted by death benefit funds for the 2002 financial year. With the exception of one public limited company, all 45 of the death benefit funds under federal supervision were constituted in the legal form of "*kleinere Versicherungsvereine*" (minor mutual insurance associations). Those 24 undertakings that had set about a recalculation of the mathematical provision at the balance sheet date were required to provide evidence of adequate solvency. One of the undertakings' own funds were not sufficient to cover the solvency margin. In this case, restructuring measures were necessary over the course of 2003 in order to restore adequate solvency. All other death benefit funds provided evidence of adequate solvency.

[82] section 53c (3) sentence 1 no. 3a of the VAG.
[83] section 53c (3c) of the VAG.

24 death benefit funds maintained own funds of approximately €46.1 million in 2002.

The solvency margins to be covered by the 24 death benefit funds amounted to €33.0 million. Own funds of €46.1 million were available to cover this amount, which equates to a coverage ratio of 139.7%. Of the 23 undertakings with adequate solvency, 15 achieved surplus coverage of up to 100%, five maintained excess coverage of between 100% and 200%; and three death benefit funds covered the solvency margin by more than 200%.

At 61.5%, the majority of the own funds were comprised of the loss reserve or, in the case of the one public limited company, subscribed capital and capital reserves. None of the undertakings included capital represented by participation rights or subordinated liabilities in own funds. The free provision for bonuses and rebates represented 38.5% of total own funds. The 23 death benefit funds with adequate solvency were able to fully cover the solvency margin with what are known as "explicit own funds", meaning that none of the undertakings were obliged to allocate future surpluses for solvency coverage. In the case of the one death benefit fund that was unable to meet solvency requirements, the explicit own funds were inadequate to cover the guarantee fund, which comprises one-sixth of the solvency margin.

Five death benefit funds applied halved rates for the calculation of the solvency margin (2% instead of 4% of mathematical provisions and 0.15% instead of 0.3% of capital at risk) because their premiums for the previous three financial years had not exceeded €500,000.

2.4.3 Health insurance undertakings

In 2003, BaFin assessed the information provided on the solvency of the 55 health insurance undertakings in 2002. Of these 55 health insurers, three that were constituted in the legal form of *kleinere Versicherungsvereine* were exempted from the solvency regulations, since their premium volumes did not exceed €1.87 million and their articles of association provided for obligatory additional contributions of the members.

An evaluation of the solvency sheets submitted for financial year 2002 produced the following results: The solvency margin to be covered by the 52 health insurance undertakings subject to reporting requirements totalled €1.298 billion. This equates to a year-on-year increase of 6.4%. For 32 undertakings, the premium index was the main determinant with regard to the amount of solvency margin. For seven, the claims index was key. The remaining 13 undertakings were only obliged to cover the minimum guarantee fund as a result of the limited scale of their business.

52 health insurance undertakings maintained own funds of approximately €3 billion in 2002.

In all, the 52 undertakings had own funds with a book value of €3.038 billion to cover the solvency margin, which represents a marked increase on the previous year (+ 11.6%). The coverage ratio rose accordingly from 223% in 2002 to 234% in the year under review.

Nine of the undertakings achieved up to 50% surplus coverage of the solvency margin, while another ten achieved surplus coverage of

between 50% and 100%; for 17 undertakings the surplus coverage was between 100% and 200%, and for 16 undertakings, it was in excess of 200%.

As was the case in 2002, one health insurer with the legal form of a mutual insurance association availed itself of the possibility of using supplementary contributions, eligible under its articles of association, as own funds. Two undertakings again included what is known as surrogate capital (subordinated liabilities and capital represented by participation rights) in the amount of €46.5 million as own funds. The requirements of section 53c (3a) and (3b) of the VAG were satisfied.

2.4.4 Property and casualty insurance undertakings

225 property and casualty insurance undertakings maintained own funds of nearly €25 billion in 2002.

In 2003, BaFin assessed the information provided concerning the solvency of the 225 property and casualty insurance undertakings in 2002. The solvency margin to be covered by these undertakings amounted to €7.41 billion. In all, the 225 undertakings maintained own funds of €24.98 billion, which equates to a coverage ratio of 337%. 215 undertakings achieved surplus coverage of the required amount with their available own funds. 10 companies were found to have a coverage shortfall totalling €136.5 million, which was met with remonstration by the supervisory authority. The situation is illustrated in detail below:

Table 19

Solvency of property and casualty insurance undertakings

Solvency margin to be covered				
	2002		2001	
	€m	Number of IUs	€m	Number of IUs
Minimum guarantee fund	18.5	28	22.6	35
Premium index	2,761.1	104	3,377.7	117
Total coverage ratio	4,634.8	93	3,712.6	76
Total	**7,414.4**	**225**	**7,112.9**	**228**
Own funds				
	2002		2001	
	€m	Number of IUs	€m	Number of IUs
Total	24,977.6	225	24,373.3	228
Of which:				
Capital represented by participation rights	246.2	5	253.5	6
Subordinated liabilities	162.7	6	180.7	5
Supplementary contributions (for mutual insurance associations)	1,476.1	23	1,323.5	25
Coverage				
	2002		2001	
	%	Number of IUs	%	Number of IUs
Total coverage ratio	337%		343%	
Coverage shortfall	136.5 Mio. €	10	4.3 Mio. €	6
Excess coverage up to 100%	36%	82	39%	88
Excess coverage between 100% and 200%	21%	47	22%	50
Excess coverage between 200% and 300%	14%	31	14%	32
Excess coverage of more than 300%	24%	55	23%	52
Total	**100%**	**225**	**100%**	**228**

2.4.5 *Pensionskassen*

129 of the 154 *Pensionskassen* under BaFin supervision in 2002 were required to submit a solvency overview. *Pensionskassen* with the legal form of kleinere Versicherungsvereine are only required to submit this documentation as at those dates on which their mathematical provision is recalculated.

129 *Pensionskassen* maintained own funds of approximately €3.7 billion in 2002.

The solvency margin for the 129 undertakings collectively was €3.108 billion. With own funds amounting to €3.711 billion in total, the resulting coverage rate was 119.4% (2002: 123.1%). The coverage ratio declined because the surplus in relation to business volumes fell compared to the previous year.

Five *Pensionskassen* were temporarily unable to meet own funds requirements.

Five *Pensionskassen* did not have own funds adequate to cover either the solvency margin or the guarantee fund. Both have since rectified this coverage shortfall. In one further case, the guarantee fund was covered, but not the solvency margin. This Pensionskasse submitted a solvency plan, which is still in the process of execution. 89 of the other *Pensionskassen* exhibited excess coverage of up to 100%. A total of 12 had excess coverage of between 100% and 200%;six had exceeded minimum coverage requirements by between 200% and 300%, and 16 had excess coverage of more than 300%.

In all, 35.4% of the undertakings' own funds were made up of capital and surrogate capital, with the free portion of the provision for bonuses and rebates accounting for 33.1% and future surpluses and hidden reserves from investments accounting for a share of 31.5%. 48 *Pensionskassen* included future surpluses in own funds following BaFin approval. Additionally, BaFin authorised two Pensionskassen to use hidden reserves from investments. One undertaking counted surrogate capital in the form of subordinated liabilities towards own funds.

24 undertakings applied halved rates for the calculation of the solvency margin (2% instead of 4% of mathematical provisions and 0.15% instead of 0.3% of capital at risk) because their premiums in the previous three financial years had not exceeded €500,000.

2.4.6 Pension funds

At the beginning of 2002, the legislature introduced pension funds as a further occupational retirement provision vehicle[84]. Subsequently, 18 pension funds were granted authorisation by Bafin to commence business operations. This so-called “fifth vehicle” complements the existing options: *Direktzusage, Unterstützungskasse, Pensionskasse* and *Direktversicherung*.

2002 was an abridged financial year for all pension funds. Consequently, all of the pension funds exhibited only a minimal business volume as at 31 December 2002. The number of beneficiaries included 57,723 active policyholders and one pensioner.

[84] cf. Act to Improve Occupational Pension Schemes (BetrAVG).

As with insurance undertakings, pension funds are required to cover possible risks by maintaining own funds. The regulations with regard to the amount and eligibility of own funds are set forth in the Ordinance Concerning the Capital Resources of Pension Funds (*Verordnung über die Kapitalausstattung von Pensionsfonds – PFKAustV*). This states that own funds must be sufficient to cover the greater of the two following amounts: The requisite solvency margin and the minimum guarantee fund.

As with life insurance undertakings, the so-called requisite solvency margin is calculated based on the scale of business, using the mathematical provision and capital at risk as a basis. The pension funds authorised to conduct business in 2002 were doing so in a very limited capacity as at 31 December 2002. This meant that for all pension funds, the sum of own funds required was based on minimum own funds requirement – the so-called minimum amount of the guarantee fund.

The minimum amount of the guarantee fund is €3 million. For pension fund mutual insurance associations, the minimum amount is reduced by one quarter, provided that the articles of association provide for supplementary contributions within the meaning of section 24 of the VAG in the amount of this difference.

Actual amounts of maintained own funds well exceeded the minimum requirements.

In actuality, however, the amount of own funds maintained by the authorised pension funds in 2002 was far in excess of the minimum amounts required. During the authorisation process, BaFin saw to it that the promoters of the pension funds made capital available that was adequate to satisfy solvency requirements and sufficient to fund the financing of any initial losses, including the start-up costs payable from the fund for the formation of the administration and sales force.

2.5 Breakdown of life insurance surpluses 2002

The surplus is stated as the total of the individual sources of income after the direct credit to policyholders has been deducted in full. At this point, it should be borne in mind that, as in previous years, the total direct credit is deducted from net interest income, because the direct credit is primarily attributable (nearly 90%) to this source of income. However, since a part of the direct credit originates from other sources of income (in particular, risk income), the deduction from the net interest income is somewhat high and the amount of net interest income slightly understated. The percentages also stated in Appendix 9, Table 141, represent the ratio of income from the individual sources to gross premiums earned (excluding amounts from the provision for bonuses and rebates) on all direct insurance business.

Table 20

Surplus

(total) direct insurance business

	1998 %	1999 %	2000 %	2001 %	2002 %
Risk	7.5	7	6.9	6.8	6.8
Investments	27.4	27.9	27.6	16.1	2
Surplus	32.8	32.6	33.2	22.1	8.0

Sources of income: Risk (mortality and other risk),
investments (net interest income and other income)
as a % of gross premiums earned on direct insurance business

The surplus decreased substantially.

The total surplus on direct business fell in comparison to 2001 by around €8.344 million, bringing it down to €5.173 million. As a percentage of gross premiums earned, the total surplus fell to 8% (2002: 22.1%). This decline is attributable to the dramatic decline in investment income, especially in the area of other investment income. Other net investment income[85] returned a loss of around €4.045 million (6.3% of gross premiums earned) in 2002, compared to earnings of €2.404 million (3.9% of gross premiums earned) in the previous year. The impact on net interest income was also severe. This is due to the fact that, unlike with directly held equities, price gains within investment funds are accounted as current profits and are thus stated as interest income instead of other income. Accordingly, total investment income declined by approximately 87% to €1.266 million (2002: €9.847 million).

The result from other risk (1.7%) and early withdrawal (0.3%) improved slightly on the preceding year (1.5% and 0.2%), while the mortality result fell by 0.2% to 5.1%. In all, net risk and early withdrawal income increased to 7.1% (2002: 7.0%) to reach €4.589 million. However, taking into account the direct credit, investment income remains the most significant source of income.

The most significant other risks included accidental death, occupational disability, and endowment. While net income from accidental death and occupational disability risks remained positive, income from endowment insurance was once again negative in 2002 due to increasing life expectancy.

Losses from acquisition costs were down slightly to 3.2% of gross premiums earned (2002: 3.3%). In the area of administrative overhead costs, the income was 3.5% of gross premiums earned, down slightly on the previous year (3.6%). Consequently, the surplus from the administrative component of actual premiums was sufficient, as in previous years, to offset the loss from acquisition costs. In this way, the acquisition and administrative cost elements of premiums have more than covered these expenses for a number of years. As in the previous year, the overall net expense income amounted to 0.3% of gross premiums earned.

[85] Balance of realised hidden reserves against write-downs on investments und realised losses.

Table 21

Sources of income

early withdrawal, expenses (for acquisition and administrative overhead), reinsurance (mortality, other risk and other reinsurance income), other income

	1998 %	1999 %	2000 %	2001 %	2002 %
Early withdrawal	-0.1	-0.1	0.1	0.2	0.3
Expenses	1	0.2	0.7	0.3	0.3
Reinsurance	-0.3	0	0.1	0.1	-0.2
Other income	-2.6	-2.6	-2.1	-1.3	-1.1

in % of gross premiums earned on direct insurance business

The difference between actual premiums and notional premiums referred to in the breakdown of surpluses is the result of the different bases used to calculate the actual premium and the mathematical provision for some new rates. The premium which would have resulted according to the calculation base for the mathematical provision is known as the actual premium (*Normbeitrag*). A negative result indicates that the calculation of premiums for certain rates took place under more optimistic assumptions (e.g. with a higher technical interest rate) than the calculation of the mathematical provision (maximum technical interest rate 3.25% for rates as from July 2000). In such cases, the undertakings must cover the present value of premium differences with assets, which initially entails additional expenses. The loss from this source of income posted in 2002 amounted to approx. €51 million (0.1% of gross premiums earned) and therefore had a minimal impact on the total result.

Reinsurance business (passive reinsurance) as a source of income exhibited a loss amounting to 0.2% of gross premiums earned (2002: 0.1% gain). This is attributable to slightly higher losses in the area of other risk and lower earnings from other income.

The loss from other income equalled 1.1% of gross premiums earned, which represents a marginal (1.3%) decline on the previous year.

Exact overall figures for the breakdown of surpluses by source of income for life insurance undertakings for the past three financial years can be viewed in Appendix 9, Table 141.

2.6 Breakdown of health insurance surpluses 2002

The following figures concerning the surpluses or shortfalls of health insurance undertakings show the percentage ratio of income to gross premiums earned on direct insurance business and reinsurance business.

Table 22
Sources of income

	2002 %	2001 %	2000 %	1999 %	1998 %
Risk	-2.02	-2.79	-0.82	0.57	0.72
Acquisition costs					
a) direct	0.07	-0.10	0.11	0.14	0.04
b) indirect	-0.20	-0.07	0.02	0.24	0.16
Claims settlement	-0.22	-0.33	-0.24	-0.17	0.07
Administrative overhead	0.56	0.51	0.52	0.55	0.58
Safety loading	6.61	6.64	6.61	6.66	6.75
Investments					
a) interest	9.68	10.51	12.59	11.54	11.18
b) other income	-4.19	0.82	1.49	2.68	2.41
Reinsurance business	0.01	0.03	0.02	-0.01	0.01
Other income	-4.64	-7.91	-10.13	-8.29	-8.16
Total[86]	5.67	7.32	10.17	13.92	13.76

The data above relates to all health insurance, including compulsory long-term care insurance (CLTC).

In Table 23, column (1) displays the sources of income, adjusted for CLTC business, set out in Table 22 for financial years 2000 to 2002. For a comparison of the individual sources of income within CLTC, column (2) provides the percentage ratios of the sources of income to gross premiums earned on CLTC business.

Table 23
Adjusted source of income

Source of income	2002 %		2001 %		2000 %	
	(1)	(2)	(1)	(2)	(1)	(2)
Risk	-3.27	11.26	-4.08	10.36	-2.24	12.40
Acquisition costs						
a) direct	0.09	-0.11	-0.09	-0.13	0.12	-0.03
b) indirect	-0.17	-0.45	0.01	-0.87	0.11	-0.83
Claims settlement	-0.27	0.32	-0.41	0.46	-0.30	0.29
Administrative overhead	0.53	0.95	0.49	0.65	0.50	0.70
Safety loading	6.76	4.99	6.81	4.88	6.80	4.90
Investments						
a) interest	9.38	12.85	10.26	13.08	12.68	11.78
b) other income	-4.12	-4.87	0.82	0.83	1.49	1.53
Reinsurance business	0.01	-------	0.03	-------	0.02	-------
Other income	-3.62	-15.53	-6.84	-18.74	-8.95	-21.14
Total[87]	**5.32**	**9.40**	**7.00**	**10.52**	**10.23**	**9.60**

[86] The total is shown as a surplus or shortfall after taxes and includes allocations to the bonus provision.
[87] The total is shown as a surplus or shortfall after taxes and includes allocations to the bonus provision.

The breakdown of the surplus by source of income shows that, on the whole, the premiums calculated by health insurers in financial year 2002 were adequate. The risk result, adjusted for CLTC, remained negative, though it was up somewhat on the previous year. This is attributable to the fact that the undertakings are making the necessary adjustments to premiums in a more timely fashion. Net direct acquisition costs were somewhat higher than previous year levels, though it must be noted that new business was more moderate. Net direct acquisition costs in CLTC, on the other hand, were only slightly negative. Acquisition costs in CLTC are financed solely from selection and waiting period savings, which are stated as two monthly premiums – the maximum amount eligible for offsetting with regard to the Pflege-Pool. A surcharge limited to the first year of insurance is assessed only on new business within the meaning of section110 (3) of the Social Code XI (*Sozialgesetzbuch – SGB XI*) for direct acquisition costs. As in the previous years, net claims settlement income had virtually no impact on earnings.

On the whole, cost coverage in health insurance was adequately calculated into premiums. Net expense income accounted for 0.18% of gross premiums earned.

Net interest income declined and other income from investments was negative.

In accordance with the calculation principles, a safety loading equalling at least 5% of gross premiums must be factored in. This source of income, along with net interest income, made a particular contribution to the surplus. The safety loading serves to offset losses when either all or some of the bases for calculation fall short of actual developments and are therefore temporarily insufficient, or when they have been rendered inadequate by random fluctuations.

Since financial year 2000, net interest income has been on the decline, due to the persistently low interest rates on capital markets. Other income from investments also fell sharply, closing down on the previous years for the first time. This is a reflection of the difficult stock market environment. Lower price levels caused write-downs and losses from sold-off investments to significantly outmatch capital gains from investment sales. Net interest earned fell again in comparison to 2001.

Net income from reinsurance business remained inconsequential for health insurers.

Other income improved in 2002 as compared to the previous year, but it remained in negative territory. Other income includes “rebates for group contracts”. Pool-relevant CLTC surpluses have been reported under this item since 1997. If an adjustment is made to factor out the pool-relevant CLTC surpluses, other income as shown in Table 22 totalled –3.5% (2001: -6.4%) and in Table 23 (column 2) –2.8% (1997: -1.5%).

In relation to gross premiums earned, the total net income for all business in financial year 2002 was once again down on the previous year.

This can be attributed to such factors as investment performance. The total result in 2002, adjusted for pool-relevant CLTC surpluses, was 6.7% in Table 22 and 22.2% in Table 23 (column 2).

2.7 Fair values of investments 2002

For investments stated on the balance sheet at historical cost, insurance undertakings are required to state the total fair value as a sum in the notes to the financial statements[88]. An exception to the requirement to state fair values is given for registered bonds, mortgages, and other receivables, which are recognised at their par value.

In their reports to BaFin, insurers must state the fair values separately for each type of investment. Part B of BaFin's Annual Report for financial year 2002 gives the fair values of investments held by primary insurers. Now, the figures for reinsurers have also been submitted. The following picture emerged for primary insurers and reinsurers (not including *Pensionskassen* and death benefit funds).

Table 24

Fair values of investments made by all insurance undertakings

All insurance undertakings (not including Pensionskassen and death benefit funds)	**Book value**		**Fair values**		**Hidden reserves**	
	abs. €m	**%**	**abs. €m**	**%**	**abs. €m**	**% of book value**
Real property and equivalent rights and buildings	22,476	2.3%	36,643	3.5%	14,168	63.0%
Investments in affiliated companies and participating interests	157,249	15.9%	211,511	20.2%	54,262	34.5%
Shares	19,245	1.9%	21,671	2.1%	2,426	12.6%
Fund units	200,064	20.2%	186,767	17.8%	-13,297	-6.6%
Bearer bonds and other fixed interest securities	73,837	7.5%	75,138	7.2%	1,301	1.8%
Other investments	515,515	52.2%	517,597	49.3%	2,082	0.4%
Total investments	**988,386**	**100.0%**	**1,049,329**	**100.0%**	**60,942**	**6.2%**
Of which: Life IU	601,395	60.8%	602,539	57.4%	1,143	0.2%
Health IU	88,284	8.9%	90,052	8.6%	1,768	2.0%
Property/casualty IU	104,616	10.6%	126,821	12.1%	22,205	21.2%
Reinsurance IU	194.090	19.6%	229,916	21.9%	35,826	18.5%

[88] Section 54 of the RechVersV.

Table 25

Fair values of investments made by reinsurance undertakings

Reinsurance IU	Book value		Fair values		Hidden reserves	
	abs. €m	%	abs. €m	%	abs. €m	% of book value
Real property and equivalent rights and buildings	1,575	0.8%	3,894	1.7%	2,318	147.2%
Investments in affiliated companies and participating interests	97,119	50.0%	130,134	56.6%	33,015	34.0%
Shares	3,341	1.7%	3,948	1.7%	607	18.2%
Fund units	16,460	8.5%	16,232	7.1%	-228	-1.4%
Bearer bonds and other fixed interest securities	18,563	9.6%	19,231	8.4%	668	3.6%
Other investments	57,032	29.4%	56,478	24.6%	-554	-1.0%
Total investments	**194,090**	**100.0%**	**229,916**	**100.0%**	**35,826**	**18.5%**

Before deducting hidden liabilities from the fund unit component totalling €13.3 million (2002: hidden reserves totalling €7.0 million), the value of the hidden reserves and other investments was €74.2 billion (2002: €150.0 billion). €68.4 billion (92%) of this amount falls into the categories of real property and equivalent rights and buildings or investments in affiliated companies and participating interests. Overall, these investments have very limited, if any, marketability, since for the most part they consist of business premises in use by the company itself, or of participating interests within a corporate group.

The time lapse between the reporting year and the publication of the BaFin Annual Report limits the informational value of these observations, and conclusions cannot be drawn from them with regard to the current situation. Because insurance companies are vulnerable to unpredictable (extreme) developments on the capital markets – in particular, falling prices for equities and fund units in tandem with low interest rates – BaFin pays particularly close attention to changes in hidden reserves and the associated effects on the insurers' income, as well as on their general financial position.

3 Supervision of individual areas of insurance and pension funds

3.1 Life insurance undertakings

3.1.1 Scenario-based assessment of the financial situation

In 2003, the situation on the capital markets once again presented life insurance undertakings with extraordinary challenges. The stock markets were characterised by a sharp decline in the Spring (DAX: 2,189 points) and a subsequent price recovery by the end of the year (DAX: 3,965 points).

Capital market interest rates hit a low in mid-2003.

The bond market was also marked by turbulence. By mid-2003, capital market interest rates fell to historically low levels. The running yield at this point was only 3.2%, but a recovery ensued, bringing the yield back up to the level seen at the start of 2003 – approximately 4%. Thus, the capital market interest rates remained low in a historical comparison.

BaFin has been conducting scenario-based assessments since 2000.

BaFin has been conducting scenario-based assessments of life insurers since 2000. The insurance supervisor uses these tests in order to gather detailed information as to whether or not the insurance undertakings have been able to fulfil guaranteed rate obligations in the current financial year, even in an environment of unfavourable share price developments. To this end, the supervisor orders earnings projections for various share price scenarios in the current financial year.

At the end of 2003, BaFin adjusted share price scenarios.

In the second half of 2003, BaFin also conducted scenario-based assessments, adjusting the share price scenarios to account for the recovering prices in the latter half of the year: the scenario conditions moved within a suitable range below the current share price level. These flexible scenario conditions, adjusted to account for the recovery on the markets, proved useful. In this way, the agency was able to ascertain the future earnings development of the undertakings at an early stage, and then project the likelihood and extent of any improvement in their financial situation and whether or not measures were necessary to limit risk.

For the scenario-based assessments, BaFin paid special attention to evidence of hidden liabilities in the investment portfolio. According to section 341b (2) sentence 1 of the HGB, insurance undertakings are permitted to classify securities recognised at cost as fixed assets. Write-downs are only required in cases where impairment is likely to be permanent, giving rise to hidden liabilities.

BaFin also took stock of consequences from the tax models.

Another important aspect of the scenario-based assessments in 2003 was the deliberation of the Bundesbank concerning the income tax framework for personal insurers.

In the assessment of August 2003, the supervisory authority enquired specifically as to the effects of the tax models then being discussed on company performance. The same was done as part of

the November 2003 assessment, for which the agency introduced two tax scenarios alongside the share price scenarios.

Moreover, BaFin also enquired about the bonus declaration for the following financial year in the November 2003 scenario-based assessment. This enabled the agency to glean an insight into whether or not the resolution of the management was in line with the proposal of the responsible actuary and gave proper consideration to the financial situation of the undertaking.

3.1.2 Protektor Lebensversicherungs AG

Protektor took over the insurance portfolio of Mannheimer.

In financial year 2003, BaFin ordered Mannheimer Lebensversicherung AG to transfer its entire insurance portfolio to Protektor Lebensversicherung AG. Protektor was authorised to conduct business in the previous year. Mannheimer Lebensversicherung AG fell into financial difficulties in financial year 2003 due to a drastic decline in its share price and insufficient risk management. The insurance undertaking's large amount of hidden liabilities meant that the underwriting liabilities could no longer be sufficiently covered with qualified investments recognised at fair value. Additionally, the threat of high write-downs acutely jeopardised the undertaking's ability to fulfil its contractual obligations.

Protektor assumed the policies and secured the claims of policyholders.

At an on-site audit as early as October 2002, BaFin ordered the undertaking to join forces with a financially solid partner. This would have ensured coverage of the underwriting liabilities and the recovery of the undertaking. No investors were willing to take on the ailing life insurer, and Mannheimer AG Holding, the company's parent, was also unable to supply the required funding. Subsequently, Protektor received BaFin approval to take over the portfolio of imperilled insurance contracts. This meant that existing insurance claims were secured and the contracts were able to be continued.

The majority of the amount required for the rescue of Mannhemer Lebensversicherung AG was paid into capital reserves by the shareholders of Protektor according to plan and – as set forth in the commitment statement – parallel to the transfer of the portfolio. A minimal proportion was made available in a different form, but also as own funds. The projected cost of maintaining the portfolio totalled only a small percentage of the €5.5 billion guaranteed amount, or approximately 1% of investments sector-wide.

3.1.3 Lowering of the maximum interest rate

On 5 November 2003, the Federal Ministry of Finance issued the second amendment to the Mathematical Provisions Ordinance (*Deckungsrückstellungsverordnung – DeckRV*). This led to the lowering of the previously applicable maximum interest rate for new contracts from 3.25% to 2.75%. The maximum interest rate had to be lowered by 0.5% because the prevailing state of capital markets means that insurance undertakings are no longer able to achieve

high returns easily. The average running yield on public-sector bonds over the last ten years, for example, has declined considerably.

The amendment came into force as of 01 January 2004. The lowering of the maximum interest rate was taken by several insurance undertakings as an opportunity to completely revamp the rate structure for new policies.

3.1.4 Interim changes to bonus amounts

In the period under review, one life insurance undertaking switched to quarterly bonus declaration. As a result, it noticeably reduced the direct credit for a portion of the contracts during the year. BaFin disapproved of the interim bonus declaration procedure, and the undertaking switched back to annual declarations.

3.1.5 Approval of certain capital redemption operations

Numerous companies offered products during the period under review that were neither insurance business nor capital redemption operations within the meaning of section 1 (4) VAG. From a financial point of view, these products represent term deposit investments. One of the products has an unspecified contract term, with termination possible on a quarterly basis. Another product is automatically extended on a quarterly basis provided the customer takes no contrary action. A further product also permitted deposits and withdrawals during the term of the contract.

These types of capital redemption operations are only allowed when the period of time and amount of both the premiums and the assumed obligations have been determined in advance. In particular, the term of the contract must be set in advance. It is not sufficient to allow the contract to run indefinitely until the customer terminates it, or for the contract to contain a clause automatically extending it for three months at a time if the customer takes no action. BaFin has initiated two administrative procedures. In one case, the company in question has already adjusted the structure of its product. The other case is currently being heard.

3.1.6 Differentiation between life and non-life insurance business

Athlete insurance has commonly been classified as non-life insurance.

BaFin expressed its view on the classification of insurance products on many occasions over the course of the year under review. This involved the differentiation between life and non-life insurance. Many enquires were made in relation to the insurance of athletes who had to be insured by their clubs against the risk of injury during sporting events. Such policies were classed as occupational disability insurance. The financial damages incurred by the club as a result of injuries caused by accident or illness were, however, insured. Therefore, the even triggering the benefit obligation was not ultimately the athlete’s occupational disability but instead the financial obligations of the club to continue paying him/her. For this

reason, these products should be classified not as life but as non-life insurance.

3.1.7 Consumer information concerning unit-linked life insurance

Informational obligations regarding unit-linked life insurance in connection with construction loans.

Enquiries and complaints about the sale of unit-linked life insurance for the redemption of construction loans increased over the course of the reporting period. The petitions submitted were concerned as to whether or not consumers had been receiving correct, transparent and complete information. BaFin demanded corresponding consumer information from the providers of unit-linked life insurance and required companies to improve their information policies. The proceedings have not yet been concluded.

3.2 Death benefit funds

Survey only reveals additional tax expenses at two death benefit funds.

BaFin conducted a survey of the death benefit funds in September 2003. This survey provided comprehensive data on the effect that the tax non-deductibility of capital losses, as well as the write-down to the lower fair value of equities and investment fund units, as then planned by the legislature, would have entailed for the funds. A total of seven of the 45 death benefit funds subject to BaFin supervision were liable for corporation tax in 2003 and would therefore have been fundamentally affected by these changes. Only two companies actually forecasted additional tax expenses. This additional tax expenditure would have put the ability of one company to meet its solvency requirements at risk had share prices dropped further still and unrealised losses been substantially reduced.

The legislature arrived at the decision in mid-December 2003 that capital losses and the write-downs of equities and investment fund units to the lower fair value should be tax deductible to a certain extent. Alongside the encouraging stock market performance until 31 December 2003, current indications suggest that all taxable benefit funds will have met the solvency requirements in financial year 2003.

3.3 Health insurance undertakings

3.3.1 Financial situation 2003

The 55 health insurers subject to supervision by BaFin generated estimated premium income of around €25 billion in financial year 2003. This equates to a year-on-year increase of around 7%. The investment portfolio increased by some 9% on the 2002 level, up to around €96 billion.

BaFin conducted stress tests with health insurers for the first time.

By 31 March 2003, health insurance undertakings were obliged to submit the results of the stress tests to BaFin for the first time. Stress tests are a forward-looking analytical instrument which, by assuming a certain market performance, simulate the possible

impacts of critical capital market shifts on the balance sheets of insurance undertakings. A comparison of the liabilities side with the “stressed” assets side is designed to allow BaFin to determine whether or not the companies in question would still able to meet the minimum supervisory requirements in the event of critical changes on the capital markets.

Stress tests were based on two different scenarios. Scenario A simulated a 35% loss in the market value of shares and a 10% loss in that of bonds. Scenario B assumed a 20% drop in the market value of shares and a 5% drop in that of bonds.

Special reporting obligations for companies that did not pass the test scenarios.

BaFin demanded that those health insurers which passed Test B but failed the more rigorous Test A forward the test results on to all members of the management board. In the event of failure in both test scenarios, both the members of the management board and the supervisory board would be informed of the test results. BaFin also demanded that insurers with negative results demonstrate their measures, planned or already taken, for restoring the required ability to bear risk.

Survey into planned tax models and minimum interest payment.

In addition, BaFin conducted surveys of the financial situation among health insurance companies in September and November, focussing on how the non-recognition of write-downs to the lower fair value of investment fund units for tax purposes would impact on company performance. BaFin also examined whether or not companies are in a position to generate the minimum guaranteed rate on mathematical provisions of 3.5% from investment income. BaFin simulated share price scenarios based on the prevailing situation on the capital markets and different tax constellations at the end of financial year 2003, with the aim of providing an early assessment of negative outcomes for both company performance and the ability to bear risk among health insurers.

No difficulties forecasted at the moment.

According to the projected results, the financial situation settled down due to share price increases in the last few months of the year. A large portion of the hidden liabilities brought forward into 2003 was reduced. BaFin is working on the assumption that all health insurers are able to fulfil their guaranteed rate obligations.

Most health insurers generated the guaranteed rate on mathematical provisions of 3.5% from investment income alone, with only certain companies having to call upon other sources of surplus, such as income from the safety loading. Due to high write-downs, BaFin expects the net interest earned for the sector to move only slightly above the prior-year level of 4.5%.

According to book and fair value, all health insurance companies were in a position to meet the *Deckungsstock* minimum requirements with qualified investments as at 30 September 2003. BaFin is not forecasting difficulties for any health insurance companies at the present time, especially since the undertakings in question have to compare the required insurance benefits with the calculated insurance benefits on an annual basis for each rate class, which can justify an increase in premiums. In this case, the entire bases for calculation have to be examined and adapted accordingly. The bear market that has dominated the past three years will also

be reflected in the balance sheets for 2003. The companies' predicted figures suggest only a slight year-on-year increase in gross surplus after tax. Direct credits from the share in investment surplus pursuant to section 12a of the VAG and allocations to the bonus provision will therefore also increase only slightly year-on-year. This means that the funds that companies are able to provide to reduce future premium increases will change only moderately.

3.3.2 Provision for bonuses and rebates from 2002

In 2002, the bonus provision developed as follows: allocations to the bonus provision were down year-on-year due to the reduced surplus.

Table 26
Bonus provision from 2002

Items	Amount in €m	Percentage rate of change
Bonus provision as at 31/12/2001	5,212	- 10.8
Withdrawals for 2002	1,981	- 1.8
of which a) single premiums	1,129	- 13.2
b) no-claims bonuses	845	+ 18.5
c) other withdrawals	7	+ 133.3
Allocations for 2002	1,141	- 17.8
Bonus provision as at 31/12/2002	**4,372**	**- 16.1**

Taking into account the amounts pursuant to section 12a VAG and the pool-relevant CLTC surplus reported in the rebate provision, the insurers have to allocate at least 80% of gross surplus to the bonus provision. The rate of allocations for the sector totalled 92.8% in 2002, clearly exceeding the minimum requirements.

Withdrawals from the provision for bonuses and rebates declined year-on-year, with almost two thirds attributable to single premiums and one third to no-claims bonuses. This ratio shows that, as in previous years, health insurers are primarily utilising funds from the provision for bonuses and rebates in order to limit premiums.

Although there was a substantial rise in other withdrawals, these proved insignificant on the whole.

Significant reductions in the bonus provision.

Given that overall withdrawals exceeded allocations, the bonus provision suffered a substantial year-on-year decline. In 2002, the rebate provision developed as follows:

Table 27
Rebate provision from 2002

Items	Amount in €m	Percentage rate of change
Rebate provision as at 31/12/2001	2,107	- 16.6
Withdrawals for 2002	644	- 47.3
of which a) single premiums	631	- 47.7
b) no-claims bonuses	7	+ 16.7
c) other withdrawals	6	- 25.0
Allocations for 2002	520	- 43.4
Rebate provision as at 31/12/2002	1,983	- 5.9
of which: amount pursuant to section 12a (3) VAG	1,007	- 26.3
from financial year	255	- 54.5
first prior-year period	425	- 13.4
second prior-year period	312	+ 22.4

Pool-relevant surplus down substantially in 2002.

There was a negligible decline in the rebate provision in financial year 2002, as allocations were down year-on-year. These allocations include the pool-relevant CLTC surplus. In reaction to the capital market situation, a fixed interest rate of 6% is no longer required due to a change in the pool agreement. The rate of return to be applied for investment income would be based more on the average interest rate for 10-year *Pfandbriefe* at the end of the financial year. This would lead to a substantial drop in pool-relevant surplus in 2002.

In addition, these allocations would include the allocations pursuant to section 12a (3) of the VAG. These allocations represent surplus on interest earnings to be calculated for policyholders over the age of 65 years on the balance-sheet date, and are also in decline due to lower net yields and reduced net interest income. According to section 12a (2) sentence 2 VAG, the percentage to be credited from the excess yield from interest payments, pursuant to section 12a (3) VAG, falls by 2 percentage points each year.

The premiums withdrawn from the rebate provision were utilised by insurers almost exclusively for single premiums. The no-claims bonuses and other withdrawals were only minor.

The percentage share in the rebate provision, as at 31 December 2002, attributable to the premium amount from financial year 2002 and the two previous years, pursuant to section 12a (3) VAG, amounted to around 50% (2001: 61%). The corresponding share from the year under review alone totalled only around 13% (2001: 26%). If, however, the rebate provision at the end of the year under review is adjusted for the amounts pursuant to section 12a (3) VAG from the first and second preceding years produces a corresponding share of around 21% (2001: 41%). The lower year-on-year percentage shares are the result of declining allocations, brought about by lower investment income and therefore dwindling surplus on interest earnings.

3.3.3 Establishment of Medicator AG

In 2003, the eight largest private health insurers established the rescue company Medicator AG.

On 3 July 2003, the private health insurance companies established the rescue company Medicator AG, with the purpose of guaranteeing that insurance contracts are still met in the event that a private insurer finds itself in a critical financial situation. The founding members were the eight largest private health insurers in Germany, which together represent 60% of the market. The company is based in Cologne and aims at €1 billion in liable capital. The founding members have already provided around €600 million.

Unlike Protektor Lebensversicherungs-AG, Medicator has been purely a holding company up until now. The takeover of portfolios is not currently envisaged. Any necessary portfolio transfer would first require authorisation as a private health insurance company. The rescue company is only supposed to provide services – as a last resort – in the event that no market participant can be found to purchase the struggling company or assume its insurance contract portfolio.

3.3.4 New mortality table

The life expectancy of the privately insured has been on the increase for some years. For this reason, the mortality table was updated again in 2000 (2001 private health insurance mortality table).

An investigation by the association of private health insurance companies (PKV-Verband) came to the conclusion that the reliability of the 2001 private health insurance mortality table is no longer sufficient within the meaning of section 2 (3) of the Calculation Ordinance (*Kalkulationsverordnung – KalV*). For this reason, the association produced a new mortality table (2004 private health insurance mortality table), which BaFin published after carrying out its own examination.

Mortality statistics from private health insurance companies from 1992 – 2001 were provided as source data. So as to ensure that the new table would continue to provide sufficiently reliable data over the coming years, the figures were corrected by a suitable trend factor.

The various life expectancies for men and women of a given age according to the different mortality tables are indicated below:

Table 28
Life expectancy of private health insurance policyholders

	Life expectancy of male policyholders in years		Life expectancy of female policyholders in years	
Age	**2001 private health insurance mortality table**	**2004 private health insurance mortality table**	**2001 private health insurance mortality table**	**2004 private health insurance mortality table**
0	80.30	82.55	84.99	86.31
50	81.59	83.65	85.83	87.13
80	88.02	88.68	90.08	90.73

Gap closing between male and female life expectancy.

Life expectancy for both male and female policyholders of all ages rose significantly on the 2004 private health insurance mortality table. Life expectancy is still several years higher among women than men, although the gap between the two genders has closed somewhat since the 2001 private health insurance mortality table. Safety loadings have been factored into the mortality tables. Calculated life expectancy is therefore higher than the life expectancy actually observed.

Higher life expectancy leading to adjustments in premiums.

As a result of reduced expected mortality and the subsequent increase in life expectancy, the introduction of the new mortality tables will lead to an increase in premiums. BaFin used the probability tables to construct a theoretical rate, covering outpatient and stationary benefits as well as dental treatment and dental replacement, so as to be able to predict the specific impact on the premium rates. As part of this rate, BaFin calculated the premiums for new adult policyholders up to age 50 at the start of the policy based on the 2001 and 2004 private health insurance mortality tables. Costs and other surcharges were not taken into account. Applying the new 2004 mortality table produced increases in premiums for women from 0.2% to 0.9% and for men from 0.9% to 2.6%. The actual premium increase for policyholders will deviate from these computed figures. It depends on a multitude of factors, such as the age and gender of the policyholder, the level of the deductible and the term of the insurance policy.

3.3.5 Crediting of time insured

In the course of one complaint, BaFin learned of a health insurance company that, during a rate class change pursuant to section 178f VVG, failed to allow for the time insured in the previous rate. The policyholder changed from a rate class without "*Zahnstaffel*" (i.e. without a temporary cap on dental benefits) to a rate class with "*Zahnstaffel*". BaFin deemed this to be a breach of section 178f VVG. The insurer was in breach of its statutory obligation to make allowances for vested rights.

In addition, the insurer was not allowed to prescribe a waiting period as the target rate class did not provide for any additional benefits.

3.3.6 Decision of the German Federal Court of Justice in the case of "Alphaklinik"

In its judgement of 12 March 2003[89], the German Federal Court of Justice (BGH) decided that, by using the description "necessary medical treatment" in section 1 (2) MBKK 76, health insurance undertakings did not restrict their payment obligations to the least expensive treatment. Furthermore, in a departure from its previous decisions, the FCJ determined that section 5 (2) MBKK 76 only provides for the possibility for reductions in the case of excessive treatment, and not in the case of excessive compensation.

[89] File no.: IV ZR 278/01.

No more benefit reductions.

This means that health insurers are no longer able to make benefit reductions based on these provisions In reaction to this, two insurers made amendments to their general terms and conditions, citing section 178g (3) VVG.

No evidence of a cost increase, as required for amendment to the general terms and conditions.

BaFin voiced its concerns about these amendments. According to section 178g (3) VVG, any amendment to the general terms and conditions that is also applicable to in-force-business must provide grounds for the change. Pursuant to section 178g (3) VVG, grounds for amendment are deemed to exist in the event of "changes to the healthcare system that are not considered to be merely temporary", or in the event the one of the terms and conditions necessary for continuing the policy is considered invalid. BaFin does not consider the FCJ's interpretation of the MBKK to meet this requirement. The structure of the healthcare system will only change if court decisions lead to permanent, substantial increases in the costs of private health insurance. Up until now, however, insurers had only voiced "concerns" in relation to any increase in prices and expenses. BaFin has seen no evidence of a cost increase already in motion that could substantiate such concerns. In BaFin's opinion, any actual changes to the healthcare system resulting from the ruling are therefore unlikely at the present time.

3.3.7 Unilateral amendments to daily hospital allowance insurance

The State of Bavaria altered its rules regarding civil service health insurance grants during the period under review and established a deductible for elective treatment. In reaction to this, certain insurers sent their policyholders updated insurance certificates concerning daily hospital allowance insurance with the deductible included. The accompanying letter simply mentions the fact that policyholders may contest the expansion of the insurance cover. One insurer set a deadline by which any objections were to be made, and indicated that the alterations would take automatic effect in the event that no objections were made.

BaFin criticised this procedure, as simply remaining silent about a policy conversion does not necessarily signify approval. The interests of the policyholders had been jeopardised. The insurers conceded to having acted wrongfully with regard to contract law and stated that they would refrain from this sort of procedure in the future.

3.3.8 On-site inspections

No risk surcharges in the „Anwartschaftsversicherung".

BaFin carried out on-site inspections at six health insurers in 2003. During a local audit, BaFin discovered that one health insurer had established risk surcharges for the duration of the "*Anwartschaftsversicherung*" (private insurance for reinstatement of health care coverage after suspension). BaFin criticised this procedure. This kind of surcharge cannot be imposed, as there are no benefit obligations for the duration of the suspension period. The company will no longer offer insurance with these terms. As a result of the premium increases at private health insurers, BaFin performed

two special audits at the turn of the year 2002/2003. The audits addressed the issue of consumer information as well as policyholders' right to change their rate class. BaFin raised the criticism that one company increased its premiums without mentioning the policyholder's right to change rate and without providing reference to the corresponding legal text.

Insufficient consumer information.

In other respects as well, both companies failed to meet the legal requirements on consumer information.

Policyholders that have reached 60 years of age should be recommended to change to a rate class that would involve a reduction in premiums. Health insurers have to state the premiums that would be payable for these rate classes and point out the option of changing to the standard rate class. They must also indicate the conditions under which the rate class can be changed, and the premium that would have to be paid in the standard rate class. Both companies failed to meet these requirements. Neither company indicated suitable rate classes that policyholders could have changed to and that would have involved a reduction in premiums. Although they made reference to the standard rate class, neither company stated the set amount that would have to be paid. Both insurers confirm that they will take these legal requirements into account in future.

In one instance, the on-site inspection ultimately revealed that the company had turned down numerous applications by policyholders to change their rate class according to section 178f of the VVG. The reasoning given in this case was that either the upper entry age for the rate class applied for had already been exceeded, or the previous claims experience was poor. This conduct was also met with reproach by BaFin. The company will not issue any more rejections of this nature.

3.4 Property and casualty insurance undertakings

High losses from insurance business and tension on the capital markets led to supervisor actions.

High losses from insurance business and tension on the capital markets demanded special attention from BaFin, and led to supervisory action being taken in 2003 against and casualty insurance companies, too. BaFin demanded that the affected companies submit interim financial statements, liquidity overviews, interim solvency certificates and calculations of coverage, and that they provide reports on both planned and executed restructuring measures. The call for capital injection was just as necessary as the call for the submission of solvency plans.

3.4.1 On-site inspections

BaFin also carried out on-site inspections of a selection of property and casualty insurers in 2003. The audits focussed on the underwriting result and the total result, technical provisions, reinsurance contracts, investments, own funds requirements, accounting, risk management system and the allocation of costs.

With regard to the underwriting results, BaFin carried out particularly discriminatory investigations into the causes of the extremely high gross, as well as net, losses. The primary reasons were high natural peril losses as well as disadvantageous cooperation and reinsurance agreements. BaFin demanded that the affected companies take suitable measures to improve their results and that they provide related reports.

Flat-rate increases or reductions on the provisions relating to individual claims are not permitted.

With regard to provisions for claims outstanding, BaFin discovered on several occasions that certain companies were carrying out flat-rate reductions on the individual claims provisions following the more realistic tax accounting valuation. Flat-rate increases and reductions on the provisions relating to individual claims, however, are not compatible with the concept of item-by-item valuation and are therefore not permitted. Tax criteria in particular, such as the more realistic valuation, do not justify a reduction of the loss provisions in the annual financial statements, which are prepared according to the German Commercial Code.

With regard to the partial loss reserve for claims incurred but not reported, the criteria for the projections were not always stated in sufficiently specific terms.

To a certain extent, BaFin criticised the partial loss reserve for claims incurred but not reported (IBNR). The forecasting procedure applied in one case was clearly unsuitable due to various deficits. In addition, the criteria upon which the forecasting procedure was based were not always sufficiently specific, and adequate documentation was not always provided. The same applies for flat-rate increases whose calculation cannot be readily ascertained. In addition, BaFin pointed out that the partial loss reserve for claims incurred but not reported are to be stated under the provision for claims outstanding.

In one case, BaFin criticised that an insurer, while determining the partial loss reserve for claims settlement expenses, was calculating the number of unknown claims incurred but not reported by means of a flat-rate surcharge procedure.

The anticipated number of claims incurred but not reported, however, is already ascertained during the calculation of the IBNR reserve.

No losses, at least overall, are allowed to materialise in settlement of provisions.

BaFin made reference to the fact that the results of actuarial procedures are also to be included, for objectivity purposes, as part of the assessment of whether or not the provisions for claims outstanding are appropriate. In this case, the individual partial reserves should be set at an amount sufficient enough to ensure that no losses – at least overall – materialise in the settlement of provisions.

One company based the calculation of its equalisation provision on an inappropriate observation period. The expense ratio was also calculated incorrectly.

The coverage of restricted assets has to be guaranteed at all times.

In terms of investments, BaFin discovered examples of failure to comply with disclosure, reporting and communication requirements[90].

[90] cf. Circular R 3/00 and R 30/2002 (VA).

Individual insurers also failed to adhere to the provisions on the mix and spread of assets. In certain cases, the minimum requirement for restricted assets was not met by sufficient qualified assets; this was partly due to high levels of receivables outstanding. The minimum requirement for restricted assets must be met in full at all times. BaFin made it clear that all of the assets allocated to the restricted assets must comply with the investment principles set out in section 54 (1) sentence 1 VAG, as well as with the relevant qualification criteria of the Investment Ordinance. This means that loss-making participating interests or holding companies with no operating business do not meet these requirements. In one case, the reduction of the minimum requirement, pursuant to section 54 (1) sentence 5 of the VAG, was erroneous. Reductions are only permitted provided that receivables are matched by liabilities from the same reinsurance contracts.

Incomplete and incorrect information given in the notes, for example concerning the fair value of the parent company, have led to accounting objections. In many cases, "Formblätter" (forms) and "Nachweisungen" (documentary proof) according to the BerVersV were filled out incorrectly. BaFin pointed out that only expenses incurred in the provision of services are to be reported under other expenses. By contrast, expense allowances to the independent agent sales force should be included in the commissions and other remunerations of representatives.

The risk management system should contain supervisory requirements and be subject to internal audit.

In some cases, the risk monitoring system required by section 91 (2) of the AktG was still under construction. BaFin received reports of further measures relating to this matter and pointed out that supervisory requirements should be integrated into the system, in particular those relating to solvency and the coverage underwriting liabilities. As a key controlling tool, the internal audit should also be extended to cover the risk management system. In addition, a functioning risk monitoring system requires that the findings of such audits be communicated to the relevant units of the company, such as the department responsible for investments and claims.

Criticism was also levelled at the distribution of costs. For example, either no allocation ratio was applied or the ratios used were outdated or unrelated. One third accounting for claims payments and two thirds accounting for the number of processed claims is the allocation ratio recognised for claims settlement expenses.

3.4.2 Insurer insolvencies

Insolvency proceedings at ANTRA.

In financial year 2003, the Managing Board of ANTRA Niederelbe-Trampfahrt Versicherungs AG (ANTRA) notified BaFin of the fact that it was overindebted. The Local Court (Amtsgericht) then opened preliminary insolvency proceedings against ANTRA's assets at BaFin's request. ANTRA is a special insurance company whose policyholders consist solely of merchants (reeders) that were able to obtain insurance cover elsewhere in the short term. The preliminary insolvency proceedings are still underway.

Insolvency proceedings at N.V. Waarborgmij.

Insolvency proceedings against the assets of the Dutch insurer N.V. Waarborgmij. S.G.W.N., Zutphen, which is registered as authorised

to conduct direct business via branches in the Federal Republic of Germany, were opened in the Netherlands on 31 October 2003. The company sold guarantee insurance in Germany. It provides guarantees for construction companies, with regard to completion and acceptance, for example, for the benefit of property developers. The company sold a product called "fully comprehensive cover for property developers" and became insolvent after a substantial number of claims were made against it as a result of guarantees for bankrupt construction companies. S.G.W.N's branch had insured a number of very large-scale construction projects. The Dutch insurance supervisory authorities had already prohibited the company from taking on any new business in April 2003.

3.4.3 Pension provisions

German property and casualty insurance companies had pension reserves of €1.78 billion (previous year: €1.58 billion) as at 31 December 2002. All of the 109 property and casualty insurers under BaFin supervision that had set up pension reserves provided the agency with the report of the responsible actuary for financial year 2002. Nine insurers had to be asked to submit the report. One responsible actuary only prepared the report following an official request to do so.

105 insurers use the DAV 1997 HUR mortality table, while three use the more conservative DAV 1994 R. One insurer, as well as using the DAV 1997 HUR table, has partly been using the out-of-date 1987 R table. The insurer in question has since announced that it will be changing the tables it uses.

51 insurers discount their total pension reserves at a rate of 3.25%. 57 insurers used the continuity principle and discounted part of their pension provisions at a rate of 3.5% or 4%.

One insurance company used a rate of 2.5%.

Examination of the actuarial reports mainly revealed violations due to missing information, the use of the wrong differentiation criteria for the technical interest rate, or confirmation texts that were incomplete in terms of content.

In addition to the pension reserves and the premium reserve for accident insurance with premium refund, a small number of insurers set up further mathematical provisions, mainly for paid-up accident insurance policies for the children of deceased policyholders. One insurer set up mathematical provisions for household insurance, while another set up mathematical provisions for unemployment insurance.

3.4.4 Accident insurance with premium refund

At the end of 2002, BaFin supervised a total of 24 insurance companies that sold accident insurance with premium refund (previous year: 26 companies). One insurance company started

conducting business for the first time in 2002, while three companies merged with other insurers providing accident insurance with premium refund.

Bonus

BaFin once again raised questions with certain insurance companies with regard to the bonus paid for accident insurance with premium refund. These related to the cross-subsidising of new business with in-force business, the participation of policyholders in all sources of surplus, consumer information, and the clauses of the insurance terms and conditions relating to bonuses.

Premium breakdown

The premiums for accident insurance with premium refund are broken down into an accident insurance component and a life insurance component, which are then allocated to the relevant accident insurance or life insurance obligations. The GDV approached BaFin with a suggested method for constructing accident insurance policies with premium refund that aims to use profit margins from the accident insurance component of the premium to help finance the insurer's life insurance obligations. BaFin has its doubts with regard to this method of breaking down premiums and believes that the part of the premium that is intended to fulfil life insurance obligations should be regarded as the life insurance component.

Deckungsstock minimum requirement

BaFin's examinations revealed that, at a number of insurers, not all of the components set out in section 66 (1a) of the VAG had been taken into account in determining the required *Deckungsstock* for accident insurance with premium refund. This meant, for example, that unearned premiums, provisions for policy surrender and credited bonus amounts were not taken into account. BaFin ordered the insurers to determine the required Deckungsstock in full in the future.

3.4.5 Motor vehicle insurance

Discrimination against foreigners in motor vehicle liability insurance

In its 2002 Annual Report, BaFin reported that some insurers were taking the country in which the licence holder obtained his/her licence into account when concluding insurance policies. The companies then rated the policyholders more unfavourably based on the country in which they had obtained their licence, or in some cases demanded that they pay supplements. These policyholders were not allowed discounts either.

BaFin discussed this issue in detail with the GDV and a consensus has been reached that discrimination against foreigners is generally prohibited (see section 81e VAG). This means that companies are forbidden from demanding extra payments, denying discounts or terminating policies on the basis of nationality alone. Furthermore, BaFin and the GDV were agreed that in order to prevent indirect discrimination, insurers must provide evidence to show that both the reason for differentiation and the amount of the disadvantage arising from the differentiation are justified from an underwriting point-of-view. BaFin also believes that, as a general rule, statistical methods should be used in order to show that differentiations are justified in terms of both grounds and amount. As far as motor vehicle insurance is concerned, insurers must also strictly observe the obligation to take on parties requiring insurance (section 5 of the Compulsory Insurance Act (*Pflichtversicherungsgesetz – PflVG*).

These conditions are not considered to be fulfilled if the first-time acquisition of a driving licence in a country other than Germany leads to long-term and substantial disadvantages. Holders of the driving licence from a country other than Germany have to obtain a German driving licence within a period of six months. This procedure usually entails a test. As a general rule, driving licences from EU/EEA member states may not be subjected to any differentiating criteria, due to the harmonisation in driving licence regulations. The insurers concerned have already altered their terms and conditions at BaFin's request, with only a few exceptions. BaFin will continue to urge companies to comply with section 81e of the VAG.

Overall annual statistics in motor vehicle liability insurance

In 2002, BaFin once again published the overall annual statistics on claims experience in the area of motor vehicle liability insurance. As in the previous year, the GDV was responsible for collecting the annual statistics in 2002. It provided BaFin with the data necessary for publication. BaFin discussed the quality assurance measures implemented during the preparation of the annual statistics for 2002 with the GDV.

The annual statistics for 2002 contain 99.3% of the total market volume[91].The number of risks covered increased by 1% to €51.6 million units per year. The claims expenses for these risks fell in 2002 – unadjusted for portfolio changes – by 3% to €246.

Foreign business of German motor vehicle liability insurers

The foreign business of those insurers supervised by BaFin was low again in 2003. The companies concerned generated gross premiums written of €57.4 million via branch offices and the provision of cross-border services. The gross claims ratio amounted to 129%.

[91] Measured in terms of premiums written.

3.4.6 Liability insurance

Railway

The owners of railway vehicles are obliged to take out liability insurance even if the vehicles are not independently involved in railway operations[92].The liability insurance covers personal injury and property damage as a result of an accident. The minimum sum insured is approximately €10.2 million per claim. It must be available at least twice in any given insurance period[93].

Auditors

Even auditors that belong to mixed firms must furnish evidence of professional indemnity insurance[94] The same applies to auditors that have concluded their insurance policies in their country of origin and that are authorised to work as auditors in Germany following a fit and proper test[95].

Weapons law

Operators of shooting ranges now have to take out liability insurance. The sum insured must amount to €1 million for personal injury and property damage, €100,000 for accidents resulting in death and €100,000 for accidents resulting in invalidity. Section 27 (1) sentence 2 of the Weapons Act (*Waffengesetz – WaffG*) states, among other things, that evidence must be provided of "insurance against personal liability totalling €1 million with an insurer authorised to conduct business within the scope of the WaffG".

[92] cf. the amendment to the Ordinance on Railway Liability Insurance (Verordnung über die Haftpflichtversicherung der Eisenbahnen – EBHaftPflV) dated 21 June 2002 (BGBl. I p. 2191).
[93] Further information can be found at www.eisenbahn–bundesamt.de.
[94] Section 10 of the Act dated 26 October 2003 (BGBl. Part I p.2074 [2079]) and Section 10 of the Act dated 1 December 2003 (BGBl. I p. 2446 [2463]).
[95] Section 131g (1) of the Auditors Act (Wirtschaftsprüferordnung – WPO).

3.5 Reinsurance undertakings

BaFin was able to include the annual financial statements of 41 (previous year: 35) reinsurance undertakings, which included 31 public limited companies, one mutual insurance association, three insurance undertakings under public law and six limited liability companies, into its reporting for financial year 2002, or 2002/2003. Two companies submitted erroneous figures.

3.5.1 Financial situation

The number of natural catastrophes in 2002 greatly exceeded the long-term average.

As a reporting period, 2002 was one of the worst ever financial years for professional reinsurers. The determining factor in this context was the downward movement on the capital markets, which not only led to a collapse in ordinary income, but also to massive write-downs. The underwriting result for reinsurers was once again impeded by numerous, and to a certain extent extraordinary, major losses, for example in non-life insurance with the flooding in Central Europe (dubbed by the German media as the "once-in-a-century flood"), the spring tornados in the USA, hurricane "Isidore" in the Caribbean and the West European wind storm "Jeanett". The impact of international accounting scandals among industrial companies, as well as massive increases in reserves, put an additional strain on the reinsurance market. A combination of several pressure factors even led one major company to halt new business in the area of property/casualty insurance.

By contrast, the markets hardened in financial year 2002, thus reinforcing the premium increases already introduced the previous year.

Gross claims ratio

The overall burden from the area of non-life insurance dropped to 71% of premiums.

The gross claims ratio before settlement dropped substantially from 81.6% to 61.2% of gross premiums earned. The renewed poor settlement result for claims from previous years did, however, place a burden on the claims ratio. The overall burden from the area of non-life insurance, i.e. including the settlement results, dropped to 71.0% from 92.2% in the prior-year period. Retrocession income was slightly negative. There was a substantial decline in net losses year-on-year, but an increase in the equalisation provision was required.

Reinsurers' costs improved year-on-year, with the gross expense ratio for overall business falling from 30.2% to its current level of 27.3%, meaning that the lower level recorded in the previous years could once again be achieved. The reinsurers' combined ratio dropped substantially to 98.3% (previous year: 122.4%) as a result of claims development.

3.5.2. Premiums situation

Reinsurance cover is not only provided by reinsurers, but also by primary insurers.

The gross premiums written from inward reinsurance business were divided between re- and primary insurers as follows.

Table 29
Gross premiums in reinsurance business

Gross premiums written	Reinsurance IU	Primary IU (inward reinsurance)	Total
Year	€m	€m	€m
2002	54,699.0	3,572.9	58,271.9
2001	45,459.9	3,382.3	48,842.2
2000	40,011.9	3,175.5	43,187.4
1999	35,595.7	2,637.7	38,233.4
1998	32,113.1	2,486.6	34,599.7

Reinsurers expanded their share in total reinsurance business further.

The above-average increase in premiums of 20.3% among the 41 reinsurers, in contrast to 5.6% among primary insurers, boosted the proportion of insurance business covered by reinsurers from 93.1% to 93.9%. The proportion of primary insurers active in reinsurance dropped from 183 to 175 insurance undertakings in the year under review. 35 of these companies were life insurance undertakings and 15 were health insurance companies.

In net terms, reinsurance business makes a positive contribution to Germany’s services account.

The premium income from inward reinsurance business relating to German primary insurers rose significantly by 7.1% (previous year: 3.3%); at the same time, overseas business shot up once again by 30.9% (previous year: 23.5%). As a result, the proportion of inward reinsurance business relating to foreign primary insurers continued to rise to its present level of 60.4% (previous year: 55.5%). The growth in premiums still clearly originated from abroad in this case.

At €32.7 billion, the insurance business from foreign-based companies reinsured by German insurance undertakings was significantly larger as a proportion of gross premiums earned than the €8.8 billion of domestic business reinsured abroad. This means that German insurers provided the global reinsurance market with more capacity than they required themselves – a net result that contributed to Germany’s service balance surplus.

€4.0 billion of reinsurers’ gross premiums written contributed to facultative reinsurance, with €50.6 billion attributable to obligatory reinsurance. At 79.1%, proportional reinsurance in the form of quota share and surplus treaties comprised the majority of overall gross premiums written.

The composition of professional reinsurers' gross premiums written, split into individual insurance classes, is as follows.

Table 30
Gross premiums of reinsurers by insurance class

Insurance classes	2002	2002	2001	2000	1999
	Gross premiums written in €m	as % of gross premiums written			
Accident insurance	2,074.2	3.8	3.3	3.9	4.0
Liability insurance	6,962.8	12.7	9.3	8.5	9.1
Motor vehicle insurance	8,102.4	14.8	17.5	19.3	19.0
Aviation insurance	1,807.4	3.3	2.7	2.4	2.4
Legal expenses insurance	384.0	0.7	0.8	1.0	1.0
Fire insurance	9,744.2	17.8	15.9	14.8	14.7
Burglary/theft insurance	224.7	0.4	0.5	0.6	0.7
Water damage insurance	56.3	0.1	0.1	0.1	0.2
Plate glass insurance	59.5	0.1	0.1	0.1	0.2
Storm insurance	721.3	1.3	1.4	1.2	1.2
Comprehensive household insurance	426.7	0.8	1.0	1.1	1.3
Comprehensive buildings insurance	922.1	1.7	2.0	2.2	2.4
Hail insurance	679.6	1.2	1.0	1.1	1.2
Livestock insurance	76.8	0.1	0.2	0.1	0.1
Engineering insurance	2.210.3	4.0	4.6	4.1	3.9
Omnium insurance	1.3	0.0	0.0	0.0	0.0
Transport insurance	2,412.6	4.4	4.6	4.4	4.4
Credit insurance	1,799.4	3.3	3.3	3.2	3.4
Extended Coverage	456.3	0.8	1.0	1.0	1.2
Business interruption insurance	547.1	1.0	0.9	1.0	1.1
Assistance benefits	9.2	0.0	0.0	0.0	0.0
Aviation liability insurance	787.6	1.4	1.3	0.5	0.5
Other	1,068.4	2.0	2.2	2.2	2.1
Property/casualty insurance business	**41,534.2**	**75.9**	**73.7**	**72.8**	**74.2**
Life insurance	11,176.5	20.4	22.7	22.7	21.5
Health insurance	1,988.2	3.6	3.6	4.5	4.4
Total volume of insurance business	**54,699.0**	**100.0**	**100.0**	**100.0**	**100.0**

Changes in the premium composition within the sector as a whole related primarily to general liability insurance (+ 3.4%), motor vehicle insurance (- 2.7%) and life insurance (-2.3%). The share of overall premiums attributable to property and casualty insurance rose by 2.2%, which was clearly the result of the increase in premiums in general liability insurance (+ 3.4%) and fire insurance (1.9%). Most of the premium growth in the fire insurance segment, as well as in several other industry-focused insurance classes, is likely to be generated from premium increases in this business segment.

Reinsurers ceded €12.7 billion from their gross premiums written of €54.7 billion to retrocessionaires. This put the retrocession ratio at 23.3% (previous year: 26.8%). The gross and net premiums earned for reinsurers in reporting year 2002 can be found broken down by insurance class in Appendix 9, Table 641.

3.5.3 Technical provisions in the individual insurance classes

Gross technical provisions rose by €8.3 billion (6.8%) to €130.6 billion. Measured in terms of gross premiums earned, the provisions ratio for overall business dropped from 278.6% to 244% year-on-year. Whilst unearned premiums increased by €0.6 billion (7.5%), the mathematical provisions rose by €3.0 billion (7.5%) and the provision for claims outstanding by €3.1 billion (4.6%).

At €70 billion, the provision for claims outstanding is still the most significant by a considerable margin, ahead of the mathematical provision (€42.3 billion). Overall, these provisions have risen by 38.9% (i.e. €19.6 billion) since 1999, and have now reached a ratio of 131.4%.

The equalisation provision amounted to €8.5 billion (previous year: €6.5 billion) at the end of the year under review. This equates to 20.8% of net premiums earned.

As in the previous year, life insurance accounted for the largest proportion of overall technical provisions. Provisions in this insurance class amounted to €43.3 billion (33.1% of overall provisioning), €39.0 billion of which were mathematical provisions. The largest proportions of technical provisions in non-life insurance were: €25.0 billion in general liability insurance (19.1% of provisions), €18.0 billion in motor vehicle insurance (13.8%) and €14.5 billion in fire insurance (11.1%).

Further details can be found in Appendix 9, Tables 630 and 631.

3.5.4 Total underwriting result

The underwriting results of the professional reinsurance undertakings are set out in the following table.

Table 31

Underwriting result of the individual classes

Insurance classes	2002 €m	2002 as %of the corresponding premiums earned	2001	2000	1999
Accident insurance	98.2	4.9	+ 4.1	+ 3.9	+ 0.5
Liability insurance	- 1,565.9	- 23.4	- 38.2	- 10.3	- 2.2
Motor vehicle insurance	- 5.6	-0.1	- 2.4	- 11.9	- 12.7
Aviation insurance	579.4	31.8	- 125.8	- 1.0	- 28.8
Legal expenses insurance	- 8.3	- 2.2	+ 4.4	+ 7.1	+ 5.0
Fire insurance	- 16.1	- 0.2	- 75.1	- 18.3	- 43.3
Burglary/theft insurance	- 15.6	- 6.8	+ 0.7	+ 3.8	+ 3.3
Water damage insurance	- 17.4	- 29.9	- 2.6	- 4.5	+ 8.8
Plate glass insurance	4.2	7.1	+ 6.5	+ 20.2	+ 18.8
Storm insurance	58.9	8.3	+ 2.0	- 9.1	- 142.3
Comprehensive household insurance	7.3	1.7	+ 4.3	+ 13.0	+ 2.8
Comprehensive buildings insurance	- 386.6	- 41.9	+ 5.6	+ 1.7	- 40.5
Hail insurance	- 57.2	- 8.6	- 2.4	- 10.7	- 17.1
Livestock insurance	6.2	8.2	+ 10.5	+ 8.6	+ 15.2
Engineering insurance	- 41.8	- 2.0	- 21.9	- 17.9	- 14.8
Omnium insurance	-0.3	- 20.1	+ 32.1	+ 28.4	- 18.2
Transport	14.2	0.6	- 48.6	- 24.8	- 22.6
Credit insurance	- 378.2	- 21.9	- 17.0	+ 7.6	+ 10.1
Extended Coverage	- 182.1	- 40.0	+ 3.9	- 22.4	- 54.0
Business interruption insurance	61.4	11.5	- 72.4	- 4.4	- 30.0
Aviation liability insurance	0.0	- 0.2	+ 18.9	+ 17.2	+ 2.9
Aviation liability insurance	454.4	57.4	- 269.2	- 0.3	- 4.5
Other	- 437.6	- 40.2	- 16.1	- 2.9	+ 8.0
Property/casualty insurance business	**- 1,828.6**	**- 4.5**	**- 35.4**	**- 10.2**	**- 19.7**
Life insurance	251.7	2.3	- 0.4	- 2.6	- 0.5
Health insurance	-19.7	- 1.0	- 7.7	- 7.3	- 11.3
Overall insurance business Gross result	- 1,596.6	- 3.0	- 26.2	- 8.5	- 15.2
Retro result	-706.1	- 5.7	+ 44.8	+ 5.0	+ 27.0
Net result 1	**- 2,302.6**	**- 5.6**	**- 19.2**	**- 9.8**	**- 11.2**
Changes in the provision for impending losses	136.4	0.3	- 0.1	+ 0.1	- 0.2
Change in the equalisation provision[1]	- 2,037.7	- 5.0	+ 0.7	- 0.2	+ 2.9
Net result 2	**- 4,203.9**	**- 10.2**	**- 18.6**	**- 9.9**	**- 8.4**

[1] including similar provisions

Reinsurers recorded significantly lower gross underwriting losses in 2002.

As in the previous year, reinsurers endured a gross underwriting loss, this time amounting to €1.6 billion, (3.0% of gross premiums earned). This represents a significant year-on-year improvement in results. Nevertheless, only 18 of 41 reinsurance undertakings recorded a gross underwriting profit for the year under review. In 2002, primary insurers also generated a gross underwriting loss from reinsurance business of €0.2 billion (5.1% of gross earned premiums).

Inward reinsurance business relating to German primary insurers produced a gross underwriting loss totalling €1.7 billion in 2002 (7.6% of domestic premiums earned).

Professional reinsurers achieved a modest gross underwriting profit of €0.1 billion from inward reinsurance business relating to foreign-based primary insurers (0.2% of premiums earned abroad). With a balance of €-0.7 billion (-5.7% of reinsurance premiums earned), the retrocession did not help generate any improvement in results – especially in comparison to the previous year. The reinsurers were left with a net underwriting result of €-2.3 billion, which equates to –5.6% of net premiums earned (previous year: €-6.1 billion; –19.2%).

The equalisation provision, as well as the nuclear plant and pharmaceutical provisions, which serve to foster risk equalisation over time, had to be augmented by €2,037.7 million (5.0% of net premiums earned) in the year under review. €136.4 million (0.3% of net premiums earned) was drawn from the provision for impending losses. The net underwriting result 2[96] amounted to €-4.2 billion (-10.2% of net premiums earned), i.e. significantly below the prior-year level (€-5.9 billion; -18.6%).

The net underwriting result generated in the year under review, both before and after changes in the equalisation provision and similar provisions per insurance class, can be found in Appendix 9, Table 641.

3.5.5 Unappropriated profit

Investment volumes rose by 18% in 2002 to around €194 billion, with a running yield of 5.6%.

Table 32 represents the composition of the reinsurers' unappropriated profit in relation to the net premiums earned.

The investment volumes of reinsurance undertakings (including deposits with ceding insurers) increased by 18.1% to €194.4 billion (previous year: €164.6 billion) in reporting year 2002. Current investment income[97] increased by €1.4 billion to €10 billion (24.4% of net premiums earned). The running yield on the average investment portfolio (including deposits with ceding undertakings) totalled 5.6%.

Income from participating interests and shares in affiliated companies formed the most significant share of investment income, at almost 50%.

21.5% of current investment income originated from interest on deposits with ceding insurers. Income from participating interests and shares in affiliated companies, i.e. from interest on loans and profit distributions, accounted for a further 45.3%. Income from bearer bonds and fixed-interest securities also accounted for a substantial share (12.5%), as did income from equities, investment fund units and other variable yield securities, with a share of 14.8%. Current investment expenses, i.e. standard depreciation and administrative expenses, rose by €948.9 million to €2.3 billion.

[96] i.e. the loss after the involvement of the retrocessionaires and changes due to additions to or withdrawals from the equalisation provision, as well as the provision for impending losses.

[97] including technical interest to be calculated in the underwriting section of the profit and loss account, albeit not including income from the disposal of investments as well as write-ups and releases of the special reserve.

Table 32

Elements of unappropriated profit

Item	2002	2002	2001	2000	1999
	€m	as % of net premiums earned			
1. Net underwriting result 1	2,302.6	- 5,6	- 19.2	- 9.8	- 11.2
9. Special allocation to provision for claims	- 214.6	- 0,5	- 0.8	- 0.9	- 1.0
2. Change in the equalisation provision, etc.	2,037.7	- 5,0	+ 0.7	- 0.1	+ 2.9
3. Net underwriting result 1a	4,555.0	- 11.1	- 19.3	- 10.9	- 6.7
(4. Current investment income[1])	+ 7,873.0	+ 19.2	(+ 19.9)	(+ 20.5)	(+ 19.5)
(5. Current investment expenses)	- 2,295.7	- 5.6	(- 4.2)	(- 3.7)	(- 2.9)
6. Current net investment income[1]	+ 5,577.3	+ 13.6	+ 15.7	+ 16.8	+ 16.0
7. Other income from ordinary activities	- 1,684.2	- 4.1	- 2.4	- 2.7	-2.3
8. = Operating result	- 661.8	- 1.6	- 6.1	+ 3.2	+ 5.0
10. Extraordinary result (incl. provision for impending losses)	+ 6,45.1	+ 15.7	+ 7.2	+ 6.0	+ 4.6
11. = Annual result before taxes	+ 5,791.2	+ 14.1	+ 1.1	+ 9.2	+ 9.7
12. Taxes					
13. = Annual result after taxes	+ 5,373.9	+ 13.1	+ 1.0	+ 7.5	+ 5.5
14. Profits or losses carried forward	- 112.1	- 0.3	+ 0.0	+ 0.1	+ 0.7
15. Change in reserves	2,39.9	- 5.7	+ 1.4	- 1.7	-2.4
16. = Unappropriated profit	+ 2,921.9	+ 7.1	+ 2.4	+ 5.9	+ 3.7

[1] without unallocated investment income (2002: €2.2 billion)

The net running yield on the average investment portfolio – including deposits with ceding insurers – amounted to 4.3%.

Overall, reinsurance undertakings generated €7.7 billion (18.8% of net premiums earned) in current net income[98] from investments in 2002. The net running yield on the average investment portfolio, including deposits with ceding insurers, amounted to 4.3%.

Accounting for all other income from investments[99] produces total investment income of €13.2 billion. The net running yield on the average investment portfolio, including deposits with ceding insurers, amounted to 7.3%.

An overview of the performance of individual types of investments can be found in Appendix 9, Table 610.

The net result from currency transactions saw a substantial improvement, totalling almost €195 million.

At €-1,684.2 million (-4.1% of net premiums earned), the other income from ordinary activities in the general section of the income statement exceeded the prior-year level by a considerable extent (previous year: €–779.3 million, equating to –2.4%). At €194.6 million, the net result from exchange gains and losses was up substantially year-on-year (€-191.2 million). Alongside various other items, the income from ordinary activities includes interest expenses amounting to €541.8 million.

[98] Current investment income less current investment expenses including unallocated investment income/expenses.

[99] Disposal gains, write-ups and income from the release of the special reserve totalling €19.9 billion, as well as other expenses such as disposal losses, extraordinary depreciation and assumption of losses amounting to €14.4 billion.

The operating result improved from €-1.9 billion to €-0.7 billion.

The operating result[100] improved year-on-year to €-661.8 million (-1.6% of net premiums earned; previous year: €-1,946.3 million). The operating result was influenced primarily by changes in the net result.

Net profit for the year before tax reached almost €5.8 billion.

The extraordinary result[101] amounted to €6.5 billion (15.7% of net premiums earned). The provision for impending losses declined by €136.4 million. The net result from the disposal of investments came to €18.4 billion. Extraordinary depreciation rose significantly to €12.1 billion. Only modest levels of extraordinary income were generated in 2002. Combined with the operating result, the net profit for the year before tax amounted to €5,791.2 million (14.1% of net premiums earned).

Unappropriated profit amounted to €2.9 billion, or 7.1% of premiums, after allocations to the reserves and profits or losses carried forward.

The net profit for the year after tax amounted to €5,373.9 million (13.1% of net premiums earned). Taking into account the allocations of €2,339.9 million (5.7%) to the reserves, and the losses carried forward of €112.1 million, the resulting unappropriated profit amounted to €2,921.9 million for the reinsurance sector as a whole (7.1% of net premiums earned; previous year: €776.8 million, i.e. 2.4%).

As in the previous year, of all of the reinsurers included in the assessment, twelve companies reported a net loss for the year and eleven of them an unappropriated loss (previous year: seven insurers).

3.5.6 Own funds

Reinsurers' own funds rose substantially to their current level of above €40 billion.

Reinsurers' available capital not including subscribed capital unpaid rose by €8.8 billion to €40.2 billion (+27.8%) in the year under review. The increase was thus more striking than in the previous year (+25.4%). The (overall) own funds ratios rose in line with a 20.3% growth in premiums: from 69.5% to 73.8% measured in terms of gross premiums written, and from 95.0% to 96.2% as a percentage of net premiums written. In contrast to property and casualty insurers, the own funds ratios are substantially higher among reinsurers. The gross capital ratio among property and casualty insurers in 2002 totalled 42.5%, or a ratio of 57.9% in relation to net premiums.

Competition also drove reinsurers to maintain appropriate own funds.

Although reinsurers have not yet been subject to legally-binding quantitative own funds requirements, BaFin is already currently monitoring their ability to meet reinsurance contracts at all times (section 1a of the VAG); this can only be guaranteed by providing sufficient own funds backing for business. On the other hand, pressure from competitors is also forcing reinsurers to maintain appropriate own funds.

[100] Total of the current net investment income, the other income from ordinary activities and the net underwriting result 1 a (after special allocation to the provision for claims outstanding, after equalisation provision but before the provision for impending losses).
[101] Essentially: changes in the provision for impending losses, net result from the disposal of investments, write-ups and changes to the special reserve.

The creditworthiness of reinsurers – a key issue for primary insurers – is also dependent on healthy own funds in particular. At the present time, only reinsurers that have the legal form of mutual insurance associations are already subject to the same quantitatively determined solvency requirements as primary insurers. As in previous years, there was only one mutual insurance association providing reinsurance that was therefore subject to this form of solvency control. The unfavourable business situation led to a reduction in the own funds basis for several reinsurance undertakings. As a result, the number of reinsurers that would be unable to meet primary insurer solvency requirements rose to seven companies. As is the case with primary insurers, this assessment only included own funds openly reported on the balance sheet. Accounting for eligible portions of the special reserve, as well as (long-term) hidden reserves in the investment portfolio, produces correspondingly higher levels of reinsurers' own funds.

3.6 Occupational retirement provision

Pensionkassen and pension funds[102] – both external occupational retirement provision vehicles – started to boom back in 2002. This was thanks not least to the legislature, which revised the statutory regulations in their favour in 2001. This upward trend continued in 2003. BaFin issued five *Pensionskassen* and five pension funds with authorisation to conduct business in the year under review. The initiators of these undertakings all opted to form public limited companies (*Aktiengesellschaft- AG*). One further authorisation procedure ended with the pension fund in question withdrawing its application. As of the end of the year, four applications were still pending for Pensionskassen and pension funds respectively.

Pensionskassen are currently the favourite vehicle for occupational retirement provision. Newly-formed *Pensionskassen* performed well last year. The same applies to existing *Pensionskassen* that introduced new rates. Pension funds, on the other hand, have yet to meet expectations. Both total premium income and the number of beneficiaries remained low. This could also be due to the fact that share prices have fallen considerably over the past few years. At the moment, the downward trend on the stock markets would appear to have turned the intended advantages of more liberal investment regulations into more of a disadvantage due to the risks connected with them. Unlike for insurance undertakings, pension funds do not have to adhere to quantitative upper limits with regard to the mix of their restricted assets.

[102] In accordance with the VAG, pension funds are not insurance undertakings, but are subject nonetheless to insurance supervision. In the main, they are subject to the same or similar legislation as insurance undertakings.

3.6.1 Pensionskassen

Economic situation in financial year 2003 and outlook

Only 29 of a total of 154 *Pensionskassen* – almost one fifth – made use of the option provided in section 341b of the HGB, which allows securities to be considered as fixed assets and reported at a value that exceeds the fair value. This meant that the vast majority of *Pensionskassen* started financial year 2003 with no hidden liabilities.

In 2002, hidden liabilities amounted to €938.8 million. This corresponds to 1.3% of the investments made by all *Pensionskassen*, or 3.0% of the investments made by the *Pensionskassen* with hidden liabilities. The hidden liabilities were offset by hidden reserves in the investments of all *Pensionskassen* (reported at cost) totalling €2,759.5 million: this meant that the *Pensionskassen* had a total of €1,820.7 million in hidden reserves in the investments reported at cost, which corresponds to 2.5% of the book value of all investments.

In financial year 2003, BaFin ordered all *Pensionskassen* with what appeared to be inadequate ability to bear risk to submit forecast statements. BaFin then used these forecast statements to assess whether or not certain capital market developments could cause these undertakings to have problems complying with the supervisory regulations on the coverage of underwriting liabilities and on solvency. BaFin has asked certain undertakings to improve their ability to bear risk.

The economic situation of the *Pensionskassen* improved in financial year 2003 thanks to the rise in share prices. Nonetheless, policyholder bonuses will fall further over the next few years, due, among other things, to the persistence of low interest rates. The new solvency requirements that came into force on 1 January 2004 will also have an impact, because they no longer allow the use of future surpluses as own funds. Since *Pensionskassen* have used these future surpluses as own funds frequently in the past, many undertakings will have to increase their explicit own funds. The law provides a transition period for all *Pensionskassen* until 31 December 2007. The question as to how *Pensionskassen* that are mutual insurance associations will be able to use their surpluses will normally be subject to BaFin approval. BaFin will only consider policyholder bonuses wholly unobjectionable if they appear to be in keeping with the financial situation of the *Pensionskasse*.

Technical interest rate

The second amendment to the Mathematical Provisions Ordinance came into force on 1 January 2004. As a result, *Pensionskassen* deemed to be undertakings of considerable economic importance (section 156a (3) VAG) can no longer offer rates that were introduced after their deregulation and for which the mathematical provisions were calculated at a technical interest rate of more than 2.75%.

Back in August 2003, BaFin[103] announced that, in light of the further drop in capital market income, it would stop approving new rates with a technical interest rate of more than 2.75% with immediate effect. This did not include applications for authorisation that had already been submitted. With regard to existing rates, BaFin will be paying more attention to ensuring that the *Pensionskassen* adhere to recognised actuarial procedures when assessing the collateral in the "interest" basis for calculation, and that they provide a clear actuarial report setting out the key steps taken as part of this assessment, including the results of the assessment. In the case of rates open for new business, the *Pensionskasse* must ascertain whether or not the technical interest rate according to the operating plan can also be used for new business in the future, or whether this rate offer is to be closed.

Reserve for expected losses

Pensionskassen must calculate provisions for expected losses (*Eintrittsverluste*) if the rate applied is no longer sufficient in order to make up the required mathematical provisions[104]. Such cases can arise when the bases for calculation of the mathematical provisions have been changed and the rate cannot be adjusted immediately, for employment law reasons, for example.

Pensionskassen have to set up a reserve in the amount of the expected losses for the following year[105] as a result of new policies, increases to existing policies and technical single premiums[106].

Nonetheless, BaFin had to remind certain *Pensionskassen* of this obligation in the year under review. BaFin also used this as an opportunity to discuss the issue of balance sheet reporting with the *Pensionskassen*. In BaFin's opinion, the key point is whether or not the expected losses related to existing policies or to policies that are expected to be taken out in the following year.

Expected losses from existing policies (as a result of increments or payment of technical single premiums) therefore result from obligations that already exist, which means that they must be reported as part of the mathematical provisions. Expected losses from joiners, on the other hand, can be classified as contingent losses, which means that they must be reported as other technical provisions.

Insofar as the rates require approval, the operating plan must specify the procedure used to calculate the reserve for expected losses.

[103] cf. VerBaFin 8/2003, p. 2.
[104] cf. AR BAV 1972 p. 51 and 1979 p. 56.
[105] Where the mathematical provisions are not calculated on an annual basis, but for a period of several years.
[106] Sections 341e and 341f HGB.

Deferred pensions with no biometric risks in the deferral period

Unlike other life insurance undertakings, *Pensionskassen* are not authorised to conduct capital redemption operations within the meaning of section 1 (4) of the VAG.

Pensionskassen can, however, get round this legal prohibition by offering deferred pension policies with a lump-sum option, which pays out the available mathematical provisions in the event of death. With this type of policy, the insurer does not incur any biometric risks in the deferral period. From the client's point of view, this type of deferred pension offers the same benefits as a capitalisation product. One *Pensionskasse* submitted an outline for a product to BaFin in the year under review, which BaFin considered sufficiently dissimilar to a capitalisation product and which was subsequently approved.

In the case of this product, policyholders are guaranteed annuity factors for the end of the deferral period. They can only exercise the lump-sum option five years after the policy start date (special arrangement in the case of terms of less than eight years in order to maintain the three-year option period before the commencement date of pension payments). The death benefit is reduced to a death grant in the event that there are no surviving dependents – which admittedly is not a feature unique to this product, as, in the event of the death of an insured party, the *Pensionskassen* can only pay benefits that exceed standard funeral costs to surviving dependents.

European Court of Justice ruling; equal pay for men and women

Following its decision from 17 May 1990[107] , the European Court of Justice (ECJ) began developing a comprehensive ruling on equality between men and women with regard to occupational retirement provision.

Among other things, the ECJ recognised that the benefits employers provide to employees as part of an occupational retirement provision scheme fall within the scope of Article 141 of the EC Treaty. This Article lays down the principle that men and women should receive equal pay for equal or equivalent work. The ECJ went on to indicate that the direct effect of Article 141 of the EC Treaty cannot be claimed for retirement provision rights acquired before 17 May 1990.

In its judgement from 6 October 1993[108], the ECJ defined the time limit for the effect of the above ruling, and in such a way that the direct effect of Article 141 of the EC Treaty can only be asserted for the area of occupational retirement provision in the case of benefits payable for periods of employment after 17 May 1990.

[107] Case 262/88; E-BetrAVG 110.3 no. 34.
[108] Case C-109/91; E-BetrAVG 110.3 no. 43.

The European Court of Justice made another strategic decision in its judgement from 9 October 2001[109]. This has considerable repercussions for German *Pensionskassen* with regard to the non-discriminatory treatment of men and women.

Article 141 of the EC Treaty once again represented the object of the ECJ judgement. This judgement states that *Pensionskassen* subject to German law are obliged to guarantee the equal treatment of men and women, when assigned with the provision of occupational retirement provision scheme benefits. This obligation also applies if employees that are discriminated against due to their gender are entitled to assert a claim against those who are directly liable for their benefits, i.e. their employers – as contractual parties of the employment agreement, and this claim is protected against insolvency and excludes discrimination.

As a result of the ECJ's decision from 9 October 2001, the responsibilities specified by the court in its judgement from 17 May 1990 are also directly applicable to German *Pensionskassen*, which become liable as joint debtors with the employer in the event of discriminatory treatment of the insured parties in question. Settlement of the liability with the employer is governed by national law and can only be determined on a case-by-case basis.

National high court case law based on the ECJ judgements described has since been established, as well. In a verdict given on 23 September 2003[110], the Federal Labour Court (Bundesarbeitsgericht – BAG) dismissed the action brought about by an occupational pensioner, who, due to severe disability, had received early statutory and occupational retirement provision benefits at the age of 60. Among other things, the plaintiff had claimed that he should only be subjected to the more favourable actuarial reductions for women. This amounts to 0.15% of the received benefits. By contrast, the reductions for men are staggered from 0.15% to 0.5% according to length of service and the retirement date. The BAG considered it acceptable to alleviate early retirement for women by setting lower reductions than for men, provided this discriminatory treatment – pursuant to the provisions of the ECJ rulings – were restricted to periods of employment prior to 17 May 1990 (the date upon which the underlying ECJ decision was pronounced). The defendant had accomplished this by adjusting benefit calculation. It only applied the higher reductions to the portion of the rights that the plaintiff had acquired up until 17 May 1990. It then applied the lower reduction for women to the share acquired by the plaintiff after this date.

[109] Case C-379/99; E-BetrAVG 110.3 no. 78.
[110] (case no. 3 AZR 304/02).

3.6.2 Pension funds

The year under review provided pension funds with their first experiences of continuing operations.

Many pension funds altered their defined contribution schemes by implementing income drawdown plans. This option had only been introduced by the legislature during the latter half of 2002.

In addition, many pension funds presented their defined benefit schemes to BaFin for clearance. Among other things, this means employers are able to make full use of the tax benefits when transferring book reserve schemes (*Direktzusagen*) to pension funds. In this instance, BaFin reiterated that payment of pension due has to be guaranteed as an insurance equivalent at of the onset of benefit obligations – meaning that pension funds must guarantee life-long annuity benefits in the event of retirement. This leads to the pension provisions built up by the employer not being sufficient to set up the corresponding reserve in the pension fund, particularly in the case of transfers of annuities that are in payment from book reserve schemes. This is caused by the different technical interest rates in the employers' financial statements and tax accounts and the maximum interest rate pursuant to the Mathematical Provisions Ordinance for Pension Funds (*Pensionsfonds-Deckungsrückstellungsverordnung – PFDeckRV*).

Pension fund performance did not match expectations and once again failed to achieve the projected targets, which had formed the basis for the business plans during approval proceedings, in 2003.

In contrast to the preceding abridged financial year, premium income and the number of beneficiaries did not enjoy overly positive performance. The forecasted premium income for financial year 2003 amounts to around €100 million as opposed to €64 million in the previous year. The number of current or future beneficiaries is estimated at around 90,000 and five respectively, compared with 57,723 and one respectively in the previous year.

A further five pension funds received approval for operations in financial year 2003, four of which have not yet started conducting business.

The liberal investment provisions in place at pension funds do not require them to adhere to quantitative upper limits regarding the mix of their restricted assets. As a result of the downward trend on the stock exchanges over several years, pension funds were unable to utilise the associated potential for higher returns by stepping up investment in international equities markets; this was less of a priority when selecting a suitable pension, particularly as the investment risk can be partially transferred to the employee or employer during the qualifying period for pension funds.

The increased popularity of pension products, with guarantees and constant investment performance, appears to be underpinning this trend.

3.6.3 Protecting occupational retirement provision in case of insolvency

As the authority responsible for administrative offence proceedings, BaFin processed 152 new applications by the Pension Guarantee Fund to institute administrative offence proceedings in 2003, as well as 35 outstanding proceedings from the previous year. Of the 187 proceedings in total, BaFin concluded 125 before issuing a fine assessment notice, either because the affected parties had met their obligations or because the proceedings were discontinued for other reasons. BaFin was forced to issue fine assessment orders in 8 cases, with additional enforcement measures being introduced in 3 cases.
The remaining 62 proceedings were still outstanding as at the end of the year under review.

IV Regulation of securities trading and investement business

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1 Insider trading and price manipulation

BaFin has a comprehensive stock of data available to support its investigations.

In its effort to detect prohibited insider trading, BaFin monitors securities trading both on and off the exchanges. BaFin has been pursuing both stock exchange and market price manipulations since July 2002. In the first year of its new nationwide competence, it performed numerous analyses and conducted investigations with the primary purpose of determining the point in time at which conduct became criminally deceptive and whether or not a manipulation had actually affected the market price.

To support its investigations of insider trading and manipulation, BaFin has a comprehensive stock of data available concerning all executed transactions in securities and derivatives. It also uses all its internal and external information resource options to obtain the required market and company data including, in particular, data on orders placed on the exchanges. The information available to BaFin concerning individual banks, financial services providers and investment companies, and its special knowledge, in the area of risk management, for example, enhance the quality of its analyses and investigations.

In addition, BaFin can demand information from issuers in particular, as well as from other persons or bodies.

The investment services enterprises or exchange trading participants involved are prohibited from notifying the persons who are subjects of the investigation or the requests for information.

1.1 Market analysis

All securities transactions in Germany must be reported to BaFin.

BaFin analyses the market to detect manipulations or insider transactions. It evaluates all of the securities transactions that are reported to it, and has, at its disposal, a comprehensive database to aid it in doing so. Pursuant to section 9 of the Securities Trading Act (*Wertpapierhandelsgesetz – WpHG*), all securities and derivatives transactions that are admitted to trading on a stock exchange within the European Economic Area or traded within the unofficial market/OTC (*Freiverkehr*) must be reported. Those obliged to report include banks, financial services institutions allowed to trade for their own account, and the local branches of foreign firms that are licensed to trade on a German exchange.

In 2003, BaFin registered a total of around 530 million reports (2002: 435 million), or an average volume of 2 million data records daily.

Several events can trigger a market analysis.

Market analyses can be triggered in very different ways. The systematic assessment of ad hoc announcements, which is designed primarily to discover insider trading, plays a major role. Another trigger could be tips from investors, market participants, issuers and the press. Overall, BaFin received more than one hundred of such tips. Regular surveys of various different media and certain internet sites are also effective sources of indicators.

Numerous tips, primarily concerning price manipulations, come from the trading surveillance units of the exchanges. In addition, the SWAP ADP system uses a mathematic/statistical procedure to pinpoint and then review the most conspicuous shares and derivatives on each trading day. The data reported becomes of interest to regulators when certain trading parameters diverge in a statistically significant way from their normal dimensions.

1,500 analyses led to 93 in-depth investigations.

During the reporting year, BaFin performed more than 1,500 analyses (2002: approx. 1,250). In 93 cases, these analyses triggered further investigations. 54 of these cases involved possible insider trading and 39 involved possible price manipulation. Thus, the previous focus of analysis on insider trading has shifted towards price manipulations. In the case of insider trading, an initial review is performed in order to determine whether or not the company's reporting contains insider information, in other words, a previously unknown fact that has considerable potential to influence the market. Most insider information relates to corporate takeovers, bankruptcies and periodic results. In this instance, the analysis section was also able to use information from other sections, such as takeovers or ad hoc disclosures.

When analysing price manipulation, BaFin identifies inaccurate statements.

The procedure used to analyse possible price manipulation differs from that used for insider trading in the sense that it involves the identification of inaccurate statements concerning facts that are

crucial for the valuation of assets such as stocks, bonds and derivatives. This also applies to any failure to disclose facts for which there is a disclosure obligation. Other deceptive practices, such as pre-arranged transactions or the dissemination of inaccurate rumours, are also the subject of analysis.

Two thirds (27) of price manipulation analyses related to such deceptive practices. These consisted primarily of influencing reference prices (marking the close), as well as wash sales and/or sham transactions (pre-arranged trades). This kind of manipulation generally related to less liquid equities, because the shares of larger companies, which only have a small portion of their shares in fixed ownership, are largely protected from such manipulations owing to their high liquidity. The suspected manipulators were primarily private investors, although several investment companies also came under scrutiny.

Good collaboration with exchange trading surveillance units pays off.

Close and confidential collaboration with trading surveillance units proved invaluable, particularly when elements of other deceptive practices were involved.

In the (9) cases of inaccurate information, BaFin observed quite different forms of publication. The information tended to appear in annual financial statements, investment newsletters and internet chat rooms, but also in the context of corporate takeovers.
The (3) cases of illegal failures to disclose involved two ad hoc announcements and statements surrounding a takeover.

Actual impact on price determines whether or not the offence is treated as a crime or as an administrative offence.

Every price manipulation analysis seeks to establish whether or not the manipulation actually affected the price. This test is important for categorising a manipulation as an administrative offence or a crime. In most cases, there was a demonstrable causal relationship between the manipulative conduct and developments in the market price.

BaFin supports prosecutors and policy by providing expert opinions.

Whether or not a manipulation actually affected the price is an issue BaFin regularly addresses in the expert opinions it prepares for prosecutors and courts. BaFin was able to establish a clear relationship between the manipulation and market price development in practically all of its expert opinions. It prepared 20 such opinions in the year under review. In most cases (12), the opinions were commissioned by prosecutors’ offices, while in five cases, they were prepared at the behest of police authorities, primarily state and federal offices of criminal investigation. In two cases, courts asked for expert opinions during ongoing trials involving price manipulation. BaFin staff testified in court as expert witnesses in these cases.

In addition, some prosecutors and police offices asked BaFin for its assessment after their investigations turned up evidence of suspected price manipulation. In most cases, BaFin confirmed the existence of probable cause.

1.2 Insider trading investigations

BaFin initiated 51 new investigations.

In 2003, BaFin opened 51 new investigations of suspected prohibited insider trading, with 82 cases still pending from previous years. 26 cases resulted in BaFin filing criminal complaints with the local prosecutors office involving a total of 137 individual suspects. BaFin dropped 16 cases due to lack of evidence.

If an analysis of market price developments, trading volume and information available on an insider security indicates possible violations, the competent section initiates a formal insider investigation. BaFin first clarifies the facts by conducting detailed questioning of the issuers or other parties. Its main aim is to find out who had insider information. BaFin follows this up by making enquiries at banks and financial services providers with a reporting obligation in order to reveal the names of all customers who bought or sold the insider security during the period under scrutiny. If there is a correlation or cross-connection confirming suspicions that insiders were trading with special information, then BaFin files a criminal complaint against these persons with the competent prosecutors office.

Insider information is often negative company news.

Insider information often involved negative news about a company, including not only profit warnings but also, increasingly, bankruptcies. At the same time, there was an increase in the number of investigations into corporate takeovers in which the bidder had been required to make a mandatory offer. In such cases, the acquirer normally offers shareholders a significantly higher price than the price prevailing on the exchange before the offer is disclosed. This is a frequent incentive for prohibited insider trading.

Some Exchange Brokers conducted insider trades in the form of "Frontrunning".

For the first time, another focus of investigations was the trading activity of market professionals. Seven of the 26 criminal complaints filed in 2003 involved a prohibited insider trading practice by brokers with responsibility for price determination (Exchange Brokers) known as "Frontrunning". BaFin regularly brings charges for such practices. In such cases, the customer places a large sell order on the exchange at a limit price that is at variance with the last reported trade. The Exchange Broker realises that he can sell the security in question on an electronic trading system at a more favourable, i.e. higher, price than the minimum price set by the customer's limit order.

Using the electronic trading platform, the Exchange Broker in question sells an equivalent number of shares "short" for own account, meaning that the securities are never in his possession. Then, in contradiction to the rules of the exchange, he determines the price on the trading floor at such a level that the customer's order is left fully or partially unfilled. The customer's shares are then taken on by the Exchange Broker for "transactions subject to the designation of the counterparty", which means that the broker undertakes to find a buyer for the shares. The broker then purchases the shares for own account to cover the short position. The difference between the limit of the customer's order and the share price achieved by the Exchange Broker in electronic trading remains as profit. In most instances, the price difference is only a few cents. But with a high enough trading volume, this difference can produce a considerable profit within a few minutes.

In the year under review, full trials resulted in two convictions, one acquittal and three convictions after summary proceedings. Prosecutors settled seven proceedings in exchange for an out-of-court settlement, and cases were dropped against 70 suspects.

In 2003, BaFin answered 18 enquiries from foreign supervisory authorities in insider matters and sought the assistance of foreign officials 93 times.
The following provides a more detailed description of some of the cases finally closed in 2003:

CPU Softwarehouse AG

Before trading began on 17 November 1999, the management board of CPU Softwarehouse AG delivered an ad hoc report to the effect that the company expected to make an after-tax loss of DEM 4.5 million in 1999. When it went public in April of that same year, the firm had announced an after-tax profit of DEM 6.5 million. After the company's stock finished trading on 16 November 1999 at a closing price of €54, it opened the following day at €50 and fell to €44 by 18 November 1999.

The accused was the "key account manager" at CPU Softwarehouse AG, who was responsible for large customer accounts. His role allowed him to learn of the impending losses no later than 12 November 1999. The accused subsequently sold 2,000 shares of CPU Softwarehouse AG on 16 November 1999.

After a full public trial, the Augsburg Regional Court (Landgericht) convicted the accused in April 2003 and assessed a criminal fine made up of 90 daily instalments of €90 each. In addition, the court ordered him to forfeit his illegal gain of €31,494.

Allweiler AG

This insider trading investigation was prompted by an ad hoc report published on 27 February 1998 after the close of trading. According to the announcement, Constellation Capital Partners LLC of the USA had informed the management board of Allweiler AG that a firm affiliated with that company had concluded agreements with the majority shareholders of Allweiler AG to buy Allweiler AG stock. Constellation Capital Partners LLC also announced its intention to extend a public tender offer for the remaining common and preferred stock of Allweiler AG over the coming weeks, either directly or through an affiliated company.

Constellation simultaneously announced the price it planned to offer the remaining shareholders for their common and preferred shares. Subsequently, the price on the exchanges of both common and preferred shares rose to the level of their respective tender offering prices.

In advance of the ad hoc announcement, the accused – a major shareholder and deputy chairman of the supervisory board of Allweiler AG – purchased a total of 1,700 preferred shares of

Allweiler AG between 20 January and 26 February 1998 for a total price of DEM 461,374. By 8 May 1998, he had resold these shares at a gain totalling DEM 165,326 (€84,529.84).

By criminal assessment dated 23 July 2003, the Offenburg Local Court (Amtsgericht) sentenced the accused to a criminal fine, payable in 100 daily instalments of €420 each or a total of €42,000, for violating the prohibition against insider trading. In addition, the court ordered forfeiture of his illegal gains of €84,529.84.

SG Holding AG

On 23 March 2000, the management board of SG Holding AG announced in an ad hoc report that its subsidiary, Schwabengarage AG, had been defrauded of around DEM 10 million. The Stuttgart prosecutors' office initiated an investigation for suspected fraud and violation of the prohibition on insider trading with BaFin's support.

The person accused of insider trading was a member of Schwabengarage AG's supervisory board. He learned of the fraudulent transactions and ensuing damages no later than 22 March 2000. He knew that once this information became public, the stock price would plummet. At around 15:45 on 22 March 2000, he placed a €9 limit order to sell more than 4,500 shares of Schwabengarage AG. This order was executed that same day.

By a criminal assessment of July 2002 which became legally binding in 2003, the Stuttgart Local Court convicted the accused of insider trading and imposed a criminal fine, payable in 90 daily instalments of €150, or a total of €13,500.

Met@box AG

On 10 April 2000, Met@box AG, a New Market company, announced in an ad hoc report that its subsidiary, Met@box International AG, had concluded a €500 million deal.

On 10 April 2000, immediately before the ad hoc report was released, the accused, the public relations spokesman for the company, bought 150 shares of Met@box AG. He sold those shares on 14 April 2000 at a profit of €5,655.

The Lehrte Local Court issued the accused a warning against violating the prohibition against insider trading and assessed and suspended a criminal fine, payable in 60 daily instalments of €30. The court ordered forfeiture of his €5,145 profit.

Digital Advertising AG

On 20 February 2001, the management board of Digital Advertising AG issued an ad hoc report announcing that its original EBIT forecast – i.e. earnings before interest and taxes – for the current financial year would have to be corrected to DEM 6 million due to extraordinary expenses of DEM 2.5 million. After the shares had

closed at €7.50 on 19 February 2001, they opened at €5.75 on 20 February 2001, and had fallen to €4.50 by the close of trading on 23 February.

The accused, a member of the management board of Digital Advertising AG, was charged with placing an order to sell more than 5,000 shares of the issuer on 5 February 2001 with knowledge of the corrected forecast. He claimed to have done this to avoid their predictable loss in market value.

The Munich Local Court acquitted the accused on the charge of insider trading. The court found that there was insufficient evidence to prove that the accused had exploited insider information. During the time frame at issue, it found that the share price of Digital Advertising AG, like the prices of all the shares listed on the "New Market", had suffered from a loss of consumer confidence. The court could not, therefore, determine whether there was any causal connection between the drop in price and the ad hoc announcement of 20 February 2001.

Steinbeiss Temming AG

On 25 October 2000, the management board of Steinbeiss Temming AG issued an ad hoc report announcing that it intended to optimise the ownership structure of the company and seek delisting, as part of a combined owner and management buy-out. For this reason, shareholders would be made a voluntary public tender offer of €59.00 per share, 28% above the average bid price of the shares over the last three months.

The accused was employed in the company's controlling department and was simultaneously a member of its ad hoc disclosure body. He was involved in the preparations for the tender offer. Between 13 September and 23 October 2000, he bought a substantial amount of stock in the company which he later unloaded at a profit of €34,500 after the tender offer was announced.
The accused admitted the insider trading charge. The Itzehoe prosecutor's office settled the proceedings upon payment of a €20,000 fine, payable in 5 monthly instalments. He was not ordered to forfeit his profit.

1.3 Investigations of price manipulation

BaFin began 51 new investigations and brought charges against 21 individuals.

BaFin initiated 51 new investigations of possible violations of the prohibition against stock exchange and market price manipulation in the year under review. There were 14 cases still pending from the second half of 2002. In seven of the cases investigated, BaFin determined that 21 suspects had successfully influenced the trading price of the manipulated security. BaFin therefore filed criminal complaints against all 21 suspects with the prosecutor's office. In three of the manipulation cases the investigation revealed that the manipulative conduct had had no effect on the trading price. These cases were therefore referred to the competent section for

administrative fines. BaFin dropped 13 cases, while 42 were still pending at the end of the year.

Evidence of manipulative conduct is derived from analysis or from the trading surveillance units.

BaFin acts when an analysis or report by the exchanges' trading surveillance units provide indicia of manipulative conduct. It makes enquiries at the participating banks as to when, under what circumstances and by whom the orders for securities were placed, and how these orders were executed. BaFin reconstructs order situations with the help of data from the trading surveillance units. If the indications are confirmed and there is probable cause to believe that there has been criminal price manipulation, BaFin files a criminal complaint on the case with the competent prosecutor's office. If no effect on the trading price of the security can be established, the matter is referred internally to the section for administrative fines.

BaFin processed nine enquiries from abroad concerning price manipulations in 2003. These came primarily from supervisory authorities in the USA and Austria. As part of its own investigations, BaFin sent out 22 enquiries to foreign supervisory authorities; a third of these went to the Swiss Federal Banking Commission. Other information requests were directed towards the British FSA and the Austrian Financial Markets Supervisory Authority (*Finanzmarktaufsicht*).

New price manipulation ordinance

The new KuMaKV ordinance provides a specific definition of unlawful manipulation.

The Federal Ministry of Finance's Ordinance Detailing Stock Exchange and Market Price Manipulation (*Verordnung zur Konkretisierung der Kurs- und Marktpreismanipulation – KuMaKV*) explains, inter alia, the factual elements of individual manipulations[111]. The KuMaKV went into force on 28 November 2003 and contains practical rules for determining assessment-relevant facts, other deceptive practices and those actions which offer a “safe harbour” exception to the list of prohibited acts.

First cases of practical application

There were several incidences of wash sales and pre-arranged transactions.

In the case of “incorrect statements” (section 20a (1) no. 1 WpHG), BaFin's investigations focused on whether or not ad hoc reports has been presented incorrectly or omitted completely. “Other actions aimed at deception” (section 20a (1) no. 2 WpHG) mainly involved suspected fictitious transactions, i.e. wash sales or pre-arranged trades/matched orders.

Other offences related to effective transactions that were made to influence certain reference prices (marking the close) and/or drive up the price (painting the tape).

[111] www.bafin.de > Rechtliche Grundlagen & Verlautbarungen.

Some of the manipulation variants and investigated cases are described in greater detail below:

Incorrect statements

Within the meaning of the prohibition on manipulation, an inaccurate assertion of fact can be any kind of utterance, irrespective of whether it be made in writing, orally or in electronic form. The context in which the statement is made, be it in an ad hoc announcement, on a balance sheet, in an annual report or to the press and/or other third parties, is also irrelevant. In this respect, incorrect statements in ad hoc announcements, or the omission of mandatory ad hoc statements, increase the risk of a successful, price influencing manipulation, because such announcements command the attention of investors and are thus of particular relevance to regulators.

False revenue figures

One instance of incorrect statements made to manipulate market price involved a group of investors and their accessories. They are suspected of having used their position as members of administrative bodies in various companies of a corporate group to falsify revenues of the issuer and then disseminate the inaccurate revenue figures in ad hoc announcements. The intention was to counter the market trend and keep the stock price at a high level by feigning achievement of the company's guidance figures. To this end, the suspects entered into sham transactions with both affiliated and non-affiliated companies of the corporate group.

The suspected motive for the crime was the impending sale of the majority interest to a British firm. The sale price was dependent on the market price development of the company's stock and on whether or not it met certain revenue targets. BaFin filed a criminal complaint with the Hamburg prosecutor's office, which has special competency in such matters. The case is still open.

Late reporting of negative news

A company listed on the New Market reported that two members of its management board had unexpectedly left their positions. Although section 15 of the WpHG requires that such information be promptly reported in an ad hoc announcement, the announcement was made around a month late. The suspects acted with the intention of preventing that negative impact on the market price of the shares that this piece of bad news could be expected to have. Up until that point, the company had only reported good news. However, since no effect on the share price could be determined to have resulted from this omission, the matter was handled as an administrative offence.

Equities research

BaFin's investigations also included a study of the stock of a car rental company. The accusation was directed at the author of the study, which contained incorrect statements with regard to the issuer's accounting practices. The suspect was simultaneously active in hedge fund transactions, meaning that he would benefit from a drop in the market price of this company's shares; a fact he also clearly acknowledged. This suspicion of attempted price manipulation was subsequently confirmed. There was, however, no impact on the stock price, because the issuer reacted publicly immediately after the study was circulated.

Other deceptive practices

The "other deceptive practices" category includes the widest range of variations.

Other deceptive practices include, in particular, transactions intended to distort the actual business situation surrounding a financial asset and/or transactions that lack economic substance. Most of these concern the direct trading activities of those involved. Other deceptive practices cover many different types of conduct on the part of those suspected.

Marking the close

One case involved a successful manipulation of the price of a stock that was used as an underlying for another product. The suspects in this case were two traders of a bank who allegedly manipulated the market price of the stock because it was the underlying of a certificate issued by a subsidiary of the bank that they simultaneously managed and distributed. This certificate featured a "knock-out" clause that would render the certificate worthless if the closing price of the underlying stock fell below a certain level during the term of the certificate. The trading activities of the two suspects caused the closing auction price of the stock on the XETRA exchange to drop below the knock-out barrier. This triggered the clause and the outstanding certificates held by investors became worthless. BaFin filed criminal charges against the traders for manipulation by other deceptive practices in the form of deliberately influencing a reference price.

In another case, employees of two banks were suspected of manipulating at least four stock prices that constituted the reference assets for various investment funds. They did this in order to push up the value of the funds and thereby prevent or minimize write-offs. To this end, the suspects fixed prearranged year-end price targets for the respective stocks. In order to achieve the desired stock price, the suspects placed a succession of purchase orders with limits set above the current price levels of the respective shares and/or gradually increased the limits on orders previously placed.

As buyers, they often accounted for more than 50 percent of the trading volume. The purchase orders were always completely or almost completely filled and achieved the intended artificial increase in market price determinations which was the sole purpose of their

trading activities. This, too, resulted in a criminal complaint for suspected influence of reference prices.

Multiple-exchange manipulations

One case involved a suspect who deliberately placed limited, low-volume orders in the XETRA electronic trading system which narrowed the difference, or spread, between bid and ask prices. The suspect's orders thus gave a false picture of a changed supply and demand situation on XETRA, which then affected pricing on the QUOTRIX electronic trading system. This is because QUOTRIX uses the supply and demand situation on XETRA's order book as the underlying reference for establishing the exchange price on QUOTRIX. The suspect thus used a multiple-exchange method in order to influence the pricing behaviour of the QUOTRIX market maker. Having achieved his goal, he cancelled the orders placed on XETRA; in other words, he had no real interest in trading the shares. This action deceived the market maker on QUOTRIX with regard to the actual market situation on XETRA to which he referred for his subsequent pricing. The suspect then profited from the narrowed spread by entering a large volume order into QUOTRIX which the market maker there was obliged to execute. The execution price on QUOTRIX was thus manipulated by deceptive practices carried out on XETRA. BaFin filed a criminal complaint.

Pre-arranged offsetting buy and sell orders

Several suspects have used offsetting buy and sell orders placed at the same limit on different exchanges over a thirteen-month time frame to effectively dictate a stock's price and trading volume. By conducting pre-arranged trading of shares back and forth among each other over an extended period of time, the suspects were able to maintain the share price at an elevated or fixed level and then use the inflated value of the shares as currency to make acquisitions. In addition, the shares were used as collateral in order to obtain loans against securities. Using the pre-arranged transactions also enabled the suspects to prevent the stock price from falling, which would have triggered an acceleration of the loans. This activity prompted BaFin to file criminal complaints against six individuals.

Manipulation using wash sales

The suspect, acting as a private individual, entered into securities transactions with himself in order to artificially increase the price and trading volume of a stock that was trading on different exchanges. He placed pre-arranged buy and sell orders with himself at limit prices inconsistent with the market with the goal of profiting from a manipulated high price. The suspect had previously purchased the stock at lower prices so that he could resell them for a profit at the artificially elevated prices after his wash sale transactions. After this trading behaviour came to their attention and following prior consultation with BaFin, the trading surveillance units of the Stuttgart and Düsseldorf exchanges called on the suspect, through

the bank at which he maintained his securities account, to cease making any further offsetting buy and sell orders. His plan was thereby thwarted even before he had concluded the process of driving the market price up. The suspect sold his entire stock portfolio within a few days at low prices, meaning that he was ultimately unable to recoup the transaction costs from the wash sales or realise any profit from the manipulation. BaFin charged him on suspicion of other deceptive practices (pump and dump scheme).

After the market learned that the major stockholder of a company listed on the exchange intended to sell his block of shares, four suspects conspired to coordinate trading activity in order to drive up the price of the shares and make any acquisition of the block of shares more expensive for interested parties. Shortly before the close of trading, they placed offsetting buy and sell orders on the floor of the Frankfurt Stock Exchange for the same amount of shares at limit prices well in excess of the current market price. The orders were such a sharp departure from the previously established exchange prices that the broker responsible for price determination refused to set a closing price for the security. As a result, there was no effect on the share price. The suspects then repeated their actions during XETRA trading, where, much to the surprise of the suspects, trading was interrupted because the limits had been set so far apart from the current market. As a result, the suspects were once again unable to achieve their intended effect. Since there was no effect on the stock price, and thus no criminal offence of manipulation, BaFin handled the matter using administrative offence procedures.

Incorrect statement in an Internet forum

According to a purported wire service report that was posted under a pseudonym in an Internet forum, a named publicly traded company was about to be taken over. Posting such misleading inaccurate reports on the Internet is deemed to constitute a prohibited price manipulation if, in a concrete case, it is intended to influence the market price of the shares affected. Since, in this case, the share price was actually affected, a criminal complaint was filed with the prosecutor's office, which was able to investigate the identity of the author behind the pseudonym.

The local prosecutor has since brought charges against the identified suspect.

Federal Court of Justice ruling on scalping

The BGH regarded scalping as price manipulation.

In a ruling dated 6 November 2003, the German Federal Court of Justice (BGH) decided that so-called “scalping” should be legally categorised as price manipulation rather than insider trading. This was the first high court decision providing a criminal opinion on scalping. In a scalping operation, the culprit first purchases securities for which he then issues a buy recommendation. If, following the recommendation, the market price rises, he can then resell the securities at a profit.

The BGH reviewed a judgement passed by the Stuttgart Regional Court in which the two accused were convicted of illegal insider trading in the form of scalping. The submitting Regional Court categorised the accused’s knowledge that he later intended to recommend the shares that he himself had acquired, as insider information. In the view of the BGH, however, the accused's own resolve to make a certain recommendation did not constitute insider information. This self-created information lacked the reference to third parties that is required for insider information. Instead, scalping is categorised as another deceptive practice included in the manipulation offence. The BGH ruled that the deceptive practice was the issue of the recommendation, which was intended to influence the market price. The market participants were misled with regard to the real reason for the recommendation, and in this regard, the BGH ruled that the issue as to whether or not the recommendations were objectively justified was irrelevant.

The BGH's interpretation followed the legal guideline set forth in the EU's Market Abuse Directive of January 2003. It also referred to the Ordinance Detailing Stock Exchange and Market Price Manipulation (KuMaKV), which had since come into force and also categorised scalping as price manipulation. The FCJ remanded the case to the Stuttgart Regional Court with instructions to evaluate the facts from the perspective of price manipulation.

The BGH also addressed the issue as to when the actual effect on the market price had taken place. It noted that, in light of the many factors that often play a role in price determination, the burden of proving such an effect should not be set too high. The BGH did not believe that a survey of market participants was necessary. Comparisons between the previous price and volume trends with the price and volume developments of the security on the specific day in question, as well as the size of the order, could suffice to establish an effect on market price. The BGH thus expressly confirmed BaFin's normal practice.

2 Ad hoc disclosure and directors´ dealings

In 2002, the implementation of the Fourth Financial Market Promotion Act (*4. Finanzmarktförderungsgesetzes – 4. FMFG*) led to the adoption of comprehensive new rules. Consequently, the focus of supervisory activities during the reporting year was on monitoring compliance with the new regulations in order to achieve a high degree of transparency for investors on the capital markets.

2.1 Publication and disclosure

New information relevant to market price must be disclosed immediately.

Every issuer of securities admitted to trading on a German exchange is subject to the obligation to make price-sensitive information available to the market (section 15 WpHG). Each new fact that is not public knowledge relating to the issuer's business activity, or affecting the assets or financial position or the general trading position of the issuer must be reported. The fact must be of a nature to considerably influence market price.

The duty to disclose is intended to prevent insider trading and create transparency.

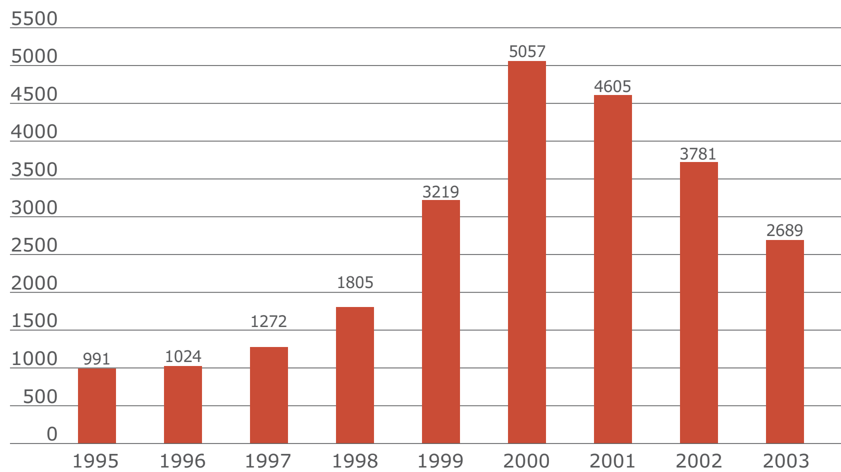
One goal of ad hoc disclosure is to counteract insider by publishing price-sensitive information early on. Making news available as soon as possible to all market participants considerably reduces the time window within which insider trading is possible. Besides this prophylactic purpose, ad hoc disclosure also aims to inform all market participants of price-sensitive facts in as timely a manner as possible, in order to ensure an appropriate exchange price and thus transparency on the capital markets.

The number of announcements continued to decline.

3,301 ad hoc reports were filed with BaFin in 2003 (2002: 4,491). 2,689 of these reports (2002: 3,781) came from domestic German issuers, while 612 (2002: 710) came from foreign issuers. The number of ad hoc reports has been falling since 2001. This can be attributed, among other things, to the poor economic development over this period. In addition, however, the newly designed ad hoc disclosure obligation introduced by the 4th FMFG has evidently had a positive impact not only on the quality of reports but also on their number. Companies are not only required to use the usual key figures in their reporting (section 15 (1) sentence 2 of the WpHG), they must also abide by the prohibition on obviously superfluous ad hoc reports (section 15 (1) sentence 3 of the WpHG).

Fig. 14

Ad hoc reporting by domestic German issuers



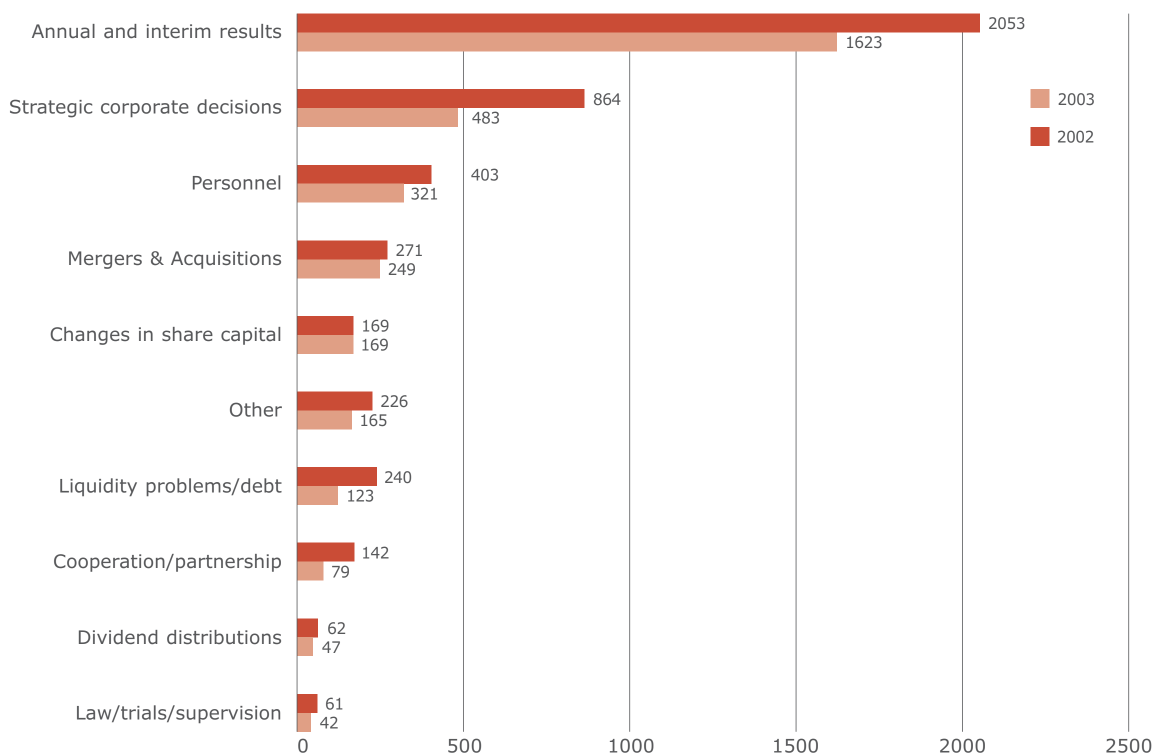
Firms favour further standardisation of key figures.

The clear majority of ad hoc reports contained issuers' annual and interim results. A benchmark study published in 2003 by the ad hoc service provider, euroadhoc, demonstrates that the capital markets largely favour a further standardisation of the key business statistics used in ad hoc reporting.

Other key issues covered in ad hoc reports included strategic company decisions such as divestitures, or the initiation of restructuring measures. Although many reports once again related to threatened or actual insolvencies in 2003, firms also increased the number of reports concerning M&A activities.

Fig. 15

Subject matter of ad hoc announcements 2003 (main categories)



Prompt publication and disclosure

Most of the cases investigated by BaFin were for suspected late reporting.

In the year under review, most of the investigations initiated by BaFin were once again prompted by suspected failure to issue ad hoc reports in a timely manner. The information subject to the ad hoc reporting duty must be disclosed promptly, i.e. without undue delay. To ensure that market participants learn of new, market relevant facts as soon as possible, the issuer may wait only as long as the specific circumstances warrant. During this reporting period, it also became clear that a disproportionately high number of ad hoc reports were published shortly before commencement of trading on the exchanges. Thus, as part of its ongoing supervision, BaFin increased its efforts to pursue the issuers publishing such pre-opening ad hoc reports.

The clear majority of ad hoc reports were published electronically.

When publishing an ad hoc report, the issuer can choose between publishing via an electronic information system or in a supra-regional official stock-exchange gazette. The overwhelming majority of ad hoc reports (3,283) were published via electronic information dissemination systems and only very few (18) in supra-regional gazettes. The trend towards using electronic information systems thus continues. BaFin and the exchanges have to be informed in advance of publication. An issuer may also use a service provider to meet its obligations. Three such service providers are currently active.

Access to electronically disseminated ad hoc reporting

Internet: www.bafin.de/links
www.vwd.de
www.n-tv.de/wirtschaft
www.dgap.de
www.huginonline.
www.euroadhoc.com
www.equitystory.de

Exemption from the duty of disclosure

BaFin performs a balance of interest test for deciding exemption petitions.

On application, BaFin can temporarily exempt an issuer from its disclosure obligations if publication would damage the issuer's legitimate interests (section 15 (1) sentence 5 of the WpHG). In deciding whether or not to grant such a petition, the interests of the issuer are weighed against the public interest in having effective information about market relevant data. As such, exemptions from the ad hoc disclosure obligation are granted for a brief period only. During this period, there is a danger that the information will leak out, in some circumstances leaving market participants with unequal access to it. Moreover, it exacerbates the danger of insider trading. BaFin therefore monitors trading volume and the price of the securities of such issuers especially carefully during this period. In the event that irregularities are detected, BaFin reserves the right to revoke the exemption.

Seven exemptions were granted during the reporting year.

Sixteen petitions for exemption from the ad hoc disclosure obligation were filed during the reporting year (2002: 26). BaFin approved seven of these and denied two. The rest were withdrawn by the

issuers. One reason for the withdrawal of petitions was the increasing familiarity of issuers with BaFin's restrictive requirements for granting exemptions.

Investigations and administrative fines

Regulators opened 67 new administrative offence proceedings and imposed administrative fines in 11 cases.

In 2003, BaFin investigated a total of 279 cases of suspected violations of the ad hoc disclosure obligation. In 67 cases, regulators initiated administrative offence proceedings, while 30 cases from the previous year were still open. The largest proportion of investigations and administrative offence proceedings related to late ad hoc reports.

In 2003, BaFin levied eleven fines ranging from €7,500 to €100,000 for late, incorrect or omitted disclosures of information for which there was an ad hoc reporting obligation under section 15 of the WpHG. Eight cases were dropped; three for want of prosecution. Four cases resulted in hearings before the Frankfurt Local Court. In these cases, the court assessed administrative fines ranging from €10,000 to €20,000. Overall, there were still 78 open cases pending at the end of the year.

2.2 Company insider transactions

Company insiders must report transactions that exceed €25,000.

Since July 2002, members of the management and supervisory boards of listed companies, their spouses and registered partners, as well as their parents and children, are required to promptly report their transactions in securities of their own company to both the issuer and BaFin. In addition, the issuer must publish such reports on its website or in an supra-regional official stock-exchange gazette (section 15a of the WpHG). The only exceptions are those transactions that do not exceed a de *minimis* threshold total of €25,000 over a 30-day time period.

In the past, the suspicion was frequently voiced that members of corporate governing bodies would use their knowledge of company internal affairs for insider trading. By disclosing the transactions, market participants are now informed as to the extent and timing of such transactions. This should further reinforce the trust of investors in the capital markets.

Directors´ dealings provide market participants with important information.

Another aim of this regulation is to create a further source of information for market participants. Directors´ dealings can serve as an indicator of how the management believes a company will develop in the future. This, too, serves to promote transparency in the capital markets.

During the reporting year, issuers reported to BaFin and disclosed 1,980 transactions pursuant to section 15a WpHG. In 2002, 1,067 such reports were submitted between July and December.

If someone with a duty to report or disclose fails to fulfil his legal obligation, BaFin may have recourse to administrative measures. These are accompanied by enforcement methods, which include, in

particular, administrative fines of up to €250,000. Where there is a finding of intentional or reckless disregard of publication or disclosure obligations, BaFin can levy administrative fines of up to €100,000.

Regulators opened 112 administrative offence proceedings and assessed four administrative fines.

In 2003, BaFin initiated 164 investigations of suspected violations of the publication or disclosure obligations. In 103 cases, administrative offence proceedings were initiated. Three such proceedings were pending from the previous year. In 2003, BaFin levied administrative fines of up to €20,000 in four cases of omitted or delayed reporting of transactions pursuant to section 15a WpHG and dropped four cases, leaving 107 cases still open at the end of the year.

One can conclude from the high number of administrative fines sought that not all of those with a reporting obligation are familiar with the factual circumstances that require a report. BaFin conducted comprehensive sampling controls during the reporting period, mainly in order to inform these persons.

The database on the Internet offers a comprehensive and up-to-date overview.

BaFin publishes a database of directors' dealings on its website that is updated on an ongoing basis. This provides investors with a central source of information on transactions by company insiders[112]. On balance, the initial experience with reporting obligations under section 15a WpHG has been positive. The keen interest in this database shown by market participants indicates that the information has been well received and, indeed, that it contributes to transparency on the capital markets.

3 Prospectuses

The prospectus provides key important on investment decisions.

The obligation of a securities offeror to prepare and publish a prospectus when making a public offer is an important element of investor protection. The prospectus is a significant informational document for investors. In addition, it is the central liability document for civil prospectus liability claims if facts material to the evaluation of the securities prove to have been omitted, or incompletely or inaccurately portrayed in the prospectus.

There is an obligation to publish a prospectus if securities are being publicly offered for the first time.

A prospectus must always be published if securities are to be offered to the public within Germany. This does not apply only if a prospectus has already been published, or if an application is being made to admit the securities to trading on a German domestic exchange. Where no application has been filed for admission to trading, the prospectus must be deposited with BaFin. The obligation to publish a prospectus relates only to the offering of securities.

The term “securities” covers, in particular, stocks, bonds, warrants and certificates.

[112] www.bafin.de > Datenbanken & Statistiken.

A prospectus can be required in some cases of asset participations.

By contrast, the prospectus obligation does not cover silent participations or shares in civil-law partnerships (*Gesellschaft des bürgerlichen Rechts*), limited liability companies (GmbH) or limited partnership (KG) interests. Certain issuers whose solvency is not in any doubt are exempt from the prospectus obligation. This includes numerous states and their regional and local subdivisions. Likewise, an offering to institutional investors or to the employees of one's own firm can be made without a prospectus. During the reporting year, BaFin received an increasing number of queries concerning the prospectus obligation for asset participations. The question as to whether or not there is a prospectus obligation in such cases depends on the structuring of the individual investment instrument. In such cases, BaFin carefully reviews the relevant product terms and conditions.

A prospectus must also be deposited if, in the case of an international tender offer, the bidder offers its own shares in exchange, e.g. a British company makes a bid to take over a target company in Italy. The prospectus obligation exists irrespective of the Securities Acquisition and Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz – WpÜG*) that has been in effect since 2002, because that law applies only to target companies domiciled in Germany

Deposit and publication procedures

BaFin checks the prospectus for completeness within ten days.

If there is publication obligation, the offeror must first deposit the prospectus with BaFin, which then checks it to see whether or not it meets all of the requirements of the Ordinance on the Prospectus for Securities Offered for Sale (*Verordnung über Wertpapier-Verkaufsprospekte – VerkProspVO*). Because regulators have checked for formal completeness only, the fact that BaFin allows publication says nothing about the reputability of the offering or the solvency of the issuer. The review takes place within ten business days. In the vast majority of cases, publication is approved.

Before granting its approval, BaFin often sends a show cause letter to the filer noting points that are still missing and that must be completed before the deadline expires. If the filer fails to complete the points in question, BaFin will deny authority to publish. If the deadline passes without any word from BaFin, approval to publish is deemed granted. After approval, the offeror is obliged to publish in a supra-regional official stock-exchange gazette, and may not begin its public offering until it has done so. In this regard, it may elect to print the complete prospectus in the exchange gazette, or arrange for an announcement that refers to the availability of a free copy of the prospectus from those paying agents identified in the prospectus.

In the case of an offering made over the Internet, the prospectus must also be posted there.

There must be at least one full working day between publication and the commencement of the offering. The offeror is required to promptly inform BaFin in writing of the date and location of publication. Those making their offering available over the Internet must also publish the prospectus there. This is normally done by posting the electronic version in .pdf format. The electronic version must be easily located on the Internet and must be downloadable and printable from there.

If the offeror chooses this format for its offering, it must provide BaFin with its location (URL).

BaFin may prohibit advertising that is misleading about the extent of its review. The offeror may not give the impression that approval of the prospectus constitutes any official endorsement or recommendation. BaFin cannot relieve the investor of his/her responsibility to make investment decisions. In the case of offers for which, contrary to the law, no prospectus has been published, caution is advised. This also applies also cases of so-called cold calling, where potential investors are called unbidden by the offeror or its distribution partner, seemingly at random, seeking to obtain their custom.

BaFin can levy administrative fines of up to €500,000 for violations.

BaFin prohibits public offerings if securities are offered for sale in violation of the prospectus obligation. It discovers violations through its own research or through tips from the general public or other agencies. BaFin can punish violations of the Prospectus Act (*Verkaufsprospektgesetz – VerkProspG*) deemed administrative offences with fines of up to €500,000.

During the reporting year, BaFin initiated 26 new cases involving the omitted or untimely publication and/or reporting of a prospectus or a corresponding supplement. 38 such cases were pending from the previous year. BaFin assessed administrative fines in 16 cases and dropped 13 others.

Deposit of prospectuses

Complete prospectuses and supplements are deposited.

A complete sales prospectus containing all of the terms and conditions of the offer must be filed with BaFin. During the reporting year, 392 such prospectuses were submitted (2002: 310). Nevertheless, large issuers, in particular, were found to have used incomplete prospectuses (338; 2002: 352). Supplements must be issued for each of these incomplete prospectuses, setting forth the individual terms and conditions for the specific issue. The terms and conditions are not fixed until shortly before the offering begins. If changes arise that are of material significance for an evaluation of the issuer or the securities, supplements must be issued within the period prior to the end of the public offering.

In 2003, the number of issues for which a prospectus was deposited with BaFin rose by more than fifty percent year-on-year. 45,048 issues were made, compared to 29,160 in 2002, and the vast majority related to derivative securities. The number of warrants grew to 31,800 (2002: 22,185) and the proportion of certificates also continued to increase. The number of stock issuances (446; 2002: 157) and issuances of bonds (1,486; 2002: 668) also registered strong growth.

The fee for depositing a complete prospectus is €200 and €50 for a supplement.

The fee for depositing a complete prospectus is €200 and €150 for an incomplete one. Depositing a supplement costs €50. In the event of non-approval, the fee is reduced by 25%.

The offeror is obliged to make its prospectus available at no charge.

BaFin maintains prospectuses on file for ten years. BaFin does make prospectuses available in cases of open investigations by police and

prosecutors, as well as in civil litigation involving, for instance, issues of prospectus liability. This, however, does not release the offeror from its obligation to make the prospectus available at no charge for the duration of the public offering. The offeror is the sole contact point for interested parties who wish to review the prospectus before making their investment decision.

Internet database

The database on the Internet provides an overview of all prospectuses deposited.

BaFin provides an Internet-based overview of all of the prospectuses that it has reviewed and that have been published after approval. The database contains individual details of the publication, such as the beginning of the offering or the issue's ISIN/WKN. The database already meets the obligations for publication on the Internet provided for in the EU Prospectus Directive. In order to view the entire prospectus, however, the issuer still has to contact the offeror.

Changes introduced by the EU Prospectus Directive

The new EU Prospectus Directive, which came into force on 31 December 2003 and is to be implemented into national law within 18 months, harmonises the requirements for public offerings and admission to the exchanges. Among other things, the new EU directive introduces the so-called European passport for issuers. This will allow securities to be offered or admitted to trading throughout the EU if the underlying prospectus has been approved in one member state.

4 Voting rights

Transparency concerning significant holdings of voting rights in listed companies informs investors about the ownership structure of a company. This information is important for shareholder investment decisions. It becomes particularly relevant in connection with obligations owed under the Securities Acquisition and Takeover Act.

A notification obligation arises as soon as thresholds of 5, 10, 25, 50 or 75 percent have been reached.

Transparency concerning significant holdings of voting rights is brought about by means of a two-step procedure: a stockholder notifies the company and BaFin if his share of voting rights reaches, exceeds or falls below the 5, 10, 25, 50 or 75 percent thresholds. The company publishes this report in a supra-regional official stock-exchange gazette, disclosing the interest and creating the desired transparency. In addition, the company sends BaFin, which makes a database of all published reports concerning voting rights held available on the Internet as a public service[113], notice of the publication.

[113] www.bafin.de > Datenbanken & Statistiken.

Notification and disclosure

The number of reports increased by more than 25 percent.

Of the companies admitted to German exchanges as at the end of 2003, there were 526 domestic German and foreign companies admitted to the official market (*Amtlicher Markt*) (2002: 737) and 541 companies to the regulated market (*Geregelter Markt*) (2002: 436). During the reporting year, BaFin received 2,060 reports (2002: 1,555) concerning changes in significant holdings of voting rights. 160 reports were received for the evaluation of the current situation as at 1 April 2002.

Compared to the prior year, the number of reports on changes in voting rights held increased by 25% and more than doubled in comparison to 2001. The main reason for the increase is that, in 2002, the 4th FMFG expanded the publication and disclosure obligations, for one by including companies in the regulated market and for another by changing the rules for the additional counting of voting rights contained in section 22 WpHG.

Samples and explanations may be found on the Internet.

BaFin often had to have reports and disclosures corrected because they lacked the statutorily prescribed data. In a series of cases, the rules for the additional counting of voting rights were either not observed or misunderstood. To make it easier for shareholders to fulfil their obligations, samples and explanations on the subject were made available on the Internet[114].

Holdings of private equity companies and holding companies.

During the year under review, private equity companies and other holding companies acquired a series of significant equity interests. The highly complex structures of the acquiring companies are based primarily on tax considerations. The companies in question are structured under numerous legal systems and have companies on several continents. As a result, capturing such structures using the rules of section 22 WpHG is not always easy. In this context, the application of attribution rules must be guided by the aim of giving investors the most accurate picture possible of the actual influence on the voting rights of the publicly traded company in question.

Insolvency administrators are obliged to publish voting rights reports.

The number of insolvent listed public limited companies (AG) continued to increase in 2003. BaFin believes that the administrator of an insolvent company is obliged to publish reports pursuant to section 25 WpHG. Listing on the exchange is not affected by insolvency. In fact, insolvency sometimes results in more lively trading of such issues. Changes in the holdings of voting rights are of particular significance to insolvent companies, because they might, for example, signal the exit or intervention of a large shareholder. This is why it is still in the interest of the investors to be informed of significant voting rights.

There are notification obligations even for short term acquisitions.

In the case of capital increases and secondary issues, the new or supplemental shares are frequently offered through an underwriter. If, in the process, an underwriter acquires an ownership interest in the shares, an obligation to report under section 25 WpHG can arise.

[114] www.bafin.de > Für Anbieter.

The obligation to notify exists irrespective of the fact that, in such situations, the shares are acquired for a short time only. In such cases, many underwriters also make use of the trading portfolio exemption (section 23 WpHG). In applying the Securities Acquisition and Takeover Act (WpÜG), an exemption from the mandatory offer rules under section 37 WpÜG can normally be issued in the event that a controlling interest is obtained.

Attribution of interests managed for customers by asset management firms.

As before, asset and fund management companies from non-EU countries continue to be in considerable need of clarification on the attribution of shares that are managed for customers on whose behalf the asset or fund management companies exercise voting rights. Normally, voting rights are attributed to the asset or fund management company and its parent pursuant to section 22 (1) sentence 1 no. 6 WpHG. This rule governs the attribution of shares "which are entrusted to the notifying party insofar as he may exercise the voting rights arising thereof at his own discretion in the absence of special instructions of the shareholder."

Exemptions

On application, BaFin may release securities service firms from their notification obligation for securities that they hold only briefly. This also applies up to a threshold of 10% to firms that wish to take advantage of short-term differences between purchase and selling prices.

At the end of the year, 92 firms had exemptions covering their portfolio of securities held for trading.

In 2003, BaFin approved four applications for the non-consideration of voting rights vested in what are known as securities held for trading. By the end of the year, 92 firms had thus been released from a notification obligation relating to their trading portfolio. Over the course of the reporting year, twelve firms waived exemption. The observance of ancillary obligations, e.g. submission of an auditor's certificate concerning adherence to the rules, caused repeated difficulties for some firms. In such cases, BaFin will make greater use of the possibility of revoking an exemption for non-compliance with ancillary obligations.

BaFin did not issue any exemptions from the obligation to report on voting rights.

A listed company may apply for exemption from the obligation to publish reports under certain circumstances. Exemption is possible if the publication would run contrary to the public interest. However, BaFin can also issue an exemption if publication would cause the company substantial injury, provided that non-publication would not materially mislead the public. BaFin did not have to make any decisions on this type of application in 2003, since some applications that were filed were later withdrawn. The main issue was to ascertain whether or not, in cases of insolvency, the costs of publication could be the reason for substantial injury to the company.

BaFin's view is that the burden of publication costs was insufficient justification for an exemption, because costs are incurred with every publication. Exemption requires substantial injury that exceeds the mere costs of publication. Since the cost of obtaining a waiver normally exceeds the cost of publication, an exemption petition would not be economical in such cases anyway.

Administrative offence proceedings

BaFin opened 454 administrative fine cases last year for late reporting of significant holdings of voting rights and for late publication or documentation. The majority of these cases related to a total of 222 individuals and companies who violated their obligation to report and publish voting rights by 1 April 2002 (section 41 (2) and (3) WpHG). 226 other cases were still pending from previous years. BaFin assessed 52 administrative fines and dropped 59 cases, leaving 569 cases still open at the end of the year.

5 Corporate takeovers

5.1 Scope of application and offer procedures

Scope of application of the WpÜG

The Securities Acquisitions and Takeover Act (WpÜG), together with its associated regulations (WpÜG Offer Ordinance, WpÜG Advisory Board Ordinance, WpÜG Fees Ordinance and WpÜG Objections Committee Ordinance) came into force on 1 January 2002. It replaced the Takeover Code (*Übernahmekodex*) and created a binding legal framework for listed company takeovers.

Target companies domiciled in Germany fall under the WpÜG.

The WpÜG covers public tender offers to acquire securities if the target company – every public limited company (AG) or partnership limited by shares (KGaA) – is domiciled in Germany and its shares are admitted for trading on an organised market within the European Economic Area. Organised markets in Germany include the official and the regulated markets but not the unofficial market/OTC (*Freiverkehr*). The EU Commission publishes a list of organised markets on a regular basis.

The residence or ordinary residence of the target company shareholders is immaterial to the scope of application of the WpÜG. Even shareholders who live outside the Federal Republic of Germany and thus outside the WpÜG's territorial scope of legal validity are included within the WpÜG's scope of application. To ensure that these shareholders learn of public tender offers, bidders are required to publish the offering documents on the Internet.

Target companies that, although admitted for trading on an organised market in Germany, are domiciled in another country do not fall under the WpÜG's scope of application. In such cases, the takeover law of the country in which the target company is domiciled applies. If there are no laws regulating corporate takeovers in that country, or if the legal regulations of that country would apply the law of the place where the target company is listed on an exchange rather than on its domicile, then there can be a legal gap, since neither German nor foreign law would apply. The EU's new Takeover Directive, which aims to harmonise national takeover laws, will fill these gaps with comprehensive jurisdictional rules.

In addition to mandatory offers, the WpÜG covers all voluntary public offers.

Besides mandatory offers that the offeror must make if it seeks to attain control over a target company, the WpÜG also covers voluntary public tender offers to acquire the securities of a target company. Non-voluntary offers, which, as a result, do not fall under the WpÜG include, for example, cash settlement offers under the Transformation Act (*Umwandlungsgesetz – UmwG*) (sections 29, 27) or the Stock Corporation Act (*Aktiengesetz – AktG*) (sections 305, 320b), which are based on a statutory obligation. Non-voluntary offers also include public offers which, as prescribed by the BGH (in its "Macrotron" decision), must be made upon request of the company because of an impending delisting. The WpÜG is not applicable in such cases, because the law does not make provisions for compensating shareholders in accordance with the applicable standards for interference with their ownership as required by the BGH. Likewise, the shareholders could not petition – as the BGH requires – for judicial review of the price determination.
The situation is different if control of the target company is attained in advance of such statutorily ordered offer. In this case, the WpÜG is applicable, and either a mandatory offer must be made or an exemption sought under section 37 WpÜG.

The offer procedure

The offer procedure is identical for all offers made pursuant to the WpÜG (mandatory offers, takeover offers and other offers for acquisition). The offer is made in accordance with the following steps: the offering process begins either with the publication of the offeror's decision to make an offer, or with its announcement that it has attained control over the target company. Such publications are made in the same way as ad hoc publications, namely, in an official stock-exchange gazette or via an electronically operated information dissemination system that is widely used by market participants.

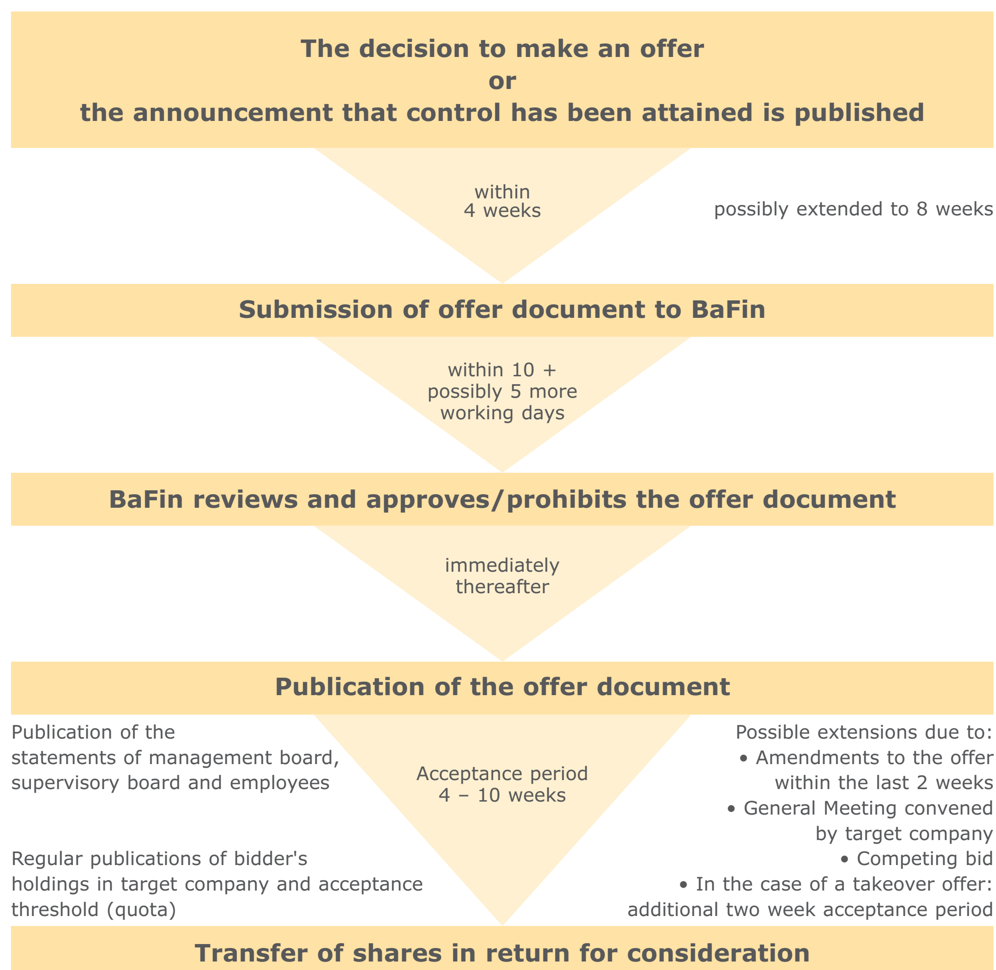
BaFin also publishes the decision on its website. After publication, the offeror has four weeks to prepare an offer document and submit it to BaFin. In exceptional cases, this deadline can be extended to eight weeks. BaFin reviews the offer document and approves publication within ten days. The review process can be lengthened to 15 days. The bidder then publishes the offer document, thus beginning the actual offering process in which the shareholders of the target company can accept the offer and thereby create a contract. After the four to ten-week offering period has ended, the offer is then settled; in other words, the tendered shares are transferred to the offeror and the purchase price is paid to the shareholders.

Effect of antitrust proceedings on the offer process.

In practice, acquisition of the target company's shares is frequently subject to the proviso that the cartel office approves the merger. The offeror may not acquire the shares in the target company until the antitrust authorities have given their consent.

This is known as a prohibition of putting a concentration into effect (*Vollzugsverbot*). Proceedings before the antitrust authorities are normally initiated to coincide with BaFin's offer process. BaFin therefore grants its approval subject to clearance given by the antitrust authorities. This condition is the only condition where

Fig. 16
The offer process



occurrence or non-occurrence need not be determined before the end of the acceptance period, because there is always the possibility that the antitrust proceedings will not be finished by the end of the offering period, but that a clearance will be issued at a later date. Thus, it is quite possible that several months could pass between the end of the actual offer process and the transferral of shares and payment of the purchase price. In order to ensure that shareholders who have accepted the offer are not disproportionately burdened by this delay, BaFin normally requires in that shareholders be granted a right to withdraw such cases. Accordingly, they may withdraw their acceptance at any time without cause.

Target company duties in the offer process.

Besides the bidder, the management and supervisory boards of the target company have certain duties to fulfil under the WpÜG. The management and supervisory boards are required to comment on the offer (section 27 (1) WpÜG). In particular, they must address the type and amount of consideration, the consequences of the offer for the target company and its employees, and the goals pursued by the offeror. If they hold shares in the target company, the members of both bodies must declare whether they themselves will accept the offer. Reasons for their positions must be given so that shareholders in the target company can comprehend how the governing bodies of

the target company arrived at their views. When evaluating the offer, the shareholders of the target company should also be able to draw on the expertise of the governing bodies of the target company. It is therefore important that such comments be published early and not towards the end of the offering period. At the same time as publication, the management and supervisory boards are required to direct their comments to the works council of the target company or directly to the employees. If the latter desires to comment, this comment must be appended to the comments of the management and supervisory boards.

5.2 Monitoring takeover procedures

BaFin monitors the entire offer procedure and acts to remedy any shortcomings that could impair the process or harm the securities market (section 4 WpÜG).

BaFin reviews the offer documents primarily for the appropriateness of the offered consideration.

The supervisory focus is on reviewing offer documents and exemption applications. BaFin reviews the offer document within a 10-day period for its formal completeness and for any obvious violations of the WpÜG. Most importantly, it reviews the appropriateness of the consideration offered. In addition, it reviews in particular the effects of a successful bid on the bidder's financial position, financial performance, and cashflows, as well as the financing of the offer. The information from the bidder as to the aims it is pursuing with respect to the target company is also particularly important.

If the offer document shows defects, BaFin can set the offeror a five day deadline to rectify them. If the bidder fails to do so, BaFin will prohibit the offer.

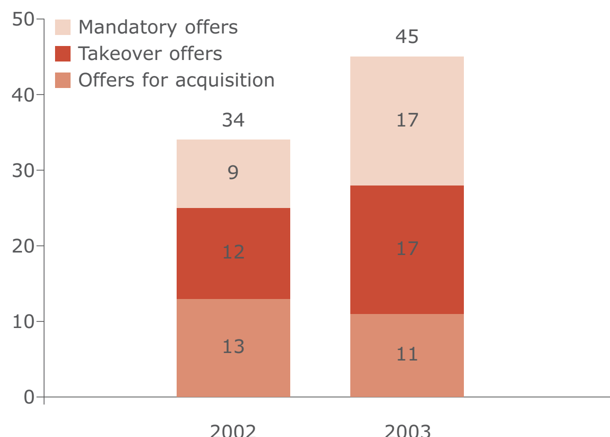
Approvals, prohibitions and exemptions

In 2003, there were 11 offers for acquisition, 17 takeover offers and 17 mandatory offers.

45 offers were approved during the reporting year. There were eleven offers for acquisition, 17 takeover offers and 17 mandatory offers. In three instances, BaFin prohibited publication of the offer document. In the first such case, no confirmation of financing was submitted. In the second case, the investment services enterprise that issued the financing confirmation was a subordinate entity of the offeror. In the third case, BaFin discovered that the offeror had failed to disclose material prior acquisitions for the offering price, which meant that the offered consideration fell below the minimum price demanded.

27 of the 45 offers stemmed from a bidder domiciled in Germany. Some of these companies, however, were special purpose companies that were organised for the purpose of carrying out the offer only. Thus, based on the domicile of the controlling company of the bidder's group, there were only 19 offers in which the participants were all German. Under both methods, the number of offerors from other countries was distributed evenly among EU member states and others. There was a focus on groups from the USA that were represented six times on the offeror side. The offer documents for

Fig. 17
Offer procedure



the procedures carried out to date can be viewed in the database on BaFin's website, as can the announcements of decisions to make an offer or of the attainment of control over a company[115].

Most of the applications for exemptions related to planned restructuring of the target company in this year as well.

In 2003, a total of 110 applications were filed for exemption from mandatory offers or disregard of voting rights under sections 36 and 37 WpÜG[116]. The majority of applications for the disregard of voting rights related to internal group restructurings. The focus of the exemptions from publication of attainment of control and from making a mandatory offer was on the intended restructuring of the target company. In addition, there were numerous exemption applications that generally involved holding relationships in the target company and the actual possibility of exercising control.

Overall, BaFin granted 63 exemption applications and refused seven. Applicants withdrew 25 applications, while 15 applications were still being processed at the end of 2003.

Objection procedures and administrative fines

The Objections Committee upheld all BaFin decisions referred to it for review.

In 2003, nine objections to BaFin's decisions were filed (2002: 5) and directed to the Objections Committee for review. BaFin's The Objections Committee is a special body which passes judgement on fundamental substantive decisions pursuant to the WpÜG. It is composed of the President of BaFin, two civil-service members and three honorary assessors. In five cases, the Objections Committee upheld BaFin's initial decisions, while in the other four, the objection was withdrawn prematurely.

Three objections were made regarding refusals of exemption applications pursuant to section 37 WpÜG. BaFin denied the applications because they failed to meet the requirements of a restructuring case, and because the applications had not been filed

[115] www.bafin.de > Datenbanken & Statistiken.
[116] cf. also Appendix 8.8 for information on individual exemptions.

within the prescribed deadline. In another case, an offer was prohibited because the investment services enterprise that issued the confirmation of financing pursuant to section 13 WpÜG was not an entity that was independent of the bidder. The Objections Committee was also called upon to make a decision on a shareholder's objection to an exemption pursuant to section 37 (1) WpÜG. Here, a newly organised company created by a spin-off attained indirect control over a target company. The objection, however, was already inadmissible. A judicial review of the three decisions of the Objections Committee concerning the denial of exemptions due to restructuring and of the decision concerning third party objection has been sought and these cases are now pending before the Higher Regional Court of Appeal (Oberlandesgericht) Frankfurt am Main.

BaFin also had to decide on a further 20 objections (2002: 13). Most of these objections were objections to requests for information and the submission of documents, as well as to decisions on fees or the inspection of records and consultations in exemption proceedings. Two objections were justified and the original decision was confirmed in 15 cases. Three objections were withdrawn.

In 2003, BaFin initiated administrative offence proceedings in 42 cases (2002: 19) for WpÜG violations. Four fines were levied (2002: 1) and 53 cases were still open at the end of the year, 15 of which had been carried over from the prior year. Many cases were opened because the management and supervisory boards of target companies had violated their duty to submit statements promptly after publication of the offer (section 27 WpÜG). In several cases, bidders had also delayed or failed to disclose that they had attained control over a target company.

5.3 Further development of takeover law

During the reporting year, BaFin and the Higher Regional Court of Appeal in Frankfurt am Main were called upon to make decisions on several important legal issues concerning the interpretation of the WpÜG.

Different share classes

Several offers were directed at different classes of stock; ordinary and preferred shares, in particular. In some cases, individual classes of shares in the target company were completely or partially unlisted. Generally speaking, a takeover or mandatory offer must extend to all shares in the target company, including those that are not publicly traded on an exchange. In the case of a mandatory offer, the WpÜG states that the offer shall extend to all shareholders, because attainment of control has just an much of an effect on the holders of unlisted shares in a company that is otherwise publicly traded. In addition, the WpÜG prohibits takeover offers for only a portion of shares.

Repurchase of own shares

The offers by Axel Springer AG, Beiersdorf AG and Spütz AG were the first offers made by companies seeking to repurchase their own shares that were filed for review by BaFin. The WpÜG applies to offers to repurchase own shares. Under the Stock Corporation Act, repurchase is limited to ten percent of shares. In such cases, the WpÜG guarantees a fair process in which every shareholder can participate and not just those who are the first to accept the offer. In addition, shareholders are adequately informed, especially if shares are offered as consideration. The obligation to submit confirmation of financing ensures that shareholders will actually receive consideration.

Appropriate consideration in the case of ordinary and preferred shares

Particularly in the cases of the offers made to the shareholders of Wella AG and ProSieben Sat.1 Media AG, there was a great deal of public and media discussion as to whether or not BaFin had applied the WpÜG correctly with respect to the appropriateness of consideration offered for ordinary and preferred shares. BaFin follows the clear statutory provisions of the implementing ordinance to the WpÜG which provide, in the case of ordinary and preferred shares, for separate calculations using the respective average market or pre-acquisition prices.

Material adverse change clauses

In 2003, BaFin was frequently called upon to clarify whether or not so-called material adverse change clauses were permissible. These clauses declare that the validity of a takeover offer is determined by the non-occurrence of certain asset changes in the target company or by force majeure events, although the WpÜG states that the conditions must be sufficiently certain. This criterion is not met in the case of clauses that contain very broadly drawn and very vague factual terminology. Such concerns can be alleviated by submitting the invalidating events to ad hoc disclosure under section 15 WpÜG, or by coupling them with a requirement for neutral third party expert opinion.

Coordinated conduct

Companies or individuals must tender a mandatory offer as soon as they have attained control over the target company. An interest in 30 percent of stock voting rights in a target company is sufficient for such an attainment of control. Under certain circumstances, the bidder's share of voting rights can be augmented by attributing to it the voting rights of third parties. Thus, the voting rights of the shareholders of the target company will be reciprocally augmented if they coordinate their action in such as way as to influence the company. The scope of the attribution rules of section 30 (2) WpÜG is in dispute. BaFin has decided in several cases that such coordinated conduct must result in a persistent and continuous

influence over the target company. The outcome of a particular case may hinge on whether or not the choice of supervisory board members is motivated by the pursuit of a wider-reaching plan with respect to management of the target company. This is particularly obvious, for example, if a new major shareholder acquires less than 30 percent of voting rights and combines its relatively large interest with that of other major shareholders in order to reach agreement on electing his slate of candidates to sit on the supervisory board. Depending on the number of supervisory board members to be elected, this could certainly represent coordinated conduct if the composition of the supervisory board is linked to the pursuit of a wider-reaching plan, such as a new business focus with concomitant appointment of new management board members.

Shareholder legal actions

The competent WpÜG senate at the higher regional court of appeal (OLG) in Frankfurt am Main passed a decision on the previously disputed issue as to whether or not the WpÜG granted shareholders the status of a party in interest and afforded them standing to sue[117]. Following an unsuccessful objection to the approval of the tender offer made to shareholders of Wella AG, some shareholders filed suit.

Other cases sought consultation rights and the right to inspect files in exemption proceedings. The OLG Frankfurt am Main confirmed BaFin's view of the law that there was nothing in the WpÜG that could be legally construed to grant party in interest status to third parties or to afford these parties standing to sue[118].

6 Investment Supervision

6.1 Investment companies

The new Investment Act (*Investmentgesetz – InvG*) assigned BaFin many new tasks in the areas of German domestic and foreign investments. Especially with respect to regulating hedge funds, the legislature has entered into new territory. One of BaFin's areas of focus was staffing its hedge fund section in preparation for its inauguration in January 2004.

[117] Order of the OLG Frankfurt dated 04 July 2003, Ref.no.: WpÜG 4/03.
[118] Orders of the OLG Frankfurt dated 27 May 2003, Ref.no.: WpÜG 1/03 and 2/03, and dated 09 Sep. 2003, Ref.no.: WpÜG 2/02 and WpÜG 3/03).

hanges introduced with the Investment Act

The Investment Act combines and modernises the Investment Companies Act (*Gesetz über Kapitalanlagegesellschaften – KAGG*) and the Foreign Investment Act (*Auslandsinvestment-Gesetz – AuslInvestmG*).

Repeal of statutorily defined types of funds.

Instead of statutorily defined fund types, there is now a catalogue of permissible assets that may be freely combined within the investment limits. In this context, it makes provisions for BaFin to issue guidelines for fund names, so that misleading fund designations can be avoided from the outset. In the first half of 2004, BaFin will issue a guideline that categorises fund types.

Introduction of a European passport for investment companies.

Up until now, there was an EU passport only for funds pursuant to the UCITS directive but not for management companies as such. Now, the management companies themselves can obtain an EU passport both for establishing branches and for the provision of cross-border services. The principle of home country control applies.

Broader permissible use of derivatives.

The use of derivatives can double the market risk potential of a fund. Details are now governed by the Derivatives Ordinance[119]. This ordinance provides information as to which risk management and which risk measurement policies are required under the Investment Act when using derivatives in funds[120].

New rules on reporting obligations.

The quarterly reports on exceeding investment limits that BaFin previously received on paper will be abolished with effect from 1 January 2005. These reports will be replaced by regular electronic deliveries to BaFin, as provided by section 9 WpHG, containing a statement of assets for every fund – except hedge funds – and reports of material transactions. BaFin will issue an ordinance governing the exact reporting intervals, as well as other details.

These new reporting obligations are designed to intensify and improve the market supervision of funds. The reports give BaFin prompt information on fund assets, allowing it to identify conflicts of interest, e.g. any comparative disadvantage of mutual funds over special funds. In addition, transparency is increased by including inter-fund transactions.

New capital requirements for investment companies.

Initial capital ,and thus minimum capital requirements, have been lowered from €2.5 million to €730,000 across the board and, in addition, a dynamic increase based on the value of fund assets under management has been introduced. There is, however, a limiting cap, i.e. required capital backing may not exceed €10 million. Irrespective of this, there is a permanent minimum capital requirement for overhead costs.

[119] BaFin Ordinance on Risk Management and Risk Measurement when Using Derivatives in Funds pursuant to the Investment Act (Verordnung der BaFin über Risikomanagement und Risikobemessung beim Einsatz von Derviaten in Sondervermögen nach dem Investmentgesetz).

[120] www.bafin.de > Rechtliche Grundlagen & Verlautbarungen.

This affects the solvency supervision of investment companies. The Investment Act does not provide for a differentiation between investment companies that only manage hedge funds and those that only manage conventional funds. Elevated risks of insolvency can ensue for investment companies that launch hedge funds. They can increase their investment level by means of generally unlimited leverage, but can also double the market risk potential of conventional funds by using derivates.

Merging funds and umbrella structures.

The possibility of merging funds whose low volume means that they are no longer economical to manage contributes to a sensible consolidation of the market. The practice of integrating several sub-funds under one "umbrella", which is common practice abroad, is now also permitted in Germany. BaFin will issue an ordinance that provides more detailed rules concerning the treatment for accounting purposes and the net asset value determination for the unit classes already introduced by the 4th FMFG and for every sub-fund that is part of an umbrella structure.

Supervision of hedge funds

The new hedge fund section was set up in Frankfurt in November.

Immediately after the InvG was adopted in November 2003, BaFin established a hedge fund section. The new section is located in Frankfurt am Main. Its duties include the issue of licences and the subsequent solvency supervision of investment companies that wish to set up and manage only hedge funds, as well as investment stock corporations that are hedge funds. The staff of this section also approve the contractual terms and conditions for hedge funds and exercise ongoing market supervision in accordance with the InvG.

The section also monitors the sale of foreign hedge funds in Germany.

Hedge funds and investment stock corporations.

Legal basis

The InvG not only contains rules governing the product, i.e. single hedge funds and funds of hedge funds and their sale, but also provisions governing the investment company. Besides investment companies, investment stock corporations with variable capital have been introduced. Unlike investment companies, these are not special credit institutions. Only selected provisions of the Banking Act (*Kreditwesengesetz – KWG*) apply. The legal form of the investment stock corporation with fixed capital was already provided for in the Investment Companies Act (KAGG), but until now no such companies had been organised.

German funds of hedge funds.

Domestic funds of hedge funds can be set up as mutual or special funds. In either case, there is a licensing obligation. Funds of hedge funds may target both domestic regulated single hedge funds and foreign investment funds with comparable investment principles for acquisition.

There are only a few quantitative diversification provisions for funds of hedge funds. Other criteria must be determined on a case-by-case basis, subject to the overarching principle of risk diversification. In

addition, funds of hedge funds are required to obtain certain minimum information about the target fund before investing in it (due diligence). They must monitor target funds continuously with respect to their investment strategy and risks.

The company therefore normally selects the target fund in a structured selection process using specific criteria that include both quantitative and qualitative elements. In performing a quantitative analysis, the emphasis is on the strategy of the target fund, its historical returns and standard deviations, correlation to other target funds with similar or identical investment strategies or benchmarks, as well as the stability of its returns under extreme or variable market situations. In qualitative analysis, the focus is on the qualification of the persons who make the investment decisions for the target fund. The analysis includes an assessment of the corporate governance of the target fund, its risk management and liquidity.

The InvG sets special requirements on the experience and practical knowledge possessed by the fund of hedge funds manager. Besides the general requirement that he be capable of managing investments, the manager must have theoretical and practical knowledge in the area of hedge fund investing.

The prospectus of funds of hedge funds must contain a warning notice that the investor risks total loss. Investors must be provided with all sales documentation, which must be in writing, before any contracts are executed.

Domestic single hedge funds.

Single hedge funds are generally permitted to borrow, use derivatives to increase investment level (leverage), and enter into leverage transactions and short sales without limit. To prevent the possible misuse of short sales, however, the Ministry of Finance is authorised to issue an ordinance limiting such transactions. BaFin will issue an ordinance governing the design of risk measuring systems for hedge funds.

Single hedge funds may outsource certain custodian duties to another comparable institution such as a prime broker provided that liability remains with the custodian. Single hedge funds may now also be launched as special and as mutual funds. Single hedge funds, however, may not be publicly sold but only distributed by means of a "private placement". Moreover, single hedge funds may be sold only by firms that BaFin has previously licensed to do so.

Initial practical experience

Preparations also include consultations on general and special contractual terms and conditions.

At the end of the reporting year, the activities of the new hedge fund section focused primarily on preparations for the effective date of the InvG in January 2004. BaFin had already conducted discussions in advance with interested investment companies to ease the application process. In addition, contact was made with industry associations to initiate the consultation process concerning the general and special contractual terms and conditions for single hedge funds and funds of hedge funds. These terms and conditions form one of the most important bases for the licensing of funds.

Final consultations with the associations took place in February 2004.

BaFin clarifies the role of the prime broker.

Initial discussions have been conducted with banks about their possible role as prime brokers. Prime brokers are used abroad by nearly every hedge fund. To date, they have not been necessary in Germany, because the custodian banks have been adequate for the existing investment possibilities of funds. However, especially for the needs of single hedge funds, prime brokers offer a wide range of multi-functional services from a single source, something most German custodian banks cannot do. These services include, in particular, furnishing collateralised loans for financing margin requirements and meeting margin calls on the futures markets, the procurement of securities and other intermediary services in connection with securities lending. Prime brokers can also organise the settlement and clearing of the securities trades by the hedge fund with the prime broker or third parties, as well as the custody of the securities. BaFin will make a definitive decision on the relationship between custodian bank, prime broker and investment company.

The first hedge funds were launched as planned in March 2004.

BaFin was able to approve the first two hedge funds of German investment companies in as early as March 2004. It will prepare a fact sheet setting forth the formal and material criteria for obtaining a licence to sell foreign funds of hedge funds in Germany.

Market supervision

The market supervision of domestic investment companies is now unified in a single section that was moved from Bonn to Frankfurt in January 2003. The focal points of its activities include supervisory inspections of investment companies, coordinating discussions with auditors and associations, preparations for setting up a new reporting system, and evaluating investment company reports and notices.

BaFin dealt intensively with fund trading practices.

One point of emphasis during the reporting year was on the investment industry's rules of conduct and the fee and cost practices. BaFin has explored the issue of what effects certain trading practices, such as trading at the preceding day's close – “late trading” – and time zone arbitrage – “market timing”, might have on domestic investment funds. To this end, it sent a questionnaire to all German investment companies, as well as their auditors and custodian banks.

No evidence of late trading could be found.

The evaluation of the predominantly open and self-critical answers to the survey questions showed uncertainty at some institutions in dealing with time-zone arbitrageurs. BaFin has thus far been unable to detect any cases of late trading. They may tend to be rare due to the special control function of the custodian bank and the elevated level of managerial responsibility at special lending institutions under German law. The new rules on reporting obligations (section 10 InvG) are leading to better use of existing information technology. The new reporting system thus allows a more effective check of whether trades transacted for the investment fund are in the interest of investors and will ensure market integrity.

Supervision of real estate funds

Positive developments in the area of open-ended real estate funds continued in 2003. As in previous years, these funds, with few exceptions, registered considerable fund inflows. In the second half of the year, however, there were isolated instances of larger fund outflows.

Overall, the 4th FMFG simplified the prerequisites for acquiring real estate, thus laying the foundation for continued positive developments even if, due to economic conditions, the European real estate market is currently rather stagnant.

Real estate funds used the possibility of making unlimited purchases abroad.

At the centre of investment interest was the acquisition of open-ended real estate funds. These make use of the new option to acquire unlimited properties outside of Europe. Investment companies have primarily been acquiring properties in the North American market, but increasingly in the Asian market as well. The number of mutual funds increased by six to 30 with a total of €87.7 billion (2002: €75 billion) in assets under management.

30 mutual funds manage approx. €87 billion.

With €13.4 billion in assets under management, the special fund area also continues to be marked by strong growth. The number of real estate special fund mandates grew by eleven to a current total of 68. Furthermore, BaFin licensed three new investment companies that wish to concentrate predominantly on the area of real estate special funds.

Figures for investment supervision

BaFin licensed four investment companies to engage in the investment business. During the reporting year, no companies were dissolved (2002: 4). Thus, at the end of 2003, 85 investment companies (2002: 81) were licensed to engage in the investment business.

BaFin approved new fund rules at 89 funds (2002: 125) and amendments in 256 cases (2002: 235). 38 funds were closed (2002: 34).

The number of mutual funds managed by domestic companies at the end of 2003 thus stood at 1,278 funds (2002: 1,380).

- 42 of these were money market funds (2002: 43).
- 166 funds of funds (2002: 187)
- 5 mixed securities and real estate funds (2002: 4)
- 40 old-age-provision funds (2002: 53)
- 30 open-ended real estate funds (2002: 24)
- 995 variously designed securities funds (2002: 1,069).

In addition, the investment companies managed 5,233 special funds (2002: 5,814).

6.2 Foreign investment funds

In 2003, BaFin continued to deal critically with the activities of individual foreign investment funds in Germany. In two cases, it was necessary to prohibit any further public sale of their units.

In addition, BaFin again had to answer numerous queries concerning the distribution authorisation of foreign funds, as well as the scope of application of the Foreign Investment Act (AuslInvestmG). The scope of application questions focused on private equity funds or certificate structures, the classification of which under the AuslInvestmG is determined on a case-by-case basis depending upon their respective structure.

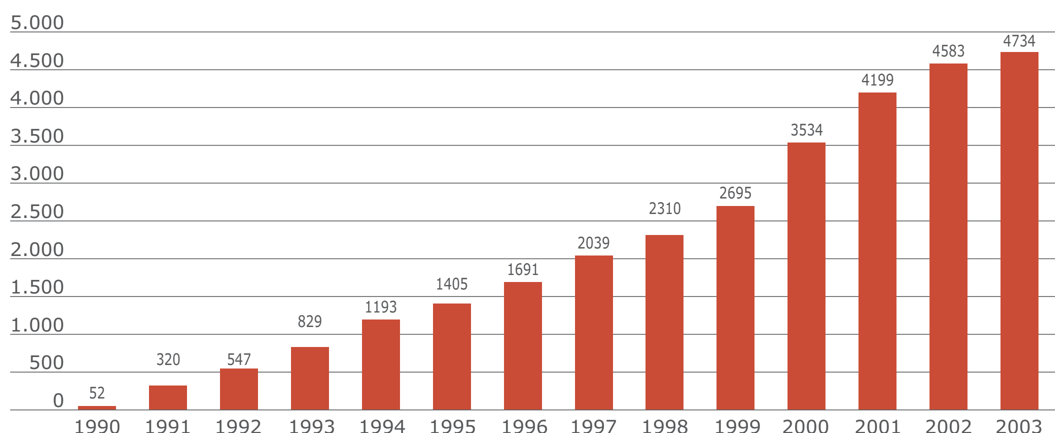
The InvG introduces some changes to the supervision of foreign investment funds. Besides the KAGG, the provisions of the AuslInvestmG have also been merged into the InvG. It is now possible for numerous new fund types from abroad to obtain a licence to publicly distribute their shares in Germany.

Accordingly, BaFin published a preliminary fact sheet at the end of 2003, which was adjusted to the new provisions[121], to provide information to foreign investment companies on distribution notices pursuant to the InvG. A separate fact sheet will be prepared in 2004 for the notices of foreign funds of hedge funds.

As in previous years, besides its ongoing supervision of foreign investment funds licensed to distribute, BaFin focused primarily on the timely processing of distribution notices for new foreign investment funds. Although the 756 notices received were fewer than in the prior year (927), the volume of notices continues to be high. The main reason for the declining trend might well be the changes under the InvG that were foreseeable as early as the middle of 2003. It is possible that these planned changes prompted foreign investment companies to delay marketing their new fund products in Germany until 2004.

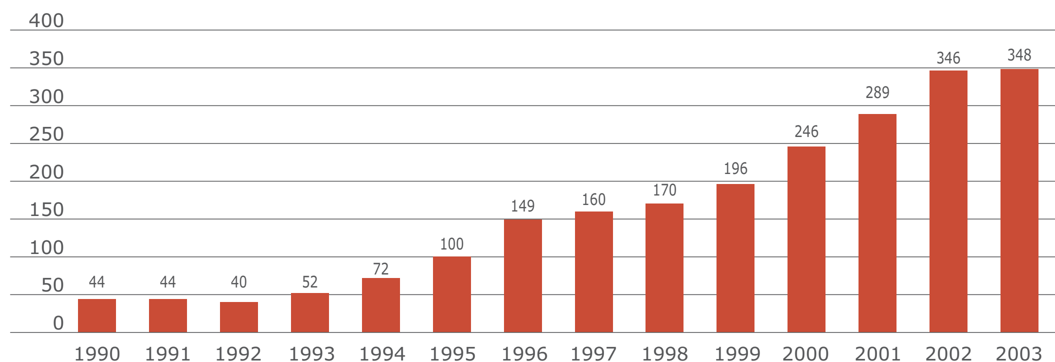
Fig. 18

Individual funds under section 15c AuslInvestmG



[121] www.bafin.de under Für Anbieter > Ausländische Investmentfonds.

Fig. 19
Individual funds under section 7 AuslInvestmG



As in 2002 (856 notices), the vast majority – 732 – of the distribution notices during the reporting year related to funds pursuant to the UCITS directive which were therefore subject to the simplified notification procedures of section 15c AuslInvestmG. The remaining 24 notices pursuant to section 7 AuslInvestmG (2002: 71 notices) were filed for other investment funds.

Although some funds were merged, liquidated or dissolved in their country of origin, there was a total of 1,378 foreign investment funds with 5,082 individual funds admitted for trading in the Federal Republic of Germany. Individual funds include the sub-funds of umbrella funds. This exceeded the previous year's record of 4,929 funds with distribution rights. The majority of these individual funds are domiciled in Luxembourg, with Ireland in second place.

V BaFin

1 Organisation
2 Budget
3 Staff
4 BaFin Lectures
5 Public Relations

In its second year of operations, BaFin continued to focus on the development of a strong and efficient integrated financial supervisory authority. This included several internal restructuring measures, as well as the establishment of new units, such as the project management staff unit.

Recruiting new staff became a central theme that demanded a lot of effort.

BaFin pursued its strong recruitment drive in 2003, not only to fill as many existing gaps in personnel as possible, but also to seek out employees for new duties ushered in by domestic and European legislation. The interest shown in BaFin, as a prospective employer, was considerable. Those involved in recruitment had to sift through a flood of applications and carry out the subsequent selection procedure.

BaFin gives high priority to in-house training for all of its employees. New employees, for example, are given a brief and summarised overview of BaFin's various areas of supervision as part of specialised introductory events held by experienced colleagues.

Staff increases also have repercussions in terms of space. The President and Vice President, as well as the staff units, sections of the cross-sectoral departments and the central administration moved into two new properties in Bonn that were leased and furnished.

1 Organisation

BaFin is led by a President and Vice President.
Chief Executive Directors preside over the three core directorates.

BaFin is led by President Jochen Sanio and Vice President Karl-Burkhard Caspari. They are supported by Chief Executive Directors, who preside over the three core directorates. Helmut Bauer is responsible for Banking Supervision, Dr. Thomas Steffen for Insurance Supervision and Georg Dreyling for Securities Supervision/Asset Management.

Organisational reforms

The staff units report directly to the President. The project management staff unit was added in November 2003, allowing BaFin to bundle the expertise and organisational competence required for different projects.

The Money Laundering Prevention Group, responsible for combating money laundering and the financing of terrorism, was shifted directly to the President as early as March 2003.

There are three cross-sectoral departments for the joint tasks.

Three cross-sectoral departments are subordinate to the Vice President. These comprise duties that affect every area of supervision: basic matters concerning the national and international financial markets (cross-sectoral department 1 – Q 1), consumer and investor protection, the certification of pension contracts/retirement schemes (Q 2) and the combating of non-authorised or prohibited financial services and insurance business (Q 3). A "legal competence centre", which is composed of the former legal sections from the directorates, was established in Q2 of the year under review.

The Q RM group is responsible for risk modelling.

In June 2003, BaFin established the cross-sectoral risk modelling group (Gruppe Querschnitt Risikomodellierung – Q RM). This group emerged from Group D, which previously belonged to Banking Supervision. The latter had been responsible for the admission of risk measurement and risk management models for supervisory purposes, the further development of supervisory law concerning the application of these models and the commission and execution of fit and proper tests. The group was expanded into a cross-directorate competence centre that covers all types of risk. This centre now conducts non-directorate-specific evaluations of the quantitative methods used for risk assessment.

Solvency and market supervision of financial services institutions is now provided as one-stop supervision.

In the year under review, BaFin began combining the supervision of financial services institutions in the securities supervision directorate. Solvency supervision of financial services institutions, previously conducted in Bonn, is being amalgamated with the supervision of proper conduct in Frankfurt am Main as part of the reorganisation process. This will guarantee "one-stop supervision" to reduce administrative expenditure. In an initial move, the solvency supervision of 114 institutions in the Federal States of Berlin and Brandenburg as well as Hamburg, Mecklenburg-West Pomerania and Schleswig-Holstein was transferred to the Frankfurt office as of 1 October 2003. The supervision of financial services institutions from the other Federal States is gradually being moved to Frankfurt am Main.

Fund supervision is gradually being moved from Bonn to Frankfurt.

In the investment supervision department, the first section to have its duties redefined – namely the section responsible for market supervision of domestic investment companies – was shifted from Bonn to Frankfurt in January 2003 Overall fund supervision will be moved to Frankfurt on a gradual basis until 2006. In November 2003, BaFin established the new hedge funds section in Frankfurt.

Five departments in Insurance Supervision.

In March 2003, BaFin also reduced the Insurance Supervision directorate from six to five departments.

Organisational development

BaFin launched an organisational development project with the assistance of professional advisors.

Having merged the three previously independent offices, which all had different philosophies and working methods, BaFin took on the task of creating a new and uniform culture.

Supported by external advisors, BaFin instigated an organisational development plan with the aim of making supervisory work and the employment of resources more efficient. To this end, BaFin hammered out initial targets and guiding principles at two closed-door meetings in early 2003.

The first result was the restructuring of the IT department.

The organisational development project officially began in August 2003, with external support provided by a consultancy firm. The first matter to be addressed was the preliminary work for the organisational examination of department Z, then still in the planning stage. As a result, BaFin severed the IT department from department Z and installed an independent department. The organisational examination of department Z opened for public tender started in May 2004. The establishment of the project management department formed part of the organisational development.

A new project management staff unit was created.

This unit set up a comprehensive project database with a knowledge management structure, compiled detailed guidelines and developed in-house training programmes for project management at BaFin. In addition, the staff unit was already performing project controlling duties and supported external advisors.

BaFin’s organisational development moves also include the development of a cost accounting concept. Cost accounting is a fundamental requirement for calculating allocation amounts, as well as the product unit costs of supervisory operations. In addition, 2004 will see the forging of a new organisational structure and a concept for the transparent determination of staff requirements.

Governance

When BaFin was formed, an Administrative Council and an Advisory Board were created. The Administrative Council monitors BaFin’s management and provides it with support in carrying out its specific tasks. Its 21 members are members of the German Federal Lower House (Bundestag), various federal ministries, and supervised institutions. The Advisory Board provides BaFin with advice to help it perform its tasks. It has 24 members comprising representatives from the banking and insurance industries, consumer protection organisations, financial academia and the Bundesbank.

There are also three advisory boards that deal with specific areas of supervision: the Insurance Advisory Council, the Securities Council and the Takeover Council.

Both BaFin and the Bundesbank belong to the Forum for Financial Market Supervision that was set-up at BaFin. This forum coordinates cooperation with the Bundesbank in issues relating to banking supervision and provides advice in integrated supervisory matters which are key to the stability of the financial system.

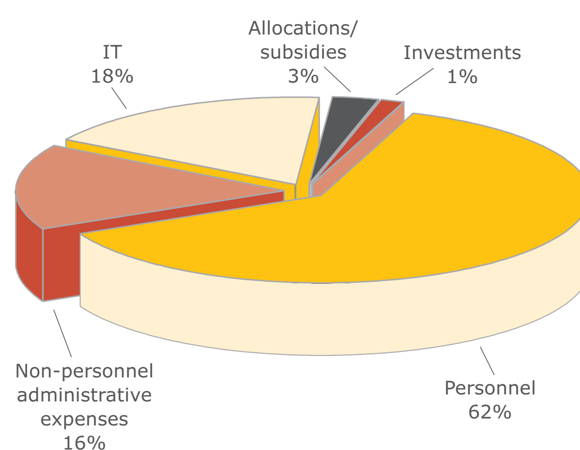
2 Budget

BaFin's financing comes from the fees and contributions paid by the supervised institutions and companies. It fully covers its costs using its own income and does not receive any funding from the federal budget. As a legal entity directly subordinate to the federal government, BaFin is obliged to prepare a budget plan which must be approved by the Administrative Council.

BaFin's budget plan for financial year 2003 provides for expenses and income of around €118.3 million (2002: €72.3 million). At €74 million, personnel expenses account for the largest proportion of this figure, followed by IT costs, which amount to €21million.

Fig. 20

Expenses



In 2003, according to the preliminary financial statements, expenses of around €91 million were offset by income of around €122 million.

According to the preliminary annual financial statements, which have yet to be approved by the Administrative Council, BaFin's expenses in 2003 totalled around €91.6 million (2002: €51 million), compared to income of approximately €121.9 million (2002: €69 million). This income was generated mainly from contribution prepayments for the 2003 allocation year, as well as from fees and separate reimbursements. Contributions are the most important source of financing. Those required to make contributions include, in particular, credit institutions, insurance companies and financial services institutions. Furthermore, BaFin also charges fees for certain official services, such as the deposit of securities sales prospectuses.

3 Staff

As in the previous year, one of BaFin's top priorities was to recruit qualified employees for operational supervision, fundamental tasks and the new cross-sectoral departments. The main aim of this recruitment drive was to fill the 228 new jobs approved by the Administrative Council for the 2003 budget. 82 of these posts were executive appointments, 91 were upper-grade or posts, 49 posts were in the medium-grade category and 6 posts were lower-grade appointments.

Around 4,900 applications for 228 posts were assessed.

BaFin published a number of advertisements for the new posts in the course of the year for each of the various professional groups: university business graduates, graduates of universities of applied sciences, mathematicians and lawyers. A good degree was a prerequisite for all of the posts. BaFin processed a total of almost 4,900 applications in 2003.

BaFin used assessment centres as part of its application process.

BaFin made substantial changes to its recruitment procedure in mid-2003 and implemented an assessment centre system for the first time. This system is designed to determine the social skills of BaFin management trainees and was especially designed for this purpose. The first stage of the recruitment process involved more than 310 interviews for upper-grade and executive posts, starting in September 2003. BaFin then put the applicants' social skills to the test in the assessment centres.
Many of the applicants selected have already started work with BaFin. Furthermore, some of the applicants were chosen to fill the 59.5 positions that the Administrative Council had approved for 2004 in November 2003.

BaFin was also able to fill a number of management posts with qualified external specialists, including heads of section for the cross-sectoral department and project management. In addition, it successfully implemented several selection procedures for IT specialists, actuaries and legal assistants.

BaFin had a total of 1,505 posts at the end of 2003. 551.5 of these posts were executive posts, 555 were upper-grade posts, 344.5 posts were in the medium-grade category and 54 posts were lower-grade.

4 BaFin Lectures

The increasing integration of the financial markets in Germany and Europe was one of the main reasons why the legislature set up BaFin in the first place. In order to support this integration not only from an organisational point of view, but also in terms of substance, BaFin introduced a new series of events: the "BaFin Lectures".

The BaFin lectures aim to allow open dialogue between the practical world of financial services and the supervisory authorities.

The BaFin Lectures establish a forum of open, interdisciplinary dialogue between representatives of the financial services industry, other supervisory authorities (including foreign authorities), academics and BaFin employees.

The lectures cover the latest supervision-related topics, and are organised in a cross-directorate fashion in keeping with the idea of integrated supervision.

The BaFin Lectures are one-day events held in the form of academic conferences at least every six to nine months. The guest speakers are almost always internationally-renowned personalities from academia and practice.

Three BaFin Lectures were held and proved to be extremely popular.

A total of three BaFin Lectures were held in the year under review. The agenda for the first conference, held in July 2003, covered the mathematical modelling of the assets and liabilities on insurance company balance sheets, stress tests for credit risk models and the evaluation of credit risk models at insurance companies. Among others, BaFin managed to secure Professor Bühlmann, a European actuarial science expert, as a speaker at the event.

The second round of BaFin lectures, held in November 2003, focused on complaints made by the general public in the insurance sector and how these are dealt with by BaFin and the insurance ombudsman, Professor Römer. The insurance ombudsman is a private, independent and free arbitration entity for consumer complaints against insurance companies. Professor Römer, a former judge at the German Federal Court of Justice, spoke about his personal experience with complaints from the general public and the consumer-oriented reforms contained in the Insurance Contract Law (*Versicherungsvertragsgesetz – VVG*).

The third set of BaFin Lectures took place in December 2003 and went into detail on the modelling of operational risks at insurance companies and credit institutions. The various guest speakers, mainly representatives of the financial services industry, once again highlighted the particular challenges that the supervisory authorities will face with regard to modelling operational risks in the future. These include, to name but a few, the definition of losses, a clear differentiation between losses from market and credit risks, data collation and mapping problems, and back-testing problems.

The BaFin Lectures proved to be encouragingly popular. At least three further events are planned for 2004, and are expected to cover business processes and corporate governance at credit and insurance institutions, hedge funds and economic capital.

The guest speakers and main topics covered by the BaFin Lectures to date are set out in detail in Appendix 4.

5 Public Relations

The public continued to show a keen interest in BaFin's work in its second year. Representatives of the press and other media, as well as private individuals and companies, again submitted several thousands of enquiries. These enquiries, which were made both orally and in writing, related to all of BaFin's activities. Given the fact that the market environment remains difficult, the enquiries focused on the situation of life insurance companies, the earnings situation of, and the need to perform write-downs at banks, the trading practices of funds and the introduction of hedge funds.

BaFin has taken a proactive approach in the public arena by regularly participating in investment trade fairs and stock exchange conferences.

BaFin once again took part in investment trade fairs and stock exchange conferences in 2003. In April 2003, it was present at the three-day investment trade fair "INVEST", which is held annually in Stuttgart. In the autumn of 2003, BaFin employees held question and answer sessions for a number of interested parties at stock exchange conferences in Hamburg and Munich. These events enabled investors and consumers in particular to obtain information on a number of topics, such as the security of their life insurance policies, deposit guarantee schemes in the banking sector and the informational obligations imposed on listed companies. There were also a large number of individuals that were interested in the licensing requirements for potential service providers.

The annual meeting with lawyers, prosecutors and criminal investigation officers from across Germany was held on 18 March 2003 and once again proved very popular. 200 participants accepted the invitation to Frankfurt. Guest speakers from academia and practice discussed a range of topics, including current rulings, and exchanged opinions on the new market manipulation regulations. One SEC employee gave a presentation on the supervisory practices and experiences of the US supervisory authorities. In 2004, BaFin will extend this event to cover more of its supervisory areas. Plans are to use this forum to cover the prevention of money laundering and the procedure for dealing with illegal financial transactions.

In the year under review, numerous groups of visitors once again took the opportunity to learn about BaFin's supervisory activities on-site. In addition to student groups, visitor groups from abroad showed a keen interest in BaFin's work.

BaFin's new website went live.

BaFin's new website has been up and running since the autumn of 2003. The comprehensive information offering, which has been expanded considerably, includes, for example, a separate "For Consumers" (*"Für Verbraucher"*) category. This section provides any interested parties with general information on banking, insurance and stock market issues. BaFin also provides visitors to the website with a range of options for solving any problems with banks, insurance companies or financial services institutions. The construction of the English version of the site was still in progress at the end of 2003.

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BaFin

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As at: May 2004

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Representatives of associations for SMEs

Ulrike Diehl	Deutsche Vereinigung für Finanzanalyse und Asset Management

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Dr. Heike Ratajczak	VAWE department head Thuringia Generali Versicherung AG
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Prof. Dr. Wolfram Wrabetz	Senior authorised signatory and Executive Board Chairman of HELVETIA Versicherungen in Germany Management Board Member of HELVETIA PATRIA Gruppe Schweiz

As at: May 2004

Speakers and themes of the BaFin Lectures in 2003

Date	Speaker	Theme
03/07	Prof. Hans Bühlmann	Mathematics aspects of the asset and liability sides
03/07	Prof. Ludger Overbeck	Stress tests for credit risk models
03/07	Dr. habil. Michel Dacarogna	Asset Liability Management in More Challenging Market Conditions
12/11	Prof. Wolfgang Römer	Experience of the Ombudsman and reform of the Insurance Contract Law
12/11	Detlef Kaulbach, BaFin	Processing of complaints by BaFin – our experience with insurance law
09/12	Kati Krempkow, BaFin	BaFin OpRisk: Basic definitions and overview of Basle II
09/12	Dr. Jack L. King, Genoa (UK) Ltd.	Combining Qualitative and Quantitative Information for Capital
09/12	Dr. Ulrich Anders, Dresdner Bank	Qualitative Aspects of OpRisk
09/12	Dr. Johannes Voit, DSGV	The Operational Risk Pilot Project of the German Savings Banks’ Association: Theoretical Concepts and Practical Experiences
09/12	Michael Kalkbrener, Deutsche Bank	Quantitative Modeling of Operational Risk
09/12	Claudio Franzetti, Aon ReSolution	Operational Aspects of Operational Risk Tools
09/12	Thomas Leddy, Swiss Re	A (Re) insurers Approach to Operational Risk
09/12	Jörg Allenspach, Swiss Re	What Insurance may do for bank's Operational Risk Management
09/12	Fred A. Peemöller, Deutsche Bank	Operational Risk Management from a senior manager's bird's eye view

International and other national bodies

International bodies

Basel Committee on Banking Supervision (BCBS)
Conference of Pension Supervisory Authorities (CPSA)
Enlargend Contact Group on Investment Supervision
Financial Action Task Force on Money Laundering (FATF)
Financial Stability Forum (FSF)
International Accounting Standards Board (IASB)
Insurance Advisory Committee
International Association of Insurance Supervisors (IAIS)
International Commission on Holocaust Era Insurance Claims (ICHEIC)
International Network of Pension Regulators and Supervisors (INPRS)
International Organisation of Securities Commissions (IOSCO)
Joint Forum on Financial Conglomerates (JF)
Organisation for Economic Cooperation and Development (OECD)

European bodies

Banking Supervision Committee (BSC)
Banking Advisory Committee (BAC)
Committe of European Banking Regulators (CEBS)
Committee on European Insurance and Occupational Pensions Supervisors (CEIOPS)
Committee of European Securities Regulators (CESR)
European Insurance and Occupational Pensions Committee (EIOPC)
Erfahrungsaustausch Deutschland, Österreich, Schweiz, Liechtenstein (Erfa-DACHL)
Ecofin Council Working Group
Financial Stability Table (FST)
Groupe des Contact (GdC)
Groupe de technique d´interpretation ´de l´application des directives bancaires (GTIAD)
Money Laundering Contact Committee at the European Commission
Conference of EU Insurance Supervisory Authorities
UCITS Contact Committee
Insurance Committee (IC)

Other official bodies

Arbeitskreis der Versicherungsbehörden der Länder (Working Group of Länder Insurance Authorities)
Arbeitskreis der Länder für Börsen und Wertpapierfragen (Länder Working Group for Issues Relating to Exchanges and Securities)
Arbeitstagung der Versicherungsaufsichtsbehörden des Bundes und der Länder (Conference of Insurance Supervisory Authorities of the Bund and Länder)

Health Insurance Committee of the DAV
(Deutsche Aktuarvereinigung e.V.)
Stock Exchange Expert Commission
Arbeitskreis der Länder
(Länder Working Group) – savings banks,
savings banks' central banks (Sparkassenzentralbanken),
regional building societies (Landesbausparkassen) –

The Federal Financial Supervisory Authority has concluded Memoranda of Understanding (MoU) with the supervisory authorities of the following countries:

1. In the area of Banking Supervision:

Belgium, Denmark, Finland, France, Greece, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal, Sweden, Spain, Great Britain.

Luxembourg (Clearstream)

Norway

Argentina, Australia, Estonia, Jersey, Hong Kong, Canada, Latvia, Lithuania, Rumania, Slovakia, Slovenia, South Korea, Czech Republic and Hungary.

United States of America (Federal Reserve Bank of New York, Federal Reserve Board and Office of the Comptroller of the Currency, as well as the New York State Banking Department).

2. In the area of Insurance Supervision:

China, Estonia, Latvia, Lithuania, Slovakia, Czech Republic and Hungary.

3. In the area of Securities Supervision:

Belgium, Denmark, Finland, France, Greece, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal, Sweden, Spain, Great Britain.

Argentina, Australia, Brazil, China, Hong Kong, Jersey, Poland, Russia, Singapore, South Africa, Taiwan, Czech Republic, Turkey and Hungary.

United States of America (Securities and Exchange Commission, Commodities and Futures Trading Commission).

Since 1999 a Multilateral Memorandum of Understanding (MMoU) concerning the exchange of information has been in effect between the supervisory authorities of the 15 EU states which are members of CESR, as well as Iceland and Norway as EEA signatories.

Additionally, 24 supervisory agencies worldwide have thus far signed the IOSCO MMoU. The current signatories are:

Alberta/Canada, Australia, British Columbia, Germany, France, Greece, Hong Kong, India, Italy, Jersey, Lithuania, Mexico, New Zealand, Ontario/Canada, Portugal, Poland, Quebec/Canada, Spain, South Africa, Turkey, Hungary, United Kingdom, United States of America (Securities and Exchange Commission, Commodities and Futures Trading Commission).

Foreign banks in the Federal Republic of Germany as at 31 December 2003

	Country	Subsidiaries	Subsidiaries of non-banks	Branches	Represen-tative offices	Cross-border services
		Number as at 31/12/2002 in brackets				
1	Afghanistan				1 (0)	
2	Andorra				1 (1)	
3	Australia			1 (1)		
4	Austria	1 (1)		8 (8)	4 (4)	32 (26)
5	Bahrain	1 (1)				
6	Belarus	2 (1)		2 (2)		22 (20)
7	Belgium	2 (1)		2 (2)		22 (20)
8	Bosnia-Herzegovina				1 (1)	
9	Brazil			1 (1)	1 (1)	
10	Canada		1 (1)		1 (1)	
11	Chechnya				1 (1)	
12	China, PR		3 (3)	2 (2)		
13	Croatia				1 (1)	
14	Denmark			3 (4)	1 (1)	10 (8)
15	Egypt	1 (1)				
16	Finland			1 (0)		3 (2)
17	France	6 (9)	5 (6)	17 (17)	12 (12)	73 (72)
18	Gibraltar					2 (0)
19	Great Britain, UK	4 (4)	4 (4)	13 (13)	4 (6)	54 (53)
20	Greece	1 (1)		3 (3)		
21	India			1 (1)		
22	Iran	1 (1)		3 (3)		
23	Ireland	1 (1)		3 (1)	2 (3)	29 (25)
24	Israel			4 (4)		
25	Italy	3 (5)	4 (4)	4 (5)	3 (8)	10 (8)
26	Japan	3 (4)	4 (4)	4 (4)	5 (6)	
27	Jordan	1 (1)				
28	Latvia				1 (1)	
29	Liechtenstein	1 (0)			1 (1)	4 (2)
30	Luxembourg	2 (2)	1 (1)	2 (2)	1 (1)	51 (49)
31	Mongolia				1 (1)	
32	Morocco				3 (3)	
33	Netherlands	5 (5)	7 (6)	9 (10)		31 (28)
34	Norway			1 (1)		3 (3)
35	Pakistan			1 (1)		
36	Philippines				3 (3)	
37	Portugal				9 (9)	6 (6)
38	Rumania	1 (1)				
39	Russia	1 (1)			2 (2)	
40	Saudi Arabia				1 (1)	
41	Slovenia	1 (1)			0 (1)	
42	South Africa	1 (1)			1 (1)	
43	South Korea/Rep. Korea	2 (2)			3 (3)	
44	Spain	1 (2)		1 (1)	8 (8)	7 (6)
45	Sweden	4 (4)	1 (1)	1 (1)		4 (3)
46	Switzerland	6 (7)	8 (8)		2 (4)	
47	Tadzhikistan				1 (0)	
48	Taiwan			0 (1)	0 (0)	
49	Tunisia				1 (1)	
50	Turkey	4 (5)		1 (1)	4 (6)	
51	U.S.A.	6 (6)	10 (13)	5 (5)	1 (2)	
52	Yugoslavia, FR			1 (1)		
		60 (67)	45 (48)	88 (89)	89 (102)	341 (318)

Statistics concerning securities supervision/asset management

8.1 Insider trading investigations

	Period	New investigations	Investigation results			Running investigations
			Dropped	Handed over to prosecutors		
		Insiders	Insiders	Cases	Persons	Total
Previous years	2000	51	24	22	0	**50**
	2001	55	19	25	0	**61**
	2002	69	15	33	0	**82**
	2003	51	16	26	137	**91**
2003	1st quarter	17	3	2	34	**94**
	2nd quarter	6	3	8	44	**89**
	3rd quarter	16	4	6	23	**95**
	4th quarter	12	6	10	36	**91**

8.2 Prosecutors' reports on concluded insider proceedings

	Period	Total	Dismissals	Dismissals after out-of-court settlement	Legally binding court decisions			
					Convictions following full trial	Convictions following summary proceedings	Acquittals	Dismissals
Previous years	2000	38	33	4	1	0	0	
	2001	39	28	9	1	1	0	
	2002	53	37	13	1	2	0	
	2003	87	70	7	2	3	1	4
2003	1st quarter	16	14	2	0	0	0	0
	2nd quarter	17	13	1	1	2	0	0
	3rd quarter	15	14	0	0	1	0	0
	4th quarter	39	29	4	1	0	1	4

8.3 Investigations of stock exchange and market price manipulation

	Period	New investi-gations	Dropped	Investigation results – Handed over to prosecutors or to the BaFin administrative fines section					Running investi-gations
				Prosecutors		Admin. fines section		Total	Total
				Cases	Persons	Vorgänge	Cases		
Previous years	01.07.-31.12.2002	17	0	3	0	0	0	**3**	**14**
	2003	51	13	7	21	3	8	**10**	**42**
2003	1st quarter	16	2	1	1	1	4	**2**	**26**
	2nd quarter	17	6	1	7	0	0	**1**	**36**
	3rd quarter	12	2	2	4	1	2	**3**	**43**
	4th quarter	6	3	3	9	1	2	**4**	**42**

8.4 Prosecutorial and court reports, and reports by the internal administrative fines section concerning concluded price manipulation proceedings

	Total	Prosecutorial decisions		Legally binding court decisions in criminal proceedings				Decisions in administrative offence proceedings	
		Dismissals	Dismissals after out-of-court settlement	Decisions by the court	Convictions following sum-mary proceedings	Convictions following full proceedings	Acquittals	Dismissals	legally bin-ding adminis-trative fines
2003	1	0	0	0	0	0	0	0	1

8.5 Number of ad hoc reports

		Total	By issuers' domicile		By form of submission	
			Germany	Outside of Germany	Electronic media	Official stock exchange gazette
Previous years	2001	5,421	4,605	816	5,389	32
	2002	4,491	3,781	710	4,467	24
	2003	3,301	2,689	612	3,283	18
2003	1st quarter 2003	870	685	185	862	8
	2nd quarter 2003	838	695	143	835	3
	3rd quarter 2003	831	687	144	828	3
	4th quarter 2003	762	622	140	758	4

8.6 Exemptions from ad hoc disclosure obligations

		Total applications for exemption	Applications for exemption		
			Denied	Approved	Withdrawn by issuer
Previous years	2001	36	32	2	2
	2002	26	18	7	1
	2003	16	7	2	7
2003	1st quarter 2003	6	3	2	1
	2nd quarter 2003	6	1	0	5
	3rd quarter 2003	2	1	0	1
	4th quarter 2003	2	2	0	0

8.7 Public tender offers to acquire securities and company takeovers

	Offer procedures* total	Of which:			
		Offers for acquisition	Takeover offers	Mandatory offers	Prohibition of offers
2002	34	13	12	9	2
2003	45	11	17	17	3

* the point at which the offer document is made public is counted as the time of the offer

8.8 Applications for exemptions pursuant to sections 20, 36, 37 of the WpÜG
(as at 31/12/2003)

	Total applications	Of which:			
		Approved	Denied	Withdrawn	In processing
2002	**113**	90	7	16	0
2003	**111**	63	7	25	16

	Applications pursuant to section 20 of the WpÜG for securities held for trading	Of which:			
		Approved	Denied	Withdrawn	In processing
2002	**3**	3	0	0	0
2003	**1**	1	0	0	0

	Applications pursuant to section 36 of the WpÜG for the non-consideration of voting rights	Of which:			
		Approved	Denied	Withdrawn	In processing
2002	**67**	61	2	4	0
of which					
Group-internal restructuring	67	61	2	4	0
2003	**53**	35	2	5	11
of which					
gift/inheritance	10	8	1	1	0
Change of legal form	1	0	0	1	0
Group-internal restructuring	42	27	1	3	11

	Applications pursuant to section 37 of the WpÜG for mandatory offers	Of which:			
		Approved	Denied	Withdrawn	In processing
2002	**43**	26	5	12	0
of which					
Blanket clause	25	14	5	6	0
Restructuring	10	7	0	3	0
Third party with a higher proportion of voting rights	5	3	0	2	0
Book value	3	2	0	1	0
2003	**57**	27	5	20	5
of which					
Blanket clause	14	5	0	7	2
Restructuring	35	15	5	12	3
Securing receivables	2	2	0	0	0
Third party with a higher proportion of voting rights	1	1	0	0	0
immediate breach of minimum threshold	1	1	0	0	0
Book value	4	3	0	1	0

8.9 Administrative offence proceedings

Grounds		New proceedings	Finally closed proceedings			Running proceedings
			Total	Administrative fines	Dismissals	
Reporting obligation pursuant to section 9	2002	12	6	5	1	9
	2003	**20**	**3**	**3**	**0**	**26**
Ad hoc disclosure	2002	31	18	5	13	30
	2003	**67**	**19**	**11**	**8**	**78**
Voting rights proportion	2002	171	95	40	55	226
	2003	**454**	**111**	**52**	**59**	**569**
Company takeovers	2002	19	4	1	3	15
	2003	**42**	**4**	**4**	**0**	**53**
Prospectuses	2002	20	12	5	7	38
	2003	**26**	**29**	**16**	**13**	**35**
Directors' dealings	2002	3	0	0	0	3
	2003	**112**	**8**	**4**	**4**	**107**
Price manipulation	2002	4	0	0	0	4
	2003	**2**	**1**	**1**	**0**	**5**
Other	2002	10	23	11	12	25
	2003	**26**	**25**	**18**	**7**	**26**
Total	2002	270	158	67	91	350
	2003	**749**	**200**	**109**	**91**	**899**

8.10 Foreign investment funds

		Funds	Individual funds	
2002	**Total**	**1,350**		**4,929**
			section 15c AuslInvestmG	4,583
			section 7 AuslInvestmG	346
2003	**Total**	**1,378**		**5,082**
			section 15c AuslInvestmG	4,734
			section 7 AuslInvestmG	348

Statistic of complaints in connection with insurance undertakings

9.1 About this statistic
9.2 Life insurance
9.3 Health insurance
9.4 Motor insurance
9.5 General liability insurance
9.6 Accident insurance
9.7 Household insurance
9.8 Insurers based in the EEA

9.1 About this statistic

In previous publications of its separate Annual Report, the former Federal Insurance Supervisory Office (*Bundesaufsichtsamt für das Versicherungswesen- BAV*), one of the three predecessors of BaFin, incorporated a complaints statistic by insurance class and insurance undertaking. The BAV had been ordered to include these details following a ruling by the Higher Administrative Court (*Oberverwaltungsgericht*) Berlin of 25 July 1995 (Case no.: OVG 8 B 16/94).

In order to define an appropriate indicator of the quality and volume of insurance business, the total number of company-specific complaints submitted to BaFin in the course of 2003 was put in relation to the total number of contracts within the respective insurance class (in force business) as at 1 January 2003. Figures regarding the in-force business are provided by the individual insurance companies. Insurers experiencing above-average growth in the reporting period, e.g. newly established companies, are at a disadvantage, due to the fact that new business added in the course of the year is not accounted for in the complaints statistic. Therefore, it should be noted that this statistic is of limited value when it comes to assessing the quality of specific insurance undertakings listed.

The in force business figures reported within the non-life category relate to insured risks. To the extent that undertakings concluded group policies with several insureds, this results in a higher number of in force policies. Owing to limited disclosure requirements (section 51 (4) no. 1 sentence 4 RechVersV), the in force business figures can only be included for insurers whose gross premiums earned in 2002 exceeded €10 million in the respective insurance classes or types.

As regards collective insurance within the category of life insurance, the figure specified relates to the number of insurance contracts. Within the area of health insurance, the number of natural persons insured is used to calculate the balance of policies, rather than the number of insureds under each policy section, which is usually higher. This figure is still not completely reliable. The statistic does not include insurance undertakings that operate within one of the

classes listed but have not been the subject of complaints.
In view of the fact that companies based within the European Economic Area are not required to submit reports to BaFin, no data has been stated for the in force business of EEA-based insurers. The number of complaints has, however, been included in order to present a more complete overview.

9.2 Life insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies	Complaints
1001	AACHENER/MCHN. LEBEN	4808715	298
1199	ABC LEBEN	28098	1
1120	ADLER LEBENSVERS.	1685	1
1173	AEGON LEBENSVERS.-AG	133257	14
1006	ALLIANZ LEBEN	10443653	335
1007	ALTE LEIPZIGER LEBEN	878512	56
1035	ARAG LEBEN	457173	32
1181	ASPECTA LEBEN	544899	64
1303	ASSTEL LEBEN	366902	76
1020	AXA LEBEN	2143100	187
1011	BARMENIA LEBEN	238435	11
1012	BASLER LEBEN	123288	8
1013	BAYER. BEAMTEN LEBEN	499837	33
1015	BAYERN-VERS.	1531510	72
1017	BERLINISCHE LEBEN	1289439	68
1145	BHW LEBEN	1010215	28
1132	CIV LEBEN	1576007	44
1122	CONCORDIA LEBEN	130069	8
1021	CONDOR LEBEN	215042	13
1078	CONTINENTALE LEBEN	569937	42
1022	COSMOS LEBEN	911718	29
1146	DBV-WINTERTHUR LEBEN	2423738	80
1023	DEBEKA LEBEN	2632173	72
1136	DEVK ALLG. LEBEN	503073	8
1025	DEVK DT. EISENBAHN LV	890435	6
1113	DIALOG LEBEN	170154	1
1110	DIREKTE LEBEN	69586	5
1138	DT. HEROLD LEBEN	2629274	268
1148	DT. LEBENSVERS.	130554	1
1028	DT. RING LEBEN	949202	107
1180	DT. ÄRZTEVERSICHERUNG	195966	9
1107	EUROPA LEBEN	334568	10
1310	FAMILIENFüRSORGE LV	309925	13
1175	FAMILIENSCHUTZ LEBEN	230113	17
1033	GERLING-K. LEBEN	1784170	166
1108	GOTHAER LEBEN AG	1228531	82
1162	GUTINGIA LEBEN	29756	7
1040	HAMB. LEBEN	14083	3
1184	HAMB. MANNHEIMER LV	7179596	297
1042	HANNOVERSCHE LEBEN	793083	85
1114	HANSEMERKUR LEBEN	191105	18
1142	HDI LEBENSVERS.	95528	8
1137	HELVETIA LEBEN	110221	6
1055	HUK-COBURG LEBEN	623834	46
1047	IDEAL LEBEN	397968	15
1048	IDUNA VEREINIGTE LV	2525136	96
1097	INTER LEBEN	231734	12
1119	INTERRISK LEBENSVERS.	64246	3
1128	ITZEHOER LEBEN	41810	1
1045	KARLSRUHER HINTERBL.	101848	2

Reg. no.	Name of insurance undertaking	Number of life insurance policies	Complaints
1050	KARLSRUHER LEBEN	1329200	63
1130	KARSTADTQUELLE LV AG	1111999	32
1054	LANDESLEBENSHILFE	26865	2
1062	LEBENSVERS. VON 1871	700381	17
1112	LVM LEBEN	644691	14
1198	MAMAX LEBEN	3345	1
1060	MANNHEIMER LEBEN	344511	200
1109	MECKLENBURG. LEBEN	144616	8
1158	MLP LEBEN	310593	50
1193	NECKERMANN LEBEN	35295	1
1164	NEUE LEBEN LEBENSVERS	547341	12
1147	NÜRNBG. LEBEN	2795756	261
1056	OEFF. LEBEN BERLIN	112149	8
1115	ONTOS LEBEN	37369	1
1159	PAX LEBEN	15512	4
1194	PB LEBENSVERSICHERUNG	201953	11
1123	PLUS LEBEN	48109	8
1081	PROV. LEBEN HANNOVER	726944	33
1083	PROV.NORD LEBEN	454349	32
1082	PROV.RHEINLAND LEBEN	1217801	46
1085	R+V LEBEN, VAG	487736	7
1141	R+V LEBENSVERS. AG	3854518	73
1018	RHEINLAND LEBEN	599733	8
1150	SAARLAND LEBEN	105471	3
1090	SCHWEIZERISCHE LEBEN	1081254	59
1168	SCHWESTERN VERS.	19821	1
1034	SECURITAS GILDE LEBEN	102678	3
1157	SKANDIA LEBEN	168925	13
1153	SPARK.-VERS.SACHS.LEB	234268	11
1104	STUTTGARTER LEBEN	472655	29
1044	SV SPARKASSEN LV	530728	27
1091	SV SPARKASSEN-VERS.	940191	41
1063	THURINGIA GENERALI LV	1130125	129
1152	UELZENER LEBEN	7431	1
1092	UNIVERSA LEBEN	277776	9
1093	VER.POSTVERS.	1351187	44
1140	VICTORIA LEBEN	2723118	202
1139	VOLKSFÜRSORGE DT. LV	4259259	202
1099	VOLKSWOHL-BUND LEBEN	839188	45
1151	VORSORGE LEBEN	30239	7
1160	VPV LEBEN	129113	14
1305	WESTF.PROV.	1280895	18
1149	WGV-SCHWÄBISCHE LEBEN	32687	1
1103	WWK LEBEN	887273	113
1005	WÜRTT. LEBEN	1889862	44
1096	ZÜRICH LEBEN	432441	10
1196	ZÜRICH LV AG	740679	60

9.3 Health insurance

Reg. no.	Name of insurance undertaking	Number of persons insured in 2003	Complaints
4034	ALLIANZ PRIV.KV AG	2271013	360
4010	ALTE OLDENBG. KRANKEN	52712	9
4112	ARAG KRANKEN	163775	21
4138	ASSTEL KRANKENV.AG	2468	1
4095	AXA KRANKEN	463176	85
4042	BARMENIA KRANKEN	706978	73
4134	BAYERISCHE BEAMTEN K	695859	78
4127	BBV KRANKEN	13834	2
4004	CENTRAL KRANKEN	1319526	177
4001	CONTINENTALE KRANKEN	1115751	104
4101	DBV-WINTERTHUR KRANK.	853704	78
4028	DEBEKA KRANKEN	2824314	99
4044	DKV AG	2832375	227
4013	DT. RING KRANKEN	572335	60
4089	EUROPA KRANKEN	198587	7
4128	GLOBALE KRANKEN	76070	12
4119	GOTHAER KV AG	493081	355
4043	HALLESCHE KRANKEN	502832	75
4018	HANSEMERKUR KRANKEN	370585	35
4117	HUK-COBURG KRANKEN	392897	28
4031	INTER KRANKEN	373746	40
4126	KARSTADTQUELLE KV AG	168194	7
4011	LANDESKRANKENHILFE	416515	47
4109	LVM KRANKEN	181079	3
4123	MANNHEIMER KRANKEN	86429	25
4141	MECKLENBURGISCHE KRA.	9665	1
4037	MÜNCHEN.VEREIN KV	214102	38
4125	NÜRNBG. KRANKEN	124957	4
4140	PAX-FAMILIENFÜRSORGE	97344	7
4135	PROVINZIAL KRANKEN	65701	1
4116	R+V KRANKEN	134110	6
4002	SIGNAL KRANKEN	1730159	113
4039	SÜDDEUTSCHE KRANKEN	360818	17
4108	UNION KRANKENVERS.	665457	35
4045	UNIVERSA KRANKEN	335353	28
4105	VICTORIA KRANKEN	814156	45
4139	WÜRTT. KRANKEN	38126	1
4137	ZÜRICH KV AG	76818	2

9.4 Motor insurance

Reg. no.	Name of insurance undertaking	Number of motor insurance policies (2003)	Complaints
5342	AACHENER/MCHN. VERS.	2084669	70
5581	ADLER VERSICHERUNG AG	149147	3
5312	ALLIANZ VERS.	15374891	184
5405	ALTE LEIPZIGER VERS.	369252	13
5515	AXA VERS.	3302935	129
5316	BAD. GEMEINDE-VERS.	485521	5
5317	BARMENIA ALLG. VERS.	237873	2
5318	BASLER VERS.	460346	30
5310	BAYER. BEAMTEN VERS.	187887	6
5325	BAYER. VERS.BANK	2628405	20
5324	BAYER.VERS.VERB.AG	1685149	19
5333	BRUDERHILFE SACH VVAG	419950	0
5338	CONCORDIA VERS.	955229	18
5340	CONTINENTALE SACHVERS	234296	12
5552	COSMOS VERS.	395230	26
5529	D.A.S. VERS.	498002	22
5343	DA DEUTSCHE ALLG.VER.	1338825	150
5311	DBV AG	281078	4
5037	DBV-WINTERTHUR	549875	63
5549	DEBEKA ALLGEMEINE	500588	5
5513	DEVK ALLG. VERS.	2517992	55
5344	DEVK DT. EISENB. SACH	929846	11
5055	DIRECT LINE	262252	49
5347	DT. HEROLD ALLG.VERS.	607582	36
5508	EUROPA SACHVERS.	280922	28
5470	FAHRLEHRERVERS.	300082	3
5359	FEUERSOZIETÄT BERLIN	177516	19
5364	FRANKF. VERS.	5207822	118
5505	GARANTA VERS.	1248925	42
5599	GENERALI LLOYD VERS.	2246637	8
5368	GERLING-K. ALLGEMEINE	1382760	40
5531	GOTHAER ALLG.VERS.AG	1547897	76
5469	GVV-KOMMUNALVERS.	134656	2
5585	GVV-PRIVATVERSICH.	208177	6
5420	HAMB. MANNHEIMER SACH	707410	20
5377	HDI HAFTPFLICHTV.	507072	9
5085	HDI PRIVAT	2661231	86
5384	HELVETIA VERS.	277426	5
5375	HUK-COBURG	7147345	116
5521	HUK-COBURG ALLG. VERS	4803383	82
5401	ITZEHOER VERSICHERUNG	636807	6
5509	KARLSRUHER VERS.	518601	19
5058	KRAVAG-ALLGEMEINE	557347	25
5080	KRAVAG-LOGISTIC	624693	13
5402	LVM SACH	4393316	26
5061	MANNHEIMER VERS.	195551	4
5412	MECKLENBURG. VERS.	690116	22
5390	NOVA ALLG.VERS.	531181	15
5426	NÜRNBG. ALLG.	327510	8

Reg. no.	Name of insurance undertaking	Number of motor insurance policies (2003)	Complaints
5686	NÜRNBG. BEAMTEN ALLG.	362146	9
5432	PATRIA VERS.	210289	16
5446	PROV.NORD BRANDKASSE	837330	9
5095	PROV.RHEINLAND VERS.	1270128	24
5438	R+V ALLGEMEINE VERS.	3297733	38
5798	RHEINLAND VERS. AG	247732	14
5773	SAARLAND FEUERVERS.	133985	0
5450	SECURITAS BREMER ALLG	148235	6
5451	SIGNAL UNFALL	324817	9
5781	SPARK.-VERS.SACHS.ALL	163606	7
5036	SV SPARK.GEB.BAD.-WÜR	578816	27
5385	SV SPARKASSEN	357384	9
5776	TELCON ALLGEMEINE	291186	42
5456	THURINGIA GENERALI	1040337	57
5458	TRANSATLANT.ALLG.VERS	163943	6
5441	VEREINTE SPEZIAL VERS	368474	41
5042	VERSICHERUNGSK.BAYERN	131274	8
5400	VGH LAND.BRAND.HAN.	1752804	16
5598	VHV AUTOVERS.	3153024	108
5472	VICTORIA VERS.	1657125	45
5473	VOLKSFÜRSORGE DT.SACH	1448441	44
5093	WESTF.PROV.VERS.AG	1322929	12
5525	WGV-SCHWÄBISCHE ALLG.	636653	10
5479	WÜRTT. GEMEINDE-VERS.	899074	2
5783	WÜRTT. VERS.	2281165	62
5050	ZÜRICH VERS. AG	1928549	14

9.5 General liability insurance

Reg. no.	Name of insurance undertaking	Number of liability insurance policies (2003)	Complaints
5342	AACHENER/MCHN. VERS.	1188151	79
5312	ALLIANZ VERS.	5314262	132
5405	ALTE LEIPZIGER VERS.	264048	11
5455	ARAG ALLG. VERS.	359021	38
5515	AXA VERS.	1797637	76
5316	BAD. GEMEINDE-VERS.	109526	4
5318	BASLER VERS.	105977	9
5325	BAYER. VERS.BANK	1130021	22
5324	BAYER.VERS.VERB.AG	940795	25
5333	BRUDERHILFE SACH VVAG	227716	1
5338	CONCORDIA VERS.	336566	11
5340	CONTINENTALE SACHVERS	214703	10
5529	D.A.S. VERS.	230336	15
5771	DARAG DT. VERS.U.RÜCK	53030	2
5311	DBV AG	401155	2
5037	DBV-WINTERTHUR	559897	29
5549	DEBEKA ALLGEMEINE	895373	16
5513	DEVK ALLG. VERS.	895306	12
5344	DEVK DT. EISENB. SACH	654997	7
5347	DT. HEROLD ALLG.VERS.	373059	15
5350	DT. RING SACHVERS.	154742	5
5359	FEUERSOZIETÄT BERLIN	123785	18
5364	FRANKF. VERS.	1400341	41
5599	GENERALI LLOYD VERS.	487571	11
5442	GERLING G&A	109344	16
5368	GERLING-K. ALLGEMEINE	880553	37
5531	GOTHAER ALLG.VERS.AG	1433954	74
5469	GVV-KOMMUNALVERS.	2670	8
5374	HAFTPFLICHTK.DARMST.	421350	20
5420	HAMB. MANNHEIMER SACH	610511	29
5377	HDI HAFTPFLICHTV.	23791	4
5085	HDI PRIVAT	471684	13
5384	HELVETIA VERS.	400947	9
5375	HUK-COBURG	1641649	23
5521	HUK-COBURG ALLG. VERS	710611	15
5546	INTER ALLG. VERS.	50530	6
5401	ITZEHOER VERSICHERUNG	180024	1
5509	KARLSRUHER VERS.	211057	9
5402	LVM SACH	1064527	29
5061	MANNHEIMER VERS.	129093	8
5412	MECKLENBURG. VERS.	249306	9
5390	NOVA ALLG.VERS.	395477	13
5426	NÜRNBG. ALLG.	312150	28
5446	PROV.NORD BRANDKASSE	347040	2
5095	PROV.RHEINLAND VERS.	822844	18
5438	R+V ALLGEMEINE VERS.	1449955	57
5798	RHEINLAND VERS. AG	145569	10
5450	SECURITAS BREMER ALLG	206199	7
5451	SIGNAL UNFALL	251710	7

Reg. no.	Name of insurance undertaking	Number of liability insurance policies (2003)	Complaints
5036	SV SPARK.GEB.BAD.-WÜR	273025	7
5385	SV SPARKASSEN	322360	5
5456	THURINGIA GENERALI	444978	52
5458	TRANSATLANT.ALLG.VERS	173529	2
5459	UELZENER ALLG. VERS.	84118	2
5042	VERSICHERUNGSK.BAYERN	17042	16
5400	VGH LAND.BRAND.HAN.	687095	7
5464	VHV	769481	35
5472	VICTORIA VERS.	1156712	47
5473	VOLKSFÜRSORGE DT.SACH	1019463	42
5093	WESTF.PROV.VERS.AG	769085	11
5525	WGV-SCHWÄBISCHE ALLG.	220079	9
5479	WÜRTT. GEMEINDE-VERS.	237773	2
5480	WÜRTT. U. BADISCHE	86585	5
5783	WÜRTT. VERS.	1042849	29
5050	ZÜRICH VERS. AG	583397	20

9.6 Accident insurance

Reg. no.	Name of insurance undertaking	Number of accident insurance policies (2003)	Complaints
5342	AACHENER/MCHN. VERS.	1415691	67
5498	ADAC-SCHUTZBRIEF VERS	732385	1
5581	ADLER VERSICHERUNG AG	142035	1
5312	ALLIANZ VERS.	6250669	86
5405	ALTE LEIPZIGER VERS.	110969	3
5455	ARAG ALLG. VERS.	382727	20
5512	ASPECTA VERSICHERUNG	82622	7
5515	AXA VERS.	1044443	38
5593	BAD. ALLG. VERS.	6673	1
5316	BAD. GEMEINDE-VERS.	49816	1
5792	BADEN-BADENER VERS.	199349	12
5317	BARMENIA ALLG. VERS.	126742	9
5633	BASLER SECURITAS	387	1
5318	BASLER VERS.	100460	2
5310	BAYER. BEAMTEN VERS.	106498	10
5325	BAYER. VERS.BANK	1162998	8
5324	BAYER.VERS.VERB.AG	560311	5
5333	BRUDERHILFE SACH VVAG	186728	1
5790	CIV VERS.	189914	9
5338	CONCORDIA VERS.	290383	10
5339	CONDOR ALLG. VERS.	39629	0
5340	CONTINENTALE SACHVERS	746523	40
5552	COSMOS VERS.	168832	6
5529	D.A.S. VERS.	278102	26
5343	DA DEUTSCHE ALLG.VER.	132707	2
5037	DBV-WINTERTHUR	195025	22
5549	DEBEKA ALLGEMEINE	1496595	14
5513	DEVK ALLG. VERS.	595175	9
5344	DEVK DT. EISENB. SACH	303133	1
5347	DT. HEROLD ALLG.VERS.	667830	7
5350	DT. RING SACHVERS.	459200	56
5508	EUROPA SACHVERS.	181627	2
5516	FAMILIENSCHUTZ VERS.	301089	48
5359	FEUERSOZIETÄT BERLIN	42603	3
5364	FRANKF. VERS.	1385996	22
5505	GARANTA VERS.	116104	1
5599	GENERALI LLOYD VERS.	682250	4
5442	GERLING G&A	153255	3
5368	GERLING-K. ALLGEMEINE	3006457	8
5531	GOTHAER ALLG.VERS.AG	888230	28
5374	HAFTPFLICHTK.DARMST.	41017	3
5420	HAMB. MANNHEIMER SACH	3261693	125
5501	HANSEMERKUR ALLG.	124171	2
5085	HDI PRIVAT	159567	3
5384	HELVETIA VERS.	152089	5
5375	HUK-COBURG	1116511	6
5521	HUK-COBURG ALLG. VERS	487358	1
5546	INTER ALLG. VERS.	108115	9
5057	INTERLLOYD (D)	32215	1
5780	INTERRISK VERS.	373519	7
5570	KARLSRUHER BEAMTEN	18672	1

Reg. no.	Name of insurance undertaking	Number of accident insurance policies (2003)	Complaints
5509	KARLSRUHER VERS.	169034	3
5562	KARSTADTQUELLE VERS.	354947	3
5402	LVM SACH	872027	9
5061	MANNHEIMER VERS.	83398	1
5412	MECKLENBURG. VERS.	156957	17
5078	MLP VERSICHERUNG	47243	1
5414	MÜNCHEN. VEREIN ALLG.	43724	3
5070	NECKERMANN VERS.	11302	1
5591	NEUE LEBEN UNFALL	641025	1
5390	NOVA ALLG.VERS.	916322	34
5426	NÜRNBG. ALLG.	566633	83
5686	NÜRNBG. BEAMTEN ALLG.	105226	2
5432	PATRIA VERS.	10127	2
5074	PB VERSICHERUNG	71292	4
5542	PLUS ALLG. VERS.	10534	2
5446	PROV.NORD BRANDKASSE	373842	3
5095	PROV.RHEINLAND VERS.	1455826	11
5583	PVAG POLIZEIVERS.	320724	4
5438	R+V ALLGEMEINE VERS.	1417177	29
5798	RHEINLAND VERS. AG	92529	4
5690	SCHWARZMEER U. OSTSEE	3416	2
5450	SECURITAS BREMER ALLG	55141	1
5451	SIGNAL UNFALL	708955	40
5586	STUTTGARTER VERS.	257056	52
5036	SV SPARK.GEB.BAD.-WÜR	190935	4
5385	SV SPARKASSEN	150982	5
5776	TELCON ALLGEMEINE	92208	6
5456	THURINGIA GENERALI	285037	35
5463	UNIVERSA ALLG. VERS.	151293	3
5511	VER. VERS.GES.AMERIKA	223098	6
5042	VERSICHERUNGSK.BAYERN	4761	1
5400	VGH LAND.BRAND.HAN.	6033657	2
5464	VHV	130499	11
5472	VICTORIA VERS.	1074161	48
5473	VOLKSFÜRSORGE DT.SACH	570706	25
5484	VOLKSWOHL-BUND SACH	190095	2
5461	VPV ALLGEMEINE VERS.	121360	3
5093	WESTF.PROV.VERS.AG	909375	3
5447	WINTERTHUR VERS.	44723	1
5476	WWK ALLGEMEINE VERS.	144138	7
5480	WÜRTT. U. BADISCHE	152838	16
5783	WÜRTT. VERS.	745367	29
5050	ZÜRICH VERS. AG	1110594	4

9.7 Household insurance

Reg. no.	Name of insurance undertaking	Number of household insurance policies (2003)	Complaints
5342	AACHENER/MCHN. VERS.	831853	77
5312	ALLIANZ VERS.	3393540	188
5405	ALTE LEIPZIGER VERS.	183036	28
5455	ARAG ALLG. VERS.	223406	30
5515	AXA VERS.	1100544	69
5318	BASLER VERS.	91908	18
5325	BAYER. VERS.BANK	695815	15
5324	BAYER.VERS.VERB.AG	532517	23
5333	BRUDERHILFE SACH VVAG	201959	0
5338	CONCORDIA VERS.	213720	13
5340	CONTINENTALE SACHVERS	110479	4
5529	D.A.S. VERS.	144560	14
5311	DBV AG	187171	6
5037	DBV-WINTERTHUR	201170	35
5549	DEBEKA ALLGEMEINE	557148	19
5513	DEVK ALLG. VERS.	758421	19
5344	DEVK DT. EISENB. SACH	469574	5
5347	DT. HEROLD ALLG.VERS.	302552	15
5350	DT. RING SACHVERS.	216786	7
5364	FRANKF. VERS.	948565	35
5599	GENERALI LLOYD VERS.	329737	15
5368	GERLING-K. ALLGEMEINE	394589	28
5531	GOTHAER ALLG.VERS.AG	906340	67
5420	HAMB. MANNHEIMER SACH	547944	34
5085	HDI PRIVAT	230932	9
5384	HELVETIA VERS.	313059	17
5375	HUK-COBURG	1157865	9
5521	HUK-COBURG ALLG. VERS	440696	7
5509	KARLSRUHER VERS.	119864	12
5402	LVM SACH	593295	38
5061	MANNHEIMER VERS.	100348	13
5412	MECKLENBURG. VERS.	153796	16
5390	NOVA ALLG.VERS.	272256	19
5426	NÜRNBG. ALLG.	185793	19
5446	PROV.NORD BRANDKASSE	293966	14
5095	PROV.RHEINLAND VERS.	578603	66
5438	R+V ALLGEMEINE VERS.	674990	70
5798	RHEINLAND VERS. AG	103659	11
5450	SECURITAS BREMER ALLG	173202	19
5036	SV SPARK.GEB.BAD.-WÜR	132462	77
5385	SV SPARKASSEN	240960	32
5456	THURINGIA GENERALI	267858	67
5400	VGH LAND.BRAND.HAN.	491812	7
5464	VHV	184358	19
5472	VICTORIA VERS.	767280	38
5473	VOLKSFÜRSORGE DT.SACH	962951	54
5461	VPV ALLGEMEINE VERS.	183699	6
5093	WESTF.PROV.VERS.AG	2420901	24
5783	WÜRTT. VERS.	739181	48
5050	ZÜRICH VERS. AG	364783	8

9.8 Insurers based in the EEA

(Branch offices and service providers based in the EEA that are merely subject to legal supervision)

Reg. no.	Name of insurance undertaking	Beschwerde
7552	Accent Europe (IRL)	1
7630	ACE European (IRL)	1
5487	ACE Insurance S.A. (B)	14
5595	AIG Europe S.A. (F)	4
5551	AIOI (GB)	4
7203	Atlanticlux (L)	37
7374	AXA Assistance (F)	1
7300	AXA Belg. (B)	1
5090	AXA Corporate S. (F)	4
1300	Canada Life (IRL)	2
1182	Cardif Leben (F)	5
5056	Cardif Vers. (F)	19
7690	Cigna Life (B)	3
7226	Cigna Life Ins CY (B)	1
7453	Clerical Med. Inv. (GB)	16
7553	Commercial U.L. (GR)	1
7281	DKV International (B)	1
5058	Domestic and Gen. (GB)	3
1161	Equitable Life (GB)	17
5053	Financial Insur. (GB)	2
7481	Fortuna Leben (FL)	2
7410	Foyer Internat. (L)	1
1178	General Acc. Life (GB)	1
5079	Hiscox Ins. (GB)	2
5072	IF Schadenvers. (S)	3
7611	Ihre Zukunft N.V. (NL)	1
7587	Ineas Insurance (NL)	11
1190	Interamerican (GB)	1
7245	Interunfall Vers. (A)	1
7685	Landmark Ins. (GB)	1
5592	Lloyd’s Vers. (GB)	4
7191	Merkur Vers. (A)	1
7734	Metlife Europe (IRL)	5
7237	Mutuelle des Arch. (F)	3
5066	N.V.Waarborgmij (NL)	22
7579	Nemian Life & P. (L)	10
5423	Northern Ass. C. (GB)	1
7723	Prismalife AG (FL)	4
7455	Probus Insurance (IRL)	1
7215	Prudentioal/Sali (RL)	37
7159	QBE Internation. (GB)	1
5045	Reliance Nat. (GB)	4
7107	Reliance National (GB)	1
7724	Rheinland Int. (NL)	3
7235	Salzburger Landes (A)	3
7658	Signal Idu. Pru. (IRL)	1
1174	Standard Life (GB)	6
7518	Sun Life Ass. Soc. (GB)	3
7285	Trans-Meridian (IRL)	1

Reg. no.	Name of insurance undertaking	Beschwerde
5081	Union Reisevers. (DK)	1
7259	USAA Ltd. Inc. (GB)	2
7456	VDV Leben Intern. (GR)	3
5046	Volvo Vers. Amazon (B)	1
7483	Vorsorge Luxemb. (L)	12
7251	Wiener Städtische (A)	1
7683	Wüstenrot (A)	1

Abbreviations

A	**Abs.**	Asset-Backed Securities
	AG	Aktiengesellschaft (German public limited company)
	AktG	Aktiengesetz (Stock Corporation Act)
	AltZertG	Altersvorsorgeverträge-Zertifizierungsgesetz (Act Governing the Certification of Contracts for Private Old-Age Provision)
	AnlV	Anlageverordnung (Investment Ordinance)
	AnSVG	Anlegerschutzverbesserungsgesetz (Act on the Improvement of Investor Protection)
	AR BAKred	Annual Report of the former Federal Banking Supervisory Office
	AR BAV	Annual Report of the former Federal Insurance Supervisory Office
	AuslInvestmG	Auslandinvestment-Gesetz (Foreign Investment Act)
B	**BA**	Bankenaufsicht (Banking Supervision)
	BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
	BAG	Bundesarbeitsgericht (Federal Labour Court)
	BAKred	Bundesaufsichtsamt für das Kreditwesen (former Federal Banking Supervisory Office)
	BAV	Bundesaufsichtsamt für das Versicherungswesen (former Federal Insurance Supervisory Office)
	BerVersV	Verordnung über die Berichterstattung von Versicherungsunternehmen (Ordinance Concerning the Reporting by Insurance Undertakings to the Federal Insurance Supervisory Office)
	BetrAVG	Gesetz zur Verbesserung der betrieblichen Altersversorgung (Act to Improve Occupational Pension Schemes)
	BGB	Bürgerliches Gesetzbuch (Civil Code)
	BGBl.	Bundesgesetzblatt (Federal Law Gazette)
	BGH	Bundesgerichtshof (German Federal Court of Justice)
	BilKoG	Bilanzkontrollgesetz (Balance Sheet Control Act)
	BMF	Bundesministerium der Finanzen (Federal Ministry of Finance)
C	**cf.**	see
	CDS	Credit Default Swaps
	CEBS	Committee of European Banking Supervisors
	CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
	CESR	Committee of European Securities Regulators
	CLN	Credit Linked Notes
	CP	Claims provisions
	CPSA	Conference of Pension Supervisory Authorities
	CLTC	Compulsory Long-Term Care Insurance
	CRT	Credit Risk Transfer

D

DAV	Deutsche Aktuarvereinigung (German Actuarial Society)
DAX	Deutscher Aktienindex (Blue Chip Index listing the 30 major German companies)
DeckRV	Verordnung über Rechnungsgrundlagen für die Deckungsrückstellungen (Mathematical Provisions Ordinance)
DMBilG	D-Markbilanzgesetz (D-Mark Accounting Act; relates to companies with a registered office in the German Democratic Republic as at 1 July 1990)
DSGV	Deutscher Sparkassen- und Giroverband (German Savings Bank Association)

E

EBHaftPflV	Verordnung über die Haftpflichtversicherung der Eisenbahnen (Ordinance on Railway Liability Insurance)
EBC	European Banking Committee
EEX	European Energy Exchange
EFC	Economic and Financial Committee
EFSSAC	Effective Financial Services Supervision in Accession Countries
EC	European Community
ECJ	European Court of Justice
ESC	European Securities Committee
EU	European Union
e.V.	eingetragener Verein (registered association)
EEA	European Economic Area
EEC	European Economic Community

F

FATF	Financial Action Task Force on Money Laundering
FESCO	Forum of European Securities Commissions
FinDAG	Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht (Act Establishing the Federal Financial Supervisory Authority)
FMFG	Finanzmarktförderungsgesetz (Financial Market Promotion Act)
FSAP	Financial Services Action Plan/ Financial Sector Assessment Program
FSF	Financial Stability Forum
FST	Financial Stability Task
FY	Fiscal Year

G

GdC	Groupe de Contact
GDV	Gesamtverband der deutschen Versicherungswirtschaft e.V. (German Insurance Association)
GmbH	Gesellschaft mit beschränkter Haftung (German private limited company)
GW	Geldwäsche (Money Laundering)
GwG	Geldwäschegesetz (Money Laundering Act)

H	**HBG**	Hypothekenbankgesetz (Mortgage Bank Act)
	HGB	Handelsgesetzbuch (Commercial Code)
	HUK	Haftpflicht-Unfall-Kraftfahrtversicherung (third-party/accident/motor vehicle insurance)
I	**IAIS**	International Association of Insurance Supervisors
	IAS	International Accounting Standards
	IASB	International Accounting Standards Board
	IASC	International Accounting Standards Committee Foundation
	IBNR reserve	Reserve for claims incurred but not reported
	IFAC	International Auditing Practice Committee
	IFRS	International Financial Reporting Standards
	InsO	Insolvenzordnung (Insolvency Code)
	InvG	Investmentgesetz (Investment Act)
	IOSCO	International Organization of Securities Commissions
	IP	Investment portfolio
	IRBA	Internal Ratings Based Approach
	ISD	Investment Services Directive
	IU	Insurance Undertaking
	IMF	International Monetary Fund
K	**KAGG**	Gesetz über Kapitalanlagegesellschaften (Investment Companies Act)
	KalV	Kalkulationsverordnung (Ordinance on the Actuarial Methods for Calculating Premiums for the Ageing Provision in Health Insurance (Calculation Ordinance))
	KapVO	Kapitalaustattungsverordnung
	KuMaKV	Verordnung zur Konkretisierung des Verbotes der Kurs- und Marktpreismanipulation (Ordinance Detailing Stock Exchange and Market Price Manipulation)
	KWG	Gesetz über das Kreditwesen (Banking Act)
L	**LTC**	Long-Term Care Insurance
M	**M & A**	Mergers & Acquisitions
	MaH	Mindestanforderungen an das Betreiben von Handelsgeschäften (Minimum Requirements for the Trading Activities of Credit Institutions)
	MaK	Mindestanforderungen an das Kreditgeschäft (Minimum Requirements for the Credit Business of Credit Institutions)
	m	Million(s)
	MoU	Memorandum/a of Understanding
	MMoU	Multilateral Memorandum/a of Understanding
O	**OECD**	Organisation for Economic Cooperation and Development
	OLG	Oberlandesgericht (Higher Regional Court)
	OVG	Oberverwaltungsgericht (Higher Administrative Court)

	Abbreviation	Meaning
P	**PfandbrG**	Gesetz über die Pfandbriefe und verwandten Schuldverschreibungen öffentlich rechtlicher Kreditanstalten (Act on Pfandbriefe and Similar Bonds of Credit Institutions under Public Law)
	PFKAustV	Verordnung über die Kapitalausstattung von Pensionsfonds (Ordinance Concerning the Capital Resources of Pension Funds)
	PFDeckRV	Pensionsfonds-Deckungsrückstellungsverordnung (Mathematical Provisions Ordinance for Pension Funds)
	PflVG	Pflichtversicherungsgesetz (Compulsory Insurance Act)
	PIOB	Public Interest Oversight Board
R	**RechVersV**	Verordnung über die Rechnungslegung von Versicherungsunternehmen (Ordinance on Insurance Accounting)
	RfB	Rückstellung für Beitragsrückerstattung (provision for bonuses and rebates)
S	**SEC**	Securities an Exchange Commission
	SGB	Sozialgesetzbuch (Social Code)
	SolvV	Solvabilitätsverordnung (Solvency Ordinance)
	SRP	Supervisory Review Process
	SWAP	Securities Watch Applications
T	**Task Force Re**	Task Force on Enhancing Transparency & Disclosure in the Reinsurance Sector
U	**UCITS**	Council directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities
	UmwG	Umwandlungsgesetz (Transformation Act)
	US-GAAP	US Generally Accepted Accounting Principles
	UStG	Umsatzsteuergesetz (VAT Act)
	u.w.	underwriting
V	**VA**	Versicherungsaufsicht (Insurance Supervision)
	VAG	Versicherungsaufsichtsgesetz (Insurance Supervision Act)
	VerBaFin	Veröffentlichungen der Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin publications)
	VerkProspG	Wertpapier-Verkaufsprospektgesetz (Act on the Prospectus for Securities Offered for Sale (Prospectus Act))
	VerkProspVO	Wertpapier-Verkaufsprospektverordnung (Ordinance on the Prospectus for Securities Offered for Sale)
	VvaG	Versicherungsverein auf Gegenseitigkeit (mutual insurance association)
	VVG	Versicherungsvertragsgesetz (Insurance Contract Law)

W

WaffG	Waffengesetz (Weapons Act)
WpHG	Wertpapierhandelsgesetz (Securities Trading Act)
WPO	Wirtschaftprüferordnung (Auditors Act)
WpÜG	Wertpapiererwerbs- und Übernahmegesetz (Securities Acquisition and Takeover Act)

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