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Bundesanstalt für Finanzdienstleistungsaufsicht

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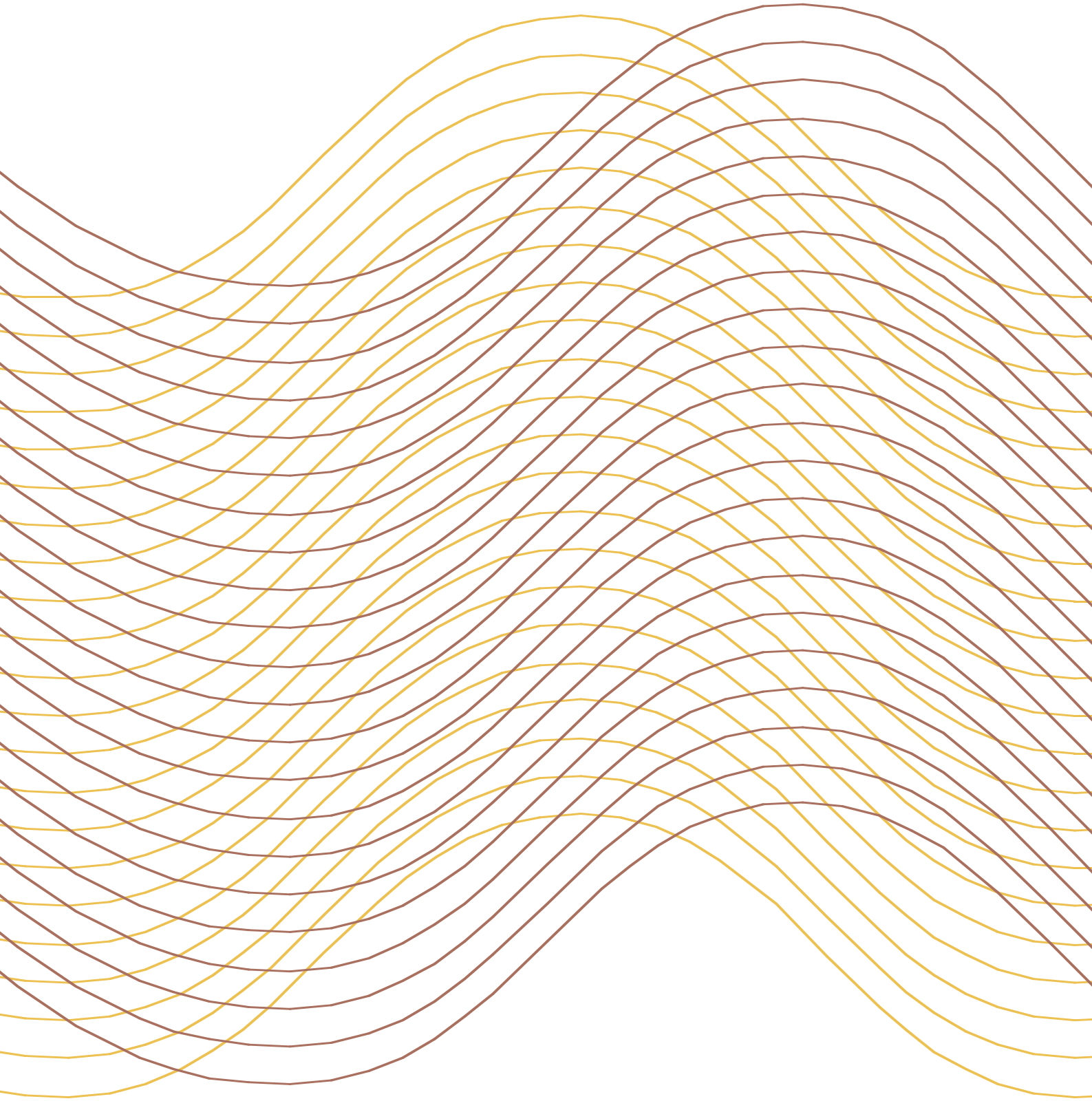

President's Statement

„The way to success is dangerous, it is in the line of fire" says the great Polish aphorist Stanislaw Jerzy Lec. BaFin experiences the truthfulness of his words every day. In this past year, our critics were particularly fierce. Too much bureaucracy, too much supervision - those were the buzzwords used against us.

But, however violent the attacks may have been, we were not swayed from our objective in 2004. BaFin must see to it that the German financial system remains stable, functional and competitive. We adhere to our central idea: As much freedom as possible with as much supervision as necessary.

We stand by this idea. And we do not lower our heads - even when criticism pours down on us. One thing is certain: Popularity is not our goal.

Jochen Sanio
President

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Jochen Sanio,
President

I Highlights of integrated financial supervision

1 Three years of BaFin

As we look back on three years of integrated financial supervision, it is time to take stock. An integrated supervision system has been implemented that keeps an eye on the entire financial market. Behind it is the idea that only an integrated financial supervision system can ensure the permanent stability of Germany as a financial centre and is in a position to also treat the same or similar matters equally in terms of supervision.

Since its establishment, BaFin has been confronted with similar challenges to organisations that have overcome a merger. The amalgamation of companies is the order of the day for businesses. With authorities, however, they are rare. In order to create the supervisory authority from the same mould, as postulated by the legislator, the aim was to fuse together three authorities with different supervisory cultures and tasks into one. The greatest proportion of integration work needed to be achieved during a phase when the personnel situation of BaFin was already extremely tight. Banking supervision, for example, was working at full capacity on a series of projects in preparation for Basel II; the insurance supervisors were being put through their paces with Solvency II negotiations and the setting up of the CEIOPS Secretariat in Frankfurt.

Supervisory objectives of BaFin.

BaFin has drafted a mission statement for itself, which outlines the requirements of modern financial supervision.[1] It has also developed a cross-functional objective system. Common objectives serve as braces between the three areas of supervision. The main objective is to maintain and promote the integrity of the financial system. It is derived from the significance of the financial sector for the economy. Its growth and prosperity depend upon a smoothly running financial sector. Preconditions for this are solvent financial institutions and functioning market processes.

Integrated financial supervision as an international trend
Since the mid-1990's, numerous larger industrialised nations have consolidated their regulatory structures. The supervisors have not only joined together in Germany, but also, among others, in Great Britain, Japan, The Netherlands, Belgium, Norway, Sweden, Canada and Australia. According to a report by the World Bank, during 2002[2], nearly 30% of countries merged their banking, insurance and securities supervisory authorities into an integrated financial supervision system. A further 30% have consolidated financial supervisors from two of the three sectors.

[1] www.bafin.de > About us.
[2] World Bank Policy Research Working Paper 3096, "International Survey of Integrated Financial Sector Supervision", July 2003.

In order to be able to react appropriately to the risks of those under supervision, several integrated financial supervisors have joined together as a network of the Integrated Financial Supervisors Conference (IFSC). The seventh IFSC will be organised by BaFin in June 2005 in Kronberg/Taunus.

Solvency and market supervision.

Solvency supervision of companies and market supervision both serve a common purpose – even if they address different entities. Company supervision concerns the question of whether those supervised can fulfil their obligations and carry out their business in a proper manner. In market supervision, market integrity and transparency are the prime objectives. By achieving these, the protection of the customers and market participants can be ensured. Their trust in the financial system is, in turn, an important precondition for its functioning.

BaFin requires the trust of the organisations that it supervises in order to fulfil its task. Therefore, it attaches importance to making its supervision approach transparent and comprehensible.

BaFin follows a risk-orientated supervision approach.

BaFin follows the concept of risk-orientated supervision in all areas. It consequently aligns supervisory actions and implementation of resources to the actual risk. By orientating itself more strongly than before towards the risk of those being supervised, BaFin is in line with the international trend. Basel II, for example, makes risk orientation a requirement of banking supervision; Solvency II will herald a similar development for insurance supervision.

The supervision environment is subjected to continuous institutional and economic change. An important success factor of BaFin is therefore its capability to adapt to these changes.

2 At a glance

BaFin has already been dealing with many important supervisory topics for a longer period of time – Basel II, for example, for many years. During the elapsed period, significant advances have been made in several national and international "construction sites", in which the German integrated financial supervision system has been active in various functions. This also forms major parts of BaFin agenda for 2005.

Basel II adopted.

In June 2004, the Basel Committee for Banking Supervision adopted a framework agreement regarding the new equity capital recommendations for credit institutions (Basel II), following several years of negotiation. A draft guideline has existed at EU level since July 2004, which largely implements Basel II. By the end of 2005, the Council and the European Parliament are expected to adopt the guideline. Implementation in German legislation is planned by mid-2006. From the end of 2005, the banks will still calculate their equity capital requirements according to the currently applicable regulations (Basel I). However, the new regulations of Basel II will

also already be used at the same time. Institutions using the simple internal rating approach (basic IRBA) can start with the new regulations at the beginning of 2007. Banks using advanced approaches for measuring credit risk (advanced IRBA) and its operational risk may implement this from the beginning of 2008. Since the end of 2004, BaFin has been available to examine and authorise the internal rating approaches of the banks.

Draft for MaRisk is on the way.

At the start of 2005, BaFin published a first draft of its minimum requirements for risk management. The document, which has been long awaited by banks and financial services organisations, contains the building blocks of the new supervision concept according to Basel II. A new expert committee is examining the draft with respect to practicality. Subsequently, the body of rules and regulations will be subjected to consultation by all organisations. The final version of MaRisk is to become available at the end of 2005.

Solvency II is progressing.

The future body of rules and regulations for the European insurance supervisory, Solvency II, has taken shape during the reporting year. In 2006, the EU Commission intends to present a framework guideline for Solvency II. It is being supported by a committee of European insurance supervisory authorities – the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). CEIOPS working groups are concerned, inter alia, with the internal control and risk management of the insurers, asset/liability management regulations and the supervisory review process.

One year of Investment Act.

At the beginning of 2004, the Investment Act came into effect. This opens new perspectives for the investment sector in Germany. Among other things, it simplified the approval process and made it more flexible – e.g. with respect to amending contractual terms. Most publicly noted was the fact that hedge funds are also permitted to be set up and authorised in Germany. During the reporting period, however, sales of the newly introduced products have initially started more hesitantly than expected. This was, presumably, primarily due to the complexity of the products.

Act on the Improvement of Investor Protection in effect.

At the end of October 2004, significant parts of the Act on the Improvement of Investor Protection (AnSVG) came into effect. With this, the German legislator implemented the European Market Abuse Directive. The AnSVG adapts the German Securities Trading Act (WpHG) to the Brussels specifications: It primarily amends the regulations regarding the prohibition of insider trading and ad-hoc publicity. Furthermore, it supplements the prohibition of market manipulations and the regulations in respect of creation and publication of financial analyses. Over and above this, it also extends the prospectus requirement for securities to corporate participations that are not securitised – i.e. to broad sections of the "grey capital market". BaFin will also be the examination and depository centre for the prospectuses of closed-end funds. BaFin explains the new legal position to issuers of paper traded on the stock market in its issuer guideline. The guideline offers help in the practical implementation of new transparency regulations: Among other things, it focuses on the insider registers, which issuers must maintain according to the new legislation. Apart from this, it also

focuses on the prohibition of insider trading and price and market manipulation, on ad-hoc publicity and directors' dealings. Following public consultation, it is to be published in spring of 2005 and will then be available on BaFin website.

Prospectuses: An important topic for BaFin in 2005.

The topic of "sales prospectuses" will keep BaFin on fully occupied for another reason in 2005: With the implementation of the EU Prospectus Guideline in July 2005, BaFin is to receive an additional task. Its activities to date with respect to the Sales Prospectus Act will change. From July, BaFin will additionally examine stock marketing listing prospectuses; until that point this is the duty of the listing offices of the stock exchanges. Additionally, BaFin will, in future, no longer only examine the prospectuses according to technical criteria, but will also search out conflicting content.

"IOSCO-Code of Conduct Fundamentals" for rating agencies.

In December 2004, the International Organisation of Securities Commissions (IOSCO) agreed on a code of conduct for rating agencies. The body of rules and regulations is intended to make rating agencies and their procedures more transparent and to strengthen the interests of issuers and investors. Formulating and publishing the IOSCO Code of Conduct Fundamentals is the first internationally co-ordinated step for controlling the often cited power of the rating agencies. They set a standard for all further activities in the direction of a possible regulation of rating agencies. On European and national levels, the rating agencies have already aroused the interest of parliaments, banks and the securities commissions.

3 Economic environment and financial stability

3.1 Financial markets

Financial markets on a steady course.

The year 2004 was broadly marked by quiet markets with marginal price movements, so that the financial system became more robust overall. The low volatility ensured planning security for the market participants. In 2003, the financial market players were, to an extent, still surprised by strong price fluctuations. Nevertheless, there are several specific risk factors, such as the oil price and dollar rate development, that have the potential of clouding the advantageous picture and triggering disruptions with negative consequences for financial stability.

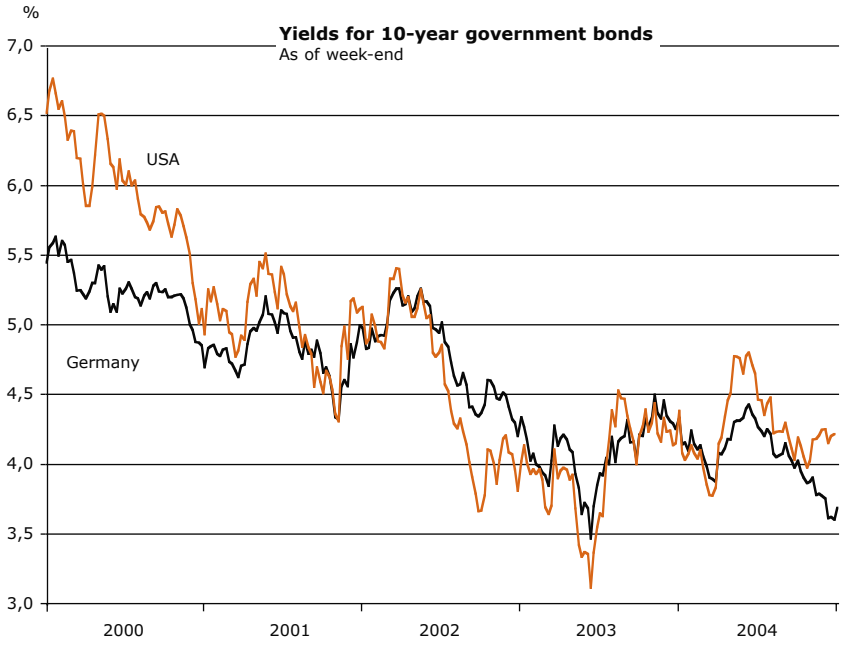
Pension markets

Low interest phase continues.

On the bond markets, the initially friendly sentiment became clouded in spring of 2004. Within only two months, the yield for ten-year US government paper rose by a full percentage point to over 4.8%. This was triggered by better than expected employment market reports from the United States. These signalled a robust economy and the market participants feared that the US Federal

Reserve (Fed) could pull back the reigns on interest rates energetically, due to the increased risk of inflation. At mid-year, the Fed did initiate the interest turnaround and increased the monetary policy prime rate in several smaller increments, over the further course of the year. The more restrictive course of monetary policy, however, did not bring with it any recognisable threats for international financial stability, as the US Federal Reserve had prepared the markets for measured interest rate increases through a timely and credible offensive communication policy. In contrast with 1994, there was no major distortion of long-term interest rates. As indications for weaker economic growth also heightened in the summer, the yield fell back down to 4%.

Figure 1
Capital market interest rates



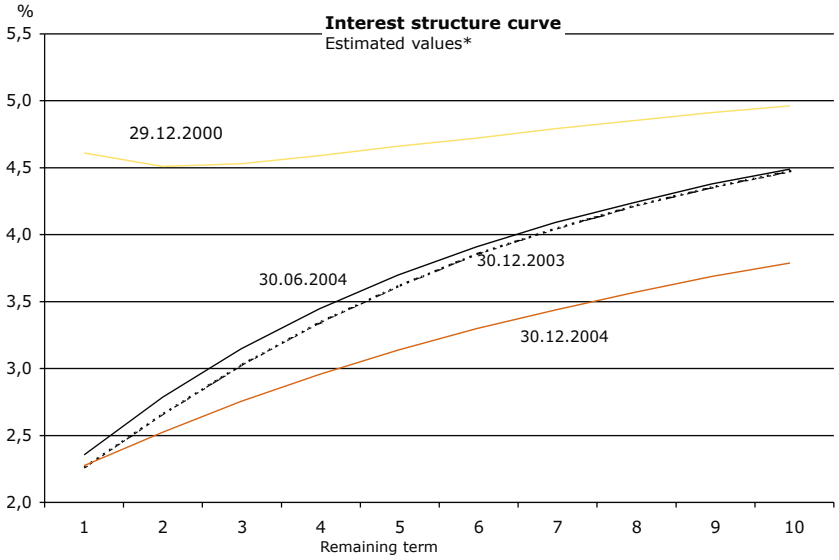
Source: Bloomberg

Until autumn, the European bond markets largely followed the market trend of the US bond markets. The deflections were, however much less distinctive. Therefore, the yield for ten-year Federal Government Bonds climbed briefly by a half of a percentage point in the spring to around 4.4%, before sinking below 4% over the further course of the year. At the end of the year, the bond markets in the USA and Europe went in different directions. The interest rate advantage for US government papers expanded significantly.

Overall, the long-term interest rates in 2004 in this country – also in real terms – moved at a very low level within a narrow band width. The yield curve flattened slightly during the second half of the year however it remains quite steep, so that the earnings of banks from maturity transformation should only have declined slightly in comparison with the previous year. All in all, the German

finance companies should therefore have successfully absorbed the moderate interest rate fluctuations.

Figure 2
Interest rate structure on the German pension market



* Interest rates for (hypothetical) zero-coupon bonds without credit default risk
Source: Deutsche Bundesbank

Capital market interest rates in the USA unusually low.

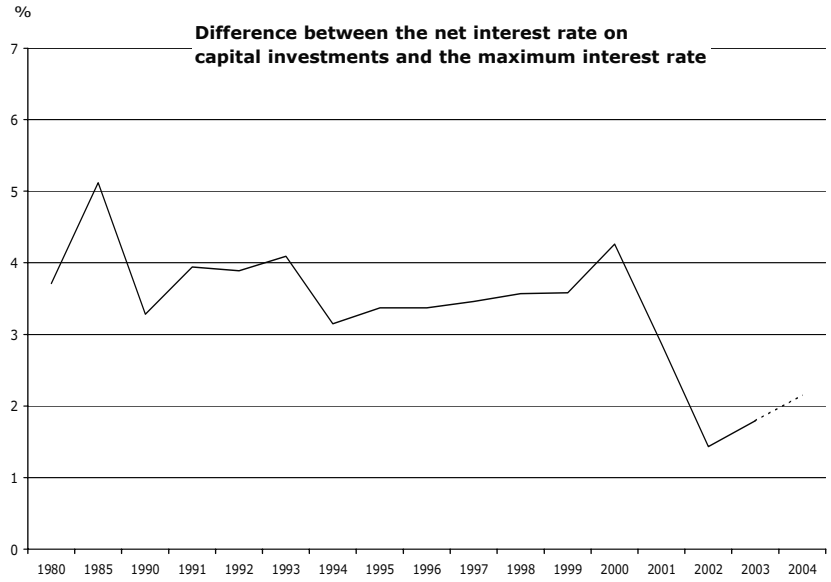
Measured on the growth and inflation prospects of the US economy, the long-term interest rates are currently unusually low, so that the probability of significant capital losses on the pension market has increased. Added to this, high capital inflow continues to be required for financing the US trade deficit. It is possible that investors will therefore also demand higher risk premiums for US government bonds. It can not be ruled out that particularly several Asian central banks will loosen exchange rate ties to the dollar and scale back their substantial purchases of US government bonds. Due to the high degree of integration of international financial markets, the European bond markets would then, presumably, follow the market trend of the US American pension markets.

Interest rate increase would essentially be positive for life insurers.

A moderate increase in interest rates would essentially be positive for life insurers, who are primarily affected on the investment side. While the minimum guaranteed interest rate by life insurers could be achieved virtually risk-free for a long time, the interest rate level on the capital market has now clearly approached the maximum interest rate (guaranteed interest rate). The reduction of the maximum interest rate for new contracts as of 1 January 2004 to 2.75%, increases the interest buffer for new contracts, however the higher interest obligations from existing contracts remain. Depending on the insurance portfolio, the insurers must on average guarantee interest rates of between 2.75% and 4%. In 2004, the average net interest rate of 4.7% for capital investments of German life insurers was just under the previous year's level of 5%, although it continued to be above the yield on ten-year Federal Government Bonds. However, insurers can currently only replace

maturing interest earning securities through those which have lower yields.

Figure 3
Yields of German life insurers



Sources: BaFin, Bloomberg

Debtors of lesser creditworthiness could suffer from stronger aversion to risk.

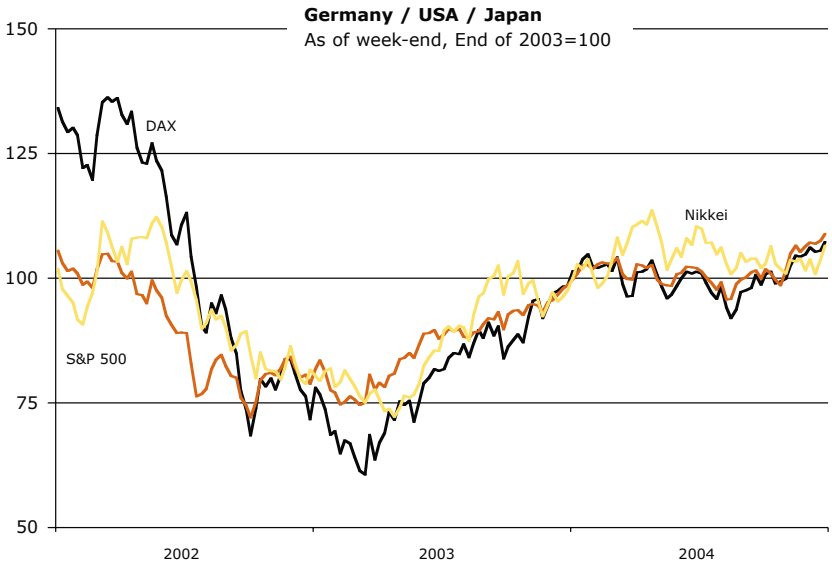
Emerging nations and companies with poor creditworthiness have so far profited disproportionately from the low level of interest rates and the liquidity available on the markets, as the risk premiums were extraordinarily low almost throughout 2004 and provided for beneficial financing conditions. It is apparent that many investors are losing sight of the risk aspect in the search for return. However, the strong market movements in the run-up to the interest rate turnaround of the US Federal Reserve show that emerging nations and financially weak companies are likely to be hit particularly hard by a general turnaround of interest rates.

Stock markets

Stock markets without impulses over long stretches.

At the start of the war in Iraq, a significant market rate recovery took place on the world's leading stock exchanges, which, however gradually weakened over the course of time. Even the positive corporate news during the first months of 2004 could not initially stop this trend. Political uncertainties and the sustained oil price surge nurtured doubts again and again about the prevailing favourable growth prospects and sales prospects of companies. Right up into the autumn, the leading share indices tended to move sideways. Only after a brief interim sprint, the S&P 500 and the DAX respectively reached new maximum annual levels towards the end of 2004.

Figure 4
Stock markets in comparison



Source: Bloomberg

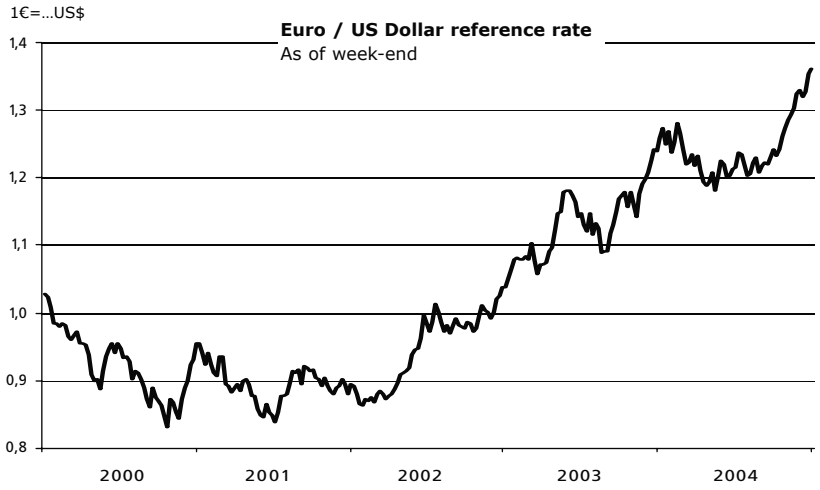
The market trend on the stock markets did not support the profitability of German financial services companies as it did in 2003 when rates increased significantly.

Foreign exchange markets

A weaker US Dollar…

After the Euro had gained strongly in value against the US Dollar over the course of 2002 and 2003, the international foreign exchange markets initially entered calm waters in 2004. The common European currency oscillated within a band width of 1.20 to 1.25 US$, before significantly gaining in value again towards the end of the year. The countercyclical effect of the Euro revaluation became normalised, as a major proportion of German exports (approx. 43%) went into Eurozone countries without exchange rate risk. However, if further unexpected and abrupt revaluation of the Euro should take place, the German export industry and with it, the diffident economic recovery, could suffer. Furthermore, the financial undertakings that are active in the dollar zone would be exposed to exchange rate risk. This particularly applies if they demonstrate an uneven balance sheet structure without appropriate hedging transactions, whereby the Dollar positions on the asset side exceed those on the liability side.

Figure 5
Exchange rate development

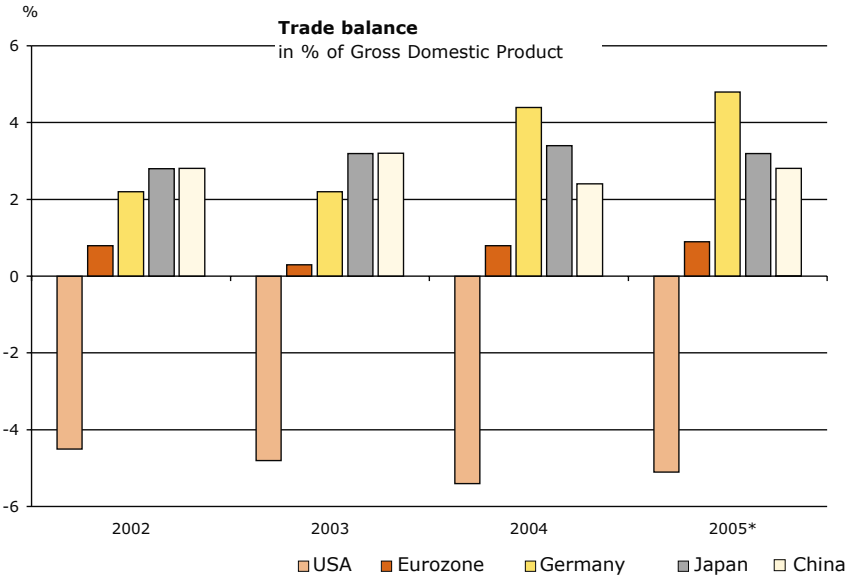


Source: Bloomberg

… and further high foreign trade imbalances.

The risks for exchange rate development resulting from external trade imbalances have become more intense in comparison with 2003. The US trade deficit has increased further. There remains a risk that international investors will in future no longer be prepared to close the US savings gap. This is supported by the fact that the majority of capital flows are now no longer used for direct investments, but rather for consumptive purposes. If prospective returns for investors fall, the result could be significant exchange rate movements.

Figure 6
External trade imbalances



Sources: IMF, World Economic Outlook * Projection

Hedge funds

Hedge funds increasingly in the spotlight.

The hedge fund industry, which has recently posted significant funds inflow, has capitalised on the low interest rate environment. By taking up borrowing at beneficial conditions, they are able to significantly increase their leverage and thereby their risk position. The rising intensity of competition through numerous new market entrants has increased performance pressure at the same time, so that there is a stimulus to switch over to more risky strategies. The strong growth raises the question of whether hedge funds could endanger the stability of the financial system. The risk still appears to be limited; however in the event that a major fund becomes imbalanced, the close links with other financial service providers could become infectious. Particularly larger investment banks are interwoven with hedge funds in their function as "prime broker". They provide a wide variety of financial services, which enable the smooth processing of complex transactions from which they achieve significant commission income. Furthermore, banks provide loans, which are taken up to increase the leverage effect. In addition, credit institutions feature as contractual partners, place their own funds into hedge funds or directly participate in them.

The development of hedge funds and their effect on financial stability

Since the beginning of 2003, the flow of funds into hedge funds has grown significantly, particularly through investments by institutional investors. The inflows amounted to around US$ 170 billion in 2003 and around US$ 200 billion in 2004. Worldwide, the capital stock managed by hedge funds at the end of 2004 is estimated to be approx. US$ 1,000 billion.[3] This is equivalent to only around 10% of the capital managed by funds in the USA. However, investment strategies that are characteristic of hedge funds accord them much more weight on the financial markets. This begs the question of possible consequences for financial stability.

The importance of hedge funds for financial stability depends, inter alia, on the effects of their financial transactions on the financial markets and the contribution of their activities to the creation of systemic risk.

Hedge fund transactions initially have a fundamentally positive effect on financial market efficiency. Their strategies are mainly based on new information. If hedge funds trade on the basis of this information and prices on the financial market therefore change, in the end, all market participants receive this information; incorrect assessments can be changed and inconsistencies between markets or trading positions can be eliminated. Speculative purchases and sales of hedge funds also increase liquidity in the markets. With the rapidly rising number of hedge funds, however, herd behaviour can not be ruled out in future. For examples, in contrast with their original active strategies, hedge funds could simply follow a market trend for a certain period of time, thereby strengthening the trend without it being fundamentally justified.

[3] TASS Research; these figures also include the capital in "Funds of Hedge Funds" (i.e. funds that invest in hedge funds), the level of which is estimated at approx. US$ 400 billion for the end of 2004.

Hedge funds can evoke systemic risks – typically in the banking sector. Investment houses and large banks, for example, not only concern themselves with transaction processing and securities administration as the prime broker. They also act as their lender and investment partner or as investors in the hedge funds. With this, imbalances of hedge funds could have consequences for banks through various channels. With the aid of adequate risk management with the banks and an attached solvency supervision, these risks should, however remain largely controllable. Hedge funds see themselves as being primarily exposed to two risks: liquidity risk, if positions can not be liquidated or only with great difficulty, and repayment risk, when debts can not be repaid in due time. As a rule, these risks arise at the same time. It is therefore important that in the event of possible insolvency of a hedge fund, its business partners, who could be a source of systemic risk, are not affected to such an extent that a financial crisis ensues.

3.2 Banks

Profitability of German banks has eased off somewhat…

The German credit institutions continued their course of restructuring in 2004. Administration costs and risk provisions could in many cases be reduced, thereby improving results. Through this, the constitution of the overall financial system improved after several difficult years. With strategic realignment and concentration on more profitable business segments, numerous banks have also put themselves into the position of being able to better exploit sources of income in future. Several banks had already started in 2003 to reduce accumulated hidden reserves with participations through write-downs and disposals. With this, they discarded ballast and advanced their concentration on core business. This process, which went hand-in-hand with a vigorous reduction in risk assets and high losses, appears now to be largely completed. The freed up equity capital can now essentially be applied for more productive use. So far, however, - not least due to the only moderate economic recovery – the flow of earnings remains restrained. In an international comparison, the profitability of the German banking sector also remains low and only offers a narrow buffer here and there.

… with a continuing high risk of default.

The foreign trade impulses primarily benefit the large companies that are active internationally and their medium-sized suppliers. This resulted in the financial situation of many smaller, domestically aligned companies remaining tight. The number of collapsed companies in 2004 was therefore only marginally lower than in the previous year. The sustained high default risk with smaller companies makes it difficult for many credit institutions to position their profitability on a permanently more stable basis. Added to this is a rapid rise in consumer insolvencies, which results in growing defaults in credit business with private customers.

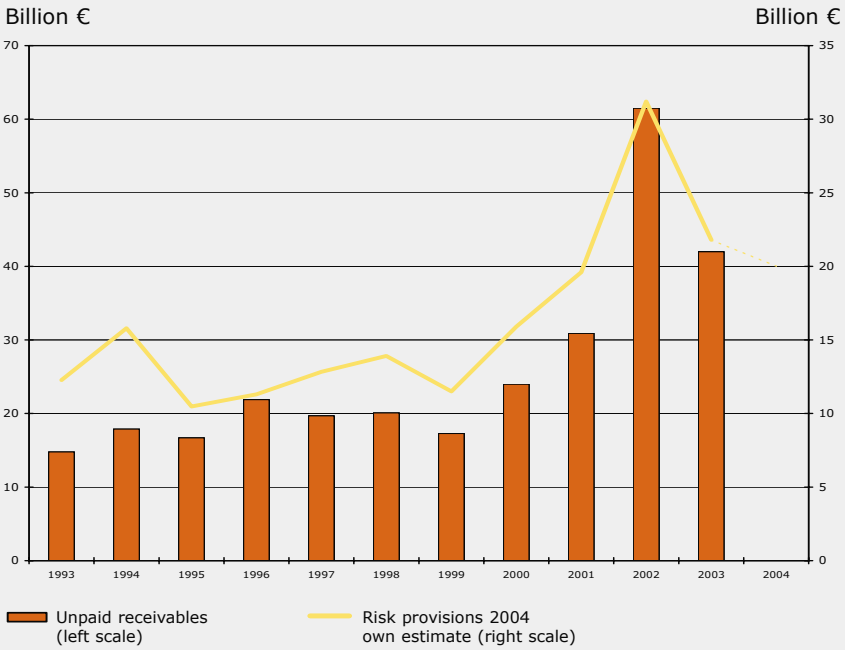
Economic cycle, credit risk and risk provisioning

Despite an increasing capital market orientation, the granting of credit to companies and private household is still distinctly at the centre of banking business. Therefore, credit risk is still by far the most significant single risk for German banks and savings banks. There is a close link between the economic environment and this risk. Phases of low growth weaken the financial position of companies and private households and result in higher credit default rates with a certain time lag.

The ongoing period of economic stagnation in Germany until mid-2003 noticeably increased the credit risk. Company insolvencies have risen significantly in recent years and nearly reached the level of the previous year, at 39,000 cases in 2004; in contrast, only 26,500 companies became insolvent in 1999.

Figure 7

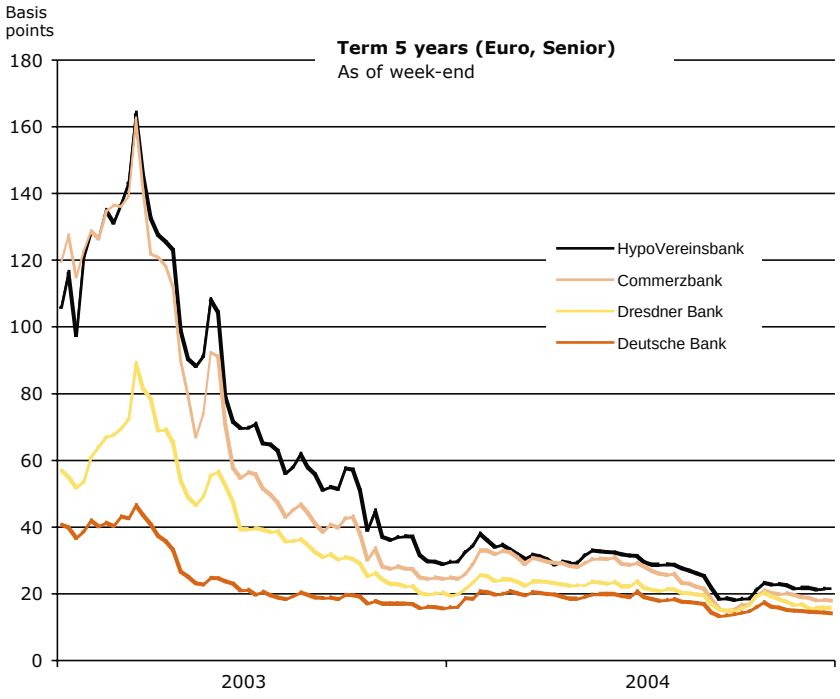
Unpaid receivables from insolvencies and risk provisions of German credit institutions



Sources: Statistisches Bundesamt, Deutsche Bundesbank, own estimate

In parallel to this, the German banks had significantly increased their risk provisioning. However, credit institutions were already able to reduce their risk provisions in 2003, despite rising numbers of insolvencies. In comparison with 2002, far fewer large companies fell into liquidity difficulties, so that the total sum of outstanding receivables was noticeably lower. A slight easing is also indicated for the near future. The peak level of company collapses appears to have been overcome, so that, in turn, the risk provisioning of the German banking sector should have remained below the level of the previous year. The slightly falling trend is expected to continue, as long as there are no serious economic disruptions. In contrast, consumer insolvencies continue to rise significantly. One explanation is the catch up effect of consumer insolvency legislation only introduced in 1999 and revised again at the end of 2001. This effect is increasingly losing its impact and the fundamental factors for insolvency are coming to the fore. Nevertheless, the increased number of consumer bankruptcies do not yet pose a serious risk for the German financial system, as the indebtedness of private households (measured on disposable income) is moderate on an international comparison.

Figure 8
Credit default swap premiums for large German banks

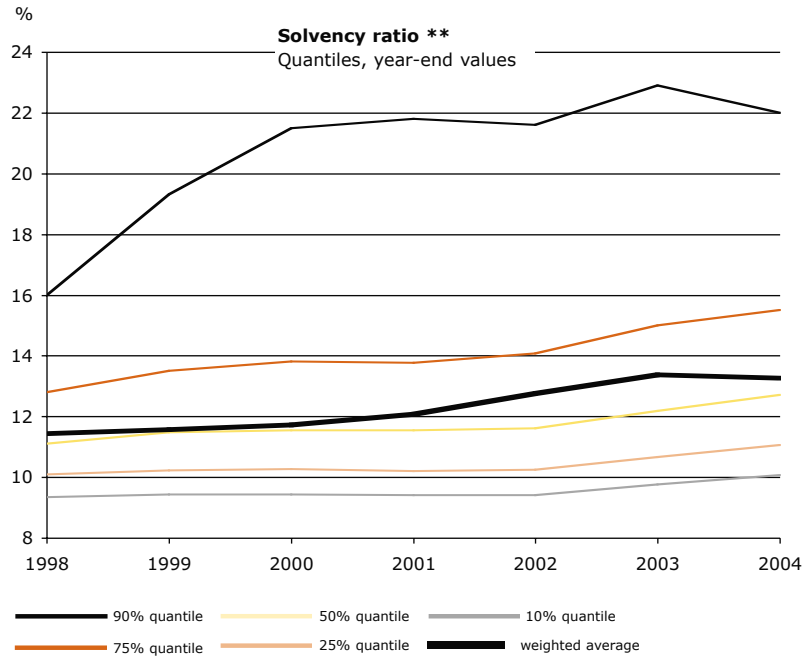


Source: Bloomberg

Market indicators do not show serious risks.

The assessment of large German banks by the rating agencies remained stable over the course of 2004, whereby the outlooks partially even improved. The downgrading trend could therefore initially be discontinued. The credit default swap premiums, which have nearly constantly moved at a low level since autumn 2003, signalise that market participants view the default risks for large German banks as being marginal right up to the end.

Figure 9
Solvency development of German banks *



* Credit institutions and financial services institutions on an single institution basis;
** Liable equity capital in relation to the weighted risk assets; minimum ratio in accordance with Principle I: 8%

Equity capital base is comfortable.

Both the core capital ratios and the equity capital ratios moved at a level in relation to risk assets which did not lead to any misgivings in respect of the stability of the financial system. This is also shown in the quantile view.[4] The rise in quantile limits in both of the past years illustrates the improved equity capital base of German credit institutions. It is particularly pleasing that the threshold level for the respective 10% of banks with the lowest equity capital ratio (10% quantile) has risen from 9.4% at the end of 2002 to 10.1%. The reverse conclusion from this is that with 90% of all institutions, the liable equity capital at the end of 2004 amounted to at least 10.1%.

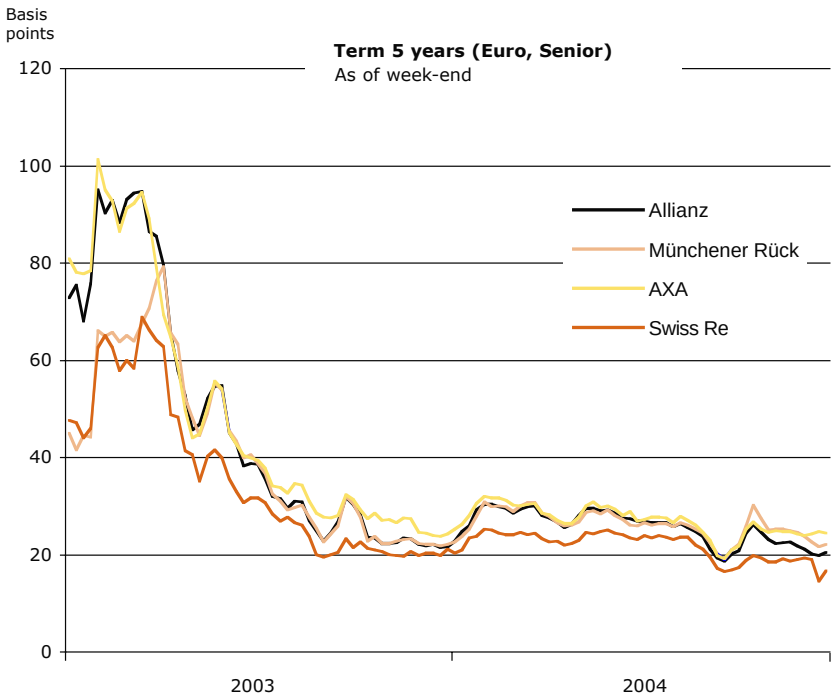
[4] The p% quantile provides the value for the regulatory equity capital ratio, which separates the lower %p of credit institutions with the lowest ratios from the remaining institutions.

3.3 Insurers

Stabilisation in the insurance sector.

The situation for German insurers strengthened further during the reporting year. Overall, the insurance sector showed improved profitability and higher solvency, hidden liabilities could be further reduced. Individual market indicators also confirm this assessment. At the start of 2003, insurance companies still showed a relatively high risk premium with credit default swap premiums which increasingly declined during the course of the year. In 2004, the credit default swap premiums then remained largely stable and even briefly declined by 20 basis points during the third quarter, whereby the German companies moved at a level similar to international competitors.

Figure 10
Credit default swap premiums of selected insurers



Source: Bloomberg

The assessments of the rating agencies improved slightly in 2004. A deterioration in ratings was barely evident during the reporting year. Instead, the improved profitability was confirmed through mainly "positive" and "stable" rating outlooks from the rating agencies.

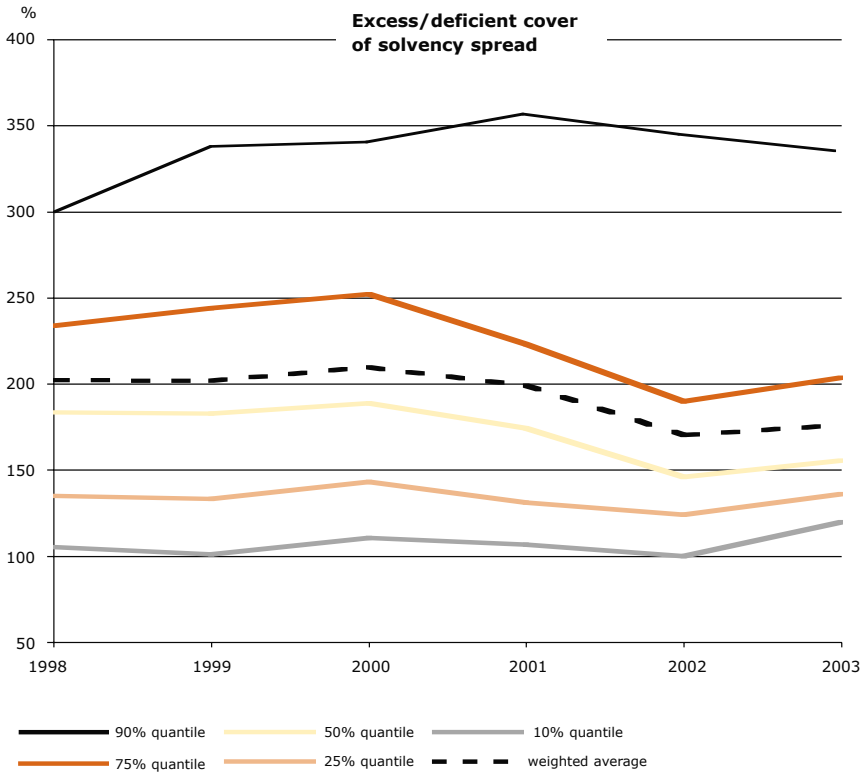
Development in the individual sectors of the insurance market.

The life insurance sector recovered further in 2004 from the capital market crisis at the beginning of the decade, as well as the reputation-damaging near-insolvency of Mannheimer Lebensversicherung during the previous year. The required updating of death tables in June 2004, due to significantly increased life expectancies, bestowed increased costs on the sector, which had already be partially

covered by several life insurers in 2003, by way of precaution. The sector obtained an upswing during the fourth quarter of 2004 through the above average growth of new business, which was partially due to the discontinuation of the tax privilege for capital value insurance policies from 1 January 2005. For 2005, the reverse is assumed, with somewhat subdued business development, which could, however be cushioned through alternative/innovative products, for example in the pension sector.

The results of the stress tests on the basis of annual reports as at 31 December 2003 document the economic recovery of the life insurance sector. Around 90% of all life insurers showed positive computed balances in all three test variations. Hidden liabilities encumbrances, still partially remaining from 2003, could also be largely reduced. At the end of 2004, there were still reserves of more than twelve billion euros contained in capital investments entered in the balance sheet at acquisition cost.

Figure 11
Development of solvency of German life insurers



Source: Bloomberg

The solvency of life insurers is also still significantly above minimum requirements at an average cover 170%. This also applies for 2004. The solvency in the middle and lower quantiles of coverage has improved over recent years, as the companies were able to offset more equity capital.

Economic situation easing for reinsurers.

For reinsurers the economic situation has also eased since 2003. The continuing recovery is expressed through largely unchanged rating opinions and mainly improved rating outlooks in 2004. The heavy storms in autumn of 2004 and the flood catastrophe in Southeast Asia have burdened the international reinsurance market; however, the effects on German reinsurers are contained. Nevertheless, these events demonstrate how volatile loss development can be in the reinsurance or indemnity insurance business.

Table 1

Overview of the German economy and financial sector*

Selected economic data	Unit	1999	2000	2001	2002	2003	2004
Economic growth[1]							
World economy	%	3,7	4,6	2,5	3,0	4,0	5,1
USA	%	4,4	3,7	0,8	1,9	3,0	4,4
Euro zone	%	2,8	3,6	1,6	0,9	0,5	2,0
Germany	%	2,0	2,9	0,8	0,1	-0,1	1,7
Company insolvencies	Number	26.476	28.235	32.278	37.579	39.320	39.213
DAX (end 1987= 1000)[a]	Points	6.958	6.434	5.160	2.893	3.965	4.256
Money market rate[2]	%	2,97	4,39	4,26	3,32	2,33	2,11
Capital market rate[3]	%	4,53	5,28	4,86	4,81	4,08	4,04
Euro-Dollar exchange rate	1 €=…$	1,07	0,92	0,90	0,94	1,13	1,24
Gross sales of fixed interest securities[4]	€ billion	571	659	688	819	959	990
Credit institutions							
Credit institutions[a]	Number	3.168	2.912	2.697	2.593	2.385	2.316
Branches[a]	Number	58.546	56.936	54.089	50.868	47.406	45.494
Employees[5]	Thousand	–	–	734	717	690	-
Loans to domestic non-banks[a]	€ billion	2.905	3.004	3.014	2.997	2.996	3.001
Net interest income	€ billion	77,8	76,9	79,2	85,6	81,8	-
Net interest margin[6]	%	1,28	1,14	1,12	1,20	1,16	-
Commission income	€ billion	22,5	28,1	25,3	24,3	24,4	-
Administrative costs	€ billion	70,2	77,7	81,0	78,3	77,3	-
Risk provisions	€ billion	11,5	15,9	19,6	31,2	21,8	-
Cost-income ratio[7]	%	66,0	68,5	71,4	67,2	66,4	-
Return on equity[8]	%	11,2	9,3	6,2	4,5	0,7	-
Equity ratio[a] [9]	%	11,6	11,7	12,1	12,8	13,4	13,3
Insurance undertakings							
Life insurers							
Hidden reserves in the investment portfolio (IP)[10]	€ billion	74,4	62,9	50,0	1,1	14,9	-
as % of the IP book value	%	14,4	11,4	8,6	0,2	2,4	-
Portion of fund units in % IP[11]	%	18,9	21,4	22,5	23,0	23,3	-
Portion of borrower's notes and loans in IP[11]	%	16,7	16,6	17,1	18,1	19,3	-
Net rate of return on IP[12]	%	7,5	7,4	6,0	4,4	5,0	-
Technical coverage provisions (gross)	€ billion	451,0	445,5	476,4	502,8	520,6	-
as % of balance sheet totals	%	76,7	76,9	78,0	79,7	79,4	-
Surplus[13]	€ billion	18,7	20,3	13,4	5,0	9,1	-
as % of gross premiums earned	%	32,4	33,1	21,5	7,7	13,4	-
Eligible own funds (A+B+C)	€ billion	38,8	42,9	44,2	39,8	42,3	-
Solvency margin[14]	€ billion	19,2	20,5	22,2	23,3	24,0	-
Coverage of solvency margin[15]	%	201,8	209,5	199,0	170,4	176,2	-
Return on equity[16]	%	11,4	12,5	7,0	3,4	5,7	-
Reinsurers							
Hidden reserves in the investment portfolio (IP)[10]	€ billion	83,6	101,7	89,2	35,8	34,3	-
as % of book value	%	67,0	75,8	54,2	18,4	15,6	-
Combined ratio (net)[17]	%	106,0	103,8	115,3	101,6	92,8	-
Gross technical provisions	€ billion	98,7	104,5	122,3	130,6	135,8	-
as % of gross premiums earned	%	279,2	265,7	278,6	244,0	264,4	-
Net profit for the year	€ billion	1,4	2,2	0,3	5,4	1,4	-
Available capital[18]	€ billion	23,9	25,1	31,5	40,2	51,4	-

Sources: BaFin, Deutsche Bundesbank, Eurostat, IMF, Statistisches Bundesamt.

* Annual totals or average values, unless stated otherwise.

a) As of year end; credit institutions according to section 1 (1) KWG and branches incl. Postbank and building societies.

1) Change in real gross domestic product year-on-year.

2) 3-month Euribor.

3) 10-year government bond yields.

4) Domestic issuers.

5) Excluding Postbank, building societies, housing enterprises with savings schemes, Central Securities Depositories, investment companies, guarantee banks.

6) Net interest income as a percentage of balance sheet totals.

7) Administrative costs in relation to operating income.

8) Net income before tax as a percentage of average balance sheet equity capital.

9) Liable equity capital in relation to the weighted risk assets according to Principle I (solvency indicator).

10) Fair values – book values of investments (IP) valued at cost.

11) As a percentage of total IP without deposits.

12) (Income from IP less expenditures for IP / arithmetic average for IP (beginning and end of the year).

13) Net profit for the year + gross expenses for premium refunds.

14) Minimum level of free, unencumbered own funds.

15) Eligible own funds / solvency margin.

16) Net profit for the year / equity capital.

17) Net expenses for insurance claims and insurance operations / net premiums earned.

18) Total capital less outstanding capital contributions.

3.4 Developments on the retail markets

Investors are seeking security and above average returns.

Since 2002, the investor behaviour of private investors has changed significantly. Following the market losses on the stock markets at the start of the decade, investors demand, on the one hand, increased security and risk limitation. At the same time, many investors are, however, looking for above average returns in view of the low capital market interest rates. Innovative products have therefore become significantly more attractive for private investors. Overall, products – and therefore also risks – that in the past had been reserved for the institutional investors, are increasingly penetrating the retail market. Several of these products – such as certificates and closed-end funds are largely non-regulated.
Many German consumers currently do not yet have sufficient knowledge regarding financial interrelations. Therefore, they are often not able to comprehensively assess the central return or risk features of capital market-orientated products. Thereby, it should be clear to every investor: Higher return prospects can inevitably only be bought with higher risks.

The number of investment certificates increased.

Several product groups have particularly profited from the change in investment behaviour. This, for example, applies to investment certificates. In the mean time, far in excess of 20,000 different certificates exist for the German market. Certificates securitise the participation in market trends for specific underlying instruments such as bonds or bond constructs, foreign exchange or raw materials. From a legal point of view, the certificates are equivalent to bonds. The investor therefore only receives a claim on the issuer under the law of obligations. The creditworthiness of the issuer therefore determines the creditworthiness of the certificate.

The certificates issued in Germany are tailored to various investment reasons and markets. With these, private investors can now also map investment profiles which had been reserved in the past for institutional investors. The structure of the certificates is thereby often very complex. This also often applies for the cost structures: In addition to a margin between bid and offer rates, ongoing administrative costs or retained dividends can have an impact. More than half of new issues are comprised of discount certificates.

Certificates are competing with funds.

The certificate industry is increasingly competing with the traditional funds sector. Nevertheless, various investment funds have significantly raised their administration charges and performance fees. The cause of this is higher commission payment to the sales partners. The tough competition for customers increases the sales and advisory costs. On the other hand, the stock marketed traded index funds were able to achieve high rates of growth while being burdened with comparatively low costs.

More demand for absolute return products.

In 2004, investors demanded more absolute return products/total return products in the funds sector. These aim for absolute earnings, notwithstanding the respective market situation, while traditional investment funds usually measure their investment success in relation to a benchmark. However, strategies aimed at absolute

earnings also have inherent risks. In view of the capital market environment during the reporting year with call money returns of approx. 2% p.a., return targets of more than 5% p.a. already pose a significant challenge for fund managers. Hedge funds, which have enhanced possibilities in comparison with traditional funds through short sales and gearing (leverage), are also considered to be absolute return products.

Hedge funds also in Germany since 2004.

Since the beginning of 2004, hedge funds can also be issued and authorised in Germany. However, so far, the hedge funds have not yet been able to fulfil the marketing expectations of their providers. As they usually feature above average administrative costs and, concurrently, the value development of German hedge funds in 2004 remain behind forecasts, fewer investors opt for this product than initially presumed. Added to this, not all investments in absolute return products flow into hedge funds themselves. In this manner, for example, hedge fund certificates directly compete with hedge funds. Undoubtedly, the main cause of the low marketing success of this form of investment is primarily the complexity of the products.

Closed-end funds post significant growth.

The providers of closed-end funds have also profited from the search for above average returns. Closed-end funds are corporate participations that are generally not subject to financial supervision. The legal form of the fund is usually a limited partnership (KG) or civil-law partnership (GbR). From 1 July 2005, BaFin will examine the prospectuses of closed-end funds. Nevertheless, investors must continue to check for themselves whether the fund participations are legitimate and the investments are sound. Closed-end funds are often complex products with only difficult to recognise, multiple risks and low tradability. Property funds have constituted the majority of closed-end funds for years. Of these, around half are funds that invest in foreign properties.

Life insurance funds are gaining in importance.

The sales of life insurance funds that invest in "used" life insurance policies have risen in 2004. Various product variations are offered. Most of the funds invest in US American and British policies, where a market exists for "used" life insurance. In Germany, this market is only developing slowly, but with high growth rates.

Life insurance contracts continue to be attractive.

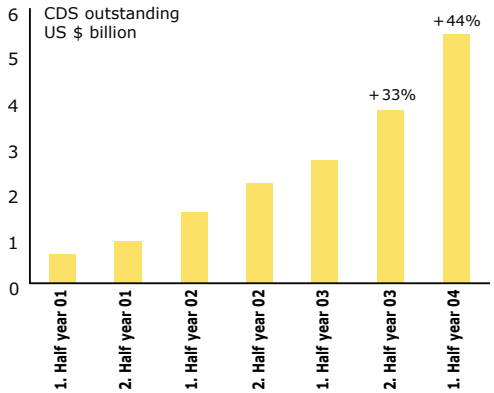
Life insurance policies continue to be the most important instrument for private provision for old age. This will also remain the case, as the new tax regulations under the law regulating the taxation of pensions and pension expenses should not lead to a reduction in life insurance business over the long term, positive and negative effects for the life insurance market nearly compensate each other. However, the emphasis is likely to shift over the long term from traditional endowment policies and primarily unit-linked insurance towards pension and risk insurance policies. Additionally, state-promoted products for private old-age provision will become established if the providers utilise the existing scope to design the products attractively, despite limiting promotion conditions.

3.5 Credit risk transfer

Credit risk transfer instruments are gaining further in importance.

Also in the past year, credit risk transfer (CRT) instruments, i.e. credit derivatives and products from the securitisation of outstanding loans, have gained in importance for financial enterprises worldwide. Even if the relative size of the credit derivative market is still relatively small[5], the market for credit default swaps grew[6] – which makes up by far the most significant portion of the credit derivative market – during the first half of 2004 by 44%, thereby achieving a volume of nearly US$ 5.5 billion. Structured products also posted strong growth. According to an investigation by the rating agency FITCH[7] the volume of portfolio products climbed by nearly 50% during last year.

Figure 12
Growth of the credit derivative market



Source: International Swaps and Derivatives Association (ISDA)

There are various reasons for the growth dynamics. Structurally, they are primarily the increased importance of risk management and portfolio diversification for financial institutions, the new risk-return profile of structured products and "arbitrage profits" through differences in tax, accounting or equity capital regulations.

There are, however, also cyclical influences. First of all, the circle of institutional market participants expanded again during the past year, whereby the proportion of insurers went down, while the proportion of hedge funds and other asset managers significantly increased. Apart from this, it could be observed that credit derivatives in the form of credit linked notes are now also being sold to small investors. Finally, all investors have come upon a situation that is characterised by low returns on the stock, pension and property markets. Investors therefore find it difficult to diversify their portfolios and achieve their benchmark targets. This leads to two

[5] Despite significant growth, the relative size of the credit derivative market is still relatively small and, for example, in the USA, makes up only 2% of the entire OTC derivative market (Source: OCC Bank Derivatives Report). For Germany/the EU, such data is not available).
[6] Information from the International Swaps and Derivatives Association (ISDA).
[7] FITCH "Global Credit Derivatives Survey", September 2004.

trends: On the one side, standardised credit derivatives such as credit default swaps and credit derivative indices are increasingly in demand, which provide easy access to a widely diversified credit risk in various regions of the world. On the other side, tailor-made products are becoming more important, for example, in the form of single-tranche CDO's or so-called CDO's of CDO. These structured products can fill a gap in the investors' "hunt for return". While standardised products tend to increase transparency and liquidity in the market, tailor-made products are more likely to reduce these aspects. A positive feature of both is that market participants can design their risk management instruments with more accuracy of fit with such instruments.

Securitisation using the example of a collateralised debt obligation

With a synthetic collateralised debt obligation (CDO), the credit risk of a portfolio of loans/bonds (reference portfolio) is transferred. An intermediary structures the credit risks that have been assumed from the "originator bank" through a credit derivative and subsequently sells these on to investors in tranches that are graded according to risk content (senior, mezzanine, equity)[8]. The tranches are in the form of a bond[9], for which the owed sum is reduced if the agreed credit events (for example failure of a company) take place.

The intermediary[10] receives proceeds from the sale of the bond to the investors and bonus payments from the credit derivative contract with the originator bank. The funds are invested in a pool of secure, liquid paper and are used for coupon payments, bond repayment, or in the case of credit events, the compensation payments to the originator bank. The payments to the investors then take place in a previously defined order. Proceeds – after deducting management fees – are first credited to senior, then mezzanine and finally, equity tranches. Losses through credit defaults affect the tranches in the reverse order. The sum of the lower tranches therefore represents a risk buffer for the respective tranches above them. In the event of losses, equity and mezzanine tranches can be quickly used up, as they are usually structured with low nominal values. In contrast, senior tranches mostly have a very high nominal value.

The risk content of the individual tranches depends directly on the credit risk of the reference portfolio, i.e. the quality of the loans as well as the default correlations. Decisive for the probability distribution of losses and therefore the assessment of risk for the individual tranches is, however, the modelling of default correlations. Formulated simply, senior tranches are relatively secure with a low correlation, as it is then unlikely that several assets in the reference portfolio will default together at the same time. Conversely, senior tranches with a high correlation are relatively risky. As the correlations can change over time, for example in the economic

[8] With a reference pool having an average rating, for example, of A, both tranches with a lower rating (e.g. BB) and a higher rating (e.g. AAA) can be issued.
[9] Credit linked note; alternatively, credit default swaps are also possible.
[10] Or in some cases a special purpose vehicle (SPV).

cycle, expectations regarding future correlation developments therefore also flow into the risk assessment.
Furthermore, equity and mezzanine tranches have a leverage effect on the credit risk of the reference portfolio. The risk and leverage effects of these transactions depend on the credit quality of the reference portfolio, as well as the risk buffer of the tranche. Comparable risk profiles can be achieved this way in various manners: With a fixed tranche size, a specific expected loss can be modelled for a mezzanine tranche, either with a highly rated reference portfolio and a low risk buffer (i.e. a small equity tranche) or with a poorly rated portfolio and a higher risk buffer. The smaller the risk buffer, the higher the leverage effect.
The external rating essentially provides an assessment of the probable loss of an instrument. For investment where the expected loss is solely linked to the creditworthiness of the debtor – for example, with bonds – a rating can generally be interpreted well. With structured products, such as a CDO tranche, however, the issue is more complicated. Depending on the structure, completely different loss distributions can result, so that ratings of bonds and structured products are difficult to compare. The fact that the risks of both products are also valued differently on the market is shown by the differences in spreads between structured products and bonds with comparable ratings.

CRT products simplify risk diversification…

CRT products essentially simplify risk diversification of market participants. Credit derivatives and synthetic CDO's have the potential to redistribute credit risks within the financial system in large volumes. Nevertheless, the new instruments also result in new risks. The central question is whether the market participants understand and adequately manage the risks entered into with CRT instruments. Credit derivatives are based on very complex modelling and therefore often have equivalent risks. Also, they are often connected with complicated agreements.

… but not all market participants recognise the risk profiles.

Various domestic and foreign cases document that the market participants were not always sufficiently informed regarding the risk profiles of structured products. Many have now already gathered experience and are now more familiar with the new instruments. The sustained high rate of product innovations, however, poses an ongoing challenge. Primarily, however, new market participants, be they financial institutions or small investors, lack this experience.

In order to avoid financial imbalances, market participants must therefore have own analysis capacities available for credit derivatives and structured products and not depend solely on external ratings for such products. Generally, supervision will pay attention to encouraging institutions that are active in this market adapt and strengthen their risk management accordingly.

4 Supervisory environment

4.1 International financial supervision

For a long time now, investors and intermediaries have not only been active within national borders, but there are also many that are globally active. It does not appear to be a hindrance that no globally valid legal framework exists, as the markets find possibilities of developing beyond borders and legal systems.

Supervision of cross-border matters.

Financial supervision is different: It has sovereign authority and is usually nationally organised, as sovereign competencies end at the country borders. The supervisors must react to this situation and make arrangements for cross-border issues. While binding regulations can be created within the EU, which supervisors must adhere to, there is no comparable legal system on the global level. Albeit, there is a great need for international harmonisation, so that those under supervision can act within a reliable legal framework in cross-border activities and the supervisors have the opportunity to exchange information and cooperate.

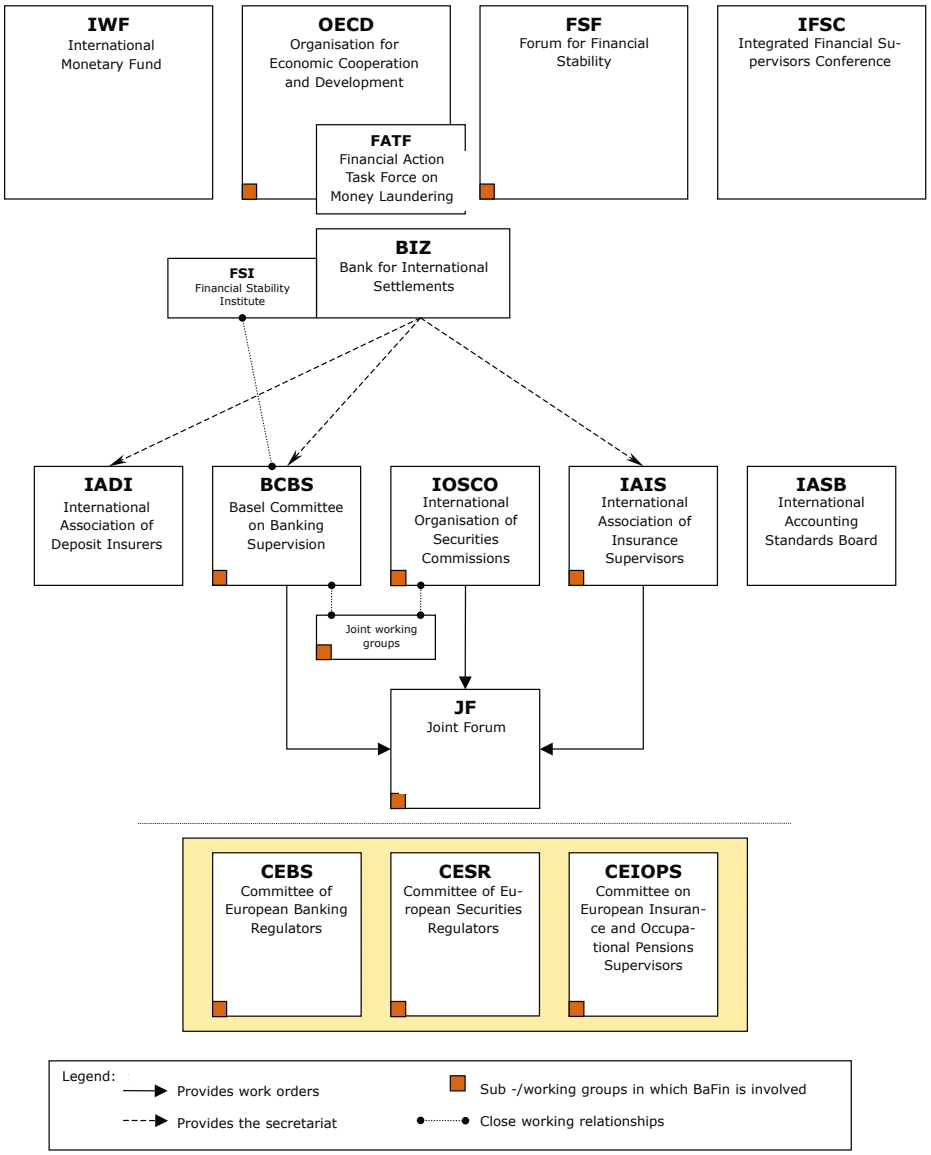
Thus, various committees and cooperation models have developed, whereby both the sphere of participating countries and participating institutions vary. Therefore, there are committees in which only the G-10 countries are represented. In several committees, government representatives are involved, as well as the supervisors, partially the central banks or also the supervised industry. With the exception of the European committees that develop binding requirements for the Member States, the standards of most of the other institutions are not legally binding. However, there is significant pressure to implement these, as they have as the greatest possible acceptance and often serve as benchmarks within the scope of the Financial Sector Assessment Program of the International Monetary Fund (IMF).

BaFin participates in many international committees.

As an integrated financial supervisor, BaFin is represented on all important – European and worldwide – committees of banking, insurance and securities supervision. Overall, BaFin is represented in well over 100 international working groups. The international BaFin activities require a high degree of cooperation: Supervisory issues overlap, on the one hand, on a European and international level and, on the other hand, in the sectoral committees. The aim of BaFin is not only to effectively represent German supervisory positions on the committees, but also the interests of the German market and the companies under supervision. The advantages of integrated financial supervision become clearly apparent here, as it enables the coordination of the German position on various questions which can then be convincingly represented in all committees.

4.2 International committees

Figure 13
International institutions and committees



4.2.1 International Organisation of Securities Commissions - IOSCO

IOSCO sets standards for securities regulators that are recognised worldwide.

The most important international forum of securities regulators is the International Organisation of Securities Commissions (IOSCO), established in 1983, in which 181 members from more than 100 countries have joined forces. The goal of the committee, which is based in Madrid, is to constantly adjust the supervisory framework in order to reflect rapidly changing conditions on the national and

international securities and derivatives markets. IOSCO, in fact, is globally recognised as setting standards in the securities sector and is essential for coordinating supervision on cross-border issues. IOSCO adopts standards and resolutions that are incorporated by its members into national regulation. The exchange of practical experiences in securities supervision between IOSCO members is a further task. Ultimately, the multilateral "IOSCO Memorandum of Understanding" is intended to strengthen the cooperation of its members on cross-border issues. The members are the regulatory authorities responsible for the securities and derivatives markets. BaFin staff is represented in the five standing working groups that prepare the work of the IOSCO Technical Committee.

Annual IOSCO conference.

At its 29th annual conference in May 2004, IOSCO adopted, inter alia, its report "Principles on Client Identification and Beneficial Ownership for the Securities Industry". In this report, IOSCO sets out basic principles of how customer identification is to take place in the securities sector in order to avoid money laundering. IOSCO also adopted two further reports: "Transparency of Corporate Bond Markets" examines transparency in the markets on which corporate bonds are traded. The report "Performance Presentation Standards for Collective Investment Schemes: Best Practice Standards" goes into how the presentation of investment fund performance should look, in order to be understandable for the investor.

Technical Committee Conference on Regulators and the Global Market Place.

High-ranking representatives of regulatory authorities from the financial and corporate sectors took part in the "Technical Committee Conference on Regulators and the Global Market Place" in New York in October 2004. With this conference, a regularly occurring IOSCO forum was to be established, at which the players in the securities markets can interact with the securities regulators. The next conference will be arranged by BaFin in Frankfurt in 2005.

Chairmen's Task Force.

The prevention of false reporting – primarily by quoted companies – was one of the central themes of IOSCO in 2004. In the USA, Italy and the Netherlands spectacular company collapses took place over recent years, which had been preceded by misleading reporting. Therefore, in April 2004, IOSCO implemented a working group on this topic. The group, to which BaFin also belongs, specified fields in which the IOSCO will become active in the future in order to avoid false company reporting. These include, inter alia, corporate governance and auditing and transparency standards for issuers.

Working group "Regulation on Secondary Markets"

Together with the "Committee on Payment and Settlement Systems (CPSS)" of the central banks, the working group completed a joint report entitled "Recommendations for Central Counterparties". This deals with the risk management of central counterparties (abbreviated: CCP's). A central counterparty is an establishment that appears as sole contractual partner for purchasers and sellers in transactions involving financial instruments. Delivery and payment obligations, as well as insolvency risk, are transferred to the central counterparty.

The report contains 15 recommendations regarding central counterparties and an evaluation methodology with which it can be examined to what extent the counterparty fulfils the requirements. The report impacts central counterparties of both spot and forward markets that are active both on the exchange and off-market. The report also deals with the organisational, financial, contractual and operational risks of a CCP and the risks that can result from its environment, such as the legal framework conditions of the respective country of domicile.

The Technical Committee of IOSCO, the CPSS and the central bank governors of the G-10 countries approved the report in November 2004. It is published on the IOSCO Web site.[11]

Working group "Enforcement and Exchange of Information"

International cooperation for the prosecution of legal violations in the securities sector

The working group "Enforcement and Exchange of Information" compiled an internal report on the experiences of its members in respect of cooperation deficits with foreign authorities. Such deficits are often present in countries where the regulatory structures lag far behind international standards; this partially involves so-called "Offshore Financial Centres". With its report, the working group moved a step closer to answering the question of how cooperation with securities regulators in such countries can be improved. The Technical Committee of IOSCO agreed on a new policy in autumn 2004 for handling uncooperative authorities: The dialogue with these authorities or countries is to be intensified, in order to gradually bring them closer to the standards of international cooperation developed by IOSCO.

Siphoning off and repatriation of assets from cross-border financial crime.

The working group is also working towards improving the legal instruments with which investors who have been the victims of fraudulent offers can be compensated. Particular attention is given to the Boiler Rooms – highly professional fraudsters that cause harm to wide groups of investors in many countries via telephone or Internet, often targeting the implementation of regulatory arbitrage. This phenomenon poses a challenge to securities regulators, legal authorities and Financial Intelligence Units. In a first step, IOSCO has established a system according to the model of CESR-Pol, with which information regarding financial service providers acting without authority can be quickly disseminated among IOSCO members.

4.2.2 Financial Stability Forum

Identification of weaknesses in international financial systems.

The Financial Stability Forum (FSF), where finance ministers and representatives of national regulatory authorities and central banks meet, is considered to be an intersection of the international committee structure. The committee, which is based in Basel, was established in 1999 in response to the Asian crisis. Its mission is to monitor the international financial system with respect to its vulnerability to risk, identify any requirement for action and to promote the coordination and exchange of information between the various authorities that are responsible for financial stability. Although the

[11] www.iosco.org > library > IOSCO Public Documents.

FSF has no direct authority with respect to the other committees, it has a key position, due to the high-level representation of all relevant institutions. The FSF has put together a collection of twelve standards of conduct[12] 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 annual meetings. During the reporting year, the primary interest of the FSF was the treatment of Offshore Financial Centres (OFC), in which the quality of transparency and regulation is to be improved. Other issues on the agenda included: Vulnerabilities of the international financial system, corporate governance, credit risk transfer and reinsurance.

4.2.3 Basel Committee on Banking Supervision

BCBS is setting globally recognised standards for banking supervision.

The Basel Committee on Banking Supervision (BCBS), which resides with the Bank for International Settlement, was established by the central banks of the G-10 countries in 1974. Representatives from 13 countries sit on the committee. The central banks and banking supervision authorities of the Member States are represented. The Basel Committee formulates regulatory standards and recommendations for banking supervision.
– such as the new Basel II capitalisation rules. Apart from this, it has set a target to improve the cooperation between nationally responsible supervision authorities. The standards that the Basel Committee has introduced so far have also been taken up by other countries that do not belong to the G-10. In fact, the BCBS has already developed into a global standard setter with its 1988 capitalisation rules (Basel I). The EU also aligns itself closely with the Basel requirements in its banking supervision legislation. BaFin is active in the BCBS, together with representatives of the Bundesbank.

4.2.4 Banking Supervision Committee - BSC

The Banking Supervision Committee (BSC) is a committee of the European System of Central Banks (ESCB). It resides with the European Central Bank. In 1998, the BSC assumed the activities of the Banking Supervisory Sub-Committee. Members of the BSC are representatives of the banking supervision authorities and the central banks of the Member States of the European Union. The BSC supports the European System of Central Banks in fulfilling its duty anchored in the EU agreement: to contribute to the stability of the European banking system. The main focus of the BSC's work lies in the analysis of the stability of the European banking systems and structural developments within the banking sector. BaFin is represented in the following BSC working groups: "Working Group on Macro Prudential Analysis" und "Working Group on Development in Banking". In 2004, BSC and CEBS established a joint "Task Force on Crisis Management".

[12] Code of Good Practices and Core Principles, see also www.fsforum.org > Compendium of Standards.

4.2.5 International Association of Insurance Supervisors – IAIS

Members of the International Association of Insurance Supervisors – IAIS, which was formed in 1994, are insurance supervisory authorities from more than 120 countries. Around 80 organisations, many insurance industry associations among them, have observer status. The IAIS promotes cooperation between the insurance regulators, establishes international standards for insurance supervision, offers training to its members and coordinates its work with supervisory authorities in other financial sectors. The standards that the IAIS formulates – primarily the Insurance Core Principles – are not only of importance for the Member States. The International Monetary Fund (IMF) and the World Bank also use them as a basis for their Financial Sector Assessment Program.

New standards for the risk management of capital investments.

At its annual meeting in October 2004, the IAIS adopted the "Guidance Paper on Investment Risk Management"[13] at the recommendation of the Executive Committees. The document is considered to be a guideline for effective risk management for insurers and reinsurers, provides recommendations and describes standards under consideration of the differing conditions of the respective regulatory systems. It also supplements the "Insurance Core Principles" of the IAIS and its "Standard on Asset Management". The paper provides suggestions for regulators that must evaluate risk management systems and their implementation within organisations. It advises regulators to orientate themselves as to how extensive, high-risk and complex the business of an insurer is, when deciding on which information to request. The objective should be to obtain the information required from the insurer that is necessary for supervision, but not to burden the organisation unnecessarily.

4.2.6 Joint Forum on Financial Conglomerates

The Joint Forum on Financial Conglomerates was formed at the beginning of 1996 and is made up of representatives from banking, insurance and securities supervision. It represents the three international organisations in the Joint Forum: the Basel Committee on Banking Supervision, the IAIS and IOSCO. The forum is of great importance for BaFin, as it deals with supervisory topics from a cross-sector point of view. In the Joint Forum, regulators from 13 countries are represented. The Joint Forum has the goal, inter alia, of expanding the understanding of regulators for the respective other sectors and developing the basic principles, according to which the regulated undertakings in a financial conglomerate are to be supervised.

Investigation on the topic of credit risk transfer.

In autumn of 2004, the Joint Forum presented a report on the topic of credit risk transfer. It provides an overview of current market developments and evaluates them from a regulatory point of view. The most important conclusion of the report: The more credit derivatives and structured products are used, the better the risk management of the market participants must become. The Joint Fo-

[13] www.iaisweb.org > Principles, Standards and Guidance.

rum report therefore includes recommendations regarding risk management and disclosure practice.[14]

4.2.7 Bank for International Settlements

The oldest international financial organisation is the Basel Bank for International Settlements (BIS); it was established in 1930. The BIS offers, inter alia, banking services that are intended to aid the central banks in the administration of their gold and foreign currency reserves. It also acts as a bank for international financial organisations. The shares in the BIS are held by 55 central banks that have voting rights at the annual general meeting. The BIS organises, inter alia, expert meetings on topics that relate to currency stability and financial stability. The BIS itself is not a supervisory standard setter; however, the secretariats of several international committees are domiciled in the BIS, such as the Basel Committee for Banking Supervision and the Forum for Financial Stability.

4.2.8 International Monetary Fund

As with the World Bank, the International Monetary Fund, which was formed in 1945, is a special organisation of the United Nations. According to the vision of its founders, the IMF was to ensure the stability of international currency and financial systems. Today, 184 countries are represented as members of the IMF. Of primary interest to BaFin is the "Financial Sector Assessment Program", which the IMF and the World Bank introduced in 1999 in the aftermath of the financial crises of the 1990's. It is part of the regular IMF country examinations. Within the scope of the program, the IMF investigates the financial systems of individual countries with respect to risk content, based on internationally recognised criteria. Particular attention is given to possible early warning indicators and the quality of banking, insurance and securities market supervision.[15]

4.2.9 Organisation for Economic Cooperation and Development – OECD

The Organisation for Economic Cooperation and Development (OECD) emerged from the Organisation for European Economic Cooperation in 1961. 30 industrialised nations are members of the OECD. The aim of the organisation is to contribute to optimal economic development in the member countries and to promote economic growth in developing countries. A further aim is to promote the expansion of global trade. The OECD supports specialist committees and working groups on various topics. Several of these are also concerned with areas that are important for financial supervision, such as with the effects of linkages between banks, insurance companies and pension funds. BaFin representatives also take part in the committee meetings and working group meetings. Also domiciled with the OECD is the Financial Action Task Force on Money Laundering (FATF).

[14] www.bis.org/bcbs/jfpubl.htm.
[15] The results are published on the Web site of the IMF: www.imf.org/external/np/fsap/fsap.asp.

4.2.10 Financial Action Task Force on Money Laundering – FATF

The Financial Action Task Force on Money Laundering (FATF) is the most important international committee for combating money laundering and the financing of terrorism.
It was formed at the G-7 summit in Paris in 1989 as a reaction to growing fears about money laundering on financial markets and has received additional tasks since the terrorist attacks of 11 September 2001. With its 40 recommendations for combating money laundering, revised while the rotating presidency was held by Germany in 2003, and its now nine special recommendations, the FATF set the most important international standards and continuously develops these further. The committee is comprised of 33 members (31 member countries and two international organisations). Other international bodies, such as IOSCO, IAIS, Interpol, IMF and the World Bank also participate in FATF meetings as observers.

On 14 May 2004, the ministers and representatives of the member countries extended the mandate of the FATF for a further period of eight years. With this, they underline the importance of the committee, as well as the necessity of its work.

4.2.11 International Organisation of Pension Supervisors – IOPS

IOPS founded.

Since 12 July 2004, the International Organisation of Pension Supervisors (IOPS) has existed in Paris, a similar body to the IAIS for occupational pensions. In addition to BaFin, the founding members are 23 further regulatory authorities and organisations.

The IOPS intends to set standards for the supervision of occupational pensions on an international level, to promote cooperation between the regulators of these institutions and to form a global forum for the exchange of information for regulators and occupational pension establishments. IOPS has an Executive Committee and a Technical Committee, of which BaFin is a member. The secretariat activities are carried out by the OECD. The focus of activities for the organisation for 2005 will be on the conception of "Guidelines for Good Practices in Pension Supervision" and "Components of Risk-based Approached and Strategic Planning".

4.2.12 Integrated Financial Supervisors Conference – IFSC

The Integrated Financial Supervisors Conference was formed in 1999 as a network of integrated financial supervisors from around the world. In August 2004, the fourth meeting of the IFSC was held. Among the topics were the training and advanced training of staff, the payment of staff and the role and implementation of specialists in supervision. The seventh IFSC will be arranged by BaFin in June 2005 in Kronberg/Taunus.

4.2.13 International Accounting Standards Board – IASB

The International Accounting Standards Board (IASB) is the highest body responsible for formulating and adopting accounting standards. It members are accountants, analysts and accounting

practitioners. The financial regulator very closely monitors the development of accounting standards, as financial accounts are among the most important sources of information for a regulator. The IASB specifications are valid worldwide as International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) and are being adopted by the European Union with the aid of the endorsement process.

The endorsement process has two stages. In the first stage, a body of experts (European Financial Reporting Advisory Group – EFRAG) evaluates the standards from a technical aspect and provides the European Commission with a recommendation to accept the standards. In a second stage, the Accounting Regulatory Committee, in which Member States are represented, must approve the standard. Following this, it can be officially carried over into European law.

The International Financial Reporting Interpretations Committee (IFRIC) of the IASB is responsible for the interpretation of the accounting standards. The German partner of the IASB is the Deutsche Rechnungslegungs Standards Committee e.V., which works in close cooperation with the board.

4.3 European bodies

CESR, CEBS and CEIOPS

On a European level, the regulators work together in three committees: the Committee of European Securities Regulators – CESR, the Committee of European Banking Supervisors – CEBS and the Committee of European Insurance and Occupational Pensions Supervisors – CEIOPS.

As an integrated financial supervisor, BaFin is active in all three committees. The committees have a dual function: Firstly, they advise, inter alia, the EU Commission within the scope of European legislation. Secondly, they ensure that regulatory practice is standardised in their sector on a Europe-wide basis. The CESR, which served as a model for the banking and insurance regulators, has already existed since June 2001. The body has already advised the Commission on various adopted guidelines. The younger CEIOPS and CEBS, which were set up pursuant to a Commission decision dated 5 November 2003, are already active in the European decision-making process. By the end of 2004, there were not yet any EU legislative processes concluded in the banking and insurance sector.[16]

Lamfalussy committees

BaFin can participate in shaping European supervision legislation on various committees.

When guidelines are passed for the financial services sector on the European level, the respective responsible national regulators are involved in their implementation: as members of the Committee of

[16] www.cesr-eu.org; www.c-ebs.org; www.ceiops.org.

European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The committees are therefore important forums for BaFin, in which it can participate in shaping financial supervision on a European level (see figure 14 "EU committee architecture").

The eldest of the three committees is the European securities regulator, CESR, formed in June 2001. The basis for the formation of the body based in Paris was the Final Report of the Committee of Wise Men on the Regulation of the Securities Market (Lamfalussy Report). The wise men had recommended that the EU legislation process be made more flexible, transparent and tight. Under the new procedure, guidelines are only passed as framework guidelines at the first stage. The detailed work is carried out by the committees, or they advise the EU Commission.

The Lamfalussy process, designed for the securities sector, is now also applied for banking and insurance sector. At the end of 2003, the EU Commission decided to implement the "Committee of European Banking Supervisors" and the "Committee of European Insurance and Occupational Pensions Supervisors". The European bank supervision body based in London took up activities in January 2004; it members are the respective national regulatory authorities and the central banks. Its equivalent for European insurance regulation has been active since November 2003 and is based in Frankfurt am Main. Its members represent national insurance regulators. Like CESR, CEBS and CEIOPS also have the task of participating in the implementation of EU legislation. They advise the EU Commission on technical details of new legislation and ensure its standardised implementation in the Member States.[17]

4.3.1 CESR

In the course of the Lamfalussy process, the CESR advises the EU Commission if it prepares implementation rules that substantiate the framework guidelines for the securities sector. The CESR is also concerned with questions of interpretation, in order to achieve a comparable implementation and application of securities guidelines in the EU Member States. Additionally, the committee supports cooperation between the national securities regulators.[18]

CESR working group transparency guidelines

In January 2005, the Transparency Guideline[19] came into effect. It must be implemented in national legislation by January 2007. The guideline regulates transparency regarding significant voting rights and the publishing and storage of capital market information. The

[17] The European legislation process is explained in detail in the Annual Report 2002, Chapter II.3.2.2. (P. 44 ff.) and in the Annual Report 2003, Chapter I.3.2.1 (P. 44 ff.). The reports can be accessed under www.bafin.de > Press & Publications.
[18] Current information, among other things, regarding the status of consultations can be found under www.cesr-eu.org.
[19] DIR 2004/109/EC, OJ EU No. L 390/38.

group is working on implementation measures in this respect. The work under these mandates is to be completed by mid-2006. The guideline adds to the already existing ones (5, 10, 25, 50 and 75%), three further thresholds, the exceeding or under-running of which triggers a duty of notification by the voting right holder: 15, 20 and 30%. For the future, BaFin expects a significantly higher number of notifications than there have been to date. Furthermore, a duty of notification will be introduced for share-related derivatives. They should also ensure that a significantly higher number of notifications reach BaFin than in the past. The time limits for notification are being shortened from currently seven days to three days and for publication, from nine days to four days.

Capital market information that has so far been published nationally must now be published Europe-wide. With the transparency guidelines, national systems for storing this information will also be introduced. Additionally, this system is to be linked with the information offered by the stock exchanges. The aim is to eventually network the systems transnationally, so that investors can inform themselves comprehensively about all quoted European companies through a central portal.

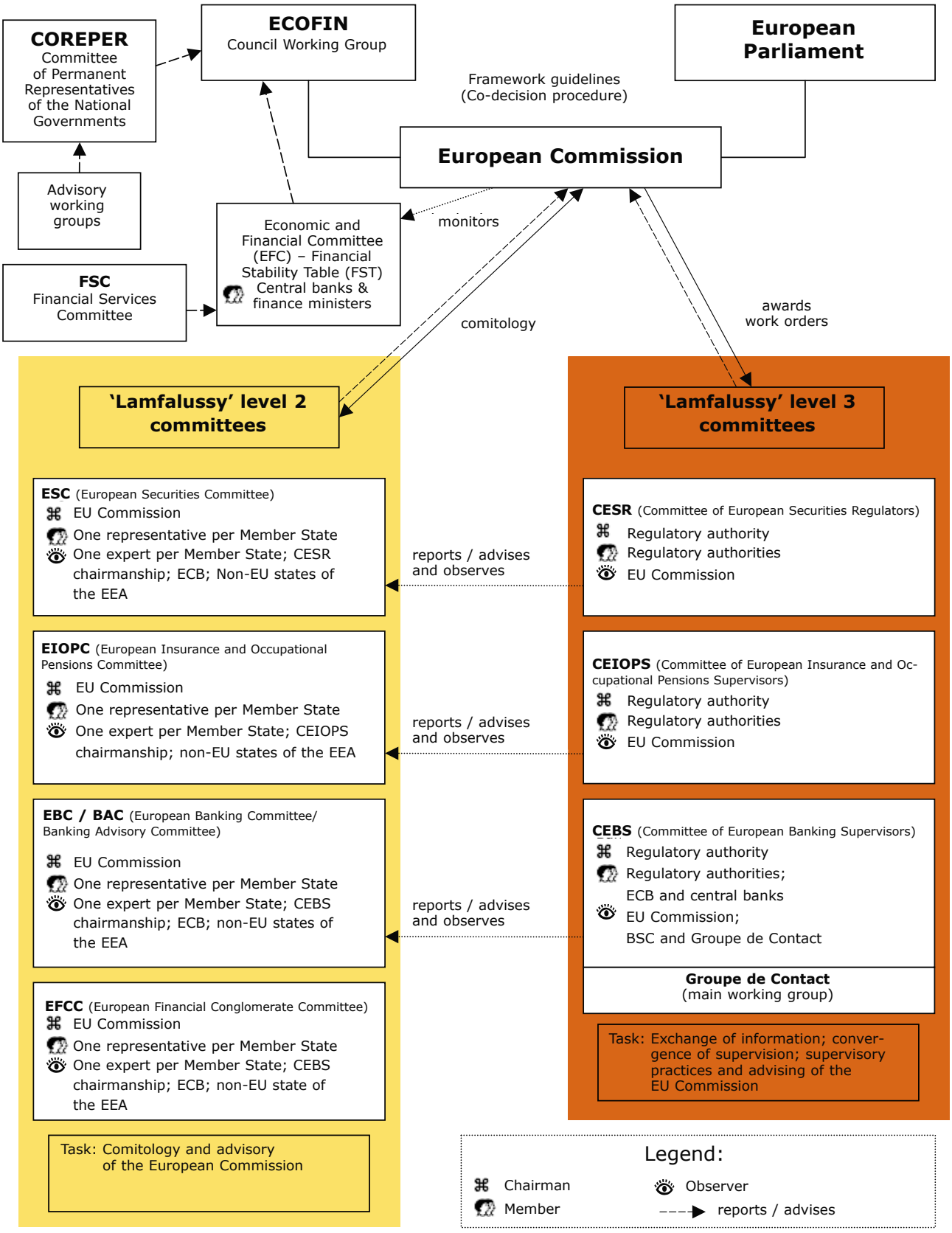
CESR expert groups regarding the Markets in Financial Instruments Directive

The new Markets in Financial Instruments Directive (MiFID) came into effect on 30 April 2004 and replaces the Investment Services Directive. It is to be transformed into intrastate legislation in 2006. The directive spans an EU-wide legal framework, within which stock exchanges, multilateral trading systems and banks carry out the instructions of investors. The directive also expands the regulations for authorisation and the conditions under which securities undertakings can become active and specifies the regulations for regulated markets and the responsible regulator. It is also creating a "European passport" for securities organisations: These are to be able to become active in the entire EU if they are admitted by their country of origin. The European Commission has instructed the CESR to transmit recommendations for concrete implementation regulations for MiFID by spring of 2005.[20]

The CESR has set up three MiFid expert groups: The group "Intermediaries" concerns itself, inter alia, with the implementing provisions for the good conduct rules for organisational and recording obligations of securities organisations, with measures for preventing conflicts of interest or to regulate them. CESR handed over its recommendations on these points to the EU Commission at the end of January 2005. Among further mandates are the best possible execution of customer orders ("Best Execution") and the definition of the new main service of "Investment Advisory". These regulations are a novelty in Europe.

[20] The respective consultation papers are published on the CESR Web site under www.cesr-eu.org.

Figure 14
EU committee architecture



The expert group "Markets" is working on implementing provisions for stock market and off-stock market trading and for systematic initialisation.[21] As it primarily concerns itself with topics that fall into the responsibility of the stock exchange regulators, these are also involved in the work process. Particularly with activities surrounding authorisation conditions for trading, there are many points of contact with the Prospectus Directive, the Transparency Directive and the directive regarding authorisation for official stock exchange listing. Here, good coordination is particularly important for avoiding conflicts with regulations contained therein. New in the MiFID is the specification of authorisation conditions for derivatives, whereby the CESR is keen to take into consideration the diverging interests and trading models of futures markets and commodities futures markets. BaFin is also working towards having the German market structure being adequately considered in the implementing provisions – primarily in questions of transparency and systematic internalisation. The regulation of systematic internalisation is completely new for the German market. The same applies to post-trading transparency in over-the-counter trading (OTC trading).

The expert group "Cooperation and Enforcement" is concerned with questions surrounding the exchange of information between supervisory authorities and with the implementing provisions regarding the obligation of securities organisations to report all transactions to the responsible securities supervisory authority. Ultimately, it concerns the effects that the MiFID will have on the national obligation to report pursuant to § 9 Securities Trading Act (WpHG). This obligation of securities firms to provide electronic notification reports on all concluded securities transactions serves to facilitate the exposure of insider trading and market manipulation. The MiFID contains regulations according to which the securities firms must, in future, report their transactions in financial instruments to the regulatory authorities in their countries of origin. The authorities will pass the notification on to the supervisors of the respective "most liquid market for the particular instrument".

Overall, each change in the existing reporting system leads to significant financial burdens for the securities firms. Therefore a "Technical Task Force" initiated by BaFin is currently targeting the technical requirements and conditions for the future Europe-wide exchange of reporting data. Its aim: to subject the required intervention in existing systems to a cost/benefit analysis and to keep it as low as possible.

CESR expert group for prospectuses

The Prospectus Directive has been in effect since December 2003. The legislators of the Member States have until 1 July 2005 for implementation into national law. In May 2004, the technical implementing measures of the European Commission regarding the Pro-

[21] Transparency regulations prior to and following trading and exceptions from it, authorisation of securities for trading on a regulated market.

spectus Directive[22] came into effect. It specifies, for example, the content of prospectuses. The Prospectus Directive is introducing the "European Passport" for prospectuses. This means that firms can offer their securities throughout Europe if the regulator in a single Member State has approved the prospectus. Furthermore, these firms can then use this prospectus Europe-wide for authorisation to a regulated market within the meaning of EU law. With this, it will become easier and cheaper for them to take up cross-border capital. Investors will be able to rely on better information about issues. Public consultation for the paper published by the CESR in June 2004 has been completed.[23]

Permanent working groups

CESR-Pol

The CESR-Pol is an operationally active group of the CESR, in which supervisors work together who concern themselves with issues surrounding market supervision. The main focus of their work lies in preventing the abuse of markets, and respectively pursuing cases of market abuse in cross-border collaboration. Since the beginning of 2004, CESR-Pol has been involved in working on the EU Directive on insider dealing and market manipulation.[24] The purpose of it is to ensure that the supervisors of the EU countries apply the directive consistently and efficiently and daily practice. The German legislator has implemented the Directive on insider dealing and market manipulation with Art. 1 of the Act on the Improvement of Investor Protection (AnSVG) dated 28 October 2004.[25]

CESR-Fin

CESR-Fin is a working group that develops proposals for the harmonised supervision of compliance with accounting standards in Europe. The aim of its work is 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 an EU regulation[26], IFRS accounting is mandatory for all financial years that begin on or after 1 January 2005. During 2004, CESR-Fin continued to work on matters regarding the enforcement of accounting standards.

CESR Strategic Task Force

Banks, insurance companies, investment firms and issuers of securities have expanded their cross-border activities in the past. This

[22] Ordinance of the Commission dated 29 April 2004 for implementation of the Directive 2003/71/EU of the European Parliament and the Council regarding the information contained in prospectuses, as well as the format, the inclusion of information using references and the publication of such prospectuses and the dissemination of advertising 809/2004, OJ EU No. L 149/1, revised OJ EU No. L 215/3.
[23] CESR´s recommendations for the consistent implementation of the European Commission, s. Regulation on Prospectuses No. 89/2004 (Ref. CESR/05-054).
[24] DIR 2203/6/EU. OJ No. L 96/16.
[25] Federal Law Gazette (Bundesgesetzblatt - BGBl.) 2004 I, p. 2630.
[26] Regulation 1606/2002, OJ EU No. L 243/1.

places the regulatory authorities before new tasks, which they intend to approach with increased cooperation. Initial steps in the direction of a closer cooperation beyond state borders consist of dividing up the responsibilities between the regulator in the home country – in which the supervised enterprise has its head office – and the regulators in the guest countries, in which the enterprise carries out its activities. The "European passport" was also introduced. For financial conglomerates, the coordinator system was introduced with the Financial Conglomerate Directive dated December 2002[27] – implemented through the Financial Conglomerate Directive Implementing Law[28]. In addition to the already existing supervision for specific enterprises in a financial conglomerate, it provides for additional supervision through a coordinator. The introduction of a "consolidated supervisor", who would work in cooperation with the responsible supervisory authority in several cases, is also currently being discussed in Brussels in the negotiation of the new capital regulations for credit institutions and securities firms[29].

Lead Supervisor.

During the past year, official discussions were initiated in various committees of how best to supervise enterprises that carry out cross-border activities. The financial industry, represented by the European Financial Services Round Table (EFR), an affiliation of chairpersons of large European banks and insurance companies, published their thoughts on the introduction of a "lead supervisor" for the solvency supervision of banks and insurance companies in the summer of 2004. The "lead supervisor" in this sense, is to be the only contact for the supervised enterprises and assume supervision in agreement with the other responsible supervisors. The securities regulators in the EU have also taken up this topic: In spring of 2004, CESR implemented a strategic task force that deals with the future supervision of the securities markets in Europe. Their eight members also include the President of BaFin. In order to find out about the ideas of market participants regarding future supervision, the group, inter alia, carried out interviews with representatives of issuers, securities services firms and stock exchanges. The task force presented the result of its work in autumn of 2004 in "Preliminary Progress Report – Which Supervisory Tools for the EU Securities Markets? – An Analytical Paper by CESR" and submitted it for public consultation. In the task force, BaFin advocated gathering practical experiences with supervision in the course of the directives implemented under the Financial Service Action Plan.

4.3.2 CEBS

CEBS working group "Common Reporting"

The CEBS working group Common Reporting (COREP) took up its work in July 2004; it is developing a Europe-wide standard banking supervision reporting. Currently, COREP is concentrating exclusively on solvency reporting.

[27] DIR 2002/87/EU, OJ. EU No. L 35/1.
[28] BGBl. 2004 I, p. 3610.
[29] Directive recommendation for the amendment of codified banking directive (2000/12/EU) and the Directive on capital adequacy of investment firms and credit institutions (93/6/EEC).

The formation of COREP is a response to suggestions from the financial industry, which must accommodate many different reporting requirements in the 25 EU states. The EU Commission and the European Central Bank are pushing the standardisation of reporting.

According to the assessment of COREP, the implementation of the new Basel capitalisation rules (Basel II) into European law (Directive on capital adequacy of investment firms and credit institutions) provides a unique opportunity to standardise European reporting. The working group has, however, taken on the task of relieving the institutions by reducing reporting requirements. The basis of COREP's work is a feasibility study in which, inter alia, BaFin and Deutsche Bundesbank significantly cooperated. On the basis of the feasibility study, COREP will determine which data is required and how the individual reporting elements are to be demarcated in a standard manner. The reporting elements are – wherever possible – to be linked with data already contained in the systems of the institutions.

National elective rights

The elective rights granted to the Member States/their supervisory authorities by the drafts of the Banking Directive and the Directive on Capital Adequacy, have encountered criticism in the financial industry and with the EU Commission. Therefore, at the request of the EU, CEBS will also deal with the topic of "elective rights" in 2005. The main argument against numerous elective rights for national supervisors is that they make it difficult to create equal competitive conditions in all EU countries. So far, the CEBS has categorised 23 of the 143 elective rights as being disposable; the advisory working group also followed the recommendation of CEBS to reduce elective rights. During the current year, CEBS will also point out elective rights that would become superfluous in the event of harmonising supervisory practice. In several cases, the supervisory practices and procedures within the EU are not yet sufficiently harmonised in order to forgo elective rights.

4.3.3 CEIOPS

In addition to Solvency II, the main emphasis of the work of CEIOPS is on occupational pensions, financial stability, insurance brokerage and insurance group supervision. CEIOPS has formed working groups in this respect. CEIOPS has published three consultation papers to date: These regulate the consultation between CEIOPS and market participants, consumers and end users, deal with the coordination of supervision for insurance groups and involve the topic of "IAS/IFRS and the current solvency system".

Occupational Pensions Working Group

The Directive on the activities and supervision of institutions for occupational retirement provision[30] allows occupational pension or-

[30] DIR 2003/41/EC; OJ. EU No. L 235/10.

ganisations to become active on a cross-border basis for the first time. The directive must be implemented in German law by 23 September 2005. The aim of this CEIOPS working group for occupational pensions is to develop an EU-wide understanding of the Pension Fund Directive. It is also concerned with regulating how the cooperation and exchange of information should look between respective supervisors if the occupational pension institution takes up activities outside of the home country. Added to this are analyses of the economic situation of occupational pension organisations and the monitoring of developments in calculating technical provisions in the EU Member States. The working group is preparing a protocol for the cooperation of the supervisory authorities in all matters involving cross-border activities of these organisations.

Financial Stability Committee

In order to assess the financial stability of the European insurance market, the regulator requires conclusive key figures from which the financial situation and specific risks of individual insurance firms and the insurance sector can be read off. The working group has further revised statistical reporting and supplemented it with standard, risk-orientated variables and key figures. In future, the reinsurance firms and Pensionskassen / pension funds are to be included in the evaluations. The aim is a standard reporting system that particularly provides insights for financial stability analyses. On this basis, the working group prepared two reports in 2004 on financial stability, one in which the most important risks were identified for the insurance sector in Europe and one on credit risk transfer.

4.4 Basel II

Basel II adopted.

The heads of the supervisory authorities and central banks of the G-10 countries adopted the framework agreement for the new capital recommendation for credit institutions (Basel II) on 26 June 2004. The Basel Committee on Banking Supervision – BCBS had presented the body of rules and regulations following five years of negotiations. Basel II is considered to be a significant milestone in the international harmonisation of banking supervisory regulations.

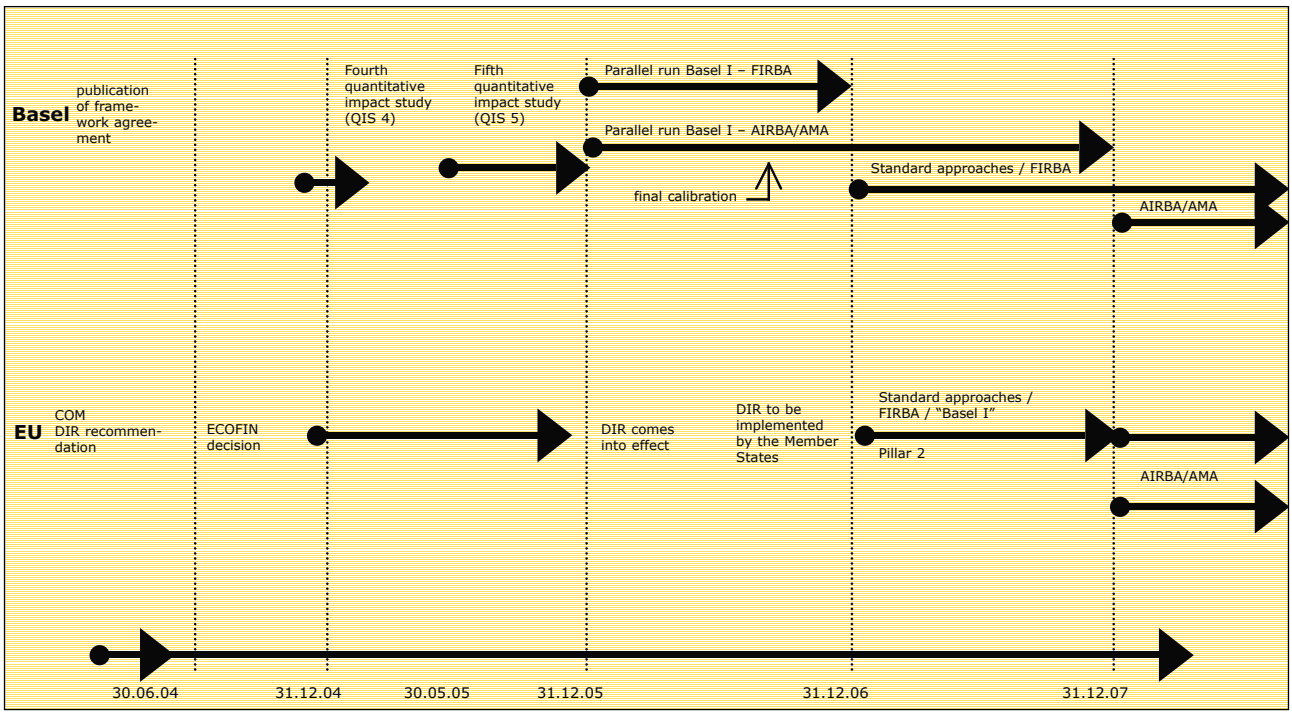
The further process at the Basel level.

Following the adoption of the framework agreement, several countries have initiated preparations for the fourth quantitative impact study (QIS 4). In Germany, QIS 4 began in December 2004 and is running until the end of February 2005. The evaluation will extend until the second quarter of 2005. For the fourth quarter of 2005, a further quantitative impact study is then planned for all countries represented in the Basel Committee, with the aid of which the consequences of the changes in the framework agreement are to be assessed. On the basis of these assessments, the Basel Committee will decide by mid-2006, whether the level of capital requirements must be adjusted.

At the end of 2005, the parallel run will begin. The banks are then to calculate their banking supervisory capital requirements in par-

allel with the currently valid regulations (Basel I). The purpose of this parallel calculation is to again examine the changes in capital requirements and to become accustomed with the risk sensitivity of the new capital requirements. For the simple, internal rating approach, the foundation IRBA (Foundation Internal Ratings Based Approach – FIRBA), there will remain a one-year parallel run until the end of 2006. For the more advanced process for measuring credit risk (Advanced IRBA - AIRBA) and operational risk (Advanced Measurement Approaches – AMA), the Basel Committee has extended the test period by a year until the end of 2007. From the start of 2007, the institutions will be permitted to apply the foundation IRBA. From that point, the standard approaches for the measurement of credit and operational risk are also binding. The advanced approaches for AIRBA and AMA can, however, only be implemented from the start of 2008. This provides the institutions wanting to use these approaches one additional year of time to prepare for the demanding minimum requirements.

Figure 15
Basel and EU timetable



Draft of the EU directive unanimously accepted by the ECOFIN council.

The new "Basel II" directives are not legally binding. They are only recommendations of the Basel Committee for Banking Supervision and initially only apply to internationally active banks that have voluntarily obligated themselves to follow them. In Germany, this applies to 19 banks. The European Union will, however, implement the recommendations of the Basel Committee through a directive (Capital Requirements Directive – CRD), thereby making it binding Europe-wide for all credit institutions. On 14 July 2004, the European Commission presented a recommendation for new capital re-

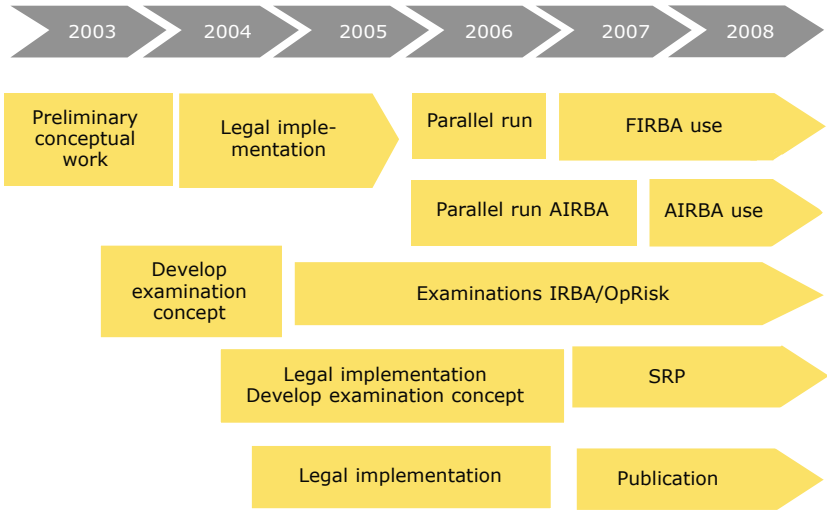
quirements for banks and securities firms. The ECOFIN council unanimously accepted this draft directive on 7 December 2004.

Further process at the European level.

The legal implementation process is now being advanced at full tilt. The council negotiations are already well advanced. The directive is to be adopted by the European Council and the European Parliament by the end of 2005 and will then take effect.

The EU directive is also designed for compulsory use from the end of 2007. As with the new Basel directives, the institutions can, however, already use the standard approach and the Foundation IRBA from the start of 2007. Furthermore, they are also permitted to use the currently valid directives (Basel I) during 2007. The EU directive does not foresee a parallel run. However, the institutions that intend to use the Foundation IRBA from the start of 2007 must have access to a rating system that they have already tested in practice; i.e. they must already use the systems in 2006. In Germany the work on national implementation of the EU directive is also running at full speed.

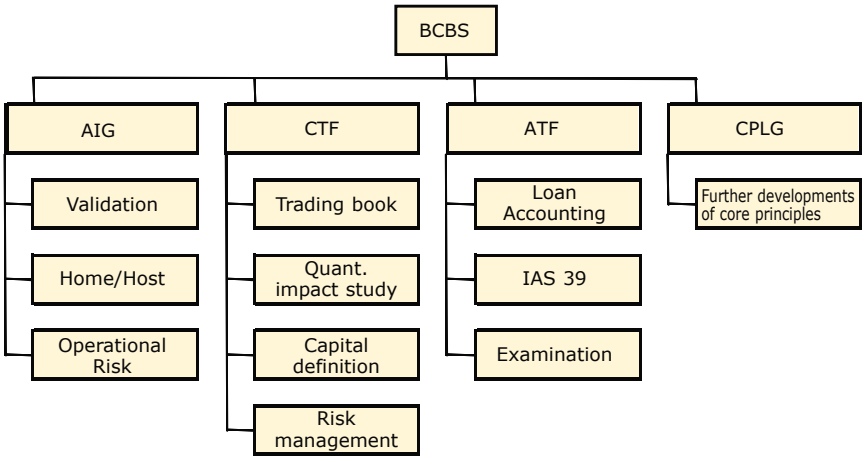
Figure 16
Timetable for Basel II implementation



The Basel Committee has restructured its working groups.

After Basel II was adopted, the Basel Committee for Banking Supervision restructured its working groups.

Figure 17
New structure of the Basel Committee



There are four main groups: the Accord Implementation Group (AIG), the Capital Task Force (CTF), the Accounting Task Force (ATF) and the Core Principles Liaison Group (CPLG).

Practice studies are to determine the coordination requirement between the home country and guest country supervisory authority.

On 18 August 2003, the Basel Committee for Banking Supervision published its "High-level Principles for the Cross-border Implementation of the New Accord". Building on this, the AIG practice studies initiated "Real Case Studies" for internationally active model institutions. On the basis of the practice studies, the AIG aims to find out how cooperation between home country and guest country supervisory authorities functions on a consolidated basis and is harmonised, following the introduction of the new Basel rules. BaFin is involved in four practice studies, together with the Deutsche Bundesbank. As guest country regulators, BaFin and the Deutsche Bundesbank are also participating in practice studies with institutional groups domiciled in foreign countries. Initial experiences with these case studies shows that the cross-border cooperation of supervisory authorities requires a high degree of mutual trust. Over the course of the practice study, employees of BaFin and the Deutsche Bundesbank have held discussions with the authorities in the USA and Great Britain, which supervise the branches of the banks in these countries. They have primarily discussed with their US American and British colleagues how functioning information channels can be created and under which circumstances an authority must accept the respective supervisory decision of the other authority. There was also agreement that it is important to establish how important a subsidiary or branch is. In doing so, both the interests of the home country and the guest country regulator must be considered. A subsidiary or branch can be systemically relevant for an institution itself – due to size or risk aspects – however, in a guest country it may have only little importance. On the other hand, a subsidiary or branch can be classified as insignificant for the institutional group, while it has systemic importance in the guest country – for example, as it is the fourth largest institution there.

Regional conference on the implementation of Basel II.

In October 2004, BaFin hosted the regional conference of the Federal Reserve Bank of New York (FedNY) and the Office of the Comptroller of the Currency (OCC) for the implementation of the new Basel capital rules at Citigroup. The most significant result of this regional conference was that guest country regulators of larger countries must respect the vested interest of smaller countries. Representatives were supervisory authorities from Europe, Africa and the Near East. Citigroup presented the status of its Basel II preparations and the FedNY and the OCC explained their supervisory approach. Ensuring established supervision through international cooperation is a central concern for BaFin.

4.5 Solvency II

Solvency II regulates the future European insurance supervision.

Solvency II is the future set of rules for European insurance supervision. With Solvency II, it is the intention of the European Commission to create a supervision system that is more strongly aligned with the actual risks of the insurers, than is currently the case with the existing valid regulations. The architecture of Solvency II is similar to Basel II, the equity capital agreement of the Basel Committee for Banking Supervision. As with the Basel rules, Solvency II also consists of three pillars. Pillar I encompasses the quantitative requirements of the new risk-orientated solvency system. Among other things, this involves the level of security of technical provisions and the level of future capital requirements of the undertakings. Pillar II deals with the qualitative requirements that the companies and supervisory authorities must fulfil in the future. With this, the question arises regarding which principles, organisation and processes must suffice in the companies in future. Part of the second pillar will also be a risk-orientated supervisory examination procedure. In Pillar III, the topics of market transparency and market discipline will be dealt with.

CEIOPS advises the EU Commission.

As a member of the European supervisory body CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors), BaFin has the task of advising the EU Commission in the formulation of the new directive. Following public consultation in July and December 2004, the Commission submitted two bundles of mandates ("First and Second Wave Calls for Advice") to CEIOPS for processing. They refer, inter alia, to questions regarding risk management, technical provisions, asset-liability control, early warning indicators, standard risk model, reporting obligations and transparent supervision activities. A third bundle ("Third Wave") of mandates is expected in spring of 2005 and will include, among other things, admissible forms of cover, procyclicity, cooperation between supervisory authorities and public and internal reporting of the insurers. The opinions for the EU commission are being prepared by working groups specifically set up by CEIOPS for this purpose. BaFin is represented in all five CEIOPS working groups regarding Solvency II. The EU Commission participates through observers and also receives interim reports every few months on progress made. Final reports are planned for twelve months, respectively, following granting of the mandates, i.e. at the latest in spring of 2006, so that the Commission can consider the work results, where applicable, in the draft recommendation of a framework directive announced for 2006.

CEIOPS working group on life insurers takes up its activities.

CEIOPS working group Pillar I Life

From the CEIOPS working group Pillar I Life, which took up its activities in April 2004, the EU Commission is expecting, among other things, opinions regarding the following topics: regulations on technical provisions, structural aspects of the Solvency Capital Requirement – SCR, determining of the Minimum Capital Requirement - MCR, terminology regulations (for example, expected value, best estimate, risk margin), valuation procedures for assets and liabilities and the role of assets that cover obligations towards insurance firms. In a later step, the prudency levels for the technical provisions and the SCR are to be determined.

The CEIOPS working group Pillar I Life, initially concerned itself primarily with the valuation of assets and liabilities with respect to compatibility with the international accounting standards, IAS/IFRS. Additional topics were the consistency of Solvency II and Basel II, to the extent that these appear possible and purposeful, and the risks that are dealt with in Pillar I.

Simulation studies are planned.

In the short to medium term, random sample type simulation studies (Quantitative Impact Studies, QIS) are planned among the life insurance undertakings in the EU Member States. They are to show which effects the solvency regime will most likely have on the European life insurance market. Furthermore, the working group intends to clarify which delineation must be carried out between Pillars I and II. For example, it is being discussed whether operational risk should only be allocated to Pillar I once the methods of calculating it have been developed. In contrast, BaFin would prefer to continue following the "holistic approach" in Pillar I. According to this – in contrast to Basel II – all of the main risks are to be mapped in Pillar I. Solvency II should not remain behind Basel II with operational risk, where this risk is at least mapped globally in Pillar I and supported with capital. However, regulators in Pillar II should additionally have the possibility of evaluating this global supporting of operational risk and correcting it, if necessary.

Ratio between MCR and SCR is to be clarified.

A further important question is what the ratio should be between the MCR and the SCR. The MCR represents the absolute minimum requirement. If an undertaking should fall below this level, it would ultimately have to withdraw from the market. The SCR should be measured, such that an insurance undertaking is equipped for all ups and downs of the business operations with this endowment of equity. In the Life and Non-Life working groups, there is agreement that the MCR should be simple to determine. A similar requirement also exists for the standard procedure, which insurers can use to determine the SCR. The standard procedure should also provide small and medium-sized undertakings with the possibility of calculating their target solvency without significant actuarial assistance.

Solvency II intends to sharpen the risk awareness of undertakings.

The aim of Solvency II is not to carry out a market shake-out through increased requirements with respect to risk models or risk management systems. The purpose of the future rules should be to sharpen the risk awareness of the undertakings and to set incentives for risk-adequate behaviour. In order to achieve this, a consi-

stent European standard must first be laid down with a standard model, without losing sight of the "holistic approach" in doing so. For this purpose, the working group has discussed already existing models, such as those used in the Netherlands, Great Britain, Portugal and Denmark. With respect to the determining of the SCR, it must be clarified however the various (major) risks are to be classified and in which way regulatory arbitrage between individual sectors of the financial industry can be avoided. Furthermore, it is important whether the SCR must be calculated more than once per year and if so, in which time intervals it must be calculated. It also still remains open, how many different risk classes must be modelled in the standard model. According to the assessment of BaFin, Solvency II must at least model the risks dealt with by Basel II, namely credit risk, market risk and operational risk. As insurance undertakings must also consider technical risk, Solvency II must model at least five risks, namely, market risk, creditworthiness risk of the individual debtors, liquidity risk, premium and reserve risk and operational risk. With the internal calculation models, the risks could even by subdivided more finely.

It must also be decided to what extent market-dependent parameters are permitted to be estimated nationally. What speaks in favour of a national estimate is the fact that volatility takes on a different form in the various capital markets. With this, however, the correct mapping of reality in a standard model would be granted higher priority than the avoidance of regulatory arbitrage.

Internal models for capital requirements are to be defined.

In future, the Life working group in Pillar I will deal more intensively with internal models for determining capital requirements. This primarily involves defining the technical minimum requirements that must be defined for internal models by regulators. It should be made possible for the insurance undertakings to initially record partial areas of the undertaking through internal models (partial use), before the entire undertaking is represented in an internal model.

CEIOPS working group Pillar I Non-Life

CEIOPS working group "Non-Life" has similar core topics to its sister group.

The CEIOPS working group Pillar I Non-Life is concerned with the same core topics as its Pillar I "sister group", Life, however – as the name already indicates – for the non-life insurers. In their work to date, the working group Non-Life has primarily dealt with the question of how a "standard formula" could look for determining new capital requirements under Solvency II. The members of the working group have discussed a series of possible technologies for risk- orientated determination of such capital requirements and are also discussing which theoretical framework such calculations should be based on. Important aspects are, for example, the level of the security to be aimed for, the classification of risks, the valuation of assets and liabilities for solvency purposes, the influence of risk reduction measures by insurers (e.g. reinsurance) and the minimum requirements for internal models for determining capital requirements.

Actual solvency must also be determined.

A judgement regarding the solvency of an undertaking can only be formed by comparing the "target solvency" with actually existing capital. Therefore, the working group must not only deal with how the new capital requirements are to be determined. There is a further question to be answered: How should the new "actual solvency", i.e. available capital, be determined? For indemnity and accident insurance, the issue arises of how the equalisation reserve is to be treated and whether, in future, valuation reserves in claim provisions are to be apportioned to capital.

Valuation of technical provisions.

The Pillar I working group Non-Life must answer a further core question: How should the technical reserves be valued in future? Solvency II has the comprehensive requirement of valuing the overall security position of an insurer. The future European solvency regulations should therefore make the safety margin contained in the provision more transparent and align and harmonise the currently rather inconsistent practice for creating provisions in the individual EU countries. The aim of this is to make the new valuation rules compatible with the international IAS/IFRS accounting standard. The working group discussed whether an explicit safety level, such as 75 or 90% should be specified in the provisions.

Field studies from 2005.

In order to assess which impact new capital requirements and a new valuation of technical provisions could have in the insurance industry, statistical field studies and quantitative analyses are required. The working group will make the necessary preparations so that such studies can be initiated in 2005. BaFin has already carried out initial statistical research on a national level, with regard to the claim provisions for motor vehicle liability insurance. Such research shows not only how the solvency rules of Solvency II can have an impact, but also are to provide information regarding the current quantitative safety level in provisions and about the significance and adequacy of individual mathematical procedures for valuing claim provisions.

CEIOPS working group Pillar II

Internal control system and risk management are core topics.

The Pillar II working group is primarily dealing with the first six work mandates from the EU Commission. This primarily involves the question of how the regulator can ensure that insurers have an adequate and comprehensive control system and effective risk management. The undertakings must be able to correctly identify, monitor and control their current and future risk. Within the EU, the principle of head office country supervision applies. In the trust that each supervisory authority maintains a certain consistent minimum supervision standard, the Member States mutually recognise their respective supervision systems. Nevertheless, there are significant differences between the various supervision standards and methods. An important aim of Solvency II is to make the supervision standards of the EU Members more convergent, in the direction of "best practice". Regulators are to be provided with specified standards to be complied with in daily supervision and when carrying out site audits. For this, the supervisor must have the necessary legal authorisations and supervisory instruments with respect to both individual undertakings and the market as a whole.

Solvency II promotes transparency of supervisory authorities.

Supervisory instruments that constitute an efficient examination process and aid in identifying possible problems in good time include EU Commission early warning indicators, stress and sensitivity tests, scenario analyses, forecasts for assessing long-term resilience of insurance undertakings and market statistics. CEIOPS has commented professionally on these supervisory instruments, however it has not deemed it necessary to incorporate them in the Solvency II framework directive. Solvency II will require that the supervisory authorities make their actions and supervisory rules more transparent towards the supervised undertakings, the insurance industry and the general public. Among other things, this is intended to promote the convergence of supervisory activities in the sense of best practice.

Insurers must show a capital investment plan.

Under Solvency II, the undertakings will be required to show an adequate capital investment plan. This capital investment plan must be suitably linked with general corporate planning and the internal control system and risk management. The CEIOPS working group Pillar II is dealing with the question of what minimum content an adequate capital investment plan should include and how the plan should be incorporated into other corporate planning and control.

In future, all insurance undertakings will be required to set up an asset-liability management system as part of their general corporate and risk management planning. The general principles of asset-liability analysis are to be harmonised on a Europe-wide basis. It must be noted that asset-liability management has a different significance and function, depending on the insurance sector. The basic principle of adequacy must therefore be warranted. For life insurers, it represents a significant risk factor if assets and liabilities are not coordinated. A focal point of asset-liability management will therefore lie in Pillar I in the area of life insurance. For non-life insurers, asset-liability management is required in the business sectors where high damages claims, substantial technical provisions or a long processing period arise. How Pillar II will deal with the topic of asset-liability management will depend highly upon what decisions are made in this respect in Pillar I.

Pillar III

Pillar III intends to strengthen market discipline through transparency.

Pillar III will deal with market discipline and market transparency, as well as reporting for regulatory purposes. The EU Commission intends to strengthen market discipline by improving transparency on the markets and urging insurers to disclose information. This idea is already familiar from Basel II. It was also the subject of the joint declaration at the conclusion of the G-8 meeting in Evian in June 2004, according to which corporate integrity, a strengthened market discipline, more transparency through disclosure practices, effective regulation and social responsibility of undertakings are common principles that form the foundation of healthy, macroeconomic growth. BaFin assumes that comprehensively informed market participants will reward it if corporate management acts with risk awareness and the undertaking has installed an effective risk management system. In contrast, risky behaviour will be sanctio-

ned. For the insurers, this results in an incentive to monitor risks more consequentially than before and to control them more efficiently.

However, market discipline can only be achieved with a flexible concept, as justice must be done to the interests of both insurers and market participants. In respect of the extent and frequency of disclosure in specific corporate practice, the principles of essentiality and protection of confidential information will be considered. The formulation of disclosure requirements depends to a great extent on which advances the work in respect of Pillars I and II achieves and what happens in other institutions – such as the International Association of Insurance Supervisors IAIS. The qualitative requirements, however, can already be identified now: integrity, quality and availability are the cornerstones of reliable financial market information and these cornerstones must be incorporated in Pillar III. With the calls for advice, it must be investigated to what extent the requirements in Pillar III can be coherently formulated with respect to the IAS/IFRS disclosure rules. Additionally, the various reporting requirements of insurers operating on a cross-border basis must be harmonised and simplified.

CEIOPS working group Insurance Groups

CEIOPS working group is incorporating solvency rules into the supervisory concept for insurance groups.

The CEIOPS working group "Group-Wide Supervision and Cross Sectoral Consistency" has the task of incorporating the new solvency rules that the other working groups are to develop into a new supervision concept for insurance groups. The EU Insurance Group Directive[31] has closed the gap which had existed so far in the double consideration of solvency elements (double gearing) with insurance undertakings that belong to an insurance group, through the introduction of the calculation for insurance group solvency. The future solvency rules of Pillar I – these will apply to the individual personal, indemnity and accident insurers – are to be transferred to the calculation at group level. The working group must, however, clarify to what extent diversification effects that reduce the capital requirements may flow into the calculation and which new risks of an insurance group are to be included. An example would be reputational risk, in the event that a subsidiary becomes insolvent.

New rules for insurance groups will also be derived from the future principles for an internal control and risk management system under Pillar II. The control of an insurance group or even a financial conglomerate poses other demands for a Management Board, than the managing of an individual company – especially as the management of an individual insurer is specialised in the insurance business. Thus, new risks arise that are to be incorporated in the control and management system. This also places increased demands on supervision – especially in the event that an insurance group or financial conglomerate is operating on a cross-border basis.

[31] DIR 98/78 EC.

First step: Survey regarding Solvency II with German insurers.

Surveys regarding the initial situation

At the end of October 2003, BaFin sent a comprehensive questionnaire to 635 undertakings as an initial step in preparation for Solvency II. The aim was to create a comprehensive, current overview of the valuation and risk measurement methods, as well as the planning of insurance undertakings and pension funds in this sector. Thus, BaFin could gain an impression of whether the undertakings are equipped for Solvency II and which requirements particularly smaller and medium-sized undertakings are able to cope with. The responses from the undertakings were evaluated over the course of 2004 and made available to the participants in an anonymised form. BaFin has assessed the information gained from the questionnaires as being positive. It has been shown that the insurers are aware that Solvency II will place higher demands on them and that they intend to prepare themselves for the new rules. Several undertakings are already considering what the requirements could look like. Solvency II follows a risk-based approach. The future body of rules and regulations will therefore bring with it a series of regulations for capital investment and asset-liability management and for the internal control systems and risk management processes of the insurers.

The majority of undertakings have risk management guidelines.

The majority of undertakings are already using internal principles or guidelines now in the areas of risk management, internal control, proper administration, indemnity and reinsurance management. Furthermore, life insurers are already using asset-liability management processes today. So far, only few undertakings link these guidelines with their capital endowment – as it will be required by Pillar II. However, that is due to the fact that the requirements under Pillar II are still in the development phase.

Life insurers use asset-liability management.

According to the survey, the life insurers appear to be increasingly collecting and evaluating risk-relevant data. The undertakings have upgraded their electronic data processing and have thus created a basis for adequate asset-liability management. Furthermore, they have laid a foundation for an internal model to calculate capital requirements. BaFin welcomes the fact that insurers are striving to quantify their risks with the aid of scientifically established, mathematical-statistical methods. BaFin survey also provided valuable information for the future supervision of smaller and medium-sized undertakings: It showed that it does not make much sense to demand that smaller and medium-sized insurers implement the principles and methods of Solvency II in the same way as the larger undertakings.

Project group Solvency

BaFin has set up an own internal project group for the Solvency II project. The group is comprised of experts from various departments and bundles the knowledge available internally. In this way, information regarding the status of discussions in the CEIOPS working groups can be exchanged and updated and BaFin can develop a consistent line regarding all Solvency II questions at an early stage.

External advisors

External advisory panel meets twice a year.

BaFin also has an external advisory panel with top-class representatives from the insurance industry, associations and science. This panel met twice in 2004 and provided BaFin with important suggestions that will find their way into international discussions on Solvency II. The advisory panel will continue to be called to meet several times a year, in order to discuss questions arising in connection with Solvency II.

Risk model for the German insurance industry.

BaFin works in close collaboration with the German Insurance Association (Gesamtverband der deutschen Versicherungswirtschaft - GDV). The GDV has developed a standard model with which the solvency capital (SCR) can be determined in Pillar I. BaFin contributed suggestions for the first draft of the model and was involved in the meeting for revising and further developing the original GDV concept. The aim was to develop a modularly structured model that is easy to use, meets the requirements of the German insurance industry and, at the same time, meets the international requirements of a standard model. Over the course of 2005, the model is to be fully developed. It could play an important role as a "German supervision model", next to the already developed risk-orientated supervisory approaches of other Member States.

4.6 EU directives for insurers and pension funds

4.6.1 Pension Fund Directive

The Pension Fund Directive[32] creates a European supervision framework for legally independent capital covered institutions in occupational pensions. In Germany, this includes the financial vehicles of a Pensionskasse, pension funds and on a voluntarily basis[33], direct insurance. Thus, the directive does not apply to direct promise (Direktzusage) and provident funds.[34] Financial supervision in the home country will in future be essentially recognised in the entire EU. Following implementation of the directive, occupational pension institutions will therefore be able to operate throughout the EU, employers will be able to use the services of a provider in a foreign EU country and undertakings operating on an EU-wide basis will be able to bundle their occupational pension in a Member State. Despite the consistent EU supervisory framework, the directive is not intended to affect the diverse occupational pension systems in the individual Member States. For labour, social and tax legislation purposes, the national regulations of the country of activity continue to prevail at any rate.

Cross-border activity.

With respect to cross-border activity, the directive is aligned with the valid EU notification procedure for insurers. According to this, the regulator in the home country of the undertaking (headquarters country principle) is responsible for supervision. However, the

[32] DIR 2003/41/EC; OJ EU No. L 235/10.
[33] The national legislator has an option pursuant to Art. 4 of the directive of whether to allocate this to the area of application of the Pension Fund Directive.
[34] Art. 2 Par. 2 Letters d und e, consideration reason 16.

Pension Fund Directive does not distinguish between branch office transactions and exchange of goods and services. The pure insurance supervisory powers of the host country supervisor are more limited than according to the third EU insurance directives. The host country supervisor only monitors the compliance with information obligations and, if necessary, the more strict national investment limits. A general legal supervision, as in the insurance sector, is not planned.[35]

4.6.2 Draft of the reinsurance directive

Following many years of intensive negotiations, the EU Commission officially presented its draft reinsurance directive on 21 April 2004. The further negotiations have now taken place on the council of ministers level and in the European Parliament; the Parliament had its first experts' hearing in November 2004. The adoption of the directive is planned for 2005.

This directive is to strengthen the protection of insurance holders and also lay down the principle of home country supervision for the reinsurers. This will harmonise the currently very differing supervisory systems in the EU. Several regulations in the directive, particularly for authorisation and solvency requirements, have already been applied in German supervision law since the Insurance Supervision Act (VAG) amendment in December 2004.

Key topics of the negotiations regarding the reinsurance directive were solvency questions, particularly for the life insurance business. Initially, the Commission had suggested higher solvency requirements for life insurance business in its draft. The German side, on the other hand, suggested a package solution. This unified the interests of the most important Member States and will, according to the status of negotiations to date, ensure that the current regulations that apply to non-life insurance business are adopted without and increase and applied consistently to the entire reinsurance business. Furthermore, the so-called "prudent person principle" that applies to asset investment, is to be incorporated. The Member States that still require specific security, in contrast to the principle of a "prudent investor", in order to secure reinsurance portions of the technical provisions of direct insurers, will presumably be granted a temporary transition period. Ultimately, according to the present situation, the additional services provided by the reinsurers within the scope of their business activity and the holding structures that have been created in Germany will be able to be retained.

4.6.3 Insolvency guarantee schemes

In autumn of 2004, the Commission submitted recommendations for a possible future directive on insolvency guarantee systems, which are, in the mean time, being discussed and commented on by a working group[36] appointed by the Insurance Committee. Among other things, the Commission recommendations provide for

[35] cf. Art. 20 Par. 9.
[36] Working Group on Insurance Guarantee Schemes.

the transfer of the portfolio of insurance policies to the fund in the event of impending insolvency of an insurance undertaking. Particularly for life and health insurance holders, this means a necessary protection, as normally in the case of insolvency, the insurance policies are cancelled and the parties affected lose their insurance protection. New insurance protection is, however often difficult or even possible to obtain, particularly due to age or previous illnesses. The area of protection of the guarantee schemes should principally follow the home country principle. Thus, the respective national guarantee scheme will also protect the insurance policies that were concluded in cross-border exchange of goods and services or branch office transactions in foreign countries. The Commission and the working group largely agree on this point.

However, the working group has not yet decided for which insurance classes of insurance and which group of insurance holders (e.g. exclusively consumers) the Member States are to set up a guarantee scheme. It is also not yet conclusively clarified to what extent compensation is to be paid, if a Member Country does not select the above described means of portfolio transfer. However, the Commission and nearly all members of the working group agree that a possible directive should only lead to minimum harmonisation. Therefore, for example, the questions of financing (e.g. advance or subsequent financing) and the organisation of the guarantee schemes are to be left to the respective national legislation.

4.7 Financial conglomerates

EU Financial Conglomerate Directive implemented.

The EU Financial Conglomerate Directive, which came into force in 2003, has as its central element solvency supervision on the conglomerate level. In future, supervision will assess the solvency of financial conglomerates, extending across branches at group level; risk arising from banking and insurance business will be recorded using a uniform regulatory approach. The current multiple use of capital to cover costs, as currently often takes place between banks and insurers within one group will therefore no longer be possible.
Regulation spanning across branches will concentrate on adequate capital endowment on the conglomerate level, the risk concentration on conglomerate level, the internal group transactions within the financial conglomerate and the internal control mechanisms and risk management on the conglomerate level.
The directive, however, also includes elements that change the regulations of the bank/investment services and insurance sectors, both on the level of the individual undertaking and on the group level. In this way, differences between the branch regulations and those for financial conglomerates are to be avoided. Thus, for example, the same regulations can apply to financial reporting for corporate groups with cross-border activities as for financial conglomerates.
The EU Financial Conglomerate Directive has now been implemented in German law.[37] With the implementation, the specific regulati-

[37] Financial Conglomerate Directive implementing law (Finanzkonglomeraterichtlinie-Umsetzungsgesetz), BGBl. 2004 I, p. 3610.

ons for financial conglomerates are integrated into the Banking Act (Kreditwesengesetz – KWG) and the Insurance Supervision Act (VAG). The decree of an accompanying regulation[38] regarding the adequacy of capital endowment on the conglomerate level ("Financial conglomerate solvency regulation") is in preparation. The formal hearing process was underway at the time of going to press.

Coordinator concept introduced for Europe-wide supervision.

For financial conglomerates that are active in more than one Member State, one national coordinator is to be responsible as the decision-making authority (coordinator). Whoever becomes the coordinator will, for example, result from which organisation heads up the group, who has admitted this organisation, or also, which sector (banking/investment or insurance sector) is the largest within the group. The tasks and responsibilities of the coordinator, however, exclusively apply for overall supervision of the financial conglomerate. Those responsible according to the respective sectoral regulations will remain with the respective national supervisory authorities. Thus, a national supervisory authority that is authorised to supervise companies on an individual or group level ("responsible authority") will play a more subordinated role in most cases. Their activities are largely limited to an exchange of information with other supervisory authorities. In contrast, a national authority that is entrusted with the sector-related group supervision of the respective supervised undertakings in a financial conglomerate ("relevant responsible authority") will work with the coordinator in various forms, for example, in planning and coordinating ongoing supervision and in crisis situations.[39]

In particular, the tasks of the coordinator are:[40]

- General supervision and assessment of the financial situation of a financial conglomerate.
- Coordination of collection and targeted passing on of expedient/essential information during ongoing monitoring and in crisis situations, including the passing on of information that a "responsible authority" requires in order to fulfil its supervision duties according to the sectoral guidelines.
- Assessment of compliance with regulations for adequate capital endowment and the stipulations regarding risk concentration and internal group transactions.
- Assessment of the structure, the organisation and the internal control systems of the financial conglomerate.
- Planning and coordination of supervisory activities during ongoing supervision and in crisis situations in cooperation with the "relevant responsible authorities".

Good initial position of an integrated financial supervision for the implementation of regulations.

The coordinator model is a new instrument in the European supervision landscape. The flow of information between the national su-

[38] The accompanying regulation is planned according to section 10b (1) sentence 2 KWG and section 104q (1) sentence 2 VAG.
[39] Art. 2 No. 16 of the directive 2002/87/EC defines the "responsible authority"; Art. 2 No. 17 the "relevant responsible authority".
[40] Section 8a (2) sentence 2 KWG / Section 104 (2) sentence 2 VAG.

pervision authorities is rising and the supervisory activities are being mutually coordinated and planned. Thus, the supervision becomes more efficient with respect to internationally active financial groups. For the financial conglomerates, cost advantages result at the same time, as, for example, several reporting requirements now only exist with respect to a single supervisory authority.

BaFin, as the integrated financial supervisor for German financial conglomerates, is responsible as the sole national contact – irrespective of which role it takes within the coordinator model and which sector the companies in the conglomerate belong to. Therefore, it particularly has an advantage in comparison with having several sectoral supervisory authorities. This applies even more, as the currently ascertained and reported German financial conglomerates show a highly heterogeneous structure. They are partly insurance-dominated, partly bank-dominated and are active purely nationally, as well as Europe-wide or worldwide.

4.8 Rating agencies

IOSCO publishes the "Code of Conduct Fundamentals for Rating Agencies".

During the reporting year, various international, European and national panels have been dealing with the topic of rating agencies and their possible regulation. At the beginning of December 2004, the International Organisation of Securities Commissions (IOSCO) completed a major step, by adopting the "Code of Conduct Fundamentals for Rating Agencies" in Berlin. The code fundamentals set out the basic codes of conduct for rating agencies. They will not become legally binding; therefore the agencies are free to decide whether and how they wish to implement the fundamentals within their own code of conduct. However, the members of the Technical Committee of IOSCO that drafted the code of conduct expect the rating agencies to completely incorporate the code fundamentals into their own regulations. If the rating agencies deviate from the code fundamentals, they are to publicly disclose this deviation. The IOSCO has created a flexible framework, so that the agencies can accommodate the different national, legal and economic circumstances in the formulation of their code of conduct.

The EU Commission and CESR will also present rules.

On 10 February 2004, the European Parliament decided that the EU Commission, in close cooperation with CESR, the Committee of European Securities Regulators, was to present recommendations for standard rules for rating agencies. At the same time, the agencies were requested to discuss the setting up of a self-regulated arbitration board by mid-2005. This had been preceded by discussions in the European Parliament regarding the treatment of rating agencies. Subsequent to the Parmalat scandal and the large majority decision of the European Parliament, the European Commission requested technical advice from the CESR in July 2004 regarding the treatment of rating agencies. With this, potential conflicts of interest within the agencies, transparency with respect to methods used, legal questions in connection with inside information and the lack of competition in the rating business are to be considered. Through the reference to the new capital regulations, CESR is also

cooperating with CEBS, the Committee of European Banking Supervisors, and has – due to the strong international dimension – taken up contact with the SEC, which is currently working on a regulation concept for rating agencies. Duplication of work with IOSCO is to be avoided. The basis of the recommendations by CESR will be the IOSCO Code of Conduct Fundamentals, as all important national regulators had cooperated in drafting them. Whether CESR will recommend registration or regulation beyond that is still open.

The role of the rating agencies on the capital market
Rating agencies are primarily information brokers that can reduce the information asymmetry between borrowers and lenders. Their rating assessments describe the capability of a debtor to repay its obligations to creditors. Reliable rating assessments therefore enable an increase in economic efficiency, as not every individual lender needs to assess all of his borrowers himself.
Through the supervisory specifications, the assessments of rating agencies will become even more significant in future. Thus, under the modified standard approach according to Basel II, banks can use external ratings for the calculation of capital requirements. In return, however, specific requirements will be imposed on those ratings/agencies. Rating agencies must, for example, work objectively, independently and transparently, publish their rating assessment and keep sufficient resources available. In insurance supervision, external ratings are currently used when financial assets are valued.[41] The planned new European regulation of solvency requirements for insurance undertakings under Solvency II will, however, significantly expand the user group for ratings.
The market for rating services has comparatively high barriers to market entry. Rating agencies live from the plausibility of their assessments and their thus acquired reputation, which is partially even recognised on a sovereign basis. Each new competitor must first build up this reputation. The low intensity of competition can also, however, have its advantages: A market structure that is characterised by a few strong undertakings possibly secures a certain quality and independence with respect to the clients.

4.9 Accounting standards

4.9.1 Developments with IAS/IFRS

Time limited "partial endorsement" of IAS 39.

With the year 2005, a new phase begins for accounting standards in the EU. This is when IAS/IFRS becomes mandatory for the consolidated financial statements of most capital market orientated undertakings. In order that IAC/IFRS can also become European law, their recognition through the EU – the "endorsement" process – was set up. With the exception of IAS 39, all standards have now been incorporated into European law.

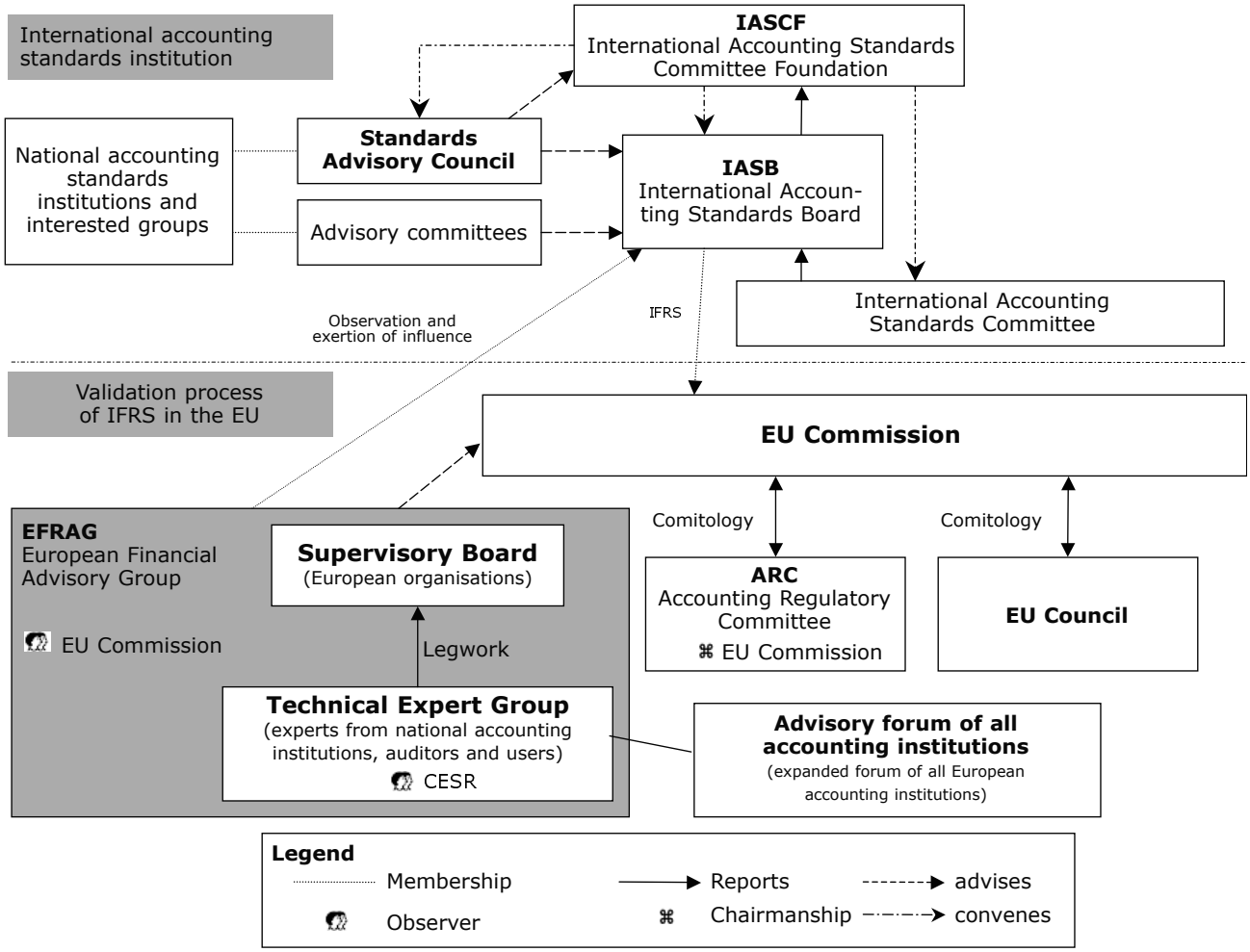
In contrast, the implementation of IAS 39 is difficult, as international debate has particularly ignited between banks, supervisors, the

[41] Circular 1/2002 and 29/2002.

EU and standard setters on the topics of hedging transactions and the "full fair value option". In October 2004, the Accounting Regulatory Committee decided not to incorporate the IAS 39 accounting standard regulation in its entirety for a limited period, but rather, to adopt it in EU law with the two following exceptions ("partial endorsement"): Thus, the fair value option does not apply to the valuation of liabilities outside of the trading book. The restrictive regulations of IAS 39 regarding macro hedging[42] relaxed, so that core deposits could be included in the fair value hedge. Within the EU, there is a Member State elective right to stipulate the more strict IASB regulation.

This, so far, unique action by the EU is, however, associated with the expectation that particularly the banks will agree on an adequate accounting for hedging transactions with the IASB. From a supervisory point of view, there are several problems connected with the application of IAS 39 that still need to be solved. This concerns, for example, the margins in the valuation of individual financial instruments and liabilities within the scope of the fair value option and the valuation of loans at the attributed present value.

Figure 18
International accounting standards institutions



[42] Accounting for hedging activities in connection with interest change risks.

Impact of IAS/IFRS on the German financial sector
In order to assess the impact of the new accounting standards for the German financial sector, BaFin carried out discussions with several banks and insurers between October and December 2004. This resulted in the following trends becoming apparent:

- Generally, the undertakings surveyed saw it as an advantage, that the new standards create more transparency and international comparability. For some institutions, this can contribute to facilitating access to equity capital instruments on the US capital market.
- The accounting standard IAS 39 was, however, viewed critically. Generally, the excessive documentation obligations and high complexity were seen as disadvantages. As there are numerous elective valuation and classification rights, several institutions fear that the analysis of annual reports will only be reserved for specialists, with the consequence that they will only be conditionally comparable.
- Generally, the undertakings and institutions surveyed are expecting increasing volatility in the reported results through the new accounting standards, with banks and insurers concerning themselves with the question of the extent to which analysts, journalists, board members and investors can deal with this volatility.
- The requirements of "hedge accounting" lead to an increase in external hedging activities. The prevailing practice used until now by banks of mainly using internal hedging transactions will be repressed by the ban on mapping in the balance sheet according to IAS/IFRS. The increase in volume of external hedging will need to be carefully monitored by the regulator, as counterparty risk and thus system stability could become more significant.
- IAS accounting standards require disclosure of all bonds contained in special funds, according to the transparent accounting principle. Special funds will therefore become less significant as balance sheet/result smoothing instruments. The prime motive for investing in special funds will be the asset management services of the fund provider. Several institutions also see a reduction in the volume of leasing transactions due to IAS/IFRS accounting standards. In return, demand could arise on the market for new services for institutional customers, such as the settlement, valuation and accounting of complex transactions from one source.
- However, the majority of the institutions and undertakings surveyed are of the opinion that the effects of IAS/IFRS accounting on the design of the product range should remain an exception. This statement does, however, contain the caveat that in most of the undertakings surveyed, the topic of IAS/IFRS has so far mainly been seen as a pure accounting/IT project. Therefore, it can by all means be anticipated that financial undertakings could carry out changes to product design and possibly even business models.

Concepts of "prudential filters" in the application of IAS/IFRS.

The introduction of IAS/IFRS accounting for group annual reports and concomitant turning away from the HGB accounting world will go hand-in-hand with significant changes in the reporting of seve-

ral transactions and in the valuation of numerous accounting positions. Therefore, it can be expected that the composition of the individual supervisory capital components will also change. The German regulator is in the relatively comfortable position that banking supervision will take place on the basis of the HGB individual accounts until further notice. This will also initially be the case with respect to consolidated supervision pursuant to section 10a KWG, as supervisory consolidation is also based on the individual accounts. With the exception that IAS/IFRS/US-GAAP group accounts can be used as a basis for determining group solvency, the situation will be similar for the insurers. During the reporting year, a trend is appearing that the duality of financial reporting with capital market-orientated undertakings, i.e. IAS/IFRS group accounts and HGB individual accounts, is only practical for a limited period of time. Therefore, it is already included in the tasks of supervisors today to prepare solutions to questions arising from the application of IAS/IFRS standards. In order to ensure sensible solutions under consideration of Germany interests in this important discussion, BaFin is asserting its influence in numerous international committees. These committees are already dealing with the possible impact of IAS/IFRS on the determining of regulatory capital. This involves the discussion of how, with an existing definition of capital, a corresponding determination of capital components can be achieved in a changed accounting standards landscape, which will meet regulatory requirements. The considerations in the banking landscape are already relatively far advanced, however the insurance supervision bodies are also already working on such concepts, which have now become known as prudential filters.

Prudential Filters
Prudential filters are understood to be concepts for limiting the setting off of IAS/IFRS accounting effects in calculating regulatory capital. The most important topics are the treatment of intangible assets, latent taxes and unrealised profits. Thus, in contrast with HGB accounting, under IAS/IFRS, unrealised profits from bonds and properties are increasingly reported. Identification primarily comes about through the setting up of the revaluation reserve for "Available for Sale" (AfS) portfolios and for own-use properties and through the P&L-effective revaluation of investment properties. For the revaluation reserve that is created within the scope of "Fair Value" valuation of bonds in the "AfS" category, there are recommendations available from Basel and Brussels, according to which 45% of the revaluation reserve will be accepted as Tier II capital / supplementary capital. The result of this is in accordance with the current KWG regulation regarding revaluation reserves. A similar regulation as for the "AfS" portfolios would also be imaginable for the treatment of revaluation effects for properties, as they are provided for in IAS 16 / IAS 40.

IAS/IFRS accounting also impacts the accounting of pension provisions. In comparison with HGB accounting, the anticipated tendency will be an increase in pension provisions. This also affects undertakings supervised by BaFin. The topic of pension provisions

has also occupied the regulator due to the disputed accounting practice in national and international financial reporting.

Pension provisions
The mapping of pension provisions in the balance sheet is an extremely complex process. The accounting rules in this respect, on an international and national basis, result in different advantages and disadvantages, so that there is still no concept that satisfies all of those involved.

The international accounting regulations, IFRS and USGAAP allow the undertakings that are rendering accounts scope for presentation and discretion with performance orientated pension benefits. These can lead to the actual obligations not being accounted for in their full amount, so that hidden encumbrances arise.

In contrast with the international accounting rules, the problem with the national commercial law / tax law regulations regarding pension provisions lies with the fact that different factors influencing the obligation level are not taken into consideration. These particularly include longevity, salary and pension trends and capital market interest rates. Ultimately, the partially impacted obligation volume and its future settlement must fundamentally be critically scrutinised. For the reasons mentioned, the international standard setters and supervisory authorities are reconsidering their strategies.

4.9.2 Enforcement

Issues regarding balance sheet control and the enforcement of accounting standards intensively occupied BaFin during the reporting year, on a national, European and international level.

National level: two-stage control procedure.

At the end of October 2004, the Balance Sheet Control Act (Bilanzkontrollgesetz - BilKoG) was adopted in Germany. According to this, from July 2005, capital market-orientated undertakings must expect an external audit of their accounting. The audit will take place on the basis of random samples, or with respect to concrete suspicion of balance sheet manipulation. The BilKoG foresees a two-stage control procedure. At the first stage, a private body authorised by the state – the auditing agency – will operate. The undertaking being audited, must participate on a voluntary basis. BaFin, which will be entitled to all public remedies, will become active at the second stage, if the undertaking does not voluntarily participate in the audit or if there are serious doubts as to the correctness of the audit agency's results. The audited undertaking must fundamentally announce accounting irregularities that have been revealed. As foreseen in the BilKoG, BaFin will perform the accounting control activities from July 2005.

European level: CESR-Fin.

As a member of CESR-Fin, BaFin had great interest in the adoption of the BilKoG. CESR-Fin is developing standards for enforcement, in order to ensure a Europe-wide consistent application of the in-

ternational accounting standards (IAS/IFRS).[43] BaFin was able to exert considerable influence on the adoption of the CESR standard[44] "Enforcement of Standards on Financial Information in Europe". This provides an EU-wide, harmonised structure of a national enforcement system. The national BilKoG already takes this basic structure into consideration.

The second standard[45] "Coordination of Enforcement Activities" serves to coordinate the national enforcement activities. According to this, the bodies responsible for the enforcement of accounting standards are to meet regularly to exchange views regarding concrete enforcement decisions in a new committee – the "European Enforcer Coordination Session" (EECS). The EECS took up its activities at the beginning of 2005.

In order to set out Standard No. 2 in more detail, the CESR has passed a guideline ("Guidance for the Implementation of Co-Ordination of Enforcement of Financial Information"). According to this, the important decision reasons in a national accounting case are to be recorded in a database in English language. Even though the database is not publicly accessible, BaFin has pleaded for company-related data to be anonymised prior to being recorded on the database. The bodies responsible for the enforcement of accounting standards are to consult the database prior to reaching an enforcement decision. Last but not least, BaFin considers it expedient to make also make non-confidential parts of the database accessible to the public for reasons of transparency.

International level: IOSCO members exchange information.

In addition to CESR, IOSCO[46] is dealing with the topic of enforcement. The aim is to achieve a worldwide harmonisation of the application of international accounting standards through standardised enforcement. For this purpose, the members of IOSCO are to regularly exchange information with one another in the area of enforcement. IOSCO is developing a respective structure and is strongly aligning it with the activities of CESR. Thus – similar to CESR – a database containing enforcement decisions is to be set up with IOSCO. Prior to making an enforcement decision, IOSCO members are to consult this database. A merging of the IOSCO and CESR databases, however, is not currently planned. Instead, there is to be an exchange of experiences between the two organisations in the area of accounting control. From the point of view of BaFin, cooperation between IOSCO and CESR is to be welcomed.

[43] Further information, also regarding individual standards, can be found under www.cesr-eu.org.
[44] CESR Standard No. 1 on Financial Information.
[45] CESR Standard No. 2 on Financial Information.
[46] Further information available under www.iosco.org.

Karl-Burkhard Caspari,
Deputy President

II Cross-sectional duties

1 Consumer complaints

In 2004, a total of 27,262 customers of insurance undertakings, credit and financial services institutions approached BaFin. This number is a good 12% higher than the previous year's figure of 24,260 petitions.

Customer complaints are an important source of insight for possible grievances with the supervised undertakings. They provide a reason to examine whether an undertaking has violated duties of conduct and whether supervisory measures are required.

BaFin examines every complaint.

That is why BaFin investigates every complaint. Frequently, it requests the respective undertaking to issue a statement, in order to obtain a complete picture. The law provides for BaFin to take action solely in the public interest. Nevertheless, it also helps individual customers with their problems, as far as possible. It does so by appealing to the undertaking to correct an error or by explaining the legal situation in plain words.

The complaint process is not an out-of-court dispute arbitration process. Ombudspeople are available for this. For damage compensation claims, it can also not take the place of a civil law action, for example.

1.1 Complaints regarding credit institutions and financial services providers

Development of the number of complaints

In 2004, 3,755 citizens lodged complaints with BaFin regarding credit institutions and financial services providers. Added to this, were 59 petitions that reached BaFin via the German Bundestag (Lower House of Parliament), and 461 general non-complaint enquiries. In total, 1,120 complaints had a favourable outcome. The undertakings had not acted unlawfully in all of these cases, occasionally they decided to settle on an ex-gratia basis.

Selected cases within the banking and financial services sector

Institutions accommodating with the "account for everyone".

Also in this year, complaints reached BaFin regarding the "account for everyone". In most of these cases, the institutions had good reasons for refusing to open an account. However, if the opening or continuing of an account was not infeasible, BaFin intervened for the benefit of the party involved and induced the institutions to set up the requested account. The preparedness of the institutions to accommodate this was gratifying. The setting up of a second account, however, can not be demanded.

Interest change clauses with long-term savings plans.

According to a current decision of the German Federal Court of Justice (Bundesgerichtshof-BGH)[47], with long-term savings plans, an "unspecified reservation of a right to change interest rates according to a form" is inadmissible. The decision does not specify which regulation should replace the clause that has been declared inadmissible or which reference amounts are admissible. If violations of the decision become known through complaints, BaFin will counteract this grievance.

Questions regarding deposit guarantees as an aid to decision-making.

Enquiries regarding deposit guarantees particularly referred to direct banks that are associated with the Federal Association of German Banks, as well as branch offices of Dutch or Austrian banks that are associated with the deposit guarantee schemes of their home countries with a guarantee limit of €20.000 per depositor. It was shown to be advantageous that many citizens made an enquiry with BaFin prior to concluding a business relationship, so that the information provided by the supervisory authority could be taken into consideration as an aid to decision-making.

Plausibility assessment regarding annual report for granting of credit justified.

Customers increasingly complained about institutions that requested a plausibility assessment by an auditor or tax accountant regarding the annual report (Section 18 KWG) prior to granting credit. From a banking supervisory point of view, these requirements were not only nothing to object too, but rather, they were desirable. The clear majority of borrowers accepted this information from BaFin.

Several institutions prepared to settle with respect to "scratch-flats".

With the submissions to finance so-called "scratch-flats", the complainants attempted to achieve that banking supervision would support them in the unwinding of the entire transaction by the financing bank. Loan agreements that were concluded in a doorstep situation can be revoked according to section 1 (1) of the Doorstep Selling Act, to the extent that the right of withdrawal was not pointed out. However, the revocation of the loan agreement hardly serves a purpose, as they can only sell the properties at a loss. There is only a possibility of also cancelling the purchase contract, if in an exceptional case, the loan and purchase contracts are to be assessed as an integrated transaction. According to the jurisprudence of the Federal Court of Justice, an economic unit exists, among other things, if the purchaser is described in the contract as "purchaser and borrower", or if the selling undertaking and the lender use uniform or harmonised forms.[48] Various institutions are prepared to settle on an ex-gratia basis, such as lowering interest rates or a partial waiver of debt, if the customer has entered into financial distress through the financing and can provide evidence of this. Not seldom, the enquiry by BaFin is the impulse that the institution needs in order to seriously examine an accommodation.

The level of early redemption penalties charged led to many complaints.

There were also many complaints lodged this year with respect to early redemption penalties. As in the previous years, the customers objected to the level of the penalty charged by the institutions. If the borrower had a right to early redemption of a long-term

[47] Judgement dated 17.02.2004; XI ZR 140/03.
[48] Judgement dated 09.04.2002; XI ZR 91/00.

loan[49] due to the sale of a property, among other things, BaFin did not determine any violations. If no such right existed and the bank was consequently free to determine whether and under what conditions early redemption would be permitted, the institutions nevertheless, generally did not demand higher amounts. In several cases, however, BaFin requested that the calculation be presented in more detail.

Complaints regarding the exchange of collateral for property loans were unfounded.

Complaints regarding institutions that rejected the exchange of collateral were all unfounded. The undertakings complied with the stipulations of the Federal Court of Justice.[50] According to this, the exchange is reasonable for an institution, if the collateral offered in exchange covers the risk of the bank just as well as the existing collateral, the borrower bears the cost of the exchange and the bank has no disadvantages in the administration or realisation of the replacement collateral.

Institutions corrected erroneous remittances.

Several customers complained to BaFin regarding incorrect entries. In only the fewest cases, the error was on the part of the bank. For online remittances through the Internet or through a self-service terminal, the customer is responsible for the correct placement of an order. The bank is only permitted to book on the basis of account numbers. With other types of remittances, where the bank had erroneously credited the transfer on the basis of the account number, rather than the account of the specified beneficiary, the entry was corrected following the respective notification by BaFin. Complaints regarding the duration of remittances were rare and always unfounded.

Charges for banking services partially too high.

During the reporting year, there were again several complaints regarding excessive charges. In several cases, the institutions also charged excessively high fees for services. Thus, an institution charged €250 for the assignment of a claim from a Berlin loan. Following intervention by BaFin, the bank significantly corrected the charge to the benefit of the customer. Furthermore, charges are not permissible, if the institutions are legally obligated to perform a service anyway, such as necessary formalities in the case of inheritance.

Right of objection with harassing advertising.

Parents complained about institutions that advertised to underaged children by post for instalment loans. Other advertising was sent to persons who were already in debt and would have entered into a precarious financial situation if they had taken up further credit. Following intervention by BaFin, many institutions apologised. The undertakings alleged that they were not familiar with the group of recipients themselves, as they had hired external companies to carry out the advertising campaign.

The customers have a right to object to this. The institutions will then instruct the company they hired to cease using their addresses.

[49] Judgement of the BGH dated 01.07.1997; XI ZR 197/96 and XI ZR 267/96 and the judgement of the BGH dated 07.11.2000; XI ZR 27/00.
[50] Judgement dated 03.02.2004; XI ZR 398/02.

1.2 Consumer complaints from the insurance sector

Development of the number of complaints

In 2004, most of the items processed by BaFin again were related to the insurance sector. The number rose from 19,778 during the previous year to 22,306 (+12.8%). 19,938 of these items were complaints, 1,141 were general non-complaint enquiries and 122 were petitions that came to BaFin via the German Bundestag or the Ministry of Finance (BMF). In addition, there were 1,060 items that did not fall within the realm of responsibility of BaFin.
Overall, 27.82% of proceedings (2003: 26.71%) had a favourable outcome for the correspondent; 72.18% of complaints were unfounded.

Table 2
Complaints received – by insurance class

Year	Life	Motor	Health	Accident	Liability	Legal Expense	Building/ Household	Other Classes	Other Complaints**
2004	8.119	2.518	4.162	1.413	1.577	1.474	1.824	518*	1.504*
2003	5.548	2.758	3.408	1.416	1.565	1.300	1.948	467*	1.368*
2002	5.504	3.151	2.765	1.770	1.671	1.499	1.600	———	———
2001	5.320	3.130	2.919	1.759	1.487	1.347	1.504	———	———
2000	4.584	2.897	2.748	1.779	1.329	1.248	1.567	———	———

* No comparative figures available for prior year due to statistical changeover.
** Misdirected, intermediary, etc.

As in the prior year (2003: 30.1%) most of the complaints (32.48%) continued to relate to claims processing / settlement in life insurance. These were followed by complaints regarding the handling of insurance policies with 29.72% (28.77%), contract termination with 16.43% (18.68%) and business conduct when negotiating contracts with 10.28% (11.2%). In addition, 11.08% (11.3%) fell into the "other" category. The main underlying grounds stated are shown in the following table:

Table 3
Grounds for complaints

Category	Number
Bonus / credit	2,496
Coverage questions	2,318
Amount of benefits	1,846
Change of conditions[51]	1,815
Advertising / advice / application recording	1,779
Manner of claims processing / delays	1,560
Termination for cause	1,515
Policy changes – extensions	1,416
Termination without cause	1,373
Changes and adjustments of premiums	1,179
Withdrawal / contest / revocation / objection	1,141

Selected cases within the insurance sector

"Interest splitting" in life insurance unsettled customers.

In life insurance, most questions again related to bonuses and surrender values. A not inconsiderable number of these items were in

[51] Judgement of the BGH dated 12.03.2003; Insurance Law (VersR) 2003, 581.

respect of so-called interest splitting, by which contracts with a low actuarial interest rate receive an overall higher return than contracts with a high actuarial rate of interest. BaFin intervened in this approach. This created misunderstandings with several customers. They saw themselves as being at a disadvantage, as the contracts with an actuarial interest rate of, e.g. 4% received the same overall return as policy holders whose contracts were calculated with a rate of, e.g. 2.75%. However, this equal treatment is required by section 11 (2) of the Insurance Supervision Act (VAG). Non-admissible interest splitting therefore does not regularly exist.

Repurchasing value or maturity payments partially miscalculated.

In the examination of repurchasing values and maturity payments, it turned out that errors occurred with several life insurers, particularly with technical contract changes. In individual cases, life insurers also used calculation methods that were unreasonably disadvantageous to customers. Thus, an insurer who had granted several policy loans to a customer settled these at the request of the insurance holder shortly before the maturity date through a technical contract change with the existing contract values. With this, the undertaking reduced the achieved final bonus entitlements in the proportion of the vastly reduced new insured amounts to the previously insured amounts. At the maturity date, the customer was therefore only paid a fraction of the amount that he would have been entitled to, if he had cancelled as of the amendment date. The undertaking was forced to correct the benefit in the amount of five figure sum.

Premium adjustments for private health insurance annoyed customers.

In health insurance, most items related to premium adjustments, as in the previous year. In addition, it was not seldom the case that insured parties approached BaFin, as their insurer had not reimbursed medical services. To the extent that it solely concerns questions of interpretation regarding the scale of fees for physicians and dentist (GOÄ), BaFin could only refer to the responsible civil courts.

Subsequent contractual changes only possible with the agreement of the customer.

In contrast, BaFin was able to take supportive action where it concerned the enforcement of mandatory law. In several complaint cases, an insurer offered his customers the conclusion of a supplementary insurance contract, "ReisePlus", by sending them a respective amended insurance policy. Customers had, however, not applied for supplementary protection. The policies contained the provision that the change was considered to be approved if the customer did not object in writing within one month after receipt of the insurance policy. As the subsequent change of a contract fundamentally requires the approval of both contractual parties, the undertaking retracted the contractual change, following intervention by BaFin, and reimbursed the costs incurred by the customers.

Contract cancellation in building insurance.

In building insurance, a main focus of complaints was on contractual cancellation. An insurance institution that possessed an insurance monopoly by virtue of federal state law, only accepted the cancellation of contracts that had been concluded prior to July 1994 if the insurance holder included an abstract from the land re-

gister dated after 30 June 1994 with the cancellation. The practice of the insurer was correct in this case. The proper cancellation of an insurance holder at the end of an agreed period only becomes effective if the insurance holder has proven that the property right (mortgage, land charge) no longer exists or the property creditor has approved the cancellation (Section 106 Insurance Contract Law (VVG). This regulation also applies for all property rights that arose prior to the discontinuation of the insurance monopoly and were not notified to the insurer.[52] In order to examine whether such property rights exist, the undertaking therefore requires the requested abstract from the land register.

In accident insurance, the insurance holders repeatedly asked BaFin for its support in the settlement of claims. The most frequent matter in dispute: Which health impairment is reimbursable as the result of an accident? In examining the required link between an accident and health complaints, the undertakings regularly rely on medical expert opinions. Here, BaFin has hardly any possibili-ties of helping those affected. As an administrative authority, it lacks the medical expertise to judge whether the medical expert opinions used as an argument by the respective undertakings are correct.

1.3 Consumer complaints regarding securities transactions

Development of the number of complaints

In 2004, 681 communications were received from customers complaining about credit institutions or financial services institutions relating to the investment services offered by these institutions. Furthermore, several investors lodged complaints by telephone or requested information or advice related to securities trading.

Selected cases from the securities sector

The emphasis of complaints was on incorrect advice.

Investors approached BaFin on several occasions complaining that they had been insufficiently or falsely advised on securities transactions. Legally, it must be differentiated here between informing and advising the customer. Investment firms are obligated to provide explanations and obtain customer information, but not to provide advice. An advisory relationship only arises on the basis of a contract under civil law. If an advisory is agreed, the credit institutions are obligated to carry this out with the required expertise, care and conscientiousness in the interest of its customers. The investors often fail to understand that "the" right advice does not exist. Thus, for example, several analysts can assess the potential of a share or fund differently. If an investment advisor bases his advice on one of these opinions, false advice does not result if the expectation is not fulfilled. For the evaluation of a piece of advice, it depends on whether it was sound at the time it was given.
During the reporting year, complaints also accumulated regarding

[52] Art. III No. 1 of the Ordinance on supplementing and amending the law regarding the insurance contract (Verordnung zur Ergänzung und Änderung des Gesetzes über den Versicherungsvertrag) dated 28.12.1942.

Many complaints regarding churning.

"fee oppression", so-called churning. Churning is the non-justifiable regrouping of capital assets at the expense of the earnings prospects of the customer. It serves the purpose of creating commission income. The interest in achieving commission is legitimate however it must not lead to carrying out transactions for the customer, solely for the purpose of generating commission income. With churning, the frequent regrouping often consumes investment capital within a short period of time. Even if profits are achieved during trading, the investor often experiences a total loss due to high fees that exceed the profits.

Complaints regarding the charging of fees for securities deposit account transfers.

Several customers complained about high fees that credit institutions charge in connection with a securities deposit account transfer for the closing of a custody account. The legal basis for the charging of these fees arises from the contractual agreements between credit institutions and customers. General business terms and conditions and special conditions for particular business areas are particularly important here. In principle, the fees of the credit institutions are freely negotiable. They are subject to contractual freedom, just as the prices of other commercial undertakings are. Currently, the Federal Court of Justice is examining the appropriateness of such fees, so that within the foreseeable future an ultimate decision will be decreed.[53] For the regulator, it is particularly important that the fees are transparent for the investors. The institutions are obligated to inform the customer regarding the type, amount and calculation of costs.

2 Combating money laundering

2.1 Improvement in international money laundering standards

Financial Action Task Force on Money Laundering (FATF)

During the reporting year, the FATF adopted a new special recommendation regarding cash couriers. Regarding other special recommendations, the FATF published supplemental interpretation principles and a "Best Practices" paper. The FATF compiles a list of countries that do not cooperate in the area of money laundering prevention. In 2004, three countries[54] were removed from this list. The FATF members were also able to lift admonitions against two countries[55] after they had made legal provisions for combating money laundering.

During the reporting year, the FATF agreed on a new methodology with the IMF and the World Bank, with the aid of which it is evaluated to what extent countries have implemented the recommen-

[53] Judgement of the BGH dated 30.11.2004; XI ZR 49/04 declares clauses regarding fees for the transfer of securities into another securities deposit account as being invalid.
[54] Egypt, Ukraine and Guatemala.
[55] Myanmar (Burma) and Nauru.

dations of the FATF. The IMF and the World Bank will use the methodology in its Financial Sector Assessment Programmes (FSAP); the FATF will use it in the mutual examination of the member countries.

Third EU Money Laundering Directive

In December 2004, the finance ministers of the EU Member States agreed to the recommendation for a "Directive for the prevention of using the financial system for the purpose of money laundering and the financing of terrorism" (Third EU Money Laundering Directive). The directive is to be adopted at the latest in autumn 2005. Its primary purpose is the harmonised implementation of the 40 recommendations of the FATF that were revised in 2003. In particular, it will more strongly emphasise the duties of care with respect to the prevention of money laundering. Furthermore, it is to harmonise the fight against terrorism and to also expand the group of obligated parties to include insurance brokers. Overall, the directive recommendation contains many points that have already been the longstanding administrative practice of BaFin. In connection with the national implementation of the directive, the guidelines for the prevention of money laundering, which IOSCO and IAIS set out in 2004 for the securities / insurance sector, are also to be implemented.

Paper of the Basel Committee for Banking Supervision on "Consolidated know-your-customer risk management"

In October, the Basel Committee for Banking Supervision adopted its new paper on "Consolidated know-your-customer risk management". It supplements the paper on "Customer due diligence for banks" from 2001. The new paper conforms to the already longstanding valid legal money laundering obligations for German institutions.[56] It contains the requirement of a group-wide approach to the prevention of money laundering. This means a standard, coordinated, global risk management in all branches and subsidiaries, as well as group-internal exchange of information, which also includes individual customer data. Furthermore, the home country regulator is to be permitted unimpeded examination of branches and subsidiaries and access to individual customer data.

2.2 Implementation of money laundering prevention

Security systems must be risk-orientated.

Each institution must create adequate transaction and customer-related security systems and controls with which it can prevent money laundering, terrorism financing and fraudulent acts to their own cost. In the foreground of this is that banks and financial services providers use a risk-orientated approach. The systems and measures must accommodate the individual size, organisation and risk situation of the respective institution. Only someone who

[56] Section 25a (1) Sentence 3 No. 6 in connection with (1a) KWG and Section 15 Money Laundering Act (Geldwäschegesetz -GwG).

knows his own risk situation in detail can adopt adequate measures for combating money laundering.

It begins with the risk analysis.

BaFin intends to publish guidelines for preparing an internal institutional risk analysis. During the reporting year, a draft was submitted to the credit industry associations for consultation. Measures for preventing money laundering, terrorism financing and fraud at the cost of an institution can be interlinked with other internal risk management measures of an institution, thereby creating synergies. In this context, the money laundering officers take on a key position as internal institutional / undertaking risk managers.

Annual report audits not sufficiently risk-orientated.

Not only institutions and undertakings must adopt a risk-orientated approach. The annual report auditors must interlink with the individual risk situation of the respective business. BaFin pointed out to the German Institute of Auditors (IdW), that the auditing and reporting with respect to credit institutions must be structured in a more risk-orientated manner and the quality of the audits must be significantly improved. The IdW has agreed to adapt and update its "Checklist for the auditing of measures of a credit institution for the prevention of misuse for money laundering purposes" in accord with BaFin.

Several banks do not yet have an adequate security system.

BaFin established that several credit institutions had also not sufficiently adapted their business and risk structure in 2004. This was also the conclusion of the 18 special audits by external auditors that were authorised by BaFin.
Not only insufficient IT-supported early warning systems were admonished, but also organisational deficiencies. On various occasions, the money laundering officer did not have the required position or resources, or there was a lack of security precautions in the group-wide implementation of regulatory money laundering obligations.

Relief for smaller institutions.

With smaller institutions, the trend continued on 2004 of outsourcing the function of the money laundering officers; mostly to other, larger institutions, to the group parent company or to joint ventures specifically established for this purpose. BaFin supports this approach. It enables smaller banks to fulfil their regulatory money laundering obligations properly and efficiently. In all cases, the institutions agreed the outsourcing and audit concepts with BaFin in advance.

Combating money laundering at insurance firms and financial services undertakings.

BaFin also examines whether financial services institutions and insurance firms are complying with their regulatory money laundering obligations. With one financial services undertaking, BaFin carried out a special audit during the reporting year. With insurers, BaFin primarily evaluated the internal audit reports of undertakings in 2004. For insurers, single deposit accounts, the payment of sizable single premiums, or transactions involving broker or intermediary accounts are areas that could be misused for the purpose of money laundering. Insurance firms must therefore properly identify their customer and examine where the funds for premiums originate. Within this context, the insurance industry determined suitable criteria for IT-supported early warning systems.

Prosecuting "Underground Banking".

The battle against so-called shadow banking systems ("Underground Banking"), was also a focal point in 2004. "Underground banking" involves persons or firms executing fund transfers or foreign currency transactions without a permit. In the shadow banking system, the transactions are mainly carried out without a "paper trail". This makes them particularly suitable for money laundering and terrorism financing. During the reporting year, BaFin opened 125 new cases against unauthorised fund transfers and/or foreign currency transactions. In 23 cases, BaFin investigated or searched the suspicious undertakings on site, supported by the police. BaFin issued formal sanctions against 20 undertakings. Several undertakings continued to engage in unauthorised transactions after BaFin had issued formal sanctions. They considered themselves to be safe, as they address a particular group of customers and immediately destroyed all documentation. BaFin was able to reconstruct and decode the records using a complex, detailed process, thereby proving the continued unauthorised processing of transactions.

3 Licensing obligation and the prosecution of unlicensed banks, financial services providers and insurers

During times of low expected returns, investors increasingly invested in investment possibilities that promise high yields. However, the promises of high yields in the form of pension plans, capital accumulation or tax savings models often conceal risky, elaborate offers of the black capital market, which also boomed in 2004.

Prosecution of the black capital market

Together with the Deutsche Bundesbank, the police authorities and the public prosecution offices, BaFin prosecutes and prohibits unauthorised transactions. Furthermore, BaFin clarifies all legal issues arising in the demarcation of the licensing obligation or the assessment of concrete business schemes.

Black capital market
BaFin considers the black capital market to be all banking and insurance business, as well as other financial services, that is carried out without the required Banking Act (KWG) or Insurance Supervision Act (VAG) authorisation. With this, not every black market undertaking plans to carry out unauthorised or illegal investment business at the outset. Many simply seek an advantage over established credit institutions and financial services institutions by saving the not insignificant start-up costs for a business organisation that complies with regulations. The consequences are primarily borne by the investors in the form of high losses in value or even the total loss of their investment.

BaFin has extensive investigative and intervention rights for combating the black capital market, which it consequently implements, thereby providing an important contribution to preserving the integrity of the capital market.

Supervisory and investigative measures.

During the reporting year, BaFin requested information on 98 suspect firms and assessed 26 fines. It furthermore, carried out 16 on-site audits and searches, whereby four searches took place at several sites at the same time. If an undertaking is carrying out unauthorised banking, financial services or insurance business, BaFin takes immediate action to ensure that these undertakings cease and unwind the transactions. For this purpose, BaFin issued 23 prohibitory injunctions, 27 unwinding orders and appointed liquidators in 13 cases during the reporting period.

BaFin is also authorised to carry out supervisory measures with respect to undertakings or persons that were involved in the preparation, conclusion or settlement of unlicensed banking or financial services transactions. This, for example, affects not only Internet providers that make Internet sites with unauthorised offers available to third parties, but also franchised credit institutions. In 2004, BaFin issued 7 prohibitory injunctions in this respect and 7 unwinding orders. It issued 26 instructions and appointed liquidators in 6 cases.

In 2004, BaFin launched 818 new investigatory actions that focussed on the prosecution of unauthorised banking and financial services transactions. In the insurance sector, investigation measures centred on the assessment of a licensing obligation were again the exception. There was, however, a rising trend in offers of credit that were linked with the conclusion of a life insurance policy. The life insurance policies were often offered by foreign undertakings that had no domestic licence for carrying out insurance business.

855 administrative offence proceedings with 278 objections.

BaFin initiated 855 administrative offence proceedings for unauthorised insurance intermediation, of which 86 were concluded during the reporting year. Some 800 proceedings alone were initiated against German insurance agents that brokered the sale of fund-linked life insurance policies of EEA insurers to German customers, without first checking whether or not the foreign life insurance firm had met the prerequisites for transacting business in Germany. Sometimes the firm did not even have a licence from the supervisory authority in its country of origin when it started marketing in Germany. In a total of 278 cases, the affected parties filed objections.

Legal recourse against BaFin measures.

The persons or undertakings against which BaFin initiated legal measures with respect to unauthorised banking, financial services and insurance transactions filed objections in 106 cases. During the same time period, 22 contested proceedings were concluded, 12 of which by rejection notice (Widerspruchsbescheid). In 11 cases, the objection was rejected, in one case, the objection was partially allowed. Often, the parties affected also initiated legal action against BaFin measures. In several cases, the impression was gained that with the aid of long drawn out proceedings through all

levels of administrative jurisdiction, a final decision in a matter was only intended to be delayed. Of a total of 130 judicial disputes in which BaFin was involved in 2004, the courts made decisions in 52 cases. In 47 of these cases, the judicial decisions were completely in favour of BaFin. In 2 cases, BaFin's view was largely confirmed and only the method of instructing the winding up of the authorised business activity needed to be temporarily cut back. In two decisions in proceedings involving interim legal protection, the Hesse Higher Administrative Court (VGH), amending the decision of the Administrative Court (VG) of Frankfurt, ordered the delay effect of the objections against orders by BaFin. Only the Administrative Court of Cologne allowed an objection claim in a judgement; this judgement is currently being appealed. One proceeding was deferred and submitted to the European Court of Justice for a decision on various issues of European law.

Unauthorised financial commission business

BaFin also focused on unauthorised financial commission business again in 2004. Financial commission business is the acquisition and disposal of financial instruments in one's own name for the account of a third party (Section 1 sentence 2 no. 4 KWG). A particular emphasis was on collective asset management, in which the obligation participation of the investor is usually structured as a certificate or a participation right and an average subscription sum of €100 to 200 million is aimed at. BaFin examined around 40 of such investment offers. The issuing conditions usually envisaged that the issuer of the participation separates the collected invested capital from his own working capital and only allows the investor to participate in the capital assets. Profits or losses therefore only increase or decrease the separately held invested capital. In contrast, the arising costs, including remuneration of the issuer are fully applied to the invested capital. Thus, the issuer acts as a commission agent in his own name for the account of a third party by administering the invested capital for the customer as a trustee. In these cases, BaFin viewed financial commission business requiring authorisation as being present, particularly if the investor could choose between portfolios with differing opportunity/risk ratios, such as a higher or lower proportion of shares. The Hesse Higher Administrative Court (VGH) essentially confirmed this view, whereby the European Court of Justice is yet to decide on this matter in a submission process.

Licence required or not?

In 2004, there were 415 inquiries regarding the licensing requirement for new business activities. In these cases, BaFin examines whether and to what extent the planned business activity requires a licence in accordance with the KWG or VAG. If this is the case, the firm needs to obtain the written licence from BaFin before it commences business operations, otherwise they are subject to supervisory measures. In addition, they can also make themselves punishable according to KWG or VAG, for which, however, the prosecution authorities are responsible.

Demarcation questions regarding Contractual Trust Arrangements.

An example of the often difficult legal demarcation between business activities that do and do not require a licence are the trust models developed for occupational pensions, the so-called Contractual Trust Arrangements. With this, undertakings outsource financial capital for occupational pensions for employees to a trust company that invests it in various financial instruments. If the trust company is acting on behalf of legally independent undertakings, it is carrying out banking transactions, for which licensing is required according to the KWG. If, on the other hand, the trust company is administering funds of an undertaking that is its parent, subsidiary or sister undertaking, corporate privilege applies according to section 2 (1) no. 7 KWG, so that no licence is required.

Exemption from supervision.

In an individual case, BaFin can also exempt an undertaking from supervision requirements, such as the licensing requirement, if this does not require supervision due to the type of business activity to be carried out (Section 2 (4) KWG). This typically involves banking activities that an undertaking only carries out as subordinated ancillary or auxiliary business, or displays a necessary link with a business activity that is exempt from licensing. This includes, for example, loans that are granted by utility companies to their customers for converting their energy systems, or by self-help facilities or non-profit foundations to students. At the end of 2004, 240 institutions were exempted from the licensing requirement. BaFin had received another 32 applications by the end of 2004. An exemption was granted to 22 undertakings in 2004.
Due to the growing offer of e-money based payment systems, the EU enacted a directive in 2000, for the supervision of so-called e-money institutions, which was implemented in German law with the coming into force of the 4th Financial Market Promotion Act (FMFG) on 1 July 2002. With the implementation, the possibility of exemption provided for in Art. 8 of the directive was also transferred into German law, which has so far been used in one case. Further cases are still pending decision. At the same time, the exemption of foreign providers that are already subject to equal supervision in their country of origin gained in importance. In 2004, BaFin exempted one Australian institution and 9 Swiss institutions.

Cross-border banking and financial services

The increasing spread of the Internet enables undertakings from third countries to gain a foothold in the German capital market, even without a physical presence. Through telephone and online banking, they are able to offer banking, insurance and financial services products in Germany from foreign countries. In some cases, domestic undertakings are only giving the impression that they are active abroad, in order to make it difficult for German authorities to prohibit their criminal actions. Since 2003, BaFin has been keeping a closer eye on cross-border financial services activities.

If unauthorised business is being carried out from abroad, the affected investors are only successful in pursuing their rights in exceptional cases. In addition, it is very difficult for investors to demand the return of even part of their invested money; often ever-

ything is lost. Even BaFin has only limited possibilities of countering this risk with measures according to the KWG, as this only applies for the German field of law. It can, however, prohibit domestic intermediators from carrying out activities, freeze funds on domestic accounts and prohibit advertisements in German printed media and Internet sites, or completely shut down the latter.

4 Automated access to account information

No access to account balances.

Since April 2003, every bank has been obligated according to section 24c KWG 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 birthdates of each account holder and co-signer, as well as the names and addresses of beneficiaries. Account balances or account movements are not recorded. BaFin has a right to access information from these files in order to fulfil its legal mandate or if it obtains authorised external requests, such as from prosecution authorities.[57]

BaFin processed 39,000 inquiries.

During the reporting year, BaFin processed a total of 39,000 inquiries. Public prosecutors and police authorities primarily use this process. Around 28,000 enquiries originated from the Federal Office of Criminal Investigation (Bundeskriminalamt), the German state criminal authorities and police headquarters and authorities. This leads to the conclusion that the prosecution authorities mainly use the access to account information for combating serious to extremely serious crimes – such as organised crime or terrorism. Around 1,400 inquiries originated from BaFin itself, mainly relating to cases of unauthorised financial transfer transactions and other unauthorised banking and financial services transactions. With this, BaFin takes up the top position – next to the Federal Office of Criminal Investigation with respect to the individual authorities. The process according to section 24c KWG has placed BaFin in the position of being able to track down issues that would otherwise have remained concealed. With this, it is able to fulfil its legal mandate more effectively than before. In total, BaFin was able to provide information on approx. 235,000 accounts in response to internal and external inquiries.

Positive response from prosecution authorities.

So far, the response from the inquirers to the automated access to account information has been entirely positive. In numerous cases, the prosecution authorities were able to gain access to unknown assets of persons charged with the aid of the account information from BaFin. BaFin was also able to support the work of the Financial Intelligence Unit of the Federal Office of Criminal Investigation, when it was providing international legal assistance in criminal cases. It was also possible to determine quickly whether or not suspected terrorist organisations or persons held accounts in Germa-

[57] BaFin has produced a leaflet regarding the automated access to account information (www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Sonstiges (German only).

ny. With the aid of the automated access to account information, the regulator was able to determine an account held with a German bank by suspected terrorists. BaFin was able to freeze the account (Section 6a KWG).

5 Risk models

For all actors in the financial sector, the principle of "same instruments – same risks" applies. Banks, insurers and securities firms use the same types of risk models to measure and control financial risks. BaFin has therefore bundled its specialist expertise in its own "QRM" (Querschnitt Risikomodellierung) group, which is responsible across BaFin regarding questions of principle and the examination of stochastic models for risk management. This group, for example, examines the risk models of investment companies and banks that control their market price risks with identical models. The advantage lies in the more efficient audits and a maximum of standard administrative treatment ("same risks – same requirements"). For 2005, it is planned to carry out product-specific audits across pillars in order to compare the respective standard of the risk models.

Risk models with credit institutions

The main purpose of risk models for institutions is the internal measurement and control of market risk. They determine the risk-related economic capital. For institutions that use such models, they are part of risk management and the risk control system. The required suitability examination of the risk models arises from the KWG requirements for an appropriate internal control system (Section 25a (1) KWG) and the associated Minimum Requirements for the Trading Activities of Credit Institutions. Principle I (section 7) supplements and specifies these norms.

The use of risk models is, however, not limited to risk categories that are subject to allocation obligations under principle I. Credit institutions are increasingly also using risk models for the interest change risk of its investment book, which does not require a suitability approval by the regulator. Nevertheless, BaFin will examine such models from 2005 in order to actively accompany the institutions in the implementation of adequate standards of risk management.

15 institutions received the green light for their models in 2004.

According to principle I, credit institutions are permitted to also use their own risk models for backing market price risks, as an alternative to the standard method. If BaFin examines the models and confirms their suitability, they can be used for both internal risk measurement purposes and for regulatory purposes. Therefore, the credit institutions have a strong incentive to adapt their internal risk measurement to the standard of principle I. BaFin confirmed to 15 credit institutions that their risk models satisfied the requirements; in 5 cases, the approval relates to a "full use".
In 2004, BaFin carried out an initial audit and the Bundesbank car-

ried out 6 subsequent audits on behalf of BaFin. During the coming year, the audits will particularly focus on illiquid financial instruments in the trading book. Outside of the official audits, BaFin and the Bundesbank regularly visit the model banks. In 2004, the opportunity presented itself to hold an early dialogue regarding developments during 14 visits. The prognosis quality of the models remained robust in 2004. The results of the back-testing of market risk models, i.e. the comparison of actual loss on a given trading day with the maximum loss forecast by the model with a confidence level of 99% resulted in only 8 outliers with 15 model banks in 2004. During the previous year, there were 20 outliers, also with 15 model banks.

BaFin in favour of modelling of event risk.

The credit risk component (event risk) of the net interest position is particularly challenging to model. The conventional models to date do not yet map this; instead, they work with surcharges. This surcharge falls away with models that can map event risk (non-surcharge models). BaFin feels that it is necessary to develop such models until they are capable of acceptance: After all, the more precisely risks can be measured, the better they can be managed. For the banking supervisory recognition of a non-surcharge model, the approval of the Basel Committee for Banking Supervision is required.

Table 4
Risk model and factor gaps

Year	New-appli-cations	Rescinded appli-cations	Rejected	Number of model banks	Minimum additional factor	Maximum additional factor	Median
2004	1	1	0	15	0,0	1,0	0,30
2003	0	0	0	15	0,0	1,8	0,20
2002	1	0	0	14	0,0	1,0	0,25
2001	2	0	0	13	0,0	1,5	0,30
2000	2	0	0	10	0,0	1,6	0,30
1999	5	0	0	8	0,1	1,6	0,85
1998	15	2	4	9	0,1	2,0	1,45
1997	5	0	2	3	-	-	-

Risk models with investment companies

Based on the requirements of the new Derivative Directive, investment companies are increasingly using risk management models for fund risk management. In 2004, the first audit was carried out on such a model, 4 further audits are planned for 2005. QRM is carrying out these audits with the responsible specialist supervisor, who is also in charge of the audit. BaFin is particularly examining the definition of key figures that are used for portfolio monitoring and, if required, the limitation of market risks (exposure or risk limits), the structure of the risk models used and the stress tests carried out.

Up to now, the quantification of risk with a fund of hedge funds has proven to be a particular challenge, if only monthly performance data is available. A similar situation applies for the structuring of adequate stress tests. With both topics, generally valid standards have not been established so far and they are the currently the subject of active scientific research.

6 Certification of pension products

The legislator completely amended the Act Governing the Certification of Contracts for Private Old-Age Provision (AltZertG) with the Old-Age Income Act as at 1 January 2005.[58] BaFin was able to clarify at an early stage, questions regarding the interpretation of the act, the change-over of private old-age pension contracts and certification according to the new legislation, together with the BMF and the responsible central organisations.

The new regulation of the AltZertG now permits a one-off capital payment in an amount up to 30% of the capital available at the start of the payment phase for all private old-age provision products.[59] The partial capital of a maximum of 30% is to be exclusively paid out at the beginning of the payment phase. A distribution over several payment dates is not possible.

The legislator significantly expanded the pre-contractual informational obligations of the undertakings[60], thereby ensuring comparable and transparent products. The undertakings must now simulate the development of the accumulated capital in a given manner. This assumes that conclusion, marketing and administration costs are included in the calculation. To the extent that different fund products such as pension funds, money market funds and share funds are used with different cost allocations (issuing premium, administration fee), BaFin considers example calculations on the basis of different cost allocations to be sufficient.

Art. 7 of the Old-Age Income Act dated 5 July 2004, modifies the AltZertG. The key points of the reform of AltZertG are:

- Reduction in the number of certification criteria from 11 to 5,
- Admission of a 30% one-off payment at the beginning of the payment phase for pension schemes and payment plans,
- Distribution of the conclusion and marketing costs over at least 5 years,
- Expanded information obligations of the offeror,
- Introduction of the same tariffs for men and women ("Unisex tariff") from 1 January 2006.

The change in legislation necessitates the change-over of all approx. 3,600 certificates. If no change-over has taken place by 1 January 2006, BaFin must revoke with respective certificates with future effect.

[58] General information and revised comments on AltZertG, standard change-over notices, exemption declarations, new applications for certifications and checklists are available under www.bafin.de > For Providers > Certification Authority.
[59] Section 1 (1) No. 4 AltZertG.
[60] Section 7 (1) No. 4 AltZertG.

Table 5

Certificates awarded until 31 December 2004[61]

Provider	Certificate for standard contract submitted by central organisation (€5.000) section 4 (2) AltZertG	Individual certificate for provider of services (€5.000) section 4 (1) AltZertG	Certificate for provider of services based on standard contract (€500) section 4 (1) AltZertG	Certificate for standard contract submitted by central organisation as authorised representative (€250) section 4 (3) AltZertG	Total
Life insurers	0	350	0	0	350
Credit institutions	12	6	0	3.218	3.236
Investment companies	1	16	4	9	30
Housing sector	1	0	0	28	29
Total	14	372	4	3.255	3.645

[61] After deducting certificates that were waived.

Helmut Bauer,
Chief Executive Director
of Banking Supervision

III Supervision of banks and financial services institutions

1 Principles of supervision

At the end of the year, BaFin supervised 2,316 credit institutions with 45,444 branches. 9,707 of these branches belonged to Deutsche Postbank AG alone. In addition, 806 financial services institutions were subject to supervision by BaFin.

Table 6
Credit institutions – broken down by type

Credit institutions – broken down by type	Number
Private commercial banks (complex groups)	67
Of which: Landesbanks	11
Savings banks (Sparkassen)	477
Cooperative banks* (Genossenschaftsbanken)	1.339
Branches of foreign banks	84
Mortgage and ship mortgage banks	22
Building societies (Bausparkassen)	27
Other private, regional and surety banks	140
Residential construction companies accepting savings deposits	42
Investment companies	80
Securities trading banks	38
Total	**2.316**

* credit cooperative primary institutions

During the year under review, BaFin awarded 23 credit institutions with authorised institution status. In 22 cases, the license lapsed (not counting mergers between savings banks and cooperative banks or the discontinuation of banking business by semi-public cooperative banks).

Table 7
Breaches of supervisory law and sanctions imposed

Severe breaches of supervisory law	Gravierende Beanstandungen	Actions		
		against managers	Administrative fines	In case of Emergency (in accordance with section 44 of the KWG)
Foreign banks and complex groups	3	0	1	0
Other private banks	15	0	0	4
Savings banks (Sparkassen)	32	3	0	1
Cooperative banks (Genossenschaftsbanken)	149	34	0	2
Mortgage banks	0	0	0	0
Building societies (Bausparkassen)	0	0	0	0
Total	199	37	1	7

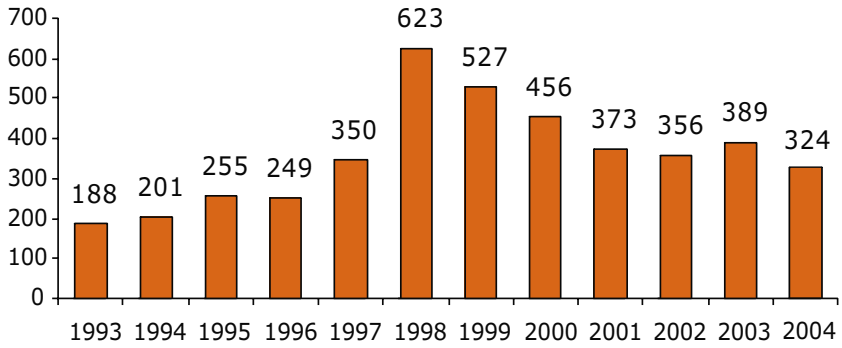
The number of severe breaches by credit institutions fell significantly in 2004. BaFin had to deal with 199 (2003: 369) such breaches as a result of violations of the KWG (German Banking Act) and other regulatory standards.

BaFin initiated sanctions against managers in 37 cases.

As a result of the severe breaches ascertained, BaFin initiated sanctions against credit institution managers in 37 cases. These include warnings and, in particularly severe cases, the dismissal of managers.

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 2004, 324 special 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 Pfandbriefe at seven mortgage credit institutions.

Figure 19
Auditing pursuant to section 44 of the KWG



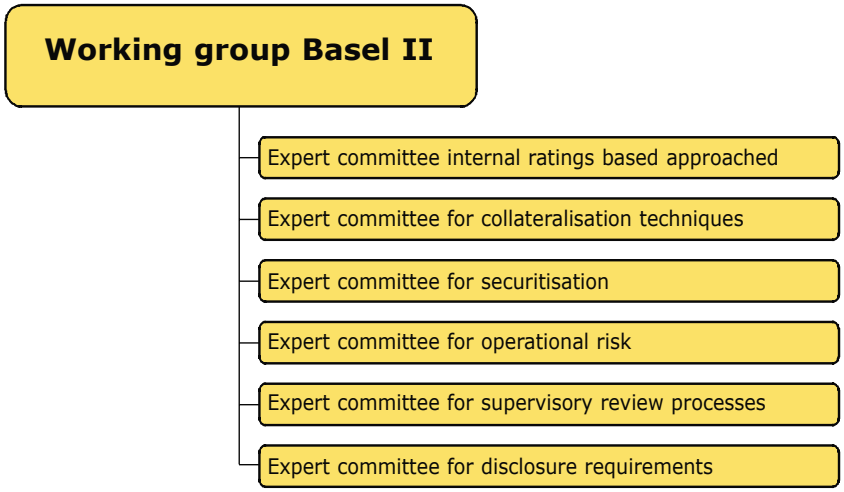
1.1 National implementation of Basel II

The banking supervisory authority is currently making in-depth preparations for the review of requirements from the revised international capital framework – Basel II. The first pillar describes the future requirements for calculating regulatory capital1. To this end, in future credit institutions may use their own, internal measures to measure three types of risk: credit risk, trading risk and operational risks. The second pillar of Basel II obliges credit institutions to reasonably value and control all material business risks, with it not being necessary to back these with regulatory equity. The second pillar also describes the ongoing supervisory review process (SRP) as a requirement for banking supervision. BaFin cooperates closely with Deutsche Bundesbank to achieve a flexible, risk-oriented and high-quality supervisory process, which allows sufficient latitude for the credit institutions to design their risk management process and supervise the necessary changes to their workflows and methods. The third pillar includes requirements to disclose the banks' qualitative and quantitative information regarding equity capital and all relevant risk indicators. This aims to improve market transparency and thus also to reinforce market discipline.

Working group for „Risk-oriented supervision"

In 2004, BaFin and Deutsche Bundesbank established a joint working group called „Risk-oriented supervision", which works on the concept-based implementation of SRP. It develops supervisory instruments and methods including the authorisation criteria for the advanced methods of pillar I and identifies organisational supervisory guidelines for pillar I and SRP.
The banking sector is included in implementation of Basel II. Together with the Bundesbank, in the fall of 2003 BaFin formed the „Basel II implementation" working group, which includes representatives from the banking sector and from the associations of the Central Credit Committee (Zentraler Kreditausschuss – ZKA). The aim of the working group is to discuss open issues in international regulatory texts and the pertinent execution of national options and to work out solutions. The working group had five formal meetings in 2004. Its recommendations are published on BaFin Web site.[62]
The expert committees of the working group comprise experts from the banking sector, Deutsche Bundesbank and BaFin. They discuss professional issues and prepare possible solutions. If the committees cannot agree, the possible consequences are portrayed in alternative scenarios. The specialist committees are structured as follows:

Figure 20
Working group Basel II and expert committees

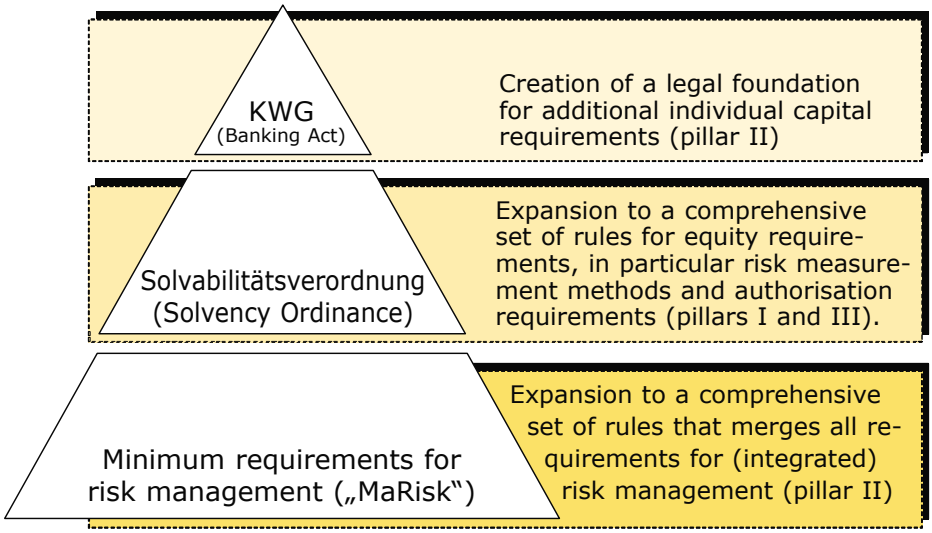


Basel II has will become national law via the EU. In Germany, they will be included, above all, in the KWG, the Solvency Ordinance and in the new minimum requirements for risk management.
The rework of the Directive relating to the taking up and pursuit of the business of credit institutions[63] and the Council Directive on capital adequacy of investment firms and credit institutions[64] are merged under the title „Capital Requirements Directive", under

[62] www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Fortentwicklung des Aufsichtsrechts (German only).
[63] DIR 2000/12/EC; OJ EU No. L 126/1.
[64] DIR 93/6/EC; OJ EU No. L 141/1.

which the Basel II regulations will be implemented in European and then national law. The national regulations are to come into force on 1 January 2007 with the reworked directives. Implementation work is focusing on the suitability of equity; this will be reflected in the solvability directive.

Figure 21
Regulatory pyramid



As part of implementation of Basel II, the requirements for large exposures and loans of €1.5 million or more (to a particular client) were modified in the KWG[65] Specific borrowers still receive across-the-board privileges[66], e.g. central governments or central banks. Loans to these counterparties do not need to be reported as or included in large exposures and loans. According to the draft directives, this type of counterparty-related privilege will no longer be possible across the board. In future, a case-by-case review must be conducted to ensure that a risk-weighting of zero percent can be applied according to the regulations for the standard approach in the solvability regulations. Under certain conditions, banks that use the advanced IRB approach can consider the financial collateral for the risk of counterparty default when measuring their cluster risks.
However, BaFin expects that the credit institutions conduct regular stress tests which include the actual value of the collateral. Finally, rules for the treatment of credit derivatives are included in the large exposures and loans provisions.
The provisions for the cooperation between EU supervisory authorities and with third-party states will also change. Central issues relate to, for example, responsibility for the supervision of banking groups with pan-European activities and the reciprocal information obligations and audit laws.

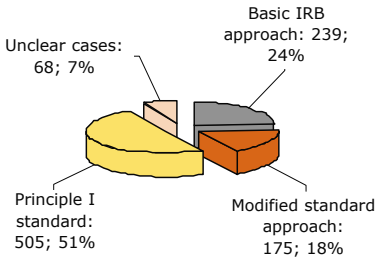
[65] In parallel to changes to the KWG, BaFin will make the required subsequent changes to the lower-level directives, namely the regulation governing large exposures and loans of 1.5 million € or more (Groß – und Millionenkreditverordnung - GroMiKV) and the reports regulation (Anzeigenverordnung - AnzV).
[66] Section 20 (2) sentence 1 no. 1 of the KWG.

1.1.1. Pillar I Credit risk

Second survey on implementation plans

In order to obtain an up-to-date overview on the institutions' preparations, in 2004, as in 2003, BaFin surveyed the credit institutions and financial services institutions[67] on which methods they will use under the new capital regulations and when they want to implement these. The information obtained in this process help to plan the required capacity for the authorisation reviews.
BaFin conducted the survey with support from Deutsche Bundesbank during the third quarter of 2004. It focused on methods for calculating equity for the credit risk. At the same time, BaFin and the Bundesbank asked the credit institutions to inform them whether they intend to use the advanced method to measure the operational risk. BaFin wrote to a total of 2,455 credit institutions – only 989 credit institutions responded. That corresponds to a response rate of more than 40% (previous year: almost 62%). Cooperative banks accounted for the lion's share of responses with 46%, followed by savings banks with around 36%, followed by other private commercial banks with around 11%.
Despite the low response rate, BaFin was able to draw key conclusions from the survey: of the institutes which responded, between 450 and 550 credit institutions[68] (44% to 55%) plan authorisation for the basic IRB approach within the next five years. 48 credit institutions plan to apply for authorisation to the advanced IRB approach within the next ten years. 239 credit institutions hope to achieve the basic IRB approach by 1 January 2007, which corresponds to 24% (previous year: 39%). 175 credit institutions or 18% are planning to use calculations using the modified standard approach as of 1 January 2007. More than half (51% of the credit institutions) want to use the opportunity to still calculate the capital requirements using the „old" Principle I in 2007. The following graph includes the credit institutions whose answers did not allow clear allocation to a specific approach under „unclear cases".

Figure 22
Method to measure credit risk intended for use from 1 January 2007[69]

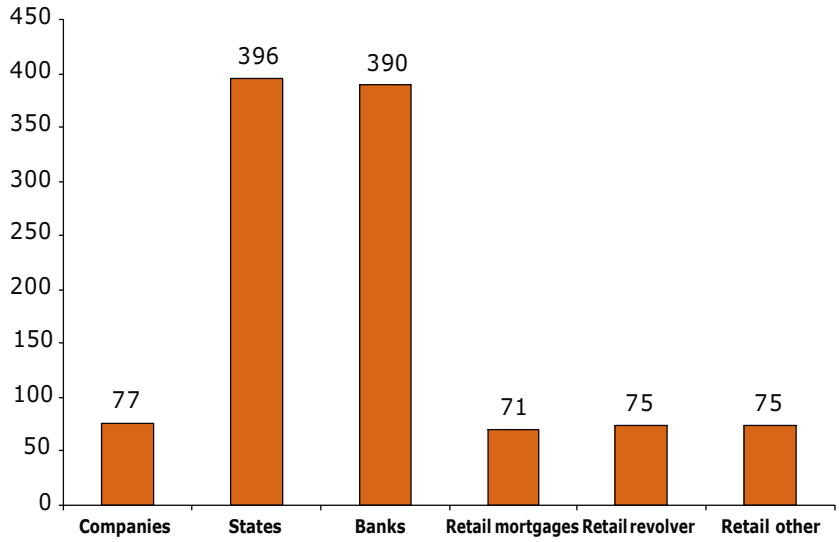


The credit institutions should have the opportunity to fully bring their receivables portfolios under the IRB approach they have chosen within a maximum five-year period. The majority of the institutes that want to use an IRB approach are planning to include all segments in the corresponding rating-based approaches by 2009 at the latest. Moreover, the information in the survey gives reason to believe that several credit institutions will be treating all of their receivables segments using the rating-based approaches intended for this purpose by 1 January 2007 or during the course of 2007. However, the majority of credit institutions that plan to use an IRB approach intend to have themselves permanently released from the IRBA for their state and bank portfolios.

[67] For information on the 2003 survey, see the Annual Report 2003, p. 38 ff.
[68] Responses from the credit institutions were, in part, contradictory, which is why it is not possible to state a clear figure here.
[69] The graph only includes credit institutions that participated in the survey.

Figure 23

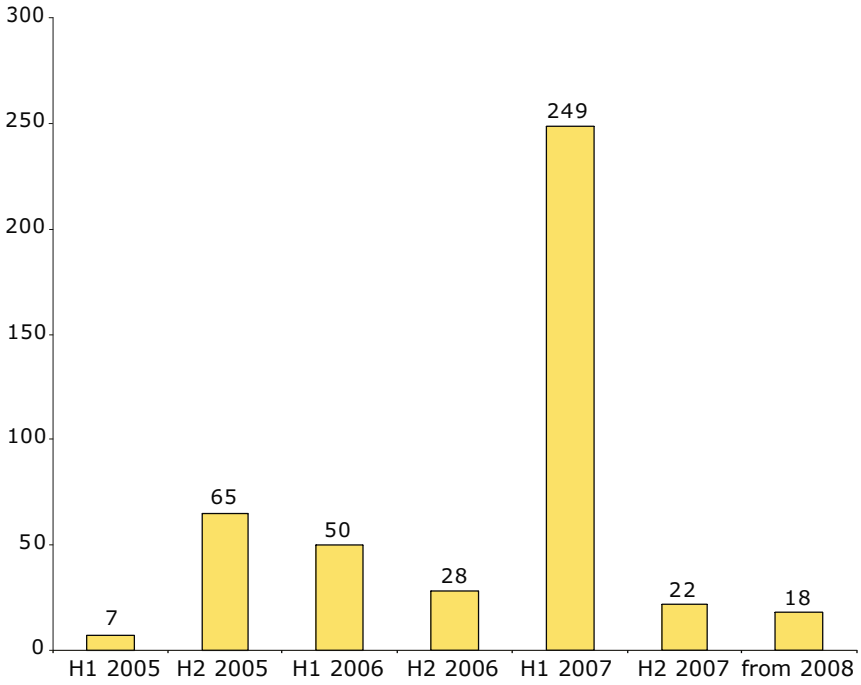
Permanent exemption from the IRB approach per class (Partial use)



Authorisation applications for the basic IRB approach will mostly be received between 2005 and 2007.

Figure 24

Planned authorisation applications basic IRBA



The expected 48 applications for authorisation for the advanced IRB approach will also mostly be received between 2005 and 2007.

Initial estimate of IRBA

In cooperation with the Deutsche Bundesbank, BaFin made an offer to the credit institutions to subject the methodical concepts behind their internal rating-based approaches to ascertain the supervisory equity requirements to an initial assessment. 22 credit institutions took advantage of this offer, and submitted a total of 73 rating-based approaches for an initial assessment. The results from this initial assessment will be included in the concepts and guidelines that BaFin prepares for acceptance of the IRBA approaches. The assessment is not an audit of the rating-based approaches, and the result does not impact any possible later acceptance of the systems. The assessment is based on the conformity of the credit institution's documented rating developments and parameter estimates with specific requirements from the third consultation paper (CP 3) on implementing Basel II. In a prepared concordance list, the credit institutions provided information on how they have implemented specific CP3 regulations for their internal rating-based approaches. In the initial assessment, only method-based concepts are to be presented that have already been implemented or which are just about to be implemented.

In the initial assessment, only method-based concepts are to be presented that have already been implemented or which are just about to be implemented.

IRBA fact sheet

Since the end of 2004, BaFin has been ready to review applications for the authorisation of internal rating-based approaches (IRBA) to identify the supervisory equity requirements. It provided the credit institutions with a fact sheet which provided detailed information on submitting the application, the audit procedure and the required documents. The IRBA authorisation application includes an implementation plan, concordance lists and the credit institution's own documentation on the internal rating-based approaches.

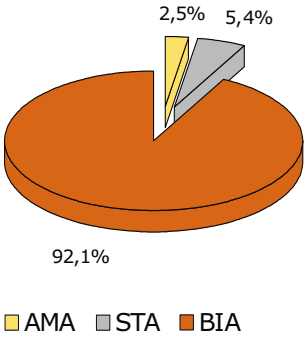
The implementation plan is to include a binding presentation of the credit institution's own implementation dates for all rating-based approaches for which IRBA authorisation is intended. Concordance lists are tables prescribed by the banking supervisory authorities, which help the credit institutions to show how they fulfil the individual IRBA requirements. These are modified in line with the continued development of the corresponding EU directives and their implementation in national law.

The IRBA authorisation procedure starts with the authorisation application by the credit institution to BaFin. Credit institutions which want to apply rating-based approaches developed in pool solutions each have to first submit a complete application themselves and they will be assessed individually. The starting point for the assessment is the submitted implementation plan. BaFin then assesses the individual rating-based approaches that are to be authorised for IRBA with regard to their suitability. Authorisation is issued with an official notice. Only then may the credit institution

submitting the application use its internal rating-based approach to calculated supervisory equity. The procedure ends when all of the internal rating-based approaches listed in the implementation plan have been admitted.

1.1.2 Pillar I Operational risk

Figure 25
Planned approach to measure operational risk



Survey to select methods

In August 2004 BaFin surveyed 2,455 credit institutions on the approaches they would select to calculate their equity requirements for operational risk. This survey linked in to last year's survey, and was restricted to the approaches which have to be authorised. The results of the survey form the basis for preparatory work for the authorisation of the standard approach and the advanced measurement approach as well as for personnel and audit forecasts for 2005 to 2007.

Of the credit institutions BaFin contacted, 58 want to introduce an advanced measurement approach (AMA) and 134 plan to introduce a standard approach (STA). BaFin believes that the other credit institutions will decide to apply the basic indicator approach (BIA). This approach is, in fact, suitable for the majority of credit institutions.

AMA „industry campaign"

In its survey, BaFin asked the credit institutions which plan to introduce the advanced measurement approach if they would like to participate in an „industry campaign". This campaign aims to get to know the implementation level in the participating institutes and to recognise the common features and differences in implementing advanced measurement approaches. A joint working group on operational risk (AG OpR) formed by Deutsche Bundesbank and BaFin developed and coordinated this campaign. A total of 15 credit institutions from all of the different banking groups participated. The main component of this campaign is a list which comprises 59 topics, which above all reflect the quantity and quality requirements for an advanced measurement approach. The participating credit institutions submitted information and documentation on their own AMA implementation. The documents will have been evaluated by the end of Q2 2005; then BaFin wants to hold in-depth discussions with the credit institutions regarding individual implementation topics. For the summer of 2005 BaFin plans to publish a comprehensive report on the results.

Application and acceptance of the approaches

According to the current status of European regulations, credit institutions can use the basic indicator approach or the standard approach as of the end of 2006, followed by the advanced measurement approach as of the end of 2007 in order to calculate the equity backing for operational risk. Whereas the first two of these three approaches include a calculation system, the advanced mea-

surement approaches are based on the credit institution's own internal models to measure operational risk.
Credit institutions which would like to use the standard or advanced approach have to fulfil certain quality – and for the latter also quantity – requirements. In addition they have to be authorised by BaFin. The suitability of the advanced measurement approach is mostly reviewed on location in the credit institutions' offices, whereas the suitability of a standard approach can generally be reviewed using a list of questions to be completed by the applicant. As is the case for the IRBA reviews, BaFin will provide fact sheets which describe the requirements for an authorisation application for s standard and for an advanced approach. The fact sheet for the standard approach is expected to be published in mid-2005, with the fact sheet for the advanced measurement approach following in the fall of 2005. The credit institutions can then file their applications for authorisation for these approaches. In 2004 the working group on operational risk developed organisational principles for the authorisation reviews. The working group on operational risk not only prepares concepts for the reviews in the credit institutions and for the audit of information provided by the credit institutions, but also prepares audit guidelines and aids. In so doing, it aims to ensure that the reviews are conducted in an efficient manner and that applications are processed in due time and cost effectively.

1.1.3 Pillar II

The second pillar of Basel II, the Supervisory Review Process (SRP), takes a look at all of the credit institutions' risks. Each credit institution must implement an Internal Capital Adequacy Assessment Process (ICAAP) which aims to ensure that a credit institution has enough „internal capital" to cover all of its risks, based on suitable methods to manage and monitor risk. This risk orientation, which applies not only to the credit institutions but also to supervision, demands a suitable set of tools to systematically recognise risk. The earlier BaFin recognises possible negative developments at the credit institutions, the more effectively it can counter these and fulfil its preventative function. On the one hand, this cuts costs for those directly and indirectly affected (creditors, shareholders, competitors, etc.) and, on the other hand, it contributes to stabilising the entire financial sector. The comprehensive recognition and valuation of risk also forms the foundations for effective allocation of scarce supervisory resources. Three years prior to the start of SRP, the supervisory authorities are in discussions with the banking sector via an expert committee regarding the implementation of SRP and its consequences. It discusses both implementation of the requirements at the credit institutions and the changes to the supervisory process and its impact.

Minimum requirements for risk management („MaRisk")

As part of SRP, in future BaFin will have to review whether the credit institutions' own methods to manage and monitor risk are suitable. In order to assess this, it will use MaRisk, which is currently being developed. MaRisk is a set of rules geared to quality, which

prescribes the framework conditions for the credit institution's structural organisation and workflows, as well as for their internal methods for risk management.

MaRisk will make concrete the statutory requirements set out in the new version of section 25a of the KWG. According to this section of the KWG, proper business organisation primarily includes defining a strategy and setting up adequate internal control methods. As is already the case for the existing minimum requirements, MaRisk will also be flexible. A large number of opening clauses will provide smaller credit institutions in particular with adequate latitude for concrete implementation.

Structure of MaRisk

MaRisk will have a modular structure. A general part will contain fundamental principles, which apply to the management and monitoring of all risks. Specific requirements for individual divisions and risk categories are included in a special section. These allow any reworks that may be needed at a later date to be restricted to individual areas of the regulations.

MaRisk summarises the already existing minimum requirements and supplements these with requirements for interest rate risks in the bank book, liquidity risks and operational risks. In addition, BaFin has taken the opportunity to rectify the interface problems in the „old" minimum requirements and redundancies.

Expert committee MaRisk

After BaFin had prepared an initial MaRisk draft in a working group together with Deutsche Bundesbank, it went on to form a expert committee which will support supervision for the further development of MaRisk. The committee comprises representatives from the credit sector, associations and bank regulators. Auditors will also participate. The committee will also meet regularly after MaRisk has been published, and will support BaFin in clarifying interpretation issues and discussing audit-related issues. BaFin believes that it will be possible to publish the final version of MaRisk in the second half of 2005.

MaK will be included in MaRisk

The version of MaRisk being prepared will include some of the minimum requirements already heeded by the credit institutions. These include the Minimum Requirements for the Credit Business of Credit Institutions (MaK) with which BaFin set a practical framework for the organisation and management of credit business in 2002.[70] The core elements of MaK include defining a credit risk strategy, splitting certain functions, clearly defined credit processes, professional monitoring of risks at portfolio level and functioning reporting. The requirements based on section 25a (1) of the KWG primarily aim to enhance the credit institutions' risk consciousness and to improve transparency. MaK includes a large number of opening clauses, which means the requirements can thus also be flexibly implemented by smaller credit institutions.

[70] Circular 34/2002 [BA].

First stage of MaK implementation.

In order to allow the credit institutions to professionally implement the requirements, BaFin has broken implementation down into two stages and has included longer implementation periods in the individual stages. Requirements without IT modifications had to be realised by 30 June 2004. The implementation period for regulations that are relevant for IT, runs until 31 December 2005.

Expert committee MaK

The MaK specialist sub-committee made a major contribution to implementation of MaK at the credit institutions in 2004. BaFin leads this committee. In addition to supervisors, the committee includes experts from credit institutions, auditors and association representatives. The committee's primary task is to discuss interpretation issues and questions relating to audits. In setting up the committee, BaFin institutionalised contact with practical work – its work ensures that the latest findings from day-to-day work are constantly taken into account in interpretations for the minimum requirements. By publishing the minutes of the committee's meetings in the Internet[71], interpretations are made transparent, so that all interested groups (institutes, auditors and associations) can use them.

Functional split under MaK: Improvement for very small credit institutions.

As a result of limited personnel resources, it was difficult for very small credit institutions to realise the functional split between the front and back office through to management level. For example, some credit institutions were only able to split functions – above all when it came to deputies – by using less experienced employees. BaFin has recognised this problem and has made the situation easier for very small credit institutions.[72] Credit institutions are allowed to wave the split requirement if it is possible to ensure that the credit business is properly managed, above all for risk-related engagements, by directly involving the credit institution's management. According to cautious estimates, around 250 credit institutions will benefit from this improvement. Candidates have to complete a self-assessment, with the reasonableness of this assessment being reviewed as part of the audit of the financial statements. In so doing, the scope and structure of the credit business must be considered.

Early risk recognition – joint project with the Bundesbank

In a joint project, BaFin and the Bundesbank are currently developing a system for the early recognition and valuation of the credit institutions' risks (risk assessment system – RAS). The system aims to provide an initial assessment of the credit institutions compared to their competitors (the peer group) to identify problem credit institutions at an early stage. The multi-level, modular structure also allows differentiated valuation of the credit institutions' own risk areas. This shows the credit institutions' fundamental strengths and – more importantly from a supervisory perspective – weaknesses. In order to assist with decision making, the supervisory authorities receive a rough guideline which shows credit insti-

[71] www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Fortentwicklung des Aufsichtsrechts > MaK > Fachgremium (German only).
[72] Letter from BaFin dated 12.01.2004, www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Schreiben (German only).

tutions and areas that audits could focus on. The aim is to assess all credit institutions using a similar system and using objective criteria – if possible using a statistical model with early warning characteristics. In the first instance, this can be implemented for cooperative banks and savings banks. However, as a rule the system can also be transferred to the other credit institutions, however the assessors must have a greater latitude in order to fulfil the requirements of heterogeneous structures.

The auditors' opinion for the credit institutions' financial statements prepared by the auditors provides fundamental information. This is supplemented by regulatory reporting. This means that in the first instance, information is processed that BaFin did not acquire on location from the credit institution under supervision, but that stems from the documents submitted. However, it is planned to expand the information base to include data from on-location audits.

The risk assessment system is a regulatory tool that will support regulatory activities, but will not replace them. It systematically prepares the available information. As such it promotes comparability among credit institutions as well as supervisory efficiency and forms an integral component of the SRP

1.2 The new Pfandbrief Act

New Pfandbrief Act comes into force in July 2005.

The act to revise Pfandbrief law will come into force in July 2005. The act will unify the underlying legal conditions for issuing Pfandbriefe and – while upholding the high quality of the Pfandbrief – it will remove the so-called „special bank principle". Pfandbrief issues had previously been based on the Mortgage Bank Act, the Act on Mortgage Bonds and Similar Bonds of Credit Institutions under Public Law and the Act on Ship Mortgage Banks. These are being discontinued and replaced by the new Pfandbrief Act. A fundamental rework of the Pfandbrief Act was necessary, as Gewährträgerhaftung (guarantee obligation) and Anstaltslast (maintenance obligation), which to date had favoured public-law credit institutions, are being revoked or modified as of 18 July 2005.

To date, mortgage banks organised under private law, the current two ship mortgage banks and public-law credit institutions have been authorised to issue Pfandbriefe. HBG and SchBkG state a special bank principle with a restriction for permitted transactions, whereas public-law banks can refer to Anstaltslast (maintenance obligation) and Gewährträgerhaftung (guarantee obligation) as additional Pfandbrief collateral. From July 2005 all credit institutions will be allowed to use this method of refinancing – after acquiring a corresponding issue license.

What are Pfandbriefe?
Pfandbriefe are bonds backed by mortgages or state credit, which are regarded as being highly secure as a result of strict statutory regulations. Mortgage banks, ship mortgage banks, Landesbanks and savings banks as issuers can thus refinance themselves parti-

cularly cost effectively using Pfandbriefe. Pfandbriefe have a total volume of around €1.1 billion, and are a key focus on the German and European bonds markets.

There are three types of Pfandbrief: mortgage bonds, ship mortgage bonds and public mortgage bonds. The difference stems from the underlying collateral: Mortgage bonds are primarily backed by loans that are secured by mortgages or land charges. Public mortgage bonds are mostly backed by loans to public authorities (federal government, states, municipalities) and ship mortgage bonds are mostly backed by ship mortgages.

So-called Jumbopfandbriefe have been issued since 1995. These have an issue volume of at least €500 million. As a result of the relatively high volume, these are characterised by particular liquidity and excellent tradability.

New act secures high quality of Pfandbriefe.

The new Pfandbrief Act aims to ensure the high quality and resulting excellent reputation of the Pfandbrief on international capital markets. As a result, uniform and particularly strict requirements for the quality of Pfandbriefe are being established for all Pfandbrief issuers. Because the assets serving as cover for the mortgage banks organised under private law have been significantly strengthened as a result of the last amendment to the HBG in April, 2004, it is no longer necessary to link the privilege of issuing Pfandbriefe with credit institutions organised under private law with a restricted business community.

The new Pfandbrief Act is retaining the tried-and-trusted elements of quality assurance. The principle of nominal-value and cash-value cover of the claims by Pfandbrief creditors plus a 2% surplus cover is being retained from the HBG and ÖPG. The previous requirements for insolvency, the trustee for the assets serving as cover and the opportunity to fully or partially transfer the Pfandbrief liabilities and assets serving as cover to other Pfandbrief credit institutions are also being retained. In the interests of Pfandbrief quality, the issuers also must undertake to publicly disclose extensive information on the quality of the assets serving as cover every quarter. The new Pfandbrief Act unifies at a high level the quality requirements for Pfandbriefe for all of the groups of issuers which were previously treated separately. This will help to ensure that the Pfandbrief will also be perceived as being a financial product with consistent high quality in future. At the same time, the new Pfandbrief Act ensures that all Pfandbrief issuers are treated equally in competitive terms.

Credit institutions must fulfil minimum requirements.

In order to ensure proper supervision, Pfandbrief business is defined as banking business within the meaning of section 1 of the KWG which requires a corresponding license within the meaning of section 32 of the KWG. During the license process credit institutions must verify that they fulfil specific conditions which are compulsory for Pfandbrief business. These include, for example, core capital of at least €25 million and a business plan which shows that the credit institution is expected to continue Pfandbrief business

over the long term. In addition, the credit institution must have the requisite organisational structure for Pfandbrief business, and be able to prove a risk management system especially for its Pfandbrief business. BaFin can revoke the license to conduct Pfandbrief business if the Pfandbrief credit institution has not issued any Pfandbriefe for more than two years, and if it is not to be expected that the Pfandbrief business will be recommenced within the next six months as regular, sustained banking business.

Discontinuation of the special bank principle does not reduce quality.

There are no concerns regarding the discontinuation of the special bank principle anchored in the HBG and SchBkG. In individual cases it has been shown that the risk-minimising effect of the restriction of the business community can be questioned if a credit institution is no longer able to generate sufficient income from its mortgage and public sector lending business alone. A loss of Pfandbrief quality need also not be feared. At the latest since the assets serving as cover have been significantly strengthened in April 2004 to combat possible insolvency by the issuer, a critical factor is the quality of the assets serving as cover and how these are utilised. As a result, it is regarded as being advantageous to retain the restriction to the amount which can be covered for mortgage bonds to 60% of the lending value, the position of the trustee as well as the „cover audits" conducted by mortgage banks at regular intervals to the Pfandbrief Act and to apply these conditions to all Pfandbrief issuers.

1.3 Changes to the good conduct rules

Good conduct when providing investment services is of major importance for investors' trust in the securities market. The AnSVG includes both fundamental changes to the requirements for the provision of investment services as well as for the investment services companies themselves. In addition, BaFin has expanded its assessment criteria for audit exemptions.

Financial analyses

The supervision of financial analyses stipulated in section 34b of the WpHG has been amended to European requirements. The provisions for the proper preparation and transfer of financial analyses are now also to be applied to all financial instruments. The provisions also now apply to all natural persons and legal entities that prepare, transfer or distribute financial analyses. There is an exception for journalists, who are excluded from the obligations of section 34b of the WpHG if they are subject to reasonable professional self-control. Further provisions are stipulated by the Regulation concerning the Analysis of Financial Instruments which came into effect on 23 December 2004.[73]

[73] BGBl. 2004 I, p. 3522.

Change to assessment criteria for audit exemption according to section 36 (1) sentence 2 of the WpHG

BaFin has expanded its assessment criteria for exemptions from audit requirements.

Since July 2002 BaFin has been able to exempt investment services companies from the annual audit of conduct rules and reporting requirements under the German Securities Trading Act upon request. In May 2004, BaFin reworked its assessment criteria of July 2002, thus significantly expanding the possibilities for exemption. This provides significant relief for smaller institutions.
A key change is the expansion of the exemption period. Prior to 27 May 2004 exemption could only be issued for one year, now a three-year exemption period is possible. BaFin only issues a three-year exemption to credit institutions which exclusively conduct business with professional customers. Whether a one or two-year exemption from the audit requirement is possible depends on the scope of the business activities. If a portfolio manager does not manage more than €five customers, he can be exempted from the audit requirement for two years. This also applies to investment and contract brokers, floor traders and financial commissioners which have a maximum of three employees or a maximum of 50 customers. Credit institutions with a license to conduct custodial services can be exempted for two years if they have no more than 500 custody accounts. All other institutes can only be exempted for one year only.

Exemption restricted by maximum limits.

Exemptions are not possible if specific maximum limits are exceeded. Exemption for portfolio managers is excluded if the investment volume is greater than €illion. Investment and contract brokers, floor traders and financial commissioners are excluded from exemption if they have more than five employees and, at the same time, more than 100 customers. The threshold for the exemption had previously been three employees including the managing director, irrespective of the volume of business. Credit institutions that have more than 750 custody accounts cannot be exempted from the audit requirement. However, credit institutions that exclusively conduct business with professional investors are not subject to any maximum thresholds.

Investment services for derivatives or credit-financed securities transactions are no longer automatically excluded from exemption. However, an exemption from the audit within the meaning of section 36 (1) sentence 2 of the WpHG is still not possible if no initial audit of the credit institution has been conducted, if the last audit showed shortcomings that do not justify exemption or if the type of business activities or the organisation of the credit institution have changed. If BaFin has founded complaints that relate to securities trading, exemption from the audit requirement is excluded. Exemption is interrupted by a defined audit schedule. After the expiration of the exemption period and the following fiscal year to be audited, no new application for exemption from the audit requirement is required. Exemption can be revoked in order to take into consideration events that occur at a later date that oppose exemption.

Change to the investment services audit directive

According to section 36 of the WpHG, BaFin regularly audits the upholding of reporting requirements and conduct rules by investment firms. Closer provisions regarding the type, scope and date of the audit are included in the new Investment Securities Audit Ordinance which came into force on 1 January 2005.[74] The amendment aims to ensure more effective supervision at lower cost.

In particular, the changes affect the opportunity for exemption from the audit, the introduction of conduct rules in connection with financial analyses and various information requirements for financial futures. Various terms were also revised, such as the definition of an error or a shortcoming. The result is uniform standards for audits. In addition, reporting is easier to compare, thus contributing to the equal treatment of investment services companies by the auditors and by BaFin. The audit form has also been revised to make the information it contains more reliable. This aims to bring about a downturn in questions and complaints. In addition, the auditors also receive improved opportunities to define risk-oriented focuses for their audits. In return, they can restrict themselves to a simplified audit, the so-called initial audit, in areas which have been seen to be free of shortcomings in previous audits. For larger companies in particular, the focused audit of all areas spread over a period of three years will lead to significant relief. To date the companies were audited every year, however with a lower intensity.

2 Ongoing solvency supervision

2.1 Complex groups

Weak earnings position shaped business growth.

Business growth at the 67 private commercial credit institutions (complex groups)[75] was again characterised by weak earnings during the year under review. Many credit institutions have launched extensive measures to improve the economic situation. For example, almost all of the credit institutions slashed their administrative expenses. The large credit institutions also had to spend less on risk provisioning for their credit business during the year under review. This reflected both a more restrictive credit issuing policy as well as the fact that some credit portfolios had been adjusted in the previous year. In contrast, earnings power from operating business lagged expectations.

New management information system improves supervision.

BaFin has set up a management information system (MIS) for the supervision of large credit institutions which are relevant for the system. Seven select credit institutions have been voluntarily submitting monthly reports of their key accounting items at a credit institution and group level. In addition, they provide information on material changes compared to the previous months or forecast figures. For example, BaFin is provided with the amount of the un-

[74] BGBl. 2004 I, p. 3515.
[75] Of which 11 Landesbanks.

realised profits and hidden liabilities on a monthly basis. The aim is to receive an up-to-date insight into these credit institutions' income, risk and financial situation. If a deterioration of the risk or earnings position can be seen, BaFin discusses the causes in talks with the reporting credit institutions and can react in good time. As the reporting credit institutions use different accounting standards, and because the allocation criteria for business transactions differ, the information provided by the credit institutions can only be compared to a limited extent. However, BaFin has been able to obtain key findings from MIS, not least due to the content which goes beyond the disclosure requirements under the HGB. For example, in 2004 BaFin was able to track developments of hidden liabilities which gave grounds for concern at some credit institutions without any notable time lag, and was able to bring about their timely reduction.

2.2 Landesbanks and savings banks

2004 was once again characterised by far-reaching restructuring for the eleven Landesbanks and 477 savings banks. Many savings banks further honed their organisation and working efficiency during the year under review. MaK implementation had a positive effect in many cases in the credit business. In addition, savings banks attempted to improve their cost structure by outsourcing divisions and cooperating at a regional level.

Landesbanks and savings banks reinforce cooperation.

Landesbanks reinforced the business policy cooperation with the savings banks in their regions by concluding association agreements. The agreements include comprehensive rules for products, services and work-sharing. In some associations, the credit institutions involved also defined common decision-making structures as well as a common risk policy and accounting standards. In so doing they aim to improve their association rating compared to their individual ratings. In addition, some of the partners created regional reserve funds – over and above the collateral funds for deposit protection. Some Landesbanks used 2004 to drive the reorientation of their equity participations, for by resolving to form parent-subsidiary relationships. In individual cases, some credit institutions parted company with non-profitable subsidiaries.
The strategic alliance agreements with the Landesbanks will open up new divisions for the individual savings banks in future – above all for syndicated loans and project financing. This earnings potential had previously been barred for most savings banks, as they are too small and the transactions are highly complex. If they use the new business opportunities, the credit institutions' risk profiles will also change.

Changes to „Gewährträgerhaftung" (guarantee obligation) and „Anstaltslast" (maintenance obligation).

The pending removal of Gewährträgerhaftung (guarantee liability) and the modification of Anstaltslast (maintenance obligation) on 18 July 2005 will have far-reaching effects on the public-law sector. This was linked to the issue of how external ratings agencies will react to these changes in their valuations. On 1 July, 2004, the agencies Standard & Poor's and Fitch published so-called „shadow ratings" for liabilities that are no longer covered by state liability.

The vast majority of Landesbanks obtained an A-grade rating, individually as a result of addition activities to stabilise ratings during the course of the year. During the year under review the first savings banks also had themselves rated. They obtained excellent results.

Some Landesbanks were also affected by the decision by the EU commission dated 20 October 2004 regarding state aid. Agreement was reached with the European Commission that the state aid received in error was to be paid back as quickly as possible. All of the Landesbanks affected have taken this into account accordingly in their 2004 financial statements.

Landesbanks improve capitalisation.

During the year under review, the Landesbanks worked towards improving their capitalisation. For example, several credit institutions reinforced their equity using silent participations. Other credit institutions increased their share capital or initiated the conversion of subordinated capital or silent participations to nominal capital. Still other Landesbanks reduced their risk assets, thus improving their equity ratios. The credit institutions reduced their risk assets by using a more restrictive lending policy, and also via the synthetic securitisation of risk assets or other portfolio management activities.

Unsatisfactory earnings position depressed savings banks' annual results.

Earnings in the savings bank sector were differentiated. Many credit institutions managed to master the transition, both in terms of loan loss provisions and earnings, and are also forecasting a positive future, no general improvement can be perceived at some savings banks - in particular in structurally weaker regions. They are continuing to struggle with significant lending burdens from the past. In individual cases this has led to lower positive net profits for the period, or even to net losses. Various credit institutions were only able to record a balanced result by reversing unrealised profits. Some savings banks were forced to cease being independent.

Savings banks aim for further consolidation.

During the year under review, the number of savings banks fell from 489 to 477. This continued the trend observed in the past few years for creating larger, better performing units. In addition to the overall environment, which continues to stagnate, the credit institutions were faced with tougher competition, in particular with direct and Internet credit institutions. Given this environment, they are aiming for further consolidation and risk limitation.

Special audits by BaFin

In 2004, BaFin conducted several audits within the meaning of section 44 of the KWG at Landesbanks and their subsidiaries. The audits focused on the statutory requirements for trading and lending business, valuations in the lending business – including for aircraft and real-estate financing – as well as the structure of internal audits.

BaFin requested 96 special audits at savings banks (previous year: 98), which mostly related to lending business. At some credit institutions, auditors ascertained organisational shortcomings in the lending business as well as an increased requirement to make va-

lue adjustments. It was not possible to cover this requirement from ongoing earnings in all cases. Other special audits related to trading and the organisation of savings banks.

Measures against savings bank board members.

During the year under review, BaFin had to warn three savings bank board members, four other cases had not been concluded by the end of the year. At some credit institutions, the results of the audits certified that some board members were not properly qualified. This caused the advisory boards to dismiss them.

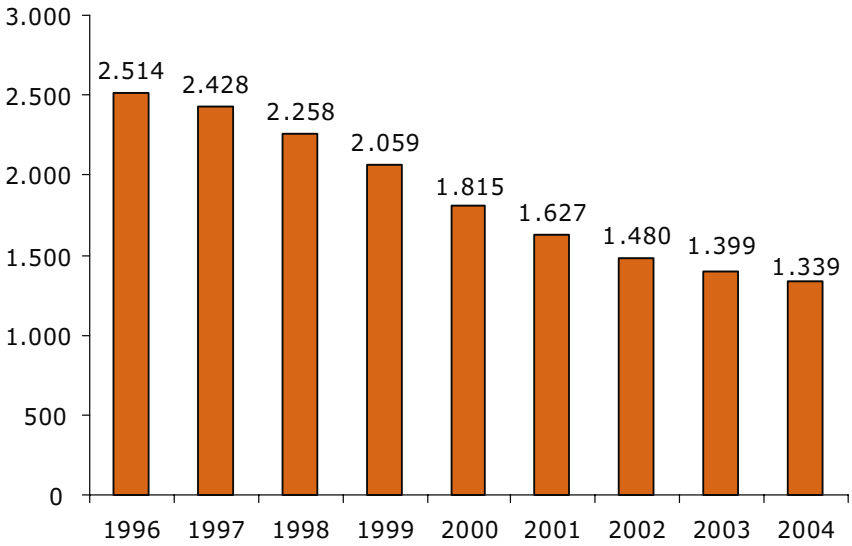
2.3 Cooperative banks

The slight economic recovery in the first half of 2004 has not had a radical impact on the economic situation of the cooperative banks. Many cooperative bank customers are retail customers and SMEs whose business activities are restricted to Germany. However, the positive economic trends were mostly borne by export business. Cooperative banks bundle their strength.

Cooperative banks bundle their strength.

At the end of the year under review, BaFin supervised 1,339 cooperative banks.[76] The number of cooperative banks decreased by 60 as a result of mergers (down 4.3%). The number of residential construction companies accepting savings deposits that are also part of the cooperative bank sector remained constant at 42. The cooperative banking group adhered strictly to its strategy of „bundling strength".

Figure 26
Number of cooperative banks



Cooperative banks reinforce alliances.

Cooperative banks reinforced their alliances within their association during the year under review and made progress in implementing the whole bank controlling system „VR Control". The aim is to use the computer-assisted system in the association to improve the business and risk management for the individual credit institutions and thus to have a positive impact on the earnings position.

[76] This number is limited to primary banks.

Volksbanken and Raiffeisenbanken resolve change to articles of incorporation.

In addition, the Volksbanken and Raiffeisenbanken resolved a crucial change to the articles of incorporation of the Bundesverband der Volksbanken und Raiffeisenbanken (BVR) on 1 December 2004. As a result, in future BVR is to act as the strategic centre for the cooperative banking group. However, the autonomy of the local banks is not to be changed.

Slight improvement to economic situation.

The overall economic situation of the cooperative banks improved slightly year-on-year. In particular, the requirement for loan-loss provisions has fallen in many cases, which has had a positive effect. However, many banks continued to have low operating results, with high costs also being a cause for concern. Reserves and hidden reserves were reversed during the year under review – albeit at a lower level than in 2003 – in order to achieve a balanced result.

BaFin pays particular attention to ensure that the banks discover deficiencies and excessive risks quickly, and that they implement countermeasures without delay. In order to form a detailed picture, BaFin required almost all of the cooperative banks to submit the audit reports for their annual financial statements. In addition, it held a larger number of supervisory talks with managers and supervisory board members in order to obtain up-to-date information on the banks' situation or to counteract deficiencies.

BaFin ordered 151 special audits.

During the year under review, BaFin ordered 151 special audits at cooperative banks. These focused on valuing loan receivables. BaFin had various loan exposures reviewed for impairment by the auditors at 120 credit institutions with a uniform audit mandate. The auditors ascertained whether write-ups or write-downs were required, of if valuation adjustments already formed had to be increased. The risk provisions to be formed in addition by the audited credit institutions were at around the same level as in the previous year. As a rule it was possible to cover these from current income. A further 27 routine audits, mostly conducted by the Bundesbank, were conducted with regard to upholding the minimum requirements for lending and trading transactions. In addition, at four banks, BaFin had concrete reason to take a closer look at specific divisions via a special audit.

The special audits and the evaluation of the auditor's reports for the financial statements resulted in BaFin ascertaining several breaches of the KWG of differing severity. As a result, it introduced a range of regulatory steps. It wrote to 149 cooperative banks as a result of severe breaches. At 34 credit institutions, BaFin warned managers or extended their period of dismissal.

Contributions to guarantee scheme at top level.

During the year under review, the cooperative guarantee scheme again had to deal with a large number of corporate reorganisations. As a result, the contribution rates for 2004 had to be increased to the maximum statutory level. Since the year under review, the associated banks have collected the contributions to the guarantee scheme irrespective of creditworthiness. These total 90%-140% of the respective annual contribution. The guarantee scheme has developed a classification system for creditworthiness ratings.

This is to be used to discover economic shortcomings at an early stage, in order to be able to react in good time. The classification system also aims to help to cut the risk costs in the entire cooperative group.

2.4 Foreign banks

The group of foreign banks offers the entire bandwidth of banking transactions and financial services that require licenses – however they have differing focal points. Their core business is foreign trade finance and corporate customers, retail banking as well as investments and securities trading.

Foreign banks use Outsourcing.

Foreign banks that focus on foreign trade finance and corporate customers continued their path towards consolidation in 2004. In contrast, credit institutions focusing on retail banking were able to continue the excellent results they have enjoyed in previous years. In the securities trading and investments sectors, a clear recovery period could be seen. All of the credit institutions enhanced their efforts to outsource individual parts of their operations – to either their head office or parent company.

European and US large banking groups are repositioning themselves.

Several large banking groups from Europe and the US are working on repositioning themselves in Germany in the asset management and retail banking segments, and they are also working on improving their strategic position. Some groups acquired small and medium-sized private banks for this purpose; others tightened their group structures and launched brand names that they already use to conduct their operations in their countries of origin and other European countries.

During the year under review there was no acute danger situation among the foreign banks; however in one case serious shortcomings in the disclosure of economic circumstances[77] lead to banking supervision activities. In addition, in individual cases BaFin dealt with questions of management. Managing Board members must have suitable professional qualifications and be dependable people, and succession within a company has to be properly regulated. In addition, BaFin pays attention to ensure that the credit institutions implement MaK and that all of the requisite conditions for licenses being awarded were present. BaFin also paid attention to ensure that, in the case of the planned acquisition of equity interests, notices were properly issued ant that the documents required for review were submitted.

Cross-border banking and financial services transactions from Switzerland to Germany

According to section 32 (1) sentence 1 of the KWG, an enterprise from a non EEC state which conducts banking business commercially in Germany or on a scale which requires a commercially orga-

[77] See section 18 of the KWG.

nised business undertaking operations, which wants to conduct banking business or offer financial services, requires a license from BaFin. This license requirement applies in particular if the foreign company wants to set up a branch in Germany or to otherwise offer its services on location, be this via a third-party sales system or – without any presence in Germany – exclusively using long-distance communications.

However, prior to commencing their business operations, companies may apply to BaFin to be exempted from ongoing KWG supervision, to the extent that they are supervised by the supervisory authorities in their home countries according to international standards, and that these authorities work satisfactorily together with BaFin. This exemption is based on section 2 (4) of the KWG.

Based on supervision in Switzerland by the Eidgenössische Bankkommission (EBK), in 2004 BaFin was able to exempt nine Swiss credit institutions with regard to ongoing KWG supervision for their cross-border banking and financial services business. The excellent cooperation despite the complex business allowed rapid and unbureaucratic process.

This has resulted in clear administrative practice for assessing the ability to exempt cross-border business activities by well-supervised credit institutions. As a result, as a rule all banking and financial services transactions can be exempted, with the exception of „financial transfer transactions" for which BaFin does not grant exemptions to prevent money laundering.

2.5 Other private, regional and specialty banks

The development of the 140 private, regional and specialty banks[78] was highly varied during the year under review – depending on their business orientation. The issues which BaFin dealt with in its ongoing supervision of banks in this group were just as wide ranging. They spanned from appointing or objecting to managers through to danger prevention by banning credit and withdrawing licenses and enquiries regarding the acquisition or new formation of credit institutions.

During the year under review, 41 candidates who wanted to become managers of private banks presented themselves to BaFin. After BaFin had checked to ensure that these persons fulfilled the statutory requirements with regard to their personal reliability and professional suitability, it rejected four applicants.

15 severe breaches of supervisory law by managers.

If a manager does not conduct his/her duties in line with statutory requirements, BaFin can impose various types of sanctions: during the year under review it issued 15 notices for severe breaches of supervisory law and pressed for immediate rectification of the situation. In 71 additional cases it wrote to the management as a

[78] Hereinafter collectively referred to as private banks.

result of existing shortcomings in their banks and gathered information when and how the banks worked on rectifying the situation.

To the extent that credit institutions had to implement activities to reinforce their capital base, BaFin paid particular attention to ensure that the funds were also actually available to the banks, or that the guarantors were sufficiently solvent. There were 13 cases of such capitalisation activities in 2004. However, at a few banks the situation developed so negatively, that BaFin at least had to consider danger prevention activities, and also implemented these in a few cases. For example, on one occasion it prohibited the granting of loans, in another case the bank itself declared – after pressure from BaFin – that it would do without issuing credit and accepting deposits. In addition, BaFin appointed three supervisors. It withdrew the license from one credit institute as a last resort. The economic situation at this credit institution deteriorated so much that BaFin had to file for bankruptcy proceedings to be opened.

21 special audits at private banks – focus on lending.

BaFin again ordered special audits within the meaning of section 44 of the KWG during the year under review. These audits are a key instrument to obtain up-to-date information on a bank's individual areas. It ordered 21 special audits at private banks, of which 19 were routine audits, and two were event-specific audits. BaFin employees participated personally in six of these audits. BaFin once again focused on lending business in nine of the audits, and had the organisation of this division, the suitability of loan loss provisions and the valuation of the loan collateral checked. At one credit institution, it obtained an overview of how this bank dealt with credit card business. In five audits, BaFin ensured that the banks upheld the special organisational requirements within the meaning of section 25a of the KWG, i.e., that they had suitable risk management and monitoring and business organisation. If demanded five audits on the subject of Minimum Requirements for the Trading Activities of Credit Institutions. The value of a specific equity participation was to be calculated in one audit.

At one bank, after presentation of the audit report, BaFin was forced to threaten a moratorium to prevent danger. The shareholders of the affected credit institution then provided the requisite funds to defer the moratorium. The credit institution is now being wound up. In another case, the findings during the audit led to BaFin expanding the scope of the audit. As a result of the audit results it also prepared a moratorium. However, it did not have to enforce this. There was already a party interested in acquiring the bank, and BaFin had no doubts as to this party's reliability.

BaFin conducted procedures to assay the ownership of institutions twelve times.

BaFin implemented twelve procedures to assay the ownership or acquisition of institutions. In some cases these were highly extensive as a result of the often complex corporate structure of the interested parties. For some of the investors, the acquisition of equity interests in existing credit institutions is an alternative to forming a new bank from scratch. Of the interested parties who approached BaFin during the year under review because they wanted to form a credit institution, to date none has filed a corresponding application.

Seven persons or companies announced such serious interest in a new formation that BaFin provided them with comprehensive information on the requisite conditions. The five cases in which BaFin issued banks with a license related either to expansions of existing licenses or were required due to a change of legal form. Two managers personally received licenses from BaFin as they wanted to work for credit institutions with the legal form of a limited partnership.

For the first time BaFin issued a license exclusively to conduct e-money business.

An additional licensing process concerned to operating e-money business. Based on an EU directive, legislators in Germany have declared that dealing with e-money constitutes banking business which requires a license. This includes issuing and managing electronic money, which means value units in the form of receivables from the respective e-money institution. These are stored on electronic data storage devices – mostly after non-cash payments. The e-money balance can then be used via a mobile telephone or with a click of the mouse in the Internet to pay for services from third parties who accept e-money in payment.

This is the first time that BaFin has issued a company specialising in e-money in Germany with a banking license to operate this branch of business. As this type of payment transaction service is already wide-spread in foreign countries, BaFin believes that further applications for the issue of a corresponding license will follow.

134 supervisory consultations of high importance.

BaFin attaches particular value to direct contact with banks: it held 134 supervisory consultations in the year under review with representatives of private, regional, and specialty banks. In so doing, it discussed, for example, shortcomings at the credit institutions, and demanded that the management face up to these issues. BaFin also gained an overview of ongoing or planned projects in the banks, for example the introduction of internal rating systems that satisfy the requirements of Basel II. As some private banks are also pilot participants in the „internal rating" project in the Bundesverband Deutscher Banken (German Federal Bank Association), BaFin also included this interesting topic in its agenda at nine visits.

2.6 Building societies

At the end of the year under review, BaFin supervised 16 private building societies and eleven regional building societies. There was no change year-on-year.

Building societies have high liquidity.

In the past, the sustained low interest rates on the capital markets have led to comparably attractive interest for home loan savings balances. In contrast, interest rates for mortgage savings loans are not so attractive. As a result of this, home loan saving deposits grew strongly, whereas demand for mortgage savings loans was comparatively sluggish. Building societies invested the corresponding high liquidity to generate income for pre- and interim financing for mortgage savings loans or in fixed-interest securities. In order to combat the tendency of regarding home-loan savings as a

pure investment, building societies have now adapted their tariffs to the low interest rates. At the same time they created incentives for home-loan savers to use mortgage savings loans to a greater extent. In so doing the building societies also combated the danger of no longer earning sufficiently high income. The ratio of home loan saving deposits and mortgage savings loans, the so-called degree of investment, was quite low at an average figure of less than 50% during the year under review. New business was at a high level again this year, after having reached a record-breaking level in 2003.

Rate approval process to be further optimised.

The building societies rates are approved by BaFin. The assessment process for rate approval was changed in 2003. The feasibility of a rate – a key factor for approval – must be verified using forecasts.
BaFin is currently in discussions with the industry with regard to the extent to which the rate approval process can be further optimised.

BaFin demanded three special audits.

In total, BaFin ordered special audits for three building societies. In addition, the deposit guarantee scheme – Entschädigungseinrichtung Deutscher Banken GmbH – audited two building societies. These audits did not reveal any substantial deficiencies.

2.7 Mortgage banks

Process of consolidation in previous years did not continue in 2004.

At the end of the year, as in the previous year, BaFin supervised 20 mortgage banks and two ship mortgage banks. The process of consolidation observed in previous years thus did not continue in 2004. However, there are likely to be further mergers as a result of the replacement of the Mortgage and Ship Mortgage Bank Act with the Pfandbrief Act in mid-2005. The discontinuation of the special bank principle means that in future it will be possible for all of the banks – after the acquisition of an underwriting license – to issue Pfandbriefe. All in all, it is thus expected that the group of Pfandbrief issuers will become more heterogeneous when new players join the field.

Market environment in the primary fields of business for mortgage banks continues to be difficult.

The market environment in the primary fields of business for mortgage banks continued to be difficult in 2004. A fundamental recovery of the domestic real estate sector mostly failed to materialise last year – with a few regional exceptions. In particular the number of new commitments for residential mortgages in Germany declined. The affected credit institutions stated key reasons being the likes of the reduction in the Eigenheimzulage (tax benefits for home owners) and the fear of unemployment. Last but not least, several credit institutions had to once again make extraordinary high write-downs as a result of the low economic dynamism in Germany. In addition, the mortgage banks were subject to high competitive pressure, which had a negative impact on the margins they could achieve. In contrast, there was almost no need to make write-downs for foreign business.

The credit institutions significantly expanded public sector lending during the year under review. In so doing, the companies exhibited a greater level of activity abroad. This can be put down to unsatisfactory margins in Germany. It was mostly only possible to generate profits in Germany with non-congruent re-financing with interest rate risks. In contrast, in foreign countries, the margins that could be achieved were higher. However, they also came under pressure abroad – not least due to the increased presence of German credit institutions.

As a result of the pressure on margins in primary areas of business, credit institutions have been paying greater attention to costs. Whereas the average total administrative expenses remained almost unchanged for all credit institutions, the number of employees fell – above all in the large credit institutions. All in all, the credit institutions specialising in public sector lending enjoy clear cost leadership, as issuing real estate loans goes hand in hand with significantly higher expenses.

BaFin ordered audits for cover assets at seven credit institutions.

BaFin ordered an audit for the cover of assets within the meaning of section 44 of the KWG for seven credit institutions to review the cover assets for mortgage-backed bonds and public-sector Pfandbriefe. BaFin conducted three of the audits itself and outsourced four to external auditors. These audits did not result in severe breaches of supervisory law that would have endangered the security of the cover pool. Violations of the cover provisions of the German Commercial Code were ascertained in individual cases and, in a few cases, also brought with them the revision of individual cover assets, however this did not have any impact on the value of the cover pool. During the year under review the Mortgage Pfandbrief Cash Value Ordinance made an impact for the first time to further increase the security of the cover pool. In addition, at two credit institutions, BaFin conducted checks to ensure that these upheld the requirements of MaH. A further audit at one credit institution related to upholding the requirements of MaK. These did not result in any severe breaches of supervisory law.

2.8 Securities trading banks, brokers and electricity traders

Weak turnover and technical change impact securities trading banks and brokers.

Four years after the equities bubble burst, business growth at securities trading banks and brokers was still suffering from private investors' reserved purchasing behaviour. The weak private turnover and the continuing technical change in the stock-market environment continued to impact the credit institutions. The credit institutions reacted with rationalisation and restructuring measures. Some of them restricted their business activities, for example by ceasing to manage accounts or by specialising in equity or bond trading.

Restructuring and rationalisation measures show their impact.

At the end of 2004 it could be seen that efforts by many credit institutions and the slight recovery of the markets were taking effect.

During the year under review, BaFin ordered four special audits. These were used to review whether the credit institutions properly processed their trading transactions and if they had set up functioning risk-control processes. These audits did not reveal any severe deficiencies.

Banking supervision measures were required at three credit institutions, as their capitalisation was not sufficient. BaFin had to withdraw the license from one securities trading bank. This bank is now involved in insolvency proceedings. A further securities trading bank returned its license voluntarily, thus avoiding impoundment.

In addition, one securities trading bank and eight brokerage companies discontinued business with customers. In these cases, other credit institutions have taken over their business.

However, despite the difficult economic climate new credit institutions have joined the fray. BaFin has issued two companies with licenses as securities trading banks.

All in all, BaFin supervised 38 securities trading banks and 29 brokers at the end of the year under review.

In addition, six electricity traders were subject to BaFin supervision. Electricity traders are credit institutions that provide banking business or financial services with electricity derivatives. Five of these companies that had already received a license in 2003, commenced their business during the year under review. Prior to this, BaFin had announced special regulations for equity requirements; these take into account the special nature of commodity wholesale.

2.9 Financial services providers

BaFin supervised 806 financial services institutions.

As of 31 December 2004, BaFin supervised 806 financial services institutions (2003: 773). 3,316 freelance employees of these credit institutions, who have assumed liability for these credit institutions, were indirectly supervised by BaFin.

BaFin issued three new licenses for financial transfer business.

In 2004, BaFin issued three people or companies with licenses to conduct financial transfer business. Many additional interested parties gathered information on the requirements for licensing.

Merger of market and solvency supervision for financial services institutions.

The merger of market and solvency supervision for financial services institutions in the Frankfurt office means that credit institutions have one point of contact for both areas of supervision. This partner can then gain a comprehensive picture of the credit institution. Solvency supervision will only continue to be provided from the Bonn office for credit institutions which provide financial services with electricity derivative, that act on their own account with financial instruments or that are authorised to obtain ownership or possession of money or securities from customers during the provision of financial services.

Seven special audits within the meaning of section 44 of the KWG.

During the year under review, BaFin ordered seven special audits at financial services institutions. In one case, it had reason to believe that the credit institution had outsourced the management of financial portfolios to an administrator who does not have the requisite license. The special audits were conducted by employees of BaFin and Deutsche Bundesbank simultaneously at several locations; the evaluation has not yet been concluded.

One financial services institution regularly violated the requirements stipulated by KWG. BaFin has already warned the parties responsible at this credit institution according to section 36 (2) of the KWG. At a subsequent special audit, BaFin reviewed whether the company's organisational structure fulfilled the requirements for the notification and external reporting system and the submission requirements. In addition, it also checked to ensure how the sales employees are linked to the organisation, and how the company controls this.

Intensive cooperation between BaFin and Bundesbank.

In addition to the special audits, in 2004 BaFin conducted 120 supervisory consultations with responsible parties at the supervised financial services institutions. Concrete supervisory law issues and problems were discussed during these consultations. As a rule, BaFin and Bundesbank jointly conduct these supervisory consultations. In addition, both institutions have further reinforced their cooperation. In addition to regular meetings, in November 2004 for the first time there was a two-day joint exchange of experience on the supervision of financial services providers.

3 Ongoing market supervision

3.1 Credit institutions and financial services institutions

Monitoring of audits by BaFin employees.

BaFin monitored 120 audits at credit institutions and financial services institutions in these institutions offices.

BaFin conducted eight special audits within the meaning of section 35 of the WpHG.

During the year under review, BaFin conducted eight special audits at credit institutions and financial services institutions within the meaning of section 35 (1) of the WpHG with various focal points. Special audits can be conducted with no specific reason. However, there are often reasons to believe that regulatory provisions have been breached. During the year under review, credit institutions increasingly pursued the target of expanding their retail capabilities and increased their sales activities. The stronger focus on the sales result can be detrimental to the customers' interests.

In one case, BaFin pursued information that a credit institution's sales activities were not always in line with its customers' interests. Bank employees are often faced with a conflict between upholding the bank's interests and the interests of its customers.

Banks often have ambitious sales targets for individual employees, and controlling their success heightens the existing conflict of interests. Each type of product also carries different opportunities for earnings, which also heightens this conflict. This conflict situation and the sales pressure can lead to customers' interests not always being adequately taken into account during advisory consultations. BaFin obtained a deeper insight into sales control and the sales process in a special audit. The special audit confirmed that the bank's employees are clearly in a conflict situation between upholding the bank's interests and customer interests. The credit institution will take measures to improve how conflicts of interests are dealt with. BaFin will support this process.

BaFin expects that one credit institution's measures to uphold customer's interests are already being used in advisory consultations. The subsequent control of advisory performance is also crucial. For example, some banks implement transaction monitoring, which allows the compliance office or the internal audit department to make specific enquiries into conspicuous transactions.

In one case, one financial services institution was suspected of churning. Churning is the frequent turnover of the customer's managed portfolio to increase commission. The special audit confirmed this for a large number of customers. Regulatory activities have been taken against this financial services institution.

A further special audit at a financial services institution was undertaken due to information about breaches of the law. The special audit already proved at the institution's offices that the institution was selling equities for which no offering prospectus had been deposited. The further results of the special audit are currently being evaluated.

At another financial services institution, BaFin conducted a special audit due to the suspicion of cold calling. Investment firms are forbidden from contacting customers by telephone unless there is already a business relationship with these customers with regard to securities services.[79] This does not apply if the potential customer has issued their permission to be called prior to the first telephone contact. In addition, doubts were cast regarding whether the institution always provided its securities service in the customers' interests and if it provided the customer with all of the information required for this purpose, in particular regarding existing conflicts of interests. The institution brokered financial instruments for young companies, for whom an IPO was intended but for whom business activities often ended in bankruptcy. The suspicion of illegal cold calling was confirmed at the institution's offices. The lacking information to customers regarding existing conflicts of interests was also confirmed. Responsible parties at the institution held significant interests in the issuers for whom the bank had sold shares. The investors should have been informed of these circumstances, as it can lead to a conflict of interests at the institution.

[79] General instruction (Allgemeinverfügung) within the meaning of section 36b (1) and (2) of the WpHG with regard to advertising using cold calling dated 27.07.1999.

BaFin conducted a further special audit at a financial services institution managed as a sole proprietorship. In this case there were pointers to a large number of violations which cast doubt on the managing director's reliability. In addition, there were customer complaints about possible violations of good behaviour rules. The auditors findings are expected to justify regulatory measures. The evaluation of the results of the audit had not been completed by the end of the year under review.

In addition, BaFin conducted a special audit at an investment services company, and at the same time at its foreign branch. This audit was conducted in close cooperation with the foreign supervisory authority. The audit covered possible actions going beyond the company's license, as well as shortcomings in monthly disclosures and annual financial statements as well as the outsourcing of activities. The company has a license for investment broking. However, there was reason to believe that it was also managing portfolios. The company performed the bulk of its business activities abroad, where it earned 90-95% of its income. The results of the audit have mostly confirmed the suspicions which gave rise to the special audit. Regulatory measures are currently being prepared.

All in all, it can be seen that special audits within the meaning of section 35 of the WpHG are an effective supervisory tool to uncover shortcomings for financial services.

BaFin participated in a search conducted by the police criminal investigation department at a financial services institution.

In November 2004 the police criminal investigation department searched the offices of a financial services institution subject to supervision by BaFin. The investigation was ordered as part of investigations by the public prosecutor's office. The managing director and the shareholders as well as individual employees at the institute were suspected of fraud by churning. Two of BaFin's employees participated in the search. BaFin's participation was beneficial for both parties, as it allowed information to be exchanged and the further proceedings to be planned.

BaFin exempted 219 credit institutions and financial services institutions from the annual audit requirement.

In 2004, BaFin exempted 219 credit institutions and financial services institutions from the requirement to implement an annual audit within the meaning of section 36 (1) of the WpHG. It rejected six applications, 29 applications were withdrawn. In addition, BaFin exempted 143 credit institutions from audits under the German Deposit Act. Nine credit institutions withdrew their application for exemption from deposit audits.

3.2 Rules of conduct for the analysis of financial instruments

Rules of conduct for the analysis of financial instruments.

As information intermediaries, analysts on securities markets make a major contribution for investors. Their activities are not only important for how the securities markets function, but also for investor protection. As they have to select and prepare information during the course of their work, it is crucial for investors to be able to

rely on the independent nature and quality of the analysis. In turn, this trust is a must-have condition for markets that function smoothly. High demands for integrity and transparency are key criteria in this regard. Analysts often work internationally and require international rules. This is taken into account in the work of IOSC0[80] and the implementation of the market abuse directive[81] and the directive for markets in financial instruments.[82] In reaction to existing shortcomings, BaFin has been monitoring competence and transparency requirements for investment recommendations within the meaning of section 34b of the WpHG since 2002.

Audits

At the end of 2004, BaFin supervised 360 credit institutions and financial services institutions that use and publish their own or third-party analyses. In addition to supervisory inspections and audit monitoring, the annual audit reports provided key information on whether the analyses had been prepared in a careful, professional and conscientious manner and if potential conflicts of interests were disclosed. During the year under review, BaFin ascertained organisational shortcomings at some institutions regarding how they dealt with conflicts of interest. The institutions also did not always uphold the requirement to identify and disclose possible conflicts of interest. As a result, BaFin's audits thus focused on how the credit institutions and financial services institutions identified the necessary information on possible conflicts of interests. A further audit focus was on how the institutions dealt with the media and the disclosure of possible conflicts of interests to the media. Last year, BaFin held talks with media associations and the affected industry circles.

Supervisory focus

Problems with the international dissemination of analyses.

In particular subsidiaries and branches of foreign companies that are included in the group-wide preparation of analyses had difficulties upholding the disclosure requirements. As a result of differing statutory requirements in other countries, these institutions were often not able to uphold the requirements that apply in Germany. As a rule, they were geared towards the provisions which apply in the company in which the group's parent company has its registered office. BaFin informed the affected institutions that the requirements under section 34b of the WpHG must also be upheld if securities analyses by foreign companies are made accessible to customers in Germany.

Independence of analysts is essential.

The independence of analysts is of key importance of the credibility and integrity of the capital markets. Excessive influence on analysts by issuers, institutional investors and third parties must also be prevented. This demands particular sensitivity by all market players. In 2004, BaFin clearly stated that accepting travel and accommodation costs for analysts' conferences must be rejected, just

[80] "Statement of Principles for Addressing Sell-Side Securities Conflicts of Interest", September 2003.
[81] DIR 2003/6/EC; OJ EU No. L 96/16.
[82] DIR 2004/39/EC; OJ EU No. L 145/1.

as presents from the issuers. The rules of conduct for the analysts' associations also include this ban.

Possible conflict of interests for analysis and issuing activities.

BaFin watched with interest how credit institutions which supported one of the few IPOs and assumed the selling risk for the securities dealt with possible conflicts of interest. The duties of the syndicate banks as part of an IPO include the preparation of research to approach potential investors in addition to valuing the company. Conflicts of interest could arise for the syndicate bank from its position as an intermediary between the issuer and the potential investors. The issuer wants to achieve the highest possible proceeds from the issue, whereas investors want to subscribe at the lowest price. Syndicate banks, in particular their analysts, are caught between these two extremes. This conflict of interests is due to the institutions' structure and cannot be avoided. However, the syndicate bank must ensure using suitable organisational activities that its own analysts can perform an unbiased analysis of the issuer or the securities to be issued. One possible measure is to set up and separate areas of non-disclosure (so-called Chinese walls), for example a strict split between the analysts that conduct valuations on behalf of issuers, and the analysts that conduct research for investors.

Increased requirements from the Anlegerschutzverbesserungsgesetz (Act on the Improvement of Investor Protection)

Requirements now also for freelance analysts.

The requirements of section 34b of the WpHG now apply to all natural persons and legal entities which create financial analyses in exercising their profession or as part of their business activities and make these accessible to others or publicly disseminate these. This means that financial analyses prepared by freelance analysts or issuers are now also covered by the scope of the regulation.

In addition, there are increased requirements for the avoidance or disclosure of existing own interests or possible conflicts of interests. For example, in financial analyses, facts must be kept separate from opinions, estimates and other non-factual information. All forecasts must be clearly marked as such, and the key assumptions on which these are based must be stated. Attention must be paid to ensure that all sources used by the author are reliable. In cases of doubt, this must be clearly stated. There are additional requirements for presentation for investment firms. All sources must be stated and the methods applied and recommendation categories have to be discussed. All possible own interests or conflicts of interests of both the author of the analysis as well as the investment firm must be disclosed. The Regulation concerning the Analysis of Financial Instruments which came into effect at the end of 2004 contains more detailed stipulations.

32 natural persons or legal entities reported themselves to BaFin.

Persons who are responsible for the preparation of financial analyses or their dissemination as part of their professional activities or their business activities have to report themselves to BaFin. This makes it easier for BaFin to recognise the natural persons and legal entities to be supervised. Securities investment firms, capital

investment firms and investment equities firms do not have to report themselves, as these are already regulated by BaFin. The individual analysts employed by a company with a reporting requirement are not covered by the reporting requirement, and neither are journalists, who are subject to comparable self-regulation. The report must include structural conflicts of interest that are not related to individual financial instruments, for example as a result of links with other credit institutions or financial services institutions. To the extent that the information included in the report changes, this must be updated within four weeks. By the end of 2004, 32 natural persons or legal entities had reported themselves. BaFin can demand information and documents and has the right to conduct special audits.

Dr. Thomas Steffen,
Chief Executive Director
of Insurance Supervision

IV Supervision of insurance undertakings and pension funds

1 Basis for supervision

1.1 Authorised insurers and pension funds

BaFin supervised 659 Insurers.

In 2004, the number of insurance undertakings under federal supervision was reduced by nine to 659. Of these insurers, 632 are active (business operations) while 27 are inactive. The data of the public law insurance undertakings under supervision at state level (nine active and two inactive) are included in the description of business trends 2004. In the period under review, the number of pension funds increased by one to 24. This can be broken down by sector using the following table:

Table 8
Number of insurance undertakings (IUs) and pension funds under supervision[83]
(Figures from the previous year in brackets)

	Active IUs			Inactive IUs*
	Federal supervision	State supervision	Total	
Life IUs	105 (106)	3 (3)	108 (109)	11 (10)
Pensionskassen	157 (157)	0 (0)	157 (157)	0 (1)
Death benefit funds	41 (43)	0 (0)	41 (45)	2 (2)
Health IUs	54 (54)	0 (0)	54 (54)	0 (1)
Property/casualty IUs	231 (235)	6 (6)	237 (241)	10 (10)
Reinsurance IUs	44 (45)	0 (0)	44 (45)	6 (4)
Total	**632 (640)**	**9 (9)**	**641 (649)**	**29 (28)**
Pension funds	24 (23)	0 (0)	24 (23)	0 (0)

* under federal and state supervision

Commencement of insurance business

Life insurers

In the year under review, BaFin authorised one public limited company to conduct life insurance business. In addition, two new branches of foreign life insurers from the EU were established in Germany. One is a British company, the other from Luxembourg.

As in the previous year, eleven foreign life insurers from EU countries registered to provide services within Germany (s. Table 9).

Table 9
Life insurers from the EEA

Great Britain	4
Ireland	2
Belgium	1
Liechtenstein	1
Luxembourg	1
The Netherlands	1
Spain	1

[83] The mostly regionally active smaller mutual insurance associations under state supervision are not included (also see Annual Report 2003 Part B, Table 5).

Table 10
Property / casualty insurers from the EEA

Ireland	10
Great Britain	7
of which Gibraltar	2
France	4
Sweden	4
Belgium	3
Czech Republic	3
The Netherlands	2
Austria	2
Denmark	1
Finland	1
Iceland	1
Italy	1
Liechtenstein	1
Norway	1
Poland	1
Portugal	1
Spain	1
Hungary	1

Property / Casualty insurers

In 2004, BaFin authorised one public limited company to start conducting property and casualty insurance business. A mutual insurance association under state supervision has been under federal supervision starting in 2004.

Four branches of foreign property / casualty insurers from EU countries were newly established, three from Great Britain and one from Ireland.

In the year under review, 45 insurance undertakings from the EEA (previous year: 37) were registered to provide services in Germany.

Furthermore, insurance undertakings previously authorised to provide services also registered expansions of their business operations. The provision of compulsory insurances remains marginal. In 2004 as well, a number of insurers discontinued services operations in Germany.

Reinsurers

In 2004, three undertakings began conducting reinsurance business; two of the procedures were part of restructuring measures.

Pensionskassen and pension funds

In the year under review, BaFin authorised three Pensionskassen (one public limited company and two mutual insurance associations) and one pension fund (public limited company) to conduct business.

1.2 Interim reporting

Since the financial year 1995, insurance undertakings have been reporting selected accounting and portfolio data to BaFin, or its predecessor BAV on a quarterly basis. Experience with the data from the financial years 1995 to 2003 shows that partly due to systematic reasons, the preliminary figures often vary from the final figures. Consequently, the preliminary figures 2004 were compared to the preliminary figures 2003. In the area of property / casualty insurance, BaFin attempts to project the final data for 2004 based on the ratio between the preliminary figures and the final figures for 1999 to 2003.

1.2.1 Business trend

Life insurance undertakings

New business increased to 11.6 million new contracts.

In the area of direct life insurance, new business (i.e. policies with the first premium paid) increased from 8.4 million to 11.6 million new contracts and is now above the previous years' level. The rea-

son for this was the increase in new business in the area of "traditional" endowment insurance and retirement savings plans and other life insurance, with a drop in the area of term insurance. At the same time, the underwritten amount of new insurance policies grew by 31.3% to €322.6 billion (previous year: €245.7 billion).

The share of endowment insurance as a proportion of new contracts increased from 27.0 to 30.4%. Term insurance accounted for 20.4% (previous year: 31.2%), while the proportion of retirement savings plans and other life insurance increased from 41.7 to 49.2%. The share of endowment insurance as a proportion of the underwritten amount of new insurance increased slightly from 22.2 to 22.6%. Term insurance decreased to 23.6% from the previous year's level of 30.7%, while the proportion of retirement savings plans and other life insurance went up from 47.1 to 53.8%.

3.9 million contracts were terminated early (surrender, conversion into paid-up policies and other early withdrawal) compared to 3.5 million contracts in the previous year. The underwritten amount of such early withdrawals increased by 0.8% to €113.6 billion. In the area of term insurance, early withdrawals increased at an above-average rate of 19.4% in terms of the number and 9.1% in terms of the underwritten amount.

Total life insurance portfolio increased to 94.6 million contracts.

As a whole, direct life insurance business totalled 94.6 million contracts (+3.5%) at the end of 2004. The underwritten amount was €2,293.1 billion (+7.2%). The proportion attributable to endowment insurance continued its downward trend: the number of contracts fell from 59.0 to 56.9%, with the underwritten amount down to 47.3% from 50.8%. The annuity insurance portion remained almost constant at 15.7% and 19.4% respectively. The retirement savings plans and other life insurances accounted for 27.4% (previous year: 24.5%) in terms of the number of contracts and for 33.3% (previous year: 29.6%) in terms of the underwritten amount.

Gross premiums written in direct insurance business were up 1.2% to €68.0 billion.

Health insurance undertakings

Written gross premiums increased to €26.4 billion.

Gross premiums written in direct health insurance business in 2004 were up 6.7% to €26.4 billion (previous year: +7.2%). Payouts for insurance claims incurred in 2004 and the previous financial years increased by 3.8% (previous year: +4.1%) to €15.7 billion. Thus, just like in the previous year, the rate of increase for all claim payments was lower than the rate of premium growth.

Property and casualty insurance undertakings

Written gross premiums increased to €58.6 million.

Compared to 2003, in 2004, the property and casualty insurers saw an increase in written gross premiums by 1.4% to €58.6 billion in the direct insurance business.

Gross claims payments from the financial year dropped by 3.0% (previous year: -11.9%) to €19.2 billion, while gross claims payments from previous years decreased by 10.6% (previous year: +9.6%) to €13.7 billion. Gross provisions relating to individual insurance claims from the financial year were created similar to the previous year with €14.0 billion; gross provisions relating to individual insurance claims from previous years were up 1.8% (previous year: +4.4%) to €42.1 billion.

The largest area by far was motor vehicle insurance, with gross premiums written totalling €22.5 billion. This represents an increase of 0.6% (2003: +2.3%). Total gross payouts for insurance claims from the financial year were down 2.6%, and payments made for previous year's claims fell by 1.3%. Gross provisions relating to individual insurance claims from the financial year increased by 0.9%, after a 3.3% decline in the previous year; gross provisions for individual claims outstanding from previous years were up 5.3% (previous year: +2.1%).

In the area of general liability insurance, the insurers received €7.3 billion in premiums (+3.8%). For insurance claims from the financial year, 5.0% less were paid out, for insurance claims from previous years 1.1% more. The gross provisions relating to individual insurance claims, particularly important for this insurance class, increased by 5.2% with regard to outstanding claims from the financial year and by 6.7% with regard to outstanding claims from previous years.

In fire insurance, the undertakings had gross premiums written of €2.1 billion, same as in the previous year. The number of contracts fell by 3.0% (previous year: -4.2%). Gross payments for financial year claims decreased by 11.1%, gross provisions relating to individual insurance claims from the financial year decreased by 12.2%. For insurance claims from previous years, 16.8% less were paid out than in 2003, with provisions down 6.3% from previous year's level.

Viewed together, comprehensive residential buildings insurance and comprehensive household insurance generated premiums of €6.3 billion (+1.5%). Payments for insurance claims from the financial year as well as the provisions remained at 2003 level, while payments for insurance claims from previous years decreased by 30.2% (previous year: +47.7%). The provisions for insurance claims from previous years fell accordingly by 9.7% in comparison with 2003 (previous year: +15.9%).

Premiums written in general accident insurance amounted to €5.9 billion (+2.9%). Gross claims payments from the financial year increased by 2.8%, gross claims payments from previous years by 4.2%. Gross provisions relating to individual insurance claims outstanding from the financial year increased by 7.7%, while gross provisions from previous years increased by 9.0%.

Extrapolation for the Financial Year 2004

As in previous years, BaFin endeavoured to project the final figures for 2004 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 order to determine the evaluated results, the ratio between fourth quarter figures and the final results 1999 to 2003 is calculated and applied to the quarterly figures 2004. This simple methodology does not produce exact projections such as election forecasts, 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.

Total direct business is likely to account for gross premiums earned of €58.6 billion compared to 58.0 in 2003. Payouts for financial years claims are projected to total €41.5 billion (previous year: €42.6 billion) with a settlement result of €2.9 billion (previous year: €4.9 billion). Total claims expenditure will thus increase from €37.7 billion to €38.6 billion, with the claims ratio rising from 65.0 to 65.9%. The expense ratio of 26.3% will be slightly higher than previous year's expense ratio. Taking into account other underwriting items, the gross underwriting result will improve to a surplus of €3.8 billion.

The following table details the projections:

Table 11
Extrapolation for the Financial Year 2004

Billion €	Total direct insurance business		Accident insurance		General liability insurance		Motor vehicle insurance		Fire insurance		Comprehensive household and residential buildings insurance	
	2004 (estimate)	2003	2004 (estimate)	2003	2004 (estimate)	2003	2004 (estimate)	2003	2004 (estimate)	2003	2004 (estimate)	2003
Gross premiums earned	58,6	58,0	5,9	5,7	7,3	7,1	22,6	22,3	2,1	2,1	6,3	6,2
Expenses for financial year claims	41,5	42,6	2,7	2,5	5,0	5,0	19,7	19,6	1,1	1,3	4,2	4,2
Settlement result	-2,9	-4,9	-0,7	-0,5	-0,3	-0,7	-1,3	-2,0	-0,3	-0,2	0,1	-0,3
Gross claims expenditure	38,6	37,7	2,0	2,0	4,7	4,3	18,5	17,6	0,9	1,1	4,2	3,9
Gross administrative expenditure	15,4	15,0	2,1	2,1	2,3	2,3	4,0	3,9	0,6	0,6	2,2	2,1
Gross balance of other underwriting items	0,9	1,3	0,7	0,8	0,0	0,0	0,0	0,0	0,1	0,1	0,1	0,1
Gross underwriting result (before premium refunds)	3,8	4,0	1,1	0,9	0,3	0,5	0,2	0,9	0,5	0,3	-0,2	0,0
Claims ratio (in %)	65,9	65,0	33,5	34,4	64,3	60,9	81,6	78,9	43,0	52,6	67,5	63,7
Expense ratio (in %)	26,3	25,9	36,4	36,3	31,8	32,1	17,6	17,3	27,4	27,6	34,5	34,1
Gross profit ratio (in %)	6,4	7,0	18,8	15,3	3,9	6,9	0,9	4,0	23,4	13,0	-3,7	0,5

1.2.2 Investments

Total insurers' investments increased by 3.1% to €1,092.1 billion.

For the sector as a whole, total investments increased by 3.1% in 2003 (previous year: +5.4%) to €1,092.1 billion (previous year: €1,059.5 billion). The proportion of properties continued to fall from 2.4 to 2.2%, while the book value of property investments

decreased by 3.9%. The book value of shares in affiliated companies declined by 2.8%. The proportion of the entire investment portfolio was at 10.4%. Following an 8.8% decline in 2003, the book value of directly held shares decreased by 14.0%. The already small proportion of shares in relation to total investments continued to fall to 1.4%, from 1.7% in 2003. Investments in fund units decreased by 1.5% (previous year: +2.8%); their proportion in total investments dropped from 22.2 to 21.1%. The book value of bearer bonds increased by 8.2% (previous year: +22.2%); with their proportion in total investments rising from 9.7 to 10.2%. Notes receivable, which are "write-off-proof" by virtue of their valuation at par, increased by 18.5% (previous year: +12.9%) and thus continued to grow as a share of total investments from 17.3 to 19.9%. The growth in total investments for health insurance undertakings, property and casualty insurers and Pensionskassen was above average (+3.1%). Conversely, investment growth was below average for life insurers and death benefit funds. Investments for reinsurance undertakings decreased, as in this class the number of disposals of investments was higher than the number of additions. The considerable increase in investments for health insurance undertakings is attributable to the statutory requirement to build up reserves from surplus in order to lower premium increases after retirement.

Please see the following table for details:

Table 12
Investments 2004

Total investments by insurance undertakings	Balance as of 1 January 2004		Additions in 2004		Balance as of 31 December 2004		Changes in 2004	
	in million €	in %	in million €	in %	in million €	in %	in million €	in %
Real property, equivalent rights and buildings	24,900	2.4	2,053	0.6	23,921	2.2	-979	-3.9
Shares in affiliated companies	117,325	11.1	9,725	2.8	114,094	10.4	-3,231	-2.8
Loans to affiliated companies	19,381	1.8	8,871	2.6	19,020	1.7	-361	-1.9
Participating interests	17,297	1.6	2,487	0.7	13,350	1.2	-3,947	-22.8
Loans to companies in which a participating interest is held	4,729	0.4	1,685	0.5	5,250	0.5	+521	+11.0
Shares	18,114	1.7	12,046	3.5	15,580	1.4	-2,534	-14.0
Fund units	235,574	22.2	45,126	13.0	232,005	21.2	-3,569	-1.5
Other variable yield securities	4,986	0.5	1,060	0.3	4,485	0.4	-501	-10.0
Bearer bonds and other fixed-interest securities	103,131	9.7	98,919	28.5	111,590	10.2	+8,459	+8.2
Mortgages	73,053	6.9	7,110	2.0	71,051	6.5	-2,002	-2.7
Registered bonds	216,051	20.4	49,637	14.3	226,319	20.7	+10,268	+4.8
Debt certificates and loans	182,964	17.3	74,227	21.4	216,808	19.9	+33,844	+18.5
Loans and prepayments on insurance certificates	5,515	0.5	1,999	0.6	5,721	0.5	+206	+3.7
Other loans	9,834	0.9	1,351	0.4	9,664	0.9	-170	-1.7
Deposits with credit institutions	23,449	2.2	30,072	8.7	20,414	1.9	-3,035	-12.9
Other investments	3,017	0.3	953	0.3	2,850	0.3	-167	-5.5
Total investments	1,059,319	100.0	347,321	100.0	1,092,121	100.0	+32,802	+3.1
Life IU	609,437	57.5	186,182	53.6	626,408	57.4	+16,971	+2.8
Pensionskassen	**75,449**	**7.1**	**26,328**	**7.6**	**80,068**	**7.3**	**+4,619**	**+6.1**
Death benefit funds	1,481	0.1	410	0.1	1,525	0.1	+44	+3.0
Health IU	97,857	9.2	26,500	7.6	108,119	9.9	+10,262	+10.5
Property / casualty IU	108,458	10.2	51,909	14.9	116,784	10.7	+8,326	+7.7
Reinsurance IU	166,637	15.7	55,993	16.1	159,217	14.6	-7,420	-4.5
All IU	**1,059,319**	**100.0**	**347,321**	**100.0**	**1,092,121**	**100.0**	**+32,802**	**+3.1**

1.3 2004 Amendment to the Insurance Supervision Act

In December 2004, the German legislator amended the Insurance Supervision Act.[84] With the Amendment to the Insurance Supervision Act 2004, the preparatory work for which BaFin was involved in, the legislator introduced guarantee funds for life insurances and private health insurances. The supervision of reinsurance undertakings was expanded and the supervision of insurance holding companies was reintroduced. Other important innovations regard the competence of the regulatory authority to engage a special commissioner or to warn managing directors.

The purpose of the amendment of the Insurance Supervision Act 2004 is the improvement of consumer protection and enforcement of Germany's position as a financial centre. Furthermore, the legislation specified BaFin's competences and - insofar as this was necessary based on the last few years' experience - extended them. The latter is especially true of preventive competences of the regulatory authority.

[84] Law amending VAG and other laws (Gesetz zur Änderung des VAG und anderer Gesetze) , BGBl 2004 I, p. 3610.

Guarantee funds for life insurance and private health Insurance

Guarantee funds improve consumer protection.

For the first time in history, legislature determined legal regulations concerning guarantee funds in the area of life and health insurance.[85] In this area, the insolvency of an insurance undertaking would be especially detrimental for insured persons, as the termination of the contracts in connection with insolvency could mean a permanent loss of insurance cover for many policy holders. Older persons holding a health insurance or persons fallen ill in the mean time would hardly have any chance of concluding a new contract with reasonable conditions. In the case of many persons holding a life insurance policy, the third pillar of retirement provision would be unhinged. Unlike the guarantee facilities in the banking sector, the guarantee funds regulated by the Insurance Supervision Act aim at the continuation of the contracts of destitute insurers. They protect the rights of policy holders, insured persons, beneficiaries and other persons benefiting from the insurance contract.

Compulsory membership in guarantee funds.

All undertakings authorised to do business in the insurance classes 19 to 23 (life insurance undertakings) or in substitutive health insurance[86] (health insurance undertakings) must be members in a guarantee fund. Retirement and death benefit funds are excluded. However, Pensionskassen can join a guarantee fund voluntarily in accordance with section 124 (2) of the Insurance Supervision Act. Pension funds on the other hand are not required to be excluded, as they are not considered to be insurance undertakings as defied by the Insurance Supervision Act. The legal regulation does not apply to undertakings headquartered in another EU member state or EEA signatory state either. The corresponding authority in the country of origin is responsible for the financial supervision of these undertakings (country of origin principle). Life and health insurance undertakings headquartered outside of the EEA are subject to different provisions. Just like German undertakings, they are subject to membership in a guarantee fund.

Supervisory authority can order the transfer of portofolios.

BaFin can order the transfer of the entire insurance portfolio to the adequate guarantee fund in case of reorganisation or insolvency.[87] A requirement for this is that other measures such as the contractual transfer of portfolios to another insurance undertaking are not an option. Consequently, the authorisation of the insurer in question expires with that order. The insured persons, not the undertakings are in need of protection. The guarantee fund can transfer the portfolio to an insurer in whole or in part; that would be a contractual transfer. The guarantee fund cannot order a transfer.

Regulations in section 127 of the Insurance Supervision Act permit the transfer of tasks and competencies of a guarantee fund to a legal entity under private law, irrespective of whether it is an insurance undertaking or not. In any case, BaFin is responsible for the supervision of the guarantee fund. Legislature took the banking

[85] Sections 124 ff. and section 6 (5) VAG.
[86] Health insurance is considered substitutive if it can adequately replace compulsory health insurance in whole or in part (section 12 (1) of the VAG.
[87] Section 125 (2) of the VAG.

sector as a reference for this solution; there, collateral compensation institutions were a success.

Two-step financing of guarantee funds.

The financing of guarantee funds for life insurance distinguishes between two steps:[88]

The first step is a preliminary financing amounting to one tenth of one % of the sum of the net underwriting provisions of all life insurance undertakings linked to the fund. The sum of annual contributions is 0.2 per mill. Fund assets are thus developed within a time period of five years. In addition, legislature distinguishes between the sum of annual contributions and the individual annual contribution. The latter may fluctuate, depending on the risk and financial situation of the individual undertakings. During the second step, the guarantee fund must request special contributions of up to one tenth of one % of the net underwriting provision, should this be necessary to fulfil its tasks.

One tenth of one % of the net underwriting provisions corresponds to approximately €500 million. Therefore, the total volume of the guarantee fund in the life insurance sector amounts to approximately one billion €.

The guarantee fund for health insurances on the other hand requests special contributions for the fulfilment of its tasks only after the takeover of contracts. The special contributions may amount to up to two per mill of the net underwriting provisions. This would be almost €200 million. The Federal Ministry of Finance shall regulate the details of the financing for life and health insurance via regulations.

Should, contrary to expectations, the amounts stated not suffice for the reorganisation of the life insurance portfolio, the supervisory authority would have to reduce the guaranteed benefits. However, the cuts are restricted to a maximum of five %.

Extended supervision of reinsurance undertakings

New supervision rules fundamentally change the supervision of reinsurance undertakings.

With the modification of the Insurance Supervision Act, new supervision rules were created for reinsurers as well, which considerably reenforce the German supervision system in this sector. With these new regulations[89] it is possible to keep up with the development of international supervision standards. Now, BaFin has considerably more adequate competencies than before in order to ensure that only those reinsurance undertakings fulfilling specific solvency requirements may conduct business in Germany. The reinsurance directive expected in the near future will lead to a further extension of these rules, also to foreign reinsurance undertakings. The new supervision system will significantly enhance the protection of previous insurers in case of reinsurers' bad debt losses. This will indirectly also protect the insured persons from financial problems of primary insurers. Last but not least, the intensification of the supervision system also enhances Germany's position as a financial

[88] Section 129 of the VAG.
[89] Part VIIa, sections 119 ff. of the VAG.

centre. The British supervisory authority has already recognised the new German supervision system of reinsurance undertakings as equal to the British system and transferred the financial supervision of two branches of a large German reinsurance undertaking to BaFin alone.

The introduction of a licensing process with clearly defined requirements and the creation of a solvency system for reinsurance undertaking constitute the core elements of the new supervision system.

Comprehensive licensing processes protect previous insurers.

The licensing process shall take effect when business operations are commenced or expanded. For already existing companies registered with BaFin, the licence to conduct business is considered to have been granted for the scope of existing business operations. A business plan must be included with the licence application, detailing comprehensive information about the company and the planned business operations, its legal and economic framework, managing directors and holders of significant interests, as well as the group structure. Objectively, the licence is generally effective for the entire reinsurance business. Upon application, it can be restricted to life reinsurance business or non-life reinsurance business. A more detailed differentiation by individual insurance classes is not provided for. In addition to the possibility of not granting the licence, competences to revoke the licence and prohibit business operations are also provided for. In this manner BaFin can effectively protect previous insurers from companies who do not fulfil the requirements for a licence or do not fulfil those requirements anymore, who do not have the required liquidity or who committed severe or repeated infringements.

New solvency system provides for supervision of own funds, provisions and investments.

The licensing process is completed by a new solvency system, including the supervision of sufficient own funds, the sufficiency of provisions as well as regulations concerning investments after a transitional period. Therefore, reinsurance undertakings must fulfil a minimum capital requirement when commencing business operations, irrespective of their business volume. In order to determine the necessary scale of own funds for the current business operations in life and non-life reinsurance, the Act provides for the adoption of solvency provisions applying to primary insurers in property and casualty insurance. In investment supervision, the Act adopted the contents of the provision in the former section 1 a (2) of the Insurance Supervision Act into the new regulations without modifications. The same applies to 1 January 2005 as the effective date for already existing and active undertakings. Effective at this time, the respective asset portfolios of reinsurers are subject to specific supervision. The purpose of this provision is to ensure the continuing fulfilability of obligations from reinsurance contracts, while taking into consideration the respective undertaking and group relationships. The Insurance Supervision Act thus for the first time stipulates the obligation of reserving assets complying with certain quality-related requirements. Also consistent with international standards, the Act requires that only those assets complying with safety, efficiency and liquidity requirements are eligible, taking into consideration the adequate mix and spread.

In addition, legislature materially extended BaFin's intervention rights to ongoing supervision as well. Therefore, BaFin can request refinancing schemes prohibiting the free disposition of invested assets, warn managers and supervise certain service providers.

Supervision of insurance holding companies

The German legislator breaks new ground with the introduction of the supervision of insurance holding companies. So far, the Insurance Supervision Act only covered such companies selectively.[90]

Managing directors must be competent and reliable.

Insurance holding companies according to section 1 b of the Insurance Supervision Act are undertakings headquartered in Germany whose core business operations constitute the purchase and holding of participations in primary insurance and reinsurance undertakings. The provisions applying to primary insurers apply analogously to holding companies by virtue of reference. Special attention should be paid to section 7 a (1) sentence 1 of the Insurance Supervision Act, according to which managing directors must be competent and reliable, and to section 83 of the Insurance Supervision Act, providing for information and auditing rights for the supervisory authority. These provisions show that the objective of holding supervision is to identify and prevent operational and financial risks with possible negative effect on the respective insurance undertakings on holding level.

BaFin has additional competences concerning the insurance holding companies. BaFin can engage special commissioners, request the dismissal of managers in case of lacking qualification or after warnings and take measures in case of insufficient adjusted (group) solvency. However, the provisions concerning internal and external accounting are not applicable to holdings.

Engaging a special commissioner

BaFin can intervene on time.

The existing regulations concerning the engagement of a special commissioner[91] were partially unclear and were interpreted restrictively. Whenever a special commissioner was engaged, the supervisory authority either had a high risk of litigation or had to wait for the company to become practically insolvent. The new section 83 a of the Insurance Supervision Act precisely distinguishes between several factual elements.

It specifies that the supervisory authority can engage a special commissioner on time whenever needed. A possible non-fulfilment of the contractual obligations is required but also sufficient for such measures. These modifications fully comply with the perception of preventative supervision.

Warning of managers

Adoption of a measure successful in the banking sector.

With the amendment to the Insurance Supervision Act 2004, legislature introduced the institution of warning managers in the insu-

[90] See section 81 (4) of the VAG as an example.
[91] Section 81 (2 a) of the VAG.

rance sector; a measure successful in the banking sector for years now. It applies to primary insurance and reinsurance undertakings as well as to insurance holding companies. A warning comes into consideration if a manager violated his/her obligations wilfully or negligently, in cases in which an immediate dismissal would be unreasonable.

Further important modifications

In addition to the modifications already mentioned, the legislator also improved control of holders of considerable participations (section 104 of the Insurance Supervision Act). The Act specifies that the purchaser requires more than just a „clean slate". The purchaser must also be able to demonstrate that he/she has adequate and sufficient means to implement his/her business plans for the continuation and development of the primary insurer's business. Also, the insured persons' interests must be sufficiently protected.

Furthermore, pursuant to section 11 a of the Insurance Supervision Act, the responsible actuary is now obliged to immediately inform both the management board and the supervisory authority of circumstances that may constitute a risk for the portfolio of the company or significantly compromise its development.

1.4 Seventh Amendment to the Insurance Supervision Act

Implementation of the Pension Fund Directive

On 4 February 2005, the Federal Government published a draft concerning the Seventh Law Amending the Insurance Supervision Act.[92] A significant part refers to the implementation of the Pension Fund Directive.[93] It constitutes the European supervision framework for legally independent capital-backed institutions of occupational retirement schemes. The Directive must be implemented in national law by 23 September 2005.

Necessary modifications to the Insurance Supervision Act.

With the implementation of the Pension Fund Directive, the regulations concerning transnational business activities are created as the core of the amending law. The legislator must also decide whether direct insurances shall be subject to the regulations of the Pension Fund Directive. As the investment provisions of the Pension Fund Directive (section 18) only provide binding standards unless an undertaking grants a guarantee, the investment provisions for Pensionskassen can remain in force to a large extent.

Compliance with labour law and social law provisions.

If a foreign institution commences business activities in Germany, the German supervisory authority must verify the provisions under social law and labour law. In addition, the German supervisory aut-

[92] Bundesrats-Drucksache 84/05.
[93] DIR 2003/41/EC; OJ EU No. L 235/10.

hority must inform the authority in the respective country of origin of the material characteristics of the German retirement provision system, as well as allocate the foreign business an executionary method according to the Company Pension Act. Furthermore, it must ensure that a regular feedback with the Mutual Benefit Association for Pension Security is in place so that the foreign institutions fulfil their possible obligation to contribute. The German government envisaged the assignment of this competency to BaFin for practicability reasons - simple procedure, clear competencies, more closeness to the undertakings.

Not valid for direct insurers.

According to the draft, the direct insurers shall not be subject to the regime of the Pension Fund Directive. The life insurers shall be supervised exclusively according to the regulations in the consolidated Life Insurance Directive, both at present and in future. The application of the Pension Fund Directive to direct insurers would have caused additional costs for them, as they would have had to set up separate accounting series for this business area.

New provisions concerning own funds

Section 53 c of the Insurance Supervision Act specifies that insurance undertakings must have free, unencumbered own funds amounting to a solvency margin calculated according to the scale of business. In order to use the constitutive scope of the European Insurance Directives[94], a modification of section 53 c of the Insurance Supervision Act seemed reasonable. The new regulation included in the draft, for the development of which BaFin played an important role, is supposed to facilitate the procurement of own funds for the undertakings. The following modifications are planned for:

- In future, 50% of all own funds may be hybrid capital (capital from profit participation rights and subordinated liabilities). At this time the proportion is 25%.
- Those 50% of hybrid capital shall be calculated in relation to the catalogue of the entire own funds. So far, capital from profit participation rights and subordinated liabilities could only amount to 25% of the sum from share capital / initial funds, reserves and profit carried forward.
- Hybrid capital is only eligible as own funds with a minimum maturity of five years. The supervisory authority is to be able to agree to a premature repayment upon due consideration.
- At present, the capital from subordinated liabilities is not to be credited to the own funds from the last two years of the term. In future, the imputation is to be passed by only in the last year and in the year before last, an imputation of 40% shall be possible.
- Insurance undertakings are to have the opportunity to provide subordinated security for subordinated liabilities entered into by a subsidiary of the insurance company established solely for the purpose of raising capital.

[94] DIR 2002/83/EC; OJ EU No. L 345/1 and DIR 2002/13/EC; OJ EU No. L 77/17.

Legal basis for forecast statements

Caused by the considerable decline in share prices, BaFin has been requesting forecast statements during the financial year from all life insurers since 2001. Thus it is possible to take counter measures in case of negative forecasts. In addition, BaFin has been conducting stress tests on an annual basis since the balance sheet date of 31 December 2002. Thus it can be determined whether an insurance undertaking is able to fulfil its obligations towards the insured person and can meet the own funds requirements in case of simulated extreme crisis developments on the capital markets.

New section 55 b of the Insurance Supervision Act is to paraphrase the requirements for forecast statements.

These supervisory instruments have been successful. It would be appropriate to use them in all classes of insurance within the scope of the general monitoring functions of BaFin, even without a concrete reason. Thus BaFin suggested creating a „section 55 b" of the Insurance Supervision Act. The draft paraphrases the legal requirements for forecast statements. The standardisation is supposed to provide legal security. It clarifies which forecast statements concerning the end of the financial year BaFin is entitled to request. According to the draft of section 55 b of the Insurance Supervision Act, forecast statements on expectations concerning business results, the solvency margin, valuation reserves and the ability to bear risk of the undertakings are permitted. As forecast statements are nowadays a part in risk management of all insurance undertakings, the draft of section 55 b of the Insurance Supervision Act also provides that insurers may use their own calculation methods upon approval by BaFin. However, the precondition for this is that the use of internal calculation methods does not complicate the supervisory assessment of the insurance market.

1.5 Ordinances and Circulars

1.5.1 Planned Revised Form of the Ordinance Concerning the Reporting by Insurance Undertakings to the Federal Insurance Supervisory Office[95]

In autumn of 2004, BaFin informally presented a consolidated version of the Ordinance Concerning the Reporting by Insurance Undertakings to the Federal Insurance Supervisory Office to the Insurance Advisory Council. A formal hearing of the Insurance Advisory Council took place in March 2005. The final issue of the ordinance is planned for 2005.

The new regulation prepared by BaFin simplifies the reporting system, extends the reporting obligations of reinsurance undertakings and shortens the notification period.

Reporting system simplified.

So far, only property and casualty insurers had to submit a separate underwriting profit and loss account for each class of insurance. With the new regulation of the Ordinance Concerning the Reporting by Insurance Undertakings to the Federal Insurance Supervisory Office, 26 profit and loss accounts are not required any more, twel-

[95] Verordnung über die Berichterstattung von Versicherungsunternehmen gegenüber der BaFin (BerVersV).

ve of which from direct insurance and fourteen from reinsurance business. With this, in future, the reporting obligation shall be mostly restricted to those classes and types of insurance that have an obligation to report externally according to the Ordinance on Insurance Accounting. Further documentary proof shall be shortened or withdrawn. All of the eight samples as well as all formless explanations shall be omitted.

Reinsurer reporting obligations extended.

In a new documentary proof, reinsurers must give information about insurance claims, provisions and expenses for all classes of insurance. Furthermore, there is another documentary proof in which the coverage of the underwriting liabilities must be constituted with qualified assets. Thus, BaFin makes allowances for the amendment to the Insurance Supervision Act 2004, which reinforces the direct supervision of reinsurance undertakings.

Notification periods shortened.

The dates on which the individual forms and documentary proofs must be submitted shall be adjusted to international standards. The currently five submission dates shall be reduced to two, three for Pensionskassen.

1.5.2 Working on the Ordinance Concerning the Reporting by Pension Funds to the Federal Insurance Supervisory Office[96]

Starting with their first authorisation in 2002, BaFin has been supervising pension funds in a similar manner it supervises insurance undertakings. Just like insurers, the presently 24 pension funds must provide the supervisory authority with information on their business operations. However, so far there are no regulations for pension funds concerning internal reporting to BaFin. The power to issue a corresponding ordinance lies with the Federal Ministry of Finance.

BaFin prepared a draft ordinance regulating which information pension funds must submit to the supervisory authority. As the provisions of the Insurance Supervision Act concerning life insurance apply analogously to pension funds, the draft is widely based on the reporting obligations of life insurers. The ordinance is expected to become effective in 2006.

1.5.3 Modification of the Investment Ordinance

New general conditions for the use of investment opportunities under investment law.

On 25 August 2004, several modifications of the applicable Investment Ordinance[97] became effective. The Investment Ordinance substantiates the permitted assets for insurance undertakings and also establishes quantitative as well as debtor-related investment standards.

The amendments to Investment Ordinance are mainly responsible for the modifications to the Investment Ordinance. The provisions concerning investments in investment funds were completely revised, simplified and adjusted to the classification of the Investment Act.

[96] Verordnung zur Berichterstattung von Pensionsfonds (BerPensV).
[97] BGBl. 2001 I, p. 3913.

In accordance with section 1 (1) no. 15 of the Investment Ordinance, insurers can generally purchase shares in domestic funds including the newly introduced funds with additional risks (hedge funds). Only shares in retirement provision funds were excluded based on insufficient fungibility. In future, the criteria for allocations to restricted assets need not be included in contractual conditions anymore. This also simplifies investments in funds. Furthermore, in future insurers can also purchase shares issued by domestic public limited companies (section 1 (1) no. 16 of the Investment Act). Foreign fund units issued by an investment company headquartered in another member state of the EEA[98] can be purchased if the requirements are similar to the ones applying to domestic funds.

Pursuant to section 51 (2) of the Investment Act, the permissible market risk potential of funds according to the directive may rise to a maximum of 200% based on the use of derivatives. Such leverage can significantly increase the market risk potential for the insurance undertaking compared to a direct investment. On this basis, section 2 (4) of the Investment Ordinance determines that the increased market risk potential, i.e. the market risk potential exceeding 100% - in reference to the potential risk of loss of a fund free from derivatives - must be allocated to the 35% risk capital ratio.

The Investment Ordinance provides a special mixing ratio of five %, taking into consideration the potential risks of hedge funds. This includes investments pursuant to section 1 (1) numbers 15 to 17 of the Investment Ordinance and other permissible investments according to the Investment Ordinance, whose yield or repayment is linked to hedge funds, such as structured products, to name one example. Those are allocatable to the numbers of the Investment Ordinance due to the legal nature of spot transactions (e.g. notes receivable of an eligible credit institution).

In addition, the authority issuing the ordinance extended the possibilities for the investment of guarantee assets - so far referred to as "coverage fund". Insurance undertakings may now also invest in shares admitted for trading at the official market or included in an organised market of a stock exchange in a country outside of the EEA. The undertakings may now also purchase bonds included in an organised market in a country outside the EEA.

A regulation from the Circular 1/2002 of the former Federal Insurance Supervisory Office was adopted in the Investment Ordinance. According to that regulation, direct and indirect investments in asset backed securities and credit linked notes as well as other investments providing a basis for the transfer of credit risks, such as structured products, may not exceed 7.5% of each of the guarantee assets and other restricted assets - so far referred to as "remaining restricted assets".

[98] Section 1 (1) no. 17 of the Investment Ordinance (Anlageverordnung – AnlV).

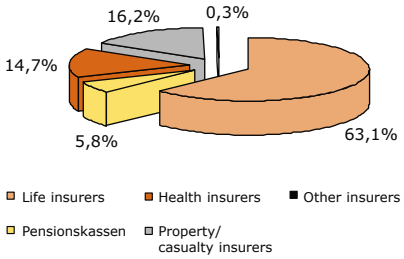
BaFin shall take the modified conditions into account during the revision of the Capital Investment Circular 29/2002 [Insurance Supervision].

1.5.4 Circular Concerning Hedge Funds

New circular substantiates Investment Ordinance.

After admitting hedge funds in the Investment Act and in the Investment Ordinance, BaFin issued an accompanying circular substantiating the requirements concerning investments in hedge funds.[99] The structure and functionality of hedge funds is very complex. They can also be almost non-transparent and full of risks, which is why insurance undertakings are very much in need of protection. Unlike other investment funds, hedge funds are not required to regularly disclose their assets structure. Therefore, it cannot be verified whether the spread in hedge funds is sufficient. The investor's return privilege may also be restricted.

Figure 27
Allocation of investments in hedge funds according to insurance class



In order to observe the insured persons' interests, insurance undertakings must analyse thoroughly whether and possibly which of these products are adequate for their portfolio before purchasing hedge funds. They must document the investment process properly. The selection and investment process must be continuously structured by effective due diligence. It is especially important that the investments in hedge funds are taken into consideration in risk management.

An insurer acts as a fund of hedge funds when investing in single hedge funds. Therefore, the risk spread provision applying to fund of hedge funds in section 113 (4) of the Investment Act applies analogously to single hedge funds within the five % ratio. This means that insurance undertakings may not invest more than one % of restricted assets in a single hedge fund.

On the reference date of 30 September 2004, investments in hedge funds amounting to €2.8 billion were reported to BaFin. In comparison to the entire capital investment volume of insurance undertakings of approximately €905 billion, the investments in hedge funds amount to 0.31% of investments.

Based on the currently low yield of hedge funds and their complex fee structure, the five % ratio is not likely to be utilised in the near future.

1.5.5 Circular Concerning Reporting on Intra-Group Transactions

Primary insurance undertakings belonging to an insurance group are subject to additional supervision by BaFin according to sections 104 a ff. of the Insurance Supervision Act. This refers, among others, to transactions of an insurance undertaking under additional supervision with its participating and affiliated companies and / or with the affiliated companies of its participating companies. Transactions between the insurance undertaking subject to additional

[99] Circular 7/2004 [Insurance Supervision].

supervision and a natural person holding participation in the insurance undertaking or in an affiliated company of the insurance undertaking are also subject to insurance supervision.

The insurance undertakings in question must submit an annual report on important intra-group transactions to BaFin. In order to ensure uniform reporting, BaFin issued a circular[100] in August 2004, substantiating the reporting requirements and obligations for insurance undertakings belonging to a group.

Reporting on Intra-Group Transactions
According to the circular, the insurance undertakings in question must submit a report concerning the transactions of the previous financial year to BaFin four months after the end of a financial year at the latest. The report must be broken down according to intra-group parties. The circular comprises all transactions that must be included in the following seven categories:

- Loans,
- Guarantees and off-balance-sheet transactions,
- Own funds for the purpose of section 53 c of the Insurance Supervision Act,
- Investments,
- Reinsurance transactions,
- Cost sharing agreements, and
- Other transactions

Within the scope of general supervision of intra-group transactions, only the volume of the respective transactions must be reported. More detailed information concerning the contents of such transactions must be submitted only upon BaFin's request. Knowing the volume of all intra-group transactions permits BaFin to notice possible conspicuous elements, follow up on these and request additional information if necessary.

Reporting on significant transactions also dividable into the above-mentioned seven categories is subject to other provisions. Here, BaFin must be informed about the respective contents and purpose of the transactions, in addition to their volume.

In case the respective transaction reaches a minimum of ten % of the required solvency margin of an insurance undertaking subject to reporting, the volume and additional information must be provided on intra-group loans and guarantees as well as on off-balance-sheet transactions and own funds according to section 53 c of the Insurance Supervision Act. In the other business categories, a significant intra-group transaction is a transaction with a volume of at least ten % of all transactions in this category. With reinsurance contracts, a differentiation must be made between inward and issuing reinsurance. Furthermore, the circular includes specifications concerning transactions likely to pose a risk for the solvency of an insurance undertaking.

[100] Circular 3/2004 [Insurance Supervision].

1.5.6 Circular Concerning Solvency

As of March 2007, new solvency requirements generally binding.

German legislature made further modifications to the Insurance Supervision Act and the Capital Resources Ordinance as of 1 January 2004 and thus implemented the standards of the European Insurance Directives concerning own funds of insurance undertakings (Solvency I)[101] in national law.[102] Now certain instruments so far automatically allocatable to free, unencumbered own funds can only be regarded as such upon approval by the supervisory authority. In addition, the calculation of the required solvency margin has changed. The new solvency requirements for insurance undertakings are binding as a rule as of 1 March 2007 (in case of Pensionskassen and death benefit funds as of 31 December 2007). Only insurers who commenced business operations in Germany after 21 March 2002 must fulfil those requirements as of 1 January 2004.

Therefore, BaFin published a new circular concerning solo-solvency, taking into consideration the modified solvency requirements.[103] Upon the new solvency requirements becoming binding, it shall replace the old Circulars 3/97[104] and 4/97[105]: For insurers who commenced business operations in Germany after 21 March 2002, it has already replaced the old circulars. The new circular also especially includes details concerning the proposed exercise of discretion in recognising own funds instruments as free, unencumbered own funds. For the first time, BaFin also publishes the proposed authorisation principles in recognising hidden reserves. As the law stands, BaFin had decision-making authority on this according to supervisory discretion.

In future as well, but then on the basis of the new regulations, all insurance undertakings must evidence their compliance with the solvency requirements. Undertakings subject to the transitional arrangement and who do not fulfil the new requirements must submit an amending statement. This statement must show that at least the old solvency requirements are fulfilled.

In future, reporting on solvency shall take place via automated data transfer to the insurance supervisory authority. BaFin developed documentary proofs customised to the individual classes of insurance.

1.6 Analysis of selected invested assets of primary insurers

Reporting

Reporting on investment has versatile evaluation possibilities.

Starting with the second quarter 2003, primary insurance undertakings have been reporting on their total investment portfolio. Re-

[101] DIR 2002/83/EC; OJ EU No. L 345/1 and DIR 2002/13/EC; OJ EC No. L 77/17.
[102] Gesetz zur Umsetzung aufsichtsrechtlicher Bestimmungen zur Sanierung und Liquidation von Versicherungsunternehmen und Kreditinstituten dated 10.12.2003 (BGBl. 2003 I, p. 2478).
[103] Circular 4/2005 [Insurance Supervision]; VerBaFin 3/2005)
[104] VerBAV 8/1997, p. 219
[105] VerBAV 9/1997, p. 246.

porting takes place pursuant to the Circular 30/2002 [Insurance Supervision] via the documentary proof 670. It includes all types of investment classified both according to the investment catalogue in section 1 (1) of the Investment Ordinance and according to special risks. The individual item names do vary from the balance sheet classification according to the Ordinance on Insurance Accounting. However, in this manner specific investment classes can be regarded. The following assessments are based on the data for life, health, property and casualty insurance undertakings as of 30 June 2004. The book value of all investments in these classes amounted to €836.1 billion at that time.

Table 13

Shares from selected investment classes in invested assets

Designation of the type of investment according to section 1 (1) no. ... of the Investment Ordinance as amended on 20 December 2001	Total assets*								Allocatable to restricted assets from the sum of the three classes	
	Life IUs		Health IUs		Property/ casualty IUs		Sum of the three classes			
	absolute in million €	share in %	absolute in million €	share in %	absolute in million €	share in %	absolute in million €	share in %	absolute in million €	share in %
Total investments	616.058	100,0	102.908	100,0	117.091	100,0	836.060	100,0	795.109	100,0
From this to:										
- Securities loans (No. 2)	630	0,1	5	0,0	31	0,0	666	0,1	432	0,1
- Corporate loans (no. 4 lit. a)	5.795	0,9	185	0,2	2.071	1,8	8.051	1,0	6.243	0,8
- Corporate bonds (no. 7)	8.968	1,5	1.047	1,0	1.569	1,3	11.584	1,4	11.337	1,4
- Investments in Private Equity participations	1.538	0,2	331	0,3	425	0,4	2.294	0,3	1.558	0,2
Simple and complex structured products according to C 3/99	29.519	4,8	6.835	6,6	4.619	3,9	40.973	4,9	40.097	5,0
of which:										
- certificated as listed bonds (no 7)	687	0,1	85	0,1	92	0,1	864	0,1	863	0,1
- Developed as notes receivableor registered bonds towards an eligible credit institutiont (no. 20).	12.312	2,0	2.475	2,4	1.903	1,6	16.690	2,0	16.628	2,1
Asset backed securities and credit linked notes according to C 1/2002	7.716	1,3	833	0,8	1.207	1,0	9.756	1,2	7.343	0,9
of which:										
- developed as a loan to a special purpose vehicle (no. 4 lit. b)	754	0,1	0	0,0	69	0,1	823	0,1	778	0,1
- certificated as listed bonds (no 7)	4.165	0,7	335	0,3	333	0,3	4.833	0,6	4.715	0,6
- Developed as notes receivable or registered bonds towards an eligible credit institution (no. 20).	144	0,0	6	0,0	121	0,1	271	0,0	228	0,0
Structured products, ABS/CLN and other financial innovations within the savings clause	**		**		**		**		3.420	0,4

* including cash with credit institutions, without mortgages.

** the investments in these blocks have already been included in the total assets above.

Alternative invested assets

Primary insurance undertakings invest risk consciously in alternative investment classes.

The table demonstrates that primary insurance undertakings invest only little in so-called alternative investments, including granting securities loans. Moreover, the mentioned corporate loans and li-

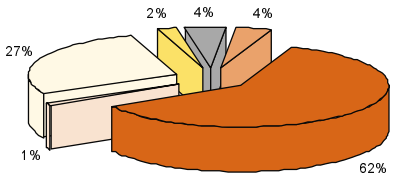
sted corporate bonds are almost exclusively investments in companies of good standing. Thus, the resulting total of the listed bonds according to section 1 (1) no. 7 of the Investment Ordinance of the investments graded with an investment grade amounts to 99%; the share of the direct investments not graded with an investment grade is therefore only marginal. So called high yield bonds are preferred in funds, whereas the degree of addition is limited and verified by BaFin on a regular basis. Therefore, direct investments in corporate loans, listed corporate bonds and participations in private equity amount to 2.7% of the entire invested assets. The share of asset backed securities and credit linked notes held previous year's level at 1.2% of the total investments. In reference to restricted assets, those ratios continue to decrease. Investments in structured products are more significant, i.e. 4.9% of total investments. Here, an increased proportion of investments with agreed upon debtors' rights of cancellation were noted, to which BaFin pays particular attention due to their risk of reinvestment. A total of about nine % of investments are invested in the listed alternative investment opportunities.

Composition of investment funds

The Investment Ordinance created the possibility of recalculating investments in shares in funds and investment companies to the individual types of investments in the investment catalogue. As now only the actual investments at risk in the fund are allocatable to the risk capital ratio of 35%, the fund investment in the total portfolio of an insurance undertaking can be taken into consideration realistically and equitably. In such a manner, for the first time ever, the risk capital ratio can be precisely estimated. However, the pre-condition for this is a transparent asset structure of the fund.

Figure 28

Recalculation of the fund assets in restricted assets according to the types of investment in section 1 (1) no. … of the Insurance Ordinance as amended on 20 December 2001



- Bond listed in the EEA and with a special cover pool (numbers 6, 7 lit. a, b) and investments in credit institutions (no. 20)
- Bonds listed outside of the EEA (no. 7 lit c)
- Shares and profit participations rights listed in the EEA (no. 15 lit. a)
- Shares and profit participations rights listed outside the EEA (no. 15 lit. b)
- Declining balance of the fund: all investments not allocatable to other categories as well as non-transparent funds.
- Shares in property funds (no. 19)

Together with the German Insurance Association (GDV) and the Bundesverband Investment und Asset Management e.V. (BVI) (Federal Association for Investment and Asset Management), BaFin prepared a data sheet[106] depicting the division of the fund assets into the most important items. The investment companies forward the data contained therein to the insurance undertakings. For the purpose of the above-mentioned recalculation, the data sheet divides the investment funds constituting approximately 22.9% of the restricted assets with a volume of €182 billion into the investment classes shown in figure 28.

The high share of bonds and investments in credit institutions (62%) also includes the liquidity held by funds not required to be shown separately. Shares and profit participations rights amount to a minimum of 29% of fund assets. Shares and profit participation rights of companies headquartered outside the EEA make up 2% of this amount. The declining balance of the fund, including all other investments not allocatable elsewhere as well as non-transparent funds is fortunately low at four % of the fund volume. This percentage constitutes approximately one % of the total restricted assets.

[106] www.bvi.de.

The more transparent development of insurance undertakings' fund assets continues to be BaFin's objective.

The risk capital ratio in accordance with the investment ordinance

There are many misunderstandings surrounding the term "risk capital". The risk capital ratio - also known as share ratio - defines the share of restricted assets that insurance undertakings may invest in certain high-risk investments (section 2 (3) of the Investment Ordinance). Presently, the ratio is 35% of restricted assets.

However, the term is often used in connection with own funds available to an insurance undertaking in order to cover risks. The funds coined as "risk capital" offset losses possibly resulting from riskier investments - so called risk capital investments.

The term "risk capital" becomes clearer in the context of the composition of the risk capital ratio as defined by the Investment Ordinance valid up until August 2004 (see Table 14).

Despite the division of fund assets, the risk capital ratio is still somewhat too high. Different factors form the basis for that. Firstly, in the course of the recalculation of investment funds, those investments not subject to other types of investment are allocated to the remaining value of a fund. Secondly, non-transparent funds are also fully allocated to this declining balance. The declining value amounts to one % of restricted assets. The risk capital ratio of the undertakings therefore amounts to 8.4 to 9.4% of restricted assets. In reference to total assets, it is lower by 0.1%. Pursuant to the amended Investment Ordinance, investments in hedge funds are also allocated to the risk capital ratio according to section 2 (3) of the Investment Ordinance. This applies analogously to direct and indirect investments linked to hedge funds according to section 1 (1) of the Investment Ordinance (see section 2 (2) lit. g of the Investment Ordinance).

In addition, in pursuance to section 2 (3) sentence 2 of the Investment Ordinance, the increased market risk potential of a fund is taken into consideration if it shows more than the single value of the market risk potential through the use of derivatives according to section 51 (2) of the Investment Act or the respective provisions in another country.

BaFin shall take those modifications into account during the revision of the Circular 30/2002 [Insurance Supervision].

Table 14
Risk capital ratio composition

Designation of the type of investment according to section 1 (1) no. ... of the Investment Ordinance as ambended on 20 December 2001	Restricted assets								Total assets*/ Sum of the three classes	
	Life IUs		Health IUs		Property/ casualty IUs		Sum of the three classes			
	absolute in million €	share in %	absolute in million €	share in %	absolute in million €	share in %	absolute in million €	share in %	absolute in million €	share in %
Total investments	596.884	100,0	100.922	100,0	97.302	100,0	795.109	100,0	836.060	100,0
From this to:										
- Securities loans (no. 2), insofar as shares (no. 12) are the purpose of the loan	64	0,0	5	0,0	23	0,0	92	0,0	147	0,0
- Claims from subordinated liabilities (no. 9)	11.029	1,8	2.923	2,9	1.587	1,6	15.538	2,0	16.154	1,9
- Profit participation rights (no. 10)	8.430	1,4	1.577	1,6	1.401	1,4	11.408	1,4	11.647	1,4
- Fully paid up shares included in an EEA organised market (no. 12, first clause)	10.202	1,7	1.540	1,5	1.417	1,5	13.159	1,7	14.117	1,7
- Fully paid up shares admitted on official markets outside the EEA (no. 12, second clause)	126	0,0	2	0,0	41	0,0	169	0,0	216	0,0
- Non-listed, fully paid up shares, shares in a GmbH, limited partner's shares and participations as dormant partner as defined in the Commercial Code (no. 13)	7.966	1,3	1.173	1,2	2.955	3,0	12.094	1,5	34.312	4,1
- Shares in securities funds (numbers 15 - 18) insofar as they - include fully paid up shares included in an EEA organised market (no. 15, lit. a)	36.518	6,1	4.131	4,1	8.917	9,2	49.567	6,2	49.908	6,0
- include fully paid up shares admitted in official markets outside the EEA (no. 15, lit. b)	2.702	0,5	407	0,4	944	1,0	4.053	0,5	4.922	0,6
- are not explicitly allocatable to other types of investment; remaining balance of the fund and non-transparent funds	6.018	1,0	707	0,7	1.172	1,2	7.897	1,0	8.505	1,0
- Sum of investments subject to the risk capital ratio of 35%	83.055	13,9	12.465	12,4	18.457	19,0	113.977	14,3	139.928	16,7

* including cash with credit institutions, without mortgages.

1.7 Insurance sector investments

Coverage of restricted assets must be in place at all times.

In the field of invested assets, BaFin determined violations of provisions on the spread of assets. In one case, 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 requirements for restricted assets must be met in full at all times.

The ten-per-cent-limit (section 3 (4) sentence 1 of the Investment Ordinance) had not always been adhered to in the area of participations. In case of absolute interim holdings, this limit was not re-

calculated in view of the investments of the insurance undertaking in other undertakings (section 3 (4) sentence 3 of the Investment Ordinance).

One insurer deducted claims towards insurance brokers from the minimum requirements for restricted assets to be covered. However, deductible contribution claims according to section 54 (1) sentence 3 of the Insurance Supervision Act only apply to claims towards insured persons. Thus claims towards brokers, e.g. from the collection of premiums, are not deductible.

Outstanding repayments for securities disposals are receivables and thus not investments as defined by the Investment Ordinance. Hence they cannot be used as coverage.

1.8 Requirements concerning the suitability of management

Principle of overall responsibility for insurance undertakings' managers.

In its decision of 8 July 2004 (Ref. 1 E 7363/03 (1)[107], the Administrative Court in Frankfurt / Main determined principles on the overall responsibility of managers of insurance undertakings. The court division explicitly applied the principle of overall responsibility for managers in the insurance sector as well. In the area of banking supervision, the principle of overall responsibility has been a recognised principle for years both in legal and supervisory practice. Therefore, the administrative court simultaneously supported the further development of an integrated financial supervision concept.

2 Life insurance undertakings and death benefit funds

Life insurers' financial situation

Stable stock markets and continuing low capital market interest shape the environment.

Life insurers' financial situation was influenced to a far lesser degree by the development of stock markets in 2004 than in the previous years. The slight increase in share prices at the end of the year was not the decisive factor for the income situation of the undertakings, also due to their reduced exposure to shares in the last few years. Developments in the bond market, characterised by considerable volatility to a continuing low interest level were much more significant for their financial situation. The running yield on public sector bonds decreased from approximately 4% at the beginning of the year to 3.5% in March, then increased to 4.1% in June and by the middle of December it declined again to 3.3%. While the lower capital market interest rates resulted in additional hidden reserves in investments by the end of 2004, the continuing

[107] WM 2004, p. 2157 ff. (not definitive).

low level of capital market interest rates increasingly burdens the undertakings' income situation, as only relatively low-interest investments are available for new investments.

Flexible scenario-based assessments successful as supervisory instrument.

For years, BaFin has been conducting scenario-based assessments by the reporting dates 30 June and 30 November. BaFin uses this instrument to gather information on whether life insurers have been able to fulfil guaranteed rate obligations in the current financial year, even in an environment of unfavourable share price developments. In 2004, BaFin determined an interest rate scenario for the first time in order to be able to assess the effects of an interest rate increase on the undertakings' hidden reserves within the scope of the low capital market interest level. BaFin determines the scenarios for each data collection separately according to market development and market environment. This flexible process proved useful. In 2004, the scenarios for share prices moved within a range of up to ten % below the current share price level. A parallel increase of the yield curve of 50 base points in comparison to the market situation on the reference date was given as the interest scenario. Based on the scenario assessments, BaFin was able to ascertain whether all life insurers were able to fulfil their obligations. Some undertakings were requested to provide additional data in order to be able to assess the likely future development more accurately.

Extensive reduction in hidden liabilities in investments to below two billion €.

When assessing the financial situation of life insurers within the scope of scenario-based assessments, BaFin took into consideration the hidden liabilities shown in the investment portfolio. Pursuant to section 341 b (2) sentence 1 of the German Commercial Code, insurance undertakings are permitted to classify securities recognised at cost as fixed assets. Write-downs are only required in cases where depreciation is likely to be permanent, giving rise to hidden liabilities. Life insurers reduced the hidden liabilities not balanced out in the securities recognised at cost as fixed assets from approximately six billion € in the previous year to below two billion €. Taking into consideration the hidden reserves not balanced out, the sector had balanced out hidden reserves of more than twelve billion € in securities recognised at cost as fixed assets by the end of 2004.

Bonus declaration for the following year.

In the scenario-based assessment as of 30 November, BaFin also enquired about the bonus declaration for the following financial year. This enabled BaFin 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 individual undertaking. The life insurer's bonus declarations remained on the same or slightly below previous year's level. The arithmetic mean of the total interest rate for endowment life insurance declared for 2005 was 4.3% (4.4% in 2004).

Twelve life insurers had negative balances in the stress tests.

The life insurers submitted the results of the stress tests to BaFin on the basis of their financial statements as of 31 December 2003. The supervisory authority included 102 life insurance undertakings for its assessment; four undertakings were released from the sub-

mission of stress tests due to their low-risk investments. Four life insurers had negative balances in all three scenarios[108]; five insurers had negative balances in two scenarios and three in one scenario. The remaining 90 life insurers had positive balances in all three scenarios.

Risk-Adjusted total interest ("Spread")

In their bonus declaration for the financial year 2004, some life insurers separated the total interest depending on the guaranteed technical interest rate ("spread"). Within the scope of this so called risk-adjusted total interest, contracts with higher technical interest rates received a lower total interest. The undertakings justified this with higher hedging expenses for a higher guaranteed interest.

Spread violates principle of equal treatment.

While actuarial considerations do not render a differentiated total interest totally out of question, BaFin considers a risk-adjusted total interest to be inadmissible.[109] It does not suit the present business model of life insurance. The breakdown of fictitious[110] hedging expenses into different technical interest rate generations burdens certain partial collectives. Investment income however is not broken down into partial collectives but instead according to the current business model of life insurers[111], allocated to the respective total portfolio. BaFin deems this to be a violation of the principle of equal treatment. A division of investment income is only possible with a segmentation of guaranteed assets. Separating guaranteed assets does not make sense due to the existing risk of reinvestment based on long contractual terms. The risk of reinvestment can only be reasonably restricted in the total portfolio, not in part collectives of technical interest rate generations.

Therefore, at the beginning of 2004, BaFin requested that the undertakings in questions restore equal treatment and that they treat all insured persons as if a risk-adjusted total interest had never been the case. The undertakings in question complied with this request.

Protektor Lebensversicherungs-AG

Protektor Lebensversicherungs-AG is an institution of the German life insurance sector. The rescue company protects Protektor policy holders from the consequences of insolvencies in the life insurance sector. The objective is to take over the portfolio of distressed life insurance undertakings, to reorganise them and then resell them afterwards.

In the financial year 2003, Protektor took over the portfolio of Mannheimer Lebensversicherung AG. Within the scope of reorganisation, Protektor transferred special portfolios requiring extensive

[108] Scenario R 10 (= loss in market value bonds - 10%); A 35 (= loss in market value shares - 35%) and RA 25 (= loss in market value bonds - 5% and loss in market value shares - 20%).
[109] VerBaFin 7/2004.
[110] The respective financial instruments are not actually bought.
[111] Each life insurer only has one guaranteed asset.

administration to other life insurers. Concerning the remaining portfolio, the rights of insured persons such as claims for benefits and risk protection remain entirely under Protektor's protection. In the financial year 2004, there was no need for Protektor to request additional payments from the shareholders.

New mortality table in retirement savings plans

Through increasing life expectancy of insured persons, the security margin of mortality tables DAV 1994 R (of the German Actuarial Society) decreased disproportionately. Therefore, the continuing use of mortality tables may lead to probable losses in mortality results. The work group "Biometric Actuarial Bases" of the Life Insurance Committee of the German Actuarial Society, in which BaFin is also represented, therefore developed new mortality tables for new policies starting in 2005 (DAV 2004 R) and the portfolio of retirement savings plans (DAV 2004 R-portfolio).

In its Circular 9/2004 [Insurance Supervision], BaFin required that for retirement savings plans concluded after 31 December 2004 not subject to rates approved by the supervisory authority, the mathematical provisions to be established under each individual contract must at all times be at least in an amount as it would be if mortality table DAV 2004 R and the other actuarial bases were to be used. Exceptions from this regulation are possible in case deviations from the preconditions in the mortality table DAV 2004 R are found. In addition premium calculation (section 11 (1) of the Insurance Supervision Act) must be determined in such a way that in the long run no funds are required for mathematical provisions to be established under individual contracts that do not come from premium payments or from bonuses from individual contracts. Furthermore, BaFin ordered that insurers without the respective clarifying notice may not advertise with bonus amounts granted so far, unless a reduction of these rates is already foreseeable when retirement savings plans are concluded.

With the implementation of the new biometrical actuarial bases, BaFin published principles on how mathematical provisions of existing retirement savings plans are to be re-assessed.[112] As of the balance sheet date 31 December 2004, insurers must create additional mathematical provisions, as a rule calculated on the basis of the mortality table DAV 2004 R-portfolio. They must observe the supervisory official announcements concerning financing, counter financing, repurchasing ability of the additional mathematical provisions as well as the bonus.

New mortality table resulted in additional expenditures of €2.3 billion.

The mortality table update for retirement savings plans required a re-assessment of the mathematical provisions for retirement savings plans. Therefore, the sector had additional expenditures of approximately €2.3 billion in 2004. While the additional expenditure affected the opportunities for future bonuses, it had no influence on guaranteed pension benefits that remained unmodified.

[112] VerBaFin 1/2005.

Life insurance undertakings' solvency in 2003

In the year under review, the solvency sheets of 106 life insurance undertakings were submitted for the financial year 2003. A review of these revealed a total solvency margin of €24,022 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.

106 life insurers maintained own funds of €42.3 billion in 2003.

As a whole, the undertakings maintained eligible own funds according to solvency provisions of €42.317 billion; this represents a 176% coverage of the solvency margin.

The composition of own funds was as follows:

Own funds A	amounting to	€7,826 billion (18.5%)
Own funds B	amounting to	€34,413 billion (81.3%)
Own funds C	amounting to	€0,078 billion (0.2%)

BaFin approved own funds C for five 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 premium refunds not yet allocated for bonuses, which in accordance with section 56 a, sentence 5 of the Insurance Supervision Act can be used to cover extraordinary losses. Own funds C represents the value of future surpluses. They can only become eligible with BaFin's approval upon request. Future surpluses can be approved as own funds only to the extent the own funds A and B leave a shortfall in coverage of the solvency margin. In the financial year 2003, BaFin approved own funds C as eligible funds for five life insurers.

The own funds of 4.7% of the undertakings covered the solvency margin exactly because the use of own funds C in the required amount was approved. 68.9% of the undertakings maintained excess coverage of the solvency margin of up to 100%; 13.2% of the undertakings had excess coverage between 100 and 200%; 5.7% between 200 and 300% and 7.5% maintained excess coverage of more than 300%.

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

Fifteen undertakings included capital represented by profit participation rights or subordinated liabilities as eligible own funds.

Insurance undertakings may allocate a limited amount of capital represented by profit participation rights or subordinated liabilities to own funds in order to cover the solvency margin.[113] In the financial year 2003, 15 undertakings included capital represented as profit participation rights or subordinated liabilities totalling €284.8 million as own funds. This was equivalent to 18.7% of these undertakings' paid-up capital. None of the undertakings exceeded the statutory upper limit[114] of 25%.

[113] Section 53 c (3) sentence 1, no. 3 a, b of the VAG.
[114] Section 53 c (3) c of the VAG.

Life insurers' solvency continues to be positive in 2004.

According to preliminary findings, life insurers' solvency has hardly changed in 2004. Minimum solvency requirements as of 31 December 2004 were clearly more than fulfilled with a coverage ratio of presumably over 170%.

Death benefit funds' solvency in 2003

In 2004, BaFin evaluated the solvency sheets submitted by death benefit funds for the financial year 2003. With the exception of one public limited company, all 43 death benefit funds under federal supervision were constituted in the legal form of minor insurance associations. Those 20 undertakings that had set about a recalculation of the mathematical provisions as of the balance sheet date were required to provide evidence of adequate solvency. All death benefit funds' own funds were sufficient to cover the solvency margin.

20 death benefit funds maintained own funds of €64.5 million in 2003.

The solvency margins to be covered by the 20 death benefit funds amounted to a total of €43.3 billion. Own funds of €64.5 million were available to cover this amount. This corresponds to a coverage ratio of 149.0%. Of the 20 death benefit funds, 13 achieved excess coverage of up to 100%, five maintained excess coverage between 100 and 200%, while two maintained excess coverage of more than 200%.

At 61.0%, the majority of own funds was 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 profit participation rights or subordinated liabilities in own funds. The proportion of free provisions for premium refunds represented 37.3% of total own funds. 1.7% were allocated to future surpluses. 18 death benefit funds were able to fully cover the solvency margin with explicit own funds. Two undertakings had to allocate future surpluses for solvency coverage.

One death benefit fund applied halved rates for the calculation of the solvency margin (two % instead of four % of mathematical provisions and 0.15 instead of 0.3% of capital at risk), due to the fact that their premiums had not exceeded 500,000 €in the past three financial years.

3 Health insurance undertakings

Financial situation 2004

In the year under review, BaFin had 54 private health insurance undertakings under supervision. The undertakings generated estimated premium income of €26.5 billion. This equates to a year-on-year increase of approximately 6.9%. The investment portfolio increased by approximately 9.4% in comparison with previous year's level, up to approximately €107 billion.

Three health insurance undertakings showed negative balances in the stress tests.

The health insurers submitted their stress test results to BaFin, just like in the previous year. The supervisory authority included 48 undertakings in its assessment; the remaining six health insurance undertakings were released from the submission of stress tests due to their low-risk investments. One health insurer had negative results in three scenarios, another health insurer in two scenarios and one in one scenario. All insurers took short-term measures in order to restore their ability to bear risk. The remaining insurers had positive balances in the tests.

Scenario-based assessments successful as supervisory instrument.

In addition to stress tests, BaFin conducted a scenario-based assessment as of 30 June 2004. Via forecast statements, the short-term effects of negative development on company performance are simulated. The scenario-based assessment was comprised of four different parts. BaFin reviewed the impact stock markets have on the company performance with two scenarios. BaFin gave two index levels of the EuroStoxx 50 as of 31 December 2004. The other scenarios implied an additional interest increase of 50 base points. BaFin did not include some insurers in the review, as those undertakings did not have shares and / or fixed-interest securities in their portfolio. Insurers operating non-substitutive health insurance were not included, as here no old-age provisions are required.

All health insurers coped with the scenarios economically.

All health insurers would be able to cope with the given scenarios from an economic point of view, however, the provision situation would deteriorate in case of an interest rate increase. In the first two scenarios, almost all health insurance undertakings were able to generate the technical interest rate of 3.5% from the investment results. In both scenarios, the balanced out hidden reserves in this sector would be considerably above four % of the investment portfolio as of 31 December 2004. In the combined scenario "price decrease with interest rate increase", the balanced out hidden reserves could decline to below three % of the investment portfolio in the entire sector, and some undertakings would have a negative balance from hidden reserves and burdens under these circumstances. The majority of health insurers would also be able to finance the technical interests from the result of investments in these scenarios as well.

None of the health insurance undertakings in difficulties.

According to current information, all health insurance undertakings are capable of fulfilling their obligations. Based on high and partially complete write-downs of hidden liabilities in the financial years 2003 and 2004, the results situation for health insurers has eased up. The gross surplus after taxes is likely to be only slightly higher than previous year's level. Net interest in the sector is expected to be between 4.5 and 4.6%. Direct credits from the share in the surplus in interest earnings pursuant to section 12 a of the Insurance Supervision Act and allocations to the premium refund provision will therefore also increase only slightly compared to the previous year in the combined scenarios. The means available to the undertakings to reduce future premium increases changed only moderately. All health insurers are expected to be able to cover the required guaranteed assets with qualified investments both according to book value and to fair value as of 31 December 2004. The existing own funds are expected to exceed the requirements in all

scenarios as of 31 December 2004 by €1.7 billion. Therefore, own funds remain unchanged compared to their level of 31 December 2003.

Unilateral contract modifications by health insurers

Policy conversion after modified state aid.

Two health insurers sent their policy holders insurance certificates for daily hospital allowance insurance without the corresponding insurance applications. The reason for this was reductions in state aid that were to be compensated with daily hospital allowance insurance.

In the accompanying letter, one insurer pointed out that the contracts become effective unless the customer does not object by a certain date. BaFin criticised this procedure. Not reacting to a unilateral policy conversion should not be construed as approval.[115] The insurer confirmed that in future the legal position shall be observed.

The second insurer offers customers entitled to state aid a "conversion service" on a regular basis. Should the customer chose this when concluding a contract, he / she revocably declares his / her consent to the required conversion of a policy within the scope of rates in case of modifications to the state aid laws. Should the insurer convert the policy, the policy holder is entitled to object to the modification. Within the scope of the current conversion measures, the insurer explicitly pointed out this contractual right in his accompanying letter.

As a principle, BaFin does not have any concerns regarding such a „conversion service". However, within the period under review, the undertaking also modified policy holders' contracts who did not select the „conversion service" in the contract. BaFin criticised such actions, as a conversion despite the lack of consent can negatively affect the policy holders' interests. The insurer declared vis-à-vis BaFin that such measures shall not be taken with the respective customers any more.

Modification of contracts after the decision by the German Federal Court of Justice („Alphaklinik").

The German Federal Court of Justice decided with its verdict of 12 March 2003 (Ref. IV ZR 278/01) that the insurers' use of the phrase „necessary medical treatment" in section 1 (2) of the Model Conditions of the Illness Cost Insurance and Daily Hospital Allowance Insurance (MBKK 76) may not restrict their payment obligations to the least expensive treatment. Furthermore, in a departure from its previous decisions, the Federal Court of Justice determined that section 5 (2) of the Model Conditions of the Illness Cost Insurance and Daily Hospital Allowance Insurance (MBKK 76) only provides for the possibility of reductions in the case of excessive treatment and not in the case of excessive compensation. However, in order to be able to make some benefit reductions even in case of excessive compensation, four insurers modified their general terms and conditions, also effective for existing insurance policies, citing section 178 g (3) of the Insurance Contract Act. As a reaction, Ba-

[115] Also see the Annual Report 2003 Part A, Chapter III.3.3.7 (p. 153 ff.).

Fin initiated administrative proceedings against the insurers in question. The evidence for a "change to the healthcare system that is not considered to be merely temporary" as a consequence of changes in high court decisions could be brought neither by insurers nor the Association of Private Health Insurance Undertakings. BaFin emphasised that with the trustee's approval, the preconditions as defined in section 178 g (3) of the Insurance Contract Act concerning effective modifications of general terms and conditions must be fulfilled based on firm facts. Mere concerns are not sufficient in this case. Upon BaFin's request, the four health insurers in question agreed in writing that the modification of model conditions and / or rates shall not be applicable to contracts already in existence at the time the modification was made. Such an application is only possible in case of a legally binding decision by a civil court, a legislative clarification or evidence valid for the entire association as recognised by BaFin. As an association-wide evidence procedure is planned, BaFin stayed the commenced administrative proceedings.

Private health insurance premium adjustments

In its leading decision of 16 June 2004 (Ref. IV ZR 117/02), the German Federal Court of Justice substantiated the measuring standards and preconditions for premium adjustments in the private health insurance sector. The standard of the review by the civil court according to section 178 g (2) of the Insurance Contract Act is whether the actual increase of claims cost is only temporary. Section 12 b (2) of the Insurance Supervision Act and section 14 of the Calculation Ordinance include detailed regulations concerning the determination of the claims cost. For the first time, the German Federal Court of Justice passed the decision that the term "rates" in this context is to be interpreted as the "unit under review" as defined in the Calculation Ordinance. Hence, premium adjustments may only be effected in those units under review (men, women, youths, and children), in which the triggering factor exceeded the statutory limit of ten % or a lower limit according to contract. According to the Federal Court of Justice, any deviation from the legally determined procedure to the policy holder's disadvantage is prohibited.

BaFin believes that pursuant to the Court's decision, general terms and conditions providing for adjustments concerning the units under review without the triggering factor are invalid. They are replaced by statutory regulations. Upon BaFin's request, by now all health insurance undertakings have agreed to adjust all regulations concerning current and future premium adjustments to the leading decision by the Federal Court of Justice.

Dental prostheses benefits

The Statutory Health Insurance Modernisation Act of 14 November 2003[116] provided for the separate financing of dental prostheses as of 1 January 2005. The dental prostheses insurance should remain

[116] Statutory Health Insurance Modernisation Act (Gesetz zur Modernisierung der gesetzlichen Krankenversicherung - GMG), BGBl. 2003 I, p. 2190.

compulsory for members in statutory health insurance; however, the insured persons should have the one-time option to cover this risk either with their health insurance undertaking or with a private health insurer by concluding a "release policy" according to section 58 of the Social Code V. In this context, the private health insurance policy should have at least the benefit range as defined in sections 55 and 56 of the Social Code V (regular provision). In 2004, twelve private health insurance undertakings introduced corresponding rates or offered gratuitous and non-gratuitous options of concluding such policies to their customers.

Special right of termination applies without limitations to rates insuring only regular provision in case of dental prosthesis.

With the law of 15 December 2004[117], the option of taking out private insurance for dental prostheses was cancelled again. The legislature standardised a special right of termination for those persons insured, "who concluded a private insurance policy based on section 58 (2) of the Fifth Book of the Social Code, in the version of the Statutory Health Insurance Modernisation Act." The insurance sector interpreted the special right of termination in various ways. BaFin was of the opinion that the special right of termination applied without limitations to rates insuring only regular provision in case of dental prosthesis. The informational obligations are the responsibility of the undertakings in this case. However, BaFin is also of the opinion that if customers, in anticipation of the Statutory Health Insurance Modernisation Act, concluded other private insurance policies with benefits for dental prosthesis, the special right of termination shall not apply. BaFin appealed to insurers to be tolerant with termination and conversion requests. Options sold for premiums had to be rescinded. Ultimately, the insurers in question acted according to BaFin's specifications. Correspondence with one undertaking was still ongoing at the end of the period under review.

Modification of the technical interest rate

In health insurance operating in the same way as life insurance, unlike the life insurance interest rate, the statutory maximum technical interest rate[118] has been 3.5% for over 50 years. The difference lies in the different guarantees of the two classes of insurance and in the possibility of verifying and possibly changing the health insurance calculation bases in case of premium adjustments.

Due to the continuing low-interest phase and the losses on stock exchanges in 2001 and 2002, the collaterals in the calculation basis "interest" declined significantly for many health insurers.

In contrast to the life insurance sector, the European Union regulations and legal provisions do not provide a procedure for deriving the maximum interest rate from capital market interest rates for this class of insurance. In addition to the option of generally reducing the maximum interest rate, the supervisory authority, together with the German Actuarial Society and the Association of Priva-

[117] Act Adjusting the Financing of Dental Prostheses (Gesetz zur Anpassung der Finanzierung von Zahnersatz) , BGBl. 2004 I, p. 3445.
[118] See section 4 of the Calculation Ordinance (Kalkulationsverordnung).

te Health Insurers discussed the implementation of company-specific procedures. Consequently, the German Actuarial Society started the development of a respective procedure. The preparations were not completed at the end of the year under review.

Special audits due to the cooperation between private and statutory health insurance undertakings

Since January 2004, statutory health insurance undertakings may cooperate with private health insurance undertakings.[119] In 2004, many undertakings used this opportunity, whereas normally insurance policies from cooperation agreements carried a discount. Based on these cooperation agreements, BaFin undertook three special audits.

Violation of the principle of equal treatment.

One insurer reimbursed insured persons for practice fees up to a maximum amount of €30 for insurance policies concluded within a certain period of time. BaFin deemed this to be a violation of the principle of equal treatment[120], as the insured persons received different benefits with the same underwriting risk and for the same contribution. The undertaking agreed to refrain from paying such reimbursements.

Cooperation terms for "old policies" as well.

Another insurer granted some of its customers a discounted contribution only for amending policies concluded after the cooperation agreement. For additional insurances taken out by customers before the cooperation, no discount was granted. Upon BaFin's request, the undertaking submitted an offer to the insured persons, according to which „old policies" were to be converted to the cooperation terms and customers were to be granted discounts.

Additional costs in the cooperation rates.

In the cooperation rates, additional costs[121] are partially very low due to the low contributions. As based on the cooperation, additional costs occurred, e.g. for contract negotiations with the health insurance undertakings and additional costs may occur in future as well, the additional costs calculated may not be sufficient. Therefore BaFin requested that insurers prove the costs for the respective partial portfolios and report on the business development of the respective partial portfolio on an annual basis. The following data must be forwarded in this context: Number of persons insured, earned gross premiums, additions by monthly target premiums and by the number of the persons insured, cancellation ratio (disposals in monthly target premiums by cancellation in comparison to medium portfolio in monthly target premiums), ratio between actual to actuarial damage with and without taking into consideration the new policies of the last three financial years and comparison between actual and calculated costs, divided into direct acquisition costs, indirect acquisition costs, claim settlements costs and other administrative costs. The actual costs allocatable to the cooperation rates must be calculated according to a method reflecting the

[119] GMG, BGBl. 2003 I, p. 2190.
[120] Section 12 (4) in connection with section 11 (2) of the VAG.
[121] The additional costs included in the premiums for acquisition, administrative and claims settlements costs.

actual situation in an adequate manner. The method must be stated as well.

Solvency 2003

In 2004, BaFin assessed the information provided on the solvency of 54 health insurance undertakings for the financial year 2003. Of these, three undertakings that were constituted in the legal form of "smaller insurance associations" were exempted from the solvency regulations, since their premium volumes did not exceed €1.87 million and their articles of association provided for obligatory supplementary contributions of the members.[122]

An evaluation of the solvency sheets submitted for the financial year 2003 produced the following results: The solvency margin to be covered by the 51 health insurance undertakings subject to reporting requirements totalled €1,398 million. This equates to a year-on-year increase of 7.7%. For 34 undertakings, the premium index was the main determinant with regard to the amount of the solvency margin. For eight undertakings the claims index was decisive. The remaining nine undertakings were only obliged to cover the minimum guarantee fund as a result of the limited scale of their business.

51 health insurers maintained own funds of €3.1 billion in 2003.

All in all, the 51 undertakings had own funds with a book value of €3,136 billion to cover the solvency margin. This equates to a year-on-year increase of 3.2%. The coverage ratio of 234% in the previous year declined accordingly to 224% in the financial year 2003. Collectively, eleven undertakings achieved up to 50% surplus coverage of their solvency margin, while another seven achieved a surplus coverage of between 50 and 100%; for 20 undertakings, the surplus coverage was between 100 and 200%, and for 13 under takings 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 as own funds, as eligible under its articles of association.[123] Two undertakings again included what is known as surrogate capital (subordinated liabilities and capital represented by profit participation rights) in the amount of €46.5 million as own funds.

4 Property and sasualty insurance undertakings

Financial situation

Financial situation eased.

In 2004, the financial situation of property and casualty insurers was stable. Also due to the favourable claims experience and stable capital markets, the situation continued to ease, just as in the

[122] Section 156 a (1) of the VAG.
[123] Section 53 c (3) sentence 1, no. 5 of the VAG.

financial year 2003. As recently as 2002 and 2001, the total result was negative due to major damage and depreciations of investments. Despite the stable situation, BaFin paid special attention to the financial situation of property and casualty insurance undertakings in 2004 as well. In a few individual cases, BaFin requested interim reports, interim solvency overviews and solvency sheets concerning adjusted solvency, reports on reorganisation measures, the continuation of measures for the improvement of the results or additional capital from some undertakings.

The financial year 2004 continued with a positive claims experience, with reduced claims quantities and payouts. The undertakings generated an underwriting gross profit equalling previous year's level. The cause of the improved result was mostly the increased received gross premiums and a slightly lower expected claims ratio after settlement. The lack of major claims had an especially positive effect on the result. The huge natural disaster at the end of the year, the Tsunami in Asia, only had a minor effect on German property and casualty insurance undertakings.

Slightly decreased results in the motor vehicle business.

After a particularly profitable year 2003, the results in 2004 showed a slight decrease in the motor vehicle insurance business due to a rekindled premium competition and higher claims expenditure caused by rising accident figures. Still, the motor vehicle sector was in the black again, just like in 2003, after six years with deficits.

In industrial insurance, the positive trend continued.

In industrial non-life insurance, last year's positive trend continued due to successful risk mitigation. In case of a normal claims experience, a positive underwriting result may be expected. With this, the turnaround in industrial non-life insurance is implemented. As a whole, property and casualty insurance undertakings achieved a positive operating result.

On-Site inspections

In 2004, the audits focussed on the underwriting results and the total result, underwriting provisions, reinsurance contracts, investments, own funds requirements, accounting, risk management systems and allocation of costs.

Within the scope of various audits, BaFin pointed out that while claims reported between the closure of registered claims and the balance sheet date must be assessed, they must be included in partial loss provisions for reported claims in the financial year, and not in partial loss provisions for claims incurred but not reported.

Flat-rate increase or reduction on provisions for claims.

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 inadmissible. Tax criteria in particular, such as the more realistic valuation, do not justify a reduction of the loss provi-

sions in the annual financial statements, which are prepared according to the German Commercial Code.

Partial loss provisions for claims incurred but not reported.

In some cases, BaFin criticised the creation of partial provisions for claims incurred but not reported. The undertaking in question did not pay sufficient attention to company-specific past figures as well as growth trends. The insurers also did not include the quantity and expense of all expected claims incurred but not reported in the following years. 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.

BaFin pointed out that when determining partial provisions for claims settlement expenses, the entire internal and external claims settlement expenses must be taken into consideration. The calculation for each insurance class must be done separately.

Losses in settlement of provisions.

BaFin suggested that as part of the assessment of whether the provisions for claims outstanding are appropriate, the settlement should be considered both according to financial years and accident years. Settlement losses occurred repeatedly in the transition from the flat-rate provisioning to individual provisioning and partial provisioning for claims settlement expenses. However, the individual partial provisions should be set at an amount sufficient to ensure that no losses - at least overall - materialise in the settlement of provisions.

Equalisation provisions.

One insurer based the calculation of equalisation provision on incorrect figures for the earned net premiums and net claims expenditure. In addition, the undertaking in question did not use the claims ratios in the tables published in BaFin's annual reports for financial years with earned premiums of up to €125,000.

Provisions for impending losses.

Insurers must establish provisions for impending losses in the insurance business.[124] If an insurer suffers regular underwriting net losses before the changes in the equalisation provision for a number of years, it must establish corresponding provisions.

Risk management system must really be suitable for risk and corporate management.

Some insurers had not implemented a working risk monitoring system in the year under review. BaFin criticised this circumstance and also pointed out that a risk management system must not only comply with the formal, statutory provisions, but must also be suitable for corporate management. After all, the whole purpose of a risk management system is risk and corporate management. Concretely, BaFin criticised that in risk management systems, the managing board does not define the risks, the undertaking does not weigh risks at all or not appropriately, thresholds, the crossing of which lead to an obligation to inform and take action, are not defined, the reporting intervals were too long and no flexible ad hoc reporting was provided for.

[124] Section 341 e (2) no. 3 of the Commercial Code (Handelsgesetzbuch – HGB).

Solvency 2003

218 property and casualty insurers maintained own funds totalling €27.11 billion.

In the year under review, BaFin assessed the information provided on the solvency of 218 property and casualty insurance undertakings for the financial year 2003. The solvency margin to be covered by these undertakings amounted to €7.84 billion. The 218 undertakings maintained own funds totalling €27.11 billion. This equates to a coverage ratio of 346%. 211 undertakings achieved surplus coverage of the required amount with their available own funds. Seven undertakings were found to have a coverage shortfall totalling €98.0 million. This was met with remonstration by the supervisory authority. The situation is illustrated in detail below:

Table 15

Solvency of property and casualty insurance undertakings

Solvency margin to be covered	**2003**		**2002**	
	million €	Number of IUs	million €	Number of IUs
Minimum guarantee fund	15,3	24	18,5	28
Premium index	3.932,0	110	2.761,1	104
Claims index	3.888,1	84	4.634,8	93
Total	**7.835,4**	**218**	**7.414,4**	**225**

Own funds	**2003**		**2002**	
	million €	Number of IUs	million €	Number of IUs
Total	27.107,6	218	24.977,6	225
of which:				
Capital represented by profit participation rights	183,2	4	246,2	5
Subordinated liabilities	276,3	9	162,7	6
Supplementary contributions (for mutual insurance associations)	488,0	22	1.476,1	23

Coverage	**2003**		**2002**	
		Number of IUs		Number of IUs
Total coverage ratio	346%		337%	
Coverage shortfall	98,0 Mio. €	7	136,5 Mio. €	10
Excess coverage up to 100%	42%	92	36%	82
Excess coverage between 100% and 200%	23%	50	21%	47
Excess coverage between 200% and 300%	10%	21	14%	31
coverage of more than 300%	22%	48	24%	55
Total	**100%**	**218**	**100%**	**225**

5 Pensionskassen and pension funds

Economic situation of Pensionskassen

At the beginning of the year under review, BaFin supervised 155 Pensionskassen. The share-indexed hidden liabilities of these undertakings could be almost fully eliminated in the financial year 2003. As of the balance sheet date 2003, they amounted to only €204 million, corresponding to 0.3% of the book value of all investments. Only 14 Pensionskassen had hidden liabilities. By the end of 2004, an almost full elimination of share-indexed hidden liabilities was expected based on the development of the stock markets.

33 of the 155 Pensionskassen were exempt from stress tests, since their investments carried only little or no risk. Of the 122 Pensionskassen with the obligation to present a stress test, 97 achieved positive results in all three scenarios. Those Pensionskassen with a negative result in one or more scenarios usually only had a low coverage shortfall. BaFin requested that these undertakings take measures in order to restore their ability to bear risk.

In addition to the risk on the assets side of the balance sheet explicitly considered in the stress tests, the risks from biometrical calculation bases, in particular the risk of longevity, are relevant for Pensionskassen. The assessment of the actuarial reports to be submitted regularly - for insurance associations at maximum intervals of three years - of the last few years showed that many Pensionskassen must adjust their bases of calculation. The consequential revaluation of the mathematical provisions will lead to increased expenses in the following years. The continuing low-interest phase makes it difficult for the Pensionskassen to generate the interest surpluses necessary to finance those adjustments.

How the modified solvency regulations affect Pensionskassen

Pensionskassen may not use future surpluses as own funds after a transitional period.

As of 1 January 2004, the solvency regulations applying to Pensionskassen were modified. According to the modified regulations, the undertakings may not use future surpluses as own funds after a transitional period expiring on 31 December 2007. Unlike life insurance undertakings, Pensionskassen have used this possibility more and more. BaFin asked all Pensionskassen not fulfilling the changed solvency regulations as of the balance sheet date 2002 to take the modifications into consideration when preparing the annual financial statements for 2003 and allocating the surplus parts to own funds. In the financial year 2003, BaFin asked all Pensionskassen not fulfilling the modified solvency regulations to submit a plan describing the remedy of non-compliance by the end of the transitional period.

The assessment of the annual financial statements and solvency sheets 2003 showed that 60 Pensionskassen do not comply with the new solvency regulations at this time. Therefore, in the next few years, many Pensionskassen will have to allocate greater surplus parts to own capital in order to achieve compliance. Some of the carrier companies declared their willingness to provide the Pensionskassen with the necessary funds. The law provides the possibility of extending the transitional period for another two years for those Pensionskassen not fulfilling the new regulations as of 31 December 2007.

Pensionskasse solvency 2003

134 of the 155 Pensionskassen under BaFin's supervision in 2003 were required to submit a solvency overview. Pensionskassen with the legal form of „smaller insurance associations" are only required to submit this documentation as of those dates on which their mathematical provisions are recalculated.[125]

134 Pensionskassen maintained own funds of approximately €4.0 billion.

The solvency margin for the 134 undertakings amounted collectively to €3,128 billion. With own funds amounting to €4,005 billion in total, the resulting coverage rate was 128.0% (previous year: 119.4%).

One Pensionskasse did not have own funds adequate to cover either the solvency margin or the guarantee fund; the undertaking has since rectified the coverage shortfall of the guarantee fund. In two further cases, the guarantee fund was covered, but not the solvency margin; the undertakings submitted solvency plans which are still in the process of execution. 90 of the other Pensionskassen exhibited excess coverage of up to 100%. 14 undertakings had surplus coverage of between 100 and 200%, three between 200 and 300%, while 24 Pensionskassen achieved a surplus in excess of 300%.

48.1% of the undertakings' own funds were made up of capital and surrogate capital, with the free portion of the provisions for premium refunds accounting for 25% and future surpluses and hidden reserves from investments accounting for 26.5%. 48 Pensionskassen included future surpluses in own funds following BaFin's approval. Additionally, BaFin authorised four Pensionskassen to use hidden reserves from investments. Four undertakings counted surrogate capital in the form of subordinated liabilities towards own funds.

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

[125] Circular 3/97 [Insurance Supervision].

Pension Funds' Economic Situation

In the financial year 2004, the economic development of the 24 pension funds authorised to conduct business again fell short of the expectations initially placed on the potential of the pension fund sector. In the financial year 2004, BaFin could only authorise one pension fund to conduct business, another two authorisation processes ended with the withdrawal of the application.

In comparison with the previous financial year, the development of premium income and the number of beneficiaries was only slow. The forecasted premium income for the financial year 2004 amounts to around €110 million as opposed to €94 million in the previous year. The number of current or future beneficiaries is estimated at around 100,000 (previous year: 89,262) and 50 (previous year: one) respectively.

The liberal investment provisions applicable to pension funds do not require them to adhere to quantitative upper limits regarding the mix of their restricted assets. As a result, pension funds could step up their investments in international equities markets. Based on the downward trend on the stock exchanges over several years, pension funds utilised this potential for higher return only in a very restricted manner, despite the fact that equities markets recovered moderately in the past two years and that a partial transfer of the investment risk to the employee and / or employer during the qualifying period for pension funds is admissible. In 2004, the absolute volume of investments in this area amounted to an estimated €200 million for the entire sector, whereas over 80% could be allocated to merely two pension funds. The projected share in investment funds amounted to approximately 86%. The proportion of direct possession of shares was negligible.

The trend in occupational retirement provision was not headed for pension funds in 2004 either. Not the liberal investment opportunities of the pension funds were in demand; instead, products with comprehensive guarantees and permanent performance were popular.

Pension funds solvency 2003

As with insurance undertakings, pension funds are required to cover possible risks by maintaining own funds.[126] 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. This states that own funds must be sufficient to cover the greater of the two following amounts: the required 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 provisions and the capital at risk as calculation parameters. The Pensionskassen only had a limited scale of business as of

[126] See section 114 of the VAG.

31 December 2003. This meant that for all pension funds, the sum of own funds required was based on the absolute minimum own fund requirement - the minimum amount of the guarantee fund. It amounts to three 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 as defined in section 24 of the Insurance Supervision Act in the amount of this difference.

Actual amount of maintained own funds well in excess of the minimum requirements.

In the year under review as well, the factual amount of own funds maintained by the pension funds was well in excess of the minimum amounts required. In 2003, all pension funds fulfilled the solvency requirements.

Georg Dreyling,
Chief Executive Director
of Securities Supervision

V Supervision of securities trading and investment business

1 Basis for supervision

1.1 Act on the Improvement of Investor Protection

Act on the Improvement of Investor Protection changes various regulations in the securities area.

The Act on the Improvement of Investor Protection[127] comprehensively changes in particular the regulations regarding ad hoc disclosure and the prohibition of insider trading. The prohibition of market manipulation and the provisions concerning the preparation and publication of financial analyses were also amended. The obligation to issue a prospectus, so far applicable to securities, will be extended to uncertificated equity participations as of July 2005.

Prohibition of insider trading.

The Securities Trading Act replaced the old term "insider fact" with the new term "inside information", mainly in order to achieve a linguistic adjustment to the other European legal systems. In addition, solely the use of inside information constitutes a prohibited insider transaction now, without the actual use of insider knowledge for an economic advantage. The penal provisions were also amended, e.g. by introducing a threat of punishment for attempted insider trading. The introduction of elements of administrative offence for secondary insiders is also new. So far, the unauthorised distribution of inside information or the recommendation to purchase or sell insider securities based on insider knowledge has not been sanctioned.

Insiders registers.

According to section 15 b of the Securities Trading Act, issuers and persons acting on their behalf shall be obliged to maintain a register of persons who have access to inside information according to regulations. On the one hand, this obligation has a preventive function, as the issuers have to inform all persons contained in the said register of their obligations and of the consequences of a violation. On the other hand, the insiders registers make it easier for BaFin to supervise insider trading in case there has been a specific suspicion already.

Ad hoc disclosure.

In the revised version of the Securities Trading Act in the area of ad hoc disclosure and directors' dealings, the disclosure obligations were extended. The separation of insider fact and ad hoc fact provided for by the Act in its former version was abandoned. In principle, any circumstance which constitutes inside information in the area of insider supervision and directly relates to the issuer, constitutes information which must now be disclosed by way of ad hoc disclosure. In addition, the issuer now has the opportunity to ex-

[127] BGBl. 2004 I, p. 2630.

empt itself from the disclosure obligation. Up to now, such an exemption could only be granted by BaFin upon request.

Directors' Dealings.

In the area of directors' dealings, the circle of persons subject to notification was expanded. It extends to natural persons as well as to legal persons. Furthermore, the de minimis threshold for an exemption from the disclosure obligation was lowered. According to law as heretofore in force, transactions were not subject to the disclosure obligation unless a limit of €25,000 per person subject to notification was exceeded within 30 days. Now, a de minimis threshold of a total of €5,000 per calendar year is in force.

The regulation relating to notification of dealing in securities and maintenance of register of insiders[128] regulates the details of the contents and the procedure concerning the disclosure of inside information according to section 15 of the Securities Trading Act, concerning transactions according to section 15 a of the Securities Trading Act as well as concerning the maintenance of insiders registers according to section 15 b of the Securities Trading Act.

Market manipulation.

In the area of market manipulation, the present prohibition of "other deceptive practices" was further concretised by establishing a third statutorily prohibited act. According to this, it is explicitly prohibited to give deceptive signals as to supply and demand or to cause an artificial price level. In addition, according to the new legal situation, market manipulation can be constituted by the committer believing it possible and accepting that he/she gives deceptive signals by his/her trading practice. So far, deceptive conduct has only been subject to sanctions if the committer acted deliberately with the intention of price manipulation. In practice, this has often been difficult to prove. Now it is easier to show evidence as the element of intent concerning such a deceptive practice is no longer given. Details of the elements of market manipulation are regulated by the Market Manipulation Concretising Ordinance (MaKonV)[129] of the Federal Ministry of Finance, which replaced the previous Ordinance Detailing Stock Exchange and Market Price Manipulation (KuMaKV).[130] Practices which do not constitute market manipulation are additionally detailed in the exemption regulation of the EU Commission of 22 December 2003.[131]

Now it is also clear that prohibited manipulation practices do not only include so called sham transactions such as wash sales or arranged transactions, but also effective transactions which appear to be admissible common trading practice. These transactions can also give deceptive signals or change a market price to an artificial level. In the past, this was doubted despite the intent of the legislator, which can be clearly recognised from the legislative history concerning the present section 20 a (1) sentence 1, no. 2 of the Securities Trading Act. There are also no doubts any more that a prohibited manipulation practice can exist even if a person's trading practices seem to be consistent with the stock exchange rules.

[128] BGBl. 2004 I p. 3376.
[129] BGBl. 2005 I, p. 515.
[130] BGBl. 2003 I, p. 2300.
[131] Regulation 2273/2003, OJ EU No. L 336/33.

Safe harbour for stabilisation measures.

Just like the former Ordinance Detailing Stock Exchange and Market Price Manipulation, the EU regulation no. 2273 of December 2003 grants an exception from the manipulation prohibition for stabilisation measures in connection with an IPO or a capital increase. Thus, in case of issues of shares, backing is allowed for a period of up to 30 calendar days after the IPO. However, backing must not be effected at a price exceeding the determined issue price. In practice this strict upper limit proved to be impracticable in relation to the determination of the initial price on the stock exchange. BaFin thus proposed to accept as admissible market practice that backings lead to an initial stock exchange price exceeding the issue price insofar as this is necessary for a full order book balancing. Such an exemption - restricted to the initial price determination on the stock exchange - would especially prohibit expensive partial executions for investors and provide for an equal initial stock exchange price on all German stock exchanges.[132]

Safe harbour for share repurchase programmes.

In addition, the EU regulation grants an exemption from the manipulation prohibition for share repurchase programmes of companies listed on the stock exchange. However, this shall only be valid for repurchase measures for the purpose of a capital reduction or for the fulfilment of obligations from notes or share purchase programmes for employees. This regulation is thus stricter than the prior national regulation set forth the Ordinance Detailing Stock Exchange and Market Price Manipulation.

More investments in assets now subject to the obligation to issue a prospectus.

The obligation to issue a prospectus, so far applicable to securities, will be extended to certain uncertificated financial assets as of July 2005. Then all shares which grant a participation in the results of a company as well as shares in assets which the issuer or a third party holds or administrates in his own name for the account of a third party (trust estate) shall be subject to the obligation to issue a prospectus. In addition, shares in other closed-end funds shall be subject to the obligation to issue a prospectus. BaFin shall be the auditing agency and deposit agency for these prospectuses.

The extension of the obligation to issue a prospectus to major parts of the "grey capital market" considerably improves the information possibilities for investors. Furthermore, the obligation to issue a prospectus leads to a prospectus liability, which also extends to claims arising from the failure to issue a prospectus. More information concerning the contents of the prospectus will be regulated by the Ordinance of Sales Prospectuses for Financial Assets expected to come into force as of 1 July 2005.

Guideline for issuers.

The considerable changes led to increased information requirements of issuers of securities listed on a stock exchange. On the occasion of several lectures and discussions, BaFin explained to the issuers the realisation of the new regulations in practice. The result of these efforts will be BaFin's new Guidelines for Issuers. These guidelines contain information concerning the maintenance of insiders registers, the prohibition of insider trading and market price

[132] BaFin will decide on the recognition after consultation by CESR on an European level.

manipulation as well as ad hoc disclosure and directors' dealings. The guidelines will be published on BaFin's Web site.

1.2 Balance Sheet Control Act

The Balance Sheet Control Act (Bilanzkontrollgesetz-BilKoG)[133], which came into force on 21 December 2004, states that financial statements are subject to external control (enforcement procedure). This is supposed to increase the investors' confidence in the correctness of the financial statements of capital market oriented companies. The verification extends to the lawfulness of the latest financial statements and reports of companies whose securities are admitted on a domestic stock exchange for trading on the official market or on the regulated market.

Two-step enforcement procedure.

The procedure is divided into two steps:
First, an institution organised according to private law shall effect sample audits and shall take action in case of concrete grounds for suspecting a violation of the accounting standards as well as upon BaFin's request. The "German Financial Reporting Enforcement Panel - DPR" was founded as the responsible body for this auditing agency. This body can only effect its audits if the respective companies are willing to cooperate. If a company refuses to cooperate, or if a company is not satisfied with the result of such an audit, BaFin can bindingly order such an audit and enforce it with sovereign competences in the second phase. The same is true if there are considerable doubts as to the correctness of the auditing result of the auditing agency or as to the orderly execution of the audit by the auditing agency. In order to execute this audit, BaFin can use the services of the auditing agency and of third parties. BaFin orders that a company must publish mistakes found in the course of an audit together with the material parts of the basis for the determination of these mistakes, unless there is no public interest. Upon request, BaFin can also exempt a company from its obligation to publish, if this could cause damage to the rightful interests of the company.

1.3 Investment Regulations

Ordinance on Derivative Financial Instruments

The Ordinance on Derivative Financial Instruments provides for extended use of derivatives.

The Ordinance on Derivative Financial Instruments (Devirateverordnung-DevirateV)[134] which came into force on 13 February 2004 regulates the use of derivatives in funds. Investment companies can now use considerably more instruments and are also allowed to take a higher market risk. Thus, with the Ordinance on Derivative Financial Instruments, the EU Commission's recommendations concerning the use of derivative financial instruments for underta-

[133] BGBl. 2004 I, p. 3408.
[134] BGBl. 2004 I, p. 153.

kings for collective investment in transferable securities (UCITS)[135] have been realised as early as 2004. When investing in derivatives, investment companies must have a risk management in place, which continuously registers measures and controls the risk from the investment in derivatives (section 1 of the Ordinance on Derivative Financial Instruments). According to the Ordinance on Derivative Financial Instruments, there are two approaches to measure risks: the "simple" and the "qualified" approach. The "simple" approach is admissible only if certain classes of simple derivatives, specified at the end of the Ordinance on Derivative Financial Instruments, are used for funds. If the investment company intends to use other derivatives, the qualified approach is mandatory. The qualified approach provides for the measurement of the market risk potential by way of an acknowledged value-at-risk model. Both approaches include risk-adequate stress tests.[136]

Regulation Concerning Fund Categories

On 14 December 2004, the regulation to establish fund categories according to section 4 (2) of the Investment Act came into force.[137] The legislator restructured the product specific regulation contained in the Investment Act and cancelled the statutory fund categories of the previous Investment Companies Act to a large extent. The new regulation now permits the flexible combination of investments in admissible assets. In order to allow investors to continue to differentiate between the offered investment funds, the regulation determines how an investment fund must be invested according to the contract terms or to the articles of association, so that it can be classified as equity fund or bond-based fund for example. As a rule, a fund named after a specific fund category must invest at least 51% of the value in assets specific for this fund category. There are special regulations for funds of funds, index funds, money market funds and pure derivative funds. There is a higher threshold for index funds for example, as these must reproduce a specific securities index acknowledged by BaFin according to the Investment Act.

Ordinance on Investment Reporting

Obligations to register in order to control investment limits concretised by the Ordinance on Investment Reporting.

The Ordinance on Investment Reporting (Investmentmeldeverordnung-InvMV), which came into force in spring of 2005, substantiates the obligations to report according to section 10, paragraphs 1 and 2 of the Investment Act, which came into force on 1 January 2005. This ordinance stipulates provisions for the contents and transmission of electronic asset statements on the basis of which BaFin verifies if funds are within the statutory investment limits. Contents and ways of transmission for reports concerning the securities transactions completed for funds are explained in more detail. The supervisor thus has better and modernised control facilities for the investment companies' investment behaviour.

[135] UCITS recommendations by the EU Commission 2004/383/EU, OJ EU No. L 144/13.
[136] Explanations concerning the Ordinance on Derivative Financial Instruments (Derivateverordnung – DerivateV) can be found under www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > Verordnungen (German only).
[137] BGBl. 2003 I, p. 2676.

Ordinance on Unit Classes

The formation of unit classes admissible according to section 34 (1) of the Investment Act provides for different legal definitions for the units of one fund. Different unit classes can differ from each other in profit distribution or retention, initial charge, repurchase reduction, currency, administration commission or a combination thereof. The Ordinance on Unit Classes, which came into force in April 2005, prescribes how the accounting representation, the financial statement and the valuation of unit classes of funds are to be effected, so that the consequences of all business transactions since the last valuation key date for the value of the individual unit class and the individual unit can be tracked. Thus, investors, auditors and BaFin receive extensive information on the development of the individual unit classes of a fund and of the individual units.

2 Supervision in the investment business

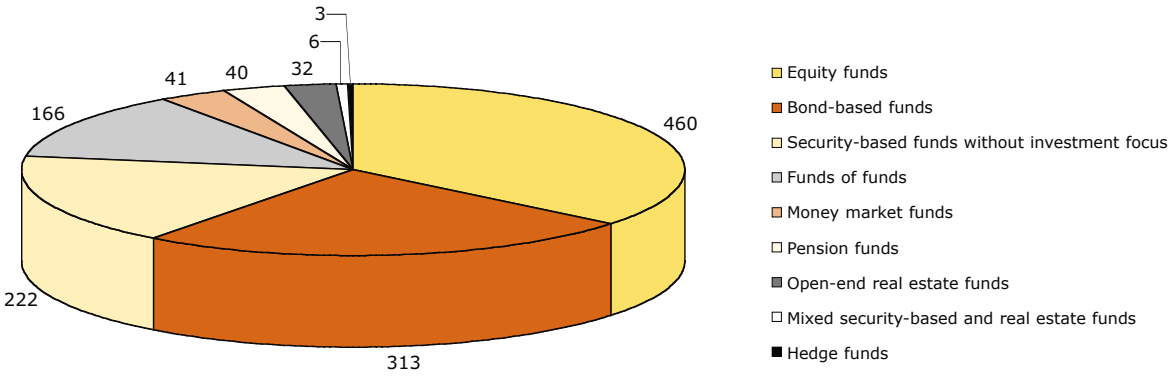
2.1 Investment companies

Investment companies take the opportunity to outsource.

There were 80 investment companies in the year 2004, i.e. almost no difference to the previous year. Two companies returned their license to operate in the investment business. Another two companies expressed their intention to discontinue business operations in 2005. In addition to the internal motives such as high IT costs or concentration on different core areas, this is probably also due to the legal framework conditions, especially to the possibility of outsourcing (section 16 of the Investment Act). Based on the offers of master investment companies and the possible outsourcing of portfolio management, an investment company does not necessarily have to perform all activities itself. If an asset manager can manage its portfolio more efficiently, restructuring the value-added activities may be the reasonable course of action for a corporate group or group of companies. In 2004, many investment companies outsourced primarily the portfolio management. Specialised funds used this opportunity more often than mutual funds. The institutional investors' requests might have been decisive in this context.

The number of mutual funds managed by domestic companies was 1,283 at the end of 2004. Furthermore, the investment companies managed 4,989 specialised funds.

Figure 29
Mutual funds managed by domestic investment companies as of 31 December 2004



Harmonisation of the model contract terms.

BaFin harmonised the General Terms of Contract and the Special Terms of Contract of several types of funds with BVI (Federal Investment and Asset Management Association). Unlike the General Terms of Contract, the Special Terms of Contract must be verified for each individual fund. The Special Terms of Contract were considerably shortened in order to further accelerate the authorisation process. For an expeditious licensing procedure, the standardisation of the terms of contract is indispensable.

First "Super UCITS"-fund authorised.

According to the Investment Act, funds pursuant to the UCITS directive are not required to only invest in securities (shares, bonds) any more; now, they can also invest in money market instruments, other fund units and derivative financial instruments. The first of these so-called super-UCITS-funds was authorised in 2004.

Extended Licenses for Investment Companies.

Based on the Investment Act, the business potentials for investment companies were extended in the area of individual asset management in case of an extension of the corresponding licenses. Now, investment companies can offer this secondary service as a second main business activity subject to licensing. However, the license for individual asset management shall be deemed to have been granted if this service was a secondary purpose of the company before the Investment Act came into force. In order to be able offer individual asset management starting 1 January 2004, in addition to collective asset management, many investment companies adapted their articles of association or memoranda respectively in order not to be subject to obtaining a license in 2004.

Market supervision

In the area of market supervision, BaFin concentrated on the evaluation of reports and notifications of investment companies and contributed to the new Ordinance on Investment Reporting.

In the year 2004, the number of long-term severe violations of investment limits could be reduced by more than 40% in comparison to January 2003. In this context, the notifications of violations of

investment limits by the companies were very helpful. The analysis of the annual and bi-annual reports of domestic funds led only to a few complaints.

Preventive measures against late trading and market timing.

Internationally, dubious trading practices of investment companies in the USA caused a great sensation. BaFin's investigations showed, however, that there was no evidence for systematic market timing (time zone arbitrage). Only in one case the suspicion of late trading (trading at known unit values) was confirmed. Beforehand, BaFin ordered special audits and questioned all companies as to what extent measures to prevent late trading and market timing had been implemented. All in all, German investment companies implemented their preventive measures against doubtful trading practices very well.

Rules of good conduct acknowledged in the sector are to be part of the funds audit reports. In this context, special audits showed how these rules of good conduct are to be developed further. BaFin especially concentrated on deficits in cost transparency, unclear purchase conditions of asset and mortgage backed securities and dependencies between parent company and specialised banks.

For the year 2005, questions on the functioning of risk management and on the implementation of the Ordinance on Derivative Financial Instruments were included in the market supervision agenda. In 2006 at the latest, the entire investment supervision of companies and products will be effected in Frankfurt am Main. This is a considerable advantage, also in view of advanced networking between portfolio and organisational level within the investment companies.

2.2 Real estate funds

At the end of 2004, German investment companies managed assets amounting to €87.7 billionin 32 real estate mutual funds and assets amounting to €13.4 billion in 82 real estate specialised funds. Specialised funds are funds, the units of which are held by a maximum of 30 investors which are not natural persons. All other funds are mutual funds (section 2 (3) of the Investment Act).

In the year under review, BaFin granted two licenses for new investment companies which manage real estate funds. In one case, BaFin authorised the amalgamation of two real estate funds, which is now permissible under to the Investment Act.

Just like in the year 2003, the general economic situation, the increase in company insolvencies and the decrease in lease prices led to worsened conditions on the German real estate markets for offices in the year under review. This development led to a net outflow of funds from real estate funds mainly investing in Germany. In relation to the whole sector, the cash inflow remained positive in the year 2004.

Bribe scandal in Frankfurt.

In 2004, the situation also worsened due to a bribe scandal. Around 80 accused persons in Frankfurt, Munich and Düsseldorf and their environs are currently under investigation by the public prosecutor's office in Frankfurt by reason of corruption, breach of trust and tax offences in connection with the purchase, sale and management of real estate. October 2004 brought the revelation that investment companies issuing open-end real estate funds were also affected by the scandal. The executive manager of an investment company and a member of a body of another investment company admitted corruption. In this case, there was close cooperation between the financial supervision and the public prosecutor's office in Frankfurt. In mid-October, BaFin ordered special audits of two affected investment companies. The fair values of some real estate contained in the funds and the investment companies' orderly course of business are subject matters of these audits. After receiving initial results, the supervision extended the auditing orders; the audits have not been completed yet.

Evaluation of real estate included in the funds
Every trading day, each investor can return his/her units in a mutual fund. Thus, the investment companies are obliged to calculate prices for the units every trading day. In case of open-end real estate funds, the unit prices are calculated on the basis of a statement of assets regulated by the Investment Act (sections 44, 79 of the Investment Act). As, in contrast to securities, the market price of real estate cannot be determined on the basis of the stock exchange price, independent experts determine the fair values (section 77 of the Investment Act). For several current real estate sales, the values determined by the experts could actually be achieved on the market. If this development continues, there should be no reason for a major change of the methodology used to determine the fair value. However, in the course of its special audits, BaFin made some determinations which led to the conclusion that the area of valuation of real estate has to be improved. The extent of these improvements to be made can be determined when the final audit reports are available.

High outflow of funds in 2004.

The scandal in Frankfurt increased the outflow of funds of some major funds. Pursuant to the Investment Act (section 80 (1) sentence 2), an investment company has to hold a minimum liquidity of 5% of the value of the funds. BaFin addressed the companies and their parent companies concerning the high outflow of funds. In the case of one investment company the parent company stood in. Also, some real estate was sold in order to maintain the liquidity of the fund.

2.3 Hedge funds

Hedge funds strategies
Hedge funds typically aim at the realisation of an absolute return. Different investment strategies are combined in order to achieve

this goal. Their strategies are not limited by regulations, so they can go in debt, use derivative financial instruments and effect bear sales in their discretion. This leads to considerable leverage effects. On the one hand, hedge funds can reduce inefficiencies of the financial system, if they effect arbitrage transactions. On the other hand, however, they take speculative positions betting on possible false estimations or on future developments on economic and financial markets; these positions are connected with a more or less high risk. Hedging, i.e. eliminating risks by positions offsetting each other is typically used to eliminate risks which are not connected with the chosen strategy. These active hedge funds' strategies are opposed to the passive performance of the index tracker.

First hedge funds authorised.

The special attention of the public was directed at the start of the first hedge funds authorisations in Germany. There was the impression that a great amount of funds were in "starting positions". However, it became evident that time and suitable market environments are necessary to successfully launch new products. The funds sector requires suitable personnel and also sufficient financial means, functioning systems in the front as well as in the back office, good marketing and a well trained sales department. In addition, extensive legal issues needed to be clarified.

The initial two hedge funds of domestic investment companies were authorised by BaFin as early as March 2004. During the whole year under review, BaFin was able to authorise seven domestic single hedge funds (one of which was an investment stock corporation) and four funds of hedge funds and the distribution of five foreign funds of hedge funds. BaFin completed seven procedures to extend existing licenses and authorised one master investment company. For the year 2005, BaFin expects a considerably higher number of authorisations.

Harmonisation of the General and Special Terms of Contract.

BaFin had more than 200 consultations with interested investment companies in order to facilitate the application procedure. In addition, BaFin prepared General and Special Terms of Contract for single funds and funds of hedge funds in cooperation with the associations by February 2004. These terms are one of the most important bases for the authorisation of funds. The Federal Ministry of Finance published a leaflet concerning the role of prime brokers.[138] Single hedge funds are now able to use the services of these service providers more easily.

Authorisation procedure.

In order to enable BaFin to authorise a hedge fund in Germany, the fund issuing company must request an authorisation. There are three possibilities to do so: An existing investment company can either apply for an extension of its licence or a new investment company to be established applies for the authorisation of hedge funds. A third possibility is the establishment of an investment company with variable capital. In contrast to the investment company, the investment stock corporation is not a specialised bank and must only observe some specific provisions of the German Banking Law.

[138] www.bafin.de > Für Anbieter > Investmentfonds > Inländische Investmentfonds (German only).

In the course of the authorisation procedure for companies, BaFin especially investigates the risk management, paying special attention to existing methods, structures and procedures for risk identification, risk measurement, risk control and risk spreading. In this context, the hedge funds supervision closely cooperates with the specialists from the section "risk modelling".

Supervisory inspections allow for an initial assessment as to whether the methods and processes of the risk management procedure are adequate or if there are deficiencies. In case of severe complaints, the procedures need to be revised before the companies can be granted authorisation. In case of smaller deficiencies, a company can be granted authorisation subject to certain conditions. During the year under review, a total of 14 supervisory inspections were effected. These supervisory inspections showed that the hedge funds sector is marked by a great variety of products, organisational structures and business procedures. After an authorisation is granted, BaFin verifies by means of inspections in situ if the companies meet the obligations permanently. In the year 2004, there was only one inspection; however, further investigations are planned for 2005.

Domestic funds of hedge funds.

Authorised companies can issue single hedge funds as well as funds of hedge funds in Germany. Domestic funds of hedge funds can be authorised as mutual funds or as specialised funds as well. In principle, 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 single funds. Other criteria must be determined on a case by case basis, subject to the superordinate principle of risk diversification. In addition, funds of hedge funds are required to obtain a certain minimum amount of 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. Quantitative criteria include but are not limited to the strategy of the target fund, its historical returns and standard deviations, correlations to other target funds with similar or identical investment strategies or benchmarks as well as the stability of its returns in extreme or variable market situations. In qualitative analyses, 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 Investment Act includes special requirements concerning the fund of hedge funds managers' experience and practical knowledge. In particular, a manager must have theoretical and practical knowledge in the area of hedge fund investing. The prospectus for funds of hedge funds products must contain a warning notice that the investor risks total loss. Investors must be provided with all sales documentation before conclusion of the contract.

Domestic single hedge funds.

Single hedge funds can also be issued as specialised funds or as mutual funds. However, single hedge funds may not be publicly[139] sold but may only be distributed by means of a private placement. Only companies authorised by BaFin to do so are allowed to sell this product. Generally, there are almost no legal restrictions concerning the strategies of single hedge funds. They are generally permitted to take out loans, use derivatives to increase the investment level, leverage transactions and short sales without limitation.

2.4 Foreign investment funds

Increased number of foreign funds licensed to distribute.

BaFin regularly supervises foreign investment funds licensed to distribute in Germany and audits the distribution notices for new foreign investment funds. There was in increase in the number of distribution notices received (862) compared to the previous year (756). Thus, the total number of foreign investment funds licensed to distribute increased to 5,127, despite many mergers, liquidations and winding-ups in their respective countries.

Above all, BaFin closely monitored the marketing activities of individual foreign investment funds. In two cases it was necessary to prohibit any further public sale as the funds used unauthorised marketing activities.

Subsequent audits according to the Investment Act.

The new legal situation led to some special cases in the year 2004. BaFin had to verify if funds according to EU directives and licensed to distribute, which were converted to the amended UCITS Directive[140] fulfilled the statutory requirements according to the Investment Act.

The new legal framework also affected the distribution notices. In 2004, BaFin published two supplements to its preliminary fact sheet for distribution notices according to the Investment Act as of the end of 2003.[141] Supplement 1 refers to the distribution notices of funds according to EU directives that are funds which correspond to the UCITS Directive. In the year under review, 843 notices were received in this category. Supplement 2 must especially be observed in case of distribution notices for funds which do not correspond with the EU directives (excluding funds of hedge funds). In the year 2004, 19 of these funds indicated their intention to start public sales in Germany.

Increasing number of funds according to EU directives.

The following graphs show the development of the portfolio of individual funds licensed to distribute, divided into funds which correspond to EU directives and funds which do not correspond to EU directives. In most cases, the decline in the number of funds licensed to distribute which do not correspond to EU directives was due to the conversion of these funds into funds corresponding to EU di-

[139] According to section 2 (11) Investment Act (Investmentgesetz – InvG), a public sale is "a sale which is effected by public offer, public advertising or similar".
[140] DIR 85/611/EEC of 13. February 2002; OJ EU No. L 375/3.
[141] www.bafin.de > Für Anbieter > Investmentfonds > Ausländische Investmentfonds (German only).

rectives. This became possible as the changed UCITS Directive now permits the funds in conformity with EU directives an extended investment policy.

Figure 30
Individual funds licensed to distribute in conformity with EU directives

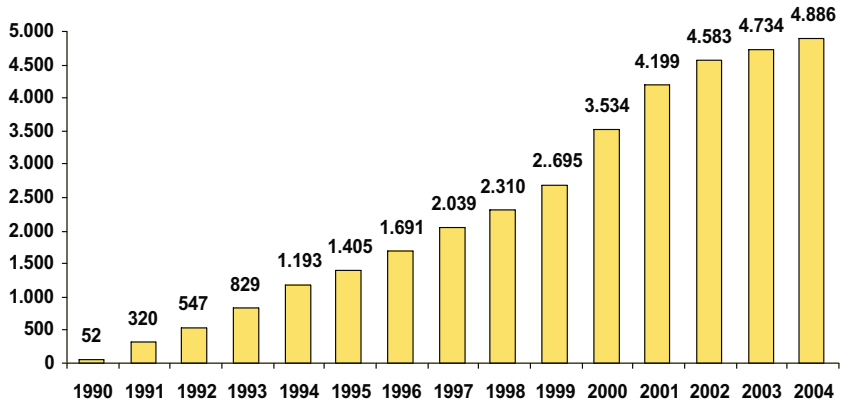
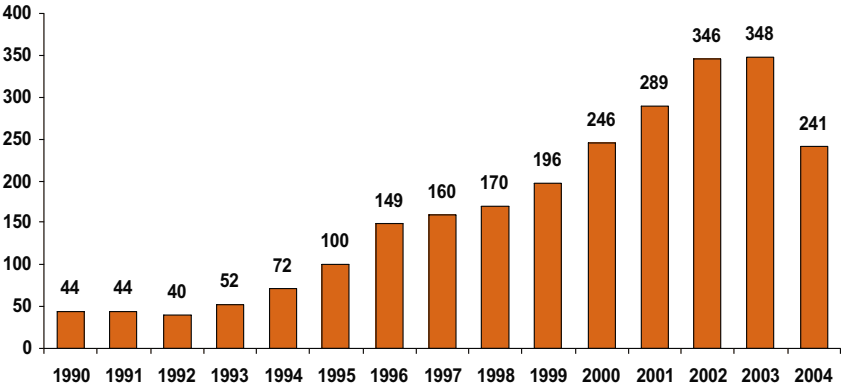


Figure 31
Individual funds licensed to distribute not in conformity with EU directives



3 Control of market transparency and market integrity

3.1 Market analysis

Analysis of transaction data.

BaFin analyses the reported transactions in order to detect insider trading and market manipulation. Pursuant to section 9 of the Securities Trading Act, credit institutions, financial services companies and other persons subject to notification must disclose to BaFin all

data concerning business transactions in financial instruments. In the year 2004, this amounted to approximately 500 million data sets.

Intelligent Miner (IM)
Due to the amount of reported transactions data, structures of liquid financial instruments are often hard to detect. However, this is necessary in order to reveal conspicuous trading practices. In the year under review, BaFin expanded its analysis instruments by adapting a common data mining product to the particular needs of market supervision and thus developing the Intelligent Miner. This Intelligent Miner allows the automated analysis of transaction data before ad hoc reports. Above all, it facilitates the procedure for financial instruments with very high trading volume, such as shares of DAX or MDAX listed companies. Data sets which show a similar trading behaviour are combined in so-called clusters. Conspicuous trading practices are unusual trading practices by persons subject to notification or by customers which differ from those of the other market participants.

1,700 analyses led to 128 investigations.

During the year under review, BaFin performed more than 1,700 analyses. In 128 cases there were positive results, with indications for insider trading or market manipulation.

The cases of insider trading (67) could almost all be attributed to elements in connection with liquidity problems / over-indebtedness, mergers & acquisitions and current results. In this context, companies' corporate actions must be emphasised.

Indications for market manipulations often referred to other deceptive practices.

The cases of market manipulation (61) could almost completely be attributed to "other deceptive practices". The other analyses identified inaccurate information. Two thirds of other deceptive practices showed indications for fictitious trading activities. In these cases, business transactions were effected without any actual, equitable exchange of financial instruments that are shares in most cases. This includes wash sales or prearranged trades. The remaining other deceptive practices related to information offences, influencing of reference prices on other markets as well as unauthorised price maintenance and price stabilisation measures.

BaFin prepares expert opinions for courts, prosecutors and the police.

In 2004, BaFin prepared eleven expert opinions for courts, prosecutors and police authorities. BaFin's employees testified in court proceedings as expert witnesses in three cases. One of these proceedings took place in Melbourne, Australia. BaFin's activities as experts included the verification of the effect of a manipulative action on the market price.

Infomatec
The Regional Court Augsburg instructed BaFin to prepare an expert opinion for the court proceedings against two former members of the management board of Infomatec AG. BaFin was to investigate whether 4 ad hoc notifications of 1998 and 1999 announcing large

orders had an effect on the price of the Infomatec share. In addition, BaFin was to investigate if the statements contained in the ad hoc reports which were inaccurate according to the prosecution were suitable to considerably affect the price of the Infomatec share. BaFin found that three of these 4 ad hoc reports had an effect on the price of the Infomatec share. In addition, the inaccurate statements could considerably influence the price of the Infomatec share.
In November 2003, the Regional Court Augsburg agreed with the expert opinion and gave one of the defendants a two years' suspended sentence and a fine of 180 daily rates of €50 each. In addition, the court ordered the cancellation of the sales revenues of the insider sales amounting to €380,000. At the beginning of May 2004, the Regional Court Augsburg sentenced the second defendant to two years' and nine months' imprisonment and ordered the cancellation of the sales revenues amounting to €4.5 million. The leapfrog appeal lodged from this judgement was dismissed by the German Federal Court of Justice with its order of 30 March 2005 (1 StR 537/04 LG Augsburg - 3 KLs 502 Js 127 369/00).

As a rule, takeover bids are of considerable price relevance.

inside information exists if and when a concrete fact - when published - is suitable to considerably affect the market price of a security. In order to empirically investigate the price relevance of securities purchase, takeover and mandatory tender offers in connection with insider offences, BaFin prepared a study concerning the measurement of price effects in connection with these offers. Among others, this study compares the target companies' offer prices with the market prices determined before publication. Furthermore, it compares the bidding companies' market prices determined after the publication with the market prices determined before the publication. All offers submitted ever since the Securities Acquisition and Takeover Act came into force in 2002 were included. After this date, purchase, takeover or mandatory tender offers for securities have basically been of considerable price relevance.

Study concerning price effects of takeover

- On average, a bidder pays a considerable bonus on the share price of the target company. This bonus is between 15 and 24% depending on the time period in question.
- The highest bonuses are paid in case of purchase offers for securities, followed by takeover and mandatory tender offers.
- Higher bonuses are paid on ordinary shares than on non-voting preference shares. In particular in case of an offer with the intention to purchase the control of a company, the value of the voting right can be expressed in numbers.
- In the short term, a positive price reaction could be noticed for the shares of the bidding company; however, no long-term general statements can be made. In this context, a detailed individual investigation will remain necessary.

3.2 Insider trading

BaFin commenced 57 new cases of insider trading.

In the year 2004, BaFin commenced 57 new cases based on the suspicion of forbidden insider trading practices. Together with the proceedings from the previous years, 88 proceedings were pending. In 23 cases BaFin transferred the case to the competent public prosecutor. In total, BaFin filed criminal complaints against 71 persons. BaFin dismissed 37 cases for lack of sufficient evidence.

Table 16
Investigations of insider trading

	Period	New cases	Results of the investigations			Pending investigations
			Dismissed	Transferred to public prosecutor		
		Insider	Insider	Transactions	Persons	Total
Previous years	2001	55	19	25		61
	2002	69	15	33		82
	2003	51	16	26	137	91
	2004	57	37	23	71	88
2004	1st quarter	7	14	3	8	81
	2nd quarter	16	4	8	35	85
	3rd quarter	16	5	5	13	91
	4th quarter	18	14	7	15	88

Increased number of convictions for insider trading.

In the year under review, there were five trials which resulted in five final convictions as well as two summary proceedings without trial which resulted in two final convictions. There was a considerable increase in convictions after a trial in 2004 (5) (2003: 2). In 192 cases, the public prosecutors dismissed the preliminary investigations, in 29 cases thereof proceedings were settled out of court with payment of a fine.

Table 17
Information by public prosecutors relating to concluded insider proceedings

	Period	Total	Dismissed	Dismissed as a result of a payment of a fine	Final court decicions			
					Court decisions	Convictions by summary proceedings without trial	Conviction after trial	Acquittals
Previous years	2001	39	28	9	0	1	1	0
	2002	53	37	13	0	2	1	0
	2003	87	70	7	4	3	2	1
	2004	199	163	29	0	2	5	0
2004	1st quarter	52	42	7	0	0	3	0
	2nd quarter	28	25	2	0	0	1	0
	3rd quarter	75	61	13	0	1	0	0
	4th quarter	44	35	7	0	1	1	0

During the year under review, BaFin received 19 enquiries related to insider trading by foreign regulatory authorities and made 124 enquiries to foreign authorities.

Difficulties in determining the potential to influence the market.

When handling cases of insider trading, public prosecutors and courts often face difficulties which often result from the investigation of whether inside information had a considerable effect on the market price of an insider security or not. In order to determine this element, an assessment as to what extent the market price was affected when the circumstances in question become known is necessary. The benchmark for this assessment is the informed, i.e. the average investor who is familiar with the stock market.

Some of experts invited by the courts to answer this question only concentrate on the issue of whether the potential of inside information to affect the market price is confirmed by a certain empiric study published in economic literature or by a subsequently prepared study. In these cases, a considerable potential to affect the market price is considered to be existent. However, an informed investor will not only rely on experts' experience when making his/her investment decision. For an informed investor's forecast, aspects in addition to the empiric experiences are decisive. This includes the general market situation, the industry's situation and the situation of the individual company at the time of the inside information. Expert opinions with a purely methodical approach cannot provide an unequivocal answer to the question of whether there is a considerable potential to influence the market price. A court making its decision only on this basis will generally acquit.

The following provides a more detailed description of some of the cases concluded in 2004.

BHW Holding AG

In an ad hoc report on 17 January 2002, BHW Holding AG announced a public secondary placement of up to 32.5% of the share capital to private and institutional investors. As a result of this report, the share price declined by 5.5%. During the time period before this report, the price of the share of BHW Holding AG had declined by 25% since the beginning of December 2001.

Several decision-makers of BHW Group sold all shares of BHW Holding AG at the beginning of December 2001.

After extensive investigations and on the grounds of insignificance, the public prosecutor's office in Hanover settled the proceedings against ten accused persons for payment of a monetary fine and against three other accused persons without any payments. Due to the legal situation valid at the time of completion of the proceedings, the public prosecutor's office in Hanover could not grant BaFin an inspection of records. The Act on the Improvement of Investor Protection now has created the legal basis for this (section 40 a (3) of the Securities Trading Act).

3sat-Börse

In February 2000, a new round of the stock market game "3sat-Börsenspiel" began which was played and broadcasted by the weekly TV-programme "3sat-Börse". The participants received a virtual

starting capital amounting to €100,000, which they had to invest in securities for a period of six months. In many cases, the viewers adopt the participants' share proposals and buy the shares for their own portfolio. On the next trading day, the share prices normally rose considerably due to the increasing demand. One of the game's participants was a well-known financial journalist and publisher of a financial paper who had already been one of three participants in the round from 7 August 1998 to 29 January 1999; a round he won.

The accused, two employees responsible for the layout of the graphics for the programme and one employee from the programme's online editorial office purchased those securities recommended by the financial journalist for their portfolios before the programme was broadcasted. After the programme they sold them again and thus reached 5-digit earnings.

After extensive investigations and on the grounds of insignificance, the public prosecutor's office in Koblenz settled the proceedings against two of the three accused for a payment of monetary fines amounting to €1,500 each and against the other accused without any payments.

Pongs & Zahn AG

In an ad hoc report on 2 October 1995, Pong & Zahn AG announced an agreement with the house banks on a financial rescue plan. As a result, the price of the shares of this company - which was on the verge of insolvency at this time - doubled.

The accused had been involved in the rescue negotiations as the representative of a "key group of shareholders" from the very beginning. Before the ad hoc report he purchased 250 ordinary shares and 426 preferential shares, having knowledge of the successful rescue plan.

The Local Court Düsseldorf acquitted the accused. The revision by the public prosecutor's office in Düsseldorf was unsuccessful. The Higher Regional Court Düsseldorf finally annulled the judgement of the Regional Court Düsseldorf and remitted the case for a new decision. The Higher Regional Court stated the grounds that the investigation of whether inside information in fact had an effect on the share price or not had to be effected from the view of a informed investor who is familiar with the stock exchange market. According to the court, the principle "in dubio pro reo" does not include the obligation to assume variants for the benefit of the accused for the existence of which there is no concrete evidence. The new decision by the Regional Court is still expected.

Eurotip AG

The accused was a member of the management board of Eurotip AG based in Munich, which was in takeover negotiations with e.multi Digitale Dienste AG.

In December 2001, the Local Court Munich initiated preliminary bankruptcy proceedings against Kinowelt Medien AG. Kinowelt Medien AG held 29.1% of the share capital of e.multi digitale Dienste AG.

On 6 March 2002, the management board of e.multi Digitale Dienste AG announced in an ad hoc report that Eurotip AG intended to take over the majority of e.multi Digitale Dienste AG. Therefore the block of shares of nearly 30% held by Kinowelt Medien AG so far was to be transferred to Eurotip AG.

On 4 March 2002, the accused purchased 38,000 shares of e.multi Digitale Dienste AG via an account of Eurotip AG. After publication of the ad hoc report he sold these shares, which were not to be used for the majority takeover. In doing so, he realised a profit amounting to €7,980. The Local Court Munich sentenced the defendant to a fine of 150 daily rates of €100 for insider trading.

rhenag Rheinische Energie AG

In November 1997, a friend of the accused who was employed at rhenag Rheinische Energie AG informed the accused of a planned extra distribution amounting to DM 50 per share entitled to dividend. As a consequence, he purchased a total of 1,758 shares of rhenag AG at a value of approx. DM 635,472 in 43 tranches. After rhenag had published details concerning the planned extra distribution in an ad hoc report on 11 May 1998, the accused sold all his shares and generated a profit of approx. DM 571,000.

The public prosecutor's office in Essen thus charged the accused with insider trading in November 2001. The Regional Court Essen dismissed the proceedings against payment of a monetary fine of DM 91,736.97 after several subsequent hearings.

Met@box AG

In an ad hoc report of 10 April 2000, Met@box AG, a New Market company, announced the conclusion of a purchase contract with an Israeli company for 500,000 set top boxes. This was not true, as actually only a preliminary contract was concluded. As a result of the report, the price of the Met@box share rose considerably.

Having knowledge of the impending ad hoc report, one of the accused, a member of the management board, purchased 1,550 Met@box shares at a total price of €50,410 on 23 February 2000. Immediately after the release of the ad hoc report, he sold the shares and realised a profit amounting to €20,390. In October 2004, the Local Court Hildesheim issued an order for summary punishment for 90 daily rates of €50 each and ordered the cancellation of €70,800.

Another member of the management board of Met@box AG, who was aware of the untruthfulness of the ad hoc report, was sentenced to seven months' imprisonment which was suspended on probation for price fraud (section 88 of the German Stock Exchange

Act a. F.) by the Local Court Hildesheim in July 2004. This judgement has not become final yet.

Elektra Beckum AG

With an ad hoc report of 5 February 1999, Elektra Beckum AG, which was in financial distress, announced that Metabo-Werke GmbH & Co. would take over 60% of the share capital of Elektra Beckum AG. Metabo Werke GmbH & Co. in turn announced its intention to financially secure the rescue of Elektra Beckum AG with a payment of €15.39 million. In addition it announced a takeover bid to the outside shareholders. As a result of this announcement, the share price rose considerably.

Two managers of a marketing agency who prepared a marketing concept for Metabo-Werke GmbH & Co. in 1998/1999 learned of the pending takeover on 25 January 1999 at the latest and purchased 500 Elektra-Beckum shares each. They sold these shares after the ad hoc report was published and achieved a profit amounting to €4,600 each.

In October 2004, the public prosecutor in Constance requested orders for summary punishment for 60 daily rates of € e final yet.

Heyde AG

On 12 February 2002, the internet service company Heyde AG published an ad hoc report by which a turnover and profit warning was issued for the financial year 2001 and the revision of the planned turnover was announced.

Having knowledge of the critical financial position of the company, the accused, a member of the company's management board at that time, sold 1,000 shares of Heyde AG on 2 January 2002 and 8 January 2002 and realised a profit amounting to €9,438.

The Local Court Friedberg issued an order for summary punishment sentencing the accused to 90 daily rates of €150 each, and ordered a cancellation of assets amounting to €9,438.

3.3 Market manipulation

BaFin commenced 52 new cases.

BaFin, who has been competent since mid-2002, commenced 52 new cases during the year under review. Together with the pending proceedings from the previous year, a total of 65 proceedings were pending at the end of 2004. In 15 cases, BaFin found an actual effect on the market price of the security under review and charged a total of 35 persons at the competent public prosecutor's office. In two cases, BaFin opened administrative offence proceedings as the manipulative behaviour did not have any effect on the market price. In 13 other cases the proceedings were dismissed.

Table 18
Investigations of market manipulations

	Period	New investigations	Investigation results						Pending investigations
			Dismissed	Transfer to public prosecutors or the section for administrative offences in BaFin					
				Public prosecutor		Section of administrative offences		Total (Cases)	Total
				Cases	Persons	Cases	Persons		
Previous years	1.Jul.-31.Dec. 2002	17	0	3	0	0	0	3	14
	2003	51	13	7	21	3	8	10	42
	2004	52	13	15	35	1	1	17	65
2004	1st quarter	15	1	4	18	1	1	5	51
	2nd quarter	4	0	3	4	0	0	3	52
	3rd quarter	22	5	4	6	0	0	4	65
	4th quarter	11	7	4	7	0	0	4	65

BaFin imposed fines of up to €250,000.

In the year 2004, there was one conviction after trial and one conviction by summary proceedings. Another reported case - initially reported as an insider case - led to a conviction for price fraud (Met@box AG). The public prosecutors dismissed 5 cases. In two other cases the opening of preliminary proceedings was rejected for legal grounds.

Within the period under review, BaFin opened administrative offence proceedings against three persons. There were five administrative offence proceedings pending from the previous year. BaFin could complete five proceedings with final and binding effect. In four cases, BaFin imposed fines of up to €250,000; one of the proceedings was dismissed. In one of the cases BaFin imposed a fine, the party concerned made an objection. The decision by the competent local court is still outstanding.

Table 19
Information by public prosecutors, courts and the internal section for administrative offences concerning concluded market manipulation proceedings

	Period	Total	Decisions by public prosecutors		Final court decisions after criminal proceedings				Decisions by administrative offence proceedings	
			Dismissed	Dismissed against payment of a monetary fine	Court decisions	Convictions by summary proceedings without trial	Conviction after trial	Acquitted	Dismissed	Final and absolute administrative offences
Previous years	2003	1	0	0	0	0	0	0	0	1
	2004	14	7	0	0	1	1	0	1	4
2004	1st quarterl	1	1	0	0	0	0	0	0	0
	2nd quarter	4	4	0	0	0	0	0	0	0
	3rd quarter	7	0	0	0	1	1	0	1	4
	4th quarter	2	2	0	0	0	0	0	0	0

In the year under review, BaFin handled eleven enquiries concerning market manipulation from abroad, mainly from regulatory authorities from the European Union and the USA. In the course of its own investigations, BaFin sent 32 enquiries to foreign regulatory authorities, mainly within the European Union (20) and within German-speaking non-member countries (7).

Safe harbour for stabilisation measures.

During the year under review, BaFin reviewed for the first time whether the regulations of the Ordinance Detailing Stock Exchange and Market Price Manipulation were adhered to in connection with the few IPOs effected. Here, the documentation obligations of the institutions acting as stabilisation managers are of particular importance. There were almost no violations. However, the difference between reported transactions for own account and documented stabilisation transactions led to enquiries from time to time. On 30 October 2004, the Ordinance Detailing Stock Exchange and Market Price Manipulations was replaced by the regulation of the EU Commission of 22 December 2003[142], with its provisions concerning stabilisation corresponding to those of the Ordinance Detailing Stock Exchange and Market Price Manipulations to a great extend.

The following provides a more detailed description of some of the final decisions made in 2004.

Arndt AG

From 7 March to 12 March 2003, a private investor repeatedly traded the very illiquid shares of Arndt AG, acting as seller and buyer at the same time. Before, he had placed concerted buy and sell orders, each at the same price and for the same number of shares, so-called wash sales. There was no actual change of ownership. By means of the high execution limits of his orders stated by him, he succeeded in tripling the market price of the share. In total, he bought and/or sold 115,000 shares of Arndt AG on the exchanges in Frankfurt and Stuttgart. This corresponded to 75% of the total turnover for these shares from time to time. Without these transactions there would sometimes have been no pricing with such turnovers for these shares.

The suspect's economic goal was to push the share price up in order to sell his shares with profit at the artificially generated price level. However, this goal could not be reached as the exchanges' trading surveillance authorities took notice of his activities. In agreement with BaFin, they requested via his depository bank that he refrain from the entry of further reciprocal buy orders and sell orders, so that his plan was discontinued early on. In the course of his transactions, the suspect bought shares amounting to €36,785 in total, and sold shares amounting to €32,795. The suspect suffered a loss of a total of €3,990, of which the transaction costs alone were €1,751.

BaFin filed a criminal complaint against the suspect with the public prosecutor in Stuttgart in November 2003. In June 2004, the Local

[142] Regulation 2273/2003; OJ EU No. L 336/33.

Court Stuttgart issued an order for summary punishment for prohibited other deceptive practices and sentenced the defendant with a fine amounting to 180 daily rates at €50 each.

Intershop AG

On 18 October 2002, the defendant used a nickname and made a posting in the discussion forum of the Internet Board „Wallstreet Online". According to the form and contents of the posting, it seemed to be from the alleged news agency „apx" and said that SAP AG would acquire a 51% share of Intershop AG. The author also stated that this acquisition was likely to result in a public takeover bid to the remaining shareholders by SAP AG. This piece of news was untrue. The mentioned news agency did not exist. The fictitious statement, however, could not so easily be identified as a fake by the other market participants. Thus, within one hour after the posting was made, approx. 580,000 shares of Intershop AG were bought. This was an increase of approx. 200% compared to the usual turnover of this share. The market price of this share also rose by approx. 16% from €1.09 to €1.26 within 30 minutes after the false report. Only after one hour did the market recognise that this report was a false report.

BaFin filed a criminal complaint against the suspect with the public prosecutor in Düsseldorf in November 2002. The competent Local Court in Munich sentenced the defendant for untruthful reports to a fine amounting to 90 daily rates at €60 each.

Möbel Walther AG

Together with other parties involved, the suspect tried to push up the price of the shares of Möbel Walther AG. In order to do so, he entered reciprocal buy orders and sell orders with unusually high limits in the floor trade on the exchange in Frankfurt and also in the electronic trading system XETRA. The background for this manipulation was an ad hoc report published by Möbel Walther AG shortly before, i.e. on 6 December 2001, in which the company stated that there was interest in the market in buying a block of almost 600,000 shares of Möbel Walther AG. Thus it intended to sell this package for a fixed price, which was considerably higher than the current market price. In case the pricing had been effected in the amount of the limits set by the suspect, this interest acquisition would have been considerably more expensive. However, the corresponding securities orders were not effected so that there was no price impact.

As the manipulation was unsuccessful, no conduct liable to criminal prosecution was given but instead an administrative offence. BaFin ordered two 6-digit administrative offences and two 5-digit administrative offences.

Sixt AG

The investigations related to a study which contained wrong statements concerning the accounting of a listed company. The suspect,

i.e. the author of this study, was simultaneously active in the hedge funds business. One strategy of hedge funds is to sell short securities betting on falling prices. Negative studies and/or sale recommendations contribute to such falling market prices. The statements made in the study must have appeared credible for the average investor and were suitable to have an effect on the share price based on concrete circumstances. However, there was no actual effect on the market price of the shares. As an immediate reaction to this study, Sixt AG made a public announcement and defended itself against the allegations made. Thus, an administrative offence was constituted, which was sentenced by BaFin with an administrative offence.

3.4 Ad hoc disclosure and directors' dealings

Ad hoc disclosure

Adherence to the publication obligations according to section 15 of the Securities Trading Act contributes materially to the financial market becoming more transparent for the investor. In addition, the early publishing of inside information reduces the danger of prohibited insider trading as speedy and complete information of all investors is ensured.

Listed companies published a total of 3,260 ad hoc reports within the year under review. Thus, the number of ad hoc notifications corresponds to that of the previous year (2003: 3,301). During the year under review, the majority of these ad hoc notifications referred to current income. 2,772 (2003: 2,689) reports were from domestic and 488 (2003: 612) from foreign issuers.

Table 20
Development of ad hoc disclosures 2002-2004

	Period	Total	By issuer's seat		By means of transmission	
			Germany	Abroad	Electronic media	Official stock-exchange gazettes
Previous years	2002	4.491	3.781	710	4.467	24
	2003	3.301	2.689	612	3.283	18
	2004	3.260	2.772	488	3.229	6
2004	1st quarter	793	662	131	792	1
	2nd quarter	794	672	122	765	4
	3rd quarter	724	619	105	723	1
	4th quarter	949	819	130	949	0

BaFin commenced 22 proceedings.

Based on a possible violation of section 15 of the Securities Trading Act, BaFin commenced 22 new proceedings during the year under review. There were 78 proceedings still pending from the previous year. BaFin imposed seven administrative offences amounting to up to €95,000 for failed, late, incorrect or incomplete publishing or

notification of facts with an effect on the market price. A total of five proceedings were dismissed; 88 proceedings were still pending as of the end of the year.

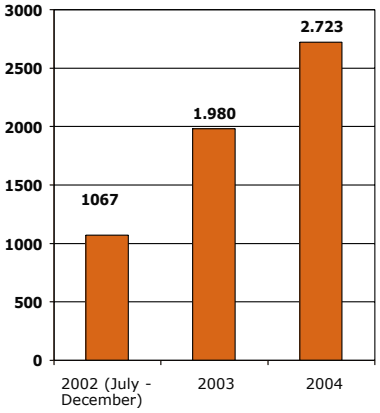
Exemptions from disclosure obligations

So far, BaFin has temporarily exempted one issuer from the obligation to disclose upon request. The basis for this decision was that a disclosure could have caused damage to the issuer's rightful interests. When deciding on such a request, the issuer's interests must be weighed up against the public interests in effective information about price relevant facts. As a rule, BaFin granted an exemption from the ad hoc disclosure obligation for a short period of time only. In accordance with the Act on the Improvement of Investor Protection, the issuer must effect this weighing and decide on the postponement of publishing inside information.

Directors' dealings

Pursuant to section 15 a of the Securities Trading Act, managers of listed issuers as well as persons and corporate bodies in close relationship with them must inform BaFin and the issuer of transactions with shares of the listed issuer. The issuer is obliged to publish this information on its Web site. This is to inform market participants about scope and time of those transactions and to further increase the investors' confidence in the capital market. Section 12 of the Ordinance on Notification of Dealing in Securities and Maintenance of Register of Insiders[143] explicitly states that the name of the person obliged to disclose must be stated in the published notification. There was another increase in the amount of reported transactions compared to the previous years. Within the period under review, BaFin was informed of 2,723 (2003: 1,980) transactions. In December 2004 and January 2005, there was a considerable increase of notifications with 491 and 276 notifications respectively (December 2003: 235, January 2004: 117), due to the extension of the disclosure obligations according to the Act on the Improvement of Investor Protection.

Figure 32
Developments of notifications of directors' dealings



Name of the person subject to a notification obligation
With its judgement on 14 May 2004 (ref. no. 9 E 1636/03 (2)), the Administrative Court in Frankfurt/Main confirmed BaFin's legal opinion that when publishing directors' dealings notifications, the name of the person subject to a notification obligation must be stated.
A member of the Supervisory Board and his family members had effected share transactions which were subject to the notification obligation and had filed a law suit due to the fact that their names had to be published by the issuer. According to the court, the reason for the duty to publish is that the issuer must publish the notification as received from the person subject to the notification obligation. The issuer is not entitled to change or shorten a notification

[143] BGBl. 2004 I, p. 3376.

received. As the notification must contain the name of the person subject to the notification obligation, this name is also part of the published notification. According to the court, the statutory provision does not violate the plaintiffs' general right to privacy. The plaintiffs lodged an appeal.

Directors' Dealings Database.

All published transactions can be retrieved from BaFin's database. Investors and market participants use the database as a central source of information, always up to date.[144]

BaFin commenced 61 proceedings.

In the year 2004, BaFin commenced 61 new proceedings. There were 107 administrative offence proceedings still pending from the previous year. In total, BaFin could complete 18 proceedings with final and binding effect. In nine cases, BaFin imposed fines of up to €14,000. A total of seven proceedings were dismissed; 152 proceedings were still pending as of the end of the year.

3.5 Voting rights

A person reaching, exceeding or falling short of voting shareholdings of 5, 10, 25, 50 or 70% of a listed company must inform the company and BaFin. The listed company must then publish this notification immediately in a supra-national official stock-exchange gazette.

As of the end of 2004, 484 domestic and foreign companies were listed on the official market (2003: 526) and 527 companies were listed on the regulated market (2003: 541) in Germany. During the year under review, 2,276 notifications (2003: 2,060) about changes in material voting shareholdings were received.

Templates for notifications and publications.

The error ratio for notifications and publications remained high in 2004. Almost every second notification or publication had to be corrected. Thus, during the year under review, special attention was paid to the improvement of the information offered to companies and shareholders. On BaFin's homepage, there are templates for notifications and publications.[145] In addition, BaFin informed companies of possible notification or disclosure obligations prior to planned IPOs or segment changes, and could thus prevent problems in connection with these notifications.

Unchanged high number of administrative offence proceedings.

BaFin commenced 445 administrative offence proceedings for suspicion of failed, late or incomplete notification or publication of material voting shareholdings. Another 569 proceedings were pending from the previous years. BaFin imposed 86 administrative offences amounting to up to €30,000. A total of 219 proceedings were dismissed; 717 proceedings were still pending as of the end of 2004.

[144] www.bafin.de > Datenbanken & Statistiken > Datenbanken > Bereich Wertpapieraufsicht (German only).
[145] www.bafin.de > Für Anbieter > Börsennotierte Unternehmen > Bedeutende Stimmrechtsanteile, § 21 ff. WpHG (German only).

BaFin can request the insolvency administrator to publish voting right notifications.

There was an increase in the number of companies in insolvency with shares admitted for trading at the stock exchange. On the one hand, this was due to the increasing insolvency ratio, on the other hand due to the fact that a revocation of the admission to listing occurs on very rare occasions only. The insolvency administrator has obligations under capital market law.

Insolvency administrator's notification obligation
With its judgement of 29 January 2004 (Ref. no. 9 E 4228/03 (V)), the Administrative Court in Frankfurt/Main confirmed that BaFin can request the insolvency administrator of a stock exchange listed company to publish voting rights notifications. Insolvency proceedings were instituted against the assets of the stock exchange listed company, so BaFin requested that the insolvency administrator publish voting rights notifications made to the insolvent company. The insolvency administrator filed a complaint. In his opinion he could not be requested to publish voting right notifications in his capacity as insolvency administrator of the stock exchange listed company. The Administrative Court Frankfurt dismissed the complaint. According to the court, BaFin can request that the insolvency administrator fulfil the disclosure obligation in connection with the abuse supervision, as the insolvency administrator has a direct responsibility based on his office. According to the court, the insolvency administrator's competence is always affected when an action requires the utilisation of the estate or in any case would have an effect on the estate in case of recourse. The fulfilment of the disclosure obligation did have an effect on the estate, as the disclosure requires the conclusion of a contract with a supra-regional official stock exchange gazette. This caused costs affecting the estate. The claimant lodged a leap-frog appeal. The Federal Administrative Court decided in favour of the claimant in April 2005.

American Depositary Receipts: notification obligation only for holder.

In case of certificates representing shares, e.g. American Depositary Receipts, only the holder of the certificate is subject to the notification obligation according to section 21 of the Securities Trading Act. The issuer of the certificate or the custodian of the represented shares is not subject to the notification obligation.[146]

Database voting shareholdings.

The database of published voting right notifications compiles with the publications of voting right notifications made.[147] However, it cannot be used as evidence as to whether a notification was made or not. In a number of cases, the database does not show the current status of participations.

3.6 Sales prospectuses

The sales prospectus provides important information for an investment decision.

A public offeror of securities not to be listed on a stock exchange must publish a sale prospectus for securities and deposit it with BaFin. The prospectus represents the central medium of informati-

[146] DIR 2001/34/EC, OJ EU No. L 184/1.
[147] www.bafin.de > Databases & Statistics > Databases.

on for an investment decision as well as the central liability document for civil prospectus liability claims. As of 1 July 2005, the Act on the Improvement of Investor Protection provides for an extension of the prospectus obligation for certain uncertificated financial assets in the Law on Prospectus for Securities Offered for Sale. Those assets include among others shareholder participations in a civil-law partnership, in a limited liability company or in a limited commercial partnership, registered bonds or profit participation rights.

BaFin verifies completeness and not correctness of the contents of the prospectuses.

Within ten business days, BaFin examines the prospectus with regard to formal completeness only, i.e. controls whether the (minimum amount of) information required according to the Sales Prospectus Ordinance are included. BaFin neither checks the correctness of the contents of the prospectus nor the credit worthiness of the issuer. Thus, if BaFin authorises the publication of the prospectus, the investor cannot draw any conclusions with regard to the reliability of the offer or to the credit worthiness of the offeror. The investor must inform him-/herself by means of the prospectus and additional sources of information, if any, before making his/her investment decision.

Securities can only be publicly offered for sale if and when BaFin authorises the publication. There must be at least one business day between the publication of the prospectus and the beginning of the public offer in order to allow the investor to obtain sufficient information before making his/her investment decision. In case the offer is made via an electronic information system, e.g. the internet, the prospectus must be published there as well.

BaFin keeps deposited prospectuses for a period of ten years.

BaFin keeps deposited prospectuses for a period of ten years. This is to ensure that they can be provided for investigations by the police and the public prosecutor as well as in case of civil proceedings, if they cannot be obtained otherwise any more. In addition, BaFin's database[148] offers an overview over all verified and published prospectuses. For a copy of the prospectus the investor must contact the offeror.

Deposited sales prospectuses

Number of issues continued to increase in 2004.

In 2004, the number of prospectuses deposited with BaFin continued to increase. There were a total of 67,170 issues for which prospectuses and/or supplements were deposited, compared to 45,048 in the year before. The issues included the following number of individual securities classes: 270 shares, 2,423 bonds, 47,056 warrants and 17,421 other securities, especially certificates.

During the year under review, BaFin initiated 26 administrative offence proceedings.

During the year under review, BaFin initiated 26 new administrative offence proceedings. There were 35 proceedings still pending from the previous year. In five cases BaFin imposed fines of up to

[148] www.bafin.de > Datenbanken & Statistiken > Datenbanken > Bereich Wertpapieraufsicht > Hinterlegte Wertpapier-Verkaufsprospekte (German only).

€17,500. A total of five proceedings were dismissed; as of the end of the reporting period, there were 51 proceedings still pending.

Individual cases

Prospectus obligation also applies to refunding offers.

A German sales prospectus for a refunding offer for defaulting Argentinean government bond issues aiming at a large number of German investors, was filed with BaFin at the end of December 2004 and published in January 2005 after careful examination. Before that, prospectuses for public refunding of government bond issues were only filed with BaFin within the scope of reciprocal recognition according to section 15 (3) of the Act on the Prospectus of Securities Offered for Sale.

Prospectus obligation also triggered by internal procedures in individual cases.

Last year, several companies with their seat abroad effected mergers according to a scheme of arrangement under English law. Although this is formally an internal procedure, it can also lead to a public offer. This depends on the individual configuration. The term "offer" in relation to prospectus law can basically be interpreted rather freely, and can also not be compared with the meaning of this term according to civil law.

4 Mergers

The Securities Acquisition and Takeover Act contains guidelines for a fair, transparent and orderly offer procedure and has been in force for three years now. Its purpose is the accelerated realisation of the procedure in order to ensure that the ability of the target company to conduct its business is only hindered for a reasonable period of time.

Acting in Concert.

A company or a person must make a mandatory offer as soon as it has obtained a participation of at least 30% of the voting rights and thus the control over a target company. When calculating a shareholder's share of voting rights, not only the voting rights held by him/her are taken into consideration but also - under certain conditions - the voting rights of third parties. Accordingly, voting rights are reciprocally attributed to the target company's shareholders when they coordinate their actions in relation to the target company.

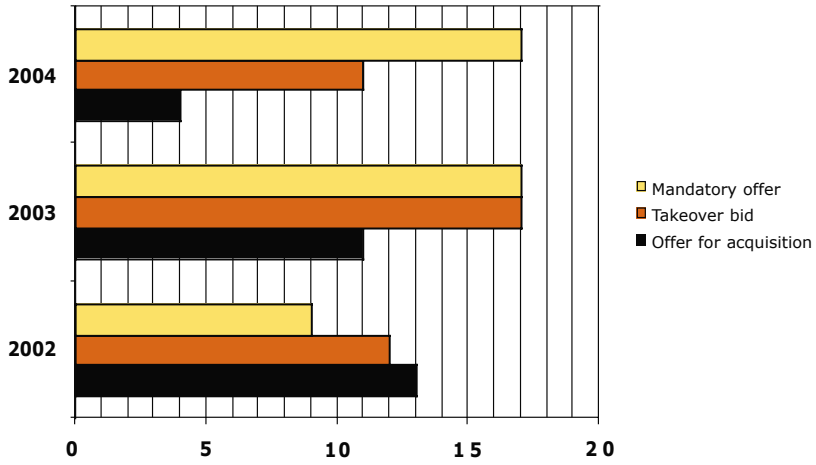
Pixelpark
In the course of an appeal, the Higher Regional Court of Appeal in Frankfurt / Main had to determine under which conditions BaFin can assume such acting in concert. Two investors had each purchased roughly 20% of a company's voting rights from a majority shareholder. The purchasers could acquire the blocks of shares at a price of €1 each, as the former chairman of the board and founder of the company who had been dismissed without prior notice shortly before had exercised his right of determination in favour of

the two purchasers. Basically, the court confirmed BaFin's legal opinion according to which voting rights are mutually attributed when shareholders consciously work together with the aim to coordinately and continually exercise their membership rights. According to the court, the specific circumstances of the purchase of the shares, public statements of the purchasers after the purchase and the fact that the appellants assumed a harmonised conduct during the preceding administrative procedure were suitable to draw conclusions concerning possible arrangements between the investors. In the present case, however, the court was not of the opinion that there was sufficient evidence for such an arrangement between the investors.

Fewer offers in the year 2004.

During the year under review, BaFin registered a decline in offer procedures. Only a total of 32 requests for authorisation of offer documents were filed, compared to 45 requests in 2003. In contrast, the number of requests for exemptions from mandatory offers increased from 111 requests in 2003 to 135 requests in 2004.

Figure 33
Year-on-year number of offer procedures



4.1 Offer procedures

BaFin authorised all offer documents for the first time.

In 2004 it became evident that a standard for the preparation of offer documents, which materially corresponds to the provisions of the Securities Acquisition and Takeover Act, became widely accepted. BaFin's criticism in connection with the filed offer documents were remedied by the bidders within the auditing period of 15 working days without exception. Thus, BaFin could authorise all 32 filed offer documents and so had a year without prohibitions for the first time since the Securities Acquisition and Takeover Act came into force. The offer documents can be viewed on BaFin's website.[149]

[149] www.bafin.de > Datenbanken & Statistiken > Datenbanken > Bereich Wertpapieraufsicht (German only).

In most offer procedures, the transaction volume[150] was lower than €100 million. The offer with the highest transaction volume was roughly €2.9 billion. This was the acquisition offer by Deutsche Telekom AG to the shareholders of T-Online International AG.

Bidders from abroad for numerous offer procedures.

The bidders' seat in half of the offer procedures (16) and/or its parent company was abroad, five of them in the Americas.

Objections procedure and administrative fines

BaFin decided on 15 objections.

BaFin decided on 15 objections against imposed fines. They were all rejected. In addition, BaFin commenced a total of 21 new administrative offence proceedings. There were 53 proceedings pending from the previous years. In four cases, BaFin imposed a fine. 14 proceedings were dismissed. Four proceedings, in which BaFin imposed fines of up to €100,000, are pending at the Higher Regional Court of Appeal in Frankfurt / Main. A total of 56 proceedings were pending as of the end of 2004.

General main focuses of review

Adequate Compensation.

BaFin examines the offer documents especially for the bidder's statements concerning the adequateness of the offered compensation. In its statements, the bidder must describe the evaluation methods used to determine the compensation and the reasons as to why these methods are adequate. In case the bidder submitted an offer document for a takeover bid or a mandatory offer, compliance with the minimum price regulations must be particularly observed. In connection with the calculation, the bidder's prior purchases[151] as well as the weighted average domestic market price for the shares of the target company[152] calculated by BaFin are to be taken into consideration. In addition, the details concerning the effect of the offer on the bidder's financial condition, financial position and income situation must be stated. Another main focus of the review is the details concerning the bidder's intent in connection with the target company.

Statement by the target company's management board and supervisory board.

After the offer document was published, the target company's management board and supervisory board must make a substantiated statement and publish it immediately after transmission of the offer document. This statement must contain their own assessment on the target company's bodies and an evaluation of the material aspects of the offer document. This includes among others the

[150] The transaction volume is calculated by multiplying the number of shares to be purchased by the bidder with the consideration per share to be paid by the bidder in the course of the offer procedure, then the additional transaction costs are added.

[151] Prior purchases within the last three months before publication of the offer document are taken into consideration, section 31, paragraphs 1, 7 of the Securities Acquisition and Takeover Act (WpÜG) in connection with section 4 of the Securities Acquisition Takeover Act Offer Ordinance (WpÜG-Angebotsverordnung).

[152] Average value for a period of three months before publication of the decision to make a takeover bid and / or before publication of the takeover of control according to section 31, paragraphs 1, 7 of the WpÜG in connection with section 5, paragraphs 1, 2 and 3 of the WpÜG-Angebotsverordnung The average values can be seen on BaFin's Web site: www.bafin.de > Datenbanken & Statistiken > Datenbanken > Bereich Wertpapieraufsicht >Mindestpreise gemäß Wertpapiererwerbs- und Übernahmegesetz (German only).

evaluation of the amount of the compensation, the possible consequences of the offer for the target company and the bidder's objectives in connection with the offer. In addition, the management board and the supervisory board must provide BaFin with evidence of the publication of their statements immediately. It is sufficient if BaFin receives such evidence within three working days after publication.[153]

Conditions for offer procedures

As a matter of principle, there are only conditions for "other offers for acquisition" and takeover bids.

The bidder can subject the realisation of "other offers for acquisition" or of takeover bids to conditions. With mandatory offers, this is different. In this case, the bidder may not bypass its obligation to make an offer by imposing conditions. Mandatory offers are generally not subjected to conditions.

Exception: cartel condition also possible for a mandatory offer.

As an exception, the bidder can subject a mandatory offer to a condition if it would otherwise violate statutory provisions, e.g. due to a permission under cartel law still outstanding. In case of the mandatory offer to the shareholders of VK Mühlen AG[154], an offer had to be subjected to a cartel condition for the first time.

Strict preconditions for offer conditions.

As a rule, offer procedures are connected with considerable consequences for the target company, its bodies and shareholders. The publication of the decision to make an offer often has a material effect on the relevant target company's market price. In addition, from this time on, the target company's management board must not do anything that could prevent the success of the offer procedure (section 33 of the Securities Acquisition and Takeover Act). This is why the bidder must make a legally binding offer. It is thus inadmissible to reserve the right to rescind or revoke the offer and a modification of the offer is only possible in very few cases defined by law.

Potestative conditions.

The possibility to subject the offer to conditions is only admissible under strict preconditions. Potestative conditions, the fulfilment of which can be exclusively effected by the bidder or persons acting in concert with the bidder, are not admissible (section 18 (1) of the Securities Acquisition and Takeover Act). Conditions contained in the offer document must be formulated with sufficient clarity. The fulfilment of the condition must be determined by the end of the acceptance period for the offer. A cartel reservation is an exception from this principle. In this case, the tangible purchase of the securities within the acceptance period is not possible. Thus, as an ex-

[153] Higher Regional Court of Appeal Frankfurt (Oberlandesgericht – OLG), order of 22 April 2003, Ref. No. WpÜG-OWI 3/02.)
[154] Mandatory offer from Leipnik-Lundenburger Invest Beteiligungs-AG to the shareholders of VK Mühlen AG on 20 August 2004.

ception, the fulfilment of the cartel condition can be effected outside the acceptance period, as the bidder cannot realise the legal part of the offer. In this case, the fulfilment of the condition must occur shortly after termination of the acceptance period.

Allocation of voting rights in case of securities lending

In view of a possible exceeding of the control limit of 30%, there is the question of allocation of voting shareholdings, especially in case of securities lending. The same is true for voting right notifications according to sections 21 ff. of the Securities Trading Act. Securities lending means a securities loan with a regular term of up to one year. The lender transfers the lent shares to the borrower's property and the borrower in turn undertakes to pay a lending fee. The usual case is the so-called "chain securities lending", in the course of which the lent securities are sold by the borrower in order to fulfil delivery obligations as a consequence of short sales or in connection with another securities lending transaction.

Allocation in case of separation of legal and beneficial ownership.

The voting rights from securities belonging to a third party and held by this third party for the account of the bidder and / or the person obliged to notify shall be allocated to the bidder (section 30 (1) sentence 1, no. 2 of the Securities Acquisition and Trading Act). Voting rights from securities in the property of the borrower according to civil law, which are, however, in the beneficial ownership of the lender, can thus be allocated to the bidder as lender. A precondition for this is that the lender can influence the exercise of the voting rights. In order to do so the securities must be held by the borrower.

In case of simple securities lending, voting rights continue to be allocated to the lender.

There are no special cases for simple securities lending. As the lent securities cannot be sold by the borrower, the voting rights continue to be allocated to the lender.

In case of chain securities lending, the time of conclusion of the contract is decisive.

In case of a chain securities lending, allocation problems for the lender can occur. Due to the resale of the securities by the borrower, which must be regularly assumed, BaFin assumes that at the time of conclusion of the securities loan and transfer of the securities to the borrower the allocation to the lender has been terminated already. As of this time, the lender must observe possible obligations to notify, irrespective of whether the borrower in fact resells the securities. The same is true for securities lending in the course of a grant of a Greenshoe option for the execution of an IPO.

Allocation in case of securities lending for a capital increase.

For securities lending transactions in connection with a capital increase, however, in case the allocation to the lender is not done, the time of placement is decisive. For transactions with this structure, the existing shareholders provide the consortium banks with shares via securities lending. The consortium banks can use these shares to execute the allotees' subscription orders before entering the capital increase. Upon starting the transfer of the allotted shares, however, the consortium banks must inform the existing shareholders granting the securities loan of the use of the lent securities, so that the existing shareholders can fulfil their possible notifi-

cation obligations concerning the change of the voting shareholdings.

If the lender exceeds the control limit of 30% in the course of the retransfer after termination of the lending period (section 29 (2) of the Securities Acquisition and Takeover Act), an exemption request which has to be filed within a certain time period according to section 37 of the Securities Acquisition and Takeover Act may be considered.

Foreign Parallel Procedures

In 2004, with the takeover bid from BCP Crystal Acquisiton GmbH & Co. KG to the shareholders of Celanese AG, a takeover was concluded according to German and in parallel also according to US-law for the first time in history. The shares of Celanese AG were admitted to trading in Germany as well as in the USA at the time of the offer procedure. The proportion of US-American shareholders was exceptionally high. In connection with this takeover bid, the bidder did not have the possibility to effect a simple procedure according to US-law (the so-called tier 1 procedure) as for this exceptional rule, the proportion of US-American shareholders must be lower than 10%.[155] The US-American parallel offer procedure was effected under SEC's supervision. As the offer had to comply with two different legal systems, the offer document was correspondingly extensive. Additional problems resulted from the fact that the US supervisory authority merely clarifies essential issues of the offer procedure before the publication of an offer document and verifies the offer document only after publication. In addition, subsequent changes to the offer document based on the US-American supervisory authority's requirements would have led to an extension of the acceptance period according to US-law, which also should have been admissible according to the Securities Acquisition and Takeover Act. In order to solve this conflict between different supervisory regulations, there was a close cooperation between the bidder and the supervisory authorities as well as between the supervisory authorities.

Exclusion possibility for cross-border offers.

In order to avoid a conflict with foreign legal provisions outside the EEA, the bidder can request permission for a cross-border offer to exempt the holder of the securities resident in the respective country from this offer (section 24 of the Securities Acquisition and Takeover Act). It is however a prerequisite that it becomes unreasonable for the bidder to execute the offer if it has to fulfil the foreign legal standards. The fact alone that the bidder has to carry a higher financial burden due to the cross-border transaction is not sufficient for an exemption. Only if it is impossible for the bidder to fulfil the legal provisions is it eligible for an exemption. As a rule, this is true for swap offers, as these are often connected with extensive registration and prospectus obligations according to foreign law. The regulation according to section 24 of the Securities Acquisition and Takeover Act has not been applied often, as the bidder can avoid the conflict with foreign law in many cases by including a

[155] Block participations of more than 10 per cent are not taken into consideration in the calculation of the ratio.

distribution restriction in the offer document and thus prohibit third parties to distribute the offer document in certain countries. In this case, the bidder must clearly state that the offer can be accepted by each shareholder and that it orderly publishes the offer document.

In addition, a ratio of the shareholder structure similar to the one in the takeover of Celanese AG will remain an exception. The number of shareholders with seat abroad is normally low, so that the bidder can observe foreign legal standards by simplified procedures as for example the US-American tier 1 regulation.

4.2 Exemption procedure

Upon gaining control, i.e. upon acquisition of at least 30% of the target company's voting rights, the bidder is obliged to publish the gain of control and to make a mandatory offer to the target company's outside shareholders. In certain cases, the bidder can be exempted from this obligation upon request. As in the two previous years, the biggest part of the exemption procedures was effected according to the provisions of sections 36 and 37 of the Securities Acquisition and Takeover Act. In the year under review, a total of 134 requests were submitted, 94 of which were granted by BaFin and 9 of which rejected. The requester withdrew 14 requests, 17 requests were still dealt with as of the end of the year. Again, there was only one request for exemption from the trading portfolio according to Section 20 of the Securities Acquisition and Takeover Act.

Gain of control due to restructuring measures was the main field of application of section 36 of the WpÜG.

Upon the bidder's request, voting rights from shares can be ignored in connection with the calculation of share of voting rights, if the bidder acquired these shares as a consequence of any of the elements named in section 36, no. 1 to 3 of the Securities Acquisition and Takeover Act. In the year under review, a total of 54 requests were submitted not to take voting rights into consideration. The number of requests based on gain of control due to an element in connection with law of succession or family law or if the bidder gained control by changing the legal form of the company (section 36, no. 1 and 2 of the Securities Acquisition and Takeover Act) was only insignificant. Gain of control due to intra-group restructuring measures was the main field of application (section 36, no. 3 of the Securities Acquisition and Takeover Act).

Planned reconstructions again main focus for exemption requests according to section 37 of the WpÜG.

BaFin can exempt the bidder from the obligation to publish the gain of control and to make a mandatory offer, if this is reasonable in view of the objectives connected with the gain of control or in view of the manner of gaining control. A prerequisite for an exemption is always that the bidder's interests in such an exemption outbalance the outside shareholders' interests in the issue of a mandatory offer. The Offer Ordinance of the Securities Acquisition and Takeover Act contains examples with specific reasons for an exemption. In contrast to section 36 of the Securities Acquisition and Takeover Act, the request according to section 37 of the Secu-

rities Acquisition and Takeover Act has to be filed within a certain time limit. On the other hand, an exemption can be granted according to section 37 of the Securities Acquisition and Takeover Act before gaining control, if the gain of control is likely to occur, i.e. will be effected within a foreseeable period of time. This way the bidder has legal certainty early on that it will be granted an exemption.

In the year 2004, a total of 80 requests for an exemption according to section 37 of the Securities Acquisition and Takeover Act were filed, in 39 cases of which the gain of control was connected with the reconstruction of the target company (section 9, sentences 1 and 3 of the Offer Ordinance of the Securities Acquisition and Takeover Act). Thus, the exemption requests for reconstruction constituted the largest part of the exemption requests filed.

Cases of reconstruction

The possibility of an exemption in connection with the reconstruction of the target company is to prevent the obligation to make a mandatory offer from having undesirable consequences for the bidder's willingness to take part in the reconstruction efforts.

A case of reconstruction is given in case of risks threatening the existence of the target company.

A case of reconstruction is given if the target company is in a crisis, i.e. if a successful company lost its economic or financial balance. A petition in bankruptcy is not necessary in order to constitute a case of reconstruction, as with commencement of bankruptcy proceedings the company is usually headed for liquidation. In order to prevent a misuse of the exemption possibilities, however, it is not sufficient for an exemption that only the target company's economic results worsened and the bidder wishes to lead the company back to its former performance. Even if the target company suffers losses in the short term, this does not necessarily constitute a case of reconstruction, especially since many companies are in such a situation if the economic situation worsens and this is the very reason they often are an attractive target for a takeover in this situation.

A case of reconstruction is given if the company suffers or will soon suffer risks which endanger the very existence of the company according to section 322 (2) sentence 2 of the German Commercial Code. That means there must be risks which clearly indicate that the continuation of the company is almost impossible or at least endangered. Such risks can be proven on the basis of the target company's newest annual report. If this annual report was prepared a longer period of time ago, the existence of a case of reconstruction can be proved by an up-to-date auditor's opinion.

Plausible restructuring concept.

For a plausible restructuring concept, the requester must explain the reasons for the company's crisis. In addition, this concept must show ways to remedy the causes for the crisis and it must indicate if the continued existence of the company can be ensured by the planned measures. BaFin only reviews if suitability of the restructuring measures is plausible. The question of whether the restruc-

turing concept finally leads to a successful restructuring of the target company is not a subject of BaFin's review.

The requester's contribution to restructuring.

The requester has to make a binding contribution to the restructuring measures, decisively supporting the continued existence of the target company and economically measurable and suitable to eliminate the crisis. This contribution has to amount to such a sum that it represents an important and indispensable part of the restructuring concept. Depending on any individual case, this restructuring contribution can include the assumption of liabilities or a declaration of a waiver of claims outstanding by the bidder. In addition to purely financial restructuring contributions, the bidder can also make other contributions with an economic value. The bidder can, for example, provide the required business related know-how in case of a business reorientation.

Third parties' contributions to restructuring.

In addition to the bidder's contribution to the restructuring measures, third parties can provide restructuring support, e.g. banks that provide a prolongation of existing financing. Should this kind of support be necessary for the realisation of the restructuring concept, the exemption shall depend on the actual provision of these supporting measures. This shall also be true if several investors team up, exceed the control limit and the sum of their contributions alone leads to a plausible overall restructuring concept.

BaFin employees

VI About BaFin

During the year under review, BaFin completed the bulk of its necessary staffing increases; it hired a total of 213 employees. In 2004 young people started their careers as apprentices with BaFin: twelve apprentices started their training during the year under review; a further 15 will follow in 2005. A new feature for BaFin in 2004 was also the introduction of cost accounting, which went into the pilot phase after comprehensive preparatory and set-up work during the fiscal year.

1 Human resources

BaFin has been given new tasks and experienced a labour-intensive change to regulatory processes since its formation. One consequence of this is growth in the number of positions and employees. When hiring, BaFin pays attention not only to applicants with specific experience, but also to trainee managers. This is reflected in the average age of BaFin's employees: Three quarters of the workforce were between 26 and 45 years old at the end of the year under review.

Specialists were in demand in 2004.

In 2004, BaFin also filled various positions in higher and upper grades with qualified, external specialists, e.g., for the supervision of hedge funds, for risk modelling and for project management. In addition, it implemented a successful selection procedure for IT specialists and actuaries. In order to acquire specialists, BaFin also used the opportunity of offering remuneration not subject to collective agreements.

At the end of 2004, BaFin had a total of 1,475 employees, of which 62% were civil servants. Employees must be civil servants, as these supervisors have far-reaching authority to take action and conduct sovereign activities. In 2004, BaFin hired a total of 213 new employees; most of these were for operational supervision, fundamental sections and cross-section departments.

Table 21
New hires in 2004

Career				Qualifications			
	Total	Women	Men	Lawyers	Economic scientists	Mathema-ticians	Other
Higher grades	78	23	55	39	24	15	0
				Graduates	IT	actuarial SB	Other
Upper grades	108	50	58	80	4	4	20
Middle grades	15	8	7				
Appren-tices	12	2	10				

More than 5,000 applications.

BaFin received 5,337 applications for its job advertisements last year. The candidates being sought were primarily economic science graduates, mathematicians and lawyers. As in the previous year, applicants for higher and upper grades undergo a multi-stage selection process. The first stage investigates the applicants' professional competence in an interview and their knowledge of English with a test. They then move on to an assessment centre, to ascertain the applicants' social competence. During the year under review, BaFin conducted around 700 interviews and invited candidates to 67 assessment centres with an average of six applicants.

Table 22
Staff as of 31 December 2004

Career	Employees			Civil servants	Employees
	Total	Women	Men	Total	Total
Higher grades	555	199	356	477	78
Upper grades	522	246	276	373	149
Middle/ simple grades	398	250	148	65	333

Training at BaFin.

In 2004, BaFin offered various apprenticeships – 16 of these were for trainee government inspectors in upper grades. These trainee managers were prepared for their tasks at BaFin in their studies at a university of applied sciences and in practical segments. They are being trained in cooperation with Deutsche Bundesbank. BaFin offers three training courses for a career in the middle grades. In 2004, five up-and-coming administrative clerks, three IT specialists and four specialists for office communications were being trained.

Qualifications at BaFin.

BaFin attaches great value to excellent further education and training for its employees. In 2004, 1,048 employees attended 333 specialist and non-specialist seminars and in-house training sessions, some of these were held with external specialists. One focal point of training was the qualification program to become an

IRB/SRP auditor. In the past year, around 337 BaFin employees participated in comprehensive further education on the subject of „Banking Business and Bank Supervision".

Figure 34
Expenditure (budget 2004)

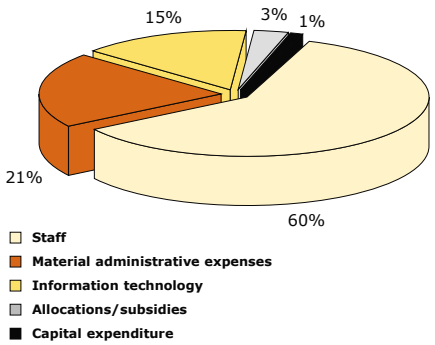


Figure 35
Income (budget 2004)

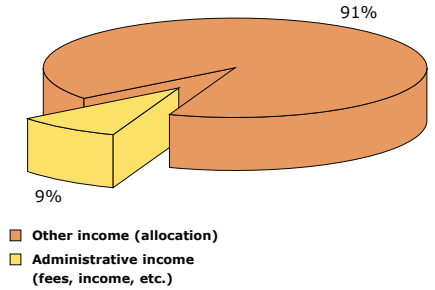
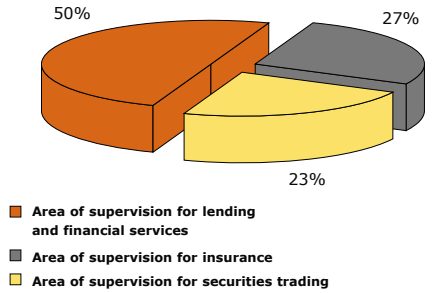


Figure 36
Allocation breakdown areas of supervision in 2003



2 Budget and finances

BaFin's annual budget is determined by the Administrative Council and approved by the Federal Ministry of Finance. The budget for 2004 included expenses and income totalling around €132.5 million. Personnel expenses constituted the largest expense block at €79.9 million, with investment expenditure taking second place at €27.2 million. According to the annual accounts not yet adopted by the Administrative Council, BaFin's total expenses during budget year 2004 totalled around €100.4 million, while income totalled around €133.4 million. This was mostly generated from advance payments for the 2004 allocation as well as from fees and separate refunds.

BaFin fully covered its expenses from its own income. It does not receive any subsidies from the federal budget. Within the meaning of section 13 of the Act Establishing the Federal Financial Supervisory Authority (FinDAG), financing comprises fees and allocations from the supervised companies. The allocations due in the year under review totalled €120.7 million, fees due totalled €10.4 million. In addition, BaFin generated interest from investing excess liquidity and, for example, income from fines and the refund of material and personnel costs as part of the administrative partnership with BMF at the Bonn office.

Allocations constitute the key source of financing. In the settlement for budget year 2003, the three areas of supervision contributed to covering costs in the share amounts stated on the left.

BaFin also used this breakdown when calculating the advance payments for allocations for budget year 2004. The final cost breakdown for 2004 is subject to the contribution settlement, which is expected in the summer of 2005.
In future, BaFin will calculate costs using cost accounting. This will allow BaFin to specifically allocate expenses to the various areas of supervision. This is included in the cost regulations in FinDAG. For detailed information on BaFin's financing and its budget plans, please refer to BaFin's Web site.[156]

3 Organisation

President Jochen Sanio has headed BaFin since its formation; the office of Deputy President is held by Karl-Burkhard Caspari. They are supported by BaFin's three Chief Executive Directors: Helmut

[156] www.bafin.de > Für Anbieter > Finanzierung der BaFin (German only) or www.bafin.de > About us.

Bauer, banking supervision, Dr. Thomas Steffen, insurance supervision, and Georg Dreyling, securities supervision/asset management.

BaFin's management is supervised by a 21-strong administrative council; BaFin receives professional support from an advisory board and three further councils.

Annex 3 provides an overview of the bodies and their membership.

Changes to insurance supervision

BaFin's activities in the coming years will focus on issues including Solvency II, the future system for supervising insurance companies. BaFin is in the process of putting the organisational requirements for Solvency II in place. At the end of 2004, BaFin set up new organisational units in its insurance pillar: There is now a manager for SRP (Supervisory Review Process). His task is to participate in designing the future European standard in the SRP working group and to introduce SRP to BaFin at an early stage. Another new position is the scientific coordinator for insurance supervision: he works pan-departmentally to prepare scientific insurance topics, ensures that these are exchanged BaFin-wide, and coordinates contacts with actuarial science institutes. In 2004, BaFin also set up the Centre of Competence for Capital Investment: this is responsible for the centralised audit of complex, high-risk, traditional investments and financial innovations.

Organisational development

Progress – including for cost accounting.

The „Organisational development" project made progress in the year under review. Work in the various sub-projects showed results. These included, for example, organisational changes in Department Group Z and the development of further education concepts for various target groups.

In addition, the sub-project for cost accounting grew strongly in 2004: The cost accounting project team has mapped the product and recipient structures at BaFin, introduced the SAP standard software, and tailored this to BaFin's requirements. All areas of BaFin now use cost accounting. This systematically records the costs that arise when BaFin provides services. These can thus be allocated to the responsible cost centres as required by FinDAG. This primarily relates to personnel expenses, which constitute the largest portion of BaFin's budget. Calculations for allocations and fees are then to be based on the results of cost accounting. Using cost accounting as a base ensures that allocations and fees are calculated properly and in a verifiable manner. Cost accounting also forms the basis for internal management and forecasting; it is used to make the utilisation rate for resources transparent and make their use even more cost effective.

The sub-project for HR development resulted in a promotion guideline and an upgrade guideline. An integrated further education concept is being worked on. The agenda also includes valuing and re-

organising workflows. This includes, for example, making workflows from the formerly independent authorities uniform, and increasing efficiency with improved technical support. A further project during the year under review was the accelerated introduction of an electronic workflow and knowledge management system (DOMEA).

BaFin-wide project „De-bureaucratisation of reporting"
In 2004, all of the supervisory pillars of BaFin ploughed through their reporting to identify opportunities to tighten their reporting and gear this to risk-oriented supervisory information requirements. BaFin has already implemented part of this modernisation project and communicated it externally.

Banking supervision
In its banking supervision, BaFin focuses not only on doing away with reporting requirements. It also dealt with granting material relief and introducing future reporting requirements as sparingly as possible. Key changes are pending for reporting when Basel II is implemented in European law. In order to avoid additional changeover costs for the institutions, BaFin has not changed the existing regulations. It is much rather the case that it has postponed all of the changes already planned for the reporting ordinance and the regulation governing large exposures and loans of €1.5 million or More. These changes will be integrated in the new implementation act. When requesting data, BaFin will – as far as possible – orient itself towards the data which the institutes already have to maintain for their internal risk control and management. It is also taking this stance when participating in the European negotiations for implementation of the CRD. BaFin has started to review possible relief outside the reporting requirements. For example, it worked on a consolidated circular on section 18 of the KWG, which summarises previous administrative practice and includes additional simplifications.

Insurance supervision
For insurance supervision, BaFin has simplified the reporting system and the number of reporting dates. The new features have been included in a consolidated version of the Ordinance Concerning the Reporting by Insurance Undertakings (BerVersV), which is to be enacted in 2005. In property and casualty insurance, each individual insurance branch no longer has to submit a separate actuarial income statement. In future this will do away with 24 income statements, of which 13 are for direct insurance and eleven for re-insurance. The reporting requirement is restricted to branches and types of insurance for which the insurance companies also have to make external reports according to the Ordinance on Insurance Accounting (RechVersV).

Securities supervision
For the area of securities supervision/asset management, the project focus was on expanding the opportunities for exemption from the annual WpHG audits and account audits. BaFin increased the exemption threshold for banks and savings banks from 500 to 750 safe custody accounts. In addition, the exemption – for institutes with up to 500 safe custody accounts – can now last for two years. Previously exemptions for a maximum of one year were possible. This means that – if the number of safe custody accounts is used as a criterion – around one third of all banks and savings banks can, as a rule, be exempted. In total, in 2003 and 2004 more than 300 banks and savings banks were exempted for one or two years from the WpHG audit and/or the audit of safe custody business In addition, more than 100 financial services institutions received an exemption.

4 Public Relations

In 2004 BaFin was once again reached by several thousand enquiries by media representatives, private individuals and companies. Public interest focused on the minimum requirements for banks' credit business, stress tests for personal insurers, the „gap" between life insurance companies, new features of the Act on the Improvement of Investor Protection and hedge funds, which have been authorised in Germany for the first time since the start of 2004. In addition to a large number of interviews, BaFin organised press conferences for Basel II as well as the regulation of ratings agencies, and also faced journalists' questions at the New Year Press Reception and its annual press conference.

INVEST Stuttgart, IAM Düsseldorf, Hamburg stock market day.

BaFin regularly uses investors fairs and stock market days to answer interested parties questions on location. For example, it participated at INVEST in Stuttgart in March 2004 and at IAM in Düsseldorf in September 2004. BaFin also participated as an exhibitor at the 9th Hamburg stock market day in October 2004. In particular investors and consumers were able to thus gain direct information on the security of their life insurance policies, banks' deposit guarantee, or the information requirements for listed companies. Potential providers used the opportunity to gather information on possible licensing requirements. In 2004 a large number of domestic and foreign groups of visitors again gained information on BaFin.

1st Practical Forum on Economic Criminal Activities and the Capital Market.

As the successor for „Practical dialogs for insider trading, price manipulation and ad hoc publicity", BaFin held a two-day „Practical forum for economic criminal activities and the capital market" in April 2004. Invitations went out to the police, public prosecutors and judges. The first day dealt with securities trading issues; the second day dealt with issues from the fields of money laundering and pursuing unauthorised financial transactions. BaFin was able to shed light on still more interfaces for cooperation by expanding the event to cover these areas of activities. The event attracted 300 participants at BaFin's Bonn offices.

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BaFin

3.1 Members of the Administrative Council

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Asmussen, Jörg (BMF – Deputy Chairman)
Dr. Hardieck, Thomas (BMWA)
Gatzer, Werner (BMF)
Görß, Peter (BMF)
Schaefer, Erich (BMJ)

Representatives of the German Bundestag
Andreae, Kerstin (MdB)
Hauer, Nina (MdB)
Kalb, Bartholomäus (MdB)
Seiffert, Heinz (MdB)
Spiller, Jörg-Otto (MdB)

Representatives of credit institutions
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Dr. Fischer, Thomas R.
Grieger, Jürgen
Dr. Hoppenstedt, Dietrich H.
Dr. Pleister, Christopher

Representatives of insurance undertakings
Dr. Förterer, Jürgen
Dr. Meyer, Lothar
Dr. Perlet, Helmut
Dr. von Fürstenwerth, Jörg

Representatives of investment companies
Benkner, Axel

As at: April 2005

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Dr. Schackmann-Fallis, Karl-Peter
Tolckmitt, Jens
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Representatives of insurance undertakings
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Dr. Hagemann, Reiner
Dr. von Bomhard, Nikolaus
Dr. Winkler, Heiko

Representative of investment companies
Päsler, Rüdiger H.

Representative of the Bundesbank
Hofmann, Gerhard

Representative of the Association of Private Health Insurers
Schulte, Reinhold

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Prof. Dr. Dr. h.c. Baums, Theodor
Prof. Dr. Wagner, Fred

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Schwind, Joachim

Representatives of consumer protection organisations
Dr. Balzer, Christian
(Arbitrator for the Customer Complaints department of RSGV)
Prof. Römer, Wolfgang (Ombudsman for insurance companies)
Siegler, Wolfgang (Stiftung Warentest)

Representative of legal and business professionals
Pohle, Alexander (AfW)

Representative of associations for SMEs
Loistl, Ulrike (DVFA)

Representative of trade unions
Feddersen, Hinrich (ver.di)

Representative of industry
Härter, Holger P. (Porsche AG)

As at: April 2005

3.3 Members of the Insurance Advisory Council

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Dr. Martin Balleer	Executive Borad Member of Deutsche Aktuarvereinigung (DAV) e.V.
Prof. Dr. Jürgen Basedow	Max-Planck-Institut for foreign and international private law ín Hamburg
Beate-Kathrin Bextermöller	Stiftung Warentest Financial Services Department
Prof. Dr. Harald Brachmann	Fachhochschule Köln Institute for Insurance Studies
Dr. Leberecht Funk	President Verband Deutscher Versicherungsmakler e.V. (VDVM) Funk Gruppe GmbH
Prof. Dr. Gerd Geib	Executive Board Member of KPMG Deutsche Treuhand-Gesellschaft AG
Dr. Reiner Hagemann	Executive Board Chairman of Allianz Versicherungs-AG and Executive Board Member of Allianz AG, Munich
Andrea Hoffmann	Head of Financial Services Department
Prof. Dr. Gottfried Koch	Universität Leipzig Institute for Insurance Studies
Dr. Bernd Michaels	Board Member of the Gesamtverband der Deutschen Versicherungswirtschaft e.V.
Dieter Philipp	President of Handwerkskammer Aachen
Dr. Gerhard Rupprecht	Executive Board Chairman of Allianz Lebensversicherungs-AG
Dr. Bernhard Schareck	Executive Board Chairman of Karlsruher Versicherungen President of the Gesamtverband der Deutschen Versicherungswirtschaft e.V.

Hauprecht Freiherr Schenck zu Schweinsberg	Chairman of the Bundesverband der Deutschen Industrie e. V. (BDI) insurance committee, Cologne Managing Director of Thyssen Krupp Versicherungsdienst GmbH, Industrieversicherungsvermittlung
Dr. Hans-Jürgen Schinzler	Chairman of Supervisory Board of Münchener Rückversicherungs-AG
Wolfgang Scholl	Verbraucherzentrale Bundesverband Financial Services Department
Prof. Dr. Wolfgang Schünemann	Universität Dortmund Chair Private Law
Reinhold Schulte	Executive Board Chairman of Signal Iduna Gruppe Chairman of the Verband der privaten Krankenversicherung e. V.
Joachim Schwind	Attorney at Law Head of Department at Hoechst AG Chairman of Pensionskasse der Mitarbeiter der Hoechst-Gruppe VVaG
Prof. Dr. Hans-Peter Schwintowski	Humboldt-Universität Berlin Faculty of Law Chair Civil, Mercantile, Commercial and European Law
Richard Sommer	ver.di-Bundesverwaltung Vereinte Dienstleistungsgewerkschaft Financial Services
Ludger Theilmeier	Former president of the Bundesverbande Deutscher Versicherungskaufleute e.V.
Elke Weidenbach	Specialist consultant for insurance, Verbraucher-Zentrale NRW e.V. Financial Services Group

As at: March 2005

The Federal Financial Supervisory Authority has concluded Memoranda of Understanding (MoU) with the supervisory authorities of the following countries:

In the area of Banking Supervision:

Belgium, Denmark, Estonia, Finland, France, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, the Netherlands, Austria, Poland, Portugal, Sweden, Slovakia, Slovenia, Spain,
Czech Republic, Hungary, United Kingdom.

Malta, Luxemburg (Clearstream), Canada

Norway

Argentina, China, Jersey, Hong Kong, Romania, South Africa, South Korea, United States of America (Federal Reserve Board, Office of the Comptroller of the Currency, New York State Banking Department, Office of Thrift Supervision)

In the area of Insurance Supervision:

China, Estonia, Latvia, Lithuania, Malta, Romania, Slovakia, Czech Republic, Hungary

In the area of Securities Supervision:

Bilateral MoU:
France, Spain, Italy, Hungary, Poland, Portugal, Slovakia,
Czech Republic, Cyprus

Argentina, Australia, Brasilia, China, Hong Kong, Jersey, Canada (Commission des Valeurs Mobilières du Quebec; Office of the Superintendent of Financial Institutions Canada), Russia, Singapore, South Africa, Taiwan, Turkey, 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 25 EU states which are members of CESR, as well as Iceland and Norway as EEA signatories; the new member states joined this MMoU in May 2004.

Additionally, 26 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, Slovakia, Spain, Sri Lanka, South Africa, Turkey, Hungary, United Kingdom, United States of America (Securities and Exchange Commission, Commodities and Futures Trading Commission).

Statistic of complaints in connection with individual undertakings

5.1 About this statistic
5.2 Llife insurance
5.3 Health insurance
5.4 Motor insurance
5.5 General liability insurance
5.6 Accident insurance
5.7 Household insurance
5.8 Residential building insurance
5.9 Legal expenses insurance
5.10 Undertakings based in the EEA

5.1 About this statistic

In previous publications of its 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 have 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 insurance company-specific complaints submitted to BaFin in the course of 2004 was put in relation to the total number of contracts within the respective insurance class (business in force) as at 1 January 2004. Figures regarding the business in force are provided by the individual insurance companies. Insurers experiencing above-average growth, e.g. newly established companies, are at a disadvantage, due to the fact that the new business added in the course of the year is not accounted for in the complaints statistic. Therefore, this statistic is of limited value when it comes to assessing the quality of specific insurance companies.

The business in force figures reported in the property and casualty insurance category relate to insured risks. To the extent that the undertakings concluded group policies with several insured parties, this results in a higher number of policies in force. Owing to the limited disclosure requirements (section 51 (4) no. 1 sentence 4 RechVersV), the business in force figures can only be included for insurers whose gross premiums earned in 2003 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 insured under each policy section, which is usually higher. This figure is still not completely reliable.

Undertakings that operate within one of the classes listed but have not been the subject of complaints during the reporting year, do not appear in the statistic.

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 business in force of EEA-based insurers. The number of complaints has, however, been included in order to present a more complete overview.

5.2 Life insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
1001	AACHENER / MCHN. LEBEN	4,871,228	320
1005	WÜRTT. LEBEN	1,871,040	71
1006	ALLIANZ LEBEN	10,227,179	609
1007	ALTE LEIPZIGER LEBEN	904,562	100
1011	BARMENIA LEBEN	235,277	19
1012	BASLER LEBEN	114,210	15
1013	BAYER. BEAMTEN LEBEN	478,062	41
1015	BAYERN-VERS.	1,553,355	142
1017	BERLINISCHE LEBEN	1,141,761	103
1018	RHEINLAND LEBEN	492,397	7
1020	AXA LEBEN	2,146,107	231
1021	CONDOR LEBEN	213,839	20
1022	COSMOS LEBEN	997,701	46
1023	DEBEKA LEBEN	2,732,139	78
1025	DEVK DT. EISENBAHN LV	877,575	13
1028	DT. RING LEBEN	927,189	116
1033	GERLING-K. LEBEN	1,792,598	184
1034	SECURITAS GILDE LEBEN	99,288	9
1035	ARAG LEBEN	435,002	54
1044	SV SPARKASSEN LV AG	544,317	46
1045	KARLSRUHER HINTERBL	112,440	8
1047	IDEAL LEBEN	411,468	15
1048	IDUNA VEREINIGTE LV	2,446,945	165
1050	KARLSRUHER LEBEN	1,271,613	87
1054	LANDESLEBENSHILFE	26,219	3
1055	HUK-COBURG LEBEN	645,071	25
1056	OEFF. LEBEN BERLIN	118,819	8
1062	LEBENSVERS. VON 1871	695,327	40
1063	GENERALI LV	1,152,589	121
1064	MÜNCHEN. VEREIN LEBEN	147,791	17
1078	CONTINENTALE LEBEN	572,076	38
1081	PROV. LEBEN HANNOVER	734,109	33
1082	PROV.RHEINLAND LEBEN	1,228,939	39
1083	PROV.NORD LEBEN	462,868	48
1085	R+V LEBEN, VAG	344,595	5
1089	SÜDDT. LEBEN	61,025	1
1090	SCHWEIZERISCHE LEBEN	1,132,014	97
1091	SV SPARKASSEN-VERS.	939,351	41
1092	UNIVERSA LEBEN	264,274	18
1093	VER. POSTVERS.	1,265,141	65
1096	ZÜRICH LEBEN	450,460	15
1097	INTER LEBEN	222,344	19
1099	VOLKSWOHL-BUND LEBEN	877,658	52
1102	WINTERTHUR LEBEN	26,789	2
1103	WWK LEBEN	903,180	103
1104	STUTTGARTER LEBEN	462,450	53
1107	EUROPA LEBEN	354,080	14
1108	GOTHAER LEBEN AG	1,261,758	114

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
1109	MECKLENBURG. LEBEN	145,162	8
1110	DIREKTE LEBEN	84,885	4
1112	LVM LEBEN	653,978	33
1113	DIALOG LEBEN	173,162	4
1114	HANSEMERKUR LEBEN	186,929	42
1115	ONTOS LEBEN	37,471	1
1119	INTERRISK LEBENSVERS.	71,379	1
1122	CONCORDIA LEBEN	131,452	2
1123	PLUS LEBEN	48,142	11
1130	KARSTADTQUELLE LV AG	1,155,189	42
1132	CIV LEBEN	1,840,121	57
1136	DEVK ALLG. LEBEN	514,444	28
1137	HELVETIA LEBEN	109,060	1
1138	DT. HEROLD LEBEN	2,668,309	333
1139	VOLKSFÜRSORGE DT. LV	4,269,531	318
1140	VICTORIA LEBEN	2,781,076	306
1141	R+V LEBENSVERS. AG	4,078,597	129
1142	HDI LEBENSVERS.	102,514	17
1145	BHW LEBEN	1,024,594	38
1146	DBV-WINTERTHUR LEBEN	2,397,212	161
1147	NÜRNBG. LEBEN	2,818,917	360
1148	DT. LEBENSVERS.	167,746	1
1149	WGV-SCHWÄBISCHE LEBEN	35,749	3
1150	SAARLAND LEBEN	105,644	4
1151	VORSORGE LEBEN	32,229	12
1153	SPARK.-VERS.SACHS.LEB	271,534	7
1157	SKANDIA LEBEN	205,589	24
1158	MLP LEBEN	339,880	53
1159	PAX LEBEN	18,383	1
1160	VPV LEBEN	145,292	32
1162	GUTINGIA LEBEN	27,416	1
1164	NEUE LEBEN LEBENSVERS	584,905	20
1167	DELTA DIREKT LEBEN	58,782	1
1173	AEGON LEBENSVERS.-AG	132,437	17
1175	FAMILIENSCHUTZ LEBEN	217,048	9
1177	OECO CAPITAL LEBEN	9,888	1
1180	DT. ÄRZTEVERSICHERUNG	205,316	14
1181	ASPECTA LEBEN	571,960	129
1184	HAMB. MANNHEIMER LV	7,001,235	631
1192	BRUNSVIGA LEBENSV.	51,641	4
1194	PB LEBENSVERSICHERUNG	224,157	23
1196	ZÜRICH LV AG	733,915	79
1198	MAMAX LEBEN	5,812	2
1303	ASSTEL LEBEN	369,358	39
1305	WESTF.PROV.	1,296,955	39
1309	PROTEKTOR LV	313,795	306
1310	FAMILIENFüRSORGE LV	308,314	9
1312	HANNOVERSCHE LVAG	789,176	102

5.3 Health insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
4034	ALLIANZ PRIV. KV AG	2,336,213	523
4010	ALTE OLDENBG. KRANKEN	54,882	4
4112	ARAG KRANKEN	179,976	127
4095	AXA KRANKEN	490,173	343
4042	BARMENIA KRANKEN	707,188	187
4134	BAYERISCHE BEAMTEN K	713,179	127
4127	BBV KRANKEN	14,415	3
4004	CENTRAL KRANKEN	1,398,308	272
4118	CONCORDIA KRANKEN	56,900	2
4001	CONTINENTALE KRANKEN	1,123,825	101
4101	DBV-WINTERTHUR KRANK.	861,301	161
4028	DEBEKA KRANKEN	2,922,953	105
4131	DEVK KRANKENVERS.-AG	101,474	3
4044	DKV AG	2,833,059	293
4013	DT. RING KRANKEN	563,903	45
4121	ENVIVAS KRANKEN	14,817	9
4089	EUROPA KRANKEN	202,701	12
4053	FREIE ARZTKASSE	28,222	3
4128	GLOBALE KRANKEN	77,983	15
4119	GOTHAER KV AG	470,365	77
4043	HALLESCHE KRANKEN	508,081	85
4018	HANSEMERKUR KRANKEN	373,123	48
4117	HUK-COBURG KRANKEN	426,211	605
4031	INTER KRANKEN	375,566	49
4126	KARSTADTQUELLE KV AG	198,898	9
4011	LAN DESKRANKENHILFE	420,710	51
4109	LVM KRANKEN	193,832	9
4123	MANNHEIMER KRANKEN	90,430	26
4141	MECKLENBURGISCHE KRA.	16,641	1
4037	MÜNCHEN.VEREIN KV	214,695	32
4125	NÜRNBG. KRANKEN	130,771	15
4143	PAX-FAMILIENF.KV AG	102,394	17
4135	PROVINZIAL KRANKEN	79,825	2
4116	R+V KRANKEN	192,517	7
4002	SIGNAL KRANKEN	1,789,146	243
4039	SÜDDEUTSCHE KRANKEN	386,291	22
4108	UNION KRANKENVERS.	669,257	35
4045	UNIVERSA KRANKEN	333,496	45
4105	VICTORIA KRANKEN	868,864	50
4139	WÜRTT. KRANKEN	63,549	2
4137	ZÜRICH KV AG	106,260	10

5.4 Motor insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
5342	AACHENER/MCHN. VERS.	2,096,749	49
5581	ADLER VERSICHERUNG AG	138,529	4
5312	ALLIANZ VERS.	15,062,000	164
5405	ALTE LEIPZIGER VERS.	340,691	10
5052	AXA DIE ALTERNATIVE	305,921	27
5515	AXA VERS.	3,213,280	119
5316	BAD. GEMEINDE-VERS.	488,793	1
5317	BARMENIA ALLG. VERS.	254,807	6
5633	BASLER SECURITAS	547,354	38
5310	BAYER. BEAMTEN VERS.	186,760	5
5325	BAYER. VERS. BANK	2,474,663	22
5324	BAYER. VERS. VERB. AG	1,670,146	14
5098	BRUDERHILFE SACH. AG	413,720	4
5338	CONCORDIA VERS.	1,265,421	29
5340	CONTINENTALE SACHVERS.	239,728	7
5552	COSMOS VERS.	423,689	35
5529	D.A.S. VERS.	501,215	25
5343	DA DEUTSCHE ALLG.VER.	1,351,060	148
5311	DBV AG	286,919	3
5037	DBV-WINTERTHUR	519,631	54
5549	DEBEKA ALLGEMEINE	519,283	7
5513	DEVK ALLG. VERS.	2,586,654	68
5344	DEVK DT. EISENB. SACH	934,675	6
5055	DIRECT LINE	319,236	53
5347	DT. HEROLD ALLG. VERS.	803,772	42
5508	EUROPA SACHVERS.	302,562	30
5470	FAHRLEHRERVERS.	307,488	4
5024	FEUERSOZIETÄT	156,565	7
5364	FRANKF. VERS.	4,990,188	85
5505	GARANTA VERS.	1,231,796	37
5456	GENERALI VERS. AG	1,521,169	49
5368	GERLING-K. ALLGEMEINE	1,251,108	21
5531	GOTHAER ALLG. VERS.AG	1,439,359	57
5585	GVV-PRIVATVERSICH.	214,218	4
5420	HAMB. MANNHEIMER SACH	723,357	37
5096	HDI INDUSTRIE VERS.	548,164	7
5085	HDI PRIVAT	2,775,665	78
5384	HELVETIA VERS.	267,767	11
5375	HUK-COBURG	7,186,825	115
5521	HUK-COBURG ALLG. VERS	4,974,610	92
5086	HUK24 AG	304,706	18
5401	ITZEHOER VERSICHERUNG	625,709	9
5509	KARLSRUHER VERS.	511,469	21
5058	KRAVAG-ALLG EM EINE	622,163	38
5080	KRAVAG-LOGISTIC	646,203	17
5402	LVM SACH	4,405,068	44
5061	MANNHEIMER VERS.	182,513	9

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
5412	MECKLENBURG. VERS.	710,459	18
5390	NOVA ALLG. VERS.	608,493	24
5426	NÜRNBG. ALLG.	320,636	8
5686	NÜRNBG. BEAMTEN ALLG.	357,887	3
5791	ONTOS VERS.	162,038	18
5432	PATRIA VERS.	179,189	10
5446	PROV. NORD BRANDKASSE	831,725	11
5095	PROV. RHEINLAND VERS.	1,282,668	15
5438	R+V ALLGEMEINE VERS.	3,289,019	47
5798	RHEINLAND VERS. AG	239,292	12
5051	S DIREKT VERSICHERUNG	126,653	4
5773	SAARLAND FEUERVERS.	148,653	3
5451	SIGNAL UNFALL	349,744	14
5781	SPARK.-VERS.SACHS.ALL	141,551	6
5036	SV SPARK.VERSICHER.	582,736	9
5385	SV SPARKASSEN	358,704	15
5776	TELCON ALLGEMEINE	315,167	21
5458	TRANSATLANT. ALLG. VERS	144,280	8
5441	VEREINTE SPEZIAL VERS	264,531	15
5042	VERSICHERUNGSK. BAYERN	132,223	4
5400	VGH LAND. BRAND. HAN.	1,779,192	12
5598	VHV AUTOVERSICHERUNG	3,439,678	79
5472	VICTORIA VERS.	1,649,148	43
5473	VOLKSFÜRSORGE DT.SACH	1,428,255	40
5093	WESTF.PROV.VERS.AG	1,346,281	9
5525	WGV-SCHWÄBISCHE ALLG.	685,477	15
5479	WÜRTT. GEMEINDE-VERS.	919,072	5
5783	WÜRTT. VERS.	2,094,913	44
5050	ZÜRICH VERS. AG	1,842,875	45

5.5 General liability insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
5342	AACHENER/MCHN. VERS.	1,236,744	62
5312	ALLIANZ VERS.	5,231,445	131
5405	ALTE LEIPZIGER VERS.	252,401	18
5455	ARAG ALLG. VERS.	21,062,946	52
5515	AXA VERS.	1,769,431	56
5316	BAD. GEMEINDE-VERS.	121,758	3
5633	BASLER SECU RITAS	305,272	25
5325	BAYER. VERS.BANK	1,126,725	28
5324	BAYER.VERS.VERB.AG	929,895	12
5098	BRUDERHILFE SACH.AG	227,814	6
5338	CONCORDIA VERS.	350,726	11
5340	CONTINENTALE SACHVERS	232,011	12
5529	D.A.S. VERS.	231,972	12
5771	DARAG DT. VERS.U.RÜCK	61,892	7
5311	DBV AG	469,207	2
5037	DBV-WINTERTHUR	645,942	37
5549	DEBEKA ALLGEMEINE	937,230	21
5513	DEVK ALLG. VERS.	919,790	22
5344	DEVK DT. EISENB. SACH	634,588	2
5347	DT. HEROLD ALLG.VERS.	368,541	16
5350	DT. RING SACHVERS.	148,189	9
5024	FEUERSOZIETÄT	123,634	8
5364	FRANKF. VERS.	1,366,530	27
5456	GENERALI VERS. AG	962,572	52
5442	GERLING G&A	98,781	11
5368	GERLING-K. ALLGEMEINE	923,037	28
5531	GOTHAER ALLG.VERS. AG	1,422,641	71
5469	GVV-KOMMUNALVERS.	2,685	8
5374	HAFTPFLICHTK.DARMST.	505,619	27
5420	HAMB. MANNHEIMER SACH	627,881	34
5377	HDI HAFTPFLICHTV	265	3
5096	HDI INDUSTRIE VERS.	22,135	4
5085	HDI PRIVAT	484,128	27
5384	HELVETIA VERS.	397,419	8
5375	HUK-COBURG	1,716,937	26
5521	HUK-COBURG ALLG. VERS	752,767	10
5546	INTER ALLG. VERS.	57,263	10
5401	ITZEHOER VERSICHERUNG	177,866	3
5509	KARLSRUHER VERS.	207,516	9
5402	LVM SACH	1,069,125	17
5061	MANNHEIMER VERS.	123,888	12
5412	MECKLENBURG. VERS.	251,226	15
5390	NOVA ALLG.VERS.	389,002	15
5426	NÜRNBG. ALLG.	303,361	21
5446	PROV.NORD BRANDKASSE	358,019	4
5095	PROV.RHEINLAND VERS.	832,182	16
5438	R+V ALLGEMEINE VERS.	1,459,794	40
5798	RHEINLAND VERS. AG	147,874	5

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
5451	SIGNAL UNFALL	246,482	10
5036	SV SPARK.VERSICHER.	284,167	2
5385	SV SPARKASSEN	346,780	8
5458	TRANSATLANT. ALLG. VERS	149,354	7
5459	UELZENER ALLG. VERS.	101,823	4
5042	VERSICHERUNGSK. BAYERN	17,057	13
5400	VGH LAN D.BRAND. HAN.	689,150	7
5464	VHV	776,583	33
5472	VICTORIA VERS.	1,159,141	44
5473	VOLKSFÜRSORGE DT.SACH	1,015,111	39
5093	WESTF.PROV.VERS.AG	784,606	10
5525	WGV-SCHWÄBISCHE ALLG.	241,898	8
5480	WÜRTT. U. BADISCHE	103,669	3
5783	WÜRTT. VERS.	1,034,649	43
5050	ZÜRICH VERS. AG	582,411	36

5.6 Accident insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
Reg. no.	Name of insurance undertaking	Number of accident insurance policies (2003)	Complaints
5342	AACHENER/MCHN. VERS.	1,922,241	62
5498	ADAC-SCHUTZBRIEF VERS	783,489	1
5312	ALLIANZ VERS.	6,022,241	88
5405	ALTE LEIPZIGER VERS.	102,352	4
5455	ARAG ALLG. VERS.	21,144,559	22
5512	ASPECTA VERSICHERUNG	128,788	13
5515	AXA VERS.	992,817	36
5593	BAD. ALLG. VERS.	6,307	1
5792	BADEN-BADENER VERS.	240,048	15
5317	BARMENIA ALLG. VERS.	126,332	9
5633	BASLER S ECU RITAS	145,724	12
5310	BAYER. BEAMTEN VERS.	102,025	3
5325	BAYER. VERS. BANK	1,126,180	14
5324	BAYER. VERS. VERB. AG	567,430	6
5790	CIV VERS.	204,257	20
5338	CONCORDIA VERS.	295,453	3
5340	CONTINENTALE SACHVERS	747,458	28
5552	COSMOS VERS.	180,877	8
5529	D.A.S. VERS.	268,291	20
5343	DA DEUTSCHE ALLG.VER.	64,180	3
5311	DBV AG	228,834	1
5037	DBV-WINTERTHUR	188,534	13
5549	DEBEKA ALLGEMEINE	1,545,533	13
5513	DEVK ALLG. VERS.	638,094	9
5347	DT. HEROLD ALLG. VERS.	681,717	13
5350	DT. RING SACHVERS.	439,693	37
5636	ELVIA REISEVERS.	4,334	1
5516	FAMILIENSCHUTZ VERS.	300,105	51
5024	FEUERSOZIETÄT	43,938	3
5364	FRANKF. VERS.	1,261,764	13
5365	GEGENSEITIGKEIT VERS.	6,956	1
5456	GENERALI VERS. AG	857,261	37
5442	GERLING G&A	143,505	7
5531	GOTHAER ALLG.VERS.AG	838,879	33
5374	HAFTPFLICHTK. DARMST.	81,442	1
5420	HAMB. MANNHEIMER SACH	2,481,018	139
5501	HANSEMERKUR ALLG.	119,142	8
5085	HDI PRIVAT	153,910	2
5384	HELVETIA VERS.	148,375	4
5375	HUK-COBURG	1,100,140	6
5521	HUK-COBURG ALLG. VERS	484,533	2
5546	INTER ALLG. VERS.	63,894	7
5780	INTERRISK VERS.	385,521	13
5509	KARLSRUHER VERS.	157,788	5
5562	KARSTADTQUELLE VERS.	354,020	9
5399	KRAVAG-SACH	15,125	1
5402	LVM SACH	843,133	5
5061	MANNHEIMER VERS.	81,119	7

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
5412	MECKLENBURG. VERS.	153,837	9
5414	MÜNCHEN. VEREIN ALLG.	41,146	3
5390	NOVA ALLG.VERS.	893,861	21
5426	NÜRNBG. ALLG.	554,497	65
5686	NÜRNBG. BEAMTEN ALLG.	106,361	5
5791	ONTOS VERS.	4,199	6
5017	OSTANGLER BRANDGILDE	5,634	1
5074	PB VERSICHERUNG	79,263	6
5446	PROV. NORD BRANDKASSE	377,744	5
5095	PROV. RHEINLAND VERS.	1,518,796	7
5583	PVAG POLIZEIVERS.	319,711	4
5438	R+V ALLGEMEINE VERS.	1,408,681	19
5798	RHEINLAND VERS. AG	90,105	10
5690	SCHWARZMEER U. OSTSEE	3,125	4
5448	SCHWEIZER NATION. VERS	14,165	1
5451	SIGNAL UNFALL	679,695	78
5781	SPARK.-VERS. SACHS. ALL	44,014	1
5586	STUTTGARTER VERS.	272,053	33
5036	SV SPARK. VERSICHER.	187,665	1
5385	SV SPARKASSEN	153,345	3
5776	TELCON ALLGEMEINE	84,744	3
5463	UNIVERSA ALLG. VERS.	134,447	2
5511	VER. VERS. GES. DTSCHL	211,468	7
5042	VERSICHERUNGSK. BAYERN	4,432	0
5400	VGH LAND. BRAND. HAN.	6,212,371	6
5464	VHV	147,303	2
5472	VICTORIA VERS.	1,040,051	49
5473	VOLKSFÜRSORGE DT. SACH	544,747	23
5484	VOLKSWOHL-BUND SACH	181,629	5
5461	VPV ALLGEMEINE VERS.	129,727	4
5093	WESTF. PROV. VERS. AG	917,111	4
5447	WINTERTHUR VERS.	42,877	1
5476	WWK ALLGEMEINE VERS.	151,422	6
5479	WÜRTT. GEMEINDE-VERS.	147,947	2
5480	WÜRTT. U. BADISCHE	214,779	4
5783	WÜRTT. VERS.	694,810	28
5590	WÜRZBURGER VERSICHER.	45,930	2
5050	ZÜRICH VERS. AG	1,273,537	18

5.7 Household insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
Reg. no.	Name of insurance undertaking	Number of household insurance policies (2003)	Complaints
5342	AACHENER/MCHN. VERS.	858,893	39
5312	ALLIANZ VERS.	3,294,809	68
5405	ALTE LEIPZIGER VERS.	176,114	10
5455	ARAG ALLG. VERS.	236,035	44
5515	AXA VERS.	1,064,715	21
5633	BASLER S ECU RITAS	261,385	8
5325	BAYER. VERS.BANK	682,060	5
5324	BAYER.VERS.VERB.AG	527,405	4
5338	CONCORDIA VERS.	218,529	6
5340	CONTINENTALE SACHVERS	116,777	7
5529	D.A.S. VERS.	145,610	11
5037	DBV-WINTERTHUR	207,040	20
5549	DEBEKA ALLGEMEINE	581,082	4
5513	DEVK ALLG. VERS.	775,004	17
5344	DEVK DT. EISENB. SACH	463,589	4
5347	DT. HEROLD ALLG.VERS.	299,218	5
5350	DT. RING SACHVERS.	215,472	2
5364	FRANKF. VERS.	915,733	1
5456	GENERALI VERS. AG	616,618	39
5368	GERLING-K. ALLGEMEINE	391,385	7
5531	GOTHAER ALLG. VERS. AG	884,358	15
5420	HAMB. MANNHEIMER SACH	457,090	22
5085	HDI PRIVAT	236,125	6
5384	HELVETIA VERS.	312,029	5
5375	HUK-COBURG	1,178,788	6
5521	HUK-COBURG ALLG. VERS	456,923	1
5509	KARLSRUHER VERS.	116,596	3
5402	LVM SACH	605,473	18
5061	MANNHEIMER VERS.	101,176	9
5412	MECKLENBURG. VERS.	156,082	4
5390	NOVA ALLG.VERS.	270,380	5
5426	NÜRNBG. ALLG.	182,759	11
5446	PROV. NORD BRANDKASSE	296,441	2
5095	PROV. RHEINLAND VERS.	573,451	16
5438	R+V ALLGEMEINE VERS.	692,402	5
5798	RHEINLAND VERS. AG	106,125	5
5036	SV SPARK. VERSICHER.	133,562	2
5385	SV SPARKASSEN	255,348	3
5400	VGH LAND. BRAND. HAN.	488,903	4
5464	VHV	209,729	4
5472	VICTORIA VERS.	758,674	26
5473	VOLKSFÜRSORGE DT. SACH	938,111	28
5461	VPV ALLGEMEINE VERS.	185,230	7
5093	WESTF. PROV. VERS. AG	2,436,023	5
5783	WÜRTT. VERS.	727,568	27
5050	ZÜRICH VERS. AG	370,944	14

5.8 Residential building insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
5342	AACHENER/MCHN. VERS.	328,403	21
5312	ALLIANZ VERS.	1,986,411	63
5405	ALTE LEIPZIGER VERS.	147,327	16
5515	AXA VERS.	548,714	44
5633	BASLER SECURITAS	143,252	12
5325	BAYER. VERS.BANK	313,718	4
5043	BAYER. L-BRAND. VERS. AG	2,659,490	9
5324	BAYER.VERS.VERB.AG	456,861	14
5338	CONCORDIA VERS.	156,763	6
5340	CONTINENTALE SACHVERS	51,344	4
5529	D.A.S. VERS.	58,420	2
5311	DBV AG	86,351	1
5037	DBV-WINTERTHUR	96,952	18
5549	DEBEKA ALLGEMEINE	165,765	4
5513	DEVK ALLG. VERS.	262,121	7
5344	DEVK DT. EISENB. SACH	154,939	1
5347	DT. HEROLD ALLG.VERS.	112,556	7
5350	DT. RING SACHVERS.	49,960	2
5024	FEUERSOZIETÄT BERLIN	92,083	9
5364	FRANKF. VERS.	414,255	6
5456	GENERALI VERS. AG	308,416	29
5368	GERLING-K. ALLGEMEINE	150,923	11
5531	GOTHAER ALLG.VERS.AG	299,183	5
5485	GRUNDEIGENTÜMER-VERS.	46,603	7
5420	HAMB. MANNHEIMER SACH	122,837	11
5085	HDI PRIVAT	86,748	2
5384	HELVETIA VERS.	152,066	8
5375	HUK-COBURG	446,450	8
5521	HUK-COBURG ALLG. VERS	113,449	2
5509	KARLSRUHER VERS.	75,505	6
5402	LVM SACH	353,536	10
5061	MANNHEIMER VERS.	49,010	8
5412	MECKLENBURG. VERS.	83,550	5
5390	NOVA ALLG.VERS.	96,886	12
5426	NÜRNBG. ALLG.	70,301	5
5446	PROV. NORD BRANDKASSE	330,881	2
5095	PROV. RHEINLAND VERS.	684,808	64
5438	R+V ALLGEMEINE VERS.	573,211	13
5798	RHEINLAND VERS. AG	70,814	8
5773	SAARLAND FEUERVERS.	81,063	1
5036	SV SPARK.VERSICHER.	1,837,234	63
5385	SV SPARKASSEN	1,149,857	36
5400	VGH LAND. BRAND. HAN.	492,764	4
5472	VICTORIA VERS.	349,985	24
5473	VOLKSFÜRSORGE DT. SACH	189,563	12
5093	WESTF. PROV. VERS.AG	2,058,467	9
5480	WÜRTT. U. BADISCHE	20,538	1
5783	WÜRTT. VERS.	358,751	18
5050	ZÜRICH VERS. AG	244,627	14

5.9 Legal expenses insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies 2003	Complaints
5826	ADAC-RECHTSSCHUTZ	2,834,161	6
5809	ADVO CARD RS	1,663,576	112
5312	ALLIANZ VERS.	2,740,768	99
5825	ALLRECHT RECHTSSCHUTZ	252,953	18
5800	ARAG ALLG. RS	1,907,187	302
5801	AUXILIA RS	524,139	26
5838	BADISCHE RECHTSSCHUTZ	112,224	16
5098	BRUDERHILFE SACH. AG	155,524	7
5831	CONCORDIA RS	333,478	41
5802	D.A.S. ALLG. RS	3,129,182	136
5549	DEBEKA ALLGEMEINE	286,131	11
5803	DEURAG DT. RS	532,818	39
5829	DEVK RECHTSSCHUTZ	959,397	16
5834	DMB RECHTSSCHUTZ	52,177	9
5347	DT. HEROLD ALLG.VERS.	115,496	20
5368	GERLING-K. ALLGEMEINE	235,311	14
5828	HAMB. MANNHEIMER RS	470,715	26
5827	HDI RECHTSSCHUTZ	264,672	39
5818	HUK-COBURG RS	1,555,596	52
5823	KARLSRUHER RS	104,240	9
5815	LVM RECHTSSCHUTZ	650,305	17
5412	MECKLENBURG. VERS.	119,996	12
5805	NEUE RECHTSSCHUTZ	454,785	18
5813	OERAG RECHTSSCHUTZ	1,104,442	55
5836	R+V RECHTSSCHUTZ	529,195	12
5806	RECHTSSCHUTZ UNION	463,006	54
5807	ROLAND RECHTSSCHUTZ	1,131,463	90
5400	VGH LAND. BRAND. HAN.	168,833	4
5832	WÜRTT. GEMEINDE-RS	322,470	23
5783	WÜRTT. VERS.	567,517	30
5050	ZÜRICH VERS. AG	326,089	32

5.10 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	Complaints
7552	Accent Europe (IRL)	1
7630	ACE European (IRL)	1
7044	Ace Insurance (B)	1
5487	ACE Insurance S.A. (B)	17
5595	AIG Europe S.A. (F)	11
1306	Aig Life Nieder. (IRL)	3
5551	AIOI (GB)	3
7644	Allianz Worldw. (IRL)	1
7366	Arisa Assurances (L)	1
7203	Atlanticlux (L)	53
7374	AXA Assistance (F)	1
7300	AXA Belg. (B)	1
5090	AXA Corporate S. (F)	2
1300	Canada Life (IRL)	61
7786	Canada Life A. (IRL)	2
1182	Cardif Leben (F)	13
5056	Cardif Vers. (F)	16
5574	Chubb Ins. Comp. (B)	2
7693	Cigna Europe (B)	1
7690	Cigna Life (B)	1
7226	Cigna Life Ins CY (B)	1
1189	Cigna Life Ins. (B)	1
7453	Clerical Med. Inv. (GB)	19
7553	Commercial U.L. (GR)	1
7281	DKV International (B)	2
5048	Domestic and Gen. (GB)	2
5058	Domestic and Gen. (GB)	3
5634	Eagle Star Ins. (GB)	1
1161	Equitable Life (GB)	13
1179	Financial Ass. (GB)	2
5053	Financial Insur. (GB)	5
7481	Fortuna Leben (FL)	2
7410	Foyer Internat. (L)	1
1178	General Acc. Life (GB)	1
7328	Grazer Wechs. Ver. (A)	1
1301	Hannover Stand. (GB)	2
5079	Hiscox Ins. (GB)	2
5072	IF Schadenvers. (S)	2
7611	Ihre Zukunft N.V. (NL)	2
7587	Ineas Insurance (NL)	10
7747	Int. Health Ins. (DK)	1
7525	Int. Ins. Hannover (GB)	1
5788	Inter Partner Ass. (B)	2
1190	Interamerican (GB)	2
5057	Interlloyd (D)	7
7245	Interunfall Vers. (A)	1
7685	Landmark Ins. (GB)	1

Reg. no.	Name of insurance undertaking	Complaints
7031	Legal/General Ass (GB)	1
5592	Lloyd’s Vers. (GB)	3
7191	Merkur Vers. (A)	1
7734	Metlife Europe (IRL)	6
1185	Metrolife-Empor. (GR)	1
5751	Mitsui Sumit. Ins. (GB)	1
7237	Mutuelle des Arch. (F)	3
5066	N.V.Waarborgmij (NL)	9
7579	Nemian Life & P. (L)	15
7806	New Technology (IRL)	4
5423	Northern Ass. C. (GB)	1
7459	Norwich u. Life (GB)	1
7723	Prismalife AG (FL)	18
7455	Probus Insurance (IRL)	1
7215	Prudentioal/Sali (IRL)	20
7159	QBE Internation. (GB)	1
7415	R+V Luxembourg L (L)	3
5045	Reliance Nat. (GB)	1
7107	Reliance National (GB)	3
7724	Rheinland Int. (NL)	3
7235	Salzburger Landes (A)	1
7658	Signal Idu. Pru. (IRL)	1
1174	Standard Life (GB)	22
7763	Stonebridge (GB)	1
5523	Sumitomo M./F. (GB)	1
7518	Sun Life Ass. Soc. (GB)	7
7204	Swiss Life S.A. (L)	1
7691	The Hullberry (NL)	8
7663	The National Ins. (GB)	2
7285	Trans-Meridian (IRL)	1
5081	Union Reisevers. (DK)	4
7259	USAA Ltd. Inc. (GB)	2
1311	VDV Leben Int. (GR)	3
7456	VDV Leben Intern. (GR)	3
5046	Volvo Vers. Amazon (B)	1
7677	Vorarlberger L. (A)	1
7483	Vorsorge Luxemb. (L)	35
7251	Wiener Städtische (A)	2
7683	Wüstenrot (A)	1

Abbreviations

A	**Abs.**	paragraph
	Abl.	Amtsblatt (Official Journal (OJ))
	ABS	Asset Backed Securities
	a.F.	old version
	AfS	Available for Sale
	AG	Aktiengesellschaft (German public limited company) / local court
	AG OpR	Working Group on Operational Risk
	AIG	Accord Implementation Group
	AIRBA	Advanced Internal Rating Based Approach
	AktG	Aktiengesetz (Stock Corporation Act)
	ALM	Asset Liability Management
	AltZertG	Altersvorsorgeverträge-Zertifizierungsgesetz (Act Governing the Certification of Contracts for Private Old-Age Provision)
	AMA	Advances Measurement Approaches
	AnlV	Anlageverordnung (Ordinance on the Investment of Restricted Assets of Insurance Undertakings – Investment Ordinance)
	AnSVG	Anlegerschutzverbesserungsgesetz (Act on the Improvement of Investor Protection)
	AntKlV	Anteilklassenverordnung (Share Class Ordinance)
	AnzV	Anzeigenverordnung (Reports Regulation)
	AO	Abgabenordnung (Tax Code) / Anordnung (order)
	AP	Assessment Process
	ARC	According Regulatory Committee
	AS-Fonds	Altersvorsorge-Sondervermögen (Special investment fund for pension provision subject to statutory requirements)
	ATF	Accounting Task Force
	ATS	Alternative Trading Systems
	AuslInvestmG	Auslandinvestment-Gesetz (Act Concerning the Marketing of Foreign Investment Units and the Taxation of Income from Foreign Investment Units)
	AVB	Allgemeine Versicherungsbedingungen (General Conditions of Insurance)
	AVmG	Altersvermögensgesetz (Act to Promote Old-Age Provision)
B	**BA**	Bankenaufsicht (Banking Supervision)
	BAC	Banking Advisory Committee
	BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
	BAG	Bundesarbeitsgericht (Federal Labour Court)
	BAKred	Bundesaufsichtsamt für das Kreditwesen (former Federal Banking Supervisory Authority)

	Bankenrichtlinie	Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions)
	BAV	Bundesaufsichtsamt für das Versicherungswesen (former Federal Insurance Supervisory Authority)
	BAWe	Bundesaufsichtsamt für den Wertpapierhandel (Federal Securities Supervisory Office)
	BBE	Bruttobeiträge (gross premiums)
	BCBS	Basel Committee in Banking Supervision
	BCP	Basel Core Principles for Effective Banking Supervision
	BerPensV	Verordnung zur Berichterstattung von Pensionsfonds (Ordinance concerning Reporting by Pension Funds)
	BerVersV	Verordnung über die Berichterstattung von Versicherungsunternehmen (Ordinance Concerning the Reporting by Insurance Undertakings)
	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)
	BIA	Basisindikatorenansatz (basis indicator approach)
	BilKoG	Bilanzkontrollgesetz (Balance Sheet Control Act)
	BIZ	Bank für Internationalen Zahlungsausgleich (Bank for International Settlements)
	BkRL	Bankenrichtlinie (Banking Directive)
	BMF	Bundesministerium der Finanzen (Federal Ministry of Finance)
	BörsG	Börsengesetz (Stock Exchange Act)
	BRE	Beitragsrückerstattung (premium refunds)
	BSC	Banking Supervision Committee
	BSpkV	Bausparkassenverordnung (Building and Loan Association Regulation)
	BVB	Besondere Vertragsbedingungen (Special Terms of Contract)
	BVI	Bundesverband Investment und Asset Management e. V. (Federal Investment and Asset Management Association)
	BVR	Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (Central organisation of the German cooperative banking group)
C	**CCP**	Central Counterparties
	CDO	Collaterised Debt Obligation
	CDS	Credit Default Swaps
	CEBS	Committee of European Banking Supervisors

	CEIOPS	Comittee of European Insurance and Occupational Pensions Supervisors
	CESR	Committee of European Securities Regulators
	CLN	Credit Linked Notes
	COREP	Common Reporting
	CP 3	3rd Basel Consultation Paper
	CPLG	Core Principles Liaison Group
	CPSA	Conference of Pension Supervisory Authorities
	CPSS	Committee on Payment and Settlement Systems
	CRD	Capital Requirements Directive
	CTF	Capital Task Force
	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)
	DGAP	Deutsche Gesellschaft für Ad-hoc-Publizität mbH (News service for information of exchange-listed companies)
	DerivateV	Derivateverordnung (Ordinance on Derivative Financial Instruments)
	DMBilG	D-Mark-Bilanzgesetz (D-Mark Accounting Act; relates to companies with a registered office in the German Democratic Republic as at 1 July 1990)
	DPR	Deutsche Prüfstelle für Rechnungslegung (Financial Reporting Enforcement Panel)
	DSGV	Deutscher Sparkassen- und Giroverband (German Savings Bank Association)
E	**EBC**	European Banking Committee
	EBK	Eidgenössische Bankkommission (Swiss Federal Banking Commission)
	ECOFIN	Economic and Financial Council
	EdB	Entschädigungseinrichtung deutscher Banken GmbH (Compensation Institution of German Banks)
	EDV	electronic data processing
	EdW	Entschädigungseinrichtung der Wertpapierhandelsunternehmen (Compensation Institution of Securities Trading Companies)
	EECS	European Enforcer Coordination Session
	EEX	European Energy Exchange
	EFC	Economic and Financial Committee
	EFCC	Economic and Financial Crimes Commission
	EFR	European Financial Services Round Table
	EFRAG	European Financial Reporting Advisory Group
	EFSSAC	Effective Financial Services Supervision in Accession Countries

	EIOPC	European Insurance and Occupational Pensions Committee
	EG	Einführungsgesetz (introductory law) / Europäische Gemeinschaft (European Community)
	ESAEG	Einlagensicherungs- und Anlegerentschädigungsgesetz (Deposit Guarantee and Investor Compension Act)
	ESC	European Securities Committee
	EStG	Einkommenssteuergesetz (Income Tax Law)
	ESZB	Europäisches System der Zentralbanken (European System of Central Banks, ESCB)
	EU	European Union
	EuGH	Europäischer Gerichtshof (European Court of Justice)
	e.V.	eingetragener Verein (registered society)
	EWG	Europäische Wirtschaftsgemeinschaft (European Economic Community EEC)
	EWR	Europäischer Wirtschaftsraum (European Economic Area, EEA)
	EWU	Europäische Wirtschaftsunion (European Economic Union, EEU)
F	**FATF**	Financial Action Task Force on Money Laundering
	FEDNY	Federal Reserve Bank of New York
	FESCO	Forum of European Securities Commissions
	FG	Fachgremien (expert committee)
	FinAV	Finanzanalyseverordnung (German Regulation concerning the Analysis of Financial Instruments)
	Finanzkonglomeraterichtlinie	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 and amending Council Directives 73/239/EEC, 79/267/ EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council
	FinDAG	Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht (Act Establishing the Federal Financial Supervisory Authority)
	FinDAGKostV	Verordnung über die Erhebung von Gebühren und die Umlegung von Kosten nach dem Finanzdienstleistungsaufsichtsgesetz (Ordinance on the Imposition of Fees and Allocation of Costs Pursuant to the FinDAG)
	FIRBA	Foundation Internal Ratings Bases Approach
	FLV	Fondsgebundene Lebensversicherungen (Unit-linked Life Insurances)
	FMFG	Finanzmarktförderungsgesetz (Financial Market Promotion Act)
	FSAP	Financial Services Action Plan / Financial Sector Assessment Program

	FSC	Financial Services Committee
	FSF	Financial Stability Forum
	FSI	Financial Stability Institute
	FSSAP	Financial System Stability Assessment Program
	FST	Financial Stability Task
G	**GAAP**	General Accepted Accounting Principles
	GB BAV	Geschäftsbericht des Bundesaufsichtsamtes für das Versicherungswesen (Annual Report of the Federal Insurance Supervisory Office)
	GbR	Gesellschaft bürgerlichen Rechts (Civil-law partnership)
	GdC	Groupe de Contact
	GDV	Gesamtverband der deutschen Versicherungswirtschaft e.V. (German Insurance Association)
	GGP	Gesamtgeschäftsplan für die Überschussbeteiligung (Overall business plan for bonuses)
	GJ	Geschäftsjahr (financial year)
	GMG	Gesetz zur Modernisierung der Gesetzlichen Krankenversicherung (Statutory Health Insurance Modernisation Act)
	GmbH	Gesellschaft mit beschränkter Haftung (German private limited company)
	GroMIKV	Großkredit- und Millionenkreditverordnung (Regulation governing large Exposures and Loans of 1.5 million Euros or More)
	GS I	Grundsatz I (Principle I)
	GS II	Grundsatz II (Principle II)
	GuV-Rechnung	Gewinn- und Verlustrechnung (Profit and Loss Statement)
	GwG	Geldwäschegesetz (Money Laundering Act)
H	**HBG**	Hypothekenbankgesetz (Mortgage Bank Act)
	HGB	Handelsgesetzbuch (Commercial Code)
	HJ	Halbjahr (six months)
	HMG	Heilmittelwerbegesetz (Law on Advertising for Medicaments)
	HUK	Haftpflicht-Unfall-Kraftfahrtversicherung (Third party/accident/motor vehicle insurance)
I	**IADI**	International Association of Deposit Insurers
	IAIS	International Association of Insurance Supervisors
	IAS	International Accounting Standards
	IASB	International Accounting Standards Board
	IASC	International Accounting Standards Committee
	IASCF	International Accounting Standards Committee Foundation

	IAS-Verordnung	Regulation 1606/2002/EC of the European Parliament and of the Council of 19 July 2002 on the Application of International Accounting Standards
	ICAAP	Internal Capital Adequacy Assessment Process
	IdW	Institut der Wirtschaftsprüfer (Institute of German Certified Public Accountants)
	IFRS	International Financial Reporting Standards
	IM	Intelligent Miner
	InsO	Insolvenzordnung (Insolvency Code)
	InvAG	Investment-Aktiengesellschaft (investment public limited company)
	InvG	Investmentgesetz (Investment Act)
	InvMV	Verordnung des Bundesministeriums der Finanzen über die Meldepflicht nach § 10 Abs. 1 und 2 des Investmentgesetzes, Investmentmeldeverordnung (Ordinance of the Federal Ministry of Financy concerning the notification obligation according to section 10 paragraphs 1 and 2 of the Investment Act, Investment Reporting Ordinance)
	IOPS	International Organization of Pension Supervisors
	IOSCO	International Organization of Securities Commissions
	IRBA	Internal Ratings Based Approach
	ISDA	International Swaps and Derivates Association
	IT	Information Technology
	IWF	Internationaler Währungsfonds (International Monetary Fund, IMF)
J	**J.**	Jahr/e (Year(s))
	JGS	Jahresgemeinschaftsstatistik über den Schadensverlauf in der Kraftfahrzeug- Haftpflichtversicherung (Overall annual statistics concerning the claim experience in motor vehicle liability insurance)
	JF	Joint Forum
K	**KA**	Kapitalanlagen (investments)
	KAG	Kapitalanlagegesellschaft (investment company)
	KAGG	Gesetz über Kapitalanlagegesellschaften (Investment Companies Act)
	KalV	Kalkulationsverordnung (Calculation Ordinance)
	Kapitaladäquanzrichtlinie	Council Directive 93/6/EEC of 15 March 1993 on capital adequacy of investment firms and credit institutions
	KfW	Kreditanstalt für Wiederaufbau (Reconstruction Loan Corporation)
	KG	Kommanditgesellschaft (limited partnership)

	KH-Versicherung	Kraftfahrzeug-Haftpflichtversicherung (motor vehicle liability insurance)
	KI	Kreditinstitut (credit institution)
	KLR	Kosten- und Leistungsrechnung (cost and results accounts)
	KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (Law Concerning the Control and Transparency of Corporations)
	KuMaKV	Verordnung des Bundesministeriums der Finanzen zur Konkretisierung des Verbotes der Kurs- und Marktpreismanipulation vom 18. November 2003 (Ordinance Detailing Stock Exchange and Market Price Manipulation)
	KWG	Gesetz über das Kreditwesen (Banking Act)
L		
	LG	Landgericht (Regional Court)
	LV	Lebensversicherung (life insurance)
M		
	M & A	Mergers & Acquisitions
	MaH	Mindestanforderungen an das Betreiben von Handelsgeschäften (Minimum Requirements for the Trading Activities of Credit Institutions)
	MaIR	Mindestanforderungen an die Ausgestaltung der Internen Revision (Minimum Requirements for the form of internal audits)
	MaK	Mindestanforderungen an das Kreditgeschäft (Minimum Requirements for the Credit Business of Credit Institutions)
	MaKonV	Verordnung des Bundesministeriums der Finanzen zur Konkretisierung des Verbotes der Marktmanipulation vom 1. März 2005, Marktmanipulations-Konkretisierungsverordnung (Ordinance of the Federal Ministry of Financing concretising the prohibition of market manipulation of 1 March 2005 - Market Manipulation Concretising Ordinance)
	MaRisk	Mindestanforderung an das Risikomanagement (Minimum Requirements for Risk Management)
	Marktmissbrauchsrichtlinie	Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation
	MCR	Minimum Capital Requirement
	MFP	IMF Code of Good Practices on Transparency in Monetary and Financial Policies
	MiFID	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC

	MIS	Management-Informationssystem (management information system)
	MoU	Memorandum/a of Understanding
	MMoU	Multilateral Memorandum/a of Understanding
N	**NCCT**	Non Cooperative Countries and Territories
	Nr.	no. / Number
O	**OCC**	Officer of the Controller of the Currency
	OECD	Organisation for Economic Cooperation and Development
	OFC	Offshore Financial Centre
	OGAW-Empfehlung	Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS-recommendation)
	OGAW-Richtlinie	Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS-Directive)
	OLG	Oberlandesgericht (Higher Regional Court of Appeal)
	ÖPG	Gesetz über die Pfandbriefe und verwandten Schuldverschreibungen öffentlich-rechtlicher Kreditanstalten (Act on Mortgage Bonds and Similar Bonds of Credit Institutions under Public Law)
	OTC-Handel	Over-the-Counter-Handel (over the counter trade)
	OVG	Oberverwaltungsgericht (Higher Administrative Court)
	OWiG	Gesetz über Ordnungswidrigkeiten (Act on Administrative Offences)
P	**P&L**	Profit and loss account
	p.a.	per annum (per year)
	Pensionsfonds-richtlinie	Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision
	PfandbriefG	Pfandbriefgesetz (Pfandbrief Act)
	PFKAustV	Verordnung über die Kapitalausstattung von Pensionsfonds (Pension Funds Capital Resource Ordinance)
	PflVG	Pflichtversicherungsgesetz (Compulsory Insurance Act)
	PIOB	Public Interest Oversight Board
	PKV	Private Krankenversicherung (private health insurance)
	PPV	Pflegepflichtversicherung (Compulsory Nursing Insurance)
	PrüfbV	Prüfungsberichtsverordnung (Audit Report Ordinance)

Q	**Q RM**	Querschnitt Risikomodellierung (cross sectoral risk modelling)
	QIS	Quantitative Impact Studies
R	**RAS**	Risk Assessment System
	RdV	Rückstellung für drohende Verluste (provisions for impending losses)
	RechVersV	Verordnung über die Rechnungslegung von Versicherungsunternehmen (Ordinance on Insurance Accounting)
	RfB	Rückstellung für Beitragsrückerstattung (provisions for premium refunds)
	RL	Richtlinie (Directive)
	RV	Rückversicherungsgeschäft (reinsurance business)
S	**S.**	Satz; Seite (sentence; page)
	SchBkG	Gesetz über Schiffspfandbriefbanken (Act on Ship Mortgage Banks)
	SCR	Solvency Capital Requirement
	SEC	Securities and Exchange Commission
	SEP	Supervisory Evaluation Process
	SGB	Sozialgesetzbuch (Social Code)
	SPV	Special Purpose Vehicle
	SRP	Supervisory Review Process
	SSR	Spätschadenrückstellung, Teilrückstellung für Spätschäden (provisions for claims incurred but not reported, partial provisions for claims incurred but not reported)
	STA	Standardansatz (standard approach)
	StPO	Strafprozessordnung (Code of Criminal Procedure)
	SÜAF	Schlussüberschussanteilfonds (final bonus share funds)
	SWAP	Securities Watch Applications
T	**Task Force Re**	Task Force on Enhancing Transparency & Disclosure in the Reinsurance Sector
	Transparenzrichtlinie	Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC
	Tz.	Textziffer (text no.)
U	**UK**	United Kingdom
	US-GAAP	US Generally Accepted Accounting Principles
	UStG	Umsatzsteuergesetz (Turnover Tax Law)
	UPR	Unfallversicherung mit Prämienrückgewähr (accident insurance with premium refund)
V	**VAG**	Versicherungsaufsichtsgesetz (Insurance Supervision Act)

	VerBAV	Veröffentlichungen des Bundesaufsichtsamtes für das Versicherungswesen (publications of the Federal Insurance Supervisory Office)
	VerBaFin	Veröffentlichungen der Bundesanstalt für die Finanzdienstleistungsaufsicht (BaFin publications)
	VerkprospG	Wertpapier-Verkaufsprospekt-Gesetz (Act on the Prospectus of Securities Offered for Sale)
	VersR	Versicherungsrecht (insurance law)
	VG	Verwaltungsgericht (administrative court)
	VGH	Verwaltungsgerichtshof (Higher Administrative Court)
	VJ	Vorjahr (previous year)
	VO	Verordnung (ordinance)
	VU	Versicherungsunternehmen (insurance undertaking IU)
	VVaG	Versicherungsverein auf Gegenseitigkeit (mutual insurance association)
	VVG	Versicherungsvertragsgesetz (Insurance Contract Act)
W	**WDR**	Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field
	WpDPV	Wertpapierdienstleistungs-Prüfungsverordnung (Investment Services Audit Ordinance)
	WpHG	Wertpapierhandelsgesetz (Securities Trading Act)
	WpÜG	Wertpapiererwerbs- und Übernahmegesetz (Securities Acquisition and Takeover Act)
	WM	Wertpapier-Mitteilungen (securities notifications)