BaFin

’05

Annual Report
Federal Financial Supervisory Authority
(Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin)

President's Statement

A great deal is expected of the supervisory authorities, and these expectations are on the rise. A good supervisor should not only be effective and efficient, it must also be at least as dynamic as the markets and companies that it supervises if it wants to be prepared for the future. There are always new products and risks inspired mostly by international competition – and this is a challenge not only for the companies, but for supervisors as well. We have to consider the best ways to respond.

It is virtually impossible to regulate complex and highly intertwined financial markets with rigid and meticulous rules. Internationally, there is almost universal consensus on the future of supervision: it should be principle-based, streamlined and open to individual solutions. BaFin took major steps towards this goal in 2005. The most important of these was the adoption of "risk classification". This will help us in the future to rank all companies under our supervision in a matrix, according to their risk profiles and importance to the stability of the financial market. The position in the matrix shows how intensive our supervision will be, tailored exactly to the company.

With this concept, we are realising the principle of risk orientation – a key precept of modern supervision. It also reflects an important element of integrated financial supervision today: a uniform supervisory approach for all companies subject to supervision, regardless of sector. This Annual Report will present to you in detail the concept of risk classification.

BaFin continually updates its methods – remaining a flexible institution which is open to learning from experience. These are the keys that will allow us to continue meeting all requirements as we move into the future.

Jochen Sanio
President

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I Highlights

Jochen Sanio, President

A number of issues shaped BaFin's agenda in 2005. The following section provides further information on a selection of them.

New responsibilities for the examination of prospectuses

The German legislature implemented the European Prospectus Directive in national law on 1 July 2005. This resulted in new responsibilities not only for market participants, but also for BaFin. Issuers are now confronted with significantly higher demands on the content of their prospectuses, in particular with regard to public offering of securities. Issuers seeking access to international capital markets have received some relief in the sense that they are now only required to prepare a prospectus in English.

Whereas, in the past, examination of prospectuses was the joint responsibility of BaFin and the stock exchange boards of admission, the integrated financial supervisory authority is now entirely responsible for this function. BaFin had to adapt very quickly to this new situation. In terms of content, the examinations have become considerably more rigorous: prospectuses are no longer merely subject to a formal check for completeness. Since 2005, BaFin checks prospectuses for legibility, comprehensibility and coherency. Such examination has proven to be highly resource-intensive, especially given that the prospectuses usually comprise several hundred pages. This was compounded by the fact that the number of companies going public increased in 2005 for the first time following years of limited IPO activity.

Prospectus requirement for non-securities investments since July 2005.

Since July 2005, non-securities investments also require authorisation from BaFin before being released for public offer. The investment product providers now have to submit a prospectus to BaFin which is approved for publication if it complies with the statutory requirements. By the end of 2005, BaFin had examined and approved prospectuses for over 600 non-securities investment products.

At workshops and various discussions BaFin provided issuers and investment product providers with information on the new legislation and administrative practice. It also offered to conduct a preliminary examination of draft prospectuses in accordance with the new rules. Both propositions met with keen interest on the part of the product providers.

New accounting controls

Enforcement for listed companies.

Until 1 July 2005, the auditing of accounting by capital market-oriented companies was left solely to supervisory boards and auditing firms. Now, the system is complemented by the enforcer as an external auditing instance. Around 1,250 companies – issuers of securities admitted to trading on the regulated or official market of a German stock exchange – are subject to this new form of supervision. As of the 31 December 2004 cut-off date, their company reports must comply with the enforcement audit standards. There are two stages in the enforcement process: stage one involves a privately sponsored association, the German Financial Reporting Enforcement Panel (Deutsche Prüfstelle für Rechnungslegung e. V. (DPR)). BaFin is positioned at stage two as the supervisory authority with sovereign powers. However, even after the introduction of enforcement, the main responsibility for ensuring a sound accounting still lies with the companies themselves, their supervisory boards and their auditors.

Merger of UniCredit and HVB

On 12 June 2005, Germany’s second-largest commercial bank HVB (Bayerische Hypo- und Vereinsbank AG) concluded its merger with UniCredit (UniCredito Italiano SpA), the largest bank in terms of market capitalisation in Italy. This was the first merger in the European banking landscape between institutions of this size. It was a major event not only for the banks themselves, but also for the supervisory authorities Banca d’Italia and BaFin. Supervising a group of this size will require closer cooperation between the two authorities than was previously the case. An understanding and assessment of the risk situation of the group as a whole must be achieved, and care must be taken to avoid a greater supervisory burden for the new company than is absolutely necessary. As a result, Banca d’Italia and BaFin concluded an agreement in the course of 2005 which forms the basis for this closer cooperation.

Acting in Concert – the case of Deutsche Börse AG

In 2005, BaFin conducted an investigation which centred around Deutsche Börse AG. The case provoked considerable public

interest. The investigation was in response to the conduct of several fund management companies linked to the UK hedge fund "The Children's Investment Fund Management" (TCI), whose intervention prompted the withdrawal of Deutsche Börse AG's takeover bid for the London Stock Exchange and the resignation of the company's CEO Werner Seifert. The suspicion was that the fund management companies, who were also Deutsche Börse shareholders, had been working in collusion with each other to control the company. This would have constituted what is known as "acting in concert", which should have resulted in the joint attribution of the voting rights held by these shareholders. Thus, the companies in question would then have exceeded the 30% control threshold, and been obliged accordingly to make an offer to the remaining shareholders. Despite several indications of "acting in concert", BaFin was unable to prove beyond reasonable doubt that the fund management companies had conspired to exercise a permanent influence over Deutsche Börse.

Decisions of 26 July 2005 by the German Federal Constitutional Court

In July 2005, the German Federal Constitutional Court (Bundesverfassungsgericht – BVerfG) decided two cases with far-reaching consequences for the insurance sector, as well as for insurance supervision.

More stringent examination for portfolio transfer authorisations.

The first ruling[1] related to two portfolio transfers in the life insurance sector. If insurance portfolios are transferred to another insurer either in full or in part by means of an agreement, such portfolio transfer requires authorisation from BaFin. Previously, section 14 of the Insurance Supervision Act (Versicherungs-aufsichtsgesetz – VAG) merely required that the interests of the insured be "adequately" safeguarded. The constitutional court judges, however, ruled that the Supervisory Authority is obliged to conduct a more "stringent examination", because the portfolio transfer results in a change of contractual partner for policyholders, without the requirement of their consent. It was found that this sort of interference in policyholders' freedom of contract can only be justified if BaFin identifies the interests of the policyholders and takes all of these interests into consideration before approving the transfer. This also means that assets accumulated through premium payments must still fully benefit policyholders as a basis for policyholder bonuses even after the portfolio transfer. In the event that the portfolio of a mutual society (Versicherungsverein auf Gegenseitigkeit – VVaG) is the subject of a transfer, an appropriate sum must also be provided to compensate for the loss of membership and the adequacy of the sum in question must be confirmed during the supervisory approval process.

The constitutional court instructed the legislature to implement the ruling by the end of 2007 at the latest. Portfolio transfers which had already been performed at the time of the decision are not affected.

[1] BVerfG decision of 26 July 2005, 1 BvR 782/94 and 1 BvR 957/96.

Immediate change to administrative practice required.

As a result of the decision by the constitutional court, the Supervisory Authority reordered its approval process to allow more stringent examination immediately following announcement of the ruling. For this purpose, BaFin developed the following administrative principles:

Impact of the decision on other insurance sectors.

- BaFin is also required to apply the more stringent examination standards developed by the Federal Constitutional Court for the life insurance sector to the remaining insurance sectors and to pension funds, given that the same underlying arguments apply to them as well.
- The general application of the more stringent examination standards does not, however, exclude the possibility of differentiation between the individual sectors for actual examinations.
- The principles set out by the Federal Constitutional Court with regard to portfolio transfers also apply to mergers. The consequences of a merger for policyholders are virtually identical to those that apply in the case of portfolio transfers.
- If the portfolio of a mutual society is transferred, an appropriate sum must be provided to compensate for the loss of membership. The principles set out by the court with regard to such compensation apply to all mutual and pension fund societies.

Fortunately, this fundamental change to administrative practice has not resulted in an approval backlog. In autumn 2005, BaFin already started to apply the new examination standards to several portfolio transfers and mergers in a number of different sectors.

New rules for final surplus participation.

The second decision in July 2005 by the Federal Constitutional Court ushered in changes for with-profits endowment policies.[2] In it, the judges criticised the current practice in the life insurance sector of withholding unrealised hidden reserves from surrendering policyholders when allocating their final bonus. The court declared that the interests of remaining and surrendering policyholders should be weighed against one another. This means that the assets accumulated with the help of policyholder premiums must be adequately taken into account for the calculation of a policyholder's final bonus.

The court also expressed its disapproval of the practice among life insurance companies of reducing surplus by offsetting several surplus components against each other. The surplus derives mainly from three income components: cost, risk and investment. In principle, all of these components must be positive, because the corresponding premium components (cost, risk and savings) have to be calculated very carefully. If the three elements are not positive, the question arises as to whether or not a negative component can be offset against a positive one. If an insurance company chooses to do so, this generally reduces the amount from surplus participation and, as a result, the final bonus allocated to the policyholder.

[2] BVerfG decision of 26 July 2005, 1 BvR 80/95.

The constitutional court found that the calculation of the final bonus is not transparent enough. Thus, neither BaFin nor the civil courts are ultimately in a position to examine them. The court has given the legislature until the end of 2007 at the latest to close this legal protection loophole. This will at any rate benefit the policyholders that take out a with-profits endowment policy after the change is implemented. The question remains as to whether the new legislation will cover existing policies. It is, however, already clear that policies which expire before the new legislation comes into force will not be covered.

Financial reinsurance

Financial reinsurance policies have two key characteristics: the focus of the ceding insurer is on the financing function, and risk transfer is limited. The policies are often taken out in order to use positive results from good financial years to compensate for the negative results of less successful years.

Lack of transparency is the main problem with financial reinsurance.

In 2005, financial reinsurance was the subject of negative headlines across the globe: the New York Attorney General and the US Securities and Exchange Commission accused several US insurance companies of using financial reinsurance policies to cook their books. As far back as 2001, the misuse of financial reinsurance was one of the key factors in the collapse of an Australian insurance company. This led to the general suspicion that the primary function of financial reinsurance was to conceal companies' true financial situation. Consequently, the lack of transparency is currently seen as the real problem with the use of financial reinsurance. BaFin is also only able to correctly assess a company's financial situation and related risks if such products are accurately represented in accounting. It is therefore not the use of financial reinsurance policies per se that causes concern, but rather the incorrect reporting of these policies in a company's annual financial statements.

However, in the case of primary insurers, the use of financial reinsurance policies may not be considered a loan, because this would constitute a violation of the prohibition against non-insurance business pursuant to section 7 (2) VAG. This is why the International Association of Insurance Supervisors, IAIS, is looking to develop criteria which can be used to distinguish between reinsurance policies with loan components and pure loan agreements. BaFin is supporting the IAIS in this endeavour. In autumn 2005, the IAIS issued supervisory guidelines on financial reinsurance that provide an overview of current supervisory practices.[3]

Financial reinsurance is given special consideration in German supervisory law: insurance undertakings have to report their use of financial reinsurance in accordance with the Ordinance on reporting by insurance undertakings (Verordnung über die Berichterstattung von Versicherungsunternehmen – BerVersV). BaFin is also

[3] Guidance Paper on Risk Transfer, Disclosure and Analysis of Finite Reinsurance.

BaFin building on Georg-von-Boeselager-Straße, Bonn

authorised to impose increased own funds requirements on companies in the event that reinsurance policies do not involve a (sufficient) risk transfer. The current implementation in German law of the remaining items contained in the EU Reinsurance Directive will subject financial reinsurance to even more stringent regulation.

Over the course of 2005, BaFin examined how, and to what extent primary and reinsurance companies apply financial reinsurance. The investigation focused both on policies held by German reinsurers with primary insurers in other European countries, as well as policies held by German primary insurers with European reinsurers. As a rule, reinsurance companies are the providers, rather than the users of financial reinsurance.

BaFin found that the reinsurance companies in question had accurately accounted for the policies investigated. If in individual cases primary insurance companies were suspected of having used financial reinsurance for fraudulent purposes, BaFin raised an official objection and demanded that the policies in question be terminated, even if the misuse did not have a significant impact on the annual financial statements of the companies.

OTC credit derivatives

Market for OTC credit derivatives is booming.

The global OTC credit derivatives market has been expanding rapidly over the past few years. There are many reasons for this. For one, it is likely that credit derivatives have become more popular because BaFin permits their use for hedging, meaning reduced own funds requirements for supervised companies. Furthermore, the new International Accounting Standards/ International Financial Reporting Standards (IAS/IFRS), which became obligatory for listed companies in 2005, have played a part in making credit derivatives more attractive. According to the German Commercial Code (Handelsgesetzbuch – HGB), the extent to which credit derivatives can be reported in the balance sheet is very limited. With IAS/IFRS, on the other hand, credit derivatives have to be reported as financial instruments on the balance sheet and are recognised at their fair value.

Settlement trailing behind strong growth.

The rapid growth of the OTC derivatives market often proves problematic for the back offices of the contracting parties. Back offices are not always able to handle the volume and complexity of the contracts. This results in a backlog of the confirmations that have to be issued for each transaction. These confirmations establish certainty for the contracting parties with regard to the content and effectiveness of the transactions. If the back office lags behind, there is a risk that a bank could be unclear as to the risks that it has assumed. The bank is then unable to identify and manage these risks adequately. It also leaves to question whether

or not the intended own funds relief has actually been achieved. In the worst-case scenario, the transaction is ineffective and the institution realises only when an exposure poses a danger of default that the planned hedge is not in place. This would create an additional need for risk provisioning, which is why the minimum requirements for risk management (Mindestanforderungen an das Risikomanagement- MaRisk) state that institutions must issue their transaction confirmations, and retrieve the confirmations issued by their business partners, in a timely manner.

The settlement backlog is a matter for all regulators.

The problem of the confirmation backlog affects market participants from the US, the UK, Switzerland and Germany, among others. This is why BaFin got together with the financial regulatory authorities from these countries and the 14 largest market participants to exchange information, which ultimately resulted in an agreement concerning the information to be provided by companies, and how often it must be delivered. Market participants now complete a monthly questionnaire which gives these authorities an aggregate overview of the credit derivatives held by all companies subject to reporting requirements. The questionnaire allows the Supervisory Authority to assess the extent to which German institutions have resolved their settlement problems and how they fare in an international comparison.

SEC Roadmap

In the future, those companies listed in the US which apply IAS/IFRS are to be spared the effort of preparing a US-GAAP reconciliation. For this reason, the US Securities and Exchange Commission (SEC) presented a Roadmap in April 2005, which aims to recognise IAS/IFRS as equivalent to US-GAAP. The SEC Roadmap, however, is nothing more than a declaration of intent, and thus not legally binding. The SEC foresees abolishing the requirement for reconciliation by 2009 at the latest. Until then, European capital market players that are also listed in the US still have to prepare either a reconciliation statement for their IAS/IFRS financial statements or additional financial statements in accordance with US-GAAP. By contrast, US issuers whose securities are admitted to trading in Europe are only required to prepare financial statements in accordance with US-GAAP.

The SEC has, however, set out a number of conditions for the recognition of the IAS/IFRS and the related waiver of the reconciliation statements. Specifically, these include the need for further convergence of IAS/IFRS and US-GAAP, as well as a functioning enforcement system in Europe to deal with violations against accounting rules. The Americans also want to keep an eye on whether or not IAS/IFRS is applied uniformly throughout Europe.

The Prospectus Directive and the Transparency Directive mean that equivalence of IAS/IFRS to the accounting standards of non-member states is also an issue for the European Commission. The Committee of European Securities Regulators (CESR) was therefore

commissioned by the European Commission to investigate the similarities and differences between the Japanese, Canadian and US accounting standards and IAS/IFRS. Apart from a few differences, the CESR came to the conclusion that US-GAAP, Canadian-GAAP and Japanese-GAAP could be considered equivalent to IAS/IFRS from a technical point of view. It called for improvements in only a few areas. The catalogue of measures developed by the CESR for this purpose sets forth, for example, additional disclosures from issuers. Originally, the European Commission hoped to make a decision on the equivalence of accounting standards from non-member states by 1 January 2007. In order to remain in sync with the SEC's time plan, this decision has been put on hold for the time being.

II Economic Environment

Karl-Burkhard Caspari (Deputy President) and Jochen Sanio (President)

1 Financial Markets

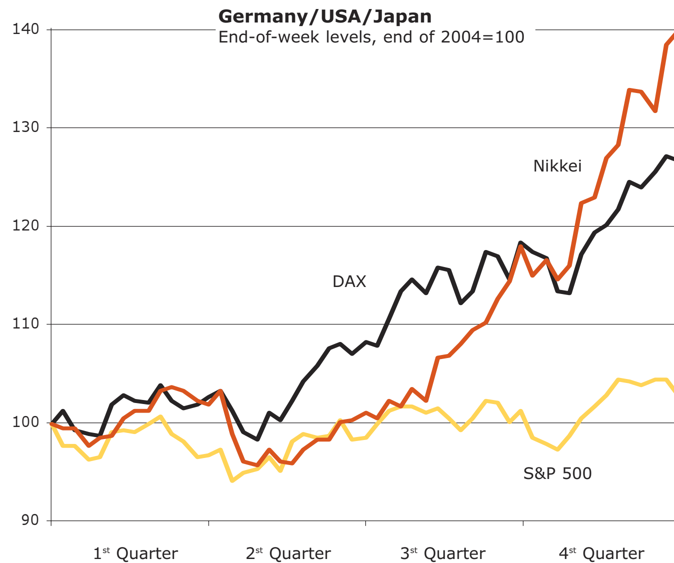
Financial markets in good form.

In 2005, international financial markets were characterised by abundant liquidity, low volatility and very low real interest rates. Temporary shocks were quickly overcome. Corporate bond markets, for instance, were disrupted when, in early May, rating agencies downgraded bonds issued by the two US automotive groups General Motors and Ford to below investment grade. Some market participants – hedge funds in particular – were forced to exit their positions at a heavy loss. But, thanks to generally low default rates and largely healthy corporate balance sheets, the markets recovered quickly. Over the remainder of the year, even the terrorist attacks in London and the hurricanes in the United States failed to have a serious impact on the capital markets, though many reinsurance companies were forced to tone down their earnings forecasts. Overall, the financial markets proved resilient in 2005 and buoyed the recovery of the German financial sector.

Stock markets continue to rise.

Although the Wall Street, for the most part, moved sideways, stock markets throughout the world climbed substantially in 2005. The positive mood persisted on most of Europe’s stock exchanges, with Germany’s share index, DAX, increasing 27% over the year. The downward trend in real interest rates together with positive corporate news fuelled this growth. Although turbulence on the corporate bond market in the spring and interim economic and inflationary concerns triggered by rising oil prices repeatedly put the brakes on overall performance, the fundamental driving forces were able to compensate the negative effects.

Figure 1
Stock markets in comparison, 2005



Source: Bloomberg

The broad-based price rises also improved the earnings position of German financial enterprises. Banks and insurance companies were able to sell-off trading positions and participating interests at a profit. Furthermore, demand for financial services increased, boosting commission income for providers of these services. And the cushion against declines also grew, as hidden reserves in equity portfolios again expanded somewhat.

Capital market rates fall to historical low.

In 2005, interest rates in Germany temporarily fell to an all-time low, with 10-year bunds yielding just 3% in September. A turnaround soon followed, however, and growing concerns regarding inflation triggered by high oil prices drove the 10-year yield at times above 3.5%. German interest rates broke away from their US counterparts. Whereas in autumn 2004, yields on comparable US bonds were similarly high, US securities extended their interest rate advantage to over one percentage point over the course of 2005. One reason for this can be traced to the more favourable prospects for economic growth in the United States. But the US Federal Reserve's tighter monetary policy in the face of almost constantly low key interest rates (2%) in the euro area also played a role. Whereas the US Federal Funds Rate was increased in several stages from 1% to 4.25% between mid 2004 and late 2005, the European Central Bank did not opt for a somewhat less expansive course until December 2005, when it raised the minimum bid rate to 2.25%.

The credit derivatives market continues to grow
Trading on international derivatives markets was extremely brisk in 2005, and sustained the high growth rates seen in previous years. The credit derivatives market is the derivatives market with the strongest growth worldwide. It was up 106%, expanding from US$

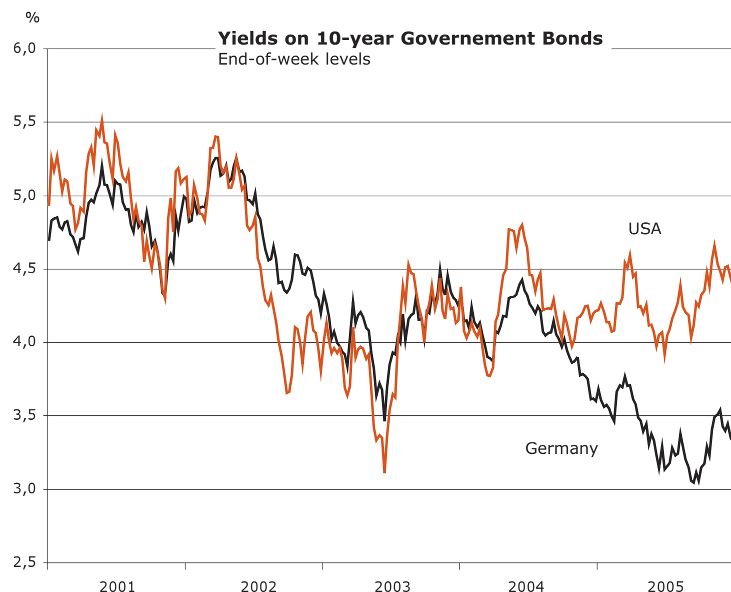
8,400 billion at the end of 2004 to US$ 17,300 billion.[4] One reason for this growth was the lively trading that followed the credit deterioration in the automotive sector, especially at General Motors, Ford and Delphi. International standardisation in the form of the ISDA Master Agreement and the sustained period of low interest rates also contributed to the strong growth, as market participants such as insurance companies and hedge funds were on the look-out for alternative investment opportunities. Credit derivatives are traded primarily between banks, with foreign banks representing more than two-thirds of German banks' transaction partners. Other significant market participants include hedge funds and insurance companies. The most widespread instrument – especially in Germany – is the credit default swap (CDS).

Such strong growth, however, can also pose a threat to financial stability. Since credit derivatives can, among other things, comprise complex combinations of credit risks and since they build on existing exposures, potentially detracting from their risk profiles, the credit derivatives market is susceptible to domino effects radiating from financial market shocks.

The credit derivatives markets grew so quickly over the course of 2005 that it was often impossible for the technical settlement of these transactions to keep pace. As a consequence, an increasing number of transactions were executed without settlement confirmation. This situation can hold substantial risks, as there is potential for contracts to be retrospectively called into question – for instance in the event of credit defaults. In September, therefore, the major market participants and a number of supervisory authorities met to discuss a number of solutions to this problem, including, for instance, the quality of electronic execution.

Figure 2

Capital market rates



Source: Bloomberg

[4] Sources: ISDA and calculations by BaFin.

Sustained period of low interest rates also the result of structural factors.

The prolonged phase of low interest rates cannot only be attributed to growth and inflation outlooks – it is also the result of structural factors.

For instance, in the context of their exchange-rate policies, a number of Asian central banks again purchased large volumes of US Treasury bonds in 2005. This high demand for Treasuries in Asia was one of the reasons that their prices remained consistently high, thus holding down yields.

Insurance companies and pension funds offering retirement savings products are also becoming increasingly interested in long-term government bonds as a way to match the maturities of their assets and liabilities. In particular, this trend can be observed in countries struggling to come to terms with the demographic problem of ageing societies, such as Germany and Japan.

Another structural aspect behind low interest rates is that companies across the world are cleaning up their balance sheets in the wake of the massive rise in debt ratios at the end of the 1990s. In recent years, many companies have actually been displaying otherwise uncommon financing surpluses, thus reducing their dependence on external sources of financing.

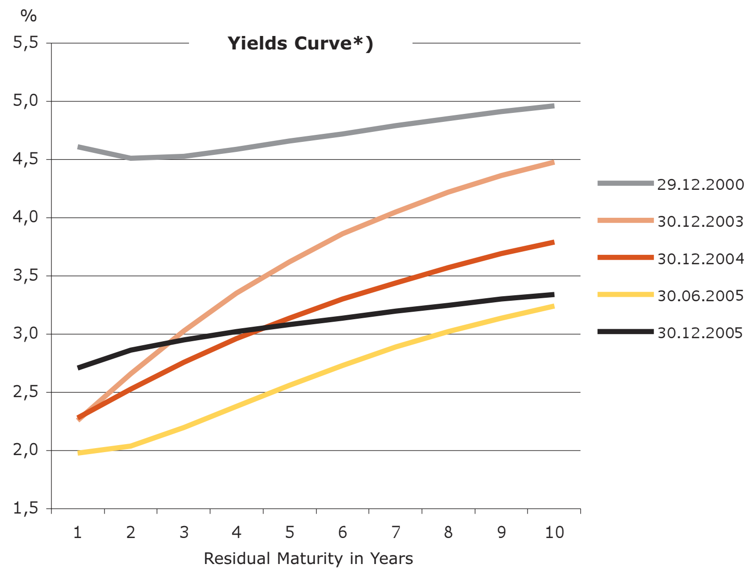
Low risk premiums for high-yield bonds continue.

Emerging markets and companies with relatively low credit ratings have benefited in particular from the low interest rate environment and the global liquidity surplus. The risk premiums on high-yield bonds declined even further from an already very low level. This trend cannot be attributed solely to the substantial improvement in credit quality within the corporate sector and emerging markets. Investors' large appetite for risk may also have played a deciding role. On the hunt for yields, investors were prepared to shift their funds into higher risk investments, often derivative products as well. As on the stock markets, it should be noted that in the event of external shocks, market participants who did not accurately assess the risks involved may suffer unexpected losses. Thus, in spring 2005, the downgrading of the credit ratings for General Motors and Ford led to substantial short-term price declines. In response, risk premiums across the entire market picked up over the course of several weeks, then dropped back again.

Yield curve flattens further.

The yield curve illustrates bond yields according to various residual maturities at a particular point in time. In the first half of 2005, the shift almost paralleled the drop in capital market rates, having flattened off significantly over the course of 2004. By the end of the year, however, yields had risen again across all maturities. Since growing inflationary concerns spurred market participants to anticipate an impending reversion by the European Central Bank to a more restrictive stance, short-term yields climbed much more sharply than long-term ones. The yield curve flattened out even further. This makes it more difficult for German banks to secure interest income. They are less able to generate net interest income from maturity transformation.

Figure 3
Yield curve for the German bond market



*) Interest rates for (hypothetical) zero coupon bonds without default risk.

Source: Deutsche Bundesbank

Abrupt interest rate rise could jeopardise financial stability.

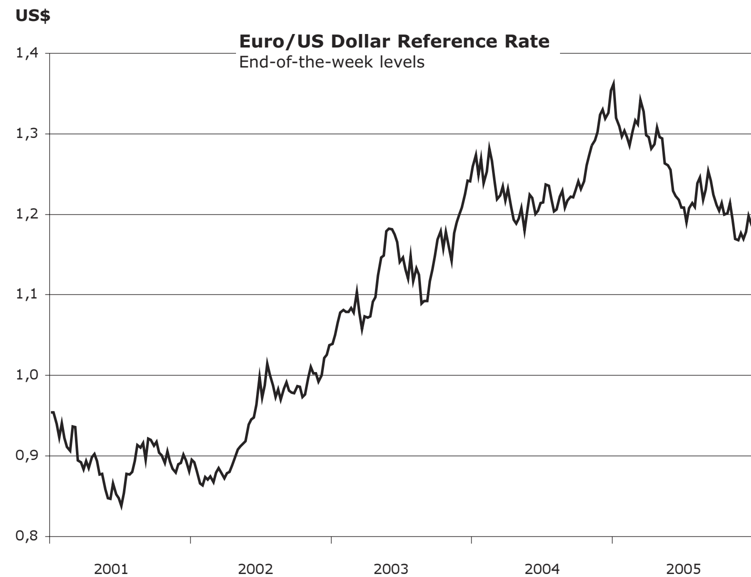
The rise in capital market rates, which began in autumn 2005, may be accelerated if the attitude gains popularity that foreign trade imbalances should be reduced. The already high current account deficit in the US swelled to over 6% of GDP in 2005. By contrast, other countries, in particular up-and-coming economies such as China and India, display growing current account surpluses. The greater this divergence, the more likely is a knee-jerk correction. There is potential for sudden interest rate increases if those investing in the US start demanding substantially higher risk premiums. Any such increase would likely spill over into other capital markets. Furthermore, the need for correction could also trigger a rapid depreciation of the dollar, with a danger of overshooting. With respect to financial stability, violent fluctuations in interest and exchange rates are particularly problematic because market participants do not have enough time to adjust to the changes, and are often forced to liquidate positions at a loss.

Exchange rates on an even keel.

No sudden exchange rate reactions were seen in 2005. The US dollar even appreciated somewhat against the euro, after tending towards weakness over the previous three years. This was due to the increasing interest rate advantage in the USA and rates of growth that continued to diverge. Towards the end of the year, the euro fell below the US$ 1.20 mark. One year previously, it had reached US$ 1.36, the highest level since its launch in 1999.

Figure 4

Exchange rate development



Source: Bloomberg

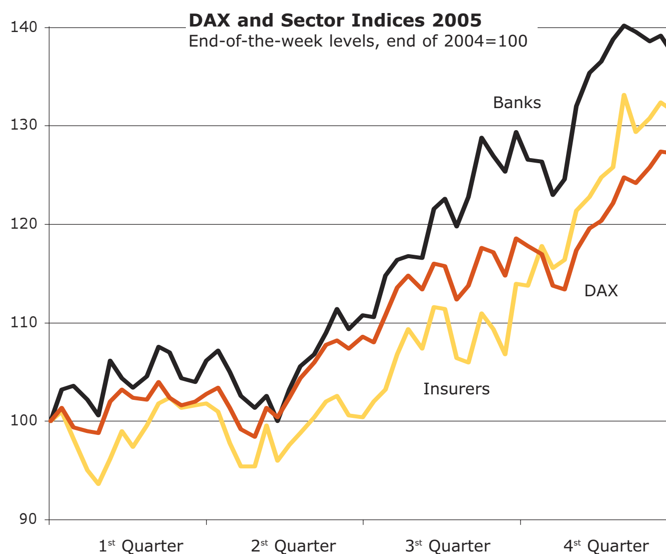
2 Banks

Market indicators paint favourable picture.

In 2005, market indicators conveyed a positive impression of the German banking sector. These indicators provide an up-to-date reflection of sentiment among market participants regarding the business development of a particular company. Share prices for German banks climbed much more strongly than the index for the market as a whole. But this above-average growth is not only attributable to improved business outlooks, but to a considerable extent also to takeover speculations and actual takeover activities.

Figure 5

Share indices for the German financial sector

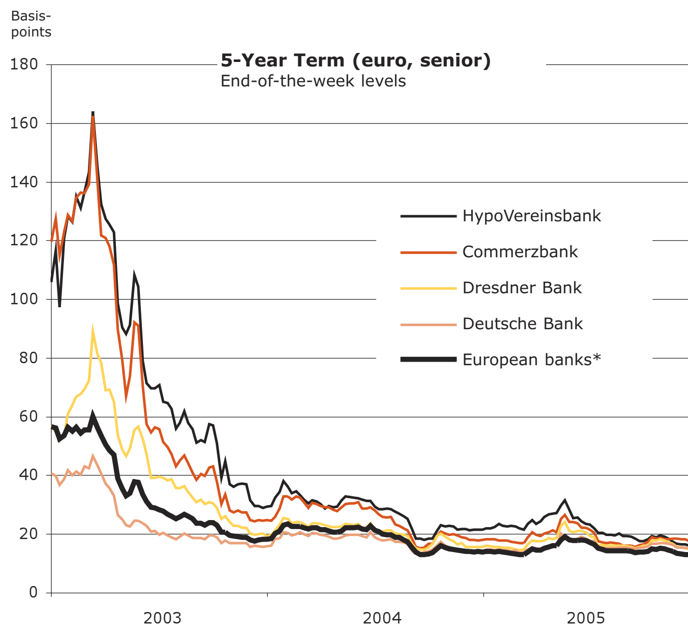


Source: Bloomberg

Credit default swap (CDS) spreads hovered around an all-time low over the course of 2005. Although CDS spreads saw a minor spike in the spring, when financial markets were unnerved by the downgrading of the ratings for General Motors and Ford, these soon headed back down. This means that the market gauged the default risk posed by major German banks as low, albeit higher than that of international competitors.

Figure 6

Credit default swap spreads for major German banks



* Unweighted average of CDS spreads for 16 major European banks.

Sources: Bloomberg, BaFin calculations

The credit ratings published by the three leading rating agencies for the long-term liabilities of non-public sector banks in Germany improved in the second half of 2005. Extraordinary factors, however, played a decisive part in this trend. For instance, the long-term rating for HypoVereinsbank rose in view of the pending takeover by Italy's UniCredit Group only because UniCredit will provide potential liquidity and solvency support following the merger. Moreover, the Fitch rating agency awarded all members of the BVR (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken) guarantee scheme an A+ rating, due to the tight cooperative structure. The positive assessment was based on the sustained success achieved by the cooperative sector in the areas of profitability, capitalisation and asset quality. It can thus be seen that simply weighing up the number of upgrades against the number of downgrades obscures the actual picture. With few exceptions, German banks generally continue to command lower ratings than their international competitors.

AHBR Pfandbrief rating stable despite liquidity problems.

The long-term rating for the second-largest German mortgage bank, Allgemeine Hypothekenbank Rheinboden (AHBR), was

downgraded to below investment grade. Such a low rating is unprecedented in the long history of the German mortgage bank sector. Owing to the uncertainty with respect to the bank's future ownership structure following the sale of BHW Holding AG minus AHRB to Deutsche Postbank AG, the bank ran into serious difficulties and had to be thrown a short-term liquidity lifeline amounting to €2.5 billion, provided equally by the five leading private banks. Even the AHBR's covered Pfandbriefe temporarily came under pressure. Notwithstanding this turmoil, however, the ratings of the Pfandbriefe remained stable – a fact that underscores the high security of this type of bond. At the end of December 2005, US financial investor Lone Star purchased a majority stake in AHBR.

Landesbanks after abolishment of the government guarantee.

The Landesbanks responded in different ways to the abolishment of government guarantees on 18 July 2005. But, the various strategies have a common denominator: withdrawal from international business and closer cooperation with the local savings banks (Sparkassen). In making these moves, the Landesbanks aim to strengthen less volatile retail business and to broaden their earnings base. Most of the restructuring is still underway, although enough has already been achieved that rating agencies have acknowledged the banks with a long-term A-range rating in most cases. Thus, low-cost refinancing should continue to be available in the future. The organisation and overall environment of the savings banks had long been preparing for the lapsing of institutional liability (Anstaltslast) and guarantor's liability (Gewährträgerhaftung), and had adapted their strategies accordingly. Many savings banks requested grades from rating agencies prior to the lapse, and the majority received good ratings. Savings bank associations also applied for ratings. The Moody's rating agency even issued a rating floor of A1 for all members of the joint liability scheme of the Sparkassen-Finanzgruppe. This means that each of the banks belonging to this group has a credit rating of at least A1.

Clear advances in profitability...

According to available information, the earnings situation of German credit institutions continued to firm up over the course of 2005. Profitability in the savings and cooperative banking sector stabilised. Following the losses of 2002 and 2003, the major private banks on the whole succeeded in sustaining the uptrend from the previous year and further improved profitability. As in 2004, cost-cutting measures and the substantial reduction of risk provisioning were the main contributors to earnings increases. The significant reduction in the need for valuation adjustments is the result of both the low level of risk on banks' balance sheets, and the normalisation of credit quality, after a record number of company insolvencies in 2003. Nevertheless, the frequency of insolvencies – and thus the banks' credit risk – is still very high. Particularly in depressed regions, workout and liquidation of troubled loan portfolios will continue to impact the earnings situation of savings banks for several years.

... but some weaknesses remain.

As their return on equity has increased, credit institutions' risk tolerance has also improved slightly. But, to a significant extent, this is due to one-off effects such as disposal gains, which will not

be repeated in the long term. And earnings power on the whole has failed to regain its earlier strength or to reach international standards. The German banking system remains susceptible to potential setbacks. It has yet to achieve the level of resilience needed to survive more or less unscathed any serious disruptions on the financial markets or in the real economy.

Operating income has displayed little dynamism. As banks carefully relax lending standards, risk assets have recently begun to increase for the first time after years of unavoidable decline. The favourable performance on capital markets is also contributing to earnings improvement by way of rising commission and trading income. The important thing now is that this positive development be sustained, especially since the earnings-boosting effect of cost containment measures is gradually dwindling, although they are still having some effect. Many banks are now so streamlined that further cost-cutting would be counter-productive. It would limit the opportunities for expansion and for generating additional income with new business. And it is very unlikely that the pace at which risk provisioning has been cut back over the past two years can be sustained. Nevertheless, in view of the slight drop in company insolvencies since February 2004, there is a realistic chance that risk provisioning will indeed continue to be reduced somewhat, provided that the tentative economic uptrend does not falter.

Interest income business, which still represents the most significant earnings component for the German banking sector, continued to suffer under the weak domestic economy throughout 2005. Widespread reluctance in both investment and consumption depressed corporate and consumer borrowing demand. There is stiff competition among credit institutions for clients with good credit. Add to this the fact that the yield curve flattened significantly over the course of 2004 and 2005, reducing the net interest income that banks generated from maturity transformation. Provided that financial markets remain vital, commission business and proprietary trading should offer the institutions some earnings support and lead to a more balanced earnings mix. This may enable them to reduce their relative dependence on interest income business as seen in international comparison.

Strategic realignment and business development of Landesbanks following the abolition of Anstaltslast and Gewährträgerhaftung

In the course of their strategic realignment, the Landesbanks have already acquired majority stakes in other private-law institutions in order to improve their retail basis and to leverage existing intragroup synergy potential. Furthermore, some Landesbanks have reached an agreement with a foreign institution to establish a ‘bad bank’ which will liquidate troubled loans for both parties. In a second stage, the bad bank is to offer its services to other credit institutions. Moreover, individual Landesbanks intend to work more closely with one another and to jointly develop financial products. They will underpin this cooperation in the form of reciprocal minority stakes.

But the Landesbanks continue to face the challenge of raising their earnings power, which has remained relatively weak. Net interest income, for instance, still accounted for 0.65% of total assets in 2004 (compare: 1.18% average for all banks). Commission income only reached one-third of the level for the banking sector as a whole (0.11% compared with 0.35% for all banks). Still, the results published for financial year 2005 already show a noticeable improvement on 2004 in terms of the earnings situation, although there continue to be discrepancies between individual Landesbanks. This was mainly caused by a further reduction in expenses for risk provisioning thanks to an easing of the risk situation in lending business. Some institutions were even able to generate income from the release of risk provisions. In addition, certain Landesbanks realised substantial hidden reserves in participating interests, thereby improving reported earnings. These extraordinary effects cannot, however, be relied upon as permanent contributors to improving the earnings situation.

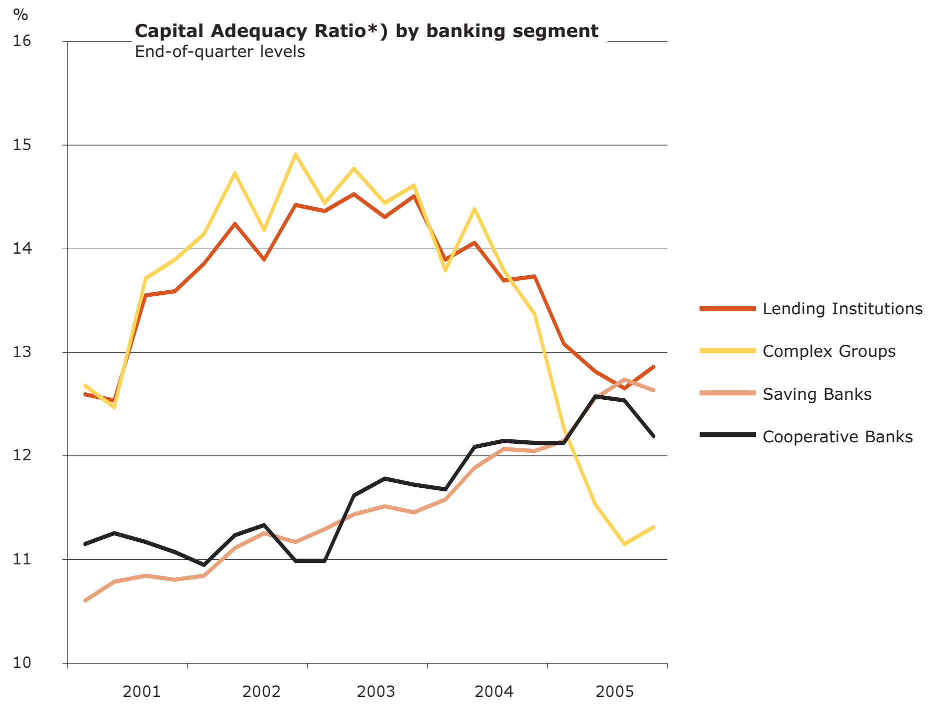
Landesbank groups affected by EU state aid cases on the contribution of state housing promotion assets (Wohnungsbausondervermögen) in the 1990s, benefited in the year under review from the fact that the one-off repayment of illegal subsidies had already been included in the 2004 financial statements.

The increased cost of refinancing caused by the abolition of state guarantees only had a limited effect on the earnings situation of the Landesbanks in 2005. All the Landesbanks took advantage of the transition period until 31 December 2015 to make timely use of the favourable conditions for long-term refinancing. Moreover, some Landesbanks collaborated with regional savings banks to develop models for improved utilisation of the available cover pool (mortgages and loans to local authorities) in order to take greater advantage of the more favourable (AAA-rated) Pfandbrief-backed refinancing, thereby further reducing the effects on refinancing costs from the lapse of state guarantees. Thus, in the coming years as well, it is likely that earnings will only gradually be burdened by higher refinancing costs.

Differing capital resources in the three pillars of the banking system.

The capital resources of the German banking sector have decreased slightly since the end of 2003, but remain satisfactory. The weighted capital adequacy ratio declined by the end of 2005 from 13.4% to 13.0%, but was well above the regulatory minimum of 8% applicable to each bank. The drop came primarily from the major private banks. For one, the large-scale losses of recent years that had not been fully compensated by capital increases were making themselves felt, and secondly the institutions are endeavouring to achieve greater balance between regulatory and economic capital. One major bank, for instance, cut both its tier one capital and total capital ratios through share buy-backs while at the same time adding to its risk-weighted assets, thus bringing these more closely in line with its internal targets. By contrast, the capital resource cushion of savings and cooperative banks has steadily increased in recent years.

Figure 7
Solvency of German banks



*) Liable capital in relation to risk-weighted assets;
Minimum in accordance with Principle 1 (Grundsatz I): 8%.

The clear advances made by the less-capitalised banks is a welcome trend. The 5% quantile increased over the past three years from 9.1% to 9.7% by the end of 2005, i.e. 95% of all institutions had a regulatory capital ratio of at leat 9.7%.

Stress tests confirm resilience of the banking sector.

The stress tests performed reinforce the impression of a stable German banking sector. The tests assume a number of extreme but plausible shock scenarios on the financial markets and assess the effects on banks' balance sheets. The last test in the year under review showed that several larger banks had used derivative

instruments as a means of hedging against a rise in capital market rates, thus limiting their susceptibility to adverse interest rate changes. A slump in stock market prices would hit major banks with large equity portfolios particularly hard. The potential for loss should, however, be limited by the fact that these institutions were able to build up hidden reserves thanks to price rises in recent years. German banks with credit exposures in Russia, Poland, Czech Republic, Hungary and Turkey in particular are facing exchange-rate risks.

German banks' business links with hedge funds

In recent times, the dramatic growth of the global hedge fund industry has given rise to increasing fears regarding the risks to financial stability. A central vector through which hedge fund difficulties could spread is their close ties to the banks. In 2005, BaFin, together with Deutsche Bundesbank, therefore conducted a Europe-wide survey, asking major German banks to provide more detailed information on their links to hedge funds. The results showed that the risks to the stability of the financial system at the time appears manageable. However, the hedge funds' lack of transparency makes it difficult to accurately assess the risk situation.

Of the 14 institutions surveyed, half reported that they had no links to hedge funds. A number of other banks invest directly in hedge funds to a very restricted extent and within strict limits, mainly with the aim of diversifying their portfolio, rounding out their specific risk/return profile. Only three banks reported any lending to hedge funds, although these loans are fully collateralised, which ensures the manageability of the credit risk. A further three banks uphold trading ties with hedge funds in OTC business. The proportion of outstanding hedge fund contracts in the entire volume of OTC business was relatively low for all three institutions.

The banks have obviously further improved their risk control systems in recent years and implemented strict conditions and minimum requirements to be observed in hedge-fund business. There appears to be wide variation, however, in the quality of risk management. Institutions with close business ties to hedge funds use advanced methods, such as PFE calculations[5], to measure the expected risk. They perform individualised stress tests and have developed clear internal guidelines and rating systems specially for hedge-fund business. Less active banks, by contrast, generally implement the standards used in other bank and fund business.

Even if the results as a whole do not give rise to much cause for concern, the survey did expose weaknesses. Some banks noted the increasing market power of large hedge funds which, in view of the stiff competition between banks for prime-brokerage mandates, could lead to standards being eroded and margins in hedge-fund

[5] Potential Future Exposure: This method of risk calculation takes into account potential changes in the value of a current credit exposure over the entire term of the contract and specifies the potential loss within a defined retention period and a particular confidence interval.

business diminishing. Moreover, most banks were not in a position to quantify their links to hedge funds across a number of business areas and to summarise these in the form of a single risk figure. Many banks were also satisfied with very rough figures for the leverage effect of hedge funds and rarely had a comprehensive overview of their activities with other business partners, which makes their risk assessments somewhat unreliable.

3 Insurers

Further stabilisation in the insurance sector.

The economic situation among German insurers continued to stabilise in the year under review. The insurance sector is more profitable and has increased earnings power. Insurance companies continued to easily satisfy solvency requirements despite more restrictive regulatory stipulations. This positive assessment is confirmed by individual market indicators.

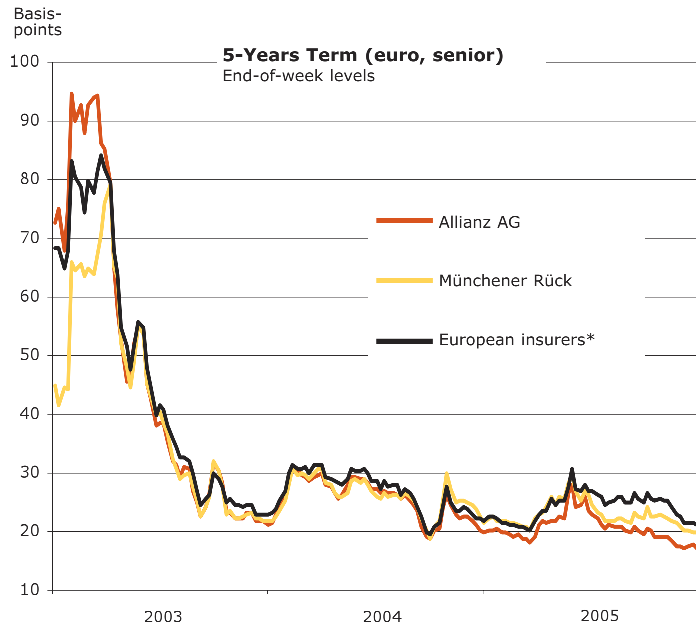
For much of 2005, the insurance sector shares substantially underperformed the DAX. It was only at the beginning of the fourth quarter, as the effects of the hurricane season in the US on balance sheets became clearer and business prospects appeared in a more positive light, that the insurance index caught up with and indeed outperformed the overall index.[6]

Credit default swap spreads for insurance companies rose from the beginning of the year to May 2005, and the spread widening followed the general trend. By the end of the year, risk premiums fell significantly again, and recently dropped below the beginning-of-the-year level. Moreover, since June 2005, German insurance companies' risk premiums have lain slightly below those of their international competitors, indicating that the market rates the default risk of German insurance companies as relatively low.

[6] Figure 5: Stock indices of the German financial sector.

Figure 8

Credit default swap spreads of selected insurance companies



* Unweighted average of the nine most liquid credit default swap spreads of European insurers.

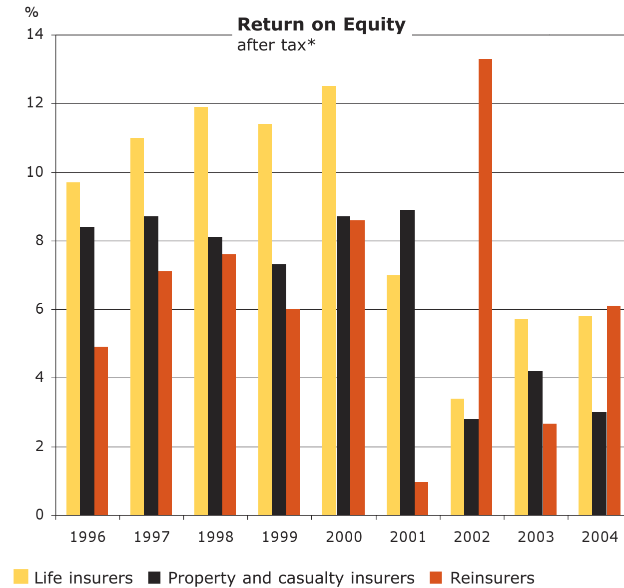
Source: Bloomberg

Agency ratings also show German insurance companies on firmer footing. The pattern observed in the previous year, where almost no financial strength ratings were reduced, was sustained. The ratings for German non-life insurers and reinsurers, in particular in the lower range of the ratings scale, have improved since 2003. This solid position is underpinned by predominantly stable rating outlooks for the individual insurance segments.

Advances in profitability.

Following a period of difficulty, the earnings situation among German insurance companies has improved dramatically in recent years. This is also reflected in the development of return on equity (RoE) in the three insurance classes. Reinsurance companies in particular were able to generate RoE in 2004 that was back on the level of the years prior to the capital market crisis.

Figure 9
Profitability of German insurers by class



* Net profit after taxes, divided by equity.

Slight increase in investments by German insurers.

Investments by German insurers (including reinsurance companies) totalled approximately €1,156 billion in 2005 (2004: €1,092 billion). Traditionally, insurers' portfolios focus on fixed-income investments. Registered bonds, notes receivable and loans account for around 40% of total investments. The proportion of investments in equities also increased only moderately in 2005, recently totalling around 9%. Both in terms of absolute volume and as a proportion of restricted assets, German insurers invested little in hedge funds, and significantly less than the regulatory limit of 5%. The investments of the roughly 40 primary insurers who invested in hedge funds represented on average 1% of their restricted assets. The ten highest hedge-fund investment ratios of insurance companies are all below 4% of restricted assets – most of them significantly below. The total volume invested by German primary insurers in hedge funds is around €4.6 billion, i.e. 0.47% of primary insurers' total capital investments.

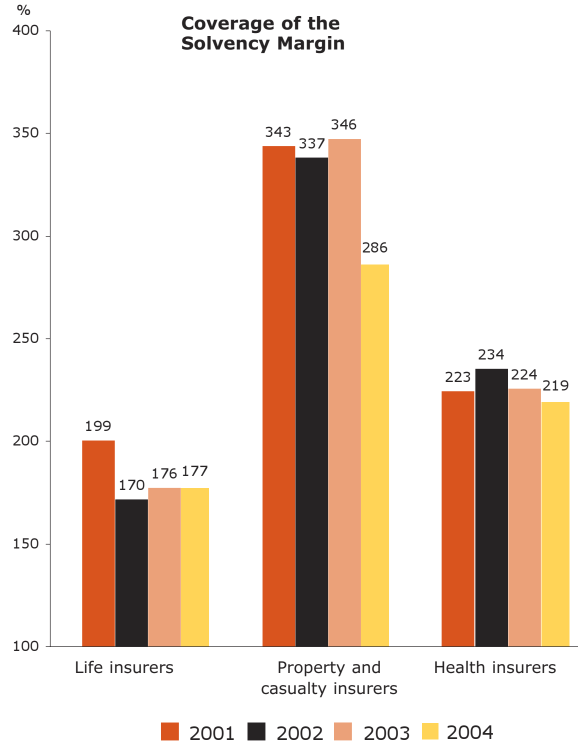
Compliance with solvency requirements remains excellent.

The class-specific solvency values of insurers remain substantially higher than the minimum capital requirements in the individual business areas. Solvency in life and health insurance changed little from 2003 to 2004. This is also likely to be the case in 2005. In 2004, the coverage ratio in property and casualty insurance fell by around 60 basis points on the previous year. This was partly caused by the new regulatory requirements (Solvency I).[7] Although transitional provisions apply until 1 March 2007, a large majority of property and casualty insurance companies have already prepared their reports according to the new, stricter rules, which resulted in falling coverage ratios. Nevertheless, the coverage ratio was still at

[7] More detailed information on the new solvency rules and their impact on coverage of solvency margins in the various insurance classes can be found in "2004 Statistics from the Federal Financial Supervisory Authority – Primary Insurers".

a high level in 2004. In life and health insurance, the new requirements had only a marginal impact in 2004.

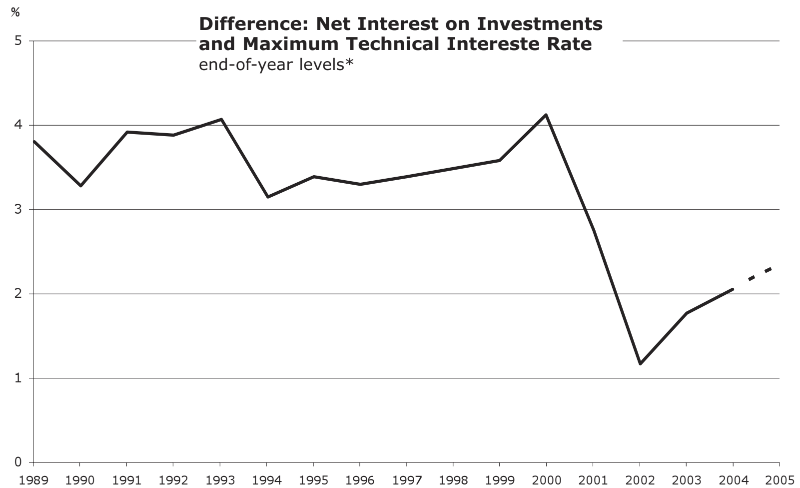
Figure 10
Solvency trends among German insurers



Low interest rates squeeze life insurers' earnings.

Having lingered below 4% since October 2004, the yield on 10-year bunds fell back to 3% at times over the course of 2005. This is putting pressure on the earnings situation of life insurers, because only relatively low-interest options are available for new investments. The spread between the capital market rate and the maximum technical interest rate of life insurers declined further and, based on 10-year government bonds, was at times hovering just under 30 basis points. According to estimates, the average net investment return for German life insurers in 2005 was up slightly on the previous-year level of 4.8%. Since only marginal return can be achieved on the capital market at present, and since the majority of high-yield securities in insurers' investment portfolios are nearing maturity, a moderate rise in interest rates would be positive for the companies. An interest-rate rise, however, which was too abrupt and unexpected would primarily hit insurers on the investment side, since it would result in a reduction of hidden reserves and a drop in the value of fixed-income securities in their portfolios.

Figure 11
Portfolio returns of German life insurers



* 2005 figures estimated.

Volume down for new life insurance policies.

In the wake of the boom in new life insurance business at the end of 2004, performance in this area slowed in the year under review. Since a large proportion of premium growth from new business in 2004 only really began to affect earnings in 2005, premium income rose in the year under review, despite the drop in new business. At the same time, demand shifted towards pension products such as “Riester” and “Rürup” plans. These tax-favoured plans became increasingly attractive.

The results of the stress tests based on annual financial statements as at 31 December 2004 illustrate the continued strengthening of the economic position of life insurance companies. A good 97% of all life insurers achieved positive results in all three stress-test scenarios, a further clear improvement on the previous-year figure of around 90%.

Increased competition in motor vehicle insurance.

2004 was a successful year for property and casualty insurance companies. Although premium income saw only a slight rise, a significant let-up in claims expense helped the combined ratio to a further decline year-on-year. After a previous drop to 92.2% in 2004 (previous year: 94.7%), 2005 again promises a relative improvement. Companies may be subject to certain financial pressure as a result of the marked increase of competition in motor vehicle insurance, the main class of property and casualty insurance, in 2005.

Natural disasters cause high claims expenses for reinsurers.

The frequent and serious storms in North and Central America hit the global reinsurance industry hard in 2005. As a result, some rating agencies adjusted the outlook for globally active reinsurers to negative or watch-listed the ratings for particular companies. German reinsurance companies, however, were impacted less by the events than international competitors, not least thanks to a more favourable business portfolio and improved risk management techniques. In certain areas of reinsurance, the natural disasters may lead to price stabilisation since policyholders and insurance

providers are likely to have modified their risk assessments. A favourable business environment resulting from higher prices – a so-called ‘hard’ market – should have a positive effect on future earnings growth among reinsurance companies.

4 Retail market developments

Continued hunt for returns.

In 2005, private investors increasingly turned to products that offer extra yield opportunities while providing a capital guarantee or mechanisms to limit downside risk.

The certificates market received a further boost from this trend, and continues to display rapid growth. The increasing variety of products goes hand-in-hand with greater product complexity. Since transparency declines as complexity increases, the risk arises that many private investors will no longer be able to make a comprehensive assessment of the key return and risk aspects of the products. This is particularly salient in view of the fact that German consumers are all too often underinformed when it comes to investment matters.

The competition between fund management companies and issuers of investment certificates remained as hard as ever in 2005. But it is not always easy to draw hard distinctions between individual products. On the one hand, individual issuers launch certificates that invest in fund products, and on the other, funds pursue investment strategies on the basis of certificates, or they use strategies that were originally applied only for certificates. And once again, as the variety and complexity of products grows, private investors find it increasingly difficult to determine the risk/return structure. BaFin welcomes providers’ efforts to apply uniform terminology across comparable products. This boosts the transparency of the offerings.

Many new products stem originally from institutional business. Credit-linked notes[8] are cited as examples, where the minimum denomination, often of only €1,000 is clearly targeted to retail sales. The upshot is that bank risks are transferred to retail clients. The expansion of product diversity gives private investors the opportunity to enter new asset classes and increase the diversification of their portfolios. However, this is often connected with risks, which are unfamiliar to many private investors and difficult to comprehend. It is therefore particularly important that clients are offered transparent information about such products.

Sales of German hedge-fund products that have been admitted to trading in Germany since the beginning of 2004 remained shy of expectations in 2005. This may be explained in part by competition between different investment forms. When investing in hedge

[8] Credit-linked notes are debt instruments based on a reference debtor where the full nominal value is only repaid on maturity if a specified credit event has failed to occur.

funds, investors often turned to hedge fund certificates, which are subject to little regulation, rather than authorised hedge funds.

Closed-end funds continued to be much in demand among private investors in 2005. And the market, which is still highly complex and relatively opaque, profited again from low interest rates and investors hunting for returns. It was further boosted by one-off effects, as investors responded to a changed tax framework. Real estate funds remained the most important segment in the closed-end fund market. Funds related to ship financing and second-hand life insurance policies enjoyed rapid growth. Some initiators of closed-end fund products tried to broaden their appeal by cutting minimum subscription requirements or offering savings plans with low monthly rates. However, since closed-end funds represent long-term corporate equity investments, it is often questionable, what investors actually have to gain from such an approach. The insolvencies filed by large fund initiators such as the Falk Group also demonstrate how risky this kind of investment is, especially for retail clients.

Client loyalty waning and competition between banks increasingly fierce.

The loyalty of private clients to their credit institution continued to decline in 2005. Low interest rates and increasing price sensitivity meant that the number of bargain-hunters in the banking arena also increased. Direct banks and Autobanks came out on top. The rising intensity of competition also increased pressure on the margins of the German banking industry as a whole.

For clients, this is in principle a positive development, but it carries a number of risks. Firstly, the high degree of product diversity may overwhelm clients, and secondly, the seductive and ubiquitous advertising campaigns for instalment loans to facilitate general purchases lure no small number of households into debt. The volume of instalment loans issued by banks has grown by around 22% over the past five years. An increasing number of households appear to see loans as a viable option for realising purchases.

Table 1

Economy and financial sector overview for Germany*)

Selected economic data	Units	1999	2000	2001	2002	2003	2004	2005
GDP growth [1]								
Global economy	%	3.7	4.7	2.4	3.0	4.0	5.1	4.3
U.S.	%	4.4	3.7	0.8	1.6	2.7	4.2	3.5
Euro-area	%	2.7	3.8	1.7	0.9	0.7	2.1	1.3
Germany	%	2.0	3.2	1.2	0.1	- 0.2	1.6	0.9
Corporate insolvencies	number	26,476	28.235	32,278	37,579	39,320	39,213	36,843
DAX (End of 1987=1000) [a]	points	6,958	6.434	5,160	2,893	3,965	4,256	5,408
Money market rate [2]	%	2.97	4.39	4.26	3.32	2.33	2.11	2.19
Capital market rate [3]	%	4.53	5.28	4.86	4.81	4.08	4.04	3.36
Exchange rate of the €	€1 =...$	1.07	0.92	0.90	0.95	1.13	1.24	1.24
Gross-sale of fixed-income Securities [4]	€ bn.	571	659	688	819	959	990	989
Credit institutions								
Loans granted [a] [5]	€ bn.	2,094	2,187	2,236	2,241	2,242	2,224	2,227
Net interest margin [6]	%	1.28	1.14	1.12	1.20	1.16	1.18	-
Net commission income	€ bn.	22.5	28.1	25.3	24.3	24.4	25.3	-
Adminiistrative expenses	€ bn.	70.2	77.7	81.0	78.3	77.3	75.8	-
Risk provisioning	€ bn.	11.5	15.9	19.6	31.2	21.8	17.2	-
Cost-income ratio [7]	%	66.0	68.4	71.4	67.2	66.5	65.5	-
RoE [8]	%	11.2	9.3	6.2	4.5	0.7	4.2	-
Capital ratio [a] [9]	%	11.6	11.7	12.1	12.8	13.4	13.3	13.0
Private lending banks								
Loans granted [a] [5]	€ bn.	560	600	605	594	579	575	580
Net interest margin [6]	%	1.43	1.17	1.15	1.34	1.17	1.25	-
Cost-income ratio [7]	%	73.9	75.4	80.4	74.2	74.0	73.5	-
RoE [8]	%	9.7	8.2	4.7	1.0	- 6.2	- 0.4	-
Capital ratio [a] [9]	%	12.4	13.0	13.6	14.4	14.5	13.7	12.9
Savings banks								
Loans granted [a] [5]	€ bn.	523	545	563	572	577	573	574
Net interest margin [6]	%	2.48	2.33	2.28	2.38	2.40	2.35	-
Cost-income ratio [7]	%	65.7	68.9	69.9	66.5	66.4	64.9	-
RoE [8]	%	15.2	13.4	9.2	8.2	10.9	9.9	-
Capital ratio [a] [9]	%	10.9	10.7	10.8	11.2	11.5	12.1	12.6
Cooperative banks								
Loans granted [a] [5]	€ bn.	318	327	331	335	338	342	348
Net interest margin [6]	%	2.49	2.45	2.41	2.49	2.51	2.51	-
Cost-income ratio [7]	%	71.2	74.5	76.7	73.1	69.6	68.7	-
RoE [8]	%	10.7	8.6	7.5	9.7	10.6	10.2	-
Capital ratio [a] [9]	%	11.2	11.2	11.1	11.0	11.7	12.1	12.2
Insurers								
Life insurance								
Hidden reserves in the investment portfolio (IP) [10]	€ bn.	74.4	62.9	31.3	6.2	14.9	35.6	66.0
as % of IP book value	%	14.4	11.4	5.5	1.1	2.4	5.5	10.0
Ratio of fund units in IP [11]	%	18.9	21.4	22.5	23.0	23.3	22.0	22.3
Ratio of borrower's notes and loans in IP [11]	%	16.7	16.6	17.1	18.1	19.3	22.0	22.3
Net rate of return on IP [12]	%	7.5	7.4	6.0	4.4	5.0	4.8	-
Net technical provisions	€ bn.	416.1	445.5	476.4	502.8	520.6	536.2	-
as % of total assets	%	83.1	83.7	83.7	83.8	79.4	78.8	-
Surplus [13]	€ bn.	18.7	20.3	13.4	5.1	9.2	9.7	-
as % of gross premiums earned	%	32.4	33.1	21.5	7.9	13.6	14.1	-
Eligible own funds [A+B+C]	€ bn.	38.8	42.9	44.2	39.8	42.3	43.9	-
Solvency margin [14]	€ bn.	19.2	20.5	22.2	23.3	24.0	24.8	-
Coverage of solvency margin [15]	%	201.8	209.5	199.0	170.4	176.2	177.4	-
Return on equity [16]	%	11.4	12.5	7.0	3.4	5.7	5.8	-
Property and casualty insurance								
Hidden reserves in the investment portfolio (IP) [10]	€ bn.	38.9	37.1	31.7	22.3	26.0	26.6	31.9
as % of IP book value	%	40.7	38.1	31.4	21.3	23.8	22.6	25.7
Ratio of fund units in IP [11]	%	21.8	23.5	25.3	27.0	27.3	26.5	28.0
Ratio of borrower's notes and loans in IP [11]	%	13.5	13.3	13.2	13.2	14.1	16.6	18.1
Combined ratio (net) [17]	%	99.8	101.0	100.2	103.2	94.7	92.2	-
Eligible own funds [A+B]	€ bn.	20.7	20.7	24.4	25.0	27.1	24.1	-
Solvency margin [14]	€ bn.	6.76	7.5	7.1	7.4	7.8	8.4	-
Coverage of solvency margin [15]	%	306.6	277.1	342.7	336.9	346.0	286.3	-
Return on equity [16]	%	7.3	8.7	8.9	2.8	4.2	3.0	-
Reinsurance								
Hidden reserves in the investment portfolio (IP) [10]	€ bn.	83.6	101.8	89.2	35.8	34.3	37.2	41.4
as % of book value	%	67.0	75.9	54.2	18.5	15.6	17.7	18.2
Combined ratio (net) [17]	%	106	103.8	115.3	101.6	92.8	93.5	-
Gross technical provisions	€ bn.	98.7	104.5	122.3	130.6	135.8	140.8	-
as % of gross premium income	%	279.2	265.7	278.6	244	264.4	298.5	-
Net profit for the year [18]	€ bn.	1.4	2.2	0.3	5.4	1.4	3.4	-
Available capital [19]	€ bn.	23.9	25.1	31.5	40.2	51.4	55.1	-
Return on equity [16]	%	6.0	8.6	1.0	13.3	2.7	6.1	-

Sources: BaFin, Deutsche Bundesbank, Eurostat, IMF

*) Annual totals or averages unless otherwise specified.
a) Year-end level.
1) Year-on-year change in real GDP.
2) 3-month Euribor.
3) 10-year government bond yields.
4) Domestic issuers.
5) Current account loans to domestic companies and private individuals.
6) Net interest income as percentage of total assets.
7) Administrative expenses in relation to operational income.
8) Net profit for the year before taxes as percentage of average balance-sheet equity.
9) Liable capital in relation to weighted risk assets (solvency indicator pursuant to Principle I).
10) Fair values - book values for investments valued at cost.
11) As percentage of total IP excl. deposits with ceding undertakings.
12) (Returns on IP - expenses for IP) / arithemetic mean of IP (beginning/end of year).
13) Net profit for the year + gross expenses for bonuses and rebates.
14) Minimum own funds free of foreseeable liabilities.
15) Eligible own funds / Solvency margin.
16) Net profit for the year / equity.
17) Net expenses for claims and insurance operations / net premiums earned.
18) Corresponds to item II.4 form 2 RechVersV.
19) Total capital - unpaid capital contributions.

Supervision is becoming increasingly international.

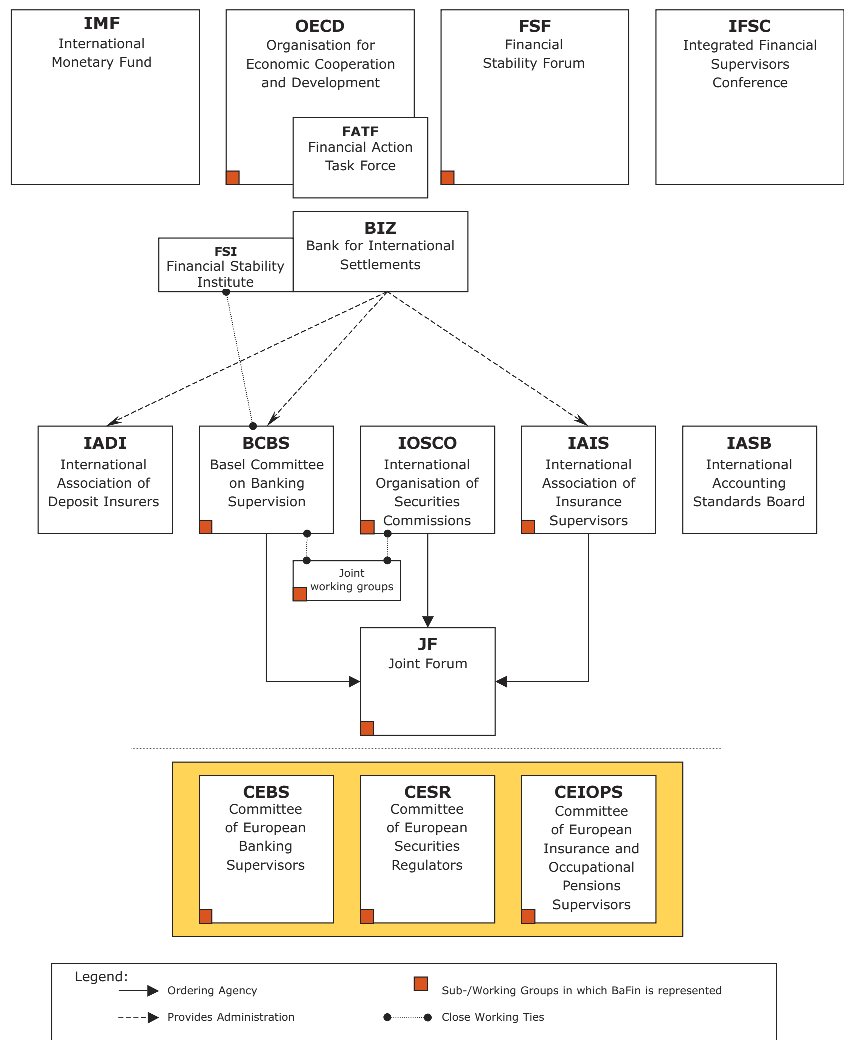
III International

1 International harmonisation

There was no let-up in the pace of change in the international financial supervisory community in 2005. As an integrated financial supervisory authority, BaFin is represented on all of the key bodies and committees, allowing Germany to express its positions to a worldwide forum.

Figure 12

International institutions and committees[9]



[9] The 2004 Annual Report contains a detailed overview of the individual organisations and bodies. The documents listed in the annual report text can be found on the websites of the respective organisations (www.bafin.de > Links > International Organisations).

1.1 Market transparency and integrity

General disclosure rules

Market transparency and discipline is a key supervisory issue. The greater the transparency offered by economic players, the faster the market can react to changes and exert its disciplinary power over companies. BaFin also supports initiatives aimed at promoting market discipline through increasing market transparency. Examples of such initiatives include efficient disclosure regulations designed to give market participants easier access to company data. This idea is nothing new. Back when Basel II was still in the design stage, disclosure was recognised as a key accompanying and supporting element. The EU has already issued a number of directives and regulations aimed at increasing transparency on the financial markets.[10]

Market transparency and discipline is also an issue in other areas, the development of the International Accounting Standards (IAS/IFRS) being only one example. Disclosure and transparency requirements, among others, are set out in the recently published IFRS 7, which deals with disclosures about financial instruments.

Harmonisation of prospectus law

IOSCO and CESR aim to harmonise prospectus rules at international/EU level. An IOSCO working group, for example, developed a set of principles for prospectuses dealing with cross-border offers of debt securities and their admission to trading (Debt Principles) in 2005 and opened these to public consultation. BaFin also held a national hearing. These principles do not, however, provide a binding legal framework, but rather serve as a means of orientation for IOSCO member states when creating new or revised versions of existing disclosure requirements. The IOSCO is likely to adopt the Debt Principles in the summer of 2006.

In 2005 the IOSCO also tackled the issue of the periodic disclosure requirements that apply to issuers whose securities are admitted to trading on an organised market. This project is likely to be completed once the Debt Principles have been adopted.

CESR adds to the technical implementing measures of the Prospectus Directive.

As far back as 2004, the European Commission added a number of technical implementing measures to the Prospectus Directive, one of which dealt with the content of prospectuses, for example.[11] In the year under review, the CESR added to these a number of recommendations. These relate, in particular, to the expansion of the technical implementing measures to cover what are known as complex financial histories. Complex financial histories refer to cases in which structural changes occur either with the issuer or

[10] The sources for all of the laws, directives, ordinances, etc. mentioned in this report can be found at www.bafin.de > Legal Foundations & Official Announcements.

[11] Commission Regulation (EC) No. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

within the issuer's group during the period of time for which historical financial information has to be included in the prospectus. Examples of structural changes include the formation of a new holding company, spin-offs or the purchase or sale of major subsidiaries. CESR published and passed on its final recommendation to the European Commission in October 2005.

CESR is also considering setting up an operational group to ensure the uniform application of the European prospectus rules. The first meeting highlighted a substantial need for coordination: the implementation of the rules into national law varies from member state to member state and the highly detailed technical implementing regulation provides considerable room for interpretation.

EU Transparency Directive

The Transparency Directive, which has to be implemented into national law by January 2007, came into force in January 2005. Within the framework of several Level 2 mandates, CESR developed implementing provisions for the Transparency Directive, which were passed on to the European Commission in June 2005. These implementing provisions are currently under examination by the European Securities Council. Further implementing provisions relate to the official storage system that is to be set up in accordance with the Transparency Directive. The Directive provides for a system whereby investors have access to a central database containing capital market information on particular issuers. An initial consultation paper on this database was published in January 2006, with CESR likely to conclude its actual work on the topic in June 2006.

MiFID results in new requirements for financial services providers

Transparency is also the guiding theme of the Markets in Financial Instruments Directive (MiFID), particularly with regard to transparency vis-à-vis investors. The new provisions, which must be applied as of November 2007 at the latest, require banks and financial services institutions to meet a broad range of information obligations to their clients. Investment firms will then have to provide detailed information on both themselves and their services, an overview of the financial instruments they have on offer, their investment strategies, service fees and possible conflicts of interest, as well as best execution principles. In 2005, the European Commission used a number of CESR recommendations to develop implementing measures containing further details on these information and disclosure obligations. The guidelines have been under discussion in the European Securities Committee since mid-2005.

Reporting for securities and derivatives transactions.

MiFID also sets out new reporting regulations for securities and derivatives transactions. Whereas all companies admitted to trading on a German stock exchange presently have to report to BaFin, reporting in the future will be based strictly on the country of origin principle. This means that, from then on, all stock exchange participants from the EEA will have to report their

transactions to the authorities in their home country. CESR has estimated that the changeover will cost market participants in Europe as a whole over €700 million.

Strict country of origin principle creates need for new reporting system.

The idea is to close any data gaps (and resulting gaps in market supervision) which arise as a result of the country of origin principle by ensuring that the foreign authorities forward the reports to the appropriate supervisory authorities as quickly as possible. CESR presented a series of recommendations for the implementation of this reporting system on behalf of the European Commission in January 2005. It then appointed a technical task force, headed by BaFin, to evaluate the most efficient and cost-effective ways of implementing a technical project of this scale. The group of experts examined a number of different models – decentralised, centralised and mixed solutions – to determine their technical feasibility and projected costs. In order to minimise the burden on market participants, BaFin’s preferred approach is largely decentralised.

Transparency of insurance companies

Market discipline and transparency are playing an ever increasing role in insurance supervision. As in the banking supervisory sphere, these concepts form the third pillar of any modern supervisory architecture, together with capital adequacy and supervisory review processes.

Supervisory authorities are working hard to promote improved market transparency, in particular as part of the Solvency II project and within the International Association of Insurance Supervisors (IAIS). One IAIS working group under BaFin’s leadership is, for example, developing standards for expanded publication requirements for insurance and reinsurance undertakings. With standards for underwriting practices at property and casualty insurers and investments already in place, the group is now concentrating on the development of standards for underwriting practices at life insurance companies. The standards are scheduled to be presented in the autumn of 2006.

The third pillar of Solvency II covers not only publication obligations but also reporting by insurance undertakings to the supervisory authorities. CEIOPS has been commissioned to develop uniform publication standards and reporting formats for insurance undertakings subject to supervision in Europe. 2006 is likely to see specific recommendations with regard to a uniform risk situation disclosure system for insurance undertakings.

Prohibited transactions

A growing number of providers offering illegal transactions are becoming active on a cross-border basis, highlighting the increasing importance of international cooperation in order to combat activities of this nature. A common stance will ensure that the international community can continue to win the battle against prohibited business activities in the future.

In 2005, the IAIS adopted an international guidance paper, with recommendations to help prevent employees or shareholders from using their insurance company as an instrument for illegal transactions.[12] The paper provides supervisory authorities with specific information on how to recognise, and impose appropriate penalties for cases in which policyholder funds have been misappropriated. The IAIS lists corporate governance, group structure, business ties and relationships with third parties as being the sources in which the supervisory authorities are most likely to find clues pointing towards this type of behaviour.

Measures relating to the Market Abuse Directive.

One of CESR's key tasks is to present a united front in combating illegal market activities, which is why CESR-Pol, the working group for surveillance and exchange of information, was commissioned to develop guidelines for the Market Abuse Directive. Following a Europe-wide consultation process, CESR published an initial guidance paper in the spring of 2005[13] to provide market participants with further information on the effects of the Market Abuse Directive. The paper contains descriptions of abusive behaviour and the criteria that apply to authorised market practices. It also sets forth when and how the institutions should report incidences of suspected market abuse and provides a form for such reports. CESR-Pol's guidelines on "urgent issues groups" offer considerable practical help in investigating illegal activities beyond the EU's borders. Such ad hoc groups have been formed on three occasions to date, specifically to coordinate efforts to obtain information on cross-border cases. BaFin was represented in two of these groups.

Strengthening the capital markets against financial fraud.

The major financial scandals reported at companies such as Enron or Parmalat continued to shape IOSCO's work in 2005. A task force set up in reaction to the Parmalat scandal published its report in February 2005.[14] The report sets out various measures for the prevention of accounting scandals and on how to restore investor confidence. IOSCO's suggestions include tightening the current standards designed to ensure auditor independence, preventing conflicts of interest affecting financial intermediaries and increasing the transparency of the bond markets. It also proposes new corporate governance regulations, in particular relating to the role of supervisory bodies and independent board members. The report will serve as a basis for further IOSCO projects over the next few years.

Secondary markets

IOSCO investigates trading transparency issues.

In the year under review, an IOSCO working group which BaFin has been chairing since September 2005 prepared a report on error trades policies. The paper examines cases in which orders have been entered or processed erroneously in electronic trading systems, and provides seven recommendations, for example on how to make error trade rules more transparent for market participants.

[12] IAIS-Guidance Paper on combating the Misuse of Insurers for Illicit Purposes.
[13] Level-3-Guidance Paper – First Set of CESR Guidance and Information on the Common Operation of the Directive Paper.
[14] Strengthening Capital Markets against Financial Fraud.

The group is also examining the regulatory impact of increased competition and growing internationalisation on stock exchanges and stock exchange regulators. The report is due for publication in 2006 following a public consultation. Ultimately, the group is to determine the information needs of national supervisory authorities with regard to the admission of trading participants based abroad (remote members), as well as for the cross-border trading of securities and derivatives. By the end of the mandate, the group aims to have a number of principles designed to facilitate the ongoing exchange of information.

CESR working on implementation of MiFID.

In April 2005, CESR sent the recommendations developed by one of its working groups with regard to market-related MiFID regulations to the European Commission. These implementing measures relate to pre- and post-trade transparency for equities on regulated markets and multilateral trading platforms, and in particular to pre-trade transparency for systematic internalisers and post-trade transparency for OTC transactions. The proposal also contains provisions on the admission of financial instruments to regulated markets. In February 2006, the European Commission submitted a draft to the European Parliament for consultation.

Investment funds

Market timing guidelines.

In 2005, IOSCO published its new guidelines on how to deal with unauthorised market timing practices in the case of fund unit transactions (late trading).[15] These guidelines provide the national supervisory authorities with advice on how to prevent such trading practices. IOSCO's work also focused on a number of corporate governance issues, in particular supervision of fund management companies by independent bodies. Whereas in the US, for example, board members must be independent, German law provides for custodian banks to monitor fund management on behalf of investors. IOSCO has also begun to examine the issue of hedge fund regulation. Here too, there is a focus on corporate governance, but also on valuation and risk management.

2005 also saw the conclusion of IOSCO's work on the issue of money laundering[16]. Thus, the investment industry now has uniform international standards for combating money laundering activities.

CESR published two new documents on the uniform application of the UCITS Directive. A consultation paper published in October 2005[17] contains numerous recommendations for an official clarification of the legal framework for the acquisition of assets under the UCITS Directive. Furthermore, new guidelines[18] ensure that the transitional provisions of the UCITS Directive are applied in a uniform manner.

[15] www.iosco.org.
[16] Development of Anti-money Laundering Guidance for CIS.
[17] CESR's Draft Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS.
[18] Guidelines for supervisors regarding the transitional provisions of the amending UCITS-Directives.

Finally, the European Commission's Green Paper on the enhancement of the EU framework for investment funds[19], published in July 2005, set new priorities for the future UCITS Directive. These include, in particular, measures for an EU-wide level playing field, e.g. a clear definition of eligible UCITS assets, a simplified notification procedure for the distribution of foreign funds or swift implementation of the Commission's recommendations on the use of derivatives and the simplified prospectus.

1.2 Organisational requirements and rules of conduct

Rules of conduct and best execution.

MiFID will change the rules of conduct that apply to investment firms. When client orders are executed, they are no longer to be settled primarily via stock exchanges but, in accordance with the best execution principle, in the most cost-effective way for the client – a first in continental Europe. Investment firms must ensure that they achieve the best possible result for their clients. They have to provide their clients with information on their execution policy explaining how this is to be achieved. In February 2006, the European Commission submitted a draft for comment to the European Parliament.

MiFID also changes the rules of conduct with regard to the obligation of advisors and asset managers to examine the suitability of financial instruments for their clients. Taken together, MiFID provides detailed rules giving even long-established rules of conduct, such as information obligations a new face.

Further standards for financial services providers.

At EU level, MiFID and the respective technical implementing measures set out harmonised organisational requirements for investment firms. Outsourcing, a topic which is also currently under review by CEBS and the Group de Contact, is of cross-sector significance. A particularly important aspect is the compatibility of the initiatives developed in the various bodies. The three Level-3-committees (CESR, CEBS and CEIOPS) have been entrusted with this task.

In 2005, an IOSCO working group developed a number of recommendations for investment services enterprises relating to the treatment of conflicts of interest. It also proposed general organisational principles equivalent to German supervisory law. With publication of this paper, German practice has become the international benchmark.

Corporate governance for insurance companies.

In 2005, the OECD released its Guidelines for Insurer's Governance, designed to provide policyholders with improved protection. The guidelines broaden existing supervisory law regulations and the OECD Corporate Governance Code to cover the insurance sector, and are aimed at supervisors and insurance companies alike, offering recommendations on efficient governance

[19] www.europa.eu.int/comm/internal_market/securities/ucits/index_de.htm.

codes at insurance companies. The Guidelines are applicable to all classes (life, property/casualty, reinsurance), but is not binding. The guidelines are designed to improve management accountability and increase transparency. To this end, companies have to name and assign their areas of responsibility clearly, establish an appropriate management structure, stipulate management duties and functions and create rules governing disclosure requirements.

Corporate governance for pension funds.

The release of the Recommendations of the Council on Guidelines for Pension Funds Governance in 2005 signalled the completion of the OECD's Corporate Governance Code. These guidelines are aimed at supervisory authorities and retirement schemes. They include governance rules for occupational retirement schemes. In order to enable retirement schemes to fulfil their purpose, i.e. to ensure retirement income, the guidelines include recommendations on the creation of articles of association, identification and clear allocation of responsibilities and functions, suitability issues, advisory activities, liability, actuarial position, safe custody, disclosure requirements and the structure of internal control and reporting systems.

1.3 Supervisory reporting

COREP

In order to harmonise bank solvency reporting requirements (which often vary considerably from member state to member state) at EU level, CEBS formed a COREP (Framework for Common Reporting of the New Solvency Ratio) working group. The group has recommended EU-wide standardisation of reporting forms, while at the same time maintaining a degree of flexibility with regard to the national implementation of specific reporting content. This allows institutions operating on a cross-border basis, in particular, to report standardised data.

COREP framework provides for two-tier system.

In 2005, CEBS initially published a number of recommendations calling for comprehensive and detailed reporting requirements in light of the fact that, in many countries, central banks use the reporting system as a source of economic statistics. BaFin and the associations of the German banking industry criticised these recommendations, with the associations in particular seeing COREP's initial approach as "maximum harmonisation". During the consultation process, BaFin and the Bundesbank ultimately managed to negotiate a substantial reduction in the specificity of the reporting forms and the introduction of a distinction in the reporting content between core information and detailed information. CEBS published the final version of the COREP framework in January 2006. In Germany, only a limited amount of data classified as detailed information will be required. The COREP framework provides for a two-tier system: a core area containing the minimum information that is required for the calculation of regulatory capital and capital requirements, and another containing detailed information that can also be used on a national basis by the individual EU member states.

In its recently published White Paper[20] the European Commission also suggested the introduction in 2007 of harmonised reporting requirements for insurance companies as part of a common reporting system.

FINREP

In December 2005, CEBS published its recommendations on a Standardised Consolidated Financial Reporting Framework (FINREP). The aim of this initiative is to reduce the burden on banks that operate on an EU-wide basis resulting from varying financial reporting requirements imposed by the supervisory authorities of the individual member states. The move is designed to take into account the concerns expressed by many internationally active banks with regard to the reporting requirements imposed by the different supervisory authorities, which they believe are too diverse. The FINREP concept forms part of CEBS' convergence efforts. Since the concept contains recommendations, each national supervisory authority can, in principle, choose whether or not to apply FINREP and if so, which FINREP information it will actually use.

As a result, the package of recommendations that is currently available is only an initial, cautious step towards harmonisation. In principle, all EU supervisory authorities still have the option of imposing additional national information requirements on institutions that operate on a cross-border basis. BaFin is committed to ensuring that CEBS continues to work towards real harmonisation.

Standardisation of consolidated financial statements
The idea of FINREP is to standardise the reports that banks submit to the supervisory authorities on their IAS/IFRS consolidated financial statements. There are two main arguments in favour of a uniform reporting system in this area. Firstly, all capital market-oriented banks in the EU have been obliged, since the beginning of 2005, to prepare their consolidated financial statements in accordance with IAS/IFRS. This means that, in many cases, the information submitted to the supervisory authorities with regard to the 2005 annual statements will be based on IAS/IFRS. Secondly, uniform reporting standards can now be applied across the EU. Furthermore, the IAS/IFRS regulations do not provide explicit instructions with regard to individual balance sheet and income statement items, which makes it more difficult for the supervisory authorities to compare and analyse financial statements.
This is why CEBS has developed a number of suggestions for uniform balance sheet and income statement formats for the IAS/IFRS consolidated financial statements prepared by banks, having taken care to ensure that these requirements are consistent with IAS/IFRS rules.

In addition to this data gleaned directly from the consolidated financial statements, however, the FINREP recommendations also contain further standardised information on individual balance

[20] www.europa.eu.int/comm/internal_market/finances/docs/white_paper/white_paper_en.pdf.

sheet and income statement items, as well as additional information. The first version of the complete FINREP package covered a very comprehensive catalogue of information requirements.

The extensive nature of these requirements met with substantial criticism from the banking industry, which also spoke of unacceptable "maximum harmonisation". BaFin acted on this criticism by pushing for a reduction in the scope of the information requirements. The final version of the FINREP package that was published in December now consists – as with COREP – of two sections: core information and additional information. While the core information only includes the consolidated IAS/IFRS balance sheet and P&L, all other data is classed as additional information. This means that if a national supervisory authority opts to use the FINREP tables, it must request at least the full core information. This system has enabled a minimum degree of harmonisation among FINREP users. It is at the discretion of the national supervisory authorities to decide on the extent to which they wish to use the additional information.

1.4 Rating agencies

CESR final report on rating agencies.

Back in 2004, at the initiative of the European Commission, a CESR working group started to address the issue of rating agencies. CESR presented its final report in the spring of 2005. The report focused on potential conflicts of interest within rating agencies, the transparency of their methods, legal issues relating to access to insider information and the advantages and disadvantages of insufficient competition in the rating business. CESR's suggestions ranged from further observation of the market to a European/ national system of registration and regulation based on the IOSCO Code Fundamentals. A clear majority of CESR members voted against compulsory registration and suggested that the best policy was to wait and see what sort of impact the Code Fundamentals would have.
IOSCO's Code Fundamentals are not legally binding. Nevertheless, given that the supervisory authorities expect the rating agencies to comply with them, and in light of the announcement that IOSCO is prepared to amend them further if necessary, and to consider the best way of enforcing them, the Code Fundamentals should prove to be fairly binding in practice.

No current plans for additional regulation.

The majority of CESR members believe that there is no need for further regulatory measures at present, or are of the opinion that such measures would actually be counterproductive. Of key importance is that the regulation of rating agencies is coordinated at international level. Even within the EU, CESR believes consistent and harmonised action as well as close coordination between supervisory authorities (as with regard to the implementation of Basel II, for example) to be indispensable.

In December 2005, the European Commission announced that, for the time being, it would not be introducing any regulation of rating agencies beyond the scope of the IOSCO Code Fundamentals. This is in line with CESR's recommendations. Nevertheless, the

Commission has also opted not to rule out future regulatory initiatives in the event that the Code Fundamentals prove inadequate. The debate on European regulation of rating agencies is expected to continue over the coming years, with further developments in the US likely to have a considerable impact on the discussions.

1.5 Occupational retirement provision

Occupational retirement schemes are among the major players on the financial markets. Consequently, BaFin once again paid particular attention to the regulation of these schemes in 2005.

Risk-based supervision of occupational retirement schemes.

In December 2005, the Annual General Meeting of the International Organisation of Pension Supervisors (IOPS) adopted the IOPS Principles of Private Pension Supervision according to plan. These principles set out a structure for the organisation of occupational retirement scheme supervision, as well as of private retirement schemes. The requirements cover legal powers, adequacy of personnel and financial resources, fundamental risk-orientation, transparency rules, appropriate procedures for the handling of confidential information and governance regulations. BaFin has been a member of the IOPS Executive Committee since the 2005 Annual General Meeting.

In 2005, IOPS launched a project[21] aimed at developing principles and standards for the risk-based supervision of occupational retirement schemes. The basis for this will be a comparative study examining the different risk-based supervisory models currently in use or those still under development in selected member states. BaFin plans to take part in the study by completing a self assessment.

Investment management in the occupational retirement sector.

Investment management is a key function for occupational retirement schemes. In order to ensure the performance and the security of the investments, the Working Party on Private Pensions, part of the OECD Insurance and Pension Committee, has developed Guidelines on Pension Fund Asset Management. These guidelines are based on the prudent person principle. They set out requirements with regard to investment policy, risk management, the degree of transparency required for decision-making, investment limits and valuation. The guidelines are currently being considered for adoption by the OECD Council.

1.6 Reinsurance Directive

The EU Reinsurance Directive came into force on 10 December 2005, with the member states obliged to implement it within 24 months. The Directive provides for an additional transition period

[21] Project on Core Elements of Risk Based Approach to Pension Supervision.

of a further twelve months for the solvency requirements and the obligations that apply with respect to reinsurance collateral.

Reinsurance Directive increases consumer protection.

The Directive is intended to improve the protection of policyholders. It also extends the principle of home country supervision to reinsurance companies. The Directive is part of an effort to harmonise what are currently highly dissimilar supervisory systems across the continent, a move which will strengthen both the European and the German financial markets.

Germany achieved most of its negotiation objectives. In the future, for example, the solvency rules that apply to the property and casualty insurance business will apply equally to the entire reinsurance sector, including life reinsurance. The "prudent person principle" was also incorporated into the investment provisions. Finally, it is expected that German reinsurance companies will be able to retain their existing holding structures and the additional services that they provide as part of their business activities.

2006 VAG amendment will round out German supervision of reinsurance companies.

The Reinsurance Directive is now to be implemented into national law as soon as possible, provided that there is still a need to do so. The legislature has already incorporated certain provisions, in particular those relating to authorisation to conduct business and solvency, into the Insurance Supervision Act (Versicherungsaufsichtsgesetz – VAG). The implementation of the Directive, a process which began in the autumn of 2005, completes the German supervisory system. The 2006 amendment to the Insurance Supervision Act will likely deal with the following issues, among others: limitation of the business purpose, legal form of a Societas Europaea (SE) European public limited company, financial reinsurance, special purpose insurance companies, additional supervision of reinsurance companies in insurance groups and the supervision of branches from non-member states. The amendment will also focus on the coordination and exchange of information between the EU supervisory authorities.

2 Basel II

Supplement to the Basel Accord.

The Basel Committee on Banking Supervision (BCBS) revised its framework for the new capital recommendations for credit institutions[22] (Basel II) in the year under review to include a number of new specific regulations. In cooperation with the International Organisation of Securities Commissions, national supervisory authorities and banks, the BCBS addressed a number of issues that were still unresolved when the framework was adopted on 26 June 2004. These relate, in particular, to the definition of the trading book and the capital requirements that apply to trading book transactions.

[22] International Convergence of Capital Measurement and Capital Standards: A Revised Framework.

Basel II amendment of trading book provisions.

BaFin played a key role in the creation of these amendments, helping to develop two novel procedures for the assessment of counterparty risk. These procedures allow for a more risk-adequate assessment of credit equivalent amounts, i.e. the amounts at which derivatives have to be reported for the purposes of large exposures and capital charges. The Basel Committee and IOSCO have also revised the regulations on the representation of default risk in market risk models, a move which came in reaction to the increasing market liquidity for loans and credit derivatives in certain market segments. Credit derivatives, for example, are now traded on the stock exchange. The Basel Committee and IOSCO have also set out requirements on how to value credit derivatives in a manner that takes into account varying levels of market liquidity. Further revisions relate to the distinction between the banking book and the trading book, settlement risk and the treatment of double default effects. Double default refers to cases in which with regard to receivables secured by way of personal security both the borrower and the individual personally liable for the fulfilment of the obligation, i.e. primarily the guarantor, default. As a result of this work, the Basel Committee published a document on The Application of Basel II to Trading Activities and the Treatment of Double Default Effects, in July 2005.

In the year under review, a joint Basel Committee and IOSCO working group took a detailed look at the approaches used by leading institutions in modelling the default risk from trading book positions. The working group established that, in the vast majority of cases, these approaches were still in the early stages of implementation.

In the spring of 2006, the Basel Committee intends to conduct another survey to determine how the level of compliance with capital requirements is progressing as a result of the new Basel regulations. This study will focus on the effects of the new regulations on the trading book. The basis for this assessment is the Fifth Quantitative Impact Study (QIS 5), which began in October 2005. BaFin will publish the results of the study.

Capital Requirements Directive adopted.

The European legislature adopted the Capital Requirements Directive (CRD) in 2005. It amends the Banking Directive and the Capital Adequacy Directive to implement the regulations contained in Basel II, with its more risk-oriented capital measurement, into European law. The provisions relating to trading book rules, which the Basel Committee added to Basel II last year, are already included in these amendments. The Banking and Capital Adequacy Directives now have to be translated into the EU’s official languages and are expected to be ready for formal publication in the summer of 2006. This will complete the legislative procedure at European level. The EU and EEA members states will thus be able to implement the new Basel capital requirements into national law by the specified deadline. The Basel Committee agreed a national implementation deadline of 1 January 2007. This does not

include first-time authorisation for institutions to apply one of the advanced credit risk and operational risk approaches. In these cases, the applicable deadline is 1 January 2008. The EU and, in particular, Germany remain committed to this deadline, despite the fact that the United States has decided to delay implementation of Basel II.

Continuation of committee work at CEBS level.

The completion of the legislative procedure has changed the focus of EU committee work. CEBS is now concentrating on answering questions relating to the application and interpretation of the Banking and Capital Adequacy Directives. In January 2006, CEBS published Guidelines on the recognition of External Credit Assessment Institutions.

CRD allows zero-rating of intra-group exposures.

The CRD contains a number of changes compared with the proposal by the European Commission in 2004. One key difference, for example, is the treatment of loans among institutions covered by the same protection scheme. National legislatures can now provide capital adequacy relief for institutions belonging to the same risk group: in the case of risk groups that fulfil certain criteria, national law may exempt institutions that belong to the risk group from the requirement to provide own funds backing for loans granted within the risk group. This is relevant for cooperative banks and public-sector savings banks (Sparkassen). The Commission’s proposal had only provided for a waiver of the capital requirements for intra-group exposures.

3 Solvency II and international developments

New regulatory framework introduces principle-based supervision.

Solvency II harmonises the regulatory solvency requirements for insurance companies within the EU, with the focus on safeguarding the rights of policyholders. The new system will result in a principle-based supervisory system that will focus more intensively on actual insurer risks than the current rules-based system. With its three-pillar structure Solvency II is similar to Basel II. Pillar I sets out the quantitative requirements on insurance companies, such as the calculation of technical provisions and the capital adequacy requirements. Pillar II deals with the qualitative requirements for both the companies and the supervisory authorities. This pillar contains a set of principles for the organisation of both the company and its processes, as well as for the powers of the supervisory authorities. The third pillar deals with market transparency, market discipline and the disclosure of information deemed relevant from a regulatory point of view. The focus of supervisory work in the future will be on the individual risk faced by each company. This analysis will provide a starting point for the supervision of groups and financial conglomerates.

BaFin has set up an external advisory panel composed of renowned representatives from the insurance industry, the associations and academia. BaFin is also working closely with the German Insurance Association (Gesamtverband der Deutschen Versicherungswirtschaft – GDV), for example to develop a standard model that can be used to determine Pillar I solvency capital, or in the drafting of requirements for internal models.

Solvency II framework directive expected by the end of 2007.

The Solvency II principles are expected to be anchored in a draft framework directive by October 2007. CEIOPS is currently acting as an advisor to the European Commission on the issue of the framework directive. BaFin chairs the CEIOPS Pillar II working group.

CEIOPS Pillar I working group

Since May 2005, the CEIOPS Pillar I working group has consisted of the two previous working groups for the life and non-life sectors. Over the course of the year under review, it developed technical recommendations on the quantitative elements of Pillar I and set out content-related guidelines for the first impact study (Quantitative Impact Studies – QIS). The study examines the impact of the planned solvency system on insurers' provisions. In 2006, the working group will refine its proposals on the valuation of technical provisions, the use of internal models and the structure of a future investment limit system.

Plans to improve the transparency of prudential margins in technical provisions.

The Solvency II regulations on the valuation of technical provisions are designed to make the prudential margins contained within these provisions more transparent and to harmonise provisioning practice across the EU in line, as far as possible, with the future IAS/IFRS standards on the valuation of technical provisions.

The intention is to value the technical provisions for life insurance companies on the basis of the present value of the projected future cash flows, and to add a prudential margin to the present value. The main aim of determining the present value and the prudential margin is to reduce uncertainty by using recognised actuarial methods and taking future developments into account. As far as the methods for determining the present values of the individual cash flows are concerned, CEIOPS currently prefers a risk-free yield curve prescribed by the supervisory authorities.

More risk-conscious structure for solvency capital requirements.

The prudential margin in the technical provisions ensures that policyholder interests are given adequate protection and that the respective portfolio can be transferred to another insurance company in the event of an emergency. It does not, however, take any unpredictable, sudden losses into account. As a result, every insurance company must also keep solvency capital available.

The Solvency Capital Requirement (SCR) will be structured in a far more risk-adequate fashion than the current capital requirements. As a general rule, all relevant, quantifiable risks have to be taken into account, including at least the following main risk categories: market risk, credit risk, underwriting risk and operational risk. In principle, the SCR should correspond to the capital required by an insurance company in order to perform its activities over the course of one year with a low probability of ruin. Ruin refers to a situation in which the investments measured at fair value are no longer sufficient to cover the technical provisions.

The insurance companies can calculate their required solvency capital using either a prescribed standard formula or an internal model. The idea for the standard formula is to initially perform a separate valuation of the individual risk categories and then to aggregate these values to produce an overall requirement. If the individual solvency capital components are simply added together, this results in an over-statement of the required solvency capital. This is why compensatory and diversification effects between the individual risks are to be taken into account. CEIPOS has already analysed a number of possible modelling methods for the determination of the solvency capital requirement for the main risk categories. The results of these analyses will form the basis for the impact studies on the SCR standards formula, which are planned for 2006.

BaFin has to approve the internal models, which will be assessed in a process-oriented manner. In comparison with the standard formula, this system, whereby companies calculate their own capital requirements, allows a more realistic assessment of the company's risk situation.

Capital separated into three quality classes.

CEIOPS aims to ensure that capital (actual value) and the solvency capital requirements (required value) are assessed in a consistent manner. The rules are also designed to comply with the Basel standards on banking supervision. The plan is to continue to assess own funds on the basis of a simplified balance sheet assessment. Transitional provisions are planned in light of the varying national accounting standards that apply to insurance companies across the EU.

CEIOPS plans to split capital into three quality classes (tiers). The components of the highest quality class (tier 1) can be used in full and on a permanent basis for loss absorption purposes. Tier one includes subscribed capital, capital and revenue reserves and will also include a proportion of innovative capital in the future. Own funds that have only limited potential for offsetting losses are to be included as supplementary capital in the second quality level (tier two). Finally, own funds that can only be used to cover the solvency requirement with supervisory approval are to be included in the third quality class (tier three). As in the banking supervisory system, capital limits based on the level of the highest quality class will be set within the classification system for tiers two and three.

Safety mechanisms complete risk-based supervisory system.

Despite extensive risk orientation, a number of safety mechanisms are to be added to Solvency II. These comprise two key elements: the minimum capital requirement (MCR) and minimum investment rules.

The MCR is to define a minimum capital requirement threshold that may not be breached. This provides a hard floor for SCR, even if the insurance company in question calculates SCR using an internal model. CEIOPS has recommended a transitional period during which the MCR will be set in accordance with the existing Solvency I rules. But the fact that the MCR will represent a considerably higher threshold than the current solvency requirements means that the level will have to be adjusted. Once the transitional period has ended, MCR calculation will be risk-sensitive, e.g. using a simplified and adjusted SCR standard formula.

Risk transfer through reinsurance may be partially taken into account.

The minimum investment rules are to be created in line with the “prudent person plus” principle. The plan is to impose a number of qualitative requirements on the investment management system. There are also plans to introduce restrictions on investments in certain asset classes and certain categories of eligible assets.

The determination of the SCR and MCR will also take into account risk minimisation through reinsurance and other risk minimisation methods. The basis for this is the actual risk transfer, i.e. risks ceded and accepted by means of reinsurance or other risk minimisation methods, and not the legal structure or accounting treatment of these risks. If an insurance company uses an internal model in order to calculate the SCR, it would be able to include risk minimisation without any particular restrictions. In the case of the standard formula for SCR and the formula for the MCR, insurance companies are unlikely to be able to fully include risk minimisation, due to the more approximate nature of the risk modelling system.

CEIOPS Pillar II working group

This CEIOPS working group is developing management, risk management and internal control requirements in accordance with Solvency II. The principle of proportionality applies in all cases: although the same supervisory principles apply to all companies, they will be applied differently depending on the complexity of the company in question.

Insurance companies to install risk management systems.

Solvency II will require every insurance company to set up a risk management system that captures and assesses all material risks and keeps these at a reasonable level. The insurance companies have to use an internal assessment process to map the risks that apply in all areas of the company. The management of the company must be given an opportunity to identify causes, effects, probabilities and the scale of the risks. In the overall assessment risk-reducing measures such as hedging or reinsurance are also to be taken into account. In the event that the company in question does not meet the requirements, the supervisory authorities will be given the opportunity to impose internal limits or additional capital requirements until any deficiencies have been corrected.

Solvency II will demand clear structures for competencies and decision-making processes.

The management must set up a framework providing clear structures for competencies and decision-making processes. This will involve structuring internal control mechanisms based on the nature, size and complexity of the company. The insurance companies are to perform their internal controls separately from their day-to-day business and risk management operations and must ensure timely, complete, accurate and consistent reporting.

Supervisory intervention if solvency control levels are exceeded.

The new supervisory system will involve the addition of Solvency Control Levels. In the event that a company falls below certain capital adequacy thresholds, supervisory measures will be taken. A number of different supervisory measures will be allocated to each level in order to make these regulations transparent, and to ensure that they are applied in a uniform manner across the EU. This will mean that the standard supervisory instruments have to be incorporated into the respective national legal systems. The first Solvency Control Level will apply if actual solvency approaches the SCR level. The supervisory authorities can then use a principle-based approach to decide on the steps they want to take. The second level comes into play if an insurance company falls below adjusted SCR.[23] Depending on the extent to which adjusted SCR has been breached, the supervisory authorities may demand business, financial or capital procurement plans, limit capital distributions or prohibit business activities that are deemed to be too risky. If a company breaches the third threshold, the MCR, the working group intends that supervisory authorities take action using a rules-based approach. The company in question will have a few days in which to submit a capital procurement plan, otherwise it will face a prohibition of new business and run off. Depending on the national law of the country in question, the supervisory authorities will be able, in such cases, to demand that the company transfer portfolios or to authorise a reduction in the guaranteed benefits.

The Supervisory Review Process will allow the supervisory authorities to monitor company requirements.

The Supervisory Review Process (SRP) is designed to allow supervisory authorities to monitor whether or not insurance companies meet certain requirements with regard to their capital resources, corporate management, risk management and internal controls. The SRP will involve assessing whether or not the level and quality of the desired capital components is adequate given the company’s internal objectives, and whether or not the company’s actual risk profile has been presented realistically in both quantitative and qualitative terms.

Supervisory authorities to receive new supervisory powers.

The supervisory authorities now have to be granted additional powers to reflect the principle-based approach of Solvency II. CEIOPS has developed a number of recommendations in this area based on the standard risk management cycle: these include giving the supervisory authorities the power to request risk models or risk data if not already available, or require that an insurance company use full or partial internal models. Until the risks are eliminated or factored in, the supervisory authorities should be able to restrict new business or increase/decrease capital requirements.

[23] SCR plus a deficit charge, e.g. in the risk management system.

Depending on the amount of the deficit, CEIOPS’ recommendations include granting the supervisory authorities the power to request business plans or to demand the dismissal of an actuary or manager.

CEIOPS Pillar III working group - Accounting

Pillar III working group focusing on market discipline, market transparency and reporting obligations.

In 2005, the CEIOPS Pillar III working group – accounting, tackled the issues of market discipline, market transparency and regulatory reporting. The idea is to bring Solvency II as closely into line with the IFRS and Basel II as possible, and to harmonise reporting by insurance companies to the supervisory authorities. In the case of companies that do not report in accordance with IFRS, the working group recommends prudential adjustments in order to make the national accounting standards compatible with Solvency II and IFRS.

Under Solvency II, the supervisory authorities require information beyond the scope of the publicly available data in the annual financial statements. This includes information on the structure of the company, its risk profile and its corporate control processes and strategies. The supervisory authorities require both historical and projected information (stress tests, scenario analyses) in order to assess the extent to which an insurance company is meeting the requirements and objectives of Pillars I and II. The management of the company can also benefit from this process by using the information for management purposes.

QIS 2005

Quantitative Impact Studies assess the ability of insurance companies to bear the financial impact of the CEIOPS recommendations.

The first QIS was launched in the fourth quarter of 2005 and compared the technical provisions in accordance with the current national legislation with the provisions that would be required under the planned new valuation principles. This involved, among other things, calculating the expected value provisions and the provisions at confidence levels of 75% and 90% respectively. The participants were also asked to explain the methodology used in this process. All life, health, property/casualty and reinsurance companies that are subject to German financial supervision participated in the German partial assessment led by BaFin. The second QIS, which will also test the MCR and SCR capital requirements, will be performed in mid-2006. Further QISs will follow.

4 Accounting and enforcement

4.1 Developments in international accounting

Fair value option

As far back as the end of 2004, the European Commission adopted a regulation endorsing IAS 39[24] with two exceptions: one relating to the full fair value option and the other to hedge accounting. The Commission provided the exception to the provisions relating to the fair value option mainly because of concerns expressed by the European Central Bank and the supervisory authorities represented on the Basel Committee, including BaFin. The International Accounting Standards Board (IASB) recognised these concerns and started work on the preparation of an amended IAS 39 standard with a restricted fair value option. The IASB published an amended version of IAS 39 in June 2005. This amended standard met with the support of the supervisory authorities and has since been adopted by the EU. The revised standard includes a restricted option allowing financial instruments that meet certain criteria to be irrevocably allocated on initial recognition to a particular category measured at fair value[25]. One criterion, for example, states that the designation must eliminate or substantially reduce artificial balance sheet distortions. Embedded derivatives that fulfil certain criteria can also be measured at fair value under the new regulation. On the whole, the amended version of IAS 39 will make it easier to present "economically matched positions".

The amended IAS 39 standard applies retroactively as of 1 January 2005, meaning that companies can apply the revised standard to their 2005 financial statements. The Basel Committee has since also published a draft[26] which is designed to provide a guideline for the use of the fair value option by banks' risk management departments. The Committee's recommendations establish a close link between the use of the option and an adequate internal bank risk management system. At the same time, the Committee highlights the fact that the paper does not include any additional accounting requirements, but rather focuses on risk management and regulatory capital issues.

The second EU exception for individual hedge accounting rules remains in force. The Commission has again, however, emphasised the need for both the European Banking Federation and the IASB to find a technical solution as soon as possible. Companies are entitled to continue application of the exceptional rule in the interim.

[24] Financial Instruments: Recognition and Measurement.
[25] Financial Asset or Financial Liability at Fair Value through Profit or Loss.
[26] Supervisory Guidance on the Use of the Fair Value Option by Banks under International Financial Reporting Standards.

Adoption of IFRS 7

In the year under review, the EU also endorsed IFRS 7[27], which was published by the IASB in 2005.[28] The IAS 1 Presentation of Financial Statements was also amended.

The amendment of IAS 1 relates to qualitative information on objectives, methods and processes in the management of capital resources. Companies now also have to report on the minimum capital requirements set forth by the supervisory authorities. This includes, among other things, providing general qualitative information on the type of these requirements, as well as on the measures taken by the company in question to ensure that it complies with these requirements.

The new IFRS 7 improves market transparency. The aim is to ensure that the relevant information is passed on. In particular, companies are now obliged to provide more information on the type and scale of risks from financial instruments. The new standard creates a requirement for minimum information on risk management, risk concentrations and the quantification of credit, liquidity and market risk. For example, sensitivity analyses will be disclosed for market risks. As far as the portrayal of credit risk is concerned, companies will have to provide information on the market value of the collateral provided if assets are affected by a default or if a value adjustment is required.

Amendment of IFRS 3

The amendment of IFRS 3 (Business Combinations) and further IASs (IAS 27, IAS 37 and IAS 19) were also on the IASB's agenda in 2005. The changes are particularly significant because they confirm the trend towards the increased use of fair values in the international accounting standards. This trend is most visible in the valuation basis for business combinations. In the past, these valuations were based on a company's historical cost, whereas now, divergent fair values can also be applied. Furthermore, goodwill will in future no longer be calculated based on the proportion attributable to the acquiring company, but rather always at 100% (known as the Full Goodwill Method). Thus, acquiring companies must always calculate goodwill for the entire target company, even if the stake acquired is less than 100%. Further amendments relate, among other things, to the removal of what is known as the "reliability of measurement" criterion for intangible assets acquired in a business combination. The comments with regard to these recommendations were highly critical. In particular, it would seem that the IASB has failed to address in detail the issue of fair value concepts in the context of business combinations. The abolition of the "reliability of measurement" criterion also appears problematic. On the whole the Full Goodwill Method seems relatively impractical. It remains to be seen how matters will proceed.

[27] Financial Instruments: Disclosures.
[28] The standard summarises the disclosure requirements for IAS 32 Financial Instruments: Disclosures and Presentation and the complete IAS 30: Disclosures in the Financial Statements of Banks and similar Financial Institutions.

Management Commentary

Another IASB project is the Management Commentary discussion paper, which was published in November 2005. The Management Commentary is considered to be the equivalent of the Management Discussion and Analysis (MD&A) required by the SEC, or the management report in Germany. The IASB defines the Management Commentary as accompanying information to the annual financial statements. It should contain information on the main trends and factors that influenced the development, performance and position of the company in the period under review. In addition, however, it should also highlight trends and factors that may affect future performance. The project is intended to harmonise international practice with respect to the management report section.

4.2 Enforcement

Establishment of the European Enforcers Coordination Session.

Listed companies that are subject to the law of an EU member state are obliged to prepare their consolidated financial statements in accordance with the IFRS for all financial years as of 1 January 2005. In order to enforce the accounting standards, CESR established the European Enforcers Coordination Session (EECS) in 2005. The EECS is a permanent body of the CESR-Fin, the CESR working group which is responsible for ensuring compliance with accounting standards. All EU and EEA enforcers are members of the EECS and can use the forum to discuss practical accounting issues. These enforcers are either public regulators, i.e. CESR members, or private organisations, depending on the supervisory structure. A two-tier enforcement procedure has been in place in Germany since July 2005, meaning that both a member of the German Financial Reporting Enforcement Panel (Deutsche Prüfstelle für Rechnungslegung e. V. (DPR)) and a BaFin representative are present within the EECS on behalf of Germany. The EECS meetings in the year under review were aimed primarily at coordinating uniform enforcement practices and strategies.

Enforcement of international accounting standards to be unified.

CESR also wants to unify enforcement of the international accounting standards. The aim is to harmonise comparable methods, i.e. to align both the principles for company selection, and enforcement methods. The Guidelines on the Application of Selection Methods bring CESR one big step closer to achieving this objective. The risk-oriented approach used by German enforcers complies with the new criteria. At present, CESR is still discussing the issue of comparable powers for European enforcers. The issue of cross-border supervision is also on the agenda for 2006.

Enforcement database.

Since August 2005, a database has been available to EECS members which will, in the future, provide an overview of the decisions by the national enforcement authorities. At present, in the spring of 2006, the database contains more than twenty decisions. In order to ensure uniform enforcement of the IFRS within and outside of Europe, IOSCO is also planning an electronic decision database for the second half of 2006.

5 International cooperation

5.1 Memoranda of Understanding and technical cooperation

The international activities of the companies supervised by BaFin necessitate constant and effective cooperation with foreign supervisory authorities. This is why BaFin concludes supervisory agreements, in the form of "Memoranda of Understanding" (MoU), with other supervisory authorities and international organisations.

IOSCO Multilateral Memorandum of Understanding becomes international benchmark.

In April 2005, IOSCO declared its Multilateral Memorandum of Understanding (MMoU) as the international benchmark for the cross-border exchange of information between securities supervisory authorities. All IOSCO members are under an obligation to apply to join the MMoU by 31 December 2009, or at least to perform an assessment in order to detect possible obstacles. Countries which do not fulfil the signing criteria will be listed in Appendix B of the MMoU. These countries must endeavour to resolve the obstacles identified. Furthermore, every supervisory authority that applies for IOSCO membership also has to apply to join the MMoU. IOSCO's new line has received political backing from the Financial Stability Forum and the G7 leaders. Its main aim is to wash out financial havens, primarily in offshore financial centres.

Plans underway for IAIS-MMoU.

The IAIS took the decision, at its 2005 annual conference, to improve the exchange of information and cooperation between IAIS members. A working group headed by BaFin has since been examining the possibility of a MMoU.

Side letter to the MoU with Italy.

In 2005, BaFin concluded a side letter on the supervision of the UniCredit/HVB-Group with Banca d'Italia. This supplements the existing Memorandum of Understanding with the Italian supervisory authority.

Two new cross-sector MoU.

BaFin also signed cross-sector, bilateral Memoranda of Understanding with the USA (Office of Thrift Supervision) and Australia in 2005. Cross-sector MoU are already in place with the supervisory authorities from Malta, Luxembourg (with regard to Clearstream-Group) and Canada.

BaFin has concluded MoU in individual areas with the following countries:

Table 2
Bilateral MoU

Banking supervision		Insurance supervision		Securities supervision	
China	2004	Romania	2004	Slovakia	2004
Poland	2004	Lithuania	2003	Canada Quebec	2003
South Africa	2004	Estonia	2002	Cyprus	2003
Romania	2003	Czech Republic	2002	Jersey	2001
Czech Republic	2003	Hungary	2002	Russia	2001
Estonia	2002	China	2001	South Africa	2001
Slovakia	2002	Lativa	2001	Singapore	2000
USA	2002	Slovakia	2001	Turkey	2000
Argentina	2001			Brazil	1999
Lithuania	2001			Poland	1999
Slovenia	2001			Argentina	1998
South Korea	2001			Australia	1998
Jersey	2000			China	1998
Lativa	2000			Hong Kong	1998
Hungary	2000			Portugal	1998
Hong Kong	1997			Czech Republic	1998
Portugal	1996			Hungary	1998
Finland	1995			Italy	1997
Norway	1995			Spain	1997
Austria	1995			Taiwan	1997
Sweden	1995			USA SEC	1997
UK	1995			USA CFTC	1997
Belgium	1993			France	1996
Denmark	1993				
Greece	1993				
Ireland	1993				
Italy	1993				
Luxembourg	1993				
Netherlands	1993				
Spain	1993				
France	1992				

5.2 Companies operating on a cross-border basis

CEBS guidelines on supervisory cooperation

Decisions taken by supervisors in the country of origin apply in host countries.

The consolidated supervision of groups of institutions demands intensive cooperation between the supervisory authorities in both the country of origin and the host country in order to identify and assess the risks incurred by the group in question and, where necessary, to impose additional capital requirements on the latter. To this end, cooperation between the European supervisory authorities is currently the subject of a major overhaul as a result of the increasing centralisation of risk management processes for banking groups. For the first time, through the Capital Requirements Directive (CRD), decisions made by the supervisory authorities in the country of origin (consolidating supervisor) now apply directly in the host countries. The European Parliament conducted a consultation process before initiating such inroads into national sovereignty of the supervisory authorities. This then formed the basis for the CEBS recommendations for cooperation between the authorities responsible for consolidated supervision and the supervisory authorities in the host countries. The recommendations include numerous rights, but also responsibilities for the supervisory authorities involved. One of the responsibilities of the consolidating supervisor according to CEBS is to develop a communication strategy for model approval, as well as for ongoing

supervision. This strategy covers the entire exchange of information during the supervisory process, as well as the agreement on technical procedures with regard to meetings, post and e-mail, and video or teleconferences. It is the responsibility of the consolidating supervisor to plan joint assessments with the supervisory authorities in the host country, in particular with regard to the implementation of Basel II. The guidance paper is designed to be recognised mutually as a basis for cooperation and is to be developed further to produce a Multilateral Memorandum of Understanding.

Basel II spring campaign

IRBA modules require extensive consultation.

For Germany's institutions as well, the approval process for the Basel II requirements does not stop at the German border. A number of banks also want to use IRBA modules abroad, meaning that numerous foreign supervisory authorities have an interest in evaluating (as well as the right to evaluate) these modules. German institutions that operate internationally are naturally just as keen as their competitors for evaluations to go as smoothly as possible with the minimum resulting burden. It is even more important that their systems are not subject to varying supervisory requirements. This is why BaFin invited the relevant foreign supervisory authorities to a number of meetings during the year under review. The aim of this spring campaign was to come to an agreement on when and how BaFin's foreign counterparts will be involved in the Basel II approval processes for German banks. BaFin organised a total of six supervisory conferences in Bonn and invited all of the supervisors responsible worldwide for the foreign units of the six German banks with the most extensive international activities. BaFin also hosted regional conferences in New York, Singapore and Vienna, the latter in cooperation with the Austrian Financial Market Authority (FMA).

The international conferences gave the participating institutions an opportunity to report on the current status of their Basel II preparations to a large group of the host country supervisors responsible for supervising them and to answer questions from the supervisory authorities. BaFin held a presentation for the participating host country supervisors outlining the current German legal framework and the progress made by the individual institutions in implementing the Basel II requirements from a supervisory point of view. Finally, it held a discussion on its ideas for cooperation between home country and host country supervisors.

Merger of HVB and UniCredit

BaFin cooperating with Banca d'Italia.

On 28 June 2005, the highest banking supervisory authorities of Italy and Germany met in Rome to discuss the planned merger between UniCredito Italiano (UniCredit) and Bayerische Hypo- und Vereinsbank (HVB). One month prior to the meeting, both banks had announced the Italian institution's plans to acquire a majority of the shares in Germany's second-largest commercial bank. UniCredit and HVB are both leaders in their home markets, and

both hold major interests in Bank Austria Creditanstalt AG in Austria, as well as in numerous central and eastern European countries.

Assessment of Shareholders.

On 21 July 2005, BaFin and Banca d'Italia gave the green light to the merger between HVB and UniCredit. According to section 2b KWG, any persons or companies who intend to acquire a qualified participating interest in a German credit institution must inform BaFin without delay. BaFin can prohibit the acquisition if it has reason to believe that the interested party is not reliable, or if other reasons lead it to believe that the institute will not be managed adequately and with due care and attention. Banca d'Italia and BaFin worked closely during the course of their respective approval processes, which allowed BaFin to include information that it received on the UniCredit group in its assessment of shareholders. UniCredit's takeover of HVB took legal effect on 17 November 2005.

New agreement with Banca d'Italia.

Both supervisory authorities understand that they can only effectively supervise the new banking group, which boasts total assets of over €700 billion and a workforce of around 124,000, if they cooperate closely with each other. The Italian and German supervisory authorities defined their respective roles in the side letter to the MoU: Banca d'Italia is the group's "consolidating supervisor", while BaFin, together with the Bundesbank, remains the responsible supervisor for the HVB sub-group. The key to the cooperation is that the supervisory authorities exchange all important information, meet on a regular basis, plan their supervisory activities in consultation with each other and perform joint audits.

The supervisory authorities in the countries in which major UniCredit group subsidiaries operate are also included in the exchange of information and the trusting working relationship. This applies, in particular, to the authorities in Austria and Poland, which represent the new group's largest foreign markets after Germany.

Close cooperation as well in the changeover to Basel II.

International cooperation will be put to a particularly important test when the institutions complete their company-wide transition to the Basel II capital adequacy regimes. All of the institutions involved in group-level supervision will then have to work together to tackle the subsequent comprehensive inspection and assessment tasks.

BaFin as European coordinator

BaFin has, for the first time, assumed the role of the European "coordinator" for a number of banking groups. The Banking Directive sets out the need for a supervisory authority to act as a coordinator if a credit institution based outside of the European Economic Area has subsidiaries or branches in several EEA member states. The coordinator is responsible for ensuring that all of the European supervisory authorities affected consult with each other before taking action in certain specific areas. It determines

whether or not the supervisory system in the non-member state in which the parent company in question is based meets EU standards. If the coordinator concludes that the system in that country is not on a par with EU standards, it consults with the responsible national supervisory authorities in the EEA to decide whether or not, and if so which, supervisory measures should be applied. It can, for example, call for the treatment of the subsidiaries and branches in the EEA as an independent banking group. The coordinator is normally the national supervisory authority that supervises the credit institution with the highest amount of total assets.

BaFin makes decisions with regard to the equivalence of the non-member state supervisory system after gathering detailed information on the supervisory regime in question. When making a decision, it also takes into account the previous success of cooperation with the respective authorities. BaFin has already made one positive decision with regard to equivalent supervision.

Table 3

Foreign banks in the Federal Republic of Germany

(As at 31 December 2004 in brackets)

	Country	Bank subsidiaries	Subsidiaries of non-banks	Branches	EU branches	Representative offices
1	Andorra					1 (1)
2	Austria	1 (1)			10 (9)	5 (4)
3	Australia			1 (1)		
4	Belarus					1 (1)
5	Belgium	2 (1)			2 (2)	
6	Bosnia-Herzegovina					1 (1)
7	Brazil			1 (1)		1 (1)
8	Canada		1 (1)			1 (1)
9	China			3 (3)		2 (2)
10	Croatia					0 (1)
11	Czech Republic					1 (1)
12	Denmark				3 (3)	1 (1)
13	Egypt	1 (1)				
14	Finland				1 (1)	
15	France	5 (5)			17 (16)	11 (12)
16	Great Britain	5 (4)	5 (5)		16 (18)	3 (3)
17	Greece	1 (1)			2 (3)	
18	India			1 (1)		
19	Iran	1 (1)		3 (3)		
20	Ireland				3 (2)	4 (3)
21	Israel					3 (4)
22	Italy	3 (2)			4 (4)	2 (3)
23	Japan	2 (2)		4 (4)		4 (4)
24	Jordan	1 (1)				
25	Latvia				1 (0)	0 (1)
26	Liechtenstein	1 (1)				0 (1)
27	Luxembourg	1 (1)			1 (1)	
28	Mongolia					1 (1)
29	Morocco					0 (3)
30	Netherlands	6 (5)	1 (1)		16 (12)	
31	Norway				1 (1)	
32	Pakistan			1 (1)		
33	Phillipines					3 (3)
34	Portugal					6 (7)
35	Russia	1 (1)				3 (5)
36	Saudi Arabia					0 (1)
37	Slovenia	1 (1)				
38	South Africa	1 (1)				1 (1)
39	South Korea	2 (2)				3 (3)
40	Spain	1 (1)			1 (1)	7 (8)
41	Sweden		1 (1)		1 (1)	
42	Switzerland	6 (7)	2 (1)			2 (2)
43	Tajikistan					1 (1)
44	Turkey	4 (3)	1 (1)	0 (1)		4 (4)
45	U.S.A.	7 (8)	5 (5)	5 (5)		
46	Yugoslavia					1 (1)
		53 (50)	**16 (15)**	**19 (20)**	**79 (74)**	**73 (85)**

Reforms due to MiFID and overall concept for funds

Home country supervision for cross-border services.

MiFID has initiated a paradigm shift in the supervision of rules of conduct. Here as well, home country supervision is the new credo for cross-border services. The rules of conduct of the host country are now only to be applied if a branch office in that country is providing the services. MiFID has also extended the scope of primary services for which a European passport can be issued, to include, e.g. investment advisory services, investment services relating to commodity derivatives, credit derivatives and other exotic derivatives.

Notification procedures for investment funds.

In October 2005, CESR published a consultation paper[29] containing guidelines that set out, in detail, the notification to be made to host country supervisors in the event of the cross-border distribution of investment units. Thus, there now exists a uniform EU-wide concept for funds.

New supervisory concept for insurance groups and financial conglomerates.

The CEIPOS Group/Cross Sector working group is currently working on a new supervisory concept for insurance groups and financial conglomerates. It recommends the establishment of MCR and SCR at group level, in accordance with the requirements for individual companies.

In this respect, the approval of internal models is particularly important to allow groups to present a realistic picture of their risk situation. A group supervisor, with responsibility for both the exchange of information and the planning and coordination of supervisory activities, will also be designated in order to ensure that all individual company supervisors receive any relevant information on the group. This responsibility covers, for example, the assessment of the group's financial situation, internal control systems and risk management. The requirements for internal control and risk management systems for groups will be based on the future Pillar II principles.

5.3 Technical cooperation

In 2005, BaFin once again offered support and advice to foreign supervisory authorities in the establishing of supervisory systems. BaFin welcomed several delegations to fact-finding visits, including, for example, the Russian Federal Financial Markets Service, the South Korean Financial Supervisory Service – FSS, the Israeli Capital Markets, Insurance and Savings Division and the Indonesian banking supervisory authority.

The German Federal Ministry of Finance signed an agreement with its Chinese counterpart in 2005 as a framework for technical cooperation in financial supervisory matters. This agreement applies alongside the existing MoU in the banking, insurance and securities sectors. The agreement is supplemented by a work programme that provides for concrete advisory services in all three supervisory areas. BaFin held a number of presentations on deposit guarantee schemes and anti-money laundering measures, among other things, at the People's Bank of China.

As part of the EU twinning programme, Germany is the partner for the Turkish Capital Markets Board. A long-term advisor started work in Ankara in 2005 and is supported by several short-term BaFin experts.

[29] Guidelines for Supervisors Regarding the Notification Procedure according to Section VIII of the UCITS Directive.

5.4 Offshore financial centres

More international pressure on offshore financial centres.

In the year under review, BaFin continued to go to considerable lengths to improve the exchange of information with countries which have a high capital inflow from abroad because of the low degree of financial market regulation. Faced with political pressure from the Financial Stability Forum, the FATF and other organisations, some of these countries have already made substantial efforts to bring their supervisory systems into line with international standards. However, a lot of work remains to be done in some areas. The Parmalat scandal, in which dubious offshore subsidiaries of the Italian food group played a key role, increased the pressure on non-cooperative countries. With the political backing of the Financial Stability Forum, IOSCO engaged in an intensive dialogue with some of the offshore financial centres deemed to pose a particular risk. IOSCO wants to help these countries engage in and expand international cooperation in the context of illegal securities activities. A CESR working group is also maintaining intensive contact with problem countries and is promoting cooperation between these countries and other supervisory authorities. Non-cooperative countries are also creating problems in the banking and insurance sectors. As a result, the 3L3 committees CEBS, CEIOPS and CESR met in August 2005 to examine the factors that are making cooperation more difficult and to issue recommendations for action to the Economic and Financial Committee. The EFC has submitted these recommendations to the European Parliament and has requested its assistance in the battle against non-cooperative countries.

5.5 Conferences

Integrated Financial Supervisors' Conference, Kronberg

On 2-3 June 2005, BaFin invited the presidents of 15 supervisory authorities to the seventh Integrated Financial Supervisors' Conference in Kronberg. The participants used a number of panels to discuss issues that are particularly important to integrated financial supervision. The Financial Literacy and Accounting panels focused on future supervisory strategies, while the Accountability panel, for example, allowed the integrated supervisory authorities to exchange experiences. Another panel at the conference demonstrated that the degree of detail in the supervisory objectives varies from authority to authority. All of the authorities, however, are faced with the difficulty of finding appropriate indicators to measure the extent to which these objectives have been achieved.

Second IOSCO Technical Committee Conference

The second IOSCO Technical Committee Conference was held in the Alte Oper opera house in Frankfurt am Main on 5-6 October. This annual conference enables dialogue with international industry at the highest level, allowing priorities to be set for the further development of securities law. BaFin hosted the 2005 conference,

which followed the 2004 conference in New York. The motto of the conference: "Global rules – local supervision – How can IOSCO fill the gap? – A dialogue between regulators and market participants".

More than 300 high-profile representatives from securities supervisory authorities, issuers, intermediaries and academia held talks with various speakers in six panels, together with investor representatives and members of the press. The main topic was the challenge faced by the supervisory authorities with respect to internationally integrated securities markets, in particular the issues between Europe and the USA. The conference also tackled the issue of IOSCO's responsibility as an international securities standard setter, adequate supervision of cross-border activities by market participants and IOSCO's programme of measures following the spectacular company collapses over the past few years. The next conference in November 2006 will be held in London.

IV Supervision of insurance undertakings and pension funds

Dr. Thomas Steffen,
Chief Executive Director
of Insurance Supervision

1 Basis for supervision

1.1 Authorised insurance undertakings and pension funds

The number of insurance undertakings subject to supervision by BaFin fell in 2005 to total 652. Of these companies, 632 were actively conducting business, while the remaining 20 were not. The description of 2005 business development includes the public-law insurance undertakings subject to supervision by the individual federal states (nine of which were actively conducting business and two of which were not).

A sector breakdown is provided in the table below:

Table 4
Number of supervised insurance undertakings (IU) and pension funds[30]
(Prior-year figures in brackets)

	Active insurance undertakings (IU)			Inactive IU		
	Federal supervision	**State supervision**	**Total**	**Federal supervision**	**State supervision**	**Total**
Life IU	104 (105)	3 (3)	107 (108)	9 (10)		9
Pensionskassen	160 (158)	0 (0)	160 (158)	0 (0)		0
Death benefit funds	41 (41)	0 (0)	41 (41)	1 (1)		1
Health IU	53 (54)	0 (0)	53 (54)	0 (0)		0
Property/casualty IU	227 (231)	6 (6)	233 (237)	6 (5)	2	8
Reinsurance undertakings	47 (44)	0 (0)	47 (44)	4 (4)		4
Total	632 (633)	9 (9)	641 (642)	20 (20)	2	22 (20)
Pension funds	24 (24)	0 (0)	24 (24)	0 (0)	0	0

[30] The data does not include small mutual societies (kleinere Versicherungsvereine auf Gegenseitigkeit) which operate on a mainly regional basis and are subject to supervision by the individual federal states (see BaFin statistics for 2004 – primary insurance undertakings Page 8, Table 5).

Table 5
Life insurers from the EEA

UK	4
thereof Gibraltar	1
Liechtenstein	3
Spain	3
Netherlands	2
Belgium	1
France	1
Ireland	1
Italy	1
Portugal	1
Slovakia	1
Czech Republic	1

Table 6
Property and casualty insurers from the EEA

UK	12
thereof Gibraltar	3
Ireland	9
Belgium	6
Netherlands	4
Italy	3
Luxembourg	3
Malta	3
Slovakia	3
Denmark	2
Estonia	2
Liechtenstein	2
Poland	2
Sweden	2
Slovenia	2
Czech Republic	2
Hungary	2
France	1
Lithuania	1
Austria	1

Life insurers

In the year under review, BaFin authorised one public limited company to conduct life insurance business. A Luxembourg-based life insurance undertaking also set up a branch office. 19 life insurance companies from other EEA countries registered to provide services in Germany (previous year: 11), and a number of service providers expanded their business activities.

Property and casualty insurers

BaFin granted two public limited companies authorisation to conduct property and casualty insurance business in 2005. One of these companies is a primary insurance captive, i.e. an insurance company whose business relates exclusively, or primarily, to covering the risks of a particular company or group. Foreign property and casualty insurers from the EU established three branches, two from the UK and one from France. 62 insurance undertakings from the EEA registered to start providing services in Germany (previous year: 45). Furthermore, a number of insurance undertakings previously authorised to provide services registered expansions of their business operations. Compulsory insurance is still only offered on a small scale, and is usually limited to motor vehicle liability insurance. Also in 2005, a number of insurance companies ceased provision of services in Germany.

Reinsurers

BaFin granted authorisations to two reinsurance undertakings in 2005, for the first time in accordance with the new supervisory and authorisation regulations for reinsurance undertakings set out in section 119 (1) of the Insurance Supervision Act (Versicherungsaufsichtsgesetz – VAG).

Pensionskassen and pension funds

BaFin authorised three Pensionskassen – two public limited companies and one mutual society – to take up business in the year under review. One public-law institution is now also subject to supervision by BaFin. No new authorisations were granted to pension funds.

1.2 Interim reporting

Since 1995, insurance undertakings have been reporting selected accounting and portfolio data to BaFin, or to the former Federal Insurance Supervisory Office (BAV), on a quarterly basis. Experience with the data from previous financial years shows that, partly for systematic reasons, the preliminary figures submitted to BaFin often vary from the final figures. Consequently, this chapter will compare the preliminary data for 2005 with the preliminary data from 2004.

1.2.1 Business development

Life insurers

New policies with the first premium paid fell to 7.2 million new contracts.

In the area of direct life insurance, newly activated policies were down on the levels recorded in previous years, from 11.6 million to 7.2 million new contracts. This was due to the sharp drop in new business for "traditional" mixed endowment policies, as well as for annuities and other life insurance. The underwritten amount of new insurance policies fell by 34.7% to total €210.6 billion (2004: €322.6 billion).

The share of mixed endowment insurance as a proportion of new contracts fell from 30.4% to 22.2%. Term insurance rose to 30.5% as compared to 20.4% in the previous year, while the contribution from retirement savings plans and other life insurance fell from 49.2% to 47.2%. Endowment insurance comprised 12.9% of the underwritten amount on new insurance policies, down from 22.6%. Term insurance rose from 23.6% in 2004 to 35.4%, while the contribution from retirement savings plans and other life insurance fell to 51.7% from 53.8%.

Early withdrawals (surrender, conversion into paid-up policies and other early withdrawals) affected 3.7 million contracts, as compared with 3.9 million contacts in 2004. The total underwritten amount accounted for by these early withdrawals fell by 2.8% to €110.5 billion. There was an above-average decline in early withdrawals from endowment policies: 7.9% in terms of policy numbers and 15% with respect to the underwritten amount.

Total policies fell slightly to 94 million.

The number of direct life insurance policies totalled 94.0 million contracts at the end of 2005 (-0.6%), with a total underwritten amount of €2,336.7 billion (+1.9%). The share of mixed endowment policies continued to fall, from 56.9% to 55.0%, in terms of the number of contracts, while, in terms of the total underwritten amount, the proportion accounted for by these policies fell from 47.3% to 44.7%. The term insurance portion remained almost constant at 15.6% in terms of the number of contracts, and 20.3% in terms of the underwritten amount. The share made up of retirement savings plans and other life insurance rose from 27.4% in 2004 to 29.5% in terms of the numbers, and from 33.3% to 35.0% in terms of the underwritten amount.

The gross premiums written in direct insurance business rose by 5.6% to €71.7 billion.

Health insurers

Gross premiums written increased to €27.3 billion.

Gross premiums written in direct health insurance business increased by 3.5% to €27.3 billion in 2005 (2004: +6.7%). Payments for insurance claims from the 2005 and previous financial years were up 4.4% to €16.5 billion. Thus, the rate of increase for all claims payments was slightly higher than the rate of premium growth.

Property and casualty insurers

Gross premiums written increased slightly to €58.9 billion.

In 2005, property and casualty insurance undertakings saw gross premiums written in direct insurance business increase slightly to €58.9 billion, up 0.5% on the previous year.

Gross expenditure for claims relating to 2005 increased by 3.0% (2004: -3.0%) to €19.7 billion, while gross expenditure for claims relating to previous financial years fell by 6.7% (2004: -10.6%) to €12.8 billion. Gross provisions relating to individual insurance claims from the year under review finished 1.5% lower than in 2004 at €13.8 billion. Gross provisions relating to individual claims from previous years were down 2.3% to total €41.4 billion.

By far the largest area was motor vehicle insurance, with gross premiums written totalling €21.9 billion. This represents a drop of 2.8% in 2005, following a slight increase of 0.6% in 2004. Total gross payments for insurance claims from 2005 were down 1.1%, and payments made for prior-year claims fell by 3.6%. Gross provisions relating to individual insurance claims from the year under review fell by 1.7% after an increase of 0.9% in the previous year. Gross provisions for individual claims outstanding from previous years were up 1.1% (2004: 5.3%).

In the area of general liability insurance, property and casualty insurance undertakings collected total premiums of €7.6 billion (+4.3%). For insurance claims from the year under review, the companies paid out 2.9% more, and for prior-year claims, 5.0% more. Gross provisions relating to individual claims, which are particularly important in this insurance class, fell by 16% with regard to outstanding claims from the reporting year (2004: +5.2%) and by 7.8% in relation to outstanding claims from previous years (2004: +6.7%).

In the area of fire insurance, the undertakings in question collected gross premiums of €2.0 billion (-2.7%). Gross expenditure for claims from 2005 rose by 19.0%, while gross provisions for individual claims from the year under review were up 7.1%. For insurance claims from previous years, the undertakings paid out 15.9% less than in 2004, with provisions down by 15.7%.

Viewed together, comprehensive residential buildings insurance and comprehensive household insurance generated premiums of €6.5 billion (+3.0%). Expenditure for 2005 claims were down 4.2% on the previous year, while provisions increased by 2.8%. Expenditure for claims from previous financial years were down 8.3%, while the provisions for claims relating to previous financial years remained virtually unchanged as against the 2004 level.

Premiums from general accident insurance totalled €6.0 billion (+0.8%). Gross expenditure for claims from the year under review increased by 12.6%, while expenditure for claims from previous years fell by 1.3%. Gross provisions for individual claims outstanding from 2005 increased by 2.1%, while provisions for prior-year claims remained largely on a par with 2004.

1.2.2 Investments

For the sector as a whole, total investments increased by 5.8% in 2005 (2004: +3.1%) to €1,155.6 billion (2004: €1,092.1 billion). The proportion of properties, however, continued to decline, falling from 2.2% to 2.1% despite the 1.5% increase in the book value of property investments. The book value of shares in affiliated companies increased by 2.8%, while the proportion of the entire investment portfolio comprised of such shares totalled 10.6%. The book value of directly held shares increased by 29.5% following a decline of 14% and 8.8% in the preceding years. The small proportion of these shares in relation to total investments increased slightly in 2005, rising from 1.4% in 2004 to 1.7%. Investments in fund units were up 11.2% on 2004, accounting for 22.3% of total investments as against 21.3% in 2004. The book value of bearer bonds grew by 10.8% (2004: +8.2%), with their contribution to total investments rising slightly from 10.2% to 10.7%. Notes receivable, which are „write-down-proof" by virtue of their valuation at par, increased by 6.2% (2004: +18.5%), while their contribution to total investments remained constant at 19.9%. The growth in total investments was above-average for Pensionskassen, health insurance undertakings and reinsurance undertakings. By contrast, investment growth was below average for life insurance undertakings, death benefit funds and property and casualty insurers.

Table 7

Investments 2005

Total investments made by insurance undertakings	Balance as at 01/01/2005		Additions in 2005		Balance as at 31/12/2005		Change in 2005	
	€m	in %	€m	in %	€m	in %	€m	in %
Real property and equivalent rights and buildings	23,901	2.2%	2,677	0.8%	24,251	2.1%	+350	+1.5%
Shares in affiliated companies	114,025	10.4%	29,568	8.3%	121,928	10.6%	+7,903	+6.9%
Loans to affiliated companies	19,023	1.7%	9,429	2.7%	15,998	1.4%	-3,025	-15.9%
Participating interests	13,315	1.2%	1,983	0.6%	9,737	0.8%	-3,578	-26.9%
Loans to companies in which a participating interest is held	5,253	0.5%	6,066	1.7%	3,255	0.3%	-1,998	-38.0%
Shares	15,612	1.4%	21,329	6.0%	20,211	1.7%	+4,599	+29.5%
Fund units	232,081	21.3%	47,791	13.5%	258,111	22.3%	+26,030	+11.2%
Other variable yield securities	4,419	0.4%	1,083	0.3%	4,679	0.4%	+260	+5.9%
Bearer bonds and other fixed-interest securities	111,586	10.2%	99,579	28.1%	123,588	10.7%	+12,002	+10.8%
Loans secured by mortgages, land charges and capital annuity charges	71,044	6.5%	5,639	1.6%	69,299	6.0%	-1,745	-2.5%
Registered bonds	226,437	20.7%	47,062	13.3%	240,058	20.8%	+13,621	+6.0%
Notes receivable and loans	216,786	19.9%	52,580	14.8%	230,319	19.9%	+13,533	+6.2%
Loans and prepayments on insurance certificates	5,701	0.5%	1,620	0.5%	5,358	0.5%	-343	-6.0%
Other loans	9,648	0.9%	1,448	0.4%	10,147	0.9%	+499	+5.2%
Deposits with credit institutions	20,383	1.9%	24,946	7.0%	15,713	1.4%	-4,670	-22.9%
Other investments	2,854	0.3%	1,668	0.5%	3,003	0.3%	+149	+5.2%
Total investments	**1.092.068**	**100.0%**	**354,468**	**100.0%**	**1,155,655**	**100.0%**	**+63,587**	**+5.8%**
Life IU	626,345	57.4%	138,102	39.0%	648,696	56.1%	+22,351	+3.6%
Pensionskassen	80,123	7.3%	23,076	6.5%	86,384	7.5%	+6,261	+7.8%
Death benefit funds	1,529	0.1%	449	0.1%	1,603	0.1%	+75	+4.9%
Health IU	108,109	9.9%	31,036	8.8%	119,204	10.3%	+11,095	+10.3%
Property/casualty IU	116,757	10.7%	68,360	19.3%	123,514	10.7%	+6,758	+5.8%
Reinsurance IU	159,206	14.6%	93,445	26.4%	176,253	15.3%	+17,048	+10.7%
All IU	**1,092,068**	**100.0%**	**354,468**	**100.0%**	**1,155,655**	**100.0%**	**+63,588**	**+5.8%**

1.3 On-site inspections

BaFin is entitled to audit the business operations of insurance undertakings on their premises, even without specific cause, and to quickly gather information at the premises of the insurance undertaking on current developments (section 83 VAG).

On-site inspections enable fast and effective supervision.

One of the advantages offered by the "on-site inspection" supervisory tool is that it allows BaFin to analyse the business processes and organisational structures of insurance undertakings in order to identify potential problems at an early stage. BaFin uses these on-site inspections for targeted assessment of the companies' financial stability, including issues such as solvency, investments, technical provisions, reinsurance relationships and risk management. BaFin also commissioned auditors to help conduct the on-site inspections.

The intensity of the inspections is based on the principles of risk-oriented supervision. In the future, BaFin will focus increasingly on criteria such as market impact and risk assessment when selecting the companies to be inspected. The selection process will take into account both quantitative economic figures and qualitative appraisals.

The number of on-site inspections performed at insurance companies increased again in 2005 to 84.

The following overview shows a breakdown of the number of on-site inspections performed over the last three years by insurance class:

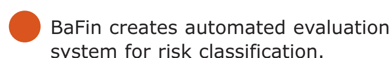
Table 8
On-site inspections by insurance class

Year	Life Insurers	Pensionskassen/ pension funds/ death benefit funds	Health Insurers	Property/casualty insurers	Reinsurers	Total
2005	17	23	8	29	7	84
2004	21	17	9	30	1	78
2003	14	15	8	19	4	60

The number of on-site inspections increased while the number of supervised companies remained virtually unchanged, i.e. the frequency of inspections increased. BaFin's objective for the coming years is an alignment with international standards.

In addition to the on-site inspections, BaFin employees also performed many supervisory inspections in order to take a closer look at individual supervision-relevant issues. BaFin also attended more than 20 insurance company supervisory board meetings in 2005 in order to get a sense of the economic situation and strategy of the companies.

1.4 Risk classification in insurance supervision



BaFin's insurance supervisory activities are already based on the principles of risk-oriented solvency supervision in preparation for the future Solvency II requirements. This means that the risk structure of the supervised insurance undertakings is playing an increasing role in the supervisory process.

BaFin plans to implement an automated evaluation system for risk classification purposes, which will take into account the particular features of each area. As part of a management information system (MIS), the risk classification system is designed to support risk-oriented solvency supervision by providing up-to-date information. The system will allow the affected companies to be split into risk classes at all stages of the supervisory process using quantitative figures and qualitative characteristics (traffic light model). There are plans to include not only an assessment of individual companies, but also peer group comparisons and sector analyses.

Until the automated system has been implemented, BaFin will base its risk classification process on a systematic survey of the employees responsible for insurance supervision. These surveys will be used to determine the market impact of the company in question, as well as its quality.

In the cases of health, life, retirement and accident insurance companies, BaFin determines market impact primarily on the basis of total investments, while in the case of property, casualty and reinsurance undertakings, gross premium income serves as the basis for assessment. The impact of the company is then classified as either high, medium or low.

Assessing the quality of a company is a more complex process and is based on the four criteria – security, success, growth and management quality. The marks awarded for each individual criterion are based on insurance-specific figures or qualitative criteria. The evaluation system aggregates the individual marks to form an overall score which is then measured against a four-tier scale ranging from high to low.

BaFin applied this risk classification process to its insurance supervision activities for the first time in the autumn of 2005. The overall results were as follows:

Table 9
Risk classification results 2005

		Quality of the Insurance undertaking				
	IU in %	high	medium-high	medium-low	low	Total
Imapct	high	1.1%	5.0%	2.8%	0.0%	8.8%
	medium	4.0%	10.4%	4.6%	0.5%	19.5%
	low	17.0%	40.1%	10.8%	3.9%	71.8%
	Total	22.1%	55.4%	18.3%	4.3%	100%*

* Irregularities in the figures set out under "total" are due to rounding differences.

No company with a high market impact was classified as low quality. There is a high concentration of companies in the “low impact – high and medium-to-high quality” quadrant, with 57.1% of all of the companies assessed falling into this category.

BaFin has now put the results of the risk classification process to practical use in its 2006 supervisory planning. The on-site inspections, for example, were planned taking into account the risk classification results for the first time. The companies deemed by BaFin to be inspection-relevant are primarily those with a high risk potential which have not been assessed in the recent past.

1.5 Stress tests

BaFin stress test established in risk management.

The BaFin stress tests[31] have successfully established themselves as a quantitative element of investment risk management and help the supervisory authorities to identify those insurance undertakings whose investment policy does not match their ability to bear risk.

The insurance companies performed the stress tests as at

[31] The results of the stress tests are provided for each individual class of insurance.

31 December 2004 using the following unchanged parameters:

Stress test scenario	Asset class	Loss in
A 35	Equities	-35%
R 10	Bonds	-10%
RA 25	Equities Bonds	-20% and -5%

The scenarios applied in the previous year were still adequate. The question as to which scenario required the most coverage at a particular insurance company depended first and foremost on the composition of the investments. This means that it was perfectly normal for a company to have results in the individual A 35 or R 10 scenarios, which were not as good as those in the combined RA 25 scenario. Credit risk markdowns, which depend on the rating of fixed-income investments, also remained unchanged.

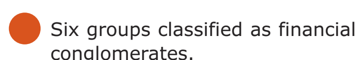
When comparing these results to the 2003 results, it is important to remember that the 2004 stress test model has been amended to include a number of requirements resulting from the German Investment Act (Investmentgesetz) and the Ordinance on the investment of restricted assets of insurance undertakings (Anlageverordnung – AnlV). These amendments focused on the classification of investment funds with a high market risk potential. Furthermore, the inclusion of hedging as permitted for the first time in 2003, in particular investment fund portfolio hedging, has also been elaborated further. BaFin has set out a number of criteria which need to be fulfilled before portfolio hedging strategies can be recognised as such in the stress test.

BaFin will continue to react to changes in the legal and economic framework in the future and will adjust the stress test model accordingly. This is the only way to promote risk-adequate investment management.

1.6 Supervision of financial conglomerates

The legislature implemented the December 2002 Financial Conglomerates Directive on 1 January 2005. Thus, the necessary statutory empowering norms are now in place to allow the practical implementation of the Directive in the KWG and VAG.

BaFin performed the formal procedure for identifying German financial conglomerates in the year under review.[32] This involved reassessing the groups identified in a preliminary survey as operating on a cross-sector basis. BaFin performed the necessary calculations on the basis of the figures as at 31 December 2003, taking into account all actual and foreseeable material changes in 2004 and 2005.[33]



Six groups classified as financial conglomerates.

To date, the formal identification procedure has resulted in six cross-sector groups being classified as financial conglomerates.

[32] cf. sections 51a to 51c KWG and sections 104n to 104p VAG.
[33] cf. section 64g (4) sentence 1 KWG and section 123c (2) sentence 1 VAG.

These companies are subject to supervision at conglomerate level by BaFin in its role as coordinator. One further group is expected to receive notice of its classification as a conglomerate in May 2006, after which it will also be subject to supervision at conglomerate level by BaFin. Two further groups, which materially fulfil the conditions for classification as a financial conglomerate, are likely to be exempted from supervision at conglomerate level. In all of the other cases assessed to date, the groups in question were informed that they were not currently classified as financial conglomerates.

The Ordinance on the capital adequacy of financial conglomerates[34] came into force in September 2005. The legislature thus made consistent use of its powers to issue regulations. The ordinance provides a more detailed definition of the requirements that apply to the solvency plan at conglomerate level, which financial conglomerates have to submit for the first time in 2006. The ordinance also contains standard reporting forms for the calculations in eight annexes. As of 2006, the conglomerates also have to report intra-group transactions and risk concentrations.

1.7 Seventh amendment to the Insurance Supervision Act

1.7.1 Capital resources

The legislature used the seventh amendment to the Insurance Supervision Act to revise the capital resources provisions of section 53c VAG.[35] It adopted the upper limit for subordinated debt and capital represented by participation rights (hybrid capital) contained in the European Directives.[36] Insurance companies are now permitted to include hybrid capital at either 50% of the required solvency margin or 50% of their total own funds, whichever amount is less. Previously, only 25% of the sum of share capital/initial fund, reserves and profits carried forward was allowed to be represented by hybrid capital. If the hybrid capital is no longer required, it can now be paid back, with the approval of the supervisory authorities, before the statutory minimum maturity of five years has expired. A further amendment relates to the imputation of subordinated debt to own funds at a rate of 40% in the year before maturity. Previously, these liabilities were no longer eligible as own funds in the final two years of their term. Insurance companies are now also entitled to provide subordinated collateral for subordinated debt incurred by a subsidiary of the insurance undertaking set up exclusively for the purpose of raising capital. In the past, collateralisation of subordinated debt was strictly prohibited.

[34] Financial Conglomerates Solvency Ordinance.
[35] BaFin 2004 Annual Report, Page 141.
[36] D 2002/83/EC and 2002/13/EC.

1.7.2 Empowering provision for forecast statements

The new provisions contained in section 55b VAG authorise BaFin to have insurance companies present forecast statements during the course of the year so that they can take action in time in the event of negative forecasts. Originally, BaFin required only life insurance companies to present forecast statements throughout the year, as a specific reaction to the troubled capital markets. BaFin extended the obligation to all insurance undertakings in 2005. The forecast statements relate to the company's business results, projected solvency margin, valuation reserves and ability to bear risk in a range of situations.

1.7.3 New regulations for Pensionskassen and pension funds

The German legislature used the amendment to the Insurance Supervision Act to set out new regulations in three key areas of occupational retirement provision. It implemented further provisions of the EU Pension Fund Directive, made a new distinction between regulated and deregulated Pensionskassen and made it easier for companies to transfer book reserve schemes (Direktzusagen), including pension provisions, to pension funds.

Implementation of the Pension Fund Directive

New responsibility for BaFin.

In implementing the Pension Fund Directive, the legislature provided its first statutory definition of a Pensionskasse (section 118a VAG). The main objective of both the Pension Fund Directive and the 2005 amendment to the VAG, however, was to allow Pensionskassen and pension funds to operate on a cross-border basis.

German Pensionskassen and pension funds must inform the supervisory authorities, i.e. BaFin in most cases, of any intention to provide occupational pensions for a sponsoring company based in another member or signatory state. They must also indicate the name of the sponsoring company and the main characteristics of the occupational pension scheme to be operated for this company. BaFin then passes this information on to the supervisory authorities in the country of activity, after ensuring that the planned activity complies with statutory requirements, in particular with regard to the adequacy of the administrative structure, the financial position and the qualification of the managers responsible for the

planned activities. German Pensionskassen and pension funds are prohibited from offering any products prohibited by the VAG on foreign markets. Authorised occupational retirement schemes domiciled in another member or signatory state that wish to conclude contracts in the Federal Republic of Germany must inform their own supervisory authorities accordingly. The supervisory authority in question shall then inform BaFin. The Supervisory Authority then has a period of two months within which it must inform the supervisory authorities in the scheme's home member state of any labour and social law regulations to which the occupational retirement scheme in question has to adhere.

BaFin must also determine under which vehicle (Durchführungsweg) the foreign scheme is to be classified, as this has a bearing on the contribution to be paid by the scheme to the Mutual Insurance Association (Pensionssicherungsverein). At the end of the two month period, the foreign institution is entitled to conclude occupational retirement contracts in the Federal Republic of Germany, although it must adhere to German labour and social law regulations, as well as to the applicable tax provisions. These fields of law have not yet been harmonised at EU level. The German legislature has also passed a number of quantitative investment regulations with which the foreign schemes must comply. These regulations include, e.g. a limit on the size of investments in a company.

In accordance with the requirements set out in the Pensions Fund Directive, the German legislature has also established additional informational obligations for undertakings in the area of occupational retirement provision. In the future, for example, these undertakings will have to report on the financial, insurance and other risks related to the retirement system, as well as the nature and distribution of these risks. They are also obliged to provide information on the amount of benefits in the event of discontinuation of employment and on the means of transfer of vested benefits entitlements to a different occupational retirement scheme in the event of employment termination.

Deregulation of Pensionskassen

Competitive Pensionskassen (Wettbewerbspensionskassen) deregulated by law.

In the past, the decision as to whether or not a Pensionskasse should be deregulated depended on its total assets and premium income. The new statutory provisions provide that Pensionskassen are now deregulated as a general rule. However, in very specific cases (section 118b VAG), Pensionskassen which have the legal form of a mutual society can request to be regulated by the Supervisory Authority. 92 Pensionskassen had made use of this option and applied for regulation by 31 December 2005. Pensionskassen subject to supervision by the individual federal states and those that are collective schemes established under a binding collective bargaining agreement, are always considered regulated Pensionskassen. Thus, ten such collective schemes are regulated by law.

As was the case with life insurance companies in 1994, all deregulated Pensionskassen now have to discontinue the rate offers that were approved by the supervisory authorities. Pensionskassen that were deregulated under the previous legislation (section 156a VAG) and that wish to apply for regulation, must also discontinue their existing, unauthorised rate offers upon commencement of regulation.

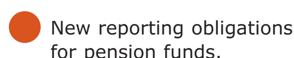
Increased flexibility for pension funds

In the future, it will be easier for employers to make use of the tax benefits that apply to the transfer of book reserve schemes (Direktzusagen) to pension funds, because employers can be exempted from the previous requirement to provide an insurance-based pension benefit guarantee if contribution payments by the employer are to be continued after the retirement commencement date and there is no fixed date set for the end of benefit payments (section 112 (1a) VAG). The fact that the insurance-based guarantee no longer has to be provided means that the mathematical provisions set up by the pension fund for these contracts can be calculated using a higher rate of interest than the maximum technical interest rate (section 1 (1) of the Mathematical Provisions Ordinance for pension funds (Pensionsfonds-Deckungsrückstellungsverordnung – PFDeckRV)). The rate of interest applied is derived on a best estimate basis. This change has fuelled expectations of increased market potential, because German companies will be able to clear their balance sheets of what are often very high pension provisions, which could increase their international competitiveness.

In the future, pension funds will also have the option of paying out 30% of the capital available, at the point in time when benefit payments commence, in a lump sum. This option has been in place for some time now in accordance with the Act governing the certification of contracts for private old-age provision (Altersvorsorge-Zertifzierungsgesetz – AltZertG).

1.8 Ordinances

Ordinance on reporting by pension funds



The Ordinance on reporting by pension funds (Verordnung zur Berichterstattung von Pensionsfonds) of October 2005 sets out binding requirements governing the information that pension funds have to report to the Supervisory Authority as part of internal reporting. Previously, BaFin had to request the necessary information on business operations from the 24 authorised pension funds on an individual basis.

The pension funds now have to report to BaFin on their business operations using forms and providing documentation, and are also obliged to submit other accounting documents. These reporting requirements are largely in line with those that apply to life insurance undertakings.

The annual reporting obligations will be applied for the first time to the annual report for the financial year commencing after 31 December 2004. The ordinance will be applied to the semi-annual interim report for the first time in 2006.

Reinsurance Capital Resources Ordinance

The Ordinance concerning the capital resources of reinsurance companies (Reinsurance Capital Resources Ordinance) came into force on 27 October 2005. The ordinance contains rules for the calculation of the solvency margin and the minimum amount of the guarantee fund for professional reinsurers. The solvency margin is a target value for own funds that a company should have available to ensure proper business operations.

For those reinsurance companies that only took up business operations after 21 December 2004[37], the minimum own funds requirement is calculated in accordance with the provisions applicable to newly authorised property and casualty reinsurance companies. This means that, as with these companies, the solvency regulations based on the EU's Solvency I Directive apply to direct insurance business, with the exception of life insurance. The regulations that apply to property and casualty insurance business also apply to life reinsurance.

The regulations that apply to property and casualty insurance business also apply to life reinsurance.

One distinctive feature of this system is that the solvency rules applicable to the property and casualty business also apply to life reinsurance. This is in line with the Directive of the European Parliament and of the Council on Reinsurance dated 16 November 2005. It also reflects the fact that the life reinsurance business is more similar to property and casualty insurance business than to the life insurance business. For reinsurance companies operating under the grandfathering provision, the new solvency rules will be applied in stages. These companies must implement the requirements set out in the ordinance by 1 March 2007.

1.9 Circulars and official announcements

Reinsurance supervision circular

The new reinsurance circular[38] explains and provides an official interpretation of the statutory provisions on reinsurance supervision which entered into force in December 2004.

Primarily, the legislative amendment established more intensive reinsurance supervision with the introduction of an authorisation procedure and the creation of a solvency system. The solvency system specifically covers supervision of adequate own funds and sufficient provisions, as well as investments rules. The now fully-fledged supervisory system for reinsurance companies is based on

[37] Date of VAG amendment 2004, which introduced sections 119 et seq. to the VAG.
[38] Circular 6/2005 (VA).

the supervisory system for primary insurers, but has a more streamlined structure.

Circular informs about authorisation procedure and ongoing supervision.

The circular now provides information on the scope of supervision and on the practical details of the authorisation procedure. It makes a distinction between authorisation for the expansion of business operations and the mere obligation to report changes to the business purpose or to its area of business. It explains the expanded solvency supervision system for newly authorised companies, as well as the transitional provisions for reinsurance companies operating under the grandfathering provision. The circular orders reinsurance undertakings operating under the grandfathering provision to submit a solvency sheet as at 31 December 2004 to BaFin together with the annual financial statements. This will allow the Supervisory Authority to assess the companies' own funds situation for 2005 as well.

The circular also provides information on investments. These have to meet certain requirements, at least to the extent that they are necessary for the reinsurance company to cover its underwriting liabilities. This investment supervision is based substantially on the individual circumstances of the reinsurance company in question and is already characterised by risk-based approaches. The reinsurance companies are provided with information on the monitoring of internal processes and investment-related risk management. Finally, for the first time, the circular contains principles for the ongoing legal supervision of reinsurance companies.

Investment circular

In September 2005, BaFin released a circular providing updated guidelines for qualified investment management and internal control procedures for the restricted assets of insurance undertakings.[39] The new circular replaces Circular 29/2002 (VA).

Internal models and procedures serve as preparation for Solvency II.

Within the scope of their asset liability management system, insurance companies must subject their investments to various capital market scenarios and investment conditions on at least a quarterly basis. In addition to standard approaches, such as the BaFin stress test, the companies may use their own calculation methods (risk-based capital) for these internal stress tests. Prudence must be exercised when selecting the appropriate assumptions, and the methodology, assumptions and results must be documented in a manner enabling verification. This also applies if the company in question deviates from the outcomes of the analysis and the resulting decisions. The option to use internal models and procedures in the internal stress test is a key step in the direction of the future Solvency II regulatory framework.

The required organisational segregation of investment management from overall risk management at the board level is particularly important. This helps avoid the concentration of responsibilities on one individual.

[39] Circular 15/2005 (VA); section 6 AnlV.

Insurance undertakings may transfer risk management and internal auditing duties to suitable companies.

BaFin has responded to the need of the insurance sector to outsource certain functions; risk management and internal auditing can now be transferred to a suitable company. These may not, however, be transferred to a credit institution, an investment company or to enterprises affiliated with either the former or the latter if the investments held by the insurance company that are offered or owed by the company in question account for more than 5% of its restricted assets. This is designed to help avoid conflicts of interest.

Insurers now have the option of themselves assessing the risk of investments that are to be rated in line with market standards in the event that individual investments are not rated. The precondition for this is the availability of the necessary personnel and knowledge resources. This also applies to non-investment grade high-yield bonds that have at least a speculative grade rating. BaFin has created a specific investment ratio of 5% of the restricted assets for high-yield investments. These also have to be included in the risk asset ratio as set out in section 2 (3) AnlV.

New impetus for the traditional loan business.

The circular also changed the insurance sector's traditional note loan business. The issuance of note loans is based primarily on a prior assessment of the creditworthiness of the primarily commercial and industrial borrowers, which is performed using what is known as the lending guidelines.[40] In order to promote the declining lending business, which is dominated by medium-sized companies, borrower creditworthiness can now also be assessed using the long-term ratings of recognised agencies. This system provides for a situation whereby the debtor's rating must be at least investment grade when the loan is granted. However, this alternative does not generally apply if the debtor is a member of the same group as the insurance undertaking within the meaning of section 18 of the German Stock Corporation Act (Aktiengesetz – AktG).

Simplified rules for investment in funds units.

The circular also focuses on the rules for investment in fund units, which have been completely revised, simplified and amended to reflect the classification set forth in the new German Investment Act. For inclusion in restricted assets, units in domestic funds, including the recently added hedge funds, may be acquired as a general rule. The only exception to this rule relates to units in retirement funds, which are deemed insufficient in terms of fungibility.

Circular facilitates private equity investments.

The circular also facilitates private equity investments and investments in small and medium-sized companies. The total of these investments, as well as other risk asset investments, may not exceed 10% of the share capital of the company in question. In practice, this resulted primarily in an obstacle to investment in subordinated debt and participation rights issued by companies with relatively little capital. The clarification that the basis of calculation for these types of investment includes not only the share capital but also the subordinated debt and capital

[40] Guidelines on the granting of corporate loans – note loans.

represented by participation rights has increased investment volume considerably.

The sum of investments relating to any one particular debtor may not exceed 5% of restricted assets. This does not apply to investments in fund units, public limited investment companies and foreign investment companies, provided that the investment fund in question is sufficiently diversified.

Circular on disclosure, reporting and notification requirements

BaFin streamlines investment reporting requirements.

Insurance undertakings must report to BaFin investments in, and the acquisition of the assets set out in section 54 (4) sentence 2 VAG, as well as their total investments (section 54d VAG). BaFin has used the new circular[41], which replaces Circular 30/2002 (VA) of 12 December 2002, to considerably streamline the investment reporting requirements. For example, six of the 19 reports that were required in the past were deleted without replacement. The reporting deadline was extended in one case, while another report was shortened. Three of the six previously required reports on derivative financial instruments were also deleted.

The amendment to the Ordinance on the investment of restricted assets of insurance undertakings has increased the options open to companies with regard to investment for their restricted assets. These new investment options are reflected in the investment reporting requirements. By way of example, the question as to whether or not a fund is eligible for inclusion in restricted assets is no longer based exclusively on the fund rules, but can also be determined to a considerable extent by the actual fund composition. Reporting is used as proof of eligible fund investments, whereby the fund assets are included in the investment categories set out in the Ordinance on the investment of restricted assets of insurance undertakings. In addition to the current requirements to include bonds, equities and real estate in the investment ratios, the relief with respect to fund investments also requires the inclusion of financial innovations such as asset-backed securities or hedge funds in the investment ratios set out in the ordinance. BaFin also incorporated into the new circular the reporting requirements that apply to hedge funds in accordance with Circular 7/2004 (VA).

With respect to reporting on the coverage of technical liabilities at book and fair value, the possibility of future hidden liabilities from investments within the guarantee assets also cannot be ruled out. In such cases, BaFin may require further additions to the guarantee assets, if this is deemed necessary to safeguard the interests of the insured. The circular contains new regulations in this respect. It sets out the circumstances in which an insurance undertaking is required to implement measures in order to resolve

[41] Circular 11/2005 (VA).

this sort of coverage shortfall. In particular, hidden liabilities from fixed-income investments in the investment portfolio which are paid back at a guaranteed value when they reach maturity may be taken into account.

Circular on guarantee assets and the guarantee asset trustee

In the year under review, BaFin completed its work on the new Circular 12/2005 (VA) relating to guarantee assets. The forms were completely revised and edited. In light of the changes to the statutory framework, BaFin also issued a new Circular 13/2005 (VA) on the guarantee asset trustee in 2005. The existing regulations on the appointment, duties and powers of the trustee were revised. The circular also takes into account the particular characteristics of pension funds with respect to the safeguarding of their investments.

Announcement on derivative financial instruments

New options for hedging against a rise in interest rates.

The reaction among insurers to the prolonged period of low interest rates has varied. Many increased the volume and maturity of their fixed-income investments, or used derivative financial instruments such as receiver forward swaps and long receiver swaptions. Both of these financial instruments allow a locked-in reinvestment rate at a specified future date. BaFin also clarified that these financial derivatives can also be used to preserve a favourable interest rate.

In the past, BaFin only permitted hedging transactions using swaps if they were concluded on existing assets and if the term of the swap did not exceed the term of the assets. During the prolonged period of low interest rates, however, there was a need to hedge the cash flows of the existing assets beyond their maturity dates. Insurance undertakings were only able to do this by acquiring assets with as long a term as possible and then concluding swap transactions on these assets. Furthermore, they were able to acquire structured products such as bonds or note loans with embedded swaps. Now, the interest rate can be hedged directly using free-standing derivatives, since receiver forward swaps and long receiver swaptions can be used even past the maturity of the assets in the portfolio. These are classed as hedging transactions if the average interest rate prior to reinvestment is locked in.

The announcement also provides for the use of credit default swaps to hedge against credit risks. Insurance undertakings can use these instruments, which have proved popular for some time, to transfer individual or portfolio credit risks to a contractual counterparty in return for payment of a premium. Previously, this was not explicitly permitted.

1.10 Composition of the risk asset ratio in accordance with the Ordinance on the investment of restricted assets of insurance undertakings

Insurance undertakings must inform BaFin of their risk asset ratios.

For the fourth-quarter of 2005, all primary insurance companies reported on their total investments. The companies had to submit a breakdown of investment types in accordance with the schedule of investments set out in section 1 (1) AnlV, also broken down by the particular risks involved.[42] The following assessments are based on the data for life, health and property/casualty insurers, as well as Pensionkassen, as at 31 December 2005. The book value of all investments in these classes totalled €979 billion at that date.

Risk asset ratio at 35% of restricted assets.

Insurance undertakings can invest 35% of their restricted assets in certain forms of risk assets. In addition to equity investments, these risk investments include participation rights, subordinated debt assets and hedge funds. The following table shows the composition of the risk asset ratio.

[42] Documentary proof form 670.

Table 10

Composition of the risk asset ratio

Form of investment in accordance with section 1 (1) no. ... AnlV, version dated 22 May 2005	Restricted assets									
	Life IU		Health IU		Property/casualty IU		Pensionskassen		Total for all four classes	
	absolute in €m	Share in %	absolute in €m	Share in %	absolute in €m	Share in %	absolute in €m	Share in %	absolute in €m	Share in %
Total investments *	630,840	100.0%	117,488	100.0%	106,445	100.0%	83,796	100.0%	938,569	100.0%
Thereof:										
Loans against securities (no. 2), provided that shares (no. 12) are the object of the loan	15	0.0%	0	0.0%	0	0.0%	0	0.0%	15	0.0%
Receivables from subordinated debt (Nr. 9)	13,035	2.1%	3,742	3.2%	1,864	1.8%	1,658	2.0%	20,299	2.2%
Participation rights (no. 10)	8,938	1.4%	1,752	1.5%	1,416	1.3%	312	0.4%	12,418	1.3%
Fully paid-up shares which are included in a regulated market (no. 12)	9,249	1.5%	1,009	0.9%	1,429	1.3%	122	0.1%	11,809	1.3%
Non-listed fully paid-up shares, participating interests in a limited liability company, limited partnership and participating interests as silent partner within the meaning of the Commercial Code (no. 13)	8,176	1.3%	1,295	1.1%	2,262	2.1%	117	0.1%	11,850	1.3%
Units in funds (no. 15-17, incl. hedge funds), provided that they - include fully paid-up shares and participation rights which are included in a regulated market	43,806	6.9%	5,049	4.3%	12,634	11.9%	10,495	12.5%	71,984	7.7%
- cannot be definitively allocated to another form of investment; residual fund value and non-transparent funds	7,571	1.2%	1,293	1.1%	1,718	1.6%	1,399	1.7%	11,981	1.3%
Investments linked to hedge funds (partly in categories other than the nos. of the AnlV set out above)**	2,721	0.4%	503	0.4%	468	0.4%	401	0.5%	4,093	0.4%
Investments in high-yield bonds	3.187	0..5%	287	0.2%	703	0.7%	468	0.6%	4,645	0.5%
Total investments subject to the 35% risk capital ratio	96,698	15.3%	14,930	12.7%	22,494	21.1%	14,972	17.9%	149,094	15.9%

* including cash at credit institutions, excluding liabilities from mortgages, land charges and capital annuity charges.
** approximate values.

Source: Sector totals as at 31 December 2005 for life, health and property/casualty insurers, as well as Pensionskassen, from documentary proof form 670, Circular 11/2005 (VA)

Equity ratio between 9% to 10.3%.

The residual value of 1.3% of the restricted assets for all classes relates to all of fund investments that could not be classified under other classes of investment. Non-transparent funds were also attributed in full to the residual value. As a result, the equity ratio of these companies lies somewhere between 9% and 10.3% of restricted assets. However, the ratio in the individual insurance classes varies: in the case of health insurers, the equity ratio is between 5.2% and 6.3%, while for property/casualty insurers, the ratio falls in the range of 13.2% to 14.8%. Pensionskassen have the highest proportion of non-transparent funds.

Since the amendment to the Ordinance on the investment of restricted assets of insurance undertakings in August 2004, further classes of investment are included in the risk asset ratio. These include investments in hedge funds or other direct and indirect investments that relate to hedge funds. Direct investments in hedge funds are minimally contained in units of funds. Most hedge fund investments, however, are note loans from suitable credit institutions or bonds whose yield and/or redemption value is determined by a hedge fund or hedge fund index. These are allocated to the schedule of investments in accordance with their cash instrument, but must be fully included in the risk asset ratio in accordance with section 2 (2) item g) AnlV. These investments account for around 0.4 percentage points of the risk asset ratio.

Subject to certain conditions, insurance undertakings are also permitted to invest up to 5% of their restricted assets in high-yield investments. These investments, which account for 0.5% of the restricted assets, are also included in the 35% ratio.

In accordance with the German Investment Act, due to the use of derivatives pursuant to section 51 (2) of the Investment Act or the corresponding provisions of another country, a fund can entail leveraged potential market risk. This increased potential market risk shall be counted towards the risk asset ratio.

Table 11

Proportion of total investments in selected asset classes

Form of investment	Restricted assets									
	Life IU		Health IU		Property/casualty IU		Pensionskassen		Total for all four classes	
	absolute in €m	Share in %	absolute in €m	Share in %	absolute in €m	Share in %	absolute in €m	Share in %	absolute in €m	Share in %
Total investments *	650,416	100.0%	119,623	100.0%	124,362	100.0%	84,555	100.0%	978,956	100.0%
Thereof:										
Private equity investments (in restricted assets in accordance with section 1 (1) no. 13 AnlV)	2,074	0.3%	325	0.3%	456	0.4%	92	0.1%	2,947	0.3%
Asset-backed securities and Credit-linked notes in accordance with C 1/2002	6,243	1.0%	736	0.6%	657	0.5%	467	0.6%	8,103	0.8%
Investments in hedge funds and in investments related to hedge funds (in restricted assets in accordance with C 7/2004)	3,047	0.5%	521	0.4%	597	0.5%	431	0.5%	4,596	0.5%

* including cash at credit institutions, excluding liabilities from mortgages, land charges and capital annuity charges.

Source: Sector totals as at 31 December 2005 for life, health and property/casualty insurers, as well as Pensionskassen, from documentary proof form 670, Circular 11/2005 (VA)

Alternative investments still account for only a very small proportion of total investments.

The table shows that the proportion of total investments accounted for by alternative investments has not changed considerably as compared with the previous year. Pensionskassen have been included in the overview for the first time. Volumes have not increased substantially, because generally only large Pensionskassen meet the investment management requirements for financial innovations and actually invest in them.

2 Life insurers

2.1 Financial situation in 2005

Environment characterised by favourable equity markets and low capital rates.

The dominant factor with respect to the financial situation of life insurers was bond market performance, which was characterised by a high degree of volatility and the persistence of low interest rates. Performance on the equity markets had exerted a positive effect on the financial situation of life insurance undertakings in 2005, but share price gains of almost 30% had only a limited impact on the earnings of these companies due to the decline in equity investments over the past few years.

The drop in capital market rates over the course of the year resulted in a temporary increase in hidden reserves in the fixed-income investments of life insurance companies. This effect, however, was offset by the fact that interest rates had risen by the end of the year. Whatever the case, an evaluation of the reserves in fixed-income investments at given points in time is of limited informational value because these investments are normally held to maturity. Thus, in most cases, neither hidden reserves nor hidden liabilities are realised during the term of the investment. This means that capital market rates over the long term are more relevant to an assessment of a company's ongoing ability to fulfil its liabilities than the level of hidden reserves in its fixed-income investments at specific points in time. The fact that capital market rates have held below the 4% mark for three years now is increasing pressure on the earnings of life insurers because only relatively low-interest options are available for new investments.

Lowering of maximum interest rate likely.

The low interest rate level prompted the Technical Interest Rate working group of the German Association of Actuaries (Deutsche Aktuarvereinigung – DAV) to recommend a reduction in the maximum interest rate pursuant to section 2 (1) of the Mathematical Provisions Ordinance (Deckungsrück-stellungsverordnung – DeckRV) from 2.75% to 2.25% as of 1 January 2007. The maximum interest rate is the highest permissible guaranteed rate for the calculation of mathematical provisions. Any reduction would only affect new business, not the existing contracts in the portfolio. BaFin informed the Federal Ministry of Finance (Bundesministerium der Finanzen – BMF) as the issuer of regulations, concerning its position on the German Association of Actuaries' interest rate report.

Scenario-based assessments proven key as supervisory instrument.

For several years, BaFin has been conducting scenario-based assessments of life insurers on two set observation dates. The insurance supervisor uses these in order to gather information as to whether or not the insurance undertakings are able to fulfil their guaranteed rate obligations in the current financial year, even in an environment of unfavourable share price developments. BaFin also introduced an interest rate scenario for the first time in 2004, in order to better assess the effect of an interest rate increase on hidden reserves in an environment of low capital market rates. BaFin sets out the individual scenarios to be applied based on market performance and the market environment. This flexible approach has proven to be effective. In 2005, the share price scenarios moved within a range of up to 15% below the share price prevailing at a given time. The scenario applied to interest rates involved a parallel increase in the yield curve of 100 basis points (as at 30 June) and 50 basis points (as at 31 October) as against the market situation on the observation date in question. These scenario-based assessments allowed BaFin to confirm, at an early stage, that all of the life insurance undertakings were in a position to fulfil their contractual obligations.

Insurance companies considerably reduced hidden liabilities in investments.

The scenario-based assessments also took into account hidden liabilities in the investment portfolio. Insurance undertakings are permitted to classify securities recognised at cost as fixed assets. Write-downs are only required in cases where impairment is likely to be permanent, which can give rise to hidden liabilities. Life insurers managed to reduce non-net hidden liabilities in the securities recognised at cost from under €2 billion in the previous year to less than €1 billion. Thus, the life insurance sector can now consider the problem of hidden liabilities, which arose as a result of the stock market slump between 2001 and 2003, as resolved. Taking into account the non-net hidden reserves, the sector still had net hidden reserves of more than €12 billion in the securities recognised at cost at the end of 2005.

Insurer solvency remains solid.

Solvency in the life insurance industry remained solid, as confirmed by an evaluation of the scenario-based assessment as at 31 October 2005. Solvency was once again well in excess of the minimum requirements. Estimates put the coverage ratio at the end of 2005 at around 180% (previous year: 177%).

Bonus for 2006 slightly down on prior-year level.

The companies subjected to the scenario-based assessment as at 31 October 2005 also provided information on their 2006 surpluses. On the whole, 2006 bonuses were on a par with, or slightly down on the prior-year level. The arithmetic average of total bonuses declared for endowment policies for 2006 stood at 4.2%. The prior years saw figures of 4.3% and 4.4%.

Positive stress test results for almost all life insurance undertakings.

In the year under review, life insurance undertakings presented BaFin with the results of the stress tests based on the annual financial statements as at 31 December 2004. BaFin included 104 life insurance companies in its assessment; five companies were exempted from the requirement to submit their stress test results due to the low-risk nature of their investments. One life insurance undertaking presented negative results in all three scenarios,

another in two scenarios, and another in one scenario.[43] All of the remaining 96 life insurance companies reported positive results in all three scenarios. This year-on-year improvement in results shows that the measures taken by life insurers to improve their ability to bear risk have borne fruit.

2.2 Rulings by the German Federal Court of Justice

Federal Court of Justice prescribes minimum surrender value.

On 12 October 2005, the Federal Court of Justice handed down three rulings[44], that the supposedly more transparent clauses used by insurance undertakings, with the consent of a trustee, to replace invalid clauses while retaining the same content were themselves invalid. The Federal Court of Justice also declared the cancellation charge agreement to be invalid. The Court used a secondary interpretation (ergänzende Vertragsauslegung) to rule that, in the event of a conversion to paid-up status or surrender, the paid-up policy value or surrender value may not fall below a minimum amount. This minimum amount corresponds to 50% of the unzillmerised assets covering mathematical provisions calculated using the same bases of calculation that apply to premium calculation. These rulings affect policies concluded between July 1994 and the end of 2001. BaFin ensures that the paid-up policies in question are adjusted by the insurance undertakings to comply with the new regulations and that any legitimate claims from cancelled policies are settled promptly.

2.3 Capital redemption products

German life insurance companies have been able to conduct capital redemption operations since mid-1994. Although this can also be considered banking business, it is treated in the same way as life insurance business if it meets the statutory requirements set out in section 1 (4) sentence 2 VAG. In such cases, these operations are not classed as non-insurance business. Thus, life insurance companies can offer products without biometric risks, such as term deposits.

BaFin provides information on the permissibility of capital redemption operations.

In practice, however, section 1 (4) sentence 2 VAG has proven to be in need of interpretation. As a result, following a consultation process, BaFin published requirements for the permissibility of capital redemption operations.[45] These requirements state that insurance companies must determine the duration and amount of all single or regular premiums in advance. If a client wishes to make an additional payment that was not specifically provided for in the original contract, the company must, in principle, have the option of rejecting this. Life insurance companies must also specify the term of the contracts in advance. Extension options are only permitted if the company has the ability to reject such extensions. Withdrawals and partial surrenders can be agreed if the company

[43] Scenarios A 35 and RA 25.
[44] Case nos.: IV ZR 162/03, IV ZR 177/03 and IV ZR 245/03.
[45] VerBaFin 10/2005, Page 3.

is in a position to ensure liquidity at all times. This necessitates ongoing liquidity planning. Life insurance companies that conduct capital redemption operations must ensure that the capital outflows can be immediately covered from the cash flow or realisable investments. As with the requirements that apply to credit institutions [46], a liquidity parameter must be set up if the insurance undertakings are required to establish a separate account within the guarantee assets. In addition to the establishment of an ongoing liquidity planning system, institutions conducting capital redemption operations must also structure products in such a way as to ensure the liquidity of the life insurer at all times and to take account of the specific situation of the company.

2.4 Official Announcements on annuities

Following several months of consultation, BaFin published an announcement[47] on the general terms and conditions of insurance and on the use of surplus in the annuities sector in January 2006.

One of the issues addressed by the announcement is the minimum requirements for transparency of general terms and conditions. If the usual guaranteed benefits provided by annuity providers are subject to certain provisos in the general terms and conditions, these benefits no longer have the nature of a guarantee. The client must be clearly informed of this particular product structure prior to the conclusion of the contract.

Bonus declaration and accounting may not contradict the contractual agreement.

The announcement also makes it clear that the bonus declaration and accounting may not contradict the contractual agreements. This means that, as a general rule, allocated bonuses cannot be used to finance guaranteed benefits. Policyholder claims with regard to these bonuses cannot be cancelled unilaterally by the insurer with retroactive effect following the declaration.

3 Health insurers

3.1 Financial situation in 2005

Financial situation of health insurance companies further stabilised.

On the basis of preliminary estimates, the 54 private health insurers subject to supervision by BaFin generated total premium income of €27.3 billion in financial year 2005. This corresponds to a year-on-year increase of 3.5%. The value of the investment portfolio increased by approximately 10.3% to around €119.2 billion.

[46] Section 11 KWG in conjunction with Principle II Concerning the Liquidity of Institutions dated 25 November 1998.
[47] VerBaFin 1/2006, Page 3.

Positive stress test results for all health insurers.

BaFin called on 46 health insurance companies to present their stress test results. The remaining eight companies were exempted from the requirement to submit their stress test results due to the low-risk nature of their investments. All of the health insurers presented positive stress test results, whereas three insurance companies had presented negative results in the prior-year. This means that, even assuming unfavourable capital market developments, all health insurers would be in a position to meet their obligations vis-à-vis the insured and to meet the statutory capital requirements.

BaFin required insurance companies to perform scenario-based assessments.

BaFin called upon 45 health insurance companies to perform scenario-based assessments by 30 June 2005 and submit the results. Nine companies were exempted from the requirement to submit their results due to their investment structure or the fact that they offered non-substitutive health insurance. The scenario-based assessments simulate the effect of adverse capital market developments on the earnings of the companies in question.

BaFin developed four different scenarios: two of these related exclusively to the influence of share price risks on company earnings. As a basis, the Supervisory Authority provided two fictitious levels for the EuroSTOXX 50 as at 31 December 2005. The two other scenarios also included interest rate risks in the assessment. Long-term interest rates once again declined considerably in the course of 2005. As a result, BaFin asked the companies to apply not only index levels, but also an increase in the yield curve by 100 basis points to their scenarios.

Sufficient hidden reserves even in the event of considerable interest rate increase.

The health insurance undertakings were able to cope well, in economic terms, with all of the scenarios. As expected, an increase in interest rates would have substantially reduced the hidden reserves for fixed-income investments, but net hidden reserves still corresponded to 4.2% of the investment portfolio, even in the worst-case scenario. A negative effect on gross profit could have been managed or offset by means of possible reporting at nominal value or as fixed assets.

Net interest earned in 2005 remains almost unchanged.

According to the scenario-based assessment, all of the health insurers were in a position to fulfil their guaranteed rate obligations. They would only have been required to resort to the adequate supplies of other surplus funds, such as the safety loading, in two cases. The sustained period of low interest rates continued to have an impact on projected investment income. As a result, BaFin expects the companies in question to be unable to increase their net interest earned by any more than the 4.8% recorded in the prior year. Earnings appear to have remained stable in 2005, although BaFin expects the gross revenue to be down slightly on 2004, mainly as a result of a drop in the underwriting result.

Adequate own funds at all companies.

It is projected that all health insurance companies will meet the solvency requirements as at 31 December 2005. The sector-wide coverage ratio of the solvency requirement is expected to lie just above the prior-year value. At present, BaFin does not expect any

of the health insurance companies under its supervision to experience financial difficulties.

3.2 Technical interest rate for private health insurance

Actuarial corporate interest rate (ACIR) process largely concluded.

In the year under review, the German Actuarial Society (DAV) worked closely with BaFin to largely complete the development of an actuarial process for determining a company-specific maximum interest rate, a process which began in 2004.

The Actuarial Corporate Interest Rate Process (ACIRP) consists of two phases which are applied in consecutive years. During the first phase, all health insurance undertakings that conduct their business in accordance with the technical principles of life insurance have to estimate, in April of each year, their current investment income for both this, and the following financial year on the basis of a flat-rate. This process takes into account the fact that a necessary reduction in the technical interest rate in the portfolio can only be performed if there is already a premium adjustment scheduled, and that premium adjustments for the entire portfolio do not take place every year, but every 1.76 years on average. The estimate is based on data as at 31 December of the previous year and 31 March of the current financial year and is calculated at a confidence level of 95%. If the calculations contained in the first phase produce values at certain insurance companies, which do not exceed the previous technical interest rate by at least 5%, a second phase is then implemented at these companies. Phase two involves taking a closer look at the specific situation of the company in order to make a more precise estimate. If the forecast level is below the technical interest rate currently in use, the company has to reduce its current rate to the estimated value.

The German Actuarial Society completed its work on the first phase in the year under review, with phase two completed in March 2006. It has been agreed that both phases of the ACIR process will be revised if they reveal weaknesses when put into practice.

No health insurer forced to reduce technical interest rate in 2006.

BaFin received the phase-one estimated values from all of the companies affected in the year under review. BaFin performed company-specific assessments, based on the draft versions of phase two, at a number of companies. The result was that no health insurer had to reduce its technical interest rate.

ACIRP binding.

BaFin expects all health insurance companies under its supervision that conduct their business in accordance with the technical principles of life insurance to furnish proof of the technical interest rate currently applied on a regular basis in accordance with the ACIRP. This procedure is seen as an adequate, but also a necessary piece of evidence for the margins of safety in the calculation base for the technical interest rate (section 2 (3) of the Calculation Ordinance (Kalkulationsverordnung – KalV)).

3.3 Results of on-site inspections: provisions of trustee agreements

No more than one trustee may be appointed at any given time.

In the course of its on-site inspections, BaFin found that certain trustee agreements grant the trustee a right to termination for cause if the insurance company transfers the trustee relationship, either in full or part, to another individual during the term of the agreement and without the consent of the existing trustee. This is a matter for concern from a supervisory point of view because such a provision implies that insurance companies could appoint further trustees while the existing trustee is still in office. The responsible trustee is the trustee who is currently in office. During the time that this trustee is appointed and the company has not terminated the agreement, the responsibility of the trustee in office can be eroded by the company's decision to appoint a further trustee. BaFin demanded that the insurance companies in question agree with the trustee to delete this provision, or to declare that the trustee relationship will not be transferred, either in full or part, to another individual during the term of the agreement without the consent of the existing trustee.

Trustee consulting activities threaten independence.

The main duties of the legal trustee involve assessing any amendments to terms and conditions and issuing an approval if required. In the course of an on-site inspection, BaFin found that one particular trustee agreement assigned additional duties to the trustee. These duties related to the provision of advice to the company in the event of changes in legislation or legal opinion relating to the laws governing the general terms and conditions of business and insurance. BaFin requested that the insurance company agree with the trustee to remove the tasks that exceeded its core duties. The reason being, the allocation of such duties blurs the border between the company, and the trustee sphere, putting the statutorily required independence of the trustee at risk. The risk is that the trustee will end up being responsible for initiating amendments to the terms and conditions, elaborating these amendments, and then assessing their appropriateness.

4 Property and casualty insurance undertakings, reinsurance undertakings

4.1 Financial situation of property and casualty insurers

Insurance companies achieve solid result in 2005.

Property and casualty insurance companies recorded a solid result in 2005, continuing what has been a positive trend over the past two financial years. A turnaround in this trend cannot, however, be ruled out in light of intense price competition.

The figures available are preliminary values based on the interim reports submitted to BaFin. Premium income from direct insurance business increased by 0.5% in 2005 to total €58.9 billion. The claims ratio increased from 63.8% to 65.3%, while the expense ratio remained virtually unchanged. The combined ratio rose from 89% to 91%. All in all, the companies generated positive net underwriting results after equalisation provisions.

Business development varied between the individual insurance classes. In motor vehicle insurance, results continued to flatten out, as they did in 2004. This was the result of increasing price competition and the reclassification of an above-average number of policies to more favourable no-claims bonus and vehicle categories. On the other hand, there was a reduction in claims expenses as a result of economic effects. On the whole, the motor vehicle insurance class reported a slightly negative underwriting result. Premiums also fell in the industrial property insurance class after rising considerably in 2002 and 2003. The combined ratio increased due to major losses.

4.2 Financial situation of reinsurers

The financial situation of reinsurance companies remained stable.

German reinsurance companies initially performed positively in 2005, thus continuing the encouraging trend of the previous year. The restructuring measures of the previous year gave a further boost to underwriting results, and thus led to more stable earnings. Among these measures, the selective and profit-oriented underwriting policies were of particular importance. Income from investments, and capital resources also showed positive development in light of the improvement in the equity markets.

Increasing demand from European primary insurers for reinsurance cover is to be expected in advance of the capital requirements under Solvency II. This may serve to strengthen reinsurance companies in the medium term.

The financial situation of German reinsurance companies can therefore still be described as stable overall, although the uncertainty about loss estimates and forecasts must be taken into account. BaFin's information is based in part on forecast statements which reinsurers had to submit for the first time for financial year 2005 in accordance with section 55b of the German Insurance Supervision Act. However, since the forecasts did not, or not conclusively, account for the effects of the US hurricanes, they are only classed as preliminary.

Uncertainty regarding losses from the hurricanes in the USA.

The natural disasters in the third and fourth quarters of 2005 were a considerable burden for reinsurers worldwide. Hurricane Katrina was one of the worst storms seen in the Gulf of Mexico for 150 years. The loss potential from Hurricane Rita was similar due to its comparable force and path. However, this hurricane caused considerably less damage as it hit lower value concentrations. A similar scenario was seen with Hurricane Wilma at the end of October. The estimates published to date of insured losses from

the natural disasters of 2005 predict losses ranging from €53 to €72 billion. Of course there are considerable uncertainties linked to these estimates.

According to a report by the IAIS from December 2005[48], international reinsurers will carry the bulk of the insured losses caused by natural disasters in 2005. The majority of the losses are attributable to the reinsurers in North America and the Bermudas, with a minimum of 35% of the total loss volume each. According to the report, reinsurers located in continental Europe will bear the burden of up to 17% of the total insured losses.

Sector expects slight price increase for reinsurance cover.

As a result of the hurricanes and the considerable damage to the oil platforms in the Gulf of Mexico, the sector expects the imminent negotiations on policy renewals to result in an increase in the price of internationally available reinsurance coverage. This would suggest that, contrary to forecasts which have been circulating for some time, the premium level has once again failed to relax. The reinsurance undertakings even expect higher margins, which, along with the accompanying capital injections, may lead to an increase in underwriting capacity. This may also result in the establishment of new reinsurance undertakings, in particular in countries with lower supervisory density.

Developments in 2004 varied from reinsurance class to reinsurance class.

As reported, property and casualty reinsurance is characterised by serious natural disasters and stable price development. There have been price increases in liability reinsurance, in particular relating to major industrial risks, and also in D&O liablity and professional indemnity. An increase in the loss provisions for previous years was necessary again, especially in the USA. Life reinsurance continued to profit from the trend towards private pensions. The health reinsurance market also saw positive development. A substantial amount of further growth potential is expected in this market, especially in China and India.

4.3 2005 stress test results

In the year under review, property and casualty undertakings presented BaFin with the results of the stress tests based on the annual financial statements as at 31 December 2004. BaFin included 188 property and casualty insurance companies in the assessment, with 38 companies exempted from the requirement to submit the stress test results.

Table 12
2005 stress test results

No. of IU with positive results in all scenarios	180
… as a % of the tests available	95.7%
No. of IU with negative results in all scenarios	6
… as a % of the tests available	3.2%
No. of IU with negative results in two scenarios	2
… as a % of the tests available	1.1%
No. of IU with negative results in one scenario	0
… as a % of the tests available	0.0%

[48] Global Reinsurance Market Report.

Almost all property and casualty insurance companies recorded positive stress test results. 3.2% of the companies reported negative results in all three scenarios, primarily as a result of the upward projection of target values required by the stress test model. There was an above average increase in the liabilities to be covered, in particular the provision for claims outstanding, partly as a result of strong corporate growth and new solvency requirements.

Nevertheless, even those companies that reported negative stress test results are expected to have an adequate risk-bearing capacity. The high growth rates are unlikely to continue due to increasing competitive pressure, and the more stringent solvency requirements were the result of a one-off adjustment to the new legal situation. The only effects which are likely to remain in force are specific, company-related special items. Furthermore, the companies in question have already introduced, or even implemented a number of measures to boost their ability to bear risk.

5 Pensionskassen and pension funds

5.1 Financial situation of Pensionskassen

Competitive Pensionskassen (Wettbewerbspensionskassen) considerably expand their business activities.

The market for occupational retirement provision was once again characterised by strong growth in 2005. Competitive Pensionskassen in particular, whose premium income rose by an estimated 25%, expanded their business activities considerably. The legislature made a substantial contribution to this development by providing tax relief for salary sacrifice schemes (Entgeltumwandlung). Business growth at predominantly employer-financed Pensionskassen was more subdued. These did not show any considerable improvement in premium income, because many sponsoring companies cut staff levels in order to reduce the burden of personnel-related expenses.

Hidden liabilities relating to equities almost eliminated by the end of 2005.

158 Pensionskassen were subject to supervision by BaFin at the beginning of the year under review. The hidden liabilities relating to equities at these companies had already been reduced considerably in 2004, totalling €16.3 million, or 0.02% of the book value of all investments at the 2004 balance sheet date. Hidden liabilities are expected to have been virtually eliminated by the end of 2005.

107 Pensionskassen report positive results in all three stress test scenarios.

Of the 158 supervised Pensionskassen, 32 were exempted from the requirement to submit a stress test based on the 2004 annual

financial statements, as there was little or no risk attached to their investments. 107 of the 126 Pensionskassen required to submit stress tests reported positive results in all three stress test scenarios. In the case of the Pensionskassen that reported negative results in one or more scenarios, the extent of the coverage shortfall was minimal in the majority of cases. These companies took a number of measures over the course of 2005 to restore their risk-bearing capacity.

Impending revaluation of mathematical provisions to result in increased expenditure.

In addition to the investment risks accounted for by the stress test, Pensionskassen also have considerable risk exposure resulting from biometric calculation bases. In particular, these include longevity risk. Many Pensionskassen will have to adjust their bases of calculation and revalue their mathematical provision, which will result in higher expenditures. The sustained period of low interest rates will make it increasingly difficult for the Pensionskassen to generate the surpluses required to finance these adjustments.

In 2005, BaFin prepared its first forecast for Pensionskassen. On 30 June 2005, these companies had to forecast the developments expected in 2005 for a number of different capital market scenarios. BaFin prescribed four scenarios involving price declines on the equity and bond markets. Pensionkassen with financial years that do not correspond to the calendar year will submit their first forecast statements for the financial year ending in 2006. 22 Pensionskassen were exempted from the requirement to present forecast statements for 2005, so that a total of 127 statements were submitted. BaFin was thus able to make an early prognosis, that the Pensionskassen would likely be able to fulfil their obligations by the end of the financial year.

Seven Pensionskassen had insufficient own funds at the end of 2004.

Seven Pensionskassen were unable to cover the solvency margin with sufficient own funds as at 31 December 2004. The coverage shortfall was either resolved in the course of 2005, or solvency plans were submitted and are still in the implementation stages. BaFin prohibited one company from underwriting new business because it was unable to present a plausible plan to restore financial health.

5.2 Financial situation of pension funds

Restrained pension fund growth.

The situation for pension funds was once again characterised by, on the whole, subdued growth in 2005. The number of future beneficiaries increased to approximately 134,000 by the end of the year (2004: 112,715), while the number of pension recipients rose to around 38,000 (2004: 225). Investments for the account and risk of the pension funds rose by 32% in 2005 to €341 million. Investments made for the account and risk of employees and employers increased by 209% to €744 million as at the end of 2005. As with the number of pension recipients, this increase was largely attributable to a single undertaking. The investments made for the account and risk of employees and employers still relate primarily to investments in fund units and life insurance policies; the majority of the investments in funds are in special funds launched specifically for this purpose.

BaFin prepared its first forecasts for pension funds.

BaFin prepared a forecast statement from pension funds for the first time as at 30 June 2005. The 24 pension funds had to forecast the developments expected in 2005 for different capital market scenarios. In this context, BaFin prescribed various scenarios involving price declines on the equity and bond markets. All companies were able to show that they would be able to cover their technical provisions in full, and have the own funds available to cover the solvency margin even in the event of unfavourable developments on the capital markets.

Benefit commitments still relate mainly to defined contribution plans with a defined benefit underpin.

Employer benefit commitments provided via pension funds still relate primarily to what are known as defined contribution plans with a defined benefit underpin. This means that the pension funds ensure retirement savings in at least the amount of the premiums paid in, to the extent that these have not been used to cover biometric risks. However, the number of defined benefit schemes is also increasing. This is due partly to the fact that the legislature has made it easier for existing employer-financed book reserve schemes to be transferred to pension funds. Many pension funds have already developed products that make use of the new options presented by law.

5.3 Supervision of public-law insurance undertakings

In the case of occupational retirement schemes that also offer statutory pension insurance, the EU pension fund directive applies only to the optional occupational retirement scheme business. The legislature used the 2004 amendment to the Insurance Supervision Act to implement this particular provision. Only one public-law insurance undertaking is currently subject to supervision by BaFin. The Federal Ministry of Finance is responsible for supervising the company as a whole, while BaFin supervises the segregated voluntary insurance business. This split supervision system applies to both the approval of the operating plan and financial supervision.

5.4 On-site inspections

The 2005 on-site inspections at Pensionskassen and pension funds focused on the total result, the underwriting results and technical provisions, investments and own funds. The inspections also focused, for the first time, on risk management systems, which have become increasingly important as a risk monitoring and corporate management tool. The inspections resulted in special audits at two companies. These audits, which focused mainly on investments and risk management, were performed by auditing firms on BaFin’s behalf.

Helmut Bauer,
Chief Executive Director
of Banking Supervision

V Supervision of banks and financial services institutions

1 Basis for Supervision

1.1 The Supervisory Review Process

With adoption of the Capital Requirements Directive (CRD), the European legislature has established a basis for the uniform implementation of the three pillars of Basel II by the EU member states. Pillar I – aims at ensuring that institutions' capital resources are more commensurate with their risk profile. This is to be achieved by enabling banks to use both internal and external rating procedures to measure their credit risk and by subjecting them to the explicit requirement to provide own funds to back their operational risk. Pillar II – provides the basic regulations governing what is known as the Supervisory Review Process (SRP), and pillar III – introduces comprehensive disclosure requirements for institutions in order to improve transparency and market discipline.

ICAAP and SREP as key components of the SRP

The SRP makes risk management at institutions a central issue. In accordance with the EU provisions, the SRP comprises two main elements: the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP). While the banks are responsible for implementing the ICAAP, the implementation of the SREP is a task for the national supervisory authorities.

Under the ICAAP, institutions must ensure that they always have sufficient internal capital available to cover all material risks. Unlike the capital referred to in the first pillar, internal capital is, in principle, not an own funds parameter in regulatory terms. Rather, internal capital acts as more of an internal management parameter that is embedded in a process chain. The CRD emphasises the process-oriented character of the internal capital regulations: the institutions are obliged to establish appropriate governance, management and control processes to meet the requirements of the ICAAP (robust governance arrangements). These arrangements must include clear organisational and procedural requirements, processes for identifying, assessing, managing, monitoring and communicating risks, and adequate internal control mechanisms.

The supervisory authorities are responsible for assessing the quality of the ICAAP, as well as the quality of the governance, management and control processes, on a regular basis. This also means that each supervisory authority is required to standardise its administrative practices for all institutions and to document its

actions. From 2007 onwards, supervisors will also be required, within the context of the SREP, to submit a final assessment of the risk situation, risk management, organisation and governance of every institution on a yearly basis and to use this assessment as a basis for further action.

The supervisory authorities must take into account the principle of double proportionality with regard to both the ICAAP and the SREP. The structure of the internal ICAAP at individual institutions depends, in particular, on the size of the institution, the type of activities it performs and its specific risk situation. The same applies to the intensity of supervision under the SREP. The resources used by the supervisory authorities in order to obtain information and to supervise the institutions on an ongoing basis must reflect both the significance of the institution, as well as the nature, scope and complexity of its business activities. The principle of double proportionality, which was included in the CRD as a result of an initiative launched by BaFin, takes account of the varying structures that apply to the credit industry in the EEA member states.

1.2 Minimum requirements for risk management

Central regulatory framework for new qualitative supervision.

The minimum requirements for risk management (Mindestanforderungen an das Risikomanagement – MaRisk) provide a central regulatory framework, in a modular form, for the new qualitative supervisory system in Germany. They include requirements with regard to the management of all material risks and thus provide a national interpretation of section 25a (1) KWG, which states, among other things, that all institutions have to develop appropriate strategies and set up adequate internal control procedures. The MaRisk requirements are by no means new in terms of content. The existing regulatory frameworks that BaFin modernised before incorporating them into the MaRisk include: the Minimum requirements for the credit business of credit institutions (Mindestanforderungen an das Kreditgeschäft – MaK) dated December 2002, the Minimum Requirements for the Trading Activities of Credit Institutions (Mindestanforderungen an das Betreiben von Handelsgeschäften – MaH) dated October 1995 and the Minimum Requirements for the Internal Audit Function of Credit Institutions (Mindestanforderungen an die Ausgestaltung der Internen Revision – MaIR) dated January 2000.

BaFin also included provisions from the CRD for which no qualitative regulations were in place in Germany. These relate primarily to the requirements governing the management of interest rate and liquidity risks, as well as individual aspects of operational risks. BaFin published the final version of the MaRisk on 20 December 2005.[49]

[49] Circular 18/2005.

Figure 13
MaRisk – Consolidation and supplementation

MaRisk			
MaK Credit risk	MaH Market risk	MaIR International audit	Other risks
Operational risks			

Basis for the development of the MaRisk

BaFin used three criteria as a basis for the MaRisk: flexibility, practicality and deregulation.

Flexibility.

BaFin paid particular attention to the heterogeneous nature of the German banking landscape when developing the MaRisk. It goes without saying that the requirements that apply to risk management at a small savings bank with limited volumes of business have to be different than those that apply to the systems of major internationally active banks. As a result, the MaRisk feature a number of opening clauses. These clauses afford the institutions a degree of flexibility in implementing the requirements so that the implementation process can take account of their individual size, business focus and risk situation. BaFin introduced the opening clauses primarily in order to take into account of the limited resources of Germany's smaller institutions.

Practicality.

Appropriate risk management requirements cannot be developed from an ivory tower, but rather only by means of ongoing dialogue with industry. As a result, BaFin continued to systematically apply the approach used in the development of the MaK and established an expert committee that examined the various drafts in the course of critical discussions, thus making a considerable contribution to the final version of the MaRisk. The MaRisk expert committee includes experts from Germany's institutions, as well as auditors, association representatives and banking supervisors. The committee will continue to meet on a regular basis following the publication of the MaRisk in order to clarify interpretation issues and discuss auditing matters.

Deregulation.

BaFin used the consolidation of the minimum requirements in order to eliminate redundancies and interface problems between the MaK, MaH and MaIR. It also subjected the 1995 MaH to a complete overhaul and brought them into line with modern regulatory approaches. The flexible nature and hands-on character of the considerably younger MaK establish them as an archetype. BaFin introduced a whole range of simplified procedures to the regulations governing trading activities, designed primarily to accommodate smaller and medium-sized institutions. By means of example, limited risk trading activities are no longer subject to the stringent regulations concerning the segregation of functions.

Modular structure of the MaRisk

The modular structure of the MaRisk means that, in the future, BaFin can quickly make any necessary amendments to individual sections of the regulation, because it can limit amendments to individual modules of the MaRisk. The structure also allows additional supervisory topics to be added to the MaRisk in the form of new modules. One plan, for example, is to incorporate the Outsourcing Circular[50] into a separate module of the MaRisk following thorough review and discussion in the expert committee.

GP and SP modules.

The MaRisk are split into two main modules: The general part (GP module) contains requirements that do not relate directly to specific types of business or risk classes. These include general risk management requirements or quantitative and qualitative requirements relating to staffing. Special requirements with regard to the internal control system and the internal audit can be found in the special part (SP module). Module SP 1 (internal control system) makes a further differentiation between regulations regarding the structure and the organisation of operations (BTO) and those relating to the identification, assessment, management, monitoring and communication of certain risk classes (risk management and control processes), which are set out in the BTR module.

Figure 14
Modular structure of the MaRisk

GP module – General part	
SP module – Special part	
SP 1 Special international control system requirements	
BTO Structure organisation of operation	BTR Risk management and control processes
SP 2 Special internal audit requirements	

Implementation of the MaRisk

Implementation deadlines designed to accommodate institutions.

The institutions can make use of the simplified procedures in lieu of the existing regulations with immediate effect. The requirements which arose as a result of the CRD, on the other hand, will become binding with effect from 1 January 2007. In the event that compliance with this deadline requires excessive effort on the part of institutions, BaFin will refrain from imposing possible sanctions until 1 January 2008. This pragmatic implementation procedure is BaFin’s way of keeping its promise and making sure that the implementation of the MaRisk does not exert any unnecessary time pressure on the institutions.

[50] Circular 11/2001 dated 6 December 2001.

1.3 Amendment of section 10a KWG to include IAS consolidated financial statements

At present, section 10a KWG still requires institutions to calculate their own funds at group level using what is known as an aggregation and deduction procedure. This procedure is based on the single-entity financial statements of the institutions in question. The legislature now plans to use national and international consolidated financial statements as the basis for the calculation of own funds. Provided that institutions prepare consolidated financial statements in accordance with either the German Commercial Code or International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS), these institutions will be obliged, in the future, to calculate their own funds at group level in accordance with their consolidated financial statements.

The new regulations are expected to come into force on 1 January 2007. BaFin and the Bundesbank developed the draft version of the new section 10a KWG in an expert committee together with representatives of the banking industry. The legislature plans to allow the institutions a transitional period until 2015. This transitional period is designed to take account of the considerable expenditure of time and administrative capacity required for the institutions to switch to the new own funds calculation procedure and use the consolidated financial statements for supervisory purposes as well. Furthermore, the application of the IAS/IFRS in particular means that many banks will have to completely overhaul their accounting systems. During the transitional period, the groups affected by the new regulations will be able to continue calculating their consolidated own funds in accordance with the existing aggregation and deduction procedure for the time being, and then make their own decision as to when they wish to switch to the procedure based on the consolidated financial statements. As of 2015, the institutions will be obliged to use their national or international consolidated financial statements to calculate their regulatory capital at group level. From this point onwards, groups subject to a statutory obligation to prepare consolidated financial statements will only be able to use the aggregation and deduction procedure in exceptional cases and with BaFin’s approval.

The amended version of section 10a KWG has a deregulatory effect because supervisory parallel calculations based on the single-entity financial statements are no longer required. It also facilitates a comparison between German banks and their international counterparts, which have been able to use their consolidated financial statements for some time now. Finally, the amendment serves to harmonise supervisory law. The Insurance Supervision Act, for example, has provided insurance companies with the option of using national and international consolidated financial statements to calculate group solvency for some time.

The unique structure of the supervisory system means that, even in the future, the institutions will not be able to carry-over own funds 1:1 from their consolidated financial statements. Rather, a number of adjustments will have to be made to take into account the differences between supervisory law and the accounting standards with regard to the specific companies to be included in capital consolidation. The institutions will also have to apply what are known as "prudential filters" in order to neutralise some of the effects that the international accounting standards have on equity.

What are prudential filters?
Prudential filters ensure that the own funds recognised as such under supervisory law continue to fulfil their purpose, i.e. to act as a risk buffer, even when banks calculate their consolidated own funds in accordance with IAS/IFRS consolidated financial statements.

The filters are required because the IAS/IFRS mean that certain own funds components are not permanently available to the institution group. This applies primarily because, unlike the German Commercial Code, the IAS/IFRS allow for direct recognition of fair values in equity in a large number of cases. This means that, under the IAS/IFRS, the institutions can report unrealised gains in a revaluation reserve (available-for-sale assets) and can recognise certain investment property items at fair value. Further examples include the impact of what are known as cash flow hedges on own funds, and the consideration of the institution's own credit risk.

Both the Basel Committee on Banking Supervision and CEBS identified these effects back in 2004 and recommended the establishment of prudential filters in order to neutralise them. In particular, one filter states that, when calculating the regulatory capital requirements, unrealised gains from the revaluation reserve are not to be counted towards a bank's tier one capital, but solely towards the tier two capital. However, these gains are only to be included in the tier two capital at a rate of 45%, as with all unrealised gains. BCBS and CEBS recommend the application of a similar regulation in the event that banks recognise real estate at fair value. The effects from cash flow hedges and the institution's own credit risk even have to be fully removed from own funds. The filters are intended to secure the sustainability of regulatory capital. They also allow an international comparison of banks' own funds irrespective of whether the institutions apply national or international accounting standards. BaFin will implement the prudential filters in an ordinance issued as a supplement to the amended version of section 10a KWG. The filters already apply to those banks that report own funds in accordance with the Basel Accord and use IAS/IFRS or US GAAP consolidated financial statements.

1.4 Raising of the threshold in section 18 KWG

Systematic deregulation in connection with section 18 KWG.

In accordance with section 18 KWG, credit institutions are obliged, as a general rule, to have their borrowers disclose their financial circumstances as of a certain threshold. With effect from 27 May 2005, the legislature[51] increased this threshold from €250,000 to €750,000, or 10% of eligible capital. This change in legislation brings the German regulations into line with those that apply in the neighbouring countries. In this respect, the legislature has done away with a possible competitive disadvantage, particularly for German credit institutions operating in regions close to the country's borders.

BaFin repeals all circulars.

The relief offered to the credit industry is not, however, limited to the increase in the threshold: BaFin repealed all of its circulars and official interpretations relating to section 18 KWG on 9 May 2005.[52] The is part of a systematic attempt to avoid fixed determinations of qualitative requirements. This strengthens the individual responsibility of the banks and provides them with flexibility, allowing them to implement the statutory obligations in a manner which suits their specific circumstances. The credit institutions now have to develop their own criteria for ensuing a comprehensive assessment of their credit risks, and must implement organisational measures to ensure that these criteria are applied. Both the criteria and the organisational measures must take the individual business activities of the respective bank into account.

1.5 Liquidity Ordinance and Ordinance on audit reports

Replacement of Principle II with the Liquidity Ordinance

In the year under review, BaFin presented the Federal Ministry of Finance with its revised draft for a Liquidity Ordinance (Liquiditätsverordnung – LiqV), which is designed to replace Principle II concerning the Liquidity of Institutions. The Liquidity Ordinance is also intended to implement the European legislation on e-money institutions[53] at national level. The European Commission will review the supervisory standards on the liquidity of institutions in the EU member states in the course of 2006.

Overhaul of the Ordinance on audit reports

BaFin undertakes a complete overhaul of the Ordinance on audit reports.

The audit reports prepared by the auditors of annual financial statements provide BaFin with crucial information about the credit and financial services institutions. In order to ensure that these

[51] The amendment was made within the framework of the Act on the Reorganisation of Pfandbrief Legislation (Gesetz zur Neuordnung des Pfandbriefrechts).
[52] BaFin has published the letter to the Central Credit Committee (Zentraler Kreditausschuss) on its website under "Legal Foundations & Official Announcements > Letters".
[53] Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions.

reports can be compared and that they contain all of the key information, auditors must comply with the provisions set out in the 1998 Ordinance on audit reports (Prüfungsberichtsverordnung – PrüfbV).[54] Given that many sections of the ordinance are in need of updating, BaFin started work on a complete overhaul of the Ordinance on audit reports in 2005 and is expected to present an initial draft for consultation by mid-2006. For several reasons, more than a mere amendment of the ordinance will be necessary in order to bring it into line with the current regulations of the Banking Act: firstly, the business structures and corresponding risk structures of the institutions are becoming increasingly complex, which has prompted BaFin to adopt a systematic risk-oriented approach. Secondly, Basel II and the IFRS have resulted in considerable changes to the international supervisory regulations and accounting standards since the Ordinance on audit reports came into force.

Audit process to become more flexible.

BaFin plans to make the audit process more flexible. In the future, auditors will have to focus more on the risk situation of the institutions being audited when defining the focus of the audits, as well as the scope and depth of their reports. BaFin also wants to allow auditors to bring the date of their procedural audits forward in a greater number of cases than was permitted in the past, after consulting the institution in question. This means that the content of the audit reports will merely have to be updated to reflect the figures at the balance sheet date.

SRP and IFRS to be taken into account.

The ordinance also takes into account the requirements of Basel II's Supervisory Review Process (SRP). Under the SRP, banking supervisors will conduct audits of banking operations with a view to assessing institutions' risk management systems and processes. The extent to which auditors can take into account the results of the special audits performed during the period under review is still under discussion. BaFin is also considering introducing special regulations for reporting on the audits of consolidated financial statements. In contrast to the consolidated financial statements prepared in accordance with the German Commercial Code, which prevailed in the past, there is some degree of difficulty involved in transferring the regulations on the reports on the audits of single-entity financial statements to IFRS consolidated financial statements. Ultimately, the new procedures are likely to be influenced by the planned new regulations for own funds consolidation: auditors will probably have to include supplementary information on those areas in which the IFRS have a particular impact on consolidated own funds, such as the application of the fair value option or the prudential filters, in their reports on the balance sheet and profit and loss account.

1.6 Circulars

Simplified procedure for the reporting of participating interests.

Banks and financial services institutions have to report their participating interests to BaFin and the Bundesbank in accordance

[54] Ordinance on the auditing of the annual financial statements and interim financial statements of credit institutions and financial services institutions, as well as on the audits in accordance with section 12 (1) sentence 3 of the Companies Act (Gesetz über Kapitalgesellschaften), and the corresponding audit reports.

with section 24 KWG. One single participating interest can fall under several of the categories set out in the Banking Act, meaning that the institution in question has to submit several notifications at the same time. A qualified participating interest, for example, can be held either directly or indirectly and can simultaneously constitute a close association. In the new circular[55], BaFin explains the definition of a qualified participating interest in accordance with section 1 (15) KWG and abolishes the requirement for institutions to submit a second, separate report on such interests.

Bonding for tour operators.

Both in accordance with the regulations governing large exposures and loans of €1.5 million or more and under the regulations contained in Principle I, guarantees and bonds are normally stated at the maximum amount for which a bank is liable. Following consultation with the credit industry, BaFin has allowed credit institutions to state lower amounts in their bonds vis-à-vis tour operators since the beginning of 2005.[56] As the institutions offering consumer protection, banks and insurance companies guarantee that the clients of tour operators receive a refund of the amount paid for their holiday in the event that travel services are no longer provided because the tour operator in question has become insolvent, or because insolvency proceedings have been opened against it. These banks and insurance companies can limit the maximum risk for which they are liable to €110 million, either per tour operator or in total. But, including bonds for tour operators at this amount would often considerably overstate the actual risk. As a result, credit institutions are now allowed to estimate the risk for which they are liable on the basis of their revenues. They must report the individually calculated risk, plus a safety mark-up of 100% to the Bundesbank without delay. Insurance companies also benefit from this risk-oriented relief with regard to the reporting procedure for loans of €1.5 million or more.

1.7 Pfandbrief legislation

German Mortgage Bond Act (Pfandbriefgesetz)

German Mortgage Bond Act in force since mid-July 2005.

On 19 July 2005, the German Mortgage Bond Act (Pfandbriefgesetz – PfandBG) replaced the existing special legislation governing Pfandbriefe: the German Mortgage Bank Act (Hypothekenbank-gesetz – HBG), the Act relating to Pfandbriefe and similar instruments issued by public-law credit institutions (Gesetz über die Pfandbriefe und verwandten Schuldverschreibungen öffentlich-rechtlicher Kreditinstitute – ÖPG) and the Ship Mortgage Bank Act (Gesetz über Schiffspfandbriefbanken). Since introduction of the new Act, uniform quality requirements apply to all issuers of Pfandbriefe. Furthermore, the fact that the legislature has abandoned the "special bank" principle set out in the Mortgage Bank Act (HGB) has led to two changes: firstly, all credit institutions can now use Pfandbriefe as a means of refinancing, provided that they meet the statutory requirements and that BaFin has authorised them to conduct Pfandbrief business. Secondly, the business activities of the former mortgage banks are no longer

[55] Circular 3/2005 dated 2 March 2005.
[56] Circular 1/2005 dated 19 January 2005.

restricted, which means that they receive the de facto status of universal banks. As far as public law credit institutions are concerned, the new Act introduces more stringent requirements with regard to the Pfandbrief business and the actual issuance of Pfandbriefe. Institutions that were granted an authorisation to issue Pfandbriefe before 19 July 2005 will retain this authorisation, limited to the respective class of Pfandbriefe. Nevertheless, in order to ensure that the authorisation remains valid, the institutions had to submit a notification in accordance with section 42 (1) PfandBG, the content of which corresponded largely to the requirements that apply to a licence application. Almost all of the affected institutions made use of this option.

Pfandbrief business must be operated on a long-term basis.

The Pfandbrief business is now classed as an area of banking business that is subject to a licensing requirement in accordance with the German Banking Act. Both the German Banking Act and the German Mortgage Bond Act set out the conditions that institutions must fulfil in order to be granted a licence. The applicant must, among other things, provide proof that it has minimum tier one capital of €25 million and must present an operating plan that shows that it intends to conduct Pfandbrief business on a regular and long-term basis and that it has introduced the necessary organisational measures to enable it to do so. The Mortgage Bond Act subjects BaFin to the requirement to assess the adequacy of Pfandbrief cover at each credit institution every two years as a general rule. BaFin is entitled to revoke the licence for Pfandbrief business, if a Pfandbrief bank no longer fulfils the licence criteria or has not issued any Pfandbriefe over the past two years and does not intend to do so in the next six months. The operating requirements state, among other things, that a Pfandbrief bank has to have adequate systems in place in order to manage credit, concentration, market and liquidity risks in the cover pool. The managers of the institution must have the appropriate experience and knowledge in its asset-side business and the refinancing of such transactions.

Increased transparency for cover pools.

The Pfandbrief banks are obliged to provide extensive information on the quality and composition of their cover pools to the public. The legislature incorporated a central coverage principle from the previous Mortgage Bank Act and the Act relating to Pfandbriefe and similar instruments issued by public-law credit institutions in the new Mortgage Bank Act. Both the nominal and present values of the claims of Pfandbrief holders have to be covered by assets such as mortgages or government loans. Excess cover of 2% also has to be maintained in particularly liquid assets. All Pfandbrief banks have to calculate a loan value for mortgage loans and may only use 60% of this value as cover. Furthermore, all Pfandbrief banks have to appoint a trustee to check that the Pfandbriefe are covered in accordance with the regulations.

Initial experience with the new legislation

The new German Mortgage Bond Act has not yet resulted in drastic changes to the Pfandbrief market. In the year under review, only four credit institutions received licences to conduct Pfandbrief

business. All of the other Pfandbrief banks – former or merged mortgage or ship mortgage banks, Landesbanks or savings banks – already had licences to issue Pfandbriefe as a means of refinancing before the new Act came into force. At the end of 2005, a total of 64 institutions had licences to issue Pfandbriefe. Four Pfandbrief banks applied to extend their limited license for Pfandbrief business to cover the issue of ship Pfandbriefe. The abolition of the “special bank” principle has enabled some banking groups to combine Pfandbrief activities with the remaining banking services offered by a universal bank under one roof by merging the parent company or the subsidiary with the superordinated or subordinated company. Some public-law credit institutions, although by no means all of them, are opting to manage their existing cover pools in accordance with the previous legislation and their new cover pools in accordance with the Mortgage Bank Act (section 51 PfandBG).

The licence criteria set out above have proven to be an effective means of protection against opportunistic conduct by certain institutions. Institutions should only conduct Pfandbrief business in a scope and manner which suggests that they will be able to do so on a long-term basis. Applicants have to submit a plausible operating plan covering the next five years to support this assumption. Another trend that has emerged concerns the former mortgage banks, which have been very cautious in making use of their right to enter into other business areas beyond the scope of the limited activities permitted under the old legislation. BaFin welcomes the fact that the former mortgage banks are continuing to focus primarily on their core competencies, despite considerable competitive pressure.

AHBR and the Pfandbrief market

On 25 October 2005, a public announcement was made to the effect that BHW-Holding AG, which had managed AHBR, was to be sold to Deutsche Postbank AG separate from the risks attached to AHBR, contrary to original plans. This resulted in substantial uncertainty on the market with respect to trading in AHBR securities. The spreads for the securities issued by AHBR widened considerably. Nevertheless, AHBR’s non-covered bonds, which are not backed by the deposit guarantee scheme, and its subordinated debt were barely tradable. Even as far as AHBR’s Pfandbriefe were concerned, spreads increased at times by 20 to 25 basis points. In the period in which uncertainty reached its peak, on 25 and 26 October 2005, virtually no market making took place for large-volume AHBR Pfandbriefe (jumbos). Investors looking to dispose of their AHBR jumbos could scarcely sell them to the market makers. The overall atmosphere of uncertainty caused the spreads of other Pfandbrief issuers to increase by as much as 3 basis points as well. However, the market calmed over the ensuing days. Even when the future of AHBR was at its most uncertain, the bank’s Pfandbriefe were never in danger of default. This is because of the comprehensive statutory requirements applicable to Pfandbriefe. Still today, more than 100 years of the German Pfandbrief have gone by without a single default.

Ordinance for mortgage lending valuations

The Mortgage Bond Act provides for a regulation that sets out the details of both the method and form to be applied to loan value calculations, as well as the minimum qualification requirements for appraisers. In this respect, the legislature has opted to retain the tried-and-tested principles of loan value calculation set out in the Mortgage Bank Act and the valuation instructions, which are still valid. BaFin is expected to issue the Ordinance for mortgage lending valuations (Beleihungswertermittlungsverordnung – BelWertV) in the spring of 2006. Both the banking associations and other interested parties contributed a number of comments and suggestions concerning the draft ordinance. BaFin also held a range of talks with the Central Credit Committee.

The provisions on loan value calculation take into account the fact that the real estate being valued is intended to serve as collateral for mortgage loans, which will, in turn, be included in the cover pool for Pfandbriefe. This is why the real estate value has to be one that can be realised during the entire term of the loan with an adequate degree of certainty (value related to a specific period of time). The market value serves a different purpose, and is normally calculated if the owner, or a potential buyer, wants to know the current value of a piece of real estate (value related to a specific point in time). Since both approaches are entirely different, the Valuation Ordinance (Wertermittlungsverordnung), which applies to market values, cannot be applied to the calculation of loan values.

2 Ongoing solvency supervision

2.1 Authorised banks

By the end of the year, 2,152 banks were under BaFin supervision, 25 of which received their banking licence in the course of the year under review. Fourteen licenses expired (not counting mergers between savings banks and cooperative banks or the discontinuation of banking business by semi-public cooperative banks).

BaFin categorises the banks roughly into four types of institution: lending institutions, institutions belonging to the savings bank sector, institutions belonging to the cooperative bank sector and other institutions. The lending institutions sector includes, among others, the major banks, the private banks and the bank branches outside of the EEA. Allocation to the savings bank or cooperative banks sector depends primarily on the economic ties between the institutions. As a result, the “free savings banks” and Landesbanks are assigned to the savings bank sector, and DZ Bank and WGZ Bank to the cooperative sector, despite the fact that these are

public limited companies. “Other institutions” include building societies, mortgage banks and securities trading banks, as well as both the federal and state housing promotion banks (Förderbank).

Table 13

Number of banks by type of institution*

Type of institution	2005	2004
Lending banks	208	216
Institutions belonging to the savings bank sector	475	489
Institutions belonging to the cooperative sector	1,337	1,382
Other institutions	132	132
Total	2,152	2,219

* As at 31 December in all cases.

Mergers at cooperative and savings banks.

The cooperative sector consisted of 1,291 primary institutions, two central banks and 44 building cooperatives. As compared to 2004, the number of primary institutions was down by 48 (3.6%). Figure 15 shows that the rate of mergers in the cooperative sector has been on the decline over the past few years. The savings bank sector comprises eleven Landesbanks, one central institution and 463 savings banks. The trend towards mergers among savings banks also continued, with the number of savings banks falling by 14 in the year under review (2.9%).

Figure 15

Number of cooperative primary banks

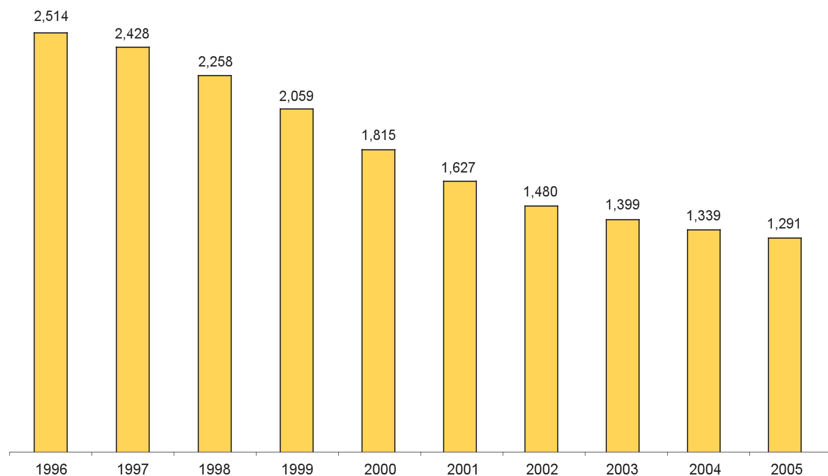
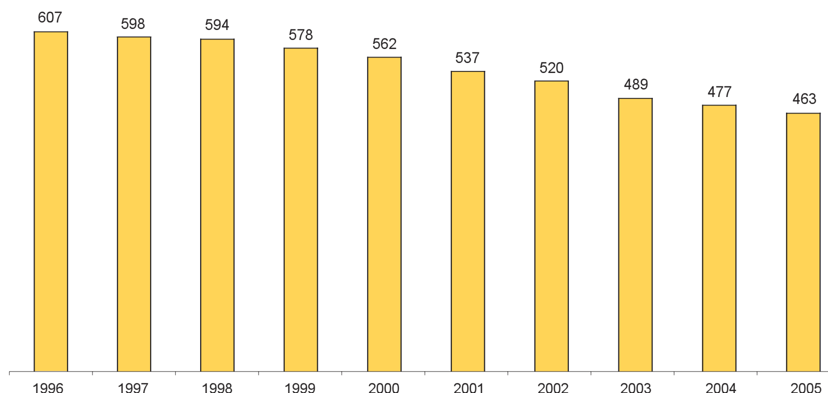


Figure 16

Number of savings banks



2.2 Supervisory instruments

Audit reports on the annual financial statements, supervisory consultations and special audits.

BaFin has several methods of keeping up-to-date with the net assets, earnings and cash flow of the institutions, as well as their risk situation and risk management. The first method relates to the reports and notifications submitted by the institutions. The standardised assessment of the annual financial statements by the auditors provides a further source of information. BaFin and the Bundesbank also hold supervisory consultations with top-level bank management in order to obtain detailed specific information on a selection of individual subjects. BaFin can also order special audits, which it may do without cause in accordance with section 44 KWG. These special audits allow BaFin to check whether or not the institutions are complying with the statutory provisions. Unlike the audits of the annual financial statements, which cover a wide range of areas, the special audits focus on individual issues and give BaFin a selective and in-depth insight into the institutions in question.

Focus of the special audits.

BaFin's special audits can focus on ten different areas.

Table 14

Special audits pursuant to section 44 (1) KWG

Abbreviation	Subject of the audit (main focus)
KSP	Special lending-related audits (Kreditsonderprüfungen – KSP), which focus, for example, on the value of exposures or compliance with section 13 KWG
MaK	Compliance with the Minimum Requirements for the Credit Business of Credit Institutions (Mindestanforderungen an das Kreditgeschäft – MaK)
MaH	Compliance with the Minimum Requirements for the Trading Activities of Credit Institutions (Mindestanforderungen an das Betreiben von Handelsgeschäften – MaH)
MaIR	Compliance with the Minimum Requirements for the Internal Audit Function of Credit Institutions (Mindestanforderungen an die Interne Revision – MaIR)
Orga	Proper business organisation within the meaning of section 25a KWG, insofar as this does not relate to compliance with particular minimum requirements
Cover	Compliance with the cover requirements of the Mortgage Bond Act (according to section 3 PfandBG, Pfandbrief cover has to be assessed every two years as a general rule)
Other	Remaining audit issues, such as compliance with Principle II or the management of the interest rate risks
MRM	Suitability of a market risk model (MRM) for calculating own funds in accordance with section 10 (1c) KWG (regulations to be set out in the Solvency Ordinance (Verordnung über die Eigenmittelausstattung der Institute – Solvabilitätsgrundsatz – SolvV in the future)
AMA	Suitability of advanced approaches (AMA) for the calculation of the own funds requirement for operational risk, as well as compliance with the minimum requirements for the use of these approaches in accordance with the Solvency Ordinance
IRBA	Suitability of rating systems and the participating interest risk models used to calculate the own funds requirements for counterparty risks within the framework of an internal ratings-based approach (IRBA), an compliance with the minimum requirements for the use of the IRBA in accordance with the Solvency Ordinance

BaFin uses the special lending-related audits to examine selected exposures in order to determine whether or not the institutions have complied with the statutory provisions governing the lending business. These audits focus on whether or not the banks have set

up sufficient risk provisions, or, in many cases, on compliance with the large exposure regulations. The audits that focus on the minimum requirements and on the organisation of an institution do not, unlike the special lending-related audits, focus on individual exposures. Rather, BaFin concentrates on the quality of the institution's internal processes, for example with regard to the introduction of new products, the granting of loans or the execution of trading activities. Compliance with the minimum requirements for risk management (MaRisk) will replace MaK, MaH and MaIR audits in the future. BaFin uses the audits of cover assets pursuant to the Mortgage Bond Act to examine whether or not the value of the assets used to cover Pfandbriefe is sufficient, and whether or not the claims of the Pfandbrief holders are secured as a result. The remaining audits cover a range of different audit areas which are rarely examined outside of the annual financial statements and are therefore not listed separately.

Audits by request – a special case.

The AMA, IRBA and market risk model audits are special cases. These are conducted, at the request of the institution in question, at institutions that want to use their own internal forecast models to calculate adequate own funds (section 10 KWG). Before these models can be used for this purpose for the first time, BaFin must approve them within the context of an audit. These acceptance audits are then followed by follow-up audits to ascertain whether or not the internal models still meet the supervisory requirements.

Risk models at credit institutions

At the end of 2005, a total of 16 credit institutions had received confirmation from BaFin that their internal market risk models met the supervisory requirements. Six institutions made full use of the option to apply internal market models. BaFin uses the term "full use" here as opposed to "partial use".

In the year under review, BaFin performed one initial audit and two follow-up audits itself, and commissioned the Bundesbank to perform a further five follow-up audits. The predictive quality of the models proved, once again, to be solid. The backtesting of market risk models identified 15 outliers at 16 model banks (2004: 8 outliers at 15 model banks). Backtesting involves comparing the actual loss recorded on a trading day with the maximum loss forecasted by the model at a confidence level of 99%.

For the first time, BaFin audited risk models that are used to internally manage the interest rate risk in the banking book, which do not have to be backed with own funds under the regulatory requirements. It examined whether or not the banks had a proper business organisation within the meaning of section 25a (1) KWG. The results were highly satisfactory. The audits allowed the credit institutions to prove that they dispose of suitable instruments to manage the present value of their interest rate risks and that they actively used these instruments.

Table 15

Risk models and factor ranges

Year	New applications	Rescinded applications	Rejected	No. of of model banks	Minimum additional factor	Maximum additional factor	Median
1997	5	0	2	3	-	-	-
1998	15	2	4	9	0.1	2.0	1.45
1999	5	0	0	8	0.1	1.6	0.85
2000	2	0	0	10	0.0	1.6	0.30
2001	2	0	0	13	0.0	1.5	0.30
2002	1	0	0	14	0.0	1.0	0.25
2003	0	0	0	15	0.0	1.8	0.20
2004	1	1	0	15	0.0	1.0	0.30
2005	2	1	0	16	0.0	1.0	0.25

BaFin ordered 335 special audits in addition to its ongoing solvency supervision activities in 2005. This is less than the 346 special audits performed in the previous year. Around one-third of all audits and three-quarters of the MaH and MaK audits were performed by the supervisory authorities – mainly the Bundesbank – themselves. External auditors were commissioned to perform the remaining audits. BaFin made the decision as to which banks were to be audited using a risk-oriented approach on the basis of the bank classifications.

The focus of the individual audits can be broken down as follows:

Table 16

Number of special audits

	2005	2004
KSP	165	196
MaK	93	36
MaH	29	74
MaIR	0	0
Orga	18	20
Cover	7	6
Other	10	7
MRM	8	7
AMA	0	0
IRBA	5	0
Total	335	346

BaFin increased the number of MaK audits, which were introduced in the second half of 2004, in the year under review. The decline in the total number of audits is primarily attributable to the considerable drop in the number of special lending-related audits and MaH audits.

BaFin performed its first IRBA audits in 2005 at the request of certain institutions, although Basel II and the Solvency Ordinance do not come into force until 1 January 2007. BaFin expects the number of these audits to increase substantially over the next two years. AMA audits will also follow. The internal rating procedures used by the institutions normally consist of several modules that can only in exceptional cases be approved in one single audit. This is why the number of IRBA audits stated in Table 16 does not correspond to the number of audited internal rating systems.

Table 17 shows a breakdown of the audits performed in 2005 by type of institution:

Table 17
Breakdown of 2005 special audits by type of institution

	Lending banks	Institutions belonging to the saving bank sector	Institutions belonging to the cooperative bank sector	Other institutions	Total
KSP	7	31	122	6	166
MaK	13	28	44	7	92
MaH	5	8	7	9	29
MaIR	0	0	0	0	0
Orga	13	5	0	0	18
Cover	0	0	0	7	7
Other	1	2	4	3	10
MRM	6	2	0	0	8
AMA	0	0	0	0	0
IRBA	1	3	0	1	5
Total	46	79	177	33	335

Given that many special audits reveal deficits at certain banks, the audits often have supervisory consequences. BaFin's possible reactions range from letters asking the institution to comment on the audit report to serious findings and administrative fines to the dismissal of the bank's management. The 335 special audits conducted in 2005 resulted in more than 200 findings of supervisory law violations or sanctions by BaFin. Often, individual audits resulted in more than one reaction by BaFin.

Table 18
Findings of supervisory law violations and sanctions imposed

Type of institutions	Serious findings	Actions against managers	Administrative fines	Measures in cases of danger (pursuant to section 46 KWG)
Lending banks	26	0	0	1
Institutions belonging to the saving bank sector	33	12	0	0
Institutions belonging to the cooperative bank sector	116	25	0	3
Other Institutions	20	2	0	4
Total	195	39	0	8

These measures are partly the result of special audits, but also stem from other sources of information, in particular the assessment of the annual financial statements.

2.3 IRBA and AMA application procedures

With effect from 1 January 2007, institutions can measure their credit risks using an internal ratings based approach (IRBA) and determine their regulatory capital requirements on this basis. This is subject to the prerequisite that BaFin has permitted the institutions to use IRBA and that it has confirmed the suitability of the rating systems used. The institutions have been entitled to submit applications for this since December 2004.[57] The advanced

[57] BaFin has posted information on the IRBA application procedure on its website under " For Providers > Credit Institutions".

measurement approaches (AMA) for capital requirements to cover operational risk can be used by banks and financial services institutions as of 1 January 2008, again provided that these approaches have been accepted by BaFin. The institutions have been able to submit AMA applications since October 2005. BaFin has published a fact sheet on the application process together with the Bundesbank.[58]

IRBA permission

17 institutions have applied for permission.

In the year under review, 17 credit institutions applied to use their internal rating systems. Audit teams have already visited three credit institutions to assess the suitability of the internal ratings. BaFin expects many more applications to be submitted, and, as a result, many more audits to be performed in 2006.

Implementation of the IRBA at major banks and Landesbanks

A BaFin survey conducted in March 2005 revealed that the major banks and Landesbanks plan to use a total of around 300 modules over the next few years, and have to register these modules for audit as a result. Individually, the banks have indicated that they will each be using up to 54 modules. BaFin expects many institutions to start submitting applications to have their individual modules audited as early as 2006. BaFin will audit the modules either individually, or in clusters, depending on the complexity.

Many credit institutions have developed the methodology behind their rating procedures in cooperation with associations and other institutions. The first IRBA acceptance audits for cooperation projects of this nature will be performed at institutions willing to act as pilot banks. BaFin will then use the findings on the methodological structure of the rating procedures derived from the application process in the audits performed at the other cooperation banks.

In 2005, 15 major banks and Landesbanks submitted IRBA applications for a total of 112 modules. BaFin has already begun auditing a total of 36 modules at five banks.

Preliminary assessment of internal rating systems complete.

The start of the IRBA authorisation audits signals the end of BaFin’s work on the preliminary assessment of internal rating systems. This assessment was based on the third consultation paper of the Basel Committee for Banking Supervision dated April 2003. The initiative gave banks the opportunity to subject their internal rating systems to a non-binding preliminary supervisory assessment by BaFin and the Bundesbank between August 2003

[58] The fact sheet can be found on the BaFin website under “For Providers > Credit Institutions”. BaFin has also published a fact sheet on the standard approach for operational risks, which can be found in the same section of its website. This approach only triggers a reporting procedure.

and October 2004. 22 institutions made use of the opportunity and submitted documentation on a total of 73 modules. Three modules were withdrawn by the institutions in question, while useable documentation was missing in the case of two others. BaFin and the Bundesbank jointly audited the remaining 68 modules. By the autumn of 2005, all of the institutions had received feedback on their progress as regards implementation, as well as on any problems that might occur during the acceptance process. Despite numerous promising approaches, many banks still have much work to do, particularly with regard to data history and documentation.

AMA approvals

Considerable activity also expected in the area of operational risk.

BaFin and the Bundesbank used their "Industry action regarding AMA / Operational risk" to find out just how interested the German banking industry currently is in the implementation of an advanced measurement approach, and how the implementation efforts have progressed so far. The initiative revealed that the results of the 2004 survey have to be put into perspective.[59] Nevertheless, the 15 banks that took part in the industry action seem to have made relatively good progress with respect to implementation in an international comparison. BaFin published its report on the industry action in September 2005. It expects to receive the first applications for the use of the AMA in the first quarter of 2006.

2.4 Risk identification and assessment

Risk profile and classification.

BaFin and the Bundesbank have developed formal procedures for the risk profiling and classification of the supervised institutions, which is designed as a basis for a risk-oriented supervisory system that meets the requirements of the Supervisory Review Process and the principle of double proportionality. These procedures already characterise current supervisory practice for the system-relevant banks.

The provisions set out in the CRD state that, as of 1 January 2007, a comprehensive risk assessment system, which must be updated annually, must be applied to the supervision of all institutions. This system must take account of the specific risk profiles of the institutions and the impact that difficulties at a particular institution would have on the stability of the banking market as a whole.

The preparation of an appropriately detailed, institution-specific risk profile that will enable the classification of all of the supervised institutions will help BaFin to act in a risk-oriented manner and to avoid placing excessive burdens upon the institutions. All of the risks incurred by certain institutions as a result of their membership in a group will also be taken into account, because BaFin will prepare risk profiles for bank groups and other de facto risk groups as well.

[59] 58 institutions had indicated in the survey that they were interested in obtaining early AMA approval.

Institution-specific risk profiling and the classification of all supervised companies information forms the basis of supervisory and audit planning. The banking supervisory audit plans for 2006 are already based on a comprehensive risk classification system.

Two-dimensional risk classification.

The risk classification process is two-dimensional. The supervisory authorities rate the quality of institution on a four-tier scale (high, medium-high, medium-low, low) and its impact on the stability of the financial sector on a three-tier scale (high, medium, low).

Risk identification at cooperative banks and savings banks.

BaFin and the Bundesbank have developed a statistically-based bank classification system for the large groups of cooperative banks and savings banks. The system consists of a quantitative and a qualitative module, and provides a largely parameter-based assessment of the institutions in comparison with their competitors in the same sector. But the system also takes into account qualitative information on the structure and organisation of operations at the banks, information which is taken primarily from the audit reports on the annual financial statements. The qualitative module is still in development, because there are still gaps in the data required in order to come to a statistically substantiated conclusion. Within the quantitative and qualitative modules, the system is split into risk areas, to which various key statistics are assigned. This means that the system not only provides a suggested overall assessment of the institution by means of the classification procedure, but also helps evaluate individual risk areas of the risk profile.

Impact classification.

The impact-related element of the risk classification procedure measures the effect that difficulties at a given institution would have on BaFin's objectives in light of the importance of that institution within the system. The potential risk to the stability of the financial sector as a whole is classified as high, medium or low for each specific institution. The process also takes into account the particular importance of an institution for a relevant sub-market of the financial sector (e.g. building societies).

The classification of the banking sector performed in November 2005 resulted in the following distribution of the institutions over the twelve classification matrix fields:

Table 19
Risk classification results 2005

Institutions in %		Quality of the Institution: high	medium-high	medium-low	low	Total
Imapct	high	0.9%	1.0%	0.5%	0.0%	2.3%
	medium	1.8%	3.3%	1.3%	0.6%	7.0%
	low	24.1%	42.0%	16.7%	7.9%	90.6%
	Total	26.7%	46.2%	18.5%	8.5%	100%*

* Irregularities in the figures set out under "total" are due to rounding differences.

2.5 Non-performing loans

Over the past three years, Germany has developed a liquid market for non-performing loans (NPL), which gives banks an additional means of actively dealing with their problem loans. In contrast to many other countries, this market has established itself in Germany without state intervention or incentive schemes.

Credit institutions are now able to use the market for relatively quick placement of their undesired default risks, allowing them to resolve capacity bottlenecks in their back offices. The cash proceeds from the NPL sales and the relief with regard to capital requirements also facilitates strategic repositioning in lending business. As a result, a liquid NPL market can help stabilise the banking sector.

Figure 17
NPL market potential

Exact figures on Germany's NPL volume are not yet known to the market. Analysis institutions and consulting firms estimate Germany's NPL volume at somewhere between €160 billion and around €300 billion. BaFin's forecasted volume, based on the bank audit reports for 2004, stands at around €211 billion, putting it in the middle of the estimate range. This calculation is based on the aggregate gross client lending volume requiring specific allowances and allows only limited international comparison.

What are non-performing loans?
German supervisory law does not provide a definition of non-performing loans. Normally, the term is taken to mean bad debt or, in a broader sense, all types of problem loans.

The supervisory definition of default for the internal rating approach is based on the objectifiable criteria of a 90-day delay in payment. Impending non-performance of a payment obligation can also constitute default. This happens when a borrower is highly unlikely to be able to meet its main obligations vis-à-vis an institution or group of institutions in full, unless the bank takes measures, such as realising collateral, for example.

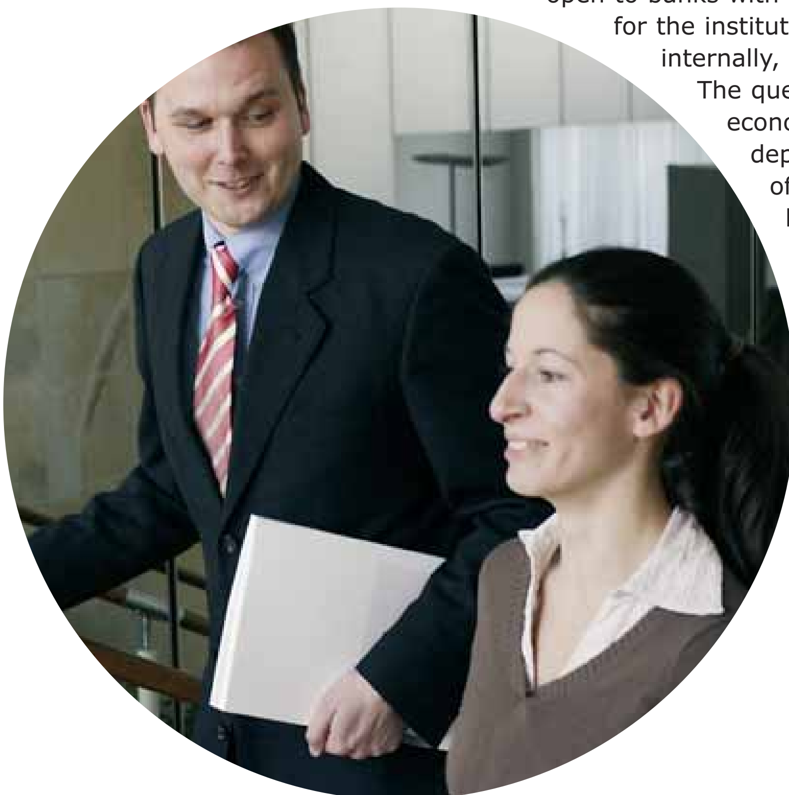
The Ordinance on Audit Reports (Prüfungsberichtsverordnung) currently distinguishes between loans without identifiable risks, loans with increased latent risks and impaired loans.

In practise, the term NPL includes not only the impaired loans, but refers to all forms of problem loans. NPL portfolios, for example, often contain a large number of loans which have not yet been terminated but are extremely likely to default (sub-performing loans). In many cases, sellers also include performing loans in the portfolio for corporate policy or strategic reasons.

In the year under review, the number of NPL transactions continued to increase as compared to the previous years, as did the volumes of the individual transactions. The focus remained on loans secured by real estate. Major banks dominated on the seller side, while on the buyer side, the main players were internationally active financial investors that have experience with NPLs in other regions and are not usually subject to the German supervisory system. Some of these investors did not stop at purchasing NPL portfolios, but went on to acquire German credit institutions. They thus have access to licensed banking platforms that are subject to the German supervisory system. International investment banks and their German branches and subsidiaries represent another key NPL investor group. These are normally subject to supervision by their home authorities and by BaFin.

The buyers pursue a range of strategies ranging from resale, restructuring and collection to the realisation of collateral. The financial investors and their service partners are better equipped to process problem loans than many banks, because they have specialised their IT, organisational structure and negotiation techniques to this business area. As much as approximately 90% of some transactions are debt financed. Without financial engineering or a high level of debt financing, the ambitious yield objectives of the financial investors (which often exceed 20% p.a.) could barely be realised. Given that German credit institutions are among the sources of refinancing for such transactions, not every NPL sale means that the risks leave the German banking sector.

Selling portfolios to financial investors is only one of the options open to banks with NPLs. It can prove just as efficient for the institutions to settle the problem loans internally, or to set up their own "bad banks". The question as to which method makes economic sense for a particular bank depends on a number of factors. One of the key issues is the price that can be charged for a portfolio, the bank's own capital resources and the extent to which value adjustments are required. The effectiveness of the risk transfer and legal uncertainties also have to be taken into account. It is up to the management of the bank to choose the strategy which is best suited to its situation.



2.6 Building and loan business and approval of terms

The Mortgage Bond Act means that the special bank principle no longer applies to mortgage banks. Building societies, on the other hand, are still subject to the special bank principle, which is anchored in the Building Societies Act (Bausparkassengesetz – BSpKG). Following the merger of Axa Colonia Bausparkasse with BHW Bausparkasse, BaFin now supervises 26 building societies, 15 of which are private and 11 of which are public-law enterprises.

New business remains strong.

The volume of new business at the building societies remained consistently high in the year under review, up considerably on the levels seen from 1997 to 2002 but down on 2003, which was an exceptional year. The institutions expect new business to stagnate at a high level over the next few years. Earnings development was relatively good as against the previous years, mainly as a result of continued cost cutting and some cases of rigorous rationalisation. The future development of the building societies will depend to a considerable degree on future interest rate trends.

Since other banks offer real estate financing at similarly low interest rates, the building societies are still reporting sluggish building society loan business. The current interest rate landscape means that low lending rates, the traditional incentive for building society loans, are no longer as attractive as they once were. All in all, building society loans are accounting for an ever smaller proportion of building societies' total lending volume. In some cases, these loans account for only a third of lending portfolios. The fact that the building societies are granting fewer building society loans is compensated for by the interim and bridging loans business. These are loans granted to savers who have not yet met the requirements to receive their building society loan.

New low interest loan terms.

The building societies have, nevertheless, responded systematically to interest rate changes over the past few years by introducing new terms, and have been offering loan interest rates of under 3% since 2005. This has led to a considerable reduction in the proportion of terms offering deposit interest rates that are high relative to the market. Building society portfolios are now dominated by terms that are in line with current market rates. Nevertheless, the fact that many savers are using their old contracts, which were concluded at high interest rates, as a long-term savings facility is still having a negative impact on the earnings of building societies. Given that the investment options open to building societies are restricted by law, it is hard for them to adequately invest the high-interest deposits of their clients.

The Building Societies Act states that building societies can only introduce new terms on the market once BaFin has approved the terms of the building society loan. This so-called preventative rate supervision is designed to ensure that the contracts can be permanently fulfilled. BaFin has continually refined its methods for assessing rates over the past few years and has for some time no

longer relied on individual figures. Rather, it analyses the results of simulations performed by the building societies to model the development of savings and loan business (Bauspargeschäft). This is due to the fact that building societies have, in recent years, developed better methods for early warning and action against risks. The building societies use these methods themselves as part of their bank-wide risk management strategy in order to manage the specific risks in savings and loan business. In the future, BaFin aims not only to assess the results of the simulation, but to analyse the simulation models themselves. Furthermore, it wants to subject rate development, and savings and loan business as a whole, to more intensive analysis in the future using the models employed by the building societies themselves. BaFin expects the building societies' internal models to prove reliable, and also believes that a generally accepted minimum standard for the management of the specific risks in savings and loan business will emerge at the same time. This would allow managers to identify imminent negative developments resulting from building and loan terms at an early stage, and to take timely action. Once all building societies have implemented these management tools and once they have proven suitable for managing risks specific to building societies, BaFin could deregulate this area and limit its activities to the monitoring of risk management. This would render BaFin approval of the rates prior to their introduction unnecessary.

2.7 Phoenix case

Considerable public attention was focused on Phoenix Kapitaldienst GmbH in the year under review. The company offered its clients a collective investment in derivatives, which it managed itself, designated as a "Managed Account". The institution commissioned foreign brokers to conclude the trades, and the Phoenix Managed Account was to be managed by a British broker.

Case for compensation determined by BaFin.

In March 2005, BaFin prohibited Phoenix Kapitaldienst AG from conducting business after the new management of the company provided information pointing towards irregularities in the management of trust funds in the Phoenix Managed Account. Trust funds totalling €680 million had disappeared and the company was not in a position to compensate for this loss. As a result, BaFin has petitioned for insolvency proceedings and found that there was a case for compensation (Entschädigungsfall). This is a prerequisite for compensation proceedings, which are performed by the Compensatory Fund of Securities Trading Companies (Entschädigungseinrichtung für Wertpapierhandelsunternehmen).[60] At the instructions of BaFin, the representatives of Phoenix immediately filed criminal complaints with the Frankfurt am Main prosecutors' office. The prosecutors' office has since brought charges against the former managing director and a registered legal agent (Prokurist).

[60] www.e-d-w.de.

Prior to the information provided by the new management of Phoenix, there had been no indication that the company had been involved in criminal activities. Phoenix Kapitaldienst GmbH obtained its licence to provide principal broking services in non-securities and financial portfolio brokerage services by making use of transitional provisions (section 64e KWG). The company reported the funds invested in the "Managed Account" in its balance sheet as trust funds and the balance was endorsed every year by the company's auditor. The forgery of accounting documents was overlooked. Even the special audit ordered by BaFin in 2002 did not point towards embezzlement of client funds or other irregularities in the institution's trading activities.

2.8 Financial services institutions

743 financial services institutions under BaFin supervision.

By the end of 2005, 743 financial services institutions were under BaFin's supervision (2004: 806). 3,403 "tied agents" were also subject to indirect supervision by BaFin (2004: 3,316). Tied agents are freelance employees that distribute financial instruments for authorised enterprises under the liability of the latter. As a result, they do not require their own licence for the brokering of financial instruments. Individual financial services institutions have numerous agents working under their liability. In these cases, BaFin performs regular checks to ensure that the institution in question is monitoring the activities of its freelance employees in an adequate manner.

Focus on portfolio management.

In the year under review, 482 institutions had a licence for portfolio management, with 159 institutions providing investment and contract broking services only. Five financial services providers were authorised to obtain ownership or possession of funds or securities from customers. This is subject to the prerequisite that the institution has capital resources totalling at least €125,000. 35 financial services institutions trade in financial instruments for their own account. As with securities trading banks, these institutions must be able to provide proof that they have capital of at least €730,000.

More than 50% of the financial services institutions are corporations.

The number of corporations continued to rise. 442 financial services institutions, or 56.2%, operated as limited liability companies in 2005, while the proportion of public limited companies totalled 18.5% (153) in the year under review. Only 12.6% (102) of the institutions were sole proprietorships which employed little or no staff.

60 applications for licences to provide financial services.

BaFin received 60 licence applications in the year under review. Many of these applications were submitted by former employees of credit institutions who wished to become self-employed portfolio managers. BaFin received a large number of applications from unemployed residents of the Berlin area, who had obviously been advised by a local job centre to consider becoming self-employed portfolio managers. None of these applications has proved successful to date, because, irrespective of whether other

application criteria were met, none of the applicants had the required minimum capital of €50,000. Eight financial services institutions wanted to expand their business activities and applied for an expansion of their licences.

BaFin maintained direct local contact with the institutions.

Discussions and audit monitoring visits provide BaFin with an excellent opportunity to form its own impression of a company and to discuss certain issues in practical situations. During the audit monitoring visits, which do not result in any additional costs for the company, BaFin employees accompany the company's auditors in the course of their regular annual audits. BaFin made a number of audit monitoring visits and held several other supervisory consultations in the year under review, often together with the Bundesbank.

By way of example, BaFin is currently monitoring an audit at one particular institution and held a supervisory consultation after one employee was found to have manipulated stock exchange prices. The consultation revealed that the company had failed to adequately monitor its employee transactions, although this had not been reflected in the audit reports produced in previous years. In order to resolve this shortcoming, the institution held compulsory training sessions on employee transactions for all employees. It also prepared a new list of all of its employee accounts, securities accounts and powers of attorney and assigned its employees to specific functions for the first time. Employees with particular functions not only have to declare any inside information, but also have to report all employee transactions to the compliance department.

Six special audits in accordance with section 44 KWG.

In 2005, BaFin ordered six special audits in accordance with section 44 KWG. One of these audits was performed by BaFin itself, while the others were performed by auditors or by the Bundesbank.

One special audit concerned the German branch office of a foreign institution. According to information provided by the supervisory authorities of the institution's home country, the foreign institution had been prohibited from distributing certain products. An insolvency petition had also been filed by the foreign parent company, and clients were complaining about the institution. The objective of the special audit was to determine whether or not the company was complying with the prohibition and the auditors discovered that documents had been manipulated. This led to the launch of supervisory proceedings to revoke the licence. The institution was also suspected of violating the distribution ban imposed by the foreign authorities, and BaFin informed the authorities of the institution's home country accordingly.

BaFin commissioned another special audit at a financial services institution operated as a sole proprietorship and based in Düsseldorf. In this case, considerable doubt had been raised as to the proper organisation of the institution's business operations after numerous clients had lodged complaints. The auditors discovered substantial deficiencies in the organisation of the

institution's business operations, as well as major violations of the law. Given that BaFin was also informed of circumstances that gave reason to assume that the owner of the business was unreliable, it revoked the company's licence.

BaFin also revoked the licence of a financial services institution at which it had performed a special audit in 2004, due to serious violations of statutory provisions. This particular institution was operating beyond the scope of its licence and regularly failed to submit notifications on time. It also failed to submit its annual financial statements and accompanying audit reports, either at all or in a timely manner. Deficiencies were also identified in relation to the outsourcing of certain areas of activity.

BaFin also revoked the licence of a financial services provider based in Frankfurt, which had violated provision of the Banking Act and the Securities Trading Act. In addition to continued violations of organisational requirements, BaFin also found out that the institution had violated the ban on "cold calling". The company had initiated telephone contact, on numerous occasions, with potential clients with whom it had no business relationship concerning investment services and who had not consented expressly to such contact. This constitutes a form of improper advertising. The enterprise in question had also failed to monitor the activities of its tied agents sufficiently and employed freelance agents without informing BaFin. It was also providing non-EEA deposit brokerage services without a licence. BaFin ruled that one of the managing directors, who also held a considerable stake in the company, was unreliable. It also found that the institution was either not prepared, or not in a position to implement the necessary organisational measures in order to conduct its business activities in a proper manner. It had already received a warning in the past after a special audit identified a number of deficiencies.

Risk-oriented supervision.

BaFin also introduced a risk matrix for the supervision of group III financial services institutions (investment and contract brokers, portfolio managers). These institutions incur different risks than banks and insurance undertakings. These relate less to solvency risks and more to market conduct. BaFin plans to apply the matrix for the first time in 2006.

3 Ongoing market supervision

3.1 Credit institutions and financial services institutions

Compliance organisation remains a focus of audit monitoring.

The organisation of compliance units was one of the focal points of the audit monitoring visits to savings banks and registered cooperative banks. Institutions are subject to particular organisational requirements under the Securities Trading Act: they must maintain all of the necessary procedures and resources, including, for example, sufficient qualified personnel, to allow them to provide the services in question. Organisational measures must be taken to keep conflicts of interest between clients and the institution, or between different clients, at a minimum. The compliance officer is responsible for the institution's internal control procedures. A need for improvement was identified at some of the audited institutions, particularly with regard to the identification and handling of possible conflicts of interest.

Focused assessment of customer service.

Following a special audit of the customer service department of one particular credit institution in 2004, BaFin introduced appropriate key audit points for three banks in the year under review. The auditors examined the impact of internal factors on customer service, and the criteria applied with regard to the inclusion of new products in the institution's product offering, the establishment of sample portfolios and the use of these portfolios in the context of customer service. The auditors also had to determine how the institutions managed their sales activities, and which organisational measures were in place to ensure the safeguarding of customer interests. Spot checks, which focused on the advice given with regard to the re-weighting of financial instruments, were performed to show whether or not the institutions gave sufficient consideration to individual client interests. Given that the transaction costs involved in an investment fund swap normally amount to between 3% and 5%, the customer services advisor must carefully check whether or not the recommended portfolio reorganisation is in the interest of the client from a cost perspective. Talks revealed that, in the majority of cases, the customer services advisors had followed a central marketing initiative. Most of them were, nevertheless, able to demonstrate that they had taken the specific interests of their clients into account when making recommendations. They had failed, however, to perform a cost/benefit analysis that compared the risk/return expectations of the old and new investment taking into account the transaction costs and the term of the investment.

One particular institution had decided to also distribute third-party funds. Spot checks showed that advisors often recommended that investors switch from unsuccessful proprietary funds to third-party funds. This recommendation was based on the performance of the unsuccessful fund and the highly positive ratings awarded to the recommended fund by rating agencies. A final assessment of the

customer advisory processes at the three institutions can only be performed once the audit reports have been received and evaluated. Only one of these reports had been submitted by the end of the year under review. This report identified shortcomings, among other things, with regard to the documentation of the advice provided and the execution of orders. On the whole, the audits highlighted the importance of internal customer service guidelines. In 2006, BaFin will continue to focus on the advisory processes of further institutions.

Four special audits in accordance with section 35 WpHG.

In 2005, BaFin ordered four special audits. These place a considerable burden on the institution in question, which has to bear the cost of the audit. This applies in particular to small financial services institutions. As a result, BaFin conducts a preliminary assessment to determine whether or not other suitable methods can be used, e.g. a supervisory consultation. It also has the option of setting certain key points for the standard annual audit.

At the beginning of 2005, BaFin ordered one special audit in accordance with the Securities Trading Act at a financial services institution operated as a sole proprietorship and based in North Rhine Westphalia. The audit focused on the institution's general and special rules of conduct and assessed its compliance with the prohibition of improper advertising by tied agents. BaFin also had the auditors examine whether or not the institution had exercised its supervisory and directing powers over freelancers. The special audit revealed substantial deficiencies, and the institution was found to have exceeded the scope of its licence. It avoided revocation of its licence by returning it before this measure was taken.

BaFin commissioned another special audit at a financial services institution in the state of Hesse, this time focussing on compliance with the special rules of conduct. In particular, the audit aimed to find out whether or not the institution had performed excessive transactions with client assets in order to generate fees (a process known as "churning"). BaFin is currently assessing the results of the audit in order to determine which supervisory measures to take.

Interpretation issues with regard to the Ordinance on investment services audits.

The Ordinance on investment services audits (Wertpapier-dienstleistungs-Prüfungsverordnung – WpDPV), which was amended with effect from 1 January 2005, was the subject of numerous interpretation-related queries which BaFin resolved with the German institute of Chartered Accountants (Institut der Wirtschaftsprüfer) and the auditing associations. The discussions focused, in particular, on the performance of audits at intervals of several years, as well as on cases for exemption.

Exemption from the duty to perform an annual audit.

In the year under review, BaFin exempted 319 credit and financial services institutions from the requirement to perform an annual audit in accordance with the Securities Trading Act (2004: 219). 276 of these exemptions were granted to credit institutions, 261 of which were savings banks and cooperative banks, and 15 of which

were private banks. 43 exemptions were granted to financial services institutions. As in the previous year, six applications for exemption were rejected, while 25 applications were withdrawn (2004: 29). BaFin also exempted 238 credit institutions from the requirement to audit their safe custody business (2004: 143). 16 credit institutions withdrew their applications for exemption from the requirement to audit their safe custody business (2004: 9).

The number of exemptions rose considerably in 2005. This is due to the changes made to the discretionary criteria, which came into force in the year under review and were expanded substantially, allowing more institutions to be exempted. The increase in the number of exemption confirms that the changes offer increased relief to institutions. The new criteria allow extension of the exemption period to a period of up to three years.

Administrative offence proceedings focus on "cold calling".

BaFin initiated new administrative offence proceedings against banks and financial services institutions in four cases, with 23 cases pending from the previous year. In two cases, the offences in question related to violations of the ban on cold calling. Another two cases related to non-compliance with the record keeping and retention requirements set out in the Securities Trading Act. A total of eight cases were dismissed, four of which were abandoned due to a lack of public interest. 15 administrative offence proceedings were still pending at the end of the period under review.

3.2 Rules of conduct with regard to financial analysis

Timely and accurate exchange of information among market participants boosts investor confidence and promotes transparency and liquidity on the securities markets. Analysts play a key role in this area. They must often strike a balance between investor interests on the one hand, and the economic interests of their employer, or their own financial interests, on the other. In order to ensure a functioning capital market, investors must be able to rely on the independence and quality of analyses. Investment recommendations influenced by conflicts of interest, for example, damage investor confidence in financial analyses and pose a threat to fair pricing on the markets. Analysts must thus demonstrate high levels of integrity and transparency. These prerequisites are reflected in national and European regulations, as well as in international standards.[61]

Statutory requirements

The EU Market Abuse Directive has extended the competency and disclosure requirements that apply to the analysis of financial instruments. BaFin has been monitoring compliance with the rules of conduct since October 2004, not only at credit and financial services institutions, but with respect to all persons that produce,

[61] Statement of Principles for Adressing Sell-Side Securities Conflicts of Interest, IOSCO, September 2003 (www.iosco.org).

distribute to the public, or communicate investment recommendations regarding financial instruments as part of their professional or business activities. These persons include freelance financial analysts or independent analysis firms in particular, but can also include issuers or journalists.

Reporting obligations.

Persons responsible for the preparation and communication of financial analyses in the course of their professional or business activities must notify BaFin. In this way, BaFin is made aware of the persons that are active in this area and can include them in supervision. Investment services enterprises, investment companies and public limited investment companies that are already supervised by BaFin are exempted from this requirement. Journalists are also exempted, provided that they are subject to an equivalent system of self-regulation.

Competency and disclosure requirements.

Section 34b WpHG sets high demands with regard to the proper preparation and presentation of financial analyses, the disclosure of circumstances or relationships that could give rise to conflicts of interest, and appropriate organisation. Financial analyses must, for example, state the name and profession of the individual who compiled them, as well as the name of the company which is responsible for the preparation of the analyses. Investment services enterprises also have to indicate the supervisory authority which oversees them. The analysis must separate facts from opinions, and estimates and forecasts must be identified as such.

The author of the analysis must disclose all possible cases of self-interest or conflicts of interest which could cast doubt on the impartiality of the analysis. In the event that the distributed financial analyses have been compiled by a third party, the third-party authorship must be noted in the analysis. In such cases, the analysis may be distributed with or without changes, or in a summarised form, although the content of the analysis may not be presented in a misleading manner. Any significant changes must be marked as such. The Ordinance on the analysis of financial instruments (Finanzanalyseverordnung – FinAnV) contains more detailed provisions on the rules of conduct that apply to the analysis of financial instruments.

Guidelines for supervisory practice

Official interpretation of section 34b WpHG.

Following extensive consultation with market participants and interested members of the general public, BaFin published an official interpretation of various individual terms in the form of a letter. Talks with market participants and associations had pointed towards an element of legal uncertainty with regard to the definition of financial analysis and the need for guidelines on BaFin’s supervisory practice. For instance, market participants were unclear as to exactly how financial analysis differs from other activities, such as investment advisory services or the preparation of marketing material. BaFin clarified that financial analysis refers to documents which, in addition to containing a simple recommendation, convey the impression that the financial

instrument or issuer concerned has been the subject of detailed consideration. The method by which the analysis is made available (in written or electronic form, or in some other way, e.g. in the context of public presentations) is of no material importance. Financial analysis does not cover individual investment advice, informal short-term investment recommendations and information which serves a purely advertising-related purpose.

Audits

No serious deficiencies found.

At the end of 2005, BaFin was supervising 402 credit and financial services institutions that prepare their own analyses or use and publish third-party analyses. The evaluation of the annual audit reports provided a preliminary indicator as to whether or not the institutions complied with the new regulations. In 2005, the companies in question focussed on adapting their organisational structures and workflows. No serious deficiencies were found. BaFin tackled any deficiencies identified in individual cases, for example with regard to the necessary disclosures in the analysis or the organisational measures to prevent conflicts of interest, and these were resolved by the institutions in question.

In 2004, BaFin had concentrated on the disclosure of possible conflicts of interest vis-à-vis the media. Its evaluations showed that those institutions that collaborate with the media disclose any possible conflict of interest to their media partners in the proper manner.

Independent analysts

65 persons registered in accordance with section 34c WpHG.

In the year under review, BaFin supervised 65 persons who had registered themselves in accordance with section 34c WpHG. The majority of persons work for independent analysis firms, as freelance financial analysts or other providers of investment recommendations that are published, e.g. on the Internet or via subscription services. In these cases, BaFin does not monitor compliance with the rules of conduct by means of an annual audit. Nevertheless, it can request information and documents and perform audits even without cause.

In 2005, BaFin focused on explaining the new legal framework to the registered persons and helping them to implement this framework. In May 2005, it invited all of the persons registered to date to an information event. Since the registered persons and companies are not normally subject to supervision by BaFin, there was often a degree of uncertainty among the participants as to the technical requirements of section 34b WpHG, as well as BaFin’s supervisory activities and the related costs. BaFin also sent out a questionnaire to all registered persons, requesting more detailed information on their analysis activities, the techniques employed and the financial instruments and market segments that constitute the subject of the analyses. BaFin also requested information on the methods used for distributing analysis, the scope of such distribution and the recipients of the analyses. Furthermore, it asked the companies to provide further details on potential

conflicts of interest and the management of such conflicts. The purpose of the questionnaire was two-fold. Firstly, it gave BaFin a first impression with respect to some of the new companies subject to its supervision. Secondly, the information will be used to determine the intensity of BaFin's supervisory activities, which can range from regular spot checks to annual on-site inspections.

Media

Exemption for journalists subject to effective self-regulation.

Journalists are exempted from the scope of section 34b WpHG if they are subject to an equivalent form of effective self-regulations, for example internal rules of conduct at media enterprises. The key factor in determining such equivalence is whether or not a comprehensible set of rules, effective control mechanisms and sanctioning powers are in place. In 2005, BaFin held numerous talks with media enterprises and associations that are currently working on, or have already established a system of self-regulation. These systems range from industry-wide regulations to internal codes of conduct at individual publishing houses. The aim is to ensure that any conflicts of interest are adequately disclosed , even if the financial analyses in question are distributed by or via the media. The German Press Council (Deutsche Presserat), for example, has revised its Press Code (Pressekodex) to reflect the new legal provisions for journalists.

Contract research and cross-border distribution

Management of conflicts of interest in the case of contract research.

The preparation of analyses on behalf of an issuer – a process known as "contract research" – is becoming increasingly important in view of the issue of analysis costs. Two aspects of contract research are relevant from a supervisory law point of view. Concerning possible conflicts of interest, it is important that recipients of these analyses are made aware of the existing agreement with the issuer. The analysis must mention the fact that the issuer has commissioned a third party to perform the research, although the amount of remuneration paid need not be disclosed. Furthermore, companies that provide contract research must have appropriate organisational measures in place to ensure that conflicts of interest are kept at a minimum. One way of ensuring this, for example, is by separating the analysis department from other business areas, such as corporate finance, or by establishing quality assurance systems, such as the "four-eyes principle".

Cross-border distribution of analyses.

The cross-border distribution of financial analyses poses a problem with regard to the implementation of section 34b WpHG. In particular, this relates to the subsidiaries and branches of foreign companies that publish analyses in Germany, which have been prepared abroad.

The fact that these companies are subject to a range of different national regulations means that they are subject to a host of requirements, some of which contradict one another. The fact that several supervisory authorities are responsible for the company can also lead to overlaps in supervisory activities. A level playing field can only be established within Europe if the provisions of the

Market Abuse Directive are implemented and applied in a consistent manner throughout the various member states. Close consultation and cooperation between the member states is the only way to advance the convergence of supervisory practice. This is a key step in the journey towards an integrated European financial market.

VI Supervision of securities trading and investment business

Georg Dreyling,
Chief Executive Director
of Securities Supervision

1 Basis for Supervision

1.1 Issuer Guidelines

Both issuers and the supervisory authorities had to deal with several changes to the legal framework in the year under review. The Act on the improvement of investor protection (Anlegerschutzverbesserungsgesetz) dated 28 October 2004 changed the regulations governing the prohibition of insider trading and market manipulation, as well as the requirements in the areas of ad hoc disclosure and directors' dealings. Further changes were ushered in by the Securities Trading Reporting and Insider Register Ordinance (Wertpapierhandelsanzeige- und Insiderverzeichnisverordnung) dated 13 December 2004 and the Ordinance specifying the prohibition of market manipulation (Marktmanipulations-Konkretisierungsverordnung) dated 1 March 2005. In order to address issuer questions with respect to the application and interpretation of the new legislation, BaFin published its issuer Guidelines in July 2005.[62] The Issuer Guidelines are the result of intensive consultation with companies and associations and are based on BaFin's own experience of the new legal framework. It is not a legal commentary, but rather offers practical advice for dealing with the new regulations. In order to meet the informational needs of foreign issuers, BaFin has made an English version of the Issuer Guidelines available on its website.[63]

The Issuer Guidelines contain details about the prohibition of insider trading and market manipulation, as well as the requirements in the areas of ad hoc disclosure, directors' dealings

[62] www.bafin.de > Press & Publications > Publications > Brochures.
[63] www.bafin.de > English Version > Press & Publications > Publications > Brochures.

and insider registers. They also provide a detailed explanation of the conditions under which the publication of ad-hoc reports pursuant to section 15 (3) WpHG can be delayed. Some of the issues that were in particular need of clarification related to the handling of inside information in the context of takeovers or share package acquisitions, as well as the publishing of financial figures in ad hoc disclosures.

The Issuer Guidelines represent a key contribution to legal certainty and have met with a positive response from companies, the associations and academia. BaFin will continue to update the guidelines to reflect its future experiences with respect to both its administrative practice and decisions by the courts.

1.2 Act implementing the Prospectus Directive and the Prospectus Act

New responsibility for listing prospectuses.

The Act implementing the Prospectus Directive (Prospektrichtlinie-Umsetzungsgesetz) dated 22 June 2005 introduced a new Securities Prospectus Act (Wertpapierprospektgesetz – WpPG), thus implementing the EU Prospectus Directive. The Securities Prospectus Act provides regulations on the preparation, approval and publication of prospectuses for securities to be offered to the public or admitted to trading on an organised market. This means that BaFin's responsibility has been extended to cover the assessment of listing prospectuses. The corresponding provisions of the former Prospectus Act (Verkaufsprospektgesetz), the Stock Exchange Act (Börsengesetz) and the Stock Exchange Admission Ordinance (Börsenzulassungsverordnung) have been largely repealed and incorporated collectively into the Securities Prospectus Act.

Provisions governing the minimum contents of a securities prospectus are set out in an EU Regulation which is valid with immediate effect.[64] As a general rule, securities prospectuses must be divided into three parts: information on the issuer, information on the securities and a summary. For some classes of security, such as certain non-equity securities and warrants, the issuer can prepare and publish a base prospectus in the first instance. The issuer, must however, publish the final terms and conditions in a timely manner, at the latest on the day of the public offer. The previous legal framework contained similar provisions in this respect.

European passport for securities prospectuses.

One of the major reforms relates to the European passport for securities prospectuses. If BaFin has approved a prospectus, issuers are entitled to use it for public offers or listings in other EU member states without having to submit it for another assessment by the authorities in the member state in question. Conversely, BaFin recognises all prospectuses that have been approved by the foreign authorities for securities offers or listings in Germany. The European passport does much to facilitate cross-border securities

[64] Regulation (EC) no. 809/2004.

offers, especially since issuers are permitted to prepare their prospectuses in English.

New prospectus requirement for non-securities investments.

Non-securities investments became subject to a prospectus requirement for the first time on 1 July 2005. The prospectus requirement covers all shares that grant the investor participation in a company's profits, as well as shares in trust assets and units in other closed-end funds. The Ordinance on prospectuses for non-securities investments (Vermögensanlagen-Verkaufsprospekt-verordnung) provides further details on the content of the prospectus. The fact that the prospectus requirement now covers the "grey capital market" results in a substantial improvement in the information available to investors. BaFin is also the approving agency and repository.

Dialogue with market participants.

Even before the new legislation came into force, BaFin discussed a range of issues with market participants and associations to ease the transition to the new prospectus legislation. BaFin also offered several workshops in the spring and summer of 2005, which were well received. BaFin used the autumn workshops as an opportunity to discuss initial experiences of issuers with the new legislation. Given that these workshops also proved popular with issuers, BaFin would like to continue its dialogue with the sector.

1.3 New investment regulations

The implementation of the Prospectus Directive also resulted in an amendment to the provisions governing the sale of foreign investment units (sections 135 et seq. of the Investment Act (Investmentgesetz – InvG)) to bring these into line with the European prospectus regulations. The new Ordinance on unit classes dated 24 March 2005 sets out regulations on the accounting treatment, accounting methods and valuation with respect to the formation of various fund unit classes as permitted in accordance with section 34 (1) InvG. This allows the measurement of the impact of all transactions executed since the previous valuation date on the value of individual unit classes and individual units. BaFin also dealt, once again, with many questions relating to the application and interpretation of the Investment Act in 2005. It will incorporate its experiences into the planned amendment to the Act.

2 Prospectuses

2.1 Securities prospectuses

Prospectus examinations

BaFin bears sole responsibility for the examination of prospectuses.

With introduction of the new Securities Prospectus Act, BaFin is given sole responsibility for prospectus examinations. The new prospectus legislation has also resulted in the establishment of a uniform, Europe-wide basis for securities prospectus examinations.

Prospectus requirement for securities
In accordance with section 2 (1) WpPG, securities, within the meaning of the Securities Prospectus Act, are transferable securities which can be traded on a market. These include, in particular
a) shares and other securities equivalent to shares in companies or other legal entities, and certificates representing shares,
b) debt instruments, in particular bonds and certificates representing securities other than those mentioned in a),
c) any other securities conferring the right to acquire or sell such securities or to receive a cash settlement amount determined by reference to transferable securities, currencies, interest rates or payments, commodities or other indices or measures,
with the exception of money market instruments with a maturity of less than 12 months.

The Prospectus Act (Verkaufsprospektgesetz – VerkProspG), which was amended at the same time, now relates exclusively to non-securities investments.

BaFin ensures that securities prospectuses are complete and coherent.

Prospectuses must be submitted for examination in the original version. They can also be submitted either in advance or at the same time via the electronic Reporting and Publishing Portal[65] Within ten to twenty working days[66], BaFin examines whether or not the prospectus is complete, understandable and contains no contradictory information. The technical requirements are based on the comprehensive EU Prospectus Regulation. The new requirements are far more demanding than the previous legislation, especially for equity prospectuses. Issuers who fail to meet the technical requirements will be notified by BaFin in a deficiency letter. The examination process is resumed as soon as the issuer submits the corrected, completed version of the prospectus. BaFin normally completes the examination process after two cycles by approving the prospectus. A prospectus is no longer automatically deemed approved once the deadline has expired. Depending on the quality of the draft prospectus and the time that the issuer requires in order to process BaFin's comments,

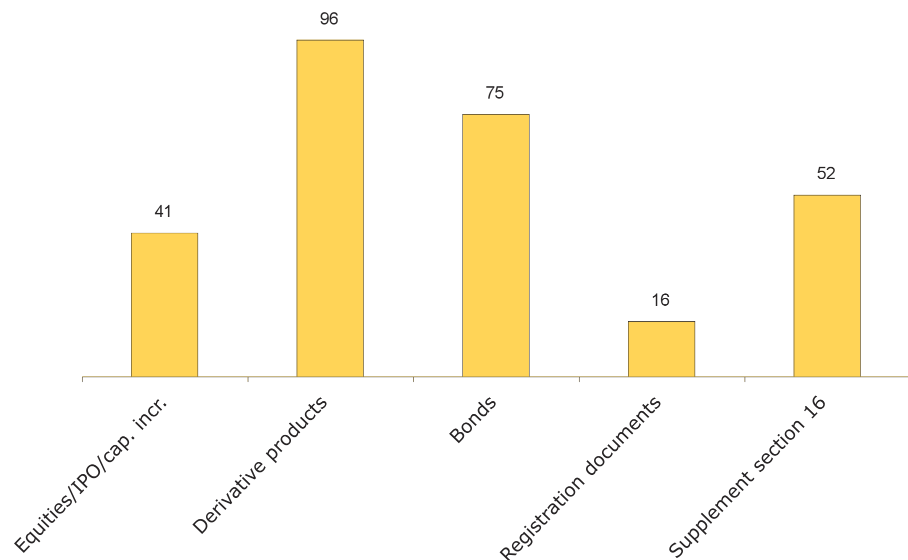
[65] www.bafin.de > For Providers > Reporting and Publishing Portal.
[66] The approval period for prospectuses relating to first-time offers or IPOs is 20 working days.

the examination process can take several weeks. BaFin does not assess the creditworthiness of the issuer. The approval of the prospectus says nothing about the reputability of the issuer. Rather, it is the transparency feature, which allows investors to assess the quality of the offer, that provides the latter with a degree of protection.

In the second half of 2005, BaFin approved (without taking into account the final terms and conditions) a total of 280 prospectuses in accordance with the new legislation, ten of which related to IPOs and 23 of which related to capital increases. The following overview provides a breakdown by individual product type.

Figure 18

Approved prospectuses from 1 July 2005 until 31 December 2005 in accordance with the Securities Prospectus Act



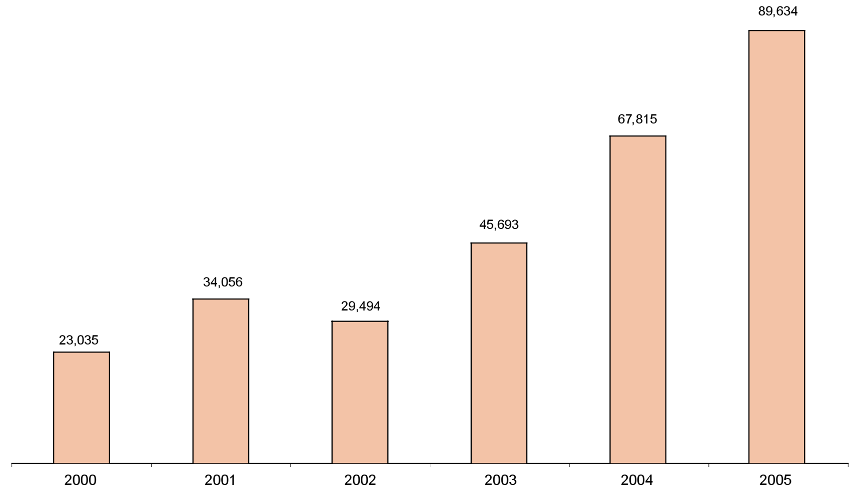
BaFin publishes an overview of the approved securities prospectuses on its website.[67]

Figure 19 shows how the volume of prospectuses examined by BaFin has developed over the past few years. The issue statistics include all complete prospectuses and base prospectuses, as well as supplements in accordance with section 16 WpPG and all final terms and conditions in accordance with both the old and new legislation. In 2005, BaFin examined a total of 470 complete prospectuses, 431 incomplete or base prospectuses and received 88,733 final terms and conditions, bringing the total number of prospectuses up to 89,634. It should be noted that BaFin has also been responsible for examining listing prospectuses since July 2005.

[67] www.bafin.de > Datenbanken & Statistiken > Datenbanken > Hinterlegte Prospekte für Wertpapiere (since 01/07/2005).

Figure 19

Total issue volume



The number of enquiries related to the interpretation of legislation rose considerably in 2005; these tripled to total 453 (2004: 148).

Administrative offence proceedings related to violations of previous legislation.

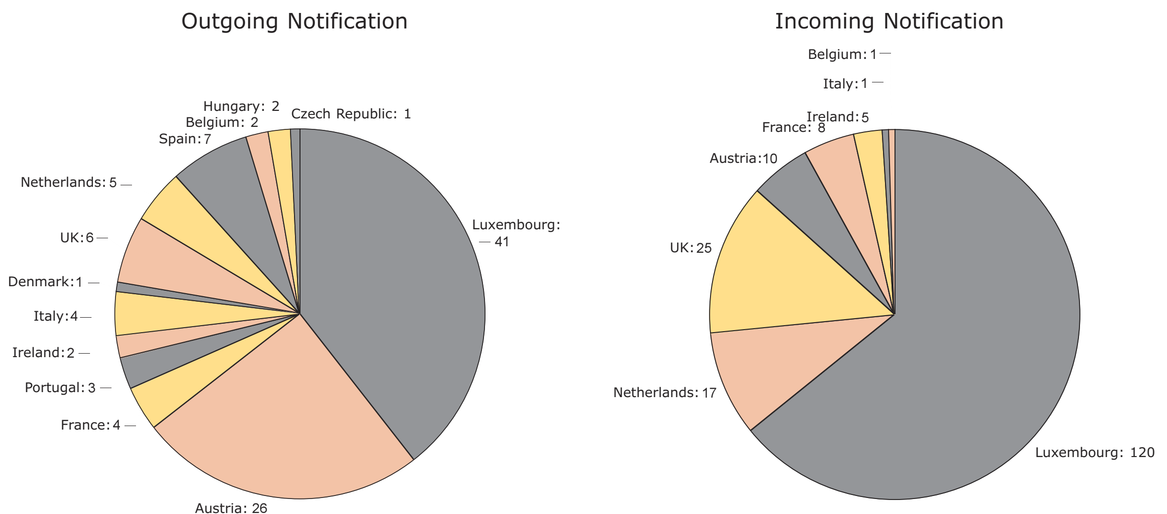
Securities may only be offered to the public when BaFin has approved the prospectus. Otherwise, the public offer is deemed illegal and is prohibited by BaFin. BaFin launched ten new administrative offence proceedings in the year under review, all of which related to the previous legislation, with 51 cases pending from the previous year. BaFin levied administrative fines of up to €6,000 in three cases, and a total of ten cases were dismissed, eight of which were abandoned due to a lack of public interest. 48 cases were still open at the end of 2005. The majority of the proceedings related to failure to publish a prospectus, or late publication.

Heavy use of the European passport.

Many providers have already made use of the European passport option.

Figure 20

Incoming and outgoing prospectus notifications



BaFin building on Lurgiallee, Frankfurt

BaFin issued notifications for 104 prospectus, 41 of which were destined for Luxembourg, 26 Austria, seven Spain, six the UK, five the Netherlands, four for both France and Italy, three Portugal, two for Ireland, Belgium and Hungary and one each for Denmark and the Czech Republic. Germany received notifications regarding 187 prospectuses, 120 from Luxembourg, 25 from the UK, 17 from the Netherlands, ten from Austria, eight from France, five from Ireland and one each from Italy and Belgium.

Publication of an annual informational document

All issuers must provide the public, at least once a year, with a document containing all of the information published by the issuer of the past twelve months. The document must be made available to the public, and submitted to BaFin at the latest 20 working days after publication of the annual financial statements. This requirement also applies to issuers whose securities were admitted to trading on an organised market before 1 July 2005. Companies listed on the Prime Standard of the Frankfurt Stock Exchange, for example, also have to include their company calendar. If the company provides a link to a reference document instead, readers must be able to find this document even without an electronic link.

2.2 Non-securities investment prospectuses

Prospectus examinations

Prospectus Act amended with effect from 1 July 2005.

Prospectus requirement for non-securities investments
In accordance with section 8f VerkProspG, a prospectus must be prepared for
a) non-securitised, publicly offered shares that grant the investor participation in a company's profits,
b) shares in assets held or managed by the issuer or a third-party on it own behalf for the account of a third party (trust assets), or
c) units in other closed-end funds.
The term "non-securities investments" also covers, for example, shares in civil-law partnerships (Gesellschaft des bürgerlichen Rechts), limited liability companies (GmbH), general partnerships (OHG) or limited partnership (KG) interests, silent partnerships or participation rights.

BaFin checks the completeness of the prospectuses, not the accuracy of their content.

Since July 2005, BaFin has been examining investment prospectuses, within a period of 20 working days, to check that they are formally complete, i.e. contain all of the information required in accordance with the Prospectus Act and the Non-Securities Investment Prospectus Ordinance (Vermögensanlagen-Verkaufsprospektverordnung – VermVerkProspV). The provider is notified during the filing procedure of any additional information that it has to provide, or any information that it has to modify so that the prospectus can be approved. The prospectus is the main source of information for investment decisions and also serves as the reference document for civil prospectus liability claims.

739 prospectuses had been submitted to BaFin by the end of 2005. BaFin approved 617 of these prospectuses and prohibited the publication of three prospectuses, while providers withdrew their prospectuses in 119 other cases.

Public offer may only be made following approval of the prospectus.

Non-securities investments may also only be offered to the public when BaFin has approved the prospectus for publication. Otherwise, the public offer is illegal and BaFin is forced to prohibit it. An unauthorised investment offer is punishable by an administrative fine of up to €500,000. The same applies if a provider publishes a prospectus that has not been approved by BaFin. No fines were levied in 2005 in accordance with the new legislation.

Susanne Bergsträsser (Head of PRO Group) and Karl-Burkhard Caspari (Deputy President)

BaFin retains the prospectuses filed with it for a period of ten years, so that it can make them available in the event of investigations by the police or the public prosecutor's office, as well as in the event of civil proceedings. BaFin's database[68] provides an overview of all of the prospectuses published and filed with it. In order to view the prospectus, the investor must contact the offeror. BaFin does not send out any prospectuses.

Smooth start thanks to preliminary examinations.

Even before the new legislation came into force, BaFin offered providers and issuers of non-securities investments an opportunity, between April and June of 2005, to have their draft prospectuses examined in accordance with the new Non-Securities Investment Prospectus Ordinance to assess their chances of approval. During this period, issuers and providers submitted around 190 prospectuses for preliminary examination and received letters containing BaFin's comments after a short period of time. BaFin was thus able to approve 44 prospectuses by 1 July 2005.

Interpretative letter on the prospectus requirement for non-securities investments.

At the end of June 2005, BaFin published an interpretative letter on the requirements for non-securities investment prospectuses, which provides details on a number of substantive issues related to the new prospectus requirement.[69] In particular, the letter deals with offers on the secondary market based on offers placed prior to 1 July 2005.

[68] www.bafin.de > Datenbanken & Statistiken > Datenbanken > Hinterlegte Vermögensanlagen-Verkaufsprospekte (seit dem 01.07.2005).
[69] www.bafin.de > Für Anbieter > Prospekte für Wertpapiere und Vermögensanlagen > Prospekte für Vermögensanlagen.

3 Supervision of investment business

3.1 Investment companies

In July 2005, there were 79 investment companies, as compared with 80 in the previous year. An increasing number of specialist providers served as fund custodians. In the past, it was usually the parent company of the investment company in question that acted as the custodian bank, but this function now is being transferred more and more often to specialist third-party providers for reasons of efficiency. Efficiency-related motivations are also driving an increasing number of investment companies to outsource individual areas (section 16 InvG). In 2005, a particularly high number of providers informed BaFin that they had outsourced their portfolio management and the calculation of risk figures within the framework of the Derivatives Ordinance (Derivateverordnung – DerivateV).

BaFin approved 180 mutual funds in 2005, while 36 mutual funds were closed. At the end of 2005, domestic companies managed 1,421 mutual funds and 4,882 institutional funds. The positive development of the stock markets and the recovery of the capital markets as a whole also had an impact on fund business.

Change in the mutual fund rules.

By 1 January 2006 at the latest, all mutual funds had to change their fund rules, which had been approved on the basis of the previous legislation, to reflect the provisions set out in the Investment Act. BaFin granted 934 mutual funds authorisation to change their fund rules to reflect the provisions of the Investment Act. A total of around 1,100 mutual funds have to make these changes.

First fund with unit classes and first fund mergers authorised.

Section 34 (1) InvG and the new Ordinance on unit classes dated April 2005 now allow companies to launch funds with unit classes. The first few funds immediately made use of the new options. Furthermore, BaFin approved fund mergers for the first time. Such mergers are normally aimed at streamlining the range of funds on offer and bundling investor capital. They involve transferring the assets of one fund to another fund from the same investment company. BaFin approved a total of nine mergers in 2005.

New approach to risk-oriented supervision.

Recently, supervisors of investment companies began using a risk matrix in their work – as have those charged with the supervision of banks, insurers and financial services providers. In the year under review, BaFin developed an IT-based approach for risk-oriented supervision: InvRisk. In addition to insolvency risk, investment companies are subject to additional market risks arising from the management of funds. These two risk positions must be consolidated into a single overall risk position, to which

end InvRisk assists supervisors with specific recommendations for risk classification and possible supervisory measures.

3.2 Market supervision

In 2005, BaFin assessed over 1,400 audit reports and annual financial statements from domestic investment funds. The assessments revealed that some providers had violated statutory and contractual investment limits and had calculated unit prices incorrectly. BaFin performed supervisory inspections and special audits at the investment companies. The supervisory inspections focused on the areas of market timing (time zone arbitrage) and late trading (trading at known unit prices), the implementation of the rules of conduct set out by the Federal Investment and Asset Management Association (Bundesverband Investment und Asset Management e.V. – BVI) and the implementation of risk management systems that comply with the Derivatives Ordinance. The inspections did not reveal any new evidence of undesirable trading practices. The special audits concentrated on the acquisition of structured products and the organisational measures taken to avoid illegal trading practices, as well as the level of costs and cost composition. The audit of the latter allowed BaFin to draw conclusions as to the impact of transaction costs on the profitability of fund investments. BaFin incorporated the initial results of the CESR working paper "Eligible Assets" into its assessment of issues relating to the eligibility of structured products, such as credit derivatives, asset-backed securities or certificates, for acquisition by investment funds. The working paper attempts to standardise the criteria relating to the eligibility of assets for acquisition by investment funds across Europe.

In 2005, BaFin's assessment of investment limits was based once again on the notifications submitted by the investment companies with respect to violations of investment limits. As in the past, the investment companies submitted these notifications on reporting forms by post in accordance with the Investment Companies Act (Gesetz über Kapitalanlagegesellschaften – KAGG) and the Investment Act (Investmentgesetz – InvG).

Notifications in accordance with the Derivatives Ordinance.

Investment companies must comply with the notification requirements set out in the Derivatives Ordinance. In several supervisory consultations BaFin emphasised that investment companies have to report and substantiate not only those cases in which they have actually exceeded the market risk previously derived from risk simulation models, but also any decisions taken by the company in question to switch from a simplified to a qualified approach, and any material changes in the benchmark fund. BaFin evaluated the notifications submitted and came to the conclusion that there is still a degree of uncertainty with respect to the new reporting requirements.

BVI rules of conduct.

A number of investment companies are already asking auditing firms to confirm that their internal regulations comply with the

rules of conduct set out by the Federal Investment and Asset Management Association (BVI). BaFin expressly welcomes this sector initiative. The next step could be to incorporate these rules of conduct, which enjoy broad recognition throughout the sector, into the audit of the annual financial statements, a move which would further improve the informational value of the audit reports. BaFin hopes to introduce a consultation process on this issue by the summer of 2006 at the latest.

3.3 Real estate funds

Real estate fund closed for the first time.

For the first time in the 40-year history of open-ended real estate funds, one company suspended redemption of fund units at the end of 2005, much to the surprise of the investment sector, investors and the general public. From one day to the next, investors' "concrete gold", believed to be among the safer forms of investment, was no longer available. Affected was the "grundbesitz-invest" real estate fund managed by DB Real Estate.

Prior to the closure of the fund in December 2005, DB Real Estate had announced that it would be ceasing to issue new unit certificates with immediate effect and revaluing all of the properties in the "grundbesitz-invest" fund. The company blamed the decision on the sustained difficult situation facing German property markets. In response to the announcement, many investors redeemed their fund units, prompting DB Real Estate to temporarily close its "grundbesitz-invest" real estate fund a few days later (section 37 (2) InvG). As a result, no more units could be redeemed.

Fund closure also led to capital outflows at other real estate funds.

The closure of the "grundbesitz-invest" fund also caused more and more investors in other real estate funds to redeem their unit certificates. In order to avert a crisis and to take immediate action, BaFin asked all real estate mutual fund companies to report their capital outflows up to four times a day. This ushered in a period of particularly close contact between BaFin and the real estate fund companies. Although capital outflows increased considerable in some cases, as was expected, the situation turned out not to be so dramatic as to result in the either closure of further real estate funds or force BaFin to intervene.

Two further funds compelled to close.

In mid-January 2006, the real estate fund company KanAm suspended unit redemption for two of its real estate mutual funds, although these two funds had proved to be top performers in the past. The decision in this case, however, was based on other motivations. A rating agency had recommended that investors sell their KanAm units after the press had circulated negative reports on the company's American real estate manager. The already tense situation was fuelling considerable uncertainty among investors, so that many opted to redeem their unit certificates. This resulted in increasing capital outflows, and there was a risk that liquidity would fall below the statutory minimum at any moment. This would have rendered the available liquidity insufficient to pay the

redemption price or to ensure proper ongoing operation of properties. As soon as liquidity fell too far, the fund was closed in accordance with section 81 InvG. The suspension period was limited to three months. One of the funds has been open again since the end of March 2006 and KanAm is once again redeeming units. The company reopened the second fund in April 2006.

Fund closure in the event of insufficient liquidity
Although property is not as marketable as securities, investors in real estate mutual funds can redeem their units on any stock exchange trading day. This maturity transformation makes open-ended real estate funds attractive for private investors as well. The fact that properties cannot be disposed of at short notice is the very reason why the investment companies run into major difficulties when a substantial volume of capital is withdrawn in a short space of time. This is why investment companies have to keep at least 5% of the value of the fund available on a daily basis in order to ensure that they can satisfy unit redemptions with immediate effect. If the company does not have sufficient funds, even taking into account bank cash balances and the proceeds from the sale of the money market instruments, investment units and securities held by the company, in order to ensure the payment of the redemption price and proper ongoing operation of properties, the company can suspend unit redemption, in order to protect its investors, for a limited period of time (section 81 InvG). If the liquidity generated by the investment company, e.g. by means of property sales, is still insufficient to satisfy redemptions at the end of this period, the company can suspend the redemption of the fund units for a limited period once again, but this time for a maximum of two years. It is only after this period has expired that the investment company is permitted to encumber the properties in the fund in order to secure the funds required for fund redemption. It is then under an obligation to discharge such encumbrances by selling fund properties as soon as this is possible at reasonable conditions. In such cases, it can also opt to sell the properties below the current market value.

The reopening of the „grundbesitz-invest" fund and need for devaluation.

As the Deutsche Bank Group prepared to reopen the "grundbesitz-invest" fund at the beginning of March 2006, BaFin ensured that it was kept up to date with the status of the preparations on a regular basis. Experts identified a need to devalue the fund by 2.4% (around €147 million), a more modest devaluation than the market had feared. As expected, capital outflows were often very high in the first few days after the company resumed unit redemption, but the "grundbesitz-invest" fund soon moved into calmer waters. This was due in part to the fact that the parent company, Deutsche Bank AG, offered to limit the damages incurred by certain investors. It made a promise to all investors that had invested in the fund during a specific period prior to its closure that, following the revaluation of the fund and taking into account any distributions that had already been made, they would be placed in such a position as to ensure that they did not incur any loss of their originally invested capital.

Capital outflows in the sector have dropped considerably on the whole.

Discussion on real estate funds and REITS.

The events that took place at the end of 2005 and the beginning of 2006 rekindled the public debate on a reform of the product. The main point of interest relates to the issue of how a distinction can be made between open-ended real estate funds and other property investments such as the planned Real Estate Investment Trusts (REITS). The intention is to incorporate any changes into the amendment to the Investment Act, which is planned for 2006.

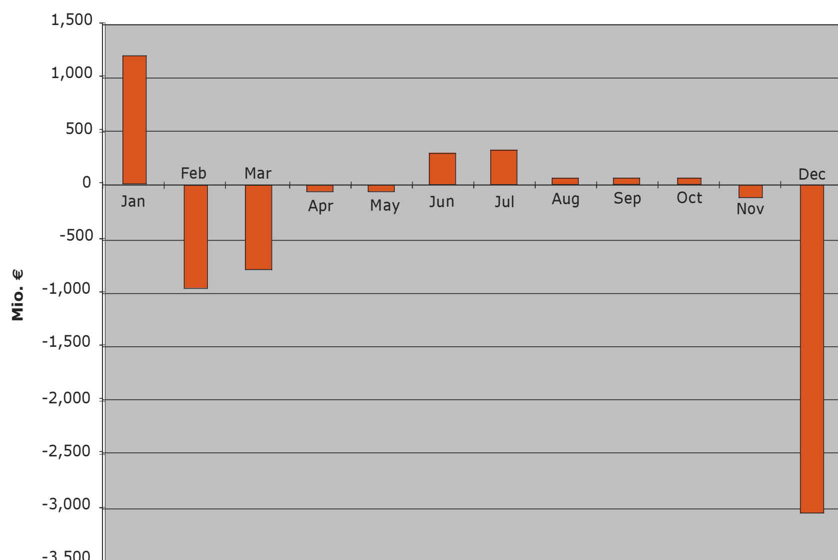
General development of open-ended real estate funds

German investment companies managed a total volume of €86.7 billion (2004: €87.7 billion) in 38 (2004: 32) real estate mutual funds, and a total volume of €16.7 billion (2004: €13.4 billion) in 100 (2004: 82) institutional real estate funds as at 31 December 2005. The main providers are the financial intermediaries in Germany, i.e. the major private banks, the cooperative and savings bank networks and insurance groups, but also niche providers.

The unfavourable situation on the German property markets and the facts revealed during the 2004 Frankfurt corruption scandal had a negative impact on net open-ended real estate fund inflows, particularly in February and March 2005. With the exception of the net fund inflows recorded in January, these funds continued to lose capital until the end of May. However, investors again channelled their money back into the sector between July and October. November brought the start of a slight outflow, which reached previously unseen proportions in December after the closure of the first real estate fund, "grundbesitz invest".

Figure 21

Net fund inflows of open-ended real estate funds 2005



Sources: BaFin, Bundesbank

Performance remains positive.

Despite the considerable capital outflows in 2005, real estate funds have been achieving continuous value growth since they were first introduced over 40 years ago. Unlike other types of investment fund, they have never reported negative year-on-year annual performance. On average, the funds have reported performance of around 3% based on the BVI method (redemption value comparison). Very successful funds – normally relatively young funds with a high proportion of foreign properties and generally a global focus – achieved performance of over 7% based on this method. Solid performance of between 2.5% and 5% per annum is usually found among the somewhat older real estate funds. These often have a European focus, but also place a fairly strong emphasis on Germany. The poorest performance returned by a fund was 0.4%.

Calculation of the unit price

The price of a real estate fund unit is calculated on the basis of a statement of net assets (sections 44 and 79 InvG). In the case of mutual funds, this price has to be calculated every trading day.

Unlike with securities, the market price of properties cannot be derived from the stock exchange price, but is based on the market value calculated by at least three independent experts following a property valuation.

These appraisers are appointed by the investment company. The company must inform BaFin of the appointment and provide documentary evidence of their independence, reliability and qualifications (section 77 (2) InvG). An appraiser is appointed for a maximum of five years. This period is extended by one year, in each case, if the appraiser generated no more than 30% of its total income from the fees paid by the investment company. If these conditions are not met, BaFin can demand that the investment company appoint another appraiser.

Valuation of property in the funds

The value of the properties contained in open-ended real estate funds must be calculated in accordance with the Valuation Ordinance (Wertermittlungsverordnung). This ordinance provides for three different valuation methods: the income, reference price and cost methods. In the case of open-ended real estate funds, the income method is applied in the majority of cases due to the type of properties contained in these funds – office properties that are expected to generate income. The reference price and cost methods are applied to these properties for the purpose of control and plausibility checks.

3.4 Hedge funds

Hedge funds remain in the public eye.

Hedge funds remained a popular subject of discussion in the year under review with the debate often focusing on issues related to the stability of the international financial markets and legal aspects relating to takeovers. Previously, the burning issue for the German public had been the first authorisations granted to hedge funds in Germany. The idea that time and a suitable market environment are needed in order to successfully launch new products was once again confirmed. Furthermore, the fund industry needs not only suitable personnel, but also sufficient financial resources, functioning front and back office systems, high-quality marketing and a trained sales force. Hedge funds are becoming a key component of the modern German financial market, despite the fact that they have been unable to meet the high initial expectations with respect to growth and market share gains.

Licensing of 13 single hedge funds and nine funds of hedge funds.

In 2005, BaFin granted licences to 13 domestic single hedge funds – one of which was a public limited investment company – and nine funds of hedge funds - one of which was a public limited investment company, and authorised the distribution of seven foreign funds of hedge funds. It concluded seven licensing procedures that related to the expansion of business operations and granted a licence to one Master KAG (umbrella fund management entity). BaFin expects the number of licences and approvals to continue rising in 2006.

Licensing and approval process
Domestic funds of hedge funds can be approved as either mutual or institutional funds. As a general rule, funds of hedge funds may target both domestic regulated single hedge funds and foreign investment funds with comparable investment principles for acquisition. The managers of funds of hedge funds are also subject to special requirements under the Investment Act with respect to their knowledge and practical experience. The prospectuses of approved products must contain a warning that the investor risks total loss. Single hedge funds may not be publicly sold but only distributed by means of a „private placement". There are virtually no statutory limitations on the strategies pursued by these funds: they are permitted to borrow, use derivatives and enter into leverage transactions and short sales.

Licensing process and on-site inspections.

Companies wishing to launch a hedge fund have three options open to them: either an existing investment company applies to have the scope of its licence expanded, or a new investment company is formed and applies for a hedge fund licence. The third option involves forming an investment company with variable capital. Public limited investment companies are not special credit institutions and only have to comply with selected provisions of the German Banking Act (Kreditwesengesetz – KWG). BaFin assesses the company's risk management, in particular, during the approval process, focusing on the structures and processes in place to identify, measure, control and manage risks.

Supervisory inspections and consultations facilitate application procedure.

Supervisory inspections prior to approval allow BaFin to perform a preliminary assessment as to the suitability of the company's risk management methods and processes and can identify any shortfalls. To this end, the Supervisory Authority holds regular talks with applicants. In the event of serious findings, the processes have to be revised before the companies can be approved, while in the case of minor deficiencies, a licence can be granted subject to certain conditions. The 13 supervisory inspections (2004: 14) showed that the hedge fund industry is characterised by a large variety of products, organisational structures and business processes. Once companies have been approved, BaFin uses on-site inspections to ascertain whether or not they are in permanent compliance with the requirements. In addition to the numerous consultations with investment companies, BaFin also maintained contact with the associations in order to continue to clarify a number of interpretation issues with regard to the Investment Act.

Three public limited investment companies.

At €300,000, the minimum share capital required to form a public limited investment company with variable capital (Investmentaktiengesellschaft mit veränderlichem Kapital – InvAG) is lower than that required to form an investment company (€730,000). To date, three companies have made use of this option, with further applications still in processing. This shows that the market is interested in making use of the possibilities offered by a public limited investment company with variable capital.

Hedge funds: Financial stability and regulation
The hedge fund industry has grown substantially across the globe over the past few years, with no end to this trend in sight. The number of prime brokers is increasing in step with the market: these provide mainly collateralised loans that offer the hedge funds, for instance, leverage. They also supply securities or provide other intermediary services in connection with securities lending. The current international debate is centred around the issue of whether or not to regulate hedge funds, and if so how. The federal government announced in its coalition agreement that it would push internationally for appropriate supervision and transparency.

One of the risks that poses a particular threat to financial stability is the counterparty risk of the prime broker. But the concern stems not from the amounts of hedge funds exposures, which are normally collateralised. Rather, the second-round effects that could result from a crisis, such as legal difficulties or losses in value when collateral is liquidated, are what is worrying. Furthermore, the application of incorrect correlation assumptions to the joint valuation of hedge funds exposures and other investments could result in problems, even for prime brokers with sound risk management. The rising number of hedge funds also carries the risk that the quality of risk management will deteriorate. There is also an increasing danger as well that numerous market participants will open similar positions in trading, which could lead to liquidity problems in the event of a crisis. Recent studies point

towards an increase in the leverage effects that are characteristic for hedge funds and could aggravate a crisis.

At present, the risks resulting from hedge funds are only supervised indirectly, namely via the risks incurred by the prime brokers. In light of the dangers set out above, however, it would appear that a direct approach is needed. This would involve monitoring the risk management systems of the hedge funds on the one hand, and subjecting the hedge funds to capital requirements on the other. A system whereby the funds would be obliged to report risk figures, for example, could help to increase transparency.

The hedge fund industry knows no national borders. As a result, the creation and further development of national legislation will not provide a sufficient basis for the supervision of these funds. Hedge fund supervision is inconceivable without internationally recognised common minimum standards and supervisory initiatives coordinated at international level.

3.5 Foreign investment funds

New record: 5,491 foreign investment funds licensed for distribution.

In 2005, besides its ongoing supervision of foreign investment funds[70] licensed for distribution, BaFin again focused on the timely processing of distribution notices for new foreign investment funds. The large majority of the 1,026 distribution notices related to UCITS funds. As a result, the total number of foreign investment funds with a license for distribution reached a new high of 5,491. BaFin also continued to look critically at the activities of individual foreign investment funds in Germany, prohibiting one company from offering fund units to the public in the future. BaFin also responded to a number of enquiries relating to the distinction between the scope of application of the Securities Prospectus Act (Wertpapierprospektgesetz – WpPG) and Prospectus Act (Verkaufsprospektgesetz – VerkProspG), and that of the Investment Act.

Transformation of non-UCITS investment funds.

In 2005, BaFin's ongoing supervision work focused on the necessary changes at non-UCITS investment funds in order to bring them into line with the Investment Act, and the implementation of the guidelines published by CESR[71] with respect to the transitional provisions of the UCITS Amending Directives. All foreign non-UCITS investment funds that were already authorised for distribution before the Investment Act came into force had to ensure compliance with the new law by 1 July 2005. BaFin published a fact sheet for the foreign investment companies[72], which dealt with the procedure for reporting the changes. Despite the fact that numerous funds have been transformed into UCITS on the basis of the new investment options offered by the UCITS

[70] Exceptions: foreign hedge funds and foreign non-UCITS pure derivatives funds.
[71] CESR's guidelines for supervisors regarding the transitional provisions of the amending UCITS Directives.
[72] www.bafin.de > Für Anbieter > Investmentfonds > Ausländische Investmentfonds.

Amending Directives, BaFin is still processing 80 reports of changes.

Implementation of the CESR Guidelines.

The guidelines provided different deadlines for those UCITS required to make changes: all UCITS funds that comply with the original version of the UCITS Directive (UCITS I funds), for example, have been subject to the additional requirement to make a simplified prospectus available since 1 October 2005. Furthermore, all UCITS I funds that were authorised, or set up additional sub-funds after the UCITS Amending Directives came into force on 13 February 2002, had to be brought into line with the new Directives in their home member states, and this change reported to BaFin by 31 December 2005 at the latest. Over 3,000 individual funds have submitted reports of this nature to BaFin thus far.

The following overviews chart the development of individual funds licensed for distribution, the number of which has increased considerably since 1990. The increase in the number of UCITS is due partly to the broader scope of investment options offered by the UCITS Amending Directives. The decline in the number of non-UCITS funds licensed for distribution is due mainly to the transformation of these funds into UCITS.

Figure 22
Individual non-UCITS funds

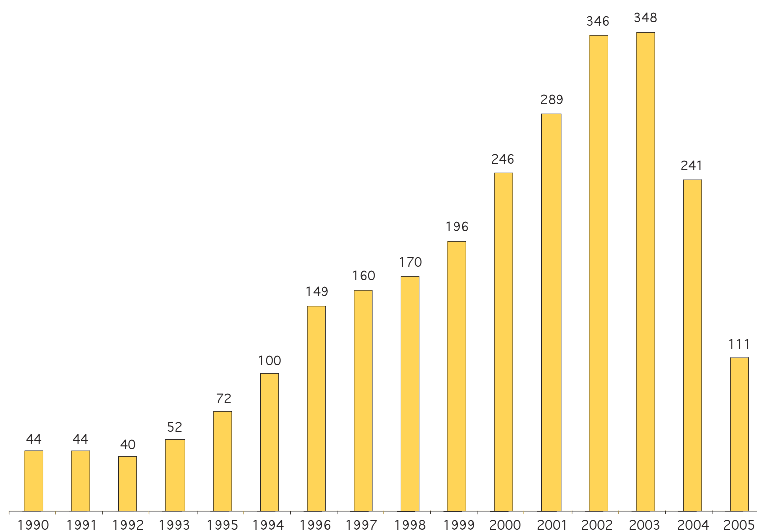
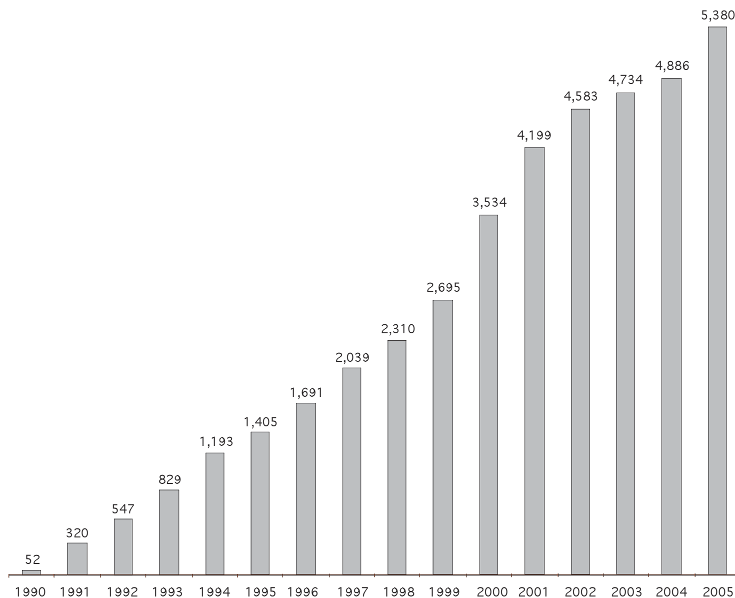


Figure 23
Individual UCITS funds



4 Monitoring of market transparency and integrity

4.1 Market analysis

BaFin received 560 million transaction reports.

Credit and financial services institutions must report all transactions in financial instruments to BaFin in accordance with section 9 WpHG. These transaction reports are a key source of information when investigating cases of insider trading and market manipulation. BaFin received roughly 560 million reports in 2005, or approximately 2.2 million data records per day on average. The quality of these transaction reports is now very high.

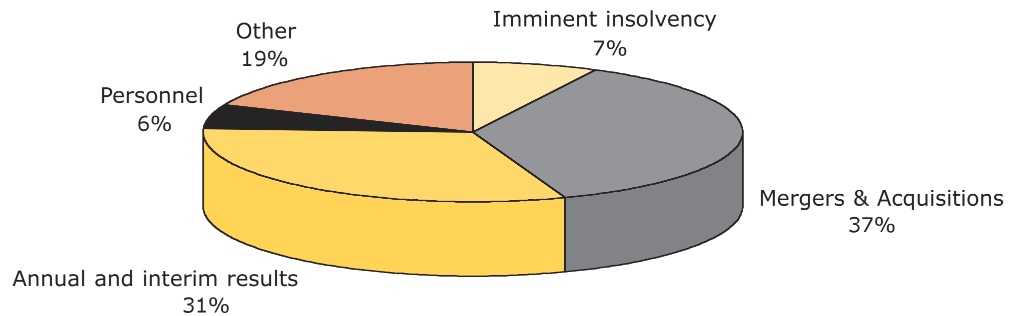
Almost all of the electronic data traffic relating to section 9 WpHG is now processed via BaFin's Reporting and Publishing Portal. This platform allows secure electronic communication with market participants.

85 cases of suspected market abuse.

BaFin performed almost 1,450 analyses in the year under review, which revealed 54 cases of suspected insider trading and 31 cases of suspected market manipulation. BaFin launched investigations into these cases.

Figure 24

Background of positive insider analyses

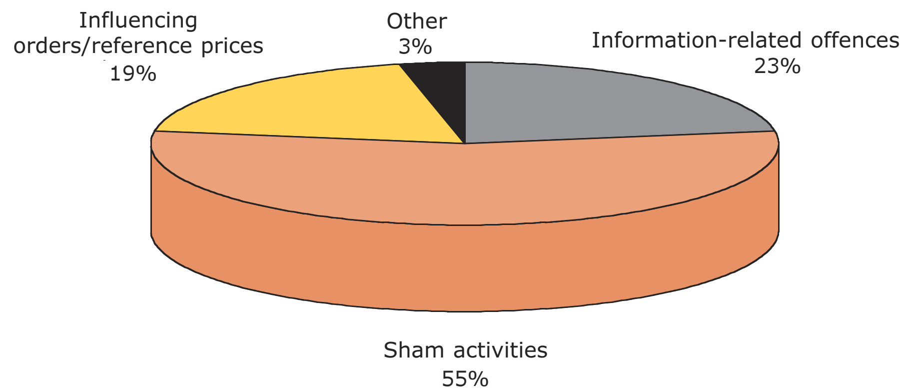


Insider offences often relate to takeovers and financial figures.

75% of the insider analyses related to mergers & acquisitions, annual and interim results and imminent insolvency, whereby the number of cases relating to imminent insolvency saw a substantial drop of roughly 75% year-on-year. Analyses of personnel news, on the other hand, were once again more prevalent.

Figure 25

Background of positive market manipulation analyses



Sham actions used to manipulate the market.

Over 50% of market manipulation analyses related to instances of sham trading. These mainly related to transactions that did not involve any actual economic exchange of financial instruments, known as "wash sales", or pre-arranged transactions. There was, however, also an increase in the number of transactions used to drive the exchange prices of financial instruments up or down. In the majority of cases, the price is influenced in such a way as to allow positions sold off at a profit. These transactions normally affect illiquid equities or "penny stocks" traded on the OTC market.

Almost a quarter of the positive market manipulation analyses related to informational offences. In the majority of these cases, incorrect or misleading information was published or information that should have been disclosed in accordance with legal regulations was concealed. There were also several instances of suspected scalping. Scalping refers to a situation in which an

investment advisor purchases equities with the intention of issuing a buy recommendation for these equities and then selling them when prices rise as a result of the recommendation. Many of these cases involve the use of traditional or electronic media in order disseminate opinions or rumours with respect to a financial instrument or their issuers. However, BaFin only found concrete evidence of scalping in one case.

In 2005, BaFin prepared four expert opinions for prosecutors in the course of its market analysis activities. These related mainly to the issue of whether or not certain pieces of information could have a considerable impact on the exchange price of a financial instrument with respect to insider offences.

Adelong Capital Limited
On 9 June 2005, the Victoria County Court, based in Melbourne (Australia) found a former director of Adelong Capital Limited guilty of disseminating false and misleading information on the German "Wallstreet Online" Internet board. The accused made incorrect and misleading statements as to Adelong's economic expectations and outlook in an interview with a German journalist in January 2000. The interview was published on the website and resulted in an increase in the price of the company's shares. Following the publication of the information, the accused sold shares and options in Adelong, generating a profit of almost AUS-$1.7 million. The court sentenced him to one year of probation and a fine of AUS-$900,000. The court also prohibited the accused from managing any company for the next five years. BaFin had prepared an expert opinion on the case for ASIC.[73] A BaFin employee appeared in court as an expert.

4.2 Insider trading

BaFin opened 54 insider trading investigations.

BaFin opened 54 new investigations relating to suspected insider trading in the year under review, and submitted 23 cases to the prosecutor's office. In total, BaFin filed complaints against 95 persons. 17 investigations were discontinued due to a lack of concrete evidence of insider trading. A total of 102 cases were still pending at the end of 2005, including investigations which had been launched in previous years.

Table 20
Insider trading investigations

Period	New investigation	Results of investigation			Open Investigation
		Discontinued	Referral to prosecutor's office		
	Insider	Insider	Cases	Persons	Total
2003	51	16	26	137	91
2004	57	37	23	71	88
2005	54	17	23	95	102

[73] Australian Securities and Investment Commission.

Nine convictions for insider trading.

Nine convictions were made in the year under review, five following a full trial and four after summary proceedings. 88 cases were dropped by the prosecutors, 19 of which were settled in exchange for an out-of-court settlement.

Table 21

Prosecutors' reports on closed insider proceedings

Period	Total	Discontinued	Discontinued after out-of-court settlement	Final court decisions			
				Decisions by the court	Convictions following summary proceedings	Convictions following full trial	Acquittals
2003	87	70	7	4	3	2	1
2004	199	163	29	0	2	5	0
2005	99	69	19	0	4	5	2

In 2005, BaFin received 14 enquiries from foreign supervisory authorities relating to insider trading-related matters and itself sought information from foreign officials 100 times.

The Act on the Improvement of Investor Protection (Anlegerschutzverbesserungsgesetz – AnSVG), dated October 2004, has resulted in far-reaching changes to the regulations on the prohibition of insider trading. Since then, the German text of the Securities Trading Act has been using the term "Insiderinformation", instead of "Insidertatsache", to denote inside information. Furthermore, inside information no longer has to be exploited for prohibited insider trading purposes – the very use of this information is sufficient to constitute an offence. The new terms are subject to intense debate within the industry. However, the investigations undertaken by the prosecuting authorities that reached a conclusion in 2005, as well as the majority of the complaints, related to offences that occurred before the new regulations came into force. It remains to be seen how the judiciary will interpret these.

The following section provides information on some of the proceedings that reached a conclusion in 2005.

Allweiler AG

On 27 February 1998, Constellation Capital Partners LLC. announced that it would be taking over the pump manufacturer Allweiler AG. It offered its independent shareholders DM 525 for the ordinary shares, and DM 386 for the preferred shares. Before the announcement was made, the ordinary shares were trading on the Frankfurt Stock Exchange at a price of DM 390, while the price of the preferred shares was DM 255.

The prosecutor's office in Constance filed for a penal order (summary proceedings) against five individuals due to a violation of the prohibition of insider trading. It charged one Allweiler AG board member with having passed the inside information on to a family member in advance, without authorisation to do so. The family member in question then purchased 100 preferred shares at

a price of DM 265, and sold them in March 1998 at a profit of DM 12,100. The prosecutor's office accused two school friends and fellow musicians of the board member – the accused played in the same orchestra – of having cashed in on profits totalling over DM 44,000 and DM 33,000 respectively by purchasing shares at the right time based on inside information. Charges were also filed against a head of department at Allweiler AG, who purchased 80 preferred shares on the basis of inside information on 6 February 1998 and then sold these on 6 April 1998 at a profit of DM 7,730.

The accused challenged the penal order and the local court of Singen acquitted all of the five after a full trial. The criminal judge was unable to ascertain with the degree of certainty required for conviction that the accused had exploited the inside information in order to execute their transactions.

However, an appeal by the prosecutor's office of Constance led to proceedings in the regional court of the same city against the board member for passing inside information on to his father without authorisation to do so. This resulted in a criminal fine of 90 daily instalments of €200. The family member was handed a criminal fine payable in 60 daily instalments of €70, while one of the school friends and fellow musicians was forced to pay a criminal fine in 50 daily instalments of €100. The regional court also ordered that the accused forfeit their profits. The regional court rejected the appeal lodged by the prosecutor's office against the acquittal of the other accused individuals.

Gigabell AG

On 15 September 2000, Gigabell AG issued an ad-hoc announcement that it had filed a petition for the opening of insolvency proceedings at the competent local court on the previous day.

Prior to this disclosure, a board member had sold 5,035 shares in Gigabell AG held in his wife's securities account via a joint account holder. On 13 and 14 September 2000, he sold a further 97,647 shares from the securities account of a family member, disposing of a further 3,508 from the securities account of another family member on 14 September. The sale of 101,155 shares in Gigabell AG in total resulted in a profit of over €1.1 million for the board member.

The Frankfurt am Main regional court sentenced the accused to a prison term of one year and ten months in total for engaging in prohibited insider trading activities and for wilfully violating his duty to file for insolvency. The court suspended the sentence, and demanded that the accused pay €50,000 to various charitable organisations within a period of one year.

Ad-hoc service provider

The accused was a freelance employee at a company which publishes and disseminates ad-hoc disclosures, as well as offering other services. In February 2002, the employee stole a chip from his employer's premises that allowed him to access the company's IT system from any Internet connection, granting him access to the ad-hoc disclosures pending publication. He used this and executed a total of 22 trades in the equities and warrants of numerous listed companies in the period from 15 February until 21 August 2002 on the basis of ad-hoc disclosures that had not yet been published. This allowed him to achieve a profit of €41,123.21.

The Frankfurt local court sentenced the accused to a suspended prison sentence of one year in July 2004. The court also ordered the forfeiture of the profit generated by the transactions. In 2005, Frankfurt regional court amended the ruling of the local court and imposed a criminal fine payable in 360 daily instalments of €15, reversing the forfeiture of the profit at the same time.

PixelNet AG

On 21 February 2001, PixelNet AG announced in an ad-hoc disclosure that it would be taking over Photo Porst AG at a symbolic price of DM 1. The share price of PixelNet AG increased by 37.7% in the period leading up to 19 March 2001. The accused, a member of the supervisory board of PixelNet AG, was aware of the takeover plans and purchased a total of 2,000 shares in PixelNet AG at a price of €6.85 on 20 February 2001. He then went on to sell all shares in March, at a profit of €4,600. On 13 January 2005, the local court of Passau sentenced the accused, following summary proceedings, to a criminal fine payable in 90 daily instalments of €230 for insider trading and ordered forfeiture of the profit at the same time.

iXOS Software AG

On 31 March 2000, iXOS Software AG published an ad-hoc disclosure releasing its 1999/2000 quarterly results and issuing a profit warning at the same time. The share price of the company then fell from €78 to €43.10.

On 29 March 2000, the accused, a member of the board of iXOS Software AG, had sold 1,000 shares in the company, thus avoiding a loss of €42,400. During the course of an internal investigation at iXOS Software AG, a family member of the accused made a false statement by claiming that she had ordered the sale of the shares without having access to any inside information.

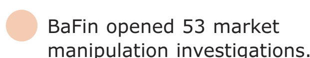
The Munich local court sentenced the accused, following summary proceedings, to a suspended prison sentence of ten months. The court also ordered that the accused pay €10,000 to a charitable organisation. The family member was sentenced, in a penal order dated the same day, to a criminal fine payable in 70 daily instalments of €50 for aiding the accused.

Netsol Technologies AG

The accused was working as a securities advisor at a German credit institution. Within the scope of this position, he became aware of the trading activities of a client in the shares of Netsol Technologies AG. Before the accused forwarded the mainly unlimited orders placed by this client to the Berlin and Munich stock exchanges, he regularly used his knowledge of the client orders and placed limited offsetting orders via his private securities account. Due to the shortage of shares, these orders had to be executed against the orders of the client. This put the accused in a position in which he was always able to buy the shares at a lower price, or sell them at a higher price than on the home stock exchange. In order to conceal his prohibited trading activities, the accused did not execute the transactions via his securities account at the institution at which he was employed, because these transactions are monitored internally by the bank’s compliance department. Instead, he opened a securities account at a direct bank in July 2002, stating that he was employed in the automotive industry. Within three months, the accused had generated a profit of €8,146 by front running transactions. He ceased his trading activities in mid-November 2002 and closed his securities account, presumably after learning that the Trading Surveillance Office of the Munich Stock Exchange was investigating the matter.

The accused delivered a convincing confession to the Cologne prosecutor’s office in April 2005. The prosecutor’s office then closed proceedings in exchange for an out-of-court settlement of €12,000.

4.3 Market manipulation


BaFin opened 53 market manipulation investigations.

BaFin opened 53 new investigations and discontinued 13 investigations in 2005. In eleven cases, BaFin found that the suspected manipulation had had an impact on the share price and filed complaints against 20 implicated persons with the prosecutor’s office. At the end of 2005, 93 investigations regarding suspected market manipulation were still pending.

Table 22
Market manipulation investigations

Period	New investigations	Investigation results							Current investigation
			Referred to prosecutor or the BaFin administrative fines section						
		Discontinued	Prosecutors		Admin. Fines section		Total (cases)		Total
			Cases	Persons	Cases	Persons			
2003	51	13	7	21	3	8	10		42
2004	52	13	15	35	1	1	16		65
2005	53	13	11	20	1	1	12		93

Three convictions were made in the year under review following a full public trial. The prosecutors dropped cases against eleven suspects, in three cases in exchange for an out-of-court settlement.

BaFin opened one new administrative offence proceeding in 2005, with three cases pending from the previous year. One of these cases was brought to final closure in the year under review with a fine of €5,000 imposed by BaFin. Two cases were discontinued due to a lack of public interest.

In 2005, BaFin received seven enquiries from foreign supervisory authorities relating to market manipulation matters and sought the information from foreign officials 17 times.

Table 23
Prosecutorial and court reports, and reports by the internal administrative fines section concerning closed price manipulation proceedings

Period	Total	Prosectorial decisions		Final court decisions in criminal proceedings				Decisions in administrative offence proceedings	
		Discontinued	Discontinued after out-of-court settlement	Decisions by the court	Convictions following summary proceedings	Convictions following full proceedings	Acquittals	Dismissal	Final admin. Fines
2003	1	0	0	0	0	0	0	0	1
2004	14	7	0	0	1	1	0	1	4
2005	17	8	3	0	0	3	0	2	1

Some of the decisions made in 2005 are set out in the section below.

Insider ring

The two accused individuals sought out interested investors in the summer of 2000 and used the funds contributed by these investors, totalling around DM 500,000, to buy securities. One of the accused was considered an investment specialist and opinion

leader on the market due to his many years of advisory experience and his publications in the press. He used the invested capital to purchase shares and then recommended these shares in the media, via hotlines and to funds that follow his investment recommendations on a regular basis. His market power enabled him to temporarily drive up the value of the shares on the stock market. The accused then sold the securities at a profit. The profits, which totalled around €60,000 were split among the two accused, who received 30% and 20% respectively, while the investors received 50%.

In August 2002, the Stuttgart regional court sentenced both men to a suspended prison sentence of one year for engaging in prohibited insider trading activities. Following an appeal, the Federal Court of Justice reversed the ruling and sent the case back to the Stuttgart regional court for a re-trial. The Federal Court explained that its decision was based on its opinion that the behaviour of the accused constituted market manipulation, not insider trading. The Stuttgart regional court subsequently found the accused guilty on several counts of engaging in prohibited market manipulation activities and sentenced them to a suspended prison sentence of six months. A final ruling was issued on 14 January 2005.

Metabox AG

On 8 July 2004, the Hildesheim regional court sentenced a board member of Metabox AG to a suspended prison sentence of seven months for manipulating the market by publishing an incorrect ad-hoc disclosure on 10 April 2000. The board member had announced a major purchase order, though he knew this to be untrue. A final ruling was issued in September 2005.

Stolberger Telecom AG

Between 7 and 12 March 2003, the accused, a professional broker, repeatedly issued purchase orders on the floor of the Frankfurt Stock Exchange which he retracted prior to their execution. The relatively illiquid shares in Stolberger Telecom AG were listed on the exchange as spot market securities, meaning that the price of the stock was determined only once a day. The accused placed his limited, high-volume purchase orders before the official price was determined. As a result, these orders had a considerable impact on the price estimates of the lead broker prior to the price determination and sent signals out to the market that there was increased demand for the stocks in question. This meant that market participants were given false information on the market situation. The accused was not actually interested in executing his purchase orders. He was merely using the orders to create a false picture as to the demand on the Frankfurt Stock Exchange. The intention was that this would then prompt trading participants on the Düsseldorf Stock Exchange, where prices were relatively low, to execute arbitrage transactions in the illiquid stock. The suspect had positioned himself on that stock exchange with a sell order for 5,000 shares. The fact that the two stock exchanges displayed

different prices allowed him to dispose of the illiquid stocks on the Düsseldorf Stock Exchange.

BaFin fined the accused €15,000 in July 2004. Following a challenge, the Frankfurt am Main local court reduced the fine to €5,000 in January 2005.

Euro Bund Future and Euro Bobl Future

In August 2004, six employees of an internationally active major bank based in London implemented the following trading strategy: they started with a base position consisting of a short in the Bund and Bobl futures, and a corresponding long position in government bonds. The suspects then bought futures contracts on the Eurex derivatives exchange within a period of around one hour on a selected trading day in order to push prices up. This involved issuing purchase orders with the limit of the best ask side whenever the price of the two future products was stagnating. The execution of these orders allowed the suspects to gradually drive up the prices of the two contracts on Eurex in a targeted manner. At the same time, they managed to indirectly increase the prices for fixed-rate government bonds with comparable terms, due to the close correlation between the performance of these bonds and that of the interest derivatives traded on Eurex. The last stage in the process involved selling government bonds worth around €12.4 billion at the artificially elevated prices within a few seconds on various electronic trading platforms. Since the suspects had made the mistake of selling more bonds than they had in their portfolio, bonds worth around €3.77 billion were bought back within a short space of time. Overall, this strategy allowed the traders to generate a profit of around US$17.5 million, whereby around two thirds of this profit was attributable to the sales, and one third to the bond buy-backs.

BaFin worked closely with other European supervisory authorities over the course of its investigations, in particular with the British FSA and the Italian CONSOB, as well as with the Eurex Trading Surveillance Office. Given that these investigations pointed towards suspected market manipulation with respect to stock exchange prices on Eurex, BaFin filed a criminal complaint with the public prosecutor's office in Frankfurt am Main. Nevertheless, the public prosecutor's office refused to investigate the case in accordance with section 170 (2) of the Criminal Procedure Code (Strafprozessordnung – StPO), stating that the accused could not be charged with criminal market manipulation for legal reasons. The prosecutor's office explained that this was due to the legal situation at the time of the offence, which was committed before the Act on the improvement of investor protection came into force. It also pointed out that, due to the change in the legal situation with effect from October 2004, pure trading activities of a similar nature aimed at influencing prices could be regarded as criminal manipulation.

Rücker AG

At the very latest on 12 June 2002, the management board members of Rücker AG, a company listed on Germany's Neuer Markt, realised that a 51% stake in a limited liability company (GmbH) was worthless and was to be deleted from the balance sheet of the public limited company. Rücker had acquired the stake around six months previously for a sum in the double-digit million range. Contrary to the obligation set out in section 15 WpHG, the members of the company's management board failed to report this need for a valuation adjustment in an immediate ad-hoc disclosure. This meant that the accused were able to avoid a substantial slump in the share price of Rücker AG, which would have reflected its actual economic circumstances. Their actions therefore had an effect on the company's share price.

The public prosecutor's office in Frankfurt am Main closed the investigative proceedings against the responsible management board members in exchange for an out-of-court settlement of €5,000 in each case in accordance with section 153a StPO.

Debitel AG

The suspect, an experienced trader, issued several consecutive low-volume purchase orders through his bank. These orders were limited in such a way that they outbid all of the available purchase orders, resulting in a gradual increase in the stock exchange price. These very low-volume orders were executed in Xetra trading. The aim of the suspect was to give the responsible designated sponsor the impression that the market situation had changed, in order to prompt him to update his quote. Designated sponsors are responsible for posting simultaneous limited orders on the bid and offer side (quotes) in the trading system during trading hours and then executing transactions at these prices.

The designated sponsor did adjust the quote and posted higher bid and offer quotes. The accused then placed high-volume purchase orders that were executed against the designated sponsor at the artificially high price. The suspect was an extremely active trader and repeated this process on numerous occasions. He generated a profit of around €50,000 within just under one month.

In November 2005, the public prosecutor's office in Frankfurt am Main opted not to bring charges in accordance with section 154 StPO, because charges had already been brought against the same person in May 2005 due to another violation of the German Securities Trading Act and the case in question was unlikely to result in a higher penalty.

Suspicious activity reports
Since November 2004, BaFin has been receiving reports from institutions and the operators of off-exchange markets if the latter have reason to suspect that certain transactions violate the prohibition of insider trading and market manipulation. The initial

experience of this new statutory obligation in accordance with section 10 WpHG has been positive. The data supplied by the institutions provide BaFin with a useful source of information for possible investigations and, in particular, allow BaFin to initiate investigations and submit reports at short notice. For example, BaFin was able to conclude one case within three months and bring charges against the suspects.

BaFin's dialogue with both institutions and associations allowed any initial uncertainties to be largely resolved, clarifying, for example, that institutions only have a duty to report a transaction once it has been executed. Nevertheless, the reporting obligation can remain in force long after the transaction has been executed if the institution receives additional information suggesting that a particular transaction can now be regarded as suspicious. BaFin welcomes the fact that the institutions have refrained from submitting superfluous reports with the sole purpose of protecting themselves from the sanctions that may be imposed in the event that reports are not filed.

BaFin received 68 suspicious activity reports in the year under review. The majority of these were submitted by private banks, securities trading banks and savings banks, and many of the institutions used a form provided by BaFin in order to lodge their reports, improving the quality of the report content. The British FSA passed one report on to BaFin. 14 of the reports resulted in formal investigations (eight insider and six market manipulation investigations). Two of these, affecting a total of nine individuals, resulted in complaints due to suspected insider trading. 21 complaints turned out negative.

4.4 Ad hoc disclosure and directors' dealings

Ad hoc disclosure

The ad hoc disclosure obligation means that listed issuers must make information on circumstances that are not known to the public available to the latter immediately. The circumstances in question must have occurred already, or must be sufficiently likely to occur. The disclosure obligation is also subject to the prerequisite that the circumstances in question can have a substantial effect on the stock exchange or market price of the financial instruments. The obligation is intended to ensure that all market participants are supplied with information quickly and in a uniform manner, and that they all have access to the same information.

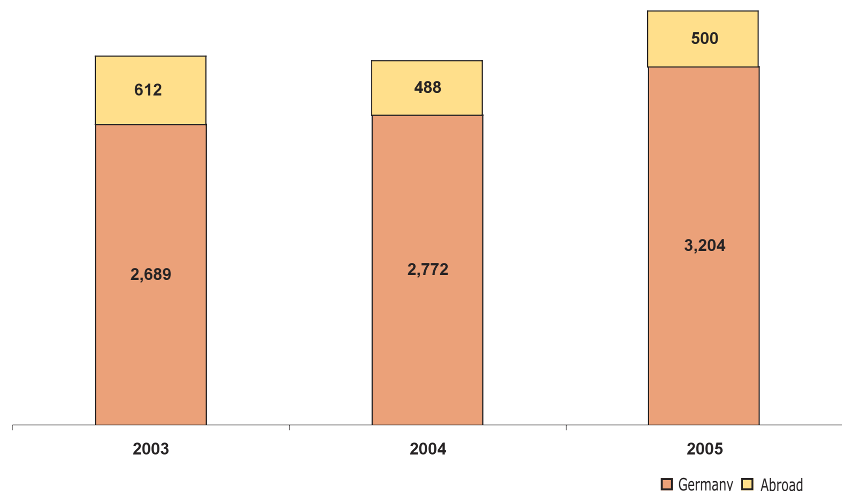
The Act on the improvement of investor protection has resulted in a long-term change in the obligations of listed issuers with respect to ad hoc disclosure. In the year under review, BaFin used a number of seminars and lectures to provide further details on the new regulations and answer various individual questions from issuers. The Issuer Guidelines, published by BaFin in mid-2005,

also provide practical help in the implementation of the new regulations. The guidelines are BaFin's way of increasing awareness among issuers with regard to their obligations and thus helping to prevent violations of the new legislation.

Slight increase in the number of disclosures.

In 2005, the number of ad hoc disclosures increased slightly as against the previous year, with issuers publishing a total of 3,704 disclosures (2004: 3,260). 3,204 of these (2004: 2,772) came from domestic issuers, while 500 (2004: 488) came from foreign issuers. The increase in the number of disclosures is due not only to the new regulations, but primarily to the change in the accounting standards applied. Many issuers applied the International Financial Reporting Standards (IFRS) for the first time, instead of the German Commercial Code (HGB), publishing their figures for the period in question in an ad hoc disclosure.

Figure 26
Ad hoc disclosures from 2003-2005



Exemptions from the disclosure requirement

Grounds for exemption.

Inside information must be disclosed if it relates to circumstances that are sufficiently likely to occur. If, however, the issuer does not yet want to publish this information, it must determine whether or not it can delay publication. Issuers can obtain an exemption from the ad hoc obligation as long as this is necessary to protect their legitimate interests, provided that there is no reason to expect that the public will be misled and if the issuer is able to guarantee that the inside information will remain confidential. Multi-stage decision-making processes (for example, a situation in which the management board has made a decision that would have a substantial impact on prices, but the supervisory board still has to consent to the decision), often constitute grounds for exemption.

The issuer is responsible for exempting itself, and can no longer submit an application for exemption from the ad hoc obligation to BaFin. When the information is published, however, the issuer must inform BaFin that the publication in question was delayed. BaFin then performs a retroactive check to ensure that the issuer had

valid grounds for exemption. After initial difficulties, issuers are now making increasing use of this option. The issuers of securities admitted to a stock exchange exempted themselves in 168 cases in 2005.

BaFin launched 24 proceedings.

BaFin launched 24 new proceedings due to possible violations of the ad hoc disclosure requirement, with 88 cases still pending from 2004. In the year under review, BaFin levied administrative fines of up to €80,000 in 13 cases in which issuers failed to report inside information that could influence prices, failed to report this information in time, or submitted incorrect or incomplete reports. A total of 21 cases were dismissed, 15 of which were discontinued due to a lack of public interest. 78 cases were still pending at the end of the year.

Directors' dealings

In accordance with section 15a WpHG, managers of listed issuers must inform BaFin and the issuer of transactions executed for their own account in shares of the company. This disclosure requirement also applies to individuals and entities that are closely related to the management employees. The issuer is obliged to publish this information on its website, which is intended to ensure that market participants are informed of the scope and timing of these transactions.

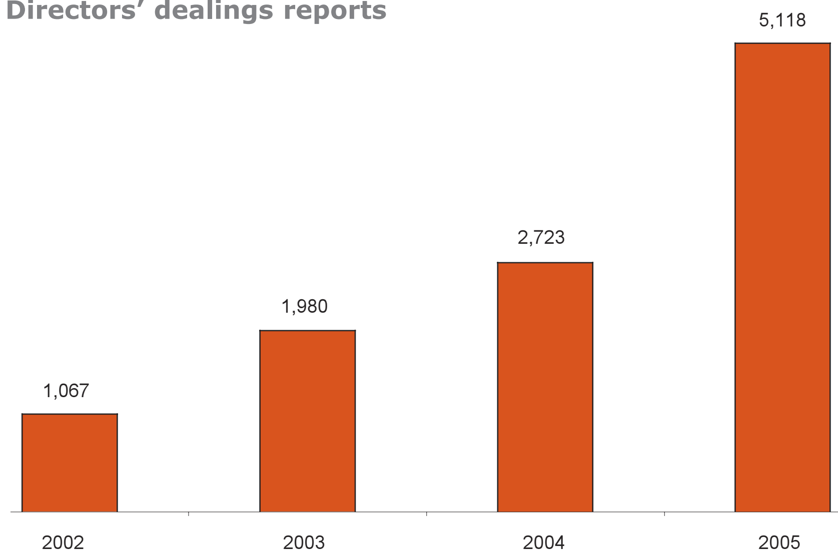
The Act on the improvement of investor protection has also made far-reaching changes to the regulations on the disclosure and publication of directors' dealings, which is why BaFin had to explain several of these changes in the year under review. It organised numerous lectures and held a number of personal talks with both management employees and those relatives of the employees that are subject to the disclosure requirement. The Issuer Guidelines also provide details on the new regulations in a number of cases. BaFin also offers a reporting form for those subject to the disclosure requirement on its website.[74]

Considerable increase in the number of directors' dealings reports.

In the period under review, individuals subject to reporting requirements reported 5,118 (2004: 2,723) transactions to BaFin. This increase is due firstly to the fact that the reporting requirement now also covers legal entities. Secondly, the reporting obligation now covers not only the members of the company's executive bodies, but also those persons that have regular access to inside information and that make key corporate decisions. The de minimis threshold was also reduced considerably. The reporting requirement now applies if the total amount of the transactions executed by management employees and all individuals that are closely related to the former exceeds €5,000 by the end of the calendar year. Previously, the de minimis threshold stood at €25,000 per person subject to the reporting requirement within 30 days.

[74] www.bafin.de > For Providers > Stock Exchange listed Companies > Directors Dealings, Section 15a WpHG.

Figure 27
Directors' dealings reports



BaFin provides a database containing the transactions published in accordance with section 15a WpHG on its website.[75] This provides investors and interested members of the general public with a central source of information on the transactions executed by company insiders.

Administrative offence proceedings.

In 2005, BaFin launched two new proceedings due to possible violations of section 15a WpHG, while 152 such cases were pending from the previous year. BaFin closed 62 cases, levying administrative fines of up to €7,500 in three cases. 59 cases were dismissed, 54 of which were discontinued due to a lack of public interest. 92 cases were still pending at the end of the year.

Insider registers

Listed issuers and service providers commissioned by these issuers have been obliged to maintain inside registers since October 2004. Companies now have to create registers for those persons working for them that have access to insider information as a result of their function. The Securities Trading Reporting and Insider Register Ordinance (Wertpapierhandelsanzeige– und Insiderverzeichnis-verordnung) sets out the minimum requirements that apply to these registers. Companies are free to decide how to structure the insider registers. The individuals included in the register must be provided with special information on the requirements that extend beyond the general corporate confidentiality requirements and the legal consequences of violations of these requirements. The Issuer Guidelines also provide more detailed information in this regard. BaFin has also held a number of lectures and personal talks to explain the new regulations.

Initial experience has shown that the new requirement has made the employees affected more sensitive in the way they deal with inside information. The registers also allow issuers to monitor the

[75] www.bafin.de > Datenbanken und Statistiken > Datenbanken.

flow of inside information and, as a result, to meet their confidentiality obligations. In the event that an actual suspicion arises, the registers make it easier for BaFin to identify the insiders involved.

4.5 Voting rights

Any person whose shareholding in a listed company reaches, exceeds or falls below 5%, 10%, 25%, 50% or 75% of the voting rights must notify the company and BaFin of this change within seven calendar days. This requirement applies to shareholders of domestic companies that are admitted to trading on the official or regulated market of a German stock exchange. In 2005, this meant that the requirement applied to 448 (2004: 484) companies on the official market, and 479 (2004: 527) on the regulated market.

BaFin received almost 3,000 reports on voting rights.

In 2005, BaFin received 2,906 reports relating to changes in voting rights. This means that 2005 is the third consecutive year to have witnessed a year-on-year increase in the number of reports (2004: 2,276, 2003: 2,060).

BaFin launched 81 proceedings.

In 2005, BaFin launched 81 proceedings against persons suspected of failing to report or publish significant holdings of voting rights, failing to report this information in time, or of submitting incorrect or incomplete reports. 717 proceedings were still pending from the previous years. BaFin levied administrative fines of up to €45,000 in 73 cases. 310 cases were dismissed, 265 of which were discontinued due to a lack of public interest. 415 cases were still open at the end of the year.

Preparations for the Transparency Directive.

In 2005, BaFin began preparations for implementation of the Transparency Directive, which is planned for 2006/2007. The Directive provides for additional reporting thresholds and shorter reporting deadlines, among other things. In order to make it easier for the affected parties to submit reports, CESR developed a standardised reporting form that will be adapted to suit the needs of the individual member states when the Transparency Directive is implemented. BaFin hopes that the form will result in a considerable drop in the number of incorrect disclosures and publications, which remains high.

5 Corporate takeovers

BaFin monitors compliance with the regulations for offer and exemption procedures set out in the Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz – WpÜG). The aim of this act is to ensure that shareholders receive equal treatment and to provide comprehensive information and

transparency for offer procedures. The intention is to complete the process as quickly as possible so as not to unreasonably hinder the target company in its business activities.

Increase in offer procedures.

BaFin noticed a recovery on the takeover market in the second half of 2005 in particular. The number of published offers totalled 38 in the year under review, as against 32 in the previous year. As in the preceding years, exemption procedures accounted for a substantial proportion of supervisory activities. In 2005, 117 applications were submitted for exemption from the requirements set out in the Securities Acquisition and Takeover Act.

Table 24

Where bidders are based

Bidder location	Location of bidder parent company	No. 2005	No. 2004	No. 2003	No. 2002
Germany	Germany	19	16	19	16
Germany	Belgium	2		2	1
Germany	Denmark		1		
Germany	UK	2		2	2
Germany	Italy				1
Germany	Netherlands		1		
Germany	Sweden				2
Germany	Switzerland				1
Germany	USA	1	4	4	2
Germany	PR China	1			
Germany	Cayman Islands		2		
Germany	Channel Islands	2			
Germany	Japan	1			
Belgium	Belgium		1		
France	France		1	1	1
UK	UK		1	1	
Ireland	Ireland				1
Italy	Italy	1		1	
Luxembourg	Luxembourg		1		2
Luxembourg	USA	1			
Netherlands	Netherlands	2		2	
Austria	Austria	2	1	1	1
Russian Federation	Russian Federation	1			
Bermuda	Bermuda			1	
British Virgin Islands	British Virgin Islands			1	
Cayman Islands	Cayman Islands			1	
Canada	Canada			3	
Switzerland	Switzerland	2	2	4	3
USA	USA	1	1	2	1
	Total	**38**	**32**	**45**	**34**

Increase in domestic takeovers.

The number of takeovers increased slightly in the year under review to 38 offer procedures (2004: 32). As in the previous year, half of the procedures related to bidders domiciled in Germany. Offer procedures featured bidders from China and Russia for the first time since the Securities Acquisition and Takeover Act came into force.

Of particular significance in the year under review were the takeover of Bayerische Hypo- und Vereinsbank AG (HVB) by the Italian UniCredito Italiano SpA (UniCredit) and BaFin's

investigations with regard to possible “acting in concert” at Deutsche Börse AG.

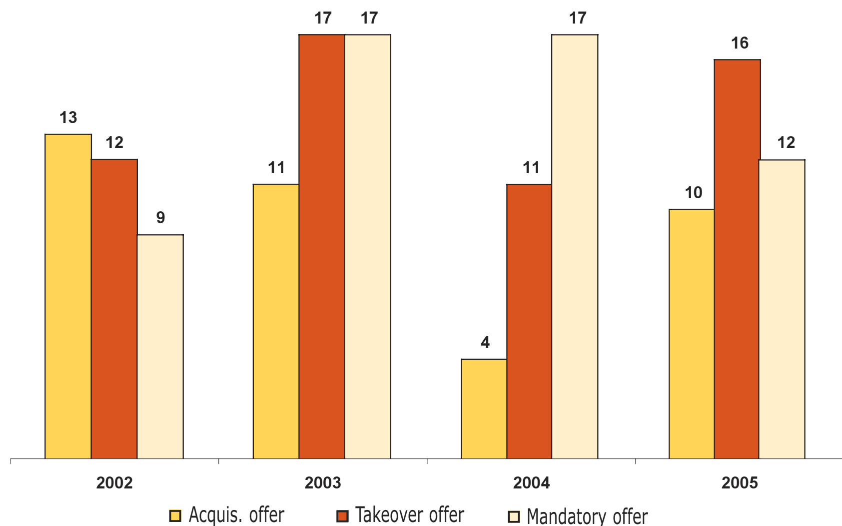
5.1 Offer procedures

Types of offer.

BaFin approved all of the 38 offer documents submitted in 2005.[76] Twelve of the offers made were mandatory offers. In accordance with section 35 (2) WpÜG, bidders are obliged to make a mandatory offer if they hold 30% or more of the voting rights, giving them control over the target companies. 16 procedures related to takeover offers, by which bidders who do not already have control of a company attempt to gain such control. There were ten acquisition offers. These are offers, which are not mandatory for the bidders, and are not intended to obtain control of the target company. The Securities Acquisition and Takeover Act provides for a simplified procedure for acquisition offers.

Figure 28

Number of offer procedures



Administrative fines.

In 2005, BaFin initiated a total of six new administrative offence proceedings for possible violations of the Securities Acquisition and Takeover Act. 56 such cases were still pending from the previous year. 19 cases were discontinued due to a lack of public interest. One case, in which BaFin had levied a fine due to the delayed submission of a mandatory offer, is still pending with the Federal Court of Justice. A total of 43 administrative offence proceedings were still pending at the end of the period under review.

Fact sheet on the repurchase of own shares.

The target company itself can act as the bidder if it wants to purchase own shares as part of an offer procedure. The repurchase of own shares is limited to 10% of the share capital under company law. This repurchase by means of an offer procedure is regarded as a special type of acquisition offer, which means that the Securities Acquisition and Takeover Act applies. Nevertheless,

[76] www.bafin.de> Datenbanken und Statistiken > Datenbanken.

the scope of application must be limited appropriately to take account of the special characteristics of a repurchase. In 2005, BaFin published a fact sheet in order to take account of the special characteristics of a repurchase of own shares by means of an offer procedure in accordance with the WpÜG.[77] Three offers for the repurchase of own shares were made in 2005.

High transaction volume at UniCredit-HVB.

As in previous years, the transaction volume[78] of most offers was below €100 million. The offer made to the shareholders of Adler Real Estate AG had the lowest transaction volume, at €159,000. The takeover offer made by UniCredit to the shareholders of HVB represented the largest transaction volume to date, at around €16.6 billion.

Takeover offer by UniCredit to the shareholders of HVB

A number of supervisory law issues were involved in the takeover offer made by UniCredit to the shareholders of HVB. BaFin maintained regular contact with the Italian supervisory authority CONSOB and, due to the parallel takeover offer to the HVB subsidiary Bank Austria Creditanstalt AG – with the Austrian Takeover Commission. This process confirmed that the Securities Acquisition and Takeover Act offers a sufficient number of options to deal with cross-border takeovers of this size and complexity.

Swap offer permitted in Germany.

While the Austrian offer to the shareholders of Bank Austria Creditanstalt AG had to be structured as a cash and swap offer, the offer to the shareholders of HVB was made as a pure swap offer. The Securities Acquisition and Takeover Act permits a pure swap offer, whereby the shareholders are only offered consideration in the form of shares, not cash. The precondition is that the shares are liquid and admitted to trading on an organised market (section 31 (2) WpÜG). If holders of voting shares – such as the HVB ordinary shareholders – are offered shares as consideration, these shares must also vest voting rights. There are no statutory provisions with regard to the quality of the voting rights. Even those shares that vest formal voting rights, but are subject to certain voting right restrictions, can be permitted as consideration.

Exclusion of certain foreign shareholders.

BaFin authorised UniCredit to exclude shareholders based in Japan, the US and Australia from the offer. Foreign shareholders can be excluded if the offer would require the bidder to comply with the provisions of another state outside of the European Economic Area and if it is therefore unreasonable to expect the bidder to make an offer (section 24 WpÜG). If, however, the foreign regulations provide the bidder with the option of exemption or relief, BaFin considers it reasonable to expect the bidder to make an offer in accordance with German law. UniCredit, though, was required to include certain institutional shareholders from the US and Australia

[77] www.bafin.de > Legal Foundations & Official Announcements> Miscellaneous.
[78] The transaction volume is calculated as the number of shares to be acquired by the bidder multiplied by the consideration per share offered by the bidder as part of the offer procedure. The additional transaction costs are then added to this amount.

in the offer, because it was only subject to simplified procedural regulations in this respect.

Exemption of the trading portfolio.

UniCredit also received an exemption for its trading portfolio in accordance with section 20 WpÜG. The exemption allows the bidder to disregard securities of the target company that are part of its trading portfolio with respect to the obligations incumbent upon the former within the framework of the offer procedure. The purchase prices for these securities, for example, can be disregarded for the determination of the consideration to be paid. The exemption is contingent on proof by the bidder that it does not intend to exert influence on the management of the target company and a demonstration of its speculative intentions.

Book value clause exemption.

Indirect control can be attained, for example, if a bidder obtains a stake of more than 50% in the target company via a takeover offer for a target company that thus becomes a subsidiary of the bidder. In such cases, the participating interests held by the target company in domestic listed public limited companies are also attributed to the bidder, which can create a need for a mandatory offer in accordance with section 35 WpÜG. If, however, the acquisition of control is not actually aimed at the indirect participating interest but rather at the target company iteself, BaFin can grant an exemption from the requirement to make a mandatory offer. The precondition is that the book value of the indirectly acquired participating interest accounts for less than 20% of the assets of the company. BaFin exempted UniCredit on these grounds, with respect to the indirect control gained over various domestic listed subsidiaries of HVB.

Prospectus information in German.

Swap offers, including those made in accordance with the Securities Acquisition and Takeover Act, are subject to prospectus law requirements. The prospectus information on the equities offered as consideration in accordance with section 7 WpPG, for example, must be included in the offer document. This is not required if a prospectus for these equities has already been published in Germany and in the German language, and provided that this prospectus remains valid during the term of the offer. UniCredit had submitted a securities prospectus for the UniCredit shares offered as consideration to the HVB shareholders to the Italian supervisory authority, CONSOB. Germany then received notification of the approved prospectus, rendering it valid. Since, however, UniCredit had only published an English-language prospectus, the German-language prospectus information had to be incorporated into the offer document.

Approvals from the antitrust and banking supervisory authorities.

A number of approvals had to be obtained from the antitrust and banking supervisory authorities in several states before the UniCredit takeover offer could be completed. UniCredit included the corresponding conditions in its offer.

Bidders can make takeover and acquisition offers subject to certain conditions provided that these have been adequately defined and that the bidder cannot influence whether or not they will actually occur. The occurrence or non-occurrence of the condition in

question must be determined before the end of the acceptance period. BaFin only makes exceptions to this rule if bidders are unable to complete their offers at the end of the acceptance period because this would result in them violating other statutory provisions. Situations in which the time of occurrence or non-occurrence of the condition is postponed beyond the end of the acceptance period results in disadvantages for the affected shareholders. They do not receive their consideration as soon as the acceptance period has ended, but remain tied to the offer nonetheless. This is why BaFin only accepts a situation in which the occurrence or non-occurrence of the condition does not fall soon after the end of the acceptance period if the shareholders are offered compensation for the disadvantages involved. This means that bidders either have to offer the shareholders an additional right to revoke, or have to ensure that the shares tendered by the shareholders can be traded and that this trading is likely to have a certain degree of liquidity. UniCredit undertook to appoint a third party as designated sponsor in order to ensure liquid trading in the HVB shares tendered as part of the offer on the stock exchange.

Amendment of the offer

New circumstances can arise following publication of the offer document and during the acceptance period which are relevant to the success of the offer. The options available with regard to offer amendments are set out in section 21 WpÜG, which gives bidders the option of increasing the consideration, offering another consideration as an alternative, reducing the acceptance threshold or waiving conditions. Outside of this legal framework, bidders cannot extend the acceptance period unilaterally in order to ensure that the offer is brought to a successful conclusion.

In the event that a bidder has subjected its offer to the condition that a certain proportion be achieved during the acceptance period, the rate of acceptance among shareholders is crucial. Although the status reports, which are published regularly during the acceptance period, show the number of acceptance declarations submitted, they do not provide a sufficiently reliable indicator as to whether or not the minimum proportion has been met shortly before the end of the acceptance period, when most shareholders accept offers.

Exclusion period in the event that an acceptance threshold is not met.

If an offer fails because the acceptance threshold was not met, the bidder is excluded from making another offer to the shareholders of the same target company for a period of one year. BaFin can exempt the bidder from the exclusion period with the consent of the target company. BaFin issued NDO Services B.V. with an exemption of this nature with respect to its failed offer to the shareholders of Arxes AG on 1 September 2005.

In the year under review, eleven offer procedures contained minimum acceptance thresholds, with only three proving successful without a need for an amendment to the original offer. Four further procedures were only successful after the acceptance threshold was reduced through an amendment to the offer. Four procedures failed because the acceptance threshold was not met.

Updating the offer document.

If a bidder makes any amendment to the content of an offer, it must publish such amendments in accordance with section 21 WpÜG. Furthermore, it must publish changes in its equity portfolio and any purchases made at a higher price on a regular basis during the acceptance period in a status report in accordance with section 23 WpÜG. If the bidder acquires the shares in return for a consideration that is higher than that specified in the offer, the offer shall automatically increase by the difference in accordance with section 31 (4) WpÜG. Bidders have no other general duties with respect to the updating of their offers in accordance with the Securities Acquisition and Takeover Act.

5.2 Exemption procedures

BaFin received 113 applications for exemption.

Bidders can apply for an exemption from the obligation to publish a notice as to its attainment of control of the target company and to make a mandatory offer to the external shareholders (section 36 and 37 WpÜG). 113 applications of this nature were submitted in 2005, accounting for the largest proportion of the total applications made under takeover law. BaFin approved 64 applications and rejected one. 15 applications were withdrawn, and 33 were still pending at the end of the year.

Restructuring once again main reason for applications.

BaFin received 43 applications for non-attribution of voting rights in accordance with section 36 WpÜG. As in previous years, the majority of the applications (31) related to the acquisition of control due to internal group restructuring measures. Twelve applications related to the acquisition of control on inheritance/family law grounds. A total of 70 exemption applications were submitted in accordance with section 37 WpÜG, five of which related to the indirect acquisition of control. BaFin can exempt applicants if this is deemed justified, for example, based on the intention behind the acquisition of control, the shareholder structure or the actual ability to exercise control. The WpÜG Offer Ordinance contains examples of specific cases for exemption. Unlike section 36 WpÜG, applications in accordance with section 37 WpÜG are subject to a deadline and must be submitted at the latest within seven calendar days of the acquisition of control.

Exemption due to blanket clause

Exemption in the event that control cannot be exercised.

In 2005, BaFin exempted an applicant because it had no real possibility of exercising control. The applicant had joined a voting pool that held more than 30% of the voting rights in a target company. The applicant submitted to the voting decisions of the other pool members and was not involved in the voting pool decision-making process with respect to upcoming votes.

Since this situation fulfilled the criteria of “acting in concert”, the voting rights attached to all of the equities in the pool were attributable to the pool members. This meant that all of the pool members acquired control of the target company and were obliged to make a mandatory offer. In accordance with BaFin’s wonted

practice, the issue as to whether or not a particular pool member can effect decisions or is subject to the influence of the other pool members is irrelevant from an attribution point of view. In the event however, that the pool member in question really has no way to exercise control over the target company due to a lack of influence in the voting pool, BaFin may consider exemption in accordance with section 37 WpÜG.

5.3 Investigations in the case of Deutsche Börse AG

BaFin's assessment of a possible acquisition of control over Deutsche Börse AG was the subject of keen public and media interest. In January 2005, Deutsche Börse AG (DBAG) made a takeover offer to the shareholders of the London Stock Exchange plc (LSE) in accordance with English law. Many of DBAG's existing shareholders, or persons that became shareholders in the months that followed, primarily British fund management companies, objected to the takeover offer and voiced their criticism in public. DBAG withdrew its takeover offer on 6 March 2005 as a result. In the spring of 2005, a number of fund management companies approached DBAG and made a number of demands. These demands included the implementation of share buy-back programmes, as well as resignation by members of DBAG's Executive and Supervisory Board. Finally, in April 2005, the British fund management company TCI submitted a proposal for the dismissal of the Chairman of the Supervisory Board to the Annual General Meeting on 25 May 2005. The Chairman of the Executive Board subsequently left DBAG on 9 May 2005, while the Chairman of the Supervisory Board announced that he would be resigning from his post at the end of the year.

On 18 May 2005, BaFin launched formal investigations into several fund management companies. These companies were suspected of having acted in concert in order to control DBAG. If this suspicion were confirmed, the fund management companies would have been required to submit a mandatory offer in accordance with section 35 WpÜG.

Acting in concert
The question as to whether or not a bidder holds 30% or more of the voting rights in a target company is not based only on the shares held directly by the bidder. Voting rights can also be attributed to bidders from shares that they do not own (section 30 WpÜG). "Acting in concert" represents a special case among these attribution rules. Voting rights will be reciprocally attributed if either the bidder or its subsidiary coordinates actions relating to

the target company with a third party, either by means of an agreement or otherwise. This is designed to reflect the actual structure of control over the target company.

"Acting in concert" subject to very clear conditions.

In detail, "Acting in concert" refers to a situation in which actions have been coordinated by means of prior communication and result in an agreement to exercise voting rights or certain other rights derived from shareholder rights. The broad interpretation by BaFin, which also applies to rights other than actual voting rights, is required in order to cover, for example, supervisory board actions. The higher regional court of appeal (OLG) in Munich subscribed to this interpretation in a decision with respect to a civil damages suit based on failure to make a mandatory offer (section 38 (1) WpÜG).[79] The ruling is pending appeal at the Federal Court of Justice. "Acting in concert" must also involve the objective of exercising sustained and continual influence over the target company. The criteria of exercising influence comprises two components: the ability to exercise influence, and the actual exercise of influence.

In principle, the election of members of the supervisory board provides an opportunity for exercising influence. Agreements on the election of supervisory board members do not fall under the exception set out in section 30 (2) WpÜG, because they have a sustained and time-intensive effect on the control structures of the target company. Whether or not a particular case actually provides an opportunity for exerting influence depends on the quantity and quality of the supervisory board mandates and the structure of the supervisory board. A situation in which the supervisory board is composed in such a way as to reflect the overarching shareholder structure cannot be regarded as an overall plan, and, as a result, intentions of this nature alone do not provide grounds for attribution.

Conclusion: no unambiguous proof.

BaFin concluded several months of investigations in October 2005. Despite numerous requests for information and documentation, and the questioning of various witnesses, BaFin was unable to find sufficient proof to back up the theory that the fund management companies had been acting in concert. In particular, the evidence available could not establish, beyond dispute, that the funds in question had any further-reaching entrepreneurial interest, or an overall plan for Deutsche Börse AG.

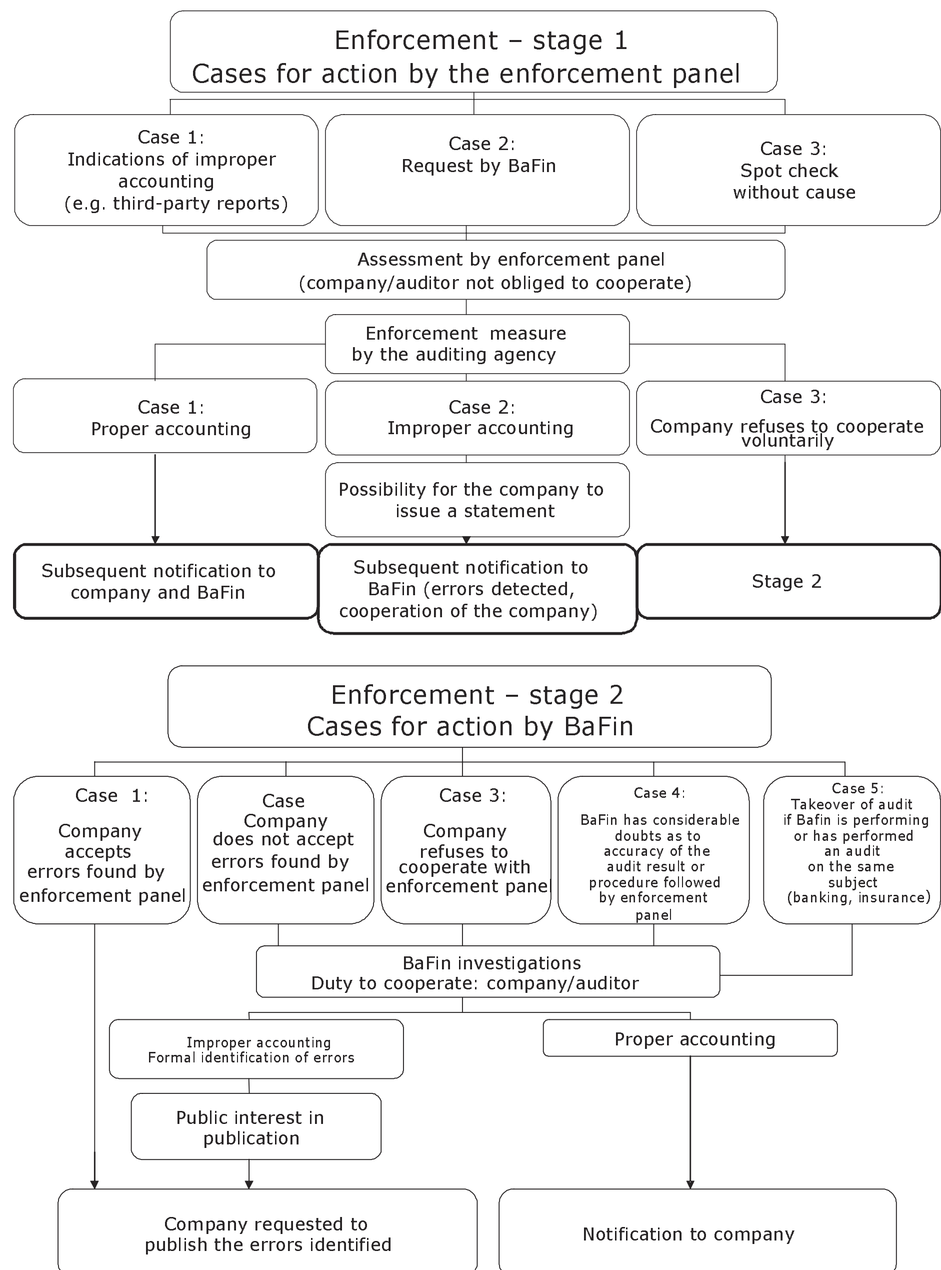
6 Accounting control/enforcement

The two-tier enforcement procedure introduced in July 2005 subjects company reports to an additional external examination. This is performed to ensure the legality of the most recently

[79] OLG Munich ZIP 2005, 856, 857.

approved annual financial statements and consolidated financial statements, including the management reports, of companies whose securities are admitted for trading on the official or regulated market of a stock exchange in Germany; the first such examination covered accounting as at the balance sheet date 31 December 2004. The examinations are based on the statutory requirements, including generally accepted accounting principles, or other international accounting standards permitted by law. These include the provisions of the German Commercial Code (HGB) on the one hand, and the IAS/IFRS international accounting

Figure 29
Enforcement process



standards adopted and applied on the basis of the European Commission's regulation endorsing IAS on the other. In the case of companies domiciled abroad, the assessment is based on the accounting standards applied in the relevant country. The aim of the enforcement process is to boost investor confidence in the accuracy of the reports issued by capital market-oriented companies.

1,212 companies subject to enforcement.

A total of 1,212 companies based in 28 countries were subject to enforcement as at 31 December 2005. 954 of these companies were German and 176 were European, of which 133 were domiciled in EU member states. 82 companies were based in nine countries outside of Europe. The largest group of companies domiciled outside of Germany was the group based in the Netherlands, which included a total of 54 companies. Outside of Europe, the largest group of companies (35) was based in the US. The spectrum of accounting standards subject to examination is broad, ranging from the German Commercial Code, to IFRS, to accounting standards of individual countries.

A list of the companies subject to enforcement is available on the BaFin website.[80]

Launch of stage one.

In August 2005, the Federal Ministry of Justice and the Federal Ministry of Finance approved both the procedural guidelines and the spot check procedure of the enforcement panel following intense preliminary talks between the German Financial Reporting Enforcement Panel (FREP) and BaFin. This was the most important step in securing the deployment of stage one. Seven extraordinary audits and 45 spot checks have been performed since then. Seven procedures, three extraordinary audits and four spot checks, were completed by the end of 2005. In one case, BaFin has since ordered publication. All in all, the enforcement panel plans to perform around 120 spot checks every year.

Table 25

Enforcement by country

Country	Number
Germany	954
Netherlands	54
US	35
Jersey	26
Japan	23
Austria	22
UK	18
Switzerland	12
France	10
Luxembourg	9
Ireland	7
Israel	7
Cayman Islands	6
Canada	5
Italy	4
Spain	4
Norway	3
Dutch Antilles	3
Belgium	1
Finland	1
Gibraltar	1
Iceland	1
Latvia	1
Sweden	1
Hungary	1
Australia	1
Brazil	1
South Africa	1
Total	**1,212**

Cooperation and financing

The organisational aspects of the new duties also had to be clarified. As a result, a number of workshops were held with FREP. At the same time, BaFin contacted the German Chamber of Public Accountants (Wirtschaftsprüferkammer), which routinely examines company reports for formal errors, and both parties agreed to an exchange of information. The two-tier enforcement procedure is financed by a separate cost allocation, the amount of which is based on the companies' stock exchange turnovers. BaFin also informed all management boards and courts in writing of the reporting requirement with respect to actions in accordance with section 246 (Anfechtugnsklage) and section 249 (Nichtigkeitsklage) of the German Stock Corporation Act (Aktiengesetz) with respect to annual reports and the appointment of special auditors. In order to provide the general public with information on the new enforcement procedure, BaFin employees held talks on the introduction of the new procedure at a range of events.

[80] www.bafin.de > Datenbanken und Statistiken > Datenbanken.

VII Cross-sectoral responsibilities

Karl-Burkhard Caspari, Deputy President

1 Money laundering prevention

1.1 International anti-money laundring measures

The 40 anti-money laundering recommendations and the nine special recommendations on the fight against terrorism-financing developed by the Financial Action Task Force on Money Laundering (FATF) set the international standards.

Third EU Money Laundering Directive comes into force.

The Third EU Money Laundering Directive[81], which came into force on 15 December 2005, means that the 40 FATF recommendations are now binding across Europe. The Directive must be implemented in national law within two years.

The Money Laundering Directive sets out a number of core due diligence requirements that credit institutions, financial services providers and certain insurance undertakings have to comply with in order to prevent money laundering and terrorism-financing. The Directive calls for a risk-oriented approach, meaning that the institutions and insurance companies must implement anti-money laundering measures that take account of their respective risk situation: companies whose business activities are at a low risk of abuse for money laundering purposes can reduce the general due diligence requirements. This means, for example, that they can opt not to verify the identification of clients and beneficiaries. Similarly, companies with a higher money laundering risk must meet more stringent due diligence requirements.

[81] www.bafin.de > Rechtliche Grundlagen & Verlautbarungen > EU-/EG-Recht.

In Germany, this sort of risk-oriented approach is nothing new. It has been a feature of the anti-money laundering requirements that apply to the German financial sector for some time now. As a result, the affected companies have no reason to expect any fundamentally new requirements.

FATF continues to focus on combating terrorism-financing.

The FATF continued to focus on the fight against terrorism financing, publishing a "Best Practices Paper" on its special recommendation with regard to cash couriers. It also changed its interpretation of the special recommendation on the requirements that apply to the transmission of data on the initiator of transactions with respect to cross-border electronic payments. The plan is to implement the latter in a uniform manner across Europe via the EU Regulation on information on the payer accompanying transfers of funds, which is currently in the EU legislative pipeline. If the regulation is passed, it will apply – unlike the Money Laundering Directive – directly in the member states.

BaFin supports China.

BaFin is supporting China in its efforts to become a member of the FATF. The country has already been granted FATF observer status. In the year under review, several Chinese delegations visited BaFin in order to gather information on its anti-money laundering efforts. BaFin employees also held a week-long seminar on money laundering prevention in Beijing.

Cooperation with foreign supervisory authorities.

BaFin holds regular meetings with foreign supervisory authorities to discuss the issue of money laundering prevention. Highlights of 2005 included the bilateral meetings with the US Federal Reserve Bank of New York and the New York State Banking Department, as well as the meeting with the UK Financial Services Authority. Both the US and UK authorities had discovered a number of shortcomings with respect to money laundering prevention at the branches and subsidiaries of German credit institutions based in those countries. On the whole, BaFin concluded that the US and UK authorities subject banks to requirements similar to those imposed by BaFin.

1.2 Risk-oriented money laundering prevention

In the year under review, BaFin continued to check that the institutions were taking risk-oriented anti-money laundering measures, the objective being to ensure that they were keeping a constant eye on their individual business risks, including cost aspects. The main protection mechanisms must be employed in those areas of the institution that are subject to the greatest risk of abuse for money laundering purposes. BaFin also called on the German Institute of Chartered Accountants (Institut der Wirtschaftsprüfer) and the auditing associations to take a more risk-oriented approach to their audits. Internal auditors at the institutions also have to practice risk-oriented auditing.

Circular on the preparation of a risk analysis.

In the year under review, BaFin published guidelines on the preparation of an internal risk analysis for the institutes.[82] These are intended to help the institutions make their anti-money laundering efforts more risk-oriented. One of the key tasks of every institution is to ensure that it analyses its own operations and produces an individual risk profile based on this. All further anti-money laundering measures must be based on the risk analysis and profile.

Relief for smaller institutions with respect to IT research.

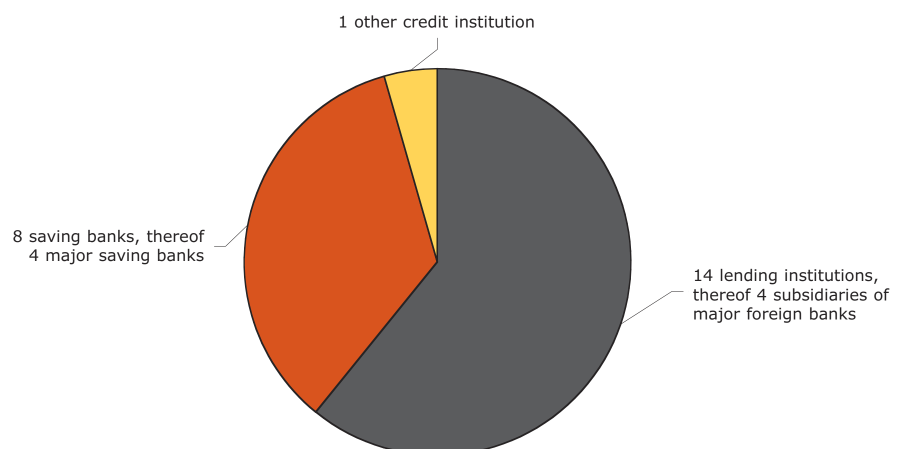
BaFin takes the view that risk-oriented and cost-conscious supervision also means not placing any more demands on the institutions than is necessary to ensure effective money laundering prevention. In the autumn of 2005, BaFin explained that smaller institutions do not necessarily have to install IT research systems. At these institutions, manual monitoring is sufficient given that they have fewer contracting parties, beneficial owners and transactions than their larger counterparts.[83]

1.3 Money laundering prevention at banks, insurance companies and financial services institutions

Combating money laundering in the banking sector.

In 2005, BaFin held 23 special audits (2004: 18) to determine whether credit institutions were complying with their duties relating to the prevention of money laundering.

Figure 30
Breakdown of 2005 special audits by type of institution



Not all of these special audits were merely routine. In the case of certain institutions, BaFin had concrete grounds for more closely examining the money laundering prevention measures.

The audit reports showed shortcomings with respect to the risk analysis, the group-wide implementation of money laundering prevention requirements, the client-related due diligence

[82] Circular 8/2005 (GM) dated 24 March 2005.
[83] Letter on the implementation of anti-money laundering measures within the meaning of section 25 (1) no. 6 KWG dated 08 November 2005.

requirements and the implementation of IT research systems. In one particular case, the deficiencies identified were so serious that a board member voluntarily tendered his resignation. In another case, BaFin issued a formal order, demanding that the company in question establish a proper business organisation.

Management must improve risk-awareness.

On the whole, it was clear in 2005 as well that far from all institutions view money laundering prevention as a component of their internal risk management systems. It is the responsibility of the management to increase this awareness within the company and to set up the corresponding organisational structures.

Risk analysis often insufficient.

The risk analysis performed at many institutions is still insufficient, with some banks failing to cover all of the transactions executed by the company or underrating risks from the outset. Only a handful of analyses provide concrete criteria for the development and establishment of the IT research system.

2005 once again highlighted how important it is for banks to include all types of business in both Germany and abroad, as well as all business areas and participating interests in their risk analyses. This means, fiduciary transactions, functions and mandates should also not be omitted, a common error committed in some of the particularly serious cases examined in 2005.

The institutions were once again able to use their money laundering prevention IT research systems to uncover other cases of serious financial crime, such as fraud against the respective institutions. This allowed the banks to avert considerable damages. For example, the research systems exposed various cases of direct debit fraud, an issue faced by a large number of credit institutions across the country. A number of VAT carousels, which use bogus transactions to evade taxes into the millions were also discovered.

Group-wide implementation.

The group-wide implementation of the anti-money laundering requirements represents a major challenge, in particular for major internationally active groups with subsidiaries and participating interests in Germany and abroad. In order to ensure that these institutions do not provide a gateway for money laundering and terrorism-financing abroad, they must introduce consistent measures within the group that meet internationally recognised prevention standards.

Anti-money laundering measures at financial services institutions and insurance companies.

In 2005, a number of weaknesses were identified at financial services institutions that offer financial transfers and foreign currency transactions, in particular with regard to the verification of client identities and checks to determine the origin of funds. In order to attract new clients, one institution had violated the provisions of the German Banking Act and the Money Laundering Act (Geldwäschegesetz) and collaborated with disreputable brokers. In the case of financial transfer services providers, a system whereby client identities are only verified when certain thresholds are exceeded is normally inadequate from a risk point of view. All client identities must be verified in order to prevent money laundering.

BaFin assessed the money laundering prevention systems in place at three life insurance undertakings. In particular, the auditors found that the identification requirements were not being met in all cases, and that high-volume transactions and the origin of funds were not always being assessed in a risk-oriented manner. One particular case relating to a policyholder shows exactly why insurance companies have to ensure that their anti-terrorism financing measures also cover term insurance. The policyholder in question had taken out term insurance policies with various life insurance companies, stating the intention to provide insurance for his family. In reality, however, the suspected motive was terrorism financing.

Prosecuting underground banking.

In 2005, BaFin launched 215 new proceedings due to unauthorised financial transfers, foreign currency and credit card transactions. This represents a substantial increase as against the previous year (125), purely as a result of the financial agent phenomenon. In the spring of 2005, it was revealed that fraudsters were advertising for "financial agents" via e-mail or the Internet. This scam involves the use of fraudulent activities, especially phishing schemes, in order to transfer funds from unsuspecting account holders to the accounts of the financial agent. In order to obtain access to the funds and to cover up the transfer routes, the fraudsters then have the financial agents send the sum transferred, minus a commission fee for the agent which normally ranges from five to ten percent, abroad by means of a wire transfer. The transfer payments made in this manner which came to BaFin's attention totalled over €1.5 million in the year under review and were destined primarily for the former CIS states. Despite warnings from BaFin, investigating officials and the media, these seemingly lucrative job offers are still being accepted by individuals acting in good faith. Ultimately, it is the financial agents who lose out. The credit institutions affected regularly demand that they return the illegally transferred funds. Furthermore, the financial agents themselves are providing financial transfers without a licence, which puts them at risk of prosecution and charges of money laundering. BaFin's activities are not, however, limited to the prosecution of individual financial agents. It has also required the financial transfer services providers in question to improve their research and monitoring measures, and initiated contact with foreign supervisory authorities in order to combat the phenomenon at international level.

2 Account access procedure

Key tool in securing the integrity of the financial marketplace.

In the year under review, the account access procedure in accordance with section 24c KWG once again proved to be a key tool in helping to ensure the integrity of the German financial marketplace. The process not only makes it easier for BaFin to perform its duties, but also assists the criminal prosecution authorities and other authorities with access to the information.

BaFin processed 62,000 requests.

In 2005, BaFin processed a total of around 62,000 requests for information (2004: approx. 39,000) and provided information on approximately 485,000 accounts (2004: around 235,000). As expected, the majority of these requests were once again made by the various criminal prosecuting authorities: public prosecutor's offices, the audit bureaus of the tax authorities, the customs investigation offices and the police. Numerous individual police agencies sent a total of around 39,000 requests for information to BaFin (2004: around 26,000). As in the previous year, the vast majority of requests came from the Federal Office of Criminal Investigation (Bundeskriminalamt), the state offices of criminal investigation, and various police headquarters and departments. Investigating officials used the account access procedure primarily to combat severe to extremely severe crimes.

Around 600 requests were submitted by BaFin itself in the year under review (2004: around 1,400). In the majority of cases, BaFin had evidence that persons were providing banking or financial services without a licence. In many cases, these unauthorised financial services related to financial transfers.

Account access boosts investor protection.

While investigating cases of unlicensed deposit business, BaFin also managed to use the account access procedure to protect investors from substantial damages in many cases. This was possible because the information enables BaFin to take action against persons acting illegally at such an early stage that they are unable to execute their plans and acquire large amounts of investor funds. In several cases, BaFin was also able to use account access to demonstrate to a number of individuals and companies that they had falsely stated that the unlicensed business in question had been ceased.

Positive response from investigating agencies.

A BaFin survey conducted in the year under review showed the broadly positive response of the criminal prosecuting authorities to the account access procedure. These emphasised that the automated account access procedure not only makes a key contribution to more effective combating of organised crime, terrorism and money laundering, but also facilitates financial investigations as a whole. They explained that their information requests are normally used in order to evidence of property and financial crimes, as well as to retrieve illegally obtained assets from convicted criminals. As a result, the account access procedure has become indispensable to many agencies.

Table 26

Authorised users of account access procedure

Authorised agency	2005		2004	
	absolute	in %	absolute	in %
BaFin	632	1.01	1,380	3.50
Police authorities	38,675	61.97	26,212	66.50
Fiscal authorities*	10,008	16.04	6,057	15.37
Prosecution authorities	7,494	12.01	3,038	7.71
Custom authorities*	5,160	8.27	2,251	5.71
Other	441	0.71	479	1.22
Total	62,410	100.00	39,417	100.00

* The fiscal and customs authorities are only authorised to have BaFin perform account enquiries in accordance with section 24c KWG with respect to criminal proceedings.

Account access in accordance with section 24c KWG and sections 93 and 93b of the German Tax Code (Abgaben-ordnung – AO)
Since 1 April 2003, credit institutions have been obliged, in accordance with section 24c KWG, to maintain an updated computer file containing all banking and securities accounts administered in Germany. This file must include the (securities) account number, the dates on which the account was opened and closed, the names and birth dates of each account holder and persons with powers of attorney over the account, as well as the names and addresses of the beneficiaries. Account balances and movements are not recorded. Section 24c KWG allows BaFin to combat terrorism-financing, money laundering and the unlicensed provision of banking and financial services transactions more effectively than in the past through a central research source. BaFin also distributes information from these files, primarily in response to requests by the criminal prosecution authorities. A definitive list of the individuals and bodies authorised to request this information from BaFin is set out in section 24c (3) KWG and section 5 GwG. The fiscal authorities are only authorised to request that BaFin perform account enquiries in accordance with section 24c KWG in relation to criminal proceedings. BaFin has published a fact sheet on its website with detailed information concerning the account access procedure in accordance with section 24c KWG.

Credit institutions are obliged to maintain a file on all (securities) accounts in accordance with section 24c (1) KWG. Since 1 April 2005, they have also been obliged to maintain the access file in accordance with the Tax Code (sections 93 (7) and (9) and 93b (1)). The legislature did not designate BaFin as the central point of enquiry for this new account access possibility for the fiscal authorities. This responsibility lies instead in the remit of the German Federal Tax Office (Bundeszentralamt für Steuern).

3 Licensing requirements and prosecution of unauthorised transactions

Companies that are not supervised by BaFin offer a range of products via internet sites, printed media and sales representatives, which investors can allegedly use to provide for their retirement, to accumulate assets or to save on taxes. The providers often combine the promise of substantial returns with contracts that carry high risk and are difficult for investors to comprehend. In order to protect investors and the German financial marketplace, BaFin examines these investment offers to ascertain whether or not they are subject to licensing/authorisation

in accordance with the German Banking Act or the Insurance Supervision Act.

3.1 Assessment of licensing/authorisation requirements

Even before commencing business operations, providers can ask BaFin to assess whether or not the services they intend to provide require a licence or authorisation. This allows providers to clarify supervisory issues at an early stage and to ensure that the activities they intend to perform comply with supervisory law. In the year under review, BaFin assessed 371 enquiries with regard to the licensing/authorisation requirement for intended business (2004: 415). 325 of the enquiries related to the Banking Act, while 46 related to the Insurance Supervision Act. If the assessment results in a determination that a licence or authorisation is required, the providers are only permitted to commence business operations once they have received a written licence or authorisation from BaFin. Furthermore, the execution of unauthorised banking, insurance and financial services transactions constitutes a criminal offence in accordance with the Banking Act and the Insurance Supervision Act. If a provider commences business operations without a licence, it puts itself at risk of criminal prosecution, in addition to supervisory measures.

Licensing requirement for contractual trust arrangements.

In the year under review, BaFin explained how contractual trust arrangements (trust models developed as a form of occupational retirement provision) are to be assessed from a supervisory law point of view. It published a fact sheet containing information on the licensing requirements and possibilities for exemption for such models. Companies use contractual trust arrangements in order to meet their pension and retirement provision obligations vis-à-vis their employees. As the sponsoring entities, the companies transfer assets to a trustee company, which is responsible for managing and investing them in various financial instruments. If the trustee is acting for legally independent sponsoring entities, it is performing banking business that is subject to a licensing requirement, in particular principal broking, safe custody business and, in some cases, guarantee business. On the other hand, something known as the "group privilege" applies if the trustee company only performs these banking transactions with a parent company, subsidiary or sister company. In such cases, the German Banking Act allows an exemption from the general licensing requirement. Furthermore, individual exemptions can be granted for certain contractual trust arrangements – but only in exceptional cases where no supervision is necessary.

Exemption from supervision.

If supervision of a particular company is not necessary due to the nature of its business activities, BaFin can exempt the company from certain requirements, especially the licensing requirement (section 2 (4) KWG). Typically, banking transactions that are only auxiliary or ancillary activities of minor significance or that are necessarily linked to other licence-free business activities, are

eligible for exemption. This would apply, for example, to loans from power utilities for heating system modernisation. In 2005, BaFin exempted 38 companies for the first time (2004: 22), with twelve further applications still pending. As a result, a total of 245 institutions were exempt from the licensing requirement at the end of 2005. The year under review also saw an increase in the number of exempted foreign providers that operate in Germany on a cross-border basis. Companies from non-EU member states may apply for exemption from the licensing requirement if they are subject to similar supervision in their home country. In 2005, BaFin exempted a total of ten institutions from Switzerland and the US.

Furthermore, companies that only provide e-money business may also be exempted based on the European Union's E-money Directive (section 2 (5) KWG). A total of four companies had been exempted in accordance with this by the end of 2005, with four applications still pending with BaFin at the end of the period under review.

Cross-border banking and financial services

More and more companies based outside of the EU are offering investment products on the German capital market, mainly via the Internet, without having branch offices or contacts within the country. Some providers choose this way of doing business in order to avoid supervision by BaFin. Some German institutions also merely claim to be operating from abroad in order to make it more difficult for the German authorities to prevent their prohibited activities. If prohibited transactions are executed from abroad, BaFin's ability to act against them is limited. It can, however, prohibit advertisement in the German media, close bank accounts at German banks and prohibit the activities of brokers operating within Germany.

3.2 Fight against the black capital market

BaFin considers the "black capital market" to refer to all banking, insurance and financial services transactions performed within Germany by companies that do not have a licence/authorisation in accordance with the Banking Act or the Insurance Supervision Act. BaFin works together with the Bundesbank in order to take action against these transactions. It also collaborates with the police and the criminal prosecuting authorities that pursue prosecution of those behind the unauthorised transactions. BaFin has comprehensive investigative and intervention powers to help it fight the black capital market. It can perform on-site inspections at suspected companies, search their premises and seize documents. If suspicion is borne out that unauthorised activities are being performed, BaFin can prohibit transactions and order liquidation of the business. Systematic intervention against the black capital market helps to ensure the integrity of the financial marketplace. Investor protection also plays a key role. Ultimately, it is investors

who bear the direct consequences of the unauthorised transactions. Often, the allegedly lucrative investments on the black capital market result in substantial losses, or even in the total loss of the invested capital.

Collective investment vehicles

A ruling passed by the Higher Administrative Court of the State of Hesse, which deals with the licensing requirement for collective investment vehicles in the form of limited partnerships (Kommanditgesellschaften), could have dramatic consequences for supervisory practice and investor protection. Until now, BaFin has considered investment models that pool investor funds and then invest these in financial instruments, as principal broking services that are subject to a licensing requirement.

Ruling by Higher Administrative Court of Hesse changes legal framework

On 14 February 2006, the Higher Administrative Court of Hesse made a preliminary judgement controverting BaFin's position in summary legal protection proceedings.[84] The ruling related to a collective investment model, in which investors could invest in a limited partnership as limited partners or as trustors via a trust limited partner. The court was of the opinion that this form of the sale and purchase of financial instruments using investor capital did not constitute acting for the account of a third party and, as a result, could not be considered principal broking services requiring a licence. Given its view, based on an assessment of the partnership and trust agreements, that the investors had been granted sufficient participation rights with respect to the investment strategy of the company, the court felt that the company was not providing services for third parties, i.e. persons outside of the company. The fact that the investors invest as trustors via a trust limited partner and do not become direct limited partners was, in the opinion of the court, irrelevant.

What are principal broking services?

Principal broking refers to the purchase and sale of financial instruments in the broker's own name but for the account of others. Up to now, BaFin has deemed investment models that are structured as participating interests in a partnership but that actually offer for-fee services to investors within this framework to be acting for the account of others. These structures lack the typical shared purpose and common economic interest of all partners. The investors put up their money in order to make use of the service offered by the company and to participate in profits. The interest of the provider, on the other hand, is focused on the continuance of the investment product, in order to retain for as long as possible the agreed fixed remuneration, which is often independent of actual profits. The performance of the financial

[84] Case no. 6 TG 1447/05.

instruments is of secondary importance to the company. Initially, the administrative courts had also shared this interpretation of principal broking services.

Impact of the new legal framework

Until the legal issue has been finally decided, the Supervisory Authority will no longer take formal measures against such limited partnership models, which were the subject of the Higher Administrative Court ruling. This form of investment products can now also be offered to the general public via unregulated trust limited partners. For as long as this legal opinion prevails, providers can exempt themselves from supervision by obtaining a sole signature from the investor. This means that the issue as to whether or not pooled investor funds can be invested in financial instruments without supervision is purely a matter of contract terms. In practice, providers will have no problems in wording contracts in such a way as to ensure that the trustors are provided with the minimum participation rights demanded by the courts. In fact, however, these rights prove to only exist on paper in cases of dispute.

There are extremely large amounts invested in such products, with individual investment models accounting for sums in the hundreds of millions. In many cases, the providers' advertising implies yields that are well in excess of the average. Most of the time, however, these yields are not achieved, alone because investors are billed numerous costs and fees that cancel out any trading successes. The initial fees that the investors are obliged to pay often account for a substantial proportion of their total capital commitment. Another reason for concern is the fact that these investment models are often promoted as retirement schemes. The providers are exploiting the willingness of the general public to provide for their retirement. But the contractual risk of a total loss of the invested capital is incompatible with the idea of retirement provision.

Increase in disreputable providers and higher losses for investors are likely.

When regulation ceases, it is likely that the number of disreputable providers will increase and, with them, the losses for inventors. There is considerable doubt as to whether or not this interpretation of principal broking services takes sufficient account of investor protection. As a result, BaFin intends to stand by its existing interpretation of principal broking services and to make use of the legal protection options open to it via the courts.

Supervisory and investigative measures

In the year under review, BaFin requested information from suspect companies in 100 cases (2004: 98) and imposed coercive penalties in 41 cases (2004: 26). It performed twelve on-site inspections and searches (2004: 16), with four searches taking place concurrently at different locations. BaFin issued 22 prohibitory orders (2004: 23) and 22 liquidation orders (2004: 27) and, as in the previous year, appointed liquidators in 13 cases.

BaFin can also take action against companies or individuals that were involved in the initiation, conclusion and settlement of unauthorised banking or financial services transactions. This includes companies that are deliberately involved in the unauthorised investment models, for instance as intermediaries, and companies that are involved in the transactions without their knowledge merely through use of their standard services. This applies, for example, to licensed credit institutions at which the providers of unauthorised transactions maintain accounts. In 2005, BaFin issued four prohibitory orders against companies involved in unauthorised transactions (2004: 7) and two liquidation orders (2004: 7). It also issued six directives (2004: 26) and appointed a liquidator in two cases (2004: 6).

In the year under review, BaFin opened 662 new investigations (2004: 818), the majority of which related to the prosecution of unauthorised banking and financial services business. In the insurance sector, the focus was once again on the assessment of licensing requirements; in this sector, BaFin conducted only 24 investigations into unauthorised business.

Legal remedies against BaFin measures.

Individuals and companies against which BaFin took formal measures filed challenges in 146 cases in the year under review (2004: 106). During the same period, BaFin concluded 55 such procedures, 19 of which by means of a rejection notice (Widerspruchsbescheid). The challenges were rejected in all cases. In many cases, the affected individuals and companies also took legal action against the measures imposed by BaFin. The courts ruled on 55 of the 152 disputes involving BaFin in 2005 (2004: 130). In 42 cases, the courts ruled in BaFin's favour, and in four cases the ruling was in favour of the affected individuals and companies. Nine rulings were partially in BaFin's favour.

One case has been suspended since 2004, because the national court has submitted a number of European law issues to the ECJ for a preliminary decision. The Advocate General of the ECJ published her opinion on the case in March 2006, and the court is expected to reach a decision in the course of this year.

4 Consumer complaints

In the course of 2005, a total of 22,165 insurance, banking and financial services consumers brought their complaints to BaFin.

This figure is around 18.7% lower on the previous year, when 27,262 complaints were lodged.

BaFin investigates every complaint.

Complaints often clue BaFin in to irregularities at institutions. This is why it investigates every complaint, assessing whether or not a company has violated rules of conduct and whether or not supervisory measures should be taken. In order to gain a full insight into the situation, BaFin often asks the affected companies to comment on the issue in question. BaFin helps individual consumers, to the extent possible, by prompting companies to correct mistakes or by explaining the legal situation in a comprehensible manner. BaFin acts solely in the public interest, which means that it cannot become involved in the private legal concerns of individual complainants.

Injured investors often enquire as to the role of the Supervisory Authority, in particular in cases of fraud and insolvency. BaFin cannot prevent criminal offences or insolvencies. There is no sure protection against disreputable products or the total loss of invested capital. This is why it is all the more important that investors themselves make sure to assess the integrity and economic plausibility of the offers they are interested in very carefully. The information provided in the media or by the consumer protection agencies can help them to do so.

Online information on the complaints procedure.

Information on the complaints procedure can be found on BaFin’s website.[85] The complaints procedure is not an out-of-court mediation, an area which is handled by ombudsmen. The procedure also cannot replace a civil lawsuit, for example in the event of damage claims.

4.1 Complaints about credit and financial services institutions

Complaint figures

3,642 citizens complained to BaFin about credit and financial services institutions in 2005 (2004: 3,755). In addition, BaFin submitted official positions on 43 complaints made to the Petition Committee of the German Bundestag, and members of the public also made 360 general non-complaint enquiries. On the whole, the number of complaints fell slightly. A total of 664 complaints, seven of which were part of a petition, were successful, while 355 complaints and one petition resulted in partial success for the consumers.

Selected cases

Credit institutions complied with recommendation of Central Credit Committee.

Many complaints once again focused on the “account for everyone” (Konto für Jedermann). The complaints related to credit institutions terminating, or refusing to set up current accounts. The

[85] www.bafin.de > For Consumers >Problems with a specific company? Where can I complain?

complaints, and the reactions of the institutions to these complaints show that the institutions are complying with the recommendation issued by the Central Credit Committee with respect to "accounts for everyone". In some of the disputed cases, the complaints resulted in the establishment or continuation of a current account for the affected parties. This is not, however, possible if, e.g. a customer wishes to open an additional current account, or if the account is continually blocked by attachments. In such cases, the credit institution is deemed, in accordance with the recommendation issued by the Central Credit Committee, to have sufficient grounds to close an existing account or refuse to open an account.

Unnecessary return of direct debits.

One credit institution always returned all direct debits in the event that several direct debits were submitted simultaneously, which collectively exceeded the available account balance. This happened even if one or several direct debits could still have been executed. Following intervention by BaFin, the institution now uses a computer program that allows unnecessary returns to be avoided.

Phishing risk in Internet banking.

Several complaints related to phishing, an Internet-based means of trickery and fraud. E-mails that appear authentic are sent to recipients asking them to visit the (seemingly genuine) website of their bank and then to enter confidential data (passwords, usernames, PINs and TANs). This data is then "phished out", allowing the culprit to access the account of the victim.

These counterfeit e-mails can usually be recognised on the basis of the noticeably poor German and the fact that they are often sent to individuals who do not even have an account at the bank in question. Neither BaFin nor the credit institutions are in a position to prevent these illegal e-mails. In many cases, the senders are based abroad. Furthermore, the security measures taken by the credit institutions cannot prevent every conceivable instance of abuse. Customers themselves must help to prevent unauthorised access to their accounts. The information provided by the credit institutions, their associations and the Federal Office for Information Security (Bundesamt für Sicherheit in der Informationstechnik – BSI) can support them in this. BaFin has also provided information about phishing on its website.[86]

Insufficient information from credit institutions on deposit interest rates.

At many institutions, savers are not provided with information on the rates of interest that apply to their deposits during the year, meaning that they cannot check the interest calculations. When BaFin becomes aware of such cases, it ensures that the customers are provided with verifiable statements.

Building societies reject additional payments.

In comparison to other deposit interest rates, the rates offered for building society deposits have become very attractive. Savers are trying to take advantage of this by making additional payments, which are rejected by building societies in some cases. If, however, the building societies are entitled to reject these payments in accordance with the contractual terms and conditions, BaFin is unable to help the savers in question.

[86] www.bafin.de > Für Verbraucher > Banken und Bausparkassen > Häufig gestellte Fragen > Girokonto.

Calculation of early redemption penalties in accordance with BGH criteria.

BaFin still receives many complaints about early redemption penalties. These penalties are imposed when fixed-interest loans are redeemed early, and many customers feel that they are too high. In all of the cases to date, however, the credit institutions in question based their calculations on the criteria issued by the German Federal Court of Justice (BGH). Nevertheless, disputes can still arise with respect to the amount of the penalties, because the BGH did not provide a set basis for individual calculation components, such as risk cost savings. Any disputes of this nature must ultimately be decided by the courts. Individual cases also related to customer requests for recalculation when the customer did not have a right to early redemption, but the bank accepted the payment nonetheless. In such cases, however, the issue is not a penalty, but an agreement to pay a cancellation fee, to which the institutions can refer as evidence. This applies even if the institution in question has used a reinvestment rate that the BGH has since declared unacceptable for use in the calculation of penalties.

Sale of loan receivables generally permissible.

A number of various enquiries and complaints related to cases in which credit institutions had sold loan receivables. The enquiries focused on the issue as to whether or not transactions of this nature were legally permissible and valid. Some borrowers feared that the agreements concluded with the previous lender would not be upheld. In the cases in question, however, there was no evidence of concrete disadvantages for the borrower. From a supervisory law point of view, there can be no challenge to the sale of loan receivables even if these are acquired by companies which do not have a banking licence. To date, there has been no high court decision as to the civil law validity of the sale of loan receivables.

Assistance in the search for unidentified accounts.

Heirs, lawyers and legal guardians turned to BaFin seeking assistance in tracking down unidentified accounts of decedents or of persons in their care. Many of these individuals referred to the account access procedure, which cannot, however, be used to provide information in such cases. BaFin is unable to help in such situations and recommends that the individuals in question use the research procedures offered by the banking associations.

Disputes with respect to the fees charged for the settlement of estates.

A number of heirs objected to the fees charged for the processing of inheritance matters. In a number of cases, it turned out that the institutions had only provided the services that were necessary – in their own interest as well – for settlement, and thus had no grounds to charge fees. All of the institutions refunded the fees in question, in some cases as a goodwill gesture, where there was a dispute relating to the charging of fees.

Information on deposit guarantee schemes to aid in investment decisions.

A number of complaints focused on the safety of deposits with certain institutions. BaFin can aid investors with investment decisions by providing them with information on the guarantee scheme to which the institution belongs and the extent of the deposit guarantees provided.

4.2 Consumer complaints from the insurance sector

Complaint figures

In 2005, the majority of complaints once again related to insurers. A total of 17,531 complaints were submitted compared to 22,306 in the previous year. These included 15,716 (2004: 19,983) complaints, 773 (2004: 1,141) general non-complaint enquiries and 114 (2004: 122) petitions that came to BaFin via the German Bundestag or the Federal Ministry of Finance.

Overall, 25.2% of proceedings (2004: 27.8%) had a favourable outcome for the complainant; 69.0% of complaints were unfounded, and in 5.8% of the cases, BaFin was not the competent authority.

Table 27

Complaints received - by insurance class

Year	Life	Motorvehicle	Health	Accident	Liability	Legal expenses	Building/ Household	Other classes	Other complaints**
2005	5,858	1,896	2,604	1,242	1,268	1,437	1,408	359	1,459
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.
** Wrong address, brokers, etc.

The substantial decline in the number of complaints relating to life and health insurers is due partly to extraordinary developments in 2004, when the number of complaints still pending with BaFin fell considerably in a year-on-year comparison, in particular with respect to life insurance companies. Adjusting for this, and taking a look at the complaint figures since the turn of the millennium, a moderate high-level rise can be seen since 2000. For 2005, it must be noted that BaFin was unable to conclude its work on a number of complaints with respect to surrender values and conversions to paid-up status because the BGH ruling of 12 October 2005 is relevant in these cases.

The largest proportion of complaints (29.81% as against 29.72% in 2004) related to the handling of insurance policies. This was followed by complaints on claims settlement in life and non-life insurance at 29.62% (2004: 32.48%), contract termination at 18.18% (2004: 16.43%) and business conduct when negotiating contracts at 10.89% (2004: 10.28%). In addition, 11.51% fell into the category “other” (2004: 11.08%). The main grounds are shown in the following table.

Tabelle 28

Grounds for complaints

Grounds	No.
Coverage issues	1,862
Bonus/credit	1,570
Advertising/advice/application processing	1,542
Benefit amounts	1,470
Manner of claims processing/delays	1,259
Policy alterations – extensions	1,212
Termination for cause	1,155
Termination without cause	1,143
Rescission/cancellation	1,026
Changes and adjustments of premiums	993
Other (handling of insurance policies)	983

Selected cases

BaFin assesses actuarial calculations.

In 2005, BaFin once again received a number of complaints with regard to surrender values and bonuses in the life insurance sector, which prompted it in several instances to examine the actuarial calculations made by these insurers. BaFin thus once again ascertained that, in a number of policy alterations, calculation procedures had been used that severely disadvantage policyholders. In one case, the insurer in question had reduced the premium at the request of the complainant a few years before the policy expired. The alteration procedure applied in the case had such a negative effect on the calculation of the final bonus that the maturity value paid out to the policyholder was lower than it would have been had the policy been converted to paid-up status at the point when the alteration was made. The insurance company had to make additional payments of several thousands of euros and agreed to correct all of the policies affected by this problem at maturity.

No rights to higher bonus.

Numerous enquiries and complaints with respect to life insurance also related to the ruling passed by the German Federal Constitutional Court (Bundesverfassungsgericht - BVerfG) on 26 July 2005.[87] Many policyholders are now demanding a higher bonus/final bonus for their life insurance policies. BaFin cannot help in such cases. The ruling obliges the legislature to create rules that meet the constitutional requirements by 31 December 2007, and to examine whether or not existing policies can be covered by the new rules.

Consumers complain about information policies of insurance companies.

Life insurance consumers repeatedly complain that companies have failed to provide them with sufficient information on the status of their bonuses. For policies taken out after the 1994 deregulation, insurers must provide their policyholders annually with information on the status of their bonuses. This statutory obligation applies irrespective of whether or not a certain guarantee capital is reached. As a result, BaFin has required one company to issue information on an annual basis even with respect to those policies that remain below certain guarantee capital values.

[87] BVerfG, NJW 2005, 2376 et seq.

Cancellation charges on early termination of retirement savings contracts.

In the year under review, there were several complaints relating to the amount of the cancellation charge on early termination of private retirement savings contracts in accordance with the Act governing the certification of contracts for private old-age provision (Gesetz über die Zertifizierung von Altersvorsorgeverträgen - AltZertG) at one particular life insurance company. The policyholders had terminated the policies in January, with effect from 1 February, and had all received benefits. When the insurance company calculated the surrender value, it deducted an increased cancellation charge, based on the scheduled premium and benefit increase in accordance with the maximum qualified amounts pursuant to section 10a (1) EStG (known as the "Riester Steps"). Policyholders, however, had the option to reject the premium increases at the point when the policy was terminated. BaFin instructed the company that the policy termination was also deemed a rejection of the increase, especially since it would not make economic sense for the policyholder to terminate the policy without rejecting the premium increase because this would result in double the cancellation charge. The companies in question recalculated the charges and paid the customers higher surrender values.

BaFin cannot assist with medical issues and benefit reductions.

In the area of health insurance, the majority of complaints once again related to premium adjustments. Complaints also focused on cases in which insurance companies had refused to provide benefits, stating that the treatment in question was not medically necessary. Since BaFin cannot assess medical matters, it had to refer the complainants to seek legal remedies. The same applied to complaints made with respect to the amount of invalidity benefits in accident insurance. Furthermore, there were numerous complaints with respect to benefit reductions based on the fee-scale regulations in health insurance. Only the competent court, however, can decide whether or not these reductions are justified.

Insurer's liability to pay compensation with respect to motor vehicle insurance.

In the area of property and casualty insurance, several complaints related to cases in which insurance companies had accused clients of violating an obligation, as a result of which the insurance company would not have to make payments. This also applied in the following case:

The vehicle belonging to the policyholder's wife had been stolen. In the claim notice, the motor vehicle insurance company asked the claimant, among other things, to specify kilometreage indicated by the vehicle's odometer on the day it was stolen. Since the policyholder's wife had not paid attention to the number on the indicator, her husband estimated it at around 64,000 km. In this case, the replacement cost for the vehicle would have been €17,650.

The policyholder sent further claim documents to the insurer upon request, including a two month-old invoice for repair work, which showed that the vehicle's odometer had registered 75,736 km at the time of the repair work. This would have resulted in a replacement cost of €17,000.

The insurer claimed that it was released from its liability to pay because of a wilful violation of the information obligation, but

offered to pay €11,000 after involvement of a lawyer, because the fault of the policyholder was deemed to be minor. BaFin informed the insurer that this case was to be considered as ordinary negligence and that, even in the event of gross negligence, it would still be obliged to make payment insofar as the violation of the obligation did not influence either the determination of the insured event or the payment amount. The insurance company then paid out the full amount of €17,000.

4.3 Consumer complaints relating to securities business

Complaint figures

In the year under review, BaFin received 589 written customer complaints about credit and financial services institutions, relating to securities transactions (2004: 681). The number of complaints was thus down on the previous year. Many investors also made a number of telephone enquiries requesting information on securities trading issues.

Selected cases

Investors complain about false advice.

In 2005, many investors once again complained that they had been misinformed, and had not been given sufficient information with respect to risks. The complaints often related to the purchase of units in investment funds that were invested in telecommunications and technology stocks, with the complainants claiming that the investment, which they had intended as a form of retirement savings, did not suit their risk profile. BaFin requested access to the banks' records and asked the advisors in question to comment on the cases. In many cases, the banks' records, some of which had been countersigned by the investor, contradicted the claims made by the complainants. However, neither the investors nor the advisors were able to give detailed information on the content of the sales meetings, some of which had taken place more than five years previous. As a result, BaFin was unable to identify a violation of statutory obligations in the majority of cases.

No need for customer signature on WpHG questionnaire.

A number of complainants asked whether or not customers are required to sign the documents used to gather customer data and provide information to customers as required by the WpHG rules of conduct. The institutions must provide investors with all pertinent information on the intended transactions. Under supervisory law, they are also obliged to obtain information from customers on their experience with or knowledge of such transactions, and to ask customers to specify their investment objectives and provide information on their financial circumstances. This information is intended to allow the company to provide customers with the needed information and advice suitable to their particular situation. Standardised questionnaires are the most common method used to gather such information, although the institutions are not obliged to use any particular form of documentation. From a supervisory law point of view, these records do not have to be signed by the customer. The institutions may have other rules, and both models are used in practice.

Fees by institutions justified in the case of partial executions.

Several customers complained that they had been charged unjustified fees by the institutions responsible for managing their securities accounts for partial executions in the XETRA electronic trading system. BaFin responded by pointing out that the institutions cannot influence the XETRA execution mechanisms. The institutions are free to structure their fees as they please, and BaFin cannot influence fee structures, which are subject to freedom of contract. From a supervisory law point of view, the institutions are obliged to make their fee structures transparent. This is normally achieved by publishing the appropriate information in a schedule of fees and services, which should be used by investors to compare providers' prices and services.

Duty to safeguard interests also applies to the safekeeping of foreign equities.

Complaints by investors that their foreign equities held in safe custody had been deleted erroneously, or without cause were more prevalent than previously seen. The institutions in question explained that the deletions were based on a corresponding posting by the intermediate custodian, an argument which was endorsed by BaFin. In the case of indirect custody, the domestic institution cannot credit its customer with any more than the intermediate custodian has credited to the domestic institution itself. Nevertheless, BaFin did emphasise that the interests of the customer must be borne in mind, even with respect to the safekeeping of foreign securities. In concrete terms, this means that end custodians must inform their customers of such postings in good time. This is intended to ensure that customers can protect their interests, e.g. the right to physical delivery of securities.

Need for improvement with respect to the transparency of some certificates.

In many cases, investors were unable to understand new perpetual maturity certificates which are not directly linked to the performance of the underlying, but to the performance of the respective futures contract. In such cases, an expected change in the value of the underlying does not necessarily result in a corresponding increase in the value of the certificate. BaFin advises investors to take a detailed look, prior to making a purchase, at the information in the prospectus on the way products function and to seek advice where appropriate. BaFin intervenes if a provider provides false or misleading information as to the way certificates work in advertising material.

"Grey" asset management often problematic.

Complaints relating to "grey" asset management – cases in which no express, verifiable asset management agreements are concluded – were particularly significant. Investors complained that the banks in question had executed loss-making securities transactions without their instructions. BaFin responded by requesting access to the transaction records required by law. Some of the institutions admitted that their records were inadequate, but explained that the customers in question had granted their advisors discretionary power, contrary to the institutions' internal guidelines. The issue as to exactly what was agreed between customer and advisor in such cases can rarely be clarified. As a result, BaFin focussed on whether or not the institutions in question have appropriate procedures in place in order to ensure that records are kept properly and whether or not their internal controls are sufficient.

VIII About BaFin

BaFin staff

1 Personnel and organisation

Personnel

The year under review was characterised by restructuring and further recruitment. The need for personnel was mainly in operational supervision, general sections and the cross-sectoral departments. Gaining staff for the new Prospectus Examination Group (PRO) was of particular importance. PRO was established as of 1 July 2005, and had to be ready to work within a short space of time.

As at 31 December 2005, BaFin had 1,631 employees, of whom, as in the previous year, roughly 62% (1,005) were civil servants. BaFin actively pursues civil servant status for its employees, if legal requirements are met, because as supervisors, they undertake sovereign tasks and have far-reaching powers of intervention.

Ten employees are currently working longer-term for BaFin at EU and international institutions, and with regulatory authorities in other EU countries. BaFin aims to offer this opportunity to more employees, not only civil servants, but also non-civil service employees.

190 new staff recruited.

At the beginning of the year, BaFin had more than 46.5 senior posts to be filled, as well as 35 upper-level posts, four medium-level and 14 lower-level. During the year under review, a total of 190 new employees were recruited (including civil service candidates, trainees and temporary staff).

Table 29
Recruitment in 2005

Level				Qualifications			
	Total	Women	Men	Lawyer	Economist	Mathematican	Other
Senior	57	25	32	29	21	6	1
				Polytechnic degree holders	IT	Actuary	Other
Upper	74	30	44	56	5	1	12
Middle	37	27	10				
Trainee	22	12	10				

More than 5,000 applicants.

BaFin filled vacancies in the year under review predominantly by recruiting economists with university or polytechnic degrees, mathematicians and lawyers. In total around 5,400 applications were received, 590 interviews conducted and 48 assessment centre sessions carried out with an average of six applicants at each.

BaFin gained highly qualified specialists.

BaFin was able to fill various positions with qualified external specialists this year as well, for example in the areas of risk modelling, enforcement, organisational development and prospectus examination. In order to attract specialists to integrated financial supervision, BaFin also made use of the option to pay non-scale salaries.

Table 30
Number of employees as at 31 December 2005

Level	Employees			Civil servants	Non-Civil servants
	Total	Women	Men	Total	Total
Senior	599	222	377	528	71
Upper	573	265	308	412	161
Middle/ Lower	459	298	161	65	394

Career training at BaFin.

As in previous years, BaFin provided training for young people: 22 senior-grade government inspector candidates, five prospective administrative clerks for the middle grade, as well as three IT specialists, 25 office communication specialists and one media and information services specialist.

BaFin employees attended 650 professional development workshops.

BaFin places great importance on good training and professional development for its staff. In 2005, 1,059 employees attended roughly 650 professional development workshops. The IRB/SRP auditor qualification programme was also extremely popular again this year.

Organisation

Pfandbrief competence centres in banking supervision.

In 2005, BaFin bundled supervision of public law and cooperative banks each into one department. The main reason for this was that the institutional groups in the two sectors are becoming increasingly important with regard to the risk situation of the member institutions. This supervision under one roof is intended to facilitate early detection of possible deficiencies and irregularities at individual banks as well as in the sector as a whole. BaFin also combined the general sections with banking supervision in 2005 in order to promote the exchange of knowledge between specialists and general personnel. BaFin responded to the new Pfandbrief legislation by establishing two new competence centres: The Pfandbrief I competence centre was established in 2005 for ongoing supervision and fundamental issues. At the beginning of 2006, the Pfandbrief II competence centre, which deals with audits of cover assets, was opened.

Reinsurers under insurance supervision.

The VAG amendment of 2004 introduced direct and comprehensive supervision for reinsurance undertakings in Germany for the first time. For this reason BaFin set up a new organisational unit to be responsible for basic matters on a national scale as well as mathematical issues relating to reinsurance.

Prospectuses and enforcement in securities supervision.

BaFin has been responsible for tasks set forth in the Accounting Enforcement Act (Bilanzkontrollgesetz) since July 2005. These tasks are performed by the newly established Enforcement Section. The legislature also introduced a prospectus requirement for non-securities investments in July. BaFin has also been responsible for listing prospectuses since that time, which was the reason behind formation of the Prospectus Examination Group (PRO), consisting of three sections, in July 2005.

New cross-sectoral International Department.

A fourth cross-sectoral department was established in 2005: Cross-sectoral International (INT) Department. The INT Department is responsible for bilateral and multilateral tasks and technical cooperation – i.e. a concentration of international activities in one department. With bundled resources, the department is in a better position to participate in developments at an international level, such as legislation in Brussels, than separate specialists would be.

Executive Office.

BaFin has optimised its organisational structure and workflows, including the establishment of the Executive Office – Coordination and Controlling (L). This comprises the following units: President's Office, Internal Audit, Organisational Systems and Development, Project Management and Strategic Controlling.

The organisational overview can be found in Appendix 1.

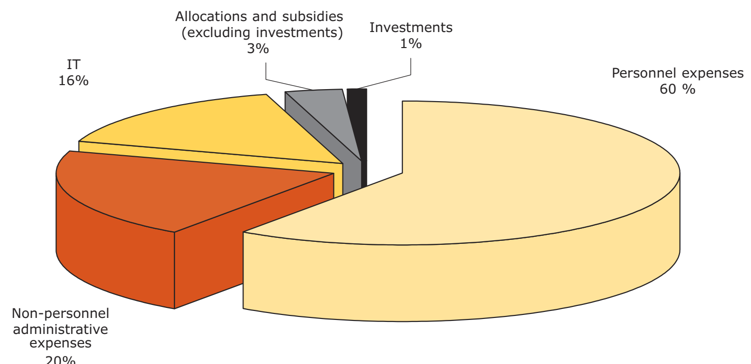
2 Budget

BaFin's annual budget is passed by its Administrative Council and approved by the Federal Ministry of Finance.

BaFin's budget plan for 2005 (including a supplementary budget) provides for expenditures and revenues of around €126.5 million (2004: €132.5 million). Personnel costs at €75.6 million (2004: €79.9 million) represented the largest block of expenses, followed by non-personnel costs at €25.7 million (2004: €27.2 million).

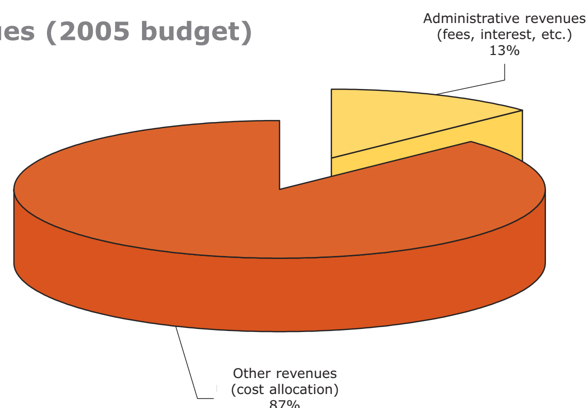
A special section of the budget plan contains the revenues and expenditures in connection with the Accounting Enforcement Act. The enforcement budget covered around €4 million in revenues and expenditures for 2005, of which roughly €3 million was allocated to the German Financial Reporting Enforcement Panel (FREP).

Figure 31
Expenditures (2005 budget)



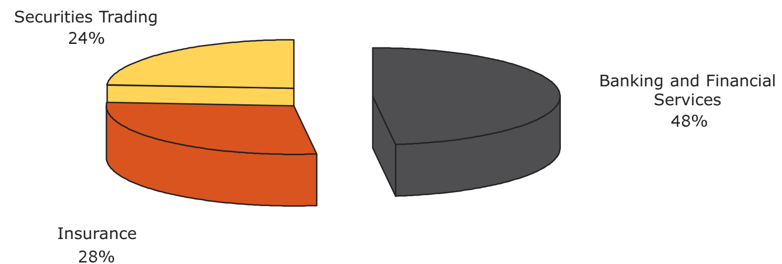
BaFin fully covers its expenditures with its own revenues and does not receive any funding from the federal budget. It is financed by cost allocation payments (2005 estimate: €110.3 million, 2004: €120.7 million), and fees including separate reimbursements (2005 estimate: €14.7 million, 2004: €10.4 million) from the companies subject to supervision.

Figure 32
Revenues (2005 budget)



Cost allocation is the most important source of financing. Following settlement for budget year 2004, the three supervisory areas contributed the following percentages to cost coverage.

Figure 33
Cost contributions by supervisory area 2004



BaFin also based the calculation of prepayments for budget year 2006 on this proportional distribution. The final distribution of costs for 2005 is subject to the final settlement of cost allocation payments, which will take place in 2006.

All areas of BaFin have been using cost accounting since 2004. The expenses incurred by BaFin are directly attributed to their source using a systematic allocation system.

According to the annual financial statements, which have yet to be approved by the Administrative Council, BaFin's expenditures in 2005 totalled around €109.7 million (2004: €100.4 million), matched against revenues of approximately €130.2 million (2004: €133.4 million). The separate cost allocation for enforcement resulted in revenues of around €9.8 million in budget year 2005 (prepayments for 2005 and 2006).

3 Public Relations

Dr. Sabine Reimer,
Head of Press and
Public Relations

2005 saw many issues relating to supervisory activities in the public forum and the press. Several thousand enquiries were submitted by journalists, private individuals and companies. The bulk of the interest was in open-ended real estate funds and the new prospectus requirement for non-securities investments. There were also a large number of enquiries relating to "acting in concert" with respect to corporate takeovers. There were requests for information about financial reinsurance (Financial Re), about the decision by the German Federal Court of Justice on life insurance and about the introduction of new mortality tables in retirement insurance. Basel II was the focus of enquiries in banking supervision, as were the Minimum requirements for risk management and the account access procedure.

2nd Forum for white-collar crime and the capital market.

In September 2005, BaFin held its second Forum for White-Collar Crime and the Capital Market in Frankfurt. More than 300 police officers, public prosecutors and judges took part in the two-day event, where discussions were held with BaFin experts about insider legislation, market manipulation, prospectus examinations, enforcement and the prevention of money laundering and illegal financial transactions.

IOSCO Technical Committee Press Conference.

In October 2005, BaFin invited the press to a conference held in Frankfurt on the occasion of the second IOSCO Technical Committee Conference: "Global rules – Local supervision: How can IOSCO fill the gap?". Numerous media representatives showed particular interest in hedge fund supervision and the role played by IOSCO.

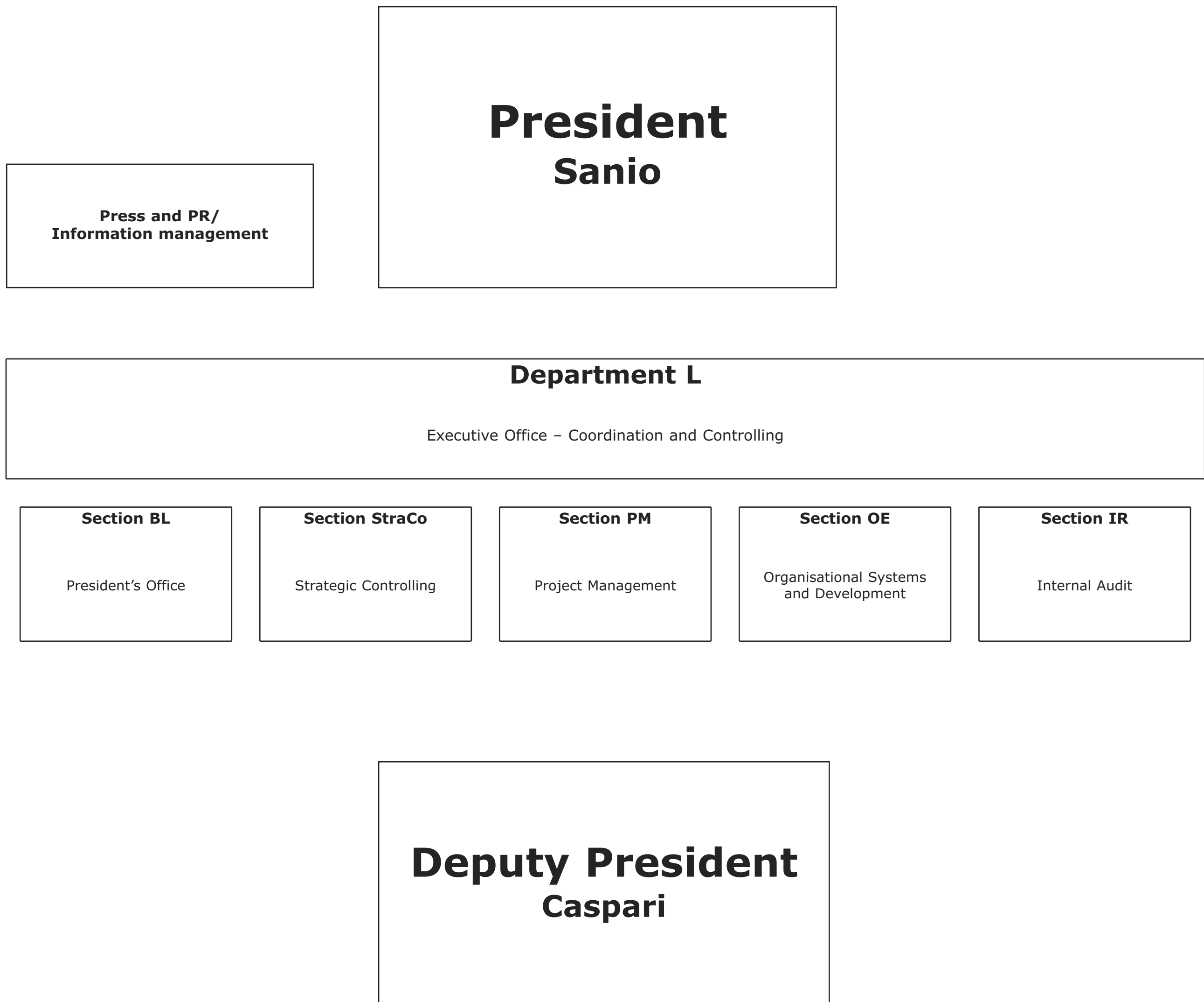
INVEST Stuttgart and stock exchange open house events.

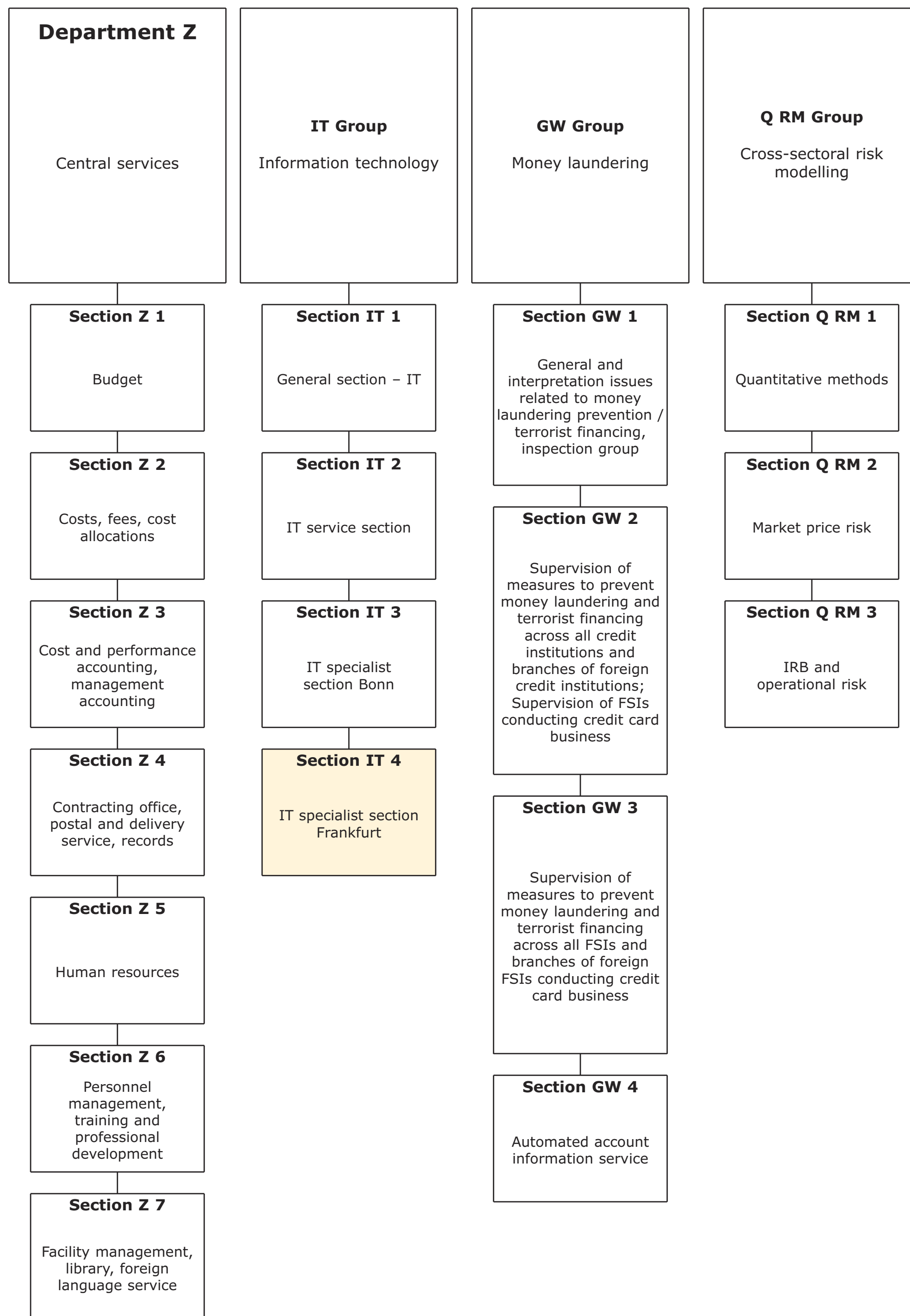
BaFin was represented at the investment fair INVEST in Stuttgart again in 2005, as well as at several stock exchange open house events. Many visitors gathered information on the work of integrated financial supervision in Germany. Other exhibitors – such as financial service providers, special interest groups, and banks – also asked questions and used the opportunity to exchange ideas.

BaFin provides information at trade fairs.

Appendix

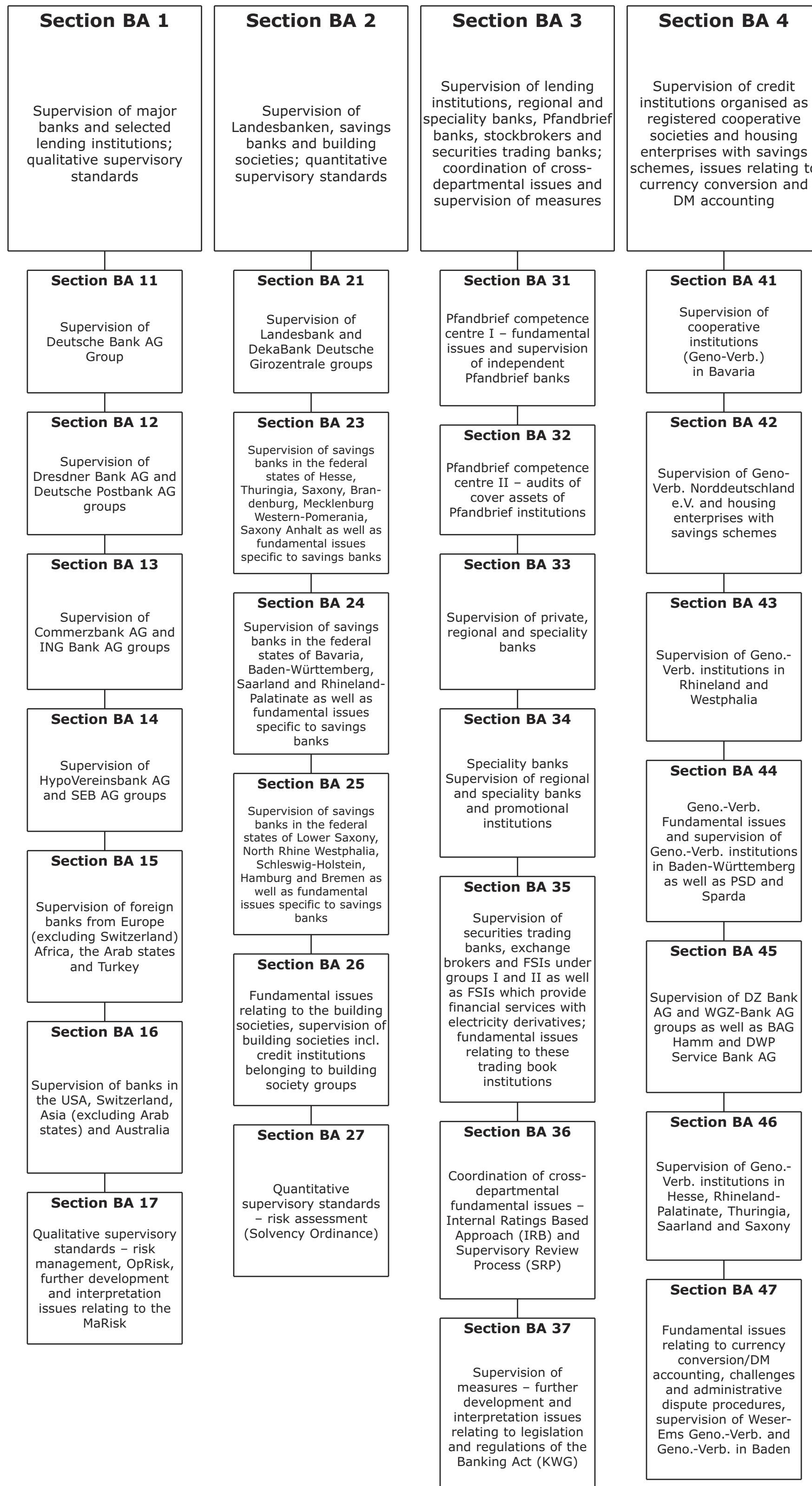
Organisational overview

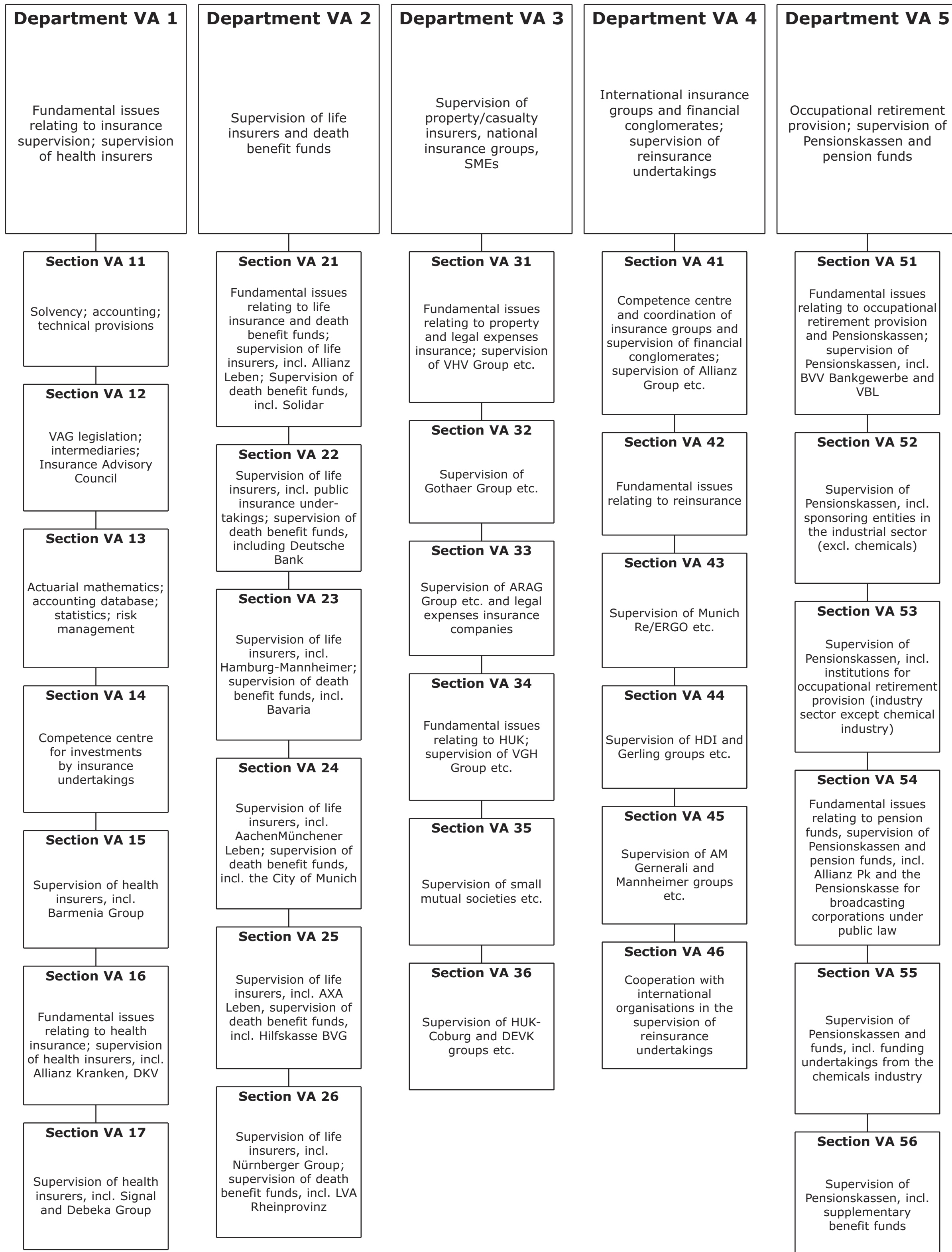


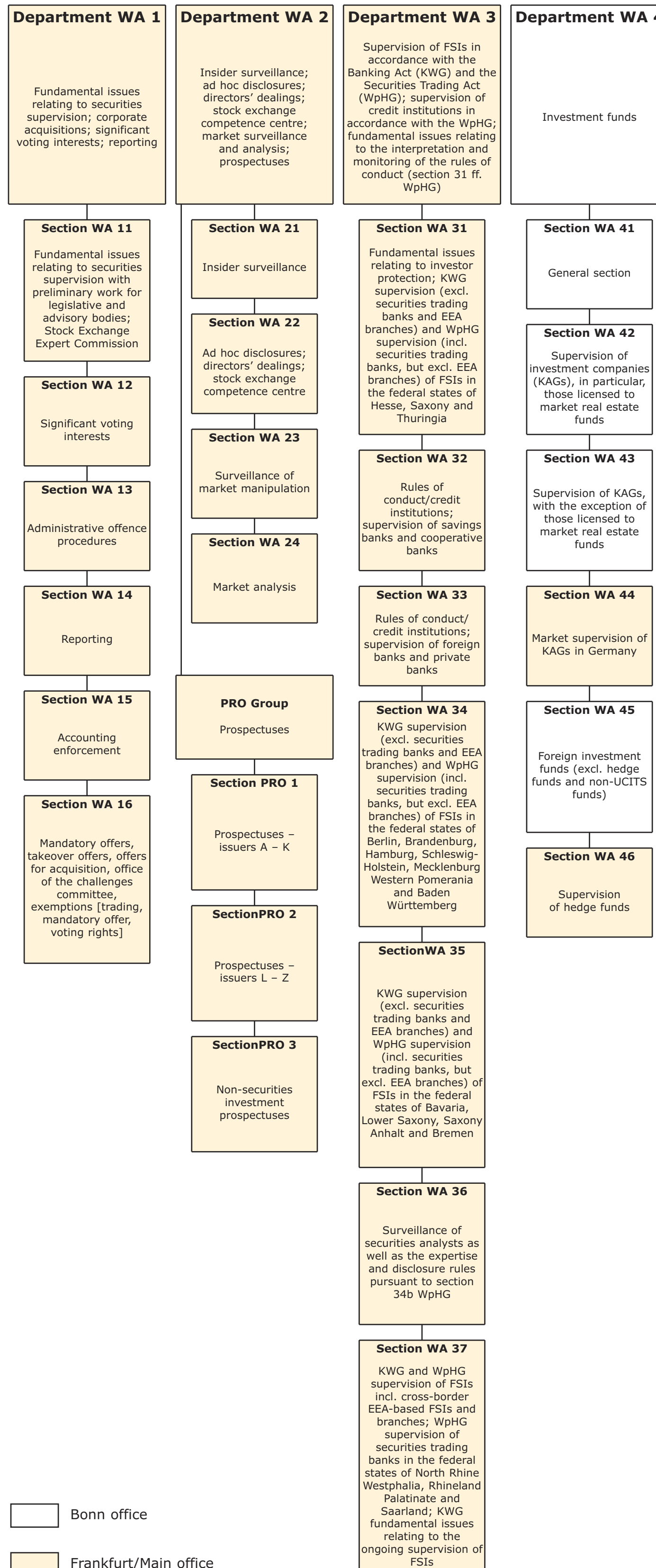


Bonn office

Frankfurt/Main office


Banking Supervision
Chief Executive Director H. Bauer
Section BA 1
Supervision of major banks and selected lending institutions; qualitative supervisory standards
Section BA 2
Supervision of Landesbanken, savings banks and building societies; quantitative supervisory standards
Section BA 3
Supervision of lending institutions, regional and speciality banks, Pfandbrief banks, stockbrokers and securities trading banks; coordination of cross-departmental issues and supervision of measures
Section BA 4
Supervision of credit institutions organised as registered cooperative societies and housing enterprises with savings schemes, issues relating to currency conversion and DM accounting
Section BA 11
Supervision of Deutsche Bank AG Group
Section BA 12
Supervision of Dresdner Bank AG and Deutsche Postbank AG groups
Section BA 13
Supervision of Commerzbank AG and ING Bank AG groups
Section BA 14
Supervision of HypoVereinsbank AG and SEB AG groups
Section BA 15
Supervision of foreign banks from Europe (excluding Switzerland) Africa, the Arab states and Turkey
Section BA 16
Supervision of banks in the USA, Switzerland, Asia (excluding Arab states) and Australia
Section BA 17
Qualitative supervisory standards – risk management, OpRisk, further development and interpretation issues relating to the MaRisk
Section BA 21
Supervision of Landesbank and DekaBank Deutsche Girozentrale groups
Section BA 23
Supervision of savings banks in the federal states of Hesse, Thuringia, Saxony, Brandenburg, Mecklenburg Western-Pomerania, Saxony Anhalt as well as fundamental issues specific to savings banks
Section BA 24
Supervision of savings banks in the federal states of Bavaria, Baden-Württemberg, Saarland and Rhineland-Palatinate as well as fundamental issues specific to savings banks
Section BA 25
Supervision of savings banks in the federal states of Lower Saxony, North Rhine Westphalia, Schleswig-Holstein, Hamburg and Bremen as well as fundamental issues specific to savings banks
Section BA 26
Fundamental issues relating to the building societies, supervision of building societies incl. credit institutions belonging to building society groups
Section BA 27
Quantitative supervisory standards – risk assessment (Solvency Ordinance)
Section BA 31
Pfandbrief competence centre I – fundamental issues and supervision of independent Pfandbrief banks
Section BA 32
Pfandbrief competence centre II – audits of cover assets of Pfandbrief institutions
Section BA 33
Supervision of private, regional and speciality banks
Section BA 34
Speciality banks Supervision of regional and speciality banks and promotional institutions
Section BA 35
Supervision of securities trading banks, exchange brokers and FSIs under groups I and II as well as FSIs which provide financial services with electricity derivatives; fundamental issues relating to these trading book institutions
Section BA 36
Coordination of cross-departmental fundamental issues – Internal Ratings Based Approach (IRB) and Supervisory Review Process (SRP)
Section BA 37
Supervision of measures – further development and interpretation issues relating to legislation and regulations of the Banking Act (KWG)
Section BA 41
Supervision of cooperative institutions (Geno-Verb.) in Bavaria
Section BA 42
Supervision of Geno-Verb. Norddeutschland e.V. and housing enterprises with savings schemes
Section BA 43
Supervision of Geno.-Verb. institutions in Rhineland and Westphalia
Section BA 44
Geno.-Verb. Fundamental issues and supervision of Geno.-Verb. institutions in Baden-Württemberg as well as PSD and Sparda
Section BA 45
Supervision of DZ Bank AG and WGZ-Bank AG groups as well as BAG Hamm and DWP Service Bank AG
Section BA 46
Supervision of Geno.-Verb. institutions in Hesse, Rhineland-Palatinate, Thuringia, Saarland and Saxony
Section BA 47
Fundamental issues relating to currency conversion/DM accounting, challenges and administrative dispute procedures, supervision of Weser-Ems Geno.-Verb. and Geno.-Verb. in Baden


Scientific coordination of insurance supervision
SRP representative
Insurance supervision
Chief Executive Director Dr. Steffen
Department VA 1
Fundamental issues relating to insurance supervision; supervision of health insurers
Department VA 2
Supervision of life insurers and death benefit funds
Department VA 3
Supervision of property/casualty insurers, national insurance groups, SMEs
Department VA 4
International insurance groups and financial conglomerates; supervision of reinsurance undertakings
Department VA 5
Occupational retirement provision; supervision of Pensionskassen and pension funds
Section VA 11
Solvency; accounting; technical provisions
Section VA 12
VAG legislation; intermediaries; Insurance Advisory Council
Section VA 13
Actuarial mathematics; accounting database; statistics; risk management
Section VA 14
Competence centre for investments by insurance undertakings
Section VA 15
Supervision of health insurers, incl. Barmenia Group
Section VA 16
Fundamental issues relating to health insurance; supervision of health insurers, incl. Allianz Kranken, DKV
Section VA 17
Supervision of health insurers, incl. Signal and Debeka Group
Section VA 21
Fundamental issues relating to life insurance and death benefit funds; supervision of life insurers, incl. Allianz Leben; Supervision of death benefit funds, incl. Solidar
Section VA 22
Supervision of life insurers, incl. public insurance under-takings; supervision of death benefit funds, including Deutsche Bank
Section VA 23
Supervision of life insurers, incl. Hamburg-Mannheimer; supervision of death benefit funds, incl. Bavaria
Section VA 24
Supervision of life insurers, incl. AachenMünchener Leben; supervision of death benefit funds, incl. the City of Munich
Section VA 25
Supervision of life insurers, incl. AXA Leben, supervision of death benefit funds, incl. Hilfskasse BVG
Section VA 26
Supervision of life insurers, incl. Nürnberger Group; supervision of death benefit funds, incl. LVA Rheinprovinz
Section VA 31
Fundamental issues relating to property and legal expenses insurance; supervision of VHV Group etc.
Section VA 32
Supervision of Gothaer Group etc.
Section VA 33
Supervision of ARAG Group etc. and legal expenses insurance companies
Section VA 34
Fundamental issues relating to HUK; supervision of VGH Group etc.
Section VA 35
Supervision of small mutual societies etc.
Section VA 36
Supervision of HUK-Coburg and DEVK groups etc.
Section VA 41
Competence centre and coordination of insurance groups and supervision of financial conglomerates; supervision of Allianz Group etc.
Section VA 42
Fundamental issues relating to reinsurance
Section VA 43
Supervision of Munich Re/ERGO etc.
Section VA 44
Supervision of HDI and Gerling groups etc.
Section VA 45
Supervision of AM Gernerali and Mannheimer groups etc.
Section VA 46
Cooperation with international organisations in the supervision of reinsurance undertakings
Section VA 51
Fundamental issues relating to occupational retirement provision and Pensionskassen; supervision of Pensionskassen, incl. BVV Bankgewerbe and VBL
Section VA 52
Supervision of Pensionskassen, incl. sponsoring entities in the industrial sector (excl. chemicals)
Section VA 53
Supervision of Pensionskassen, incl. institutions for occupational retirement provision (industry sector except chemical industry)
Section VA 54
Fundamental issues relating to pension funds, supervision of Pensionskassen and pension funds, incl. Allianz Pk and the Pensionskasse for broadcasting corporations under public law
Section VA 55
Supervision of Pensionskassen and funds, incl. funding undertakings from the chemicals industry
Section VA 56
Supervision of Pensionskassen, incl. supplementary benefit funds


Securities supervision/
asset management
Chief Executive Director Dreyling
Department WA 1
Fundamental issues relating to securities supervision; corporate acquisitions; significant voting interests; reporting
Department WA 2
Insider surveillance; ad hoc disclosures; directors' dealings; stock exchange competence centre; market surveillance and analysis; prospectuses
Department WA 3
Supervision of FSIs in accordance with the Banking Act (KWG) and the Securities Trading Act (WpHG); supervision of credit institutions in accordance with the WpHG; fundamental issues relating to the interpretation and monitoring of the rules of conduct (section 31 ff. WpHG)
Department WA 4
Investment funds
Section WA 11
Fundamental issues relating to securities supervision with preliminary work for legislative and advisory bodies; Stock Exchange Expert Commission
Section WA 12
Significant voting interests
Section WA 13
Administrative offence procedures
Section WA 14
Reporting
Section WA 15
Accounting enforcement
Section WA 16
Mandatory offers, takeover offers, offers for acquisition, office of the challenges committee, exemptions [trading, mandatory offer, voting rights]
Section WA 21
Insider surveillance
Section WA 22
Ad hoc disclosures; directors' dealings; stock exchange competence centre
Section WA 23
Surveillance of market manipulation
Section WA 24
Market analysis
PRO Group
Prospectuses
Section PRO 1
Prospectuses – issuers A – K
SectionPRO 2
Prospectuses – issuers L – Z
SectionPRO 3
Non-securities investment prospectuses
Section WA 31
Fundamental issues relating to investor protection; KWG supervision (excl. securities trading banks and EEA branches) and WpHG supervision (incl. securities trading banks, but excl. EEA branches) of FSIs in the federal states of Hesse, Saxony and Thuringia
Section WA 32
Rules of conduct/credit institutions; supervision of savings banks and cooperative banks
Section WA 33
Rules of conduct/ credit institutions; supervision of foreign banks and private banks
Section WA 34
KWG supervision (excl. securities trading banks and EEA branches) and WpHG supervision (incl. securities trading banks, but excl. EEA branches) of FSIs in the federal states of Berlin, Brandenburg, Hamburg, Schleswig-Holstein, Mecklenburg Western Pomerania and Baden Württemberg
SectionWA 35
KWG supervision (excl. securities trading banks and EEA branches) and WpHG supervision (incl. securities trading banks, but excl. EEA branches) of FSIs in the federal states of Bavaria, Lower Saxony, Saxony Anhalt and Bremen
Section WA 36
Surveillance of securities analysts as well as the expertise and disclosure rules pursuant to section 34b WpHG
Section WA 37
KWG and WpHG supervision of FSIs incl. cross-border EEA-based FSIs and branches; WpHG supervision of securities trading banks in the federal states of North Rhine Westphalia, Rhineland Palatinate and Saarland; KWG fundamental issues relating to the ongoing supervision of FSIs
Section WA 41
General section
Section WA 42
Supervision of investment companies (KAGs), in particular, those licensed to market real estate funds
Section WA 43
Supervision of KAGs, with the exception of those licensed to market real estate funds
Section WA 44
Market supervision of KAGs in Germany
Section WA 45
Foreign investment funds (excl. hedge funds and non-UCITS funds)
Section WA 46
Supervision of hedge funds
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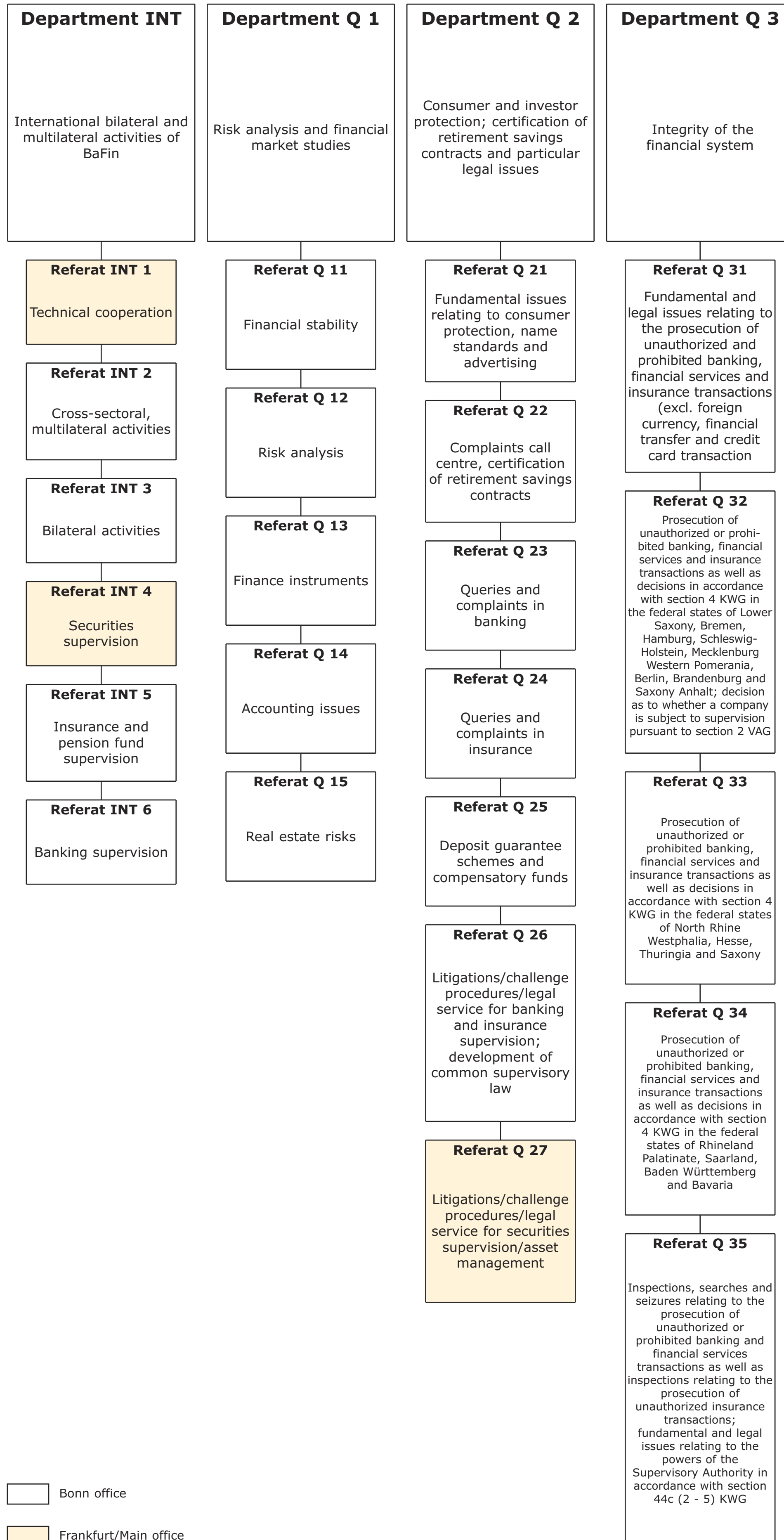
Frankfurt/Main office


Department INT
International bilateral and multilateral activities of BaFin
Referat INT 1
Technical cooperation
Referat INT 2
Cross-sectoral, multilateral activities
Referat INT 3
Bilateral activities
Referat INT 4
Securities supervision
Referat INT 5
Insurance and pension fund supervision
Referat INT 6
Banking supervision
Department Q 1
Risk analysis and financial market studies
Referat Q 11
Financial stability
Referat Q 12
Risk analysis
Referat Q 13
Finance instruments
Referat Q 14
Accounting issues
Referat Q 15
Real estate risks
Department Q 2
Consumer and investor protection; certification of retirement savings contracts and particular legal issues
Referat Q 21
Fundamental issues relating to consumer protection, name standards and advertising
Referat Q 22
Complaints call centre, certification of retirement savings contracts
Referat Q 23
Queries and complaints in banking
Referat Q 24
Queries and complaints in insurance
Referat Q 25
Deposit guarantee schemes and compensatory funds
Referat Q 26
Litigations/challenge procedures/legal service for banking and insurance supervision; development of common supervisory law
Referat Q 27
Litigations/challenge procedures/legal service for securities supervision/asset management
Department Q 3
Integrity of the financial system
Referat Q 31
Fundamental and legal issues relating to the prosecution of unauthorized and prohibited banking, financial services and insurance transactions (excl. foreign currency, financial transfer and credit card transaction
Referat Q 32
Prosecution of unauthorized or prohibited banking, financial services and insurance transactions as well as decisions in accordance with section 4 KWG in the federal states of Lower Saxony, Bremen, Hamburg, Schleswig-Holstein, Mecklenburg Western Pomerania, Berlin, Brandenburg and Saxony Anhalt; decision as to whether a company is subject to supervision pursuant to section 2 VAG
Referat Q 33
Prosecution of unauthorized or prohibited banking, financial services and insurance transactions as well as decisions in accordance with section 4 KWG in the federal states of North Rhine Westphalia, Hesse, Thuringia and Saxony
Referat Q 34
Prosecution of unauthorized or prohibited banking, financial services and insurance transactions as well as decisions in accordance with section 4 KWG in the federal states of Rhineland Palatinate, Saarland, Baden Württemberg and Bavaria
Referat Q 35
Inspections, searches and seizures relating to the prosecution of unauthorized or prohibited banking and financial services transactions as well as inspections relating to the prosecution of unauthorized insurance transactions; fundamental and legal issues relating to the powers of the Supervisory Authority in accordance with section 44c (2 - 5) KWG
Bonn office
Frankfurt/Main office

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Asmussen, Jörg (BMF – Deputy Chairman)
Dr. Stein, Klaus-Dieter (BMF)
Conert, Jens (BMF)
Dr. Hardieck, Thomas (BMWi)
Schaefer, Erich (BMJ)

Representatives of the German Bundestag (Lower House of Parliament)
Kalb, Bartholomäus (MdB)
Bernhardt, Otto (MdB)
Spiller, Jörg-Otto (MdB)
Hauer, Nina (MdB)
Thiele, Carl-Ludwig (MdB)

Representatives of credit institutions
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Müller, Klaus-Peter
Dr. Hoppenstedt, Dietrich H.
Rasche, Henning
Dr. Fischer, Thomas R.

Representatives of insurance undertakings
Dr. Förterer, Jürgen
Dr. von Fürstenwerth, Jörg
Dr. Meyer, Lothar
Dr. Perlet, Helmut

Representative of investment companies
Dr. Rieß, Markus

As at: April 2006

2.2 Members of the Advisory Board

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Dr. Schackmann-Fallis, Karl-Peter
Lehnhoff, Jochen
Tolckmitt, Jens
Boos, Karl-Heinz
Zehnder, Andreas J.

Representatives of insurance undertakings
Dr. Schareck, Bernhard
Dr. Rupprecht, Gerhard
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

Representatives of academic groups
Prof. Dr. Dr. h.c. Baums, Theodor
Prof. Dr. Wagner, Fred
Prof. Dr. Dr. Achleitner, Ann-Kristin (Deputy Chairperson of the BaFin Advisory Board)

Representatives of the Task Force for Occupational Retirement Provision – aba –
Schwind, Joachim

Representatives of consumer protection organisations
tba
Prof. Römer, Wolfgang (Ombudsman for insurance undertakings)
Dr. Balzer, Christian (Arbitrator for the Customer Complaints department of RSGV)

Representative of legal and business professionals
Pohle, Alexander (AfW)

Representative of associations for SMEs
Loistl, Ulrike (DVFA)

Representative of trade unions
Foullong, Uwe (ver.di)

Representative of industry
Härter, Holger P. (Porsche AG)

As at: April 2006

2.3 Members of the Insurance Advisory Council

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Dr. Martin Balleer	Former Executive Board Member of the Deutsche Aktuarvereinigung (DAV) e.V.
Prof. Dr. Dr. h.c. Jürgen Basedow	Max Planck Institute for Comparative and International Private Law, Hamburg
Beate-Kathrin Bextermöller	Stiftung Warentest Financial Services Department
Prof. Dr. Harald Brachmann	Fachhochschule Köln Institute for Insurance Studies
Dr. Leberecht Funk	President of the Verband Deutscher Versicherungsmakler e.V. (VDVM) Funk Gruppe GmbH
Prof. Dr. Gerd Geib	Executive Board Member of KPMG Deutsche Treuhand-Gesellschaft AG
Andrea Hoffmann	Head of Financial Services Department Verbraucherzentrale Sachsen e.V.
Prof. Dr. Gottfried Koch	Universität Leipzig Institute for Insurance Studies
Dr. Lothar Meyer	Executive Board Chairman of Ergo Versicherungsgruppe AG
Dieter Philipp	President of the Aachen Chamber of Trades (Handwerkskammer)
Dr. Gerhard Rupprecht	Executive Board Chairman of Allianz Deutschland AG
Dr. Bernhard Schareck	Executive Board Member of Wüstenrot & Württembergische AG and Executive Board Chairman of Karlsruher HK AG, 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 the Supervisory Board of Münchener Rückversicherungs-Gesellschaft Aktiengesellschaft in Munich
Wolfgang Scholl	Verbraucherzentrale Bundesverband – Financial Services Section
Prof. Dr. Wolfgang Schünemann	Universität Dortmund Chair for Private Law
Reinhold Schulte	Executive Board Chairman of Signal Iduna Group Chairman of the Verband der privaten Krankenversicherung e. V.
Joachim Schwind	Attorney at Law Division Head of Hoechst AG CEO of Pensionskasse der Mitarbeiter der Hoechst-Gruppe VVaG and Höchster Pensionskasse VVaG
Prof. Dr. Hans-Peter Schwintowski	Humboldt-Universität Berlin Faculty of Law, Chairman of the academic advisory committee of the Bund der Versicherten e. V.
Richard Sommer	ver.di-Bundesverwaltung Vereinte Dienstleistungs-gewerkschaft Financial Services
Ludger Theilmeier	Former president of the Bundesverband Deutscher Versicherungskaufleute e.V.
Elke Weidenbach	Specialist consultant for insurance, Verbraucher-Zentrale NRW e.V. Financial Services Group

tba

As at: April 2006

Statistic of complaints in connection with individual undertakings

3.1 About this statistic
3.2 Life insurance
3.3 Health insurance
3.4 Motor insurance
3.5 General liability insurance
3.6 Accident insurance
3.7 Household insurance
3.8 Residential buildings insurance
3.9 Legal expenses insurance
3.10 Insurers based in the EEA

3.1 About this statistic

BaFin has been publishing complaint statistics by insurance company and class for a number of years now. Its predecessor, the Federal Insurance Supervisory Office (Bundesaufsichtsamt für das Versicherungswesen – BAV) had been ordered to include this information following a ruling passed by the Berlin Higher Administrative Court on 25 July 1995 (Case no.: OVG 8 B 16/94).

In order to provide an indicator as to the quality and volume of insurance business, the number of complaints fully processed by BaFin in the course of 2005 is compared to the total number of contracts within the respective insurance class (existing business) as at 31 December 2004. Figures regarding existing business are provided by the individual insurance companies. The information on existing business puts those insurers that recorded strong growth in the reporting period (often newly established companies) at a disadvantage, because the new business generated in the course of the year, which gives rise to the complaints, is not accounted for in the complaint statistics. As a result, this statistic is of limited informational value when it comes to assessing the quality of individual undertakings.

As far as collective insurance within the category of life insurance is concerned, the existing business figure specified relates to the number of insurance contracts. Within the area of health insurance, existing business is based on the number of natural persons with health insurance policies, rather than the number of insureds under each policy, which is usually higher. This figure is still not completely reliable. The existing business figures reported within the property and casualty sector relate to insured risks. If undertakings have concluded group policies with several insureds, this increases the existing business figure.

Owing to limited disclosure requirements (section 51 (4) no. 1 sentence 4 of the Ordinance on insurance accounting (Verordnung über die Rechnungslegung von Versicherungsunternehmen – RechVersV)), the existing business figures can only be included for insurers whose gross premiums earned in 2004 exceeded €10 million in the respective insurance classes or types. In the case of companies that did not meet this threshold in individual insurance classes, no information on existing business is given in the table (n.a.).

The statistics do not include insurance undertakings that operate within one of the classes listed but were not the subject of complaints in 2005.

In view of the fact that companies from within the European Economic Area are not required to submit reports to BaFin, no data is stated for the existing business of EEA insurers. The number of complaints, however, has been included in order to present a more complete overview.

3.2 Life insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies as at 31/12/2004	Complaints
1001	AachenMünchener Leb.	5,137,796	225
1199	ABC Leben	32,678	1
1120	Adler Lebensvers.	n.a.	1
1006	Allianz Leben	10,495,273	357
1007	Alte Leipziger Leben	945,954	78
1035	ARAG Leben	417,306	28
1181	Aspecta Leben	677,095	92
1303	Asstel Leben	389,712	49
1020	Axa Leben	2,176,688	222
1011	Barmenia Leben	247,353	22
1012	Basler Leben	110,132	11
1013	Bayer. Beamten Leben	451,044	29
1015	Bayern-Vers.	1,654,984	78
1017	Berlinische Leben	987,323	57
1145	BHW Leben	1,095,375	31
1192	Brunsviga Lebensv.	47,013	1
1132	CIV Leben	1,938,403	45
1122	Concordia Leben	142,822	1
1021	Condor Leben	218,818	14
1078	Continentale Leben	627,217	40
1022	Cosmos Leben	1,099,701	44
1146	DBV-Winterthur Leben	2,384,688	126
1023	Debeka Leben	3,007,480	70
1136	DEVK Allg. Leben	584,547	18
1025	DEVK Dt. Eisenbahn LV	893,259	14
1113	Dialog Leben	184,719	4
1110	Direkte Leben	102,548	1
1180	Dt. Ärzteversicherung	210,066	14
1138	Dt. Herold Leben	2,832,853	198
1028	Dt. Ring Leben	937,657	62
1107	Europa Leben	393,790	10
1310	Familienfürsorge LV	311,261	8
1175	Familienschutz Leben	200,751	11
1063	Generali LV	1,217,570	91
1033	Gerling-K. Leben	1,930,594	146
1108	Gothaer Leben AG	1,320,908	164
1162	Gutingia Leben	28,552	3
1184	Hamb. Mannheimer LV	6,908,756	323
1312	Hannoversche LV AG	786,030	41
1114	Hansemerkur Leben	185,360	23
1142	HDI Lebensvers.	112,509	8
1158	Heidelberger LV (formerly MLP Leben)	442,620	33
1137	Helvetia Leben	119,185	4
1055	HUK-COBURG Leben	718,123	25
1047	Ideal Leben	445,684	6
1048	Iduna Vereinigte LV	2,440,223	121
1097	Inter Leben	220,085	12
1119	Interrisk Lebensvers.	78,849	6

Reg. no.	Name of insurance undertaking	Number of life insurance policies as at 31/12/2004	Complaints
1128	Itzehoer Leben	53,559	2
1045	Karlsruher HK AG	127,036	4
1050	Karlsruher Leben	1,269,277	88
1130	KarstadtQuelle LV AG	1,195,507	20
1054	Landeslebenshilfe	26,145	3
1062	Lebensvers. von 1871	739,952	19
1112	LVM Leben	711,021	18
1109	Mecklenburg. Leben	158,749	4
1173	Moneymaxx Lebensv.-AG	138,621	17
1064	Münchener Verein Leben	151,867	10
1193	Neckermann Leben	53,732	2
1134	Neue Bayer. Beamten	71,692	5
1164	Neue Leben Lebensvers.	669,329	40
1147	Nürnbg. Leben	2,933,257	251
1056	Oeff. Leben Berlin	129,132	2
1115	Ontos Leben	37,551	3
1194	PB Lebensversicherung	264,985	17
1123	Plus Leben	45,334	4
1309	Protektor LV AG	266,614	89
1081	Prov. Leben Hannover	791,913	25
1083	Prov. Nordwest Leben	478,173	32
1082	Prov. Rheinland Leben	1,311,892	40
1111	Prudentia-Leben	52,031	1
1085	R+V Leben, VAG	243,951	1
1141	R+V Lebensvers. AG	4,400,792	122
1018	Rheinland Leben	407,515	7
1150	Saarland Leben	110,280	1
1090	Schweizerische Leben	1,184,219	99
1034	Securitas Gilde Leben	96,337	7
1157	Skandia Leben	313,985	21
1153	Spark.-Vers.Sachsen Leben	318,996	5
1104	Stuttgarter Leben	489,791	47
1091	SV Sparkassenvers.	1,592,258	86
1092	Universa Leben	252,772	13
1093	Ver. Postvers.	n.a.	6
1140	Victoria Leben	2,792,594	262
1139	Volksfürsorge Dt. LV	4,329,669	253
1099	Volkswohl-Bund Leben	968,477	52
1151	Vorsorge Leben	54,723	12
1160	VPV Leben	1,367,738	52
1305	Westf. Prov.	1,358,641	31
1149	WGV-Schwäbische Leben	45,734	1
1005	Württ. Leben	1,916,822	72
1103	WWK Leben	982,100	81
1196	Zürich LV AG	722,291	77

3.3 Health insurance

Reg. no.	Name of insurance undertaking	Number of insured persons as at 31/12/2004	Complaints
4034	Allianz Priv. KV AG	2,397,791	304
4010	Alte Oldenbg. Kranken	78,815	8
4112	ARAG Kranken	201,696	17
4095	AXA Kranken	493,379	146
4042	Barmenia Kranken	737,863	55
4134	Bayerische Beamten K	752,869	128
4004	Central Kranken	1,481,077	146
4118	Concordia Kranken	66,326	5
4001	Continentale Kranken	1,132,732	76
4101	DBV-Winterthur Krank.	855,235	122
4028	DEBEKA Kranken	3,055,699	121
4131	DEVK Krankenvers.-AG	117,763	1
4044	DKV AG	2,894,100	351
4013	Dt. Ring Kranken	579,858	44
4115	Düsseldorfer Vers.Kr.	6,560	2
4121	Envivas Kranken	9,089	4
4089	Europa Kranken	205,909	11
4128	Globale Kranken	77,344	7
4119	Gothaer KV AG	460,614	41
4043	Hallesche Kranken	518,162	67
4018	Hansemerkur Kranken	420,629	49
4117	HUK-COBURG Kranken	476,690	43
4031	Inter Kranken	382,251	65
4126	KarstadtQuelle KV AG	275,660	13
4011	Landeskrankenhilfe	424,955	39
4109	LVM Kranken	210,599	5
4123	Mannheimer Kranken	83,900	6
4141	Mecklenburgische Kranken	20,377	1
4037	München. Verein KV	219,826	58
4125	Nürnbg. Kranken	141,235	6
4080	Opel Aktiv Plus	99,554	2
4143	Pax-Familienf.KV AG	106,691	6
4116	R+V Kranken	251,073	6
4002	Signal Kranken	1,921,025	148
4039	Süddeutsche Kranken	423,747	18
4108	Union Krankenvers.	783,363	63
4045	Universa Kranken	339,887	42
4105	Victoria Kranken	943,539	62
4111	Volksfürsorge Kranken	n.a.	1
4137	Zürich KV AG	119,870	36

3.4 Motor insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5342	AachenMünchener Vers.	2,028,383	47
5498	ADAC-Schutzbrief Vers	n.a.	4
5312	Allianz Vers.	14,948,789	94
5405	Alte Leipziger Vers.	325,755	3
5455	ARAG Allg. Vers.	n.a.	6
5397	Asstel Sach	n.a.	5
5052	AXA die Alternative	487,341	18
5515	AXA Vers.	3,211,803	66
5593	Bad. Allg. Vers.	n.a.	1
5316	Bad. Gemeinde-Vers.	495,861	1
5317	Barmenia Allg. Vers.	287,878	3
5633	Basler Securitas	559,042	27
5318	Basler Vers.	n.a.	2
5310	Bayer. Beamtenvers.	180,993	5
5325	Bayer. Vers. Bank	2,440,534	23
5324	Bayer. Vers. Verb. AG	1,622,668	18
5098	Bruderhilfe Sach. AG	404,548	3
5547	CG Car-Garantie	n.a.	1
5338	Concordia Vers.	1,451,633	16
5339	Condor Allg. Vers.	92,523	4
5340	Continentale Sachvers	261,057	12
5552	Cosmos Vers.	412,138	32
5802	D.A.S. Allg. RS	n.a.	1
5529	D.A.S. Vers.	490,972	20
5343	DA Deutsche Allg. Ver.	1,341,623	76
5771	DARAG DT. VERS.U.RÜCK	n.a.	2
5311	DBV AG	295,929	3
5037	DBV-Winterthur	911,662	36
5549	Debeka Allgemeine	550,455	11
5513	DEVK Allg. Vers.	2,663,214	53
5344	DEVK Dt. Eisenb. Sach	949,205	8
5055	Direct Line	382,468	39
5347	Dt. Herold Allg. Vers.	900,920	32
5350	Dt. Ring Sachvers.	n.a.	2
5084	Dtsch. Internet	n.a.	4
5508	Europa Sachvers.	344,952	28
5470	Fahrlehrervers.	310,840	2
5024	Feuersozietät	138,653	6
5364	Frankf. Vers.	4,861,263	46
5505	Garanta Vers.	1,165,265	36
5456	Generali Vers. AG	1,380,325	53
5368	Gerling-K. Allgemeine	1,150,287	21
5589	GGG KFZ Reparaturvers	n.a.	1
5531	Gothaer Allg. Vers. AG	1,381,093	37
5585	GVV-Privatversich.	222,552	2
5420	Hamb. Mannheimer Sach	700,695	21
5501	Hansemerkur Allg.	n.a.	4
5096	HDI Industrie Vers.	547,264	1

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5085	HDI Privat	2,871,581	107
5044	HDNA VVAG	n.a.	1
5384	Helvetia Vers.	271,770	7
5086	HUK24 AG	501,547	17
5375	HUK-COBURG	7,199,997	85
5521	HUK-COBURG Allg. Vers	5,148,664	84
5818	HUK-COBURG RS	n.a.	1
5401	Itzehoer Versicherung	669,407	13
5078	Janitos Versicherung	n.a.	8
5570	Karlsruher Beamten	n.a.	6
5509	Karlsruher Vers.	460,737	10
5562	KarstadtQuelle Vers.	n.a.	1
5058	Kravag-Allgemine	820,501	24
5080	Kravag-Logistic	634,342	6
5362	Landesschadenhilfe	n.a.	1
5402	LVM Sach	4,403,651	33
5061	Mannheimer Vers.	169,163	4
5412	Mecklenburg. Vers.	759,453	16
5390	Nova Allg. Vers.	637,263	26
5426	Nürnbg. Allg.	303,347	8
5686	Nürnbg. Beamten Allg.	341,939	6
5791	Ontos Vers.	190,237	20
5519	Optima Vers.	n.a.	1
5787	OVAG - Ostdt. Vers.	n.a.	2
5432	Patria Vers.	152,283	6
5446	Prov. Nord Brandkasse	812,784	3
5095	Prov. Rheinland Vers.	1,263,226	15
5438	R+V Allgemeine Vers.	3,369,464	35
5799	Real Garant Vers.	n.a.	2
5798	Rheinland Vers. AG	225,242	11
5051	S Direkt Versicherung	117,094	2
5773	Saarland Feuervers.	145,161	1
5690	Schwarzmeer u. Ostsee	n.a.	10
5451	Signal Unfall	360,337	3
5781	Spark.-Vers. Sachs. All	139,032	7
5772	Staatl. Vers. Der DDR	n.a.	2
5036	SV Spark. Versicher.	919,592	22
5385	SV Sparkassen	n.a.	1
5458	Transatlant. Allg.Vers	n.a.	1
5463	Universa Allg. Vers.	n.a.	1
5441	Vereinte Spezial Vers	336,552	8
5042	Versicherungsk. Bayern	132,951	1
5400	VGH Land. Brand. Han.	1,777,432	15
5464	VHV	n.a.	6
5862	VHV Allgemeine Vers.	n.a.	1
5598	VHV Autoversicherung	3,484,281	72
5472	Victoria Vers.	1,662,725	30
5473	Volksfürsorge Dt. Sach	1,266,337	36
5093	Westf. Prov. Vers. AG	1,364,591	13
5525	WGV-Schwäbische Allg.	744,995	18
5479	Württ. Gemeinde-Vers.	930,962	9
5480	Württ. U. Badische	n.a.	8

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5783	Württ. Vers.	2,011,755	25
5476	WWK Allgemeine Vers.	n.a.	2
5050	Zürich Vers. AG	1,779,860	55

3.5 General liability insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5342	AachenMünchener Vers.	1,264,230	45
5581	Adler Versicherung AG	n.a.	4
5035	Agila Haustier AG	n.a.	1
5312	Allianz Vers.	5,140,489	97
5405	Alte Leipziger Vers.	240,826	10
5455	ARAG Allg. Vers.	20,840,909	30
5512	Aspecta Versicherung	n.a.	1
5397	Asstel Sach	n.a.	1
5052	AXA Die Alternative	n.a.	2
5515	AXA Vers.	1,729,508	43
5316	Bad. Gemeinde-Vers.	123,430	4
5317	Barmenia Allg. Vers.	n.a.	2
5633	Basler Securitas	296,069	14
5310	Bayer. Beamten Vers.	n.a.	7
5319	Bayer. Hausbesitzer	n.a.	1
5325	Bayer. Vers. Bank	1,113,958	16
5324	Bayer. Vers. Verb. AG	937,218	16
5098	Bruderhilfe Sach. AG	227,979	3
5040	CIC Deutschland	n.a.	31
5831	Concordia RS	n.a.	1
5338	Concordia Vers.	364,734	7
5340	Continentale Sachvers	249,140	10
5552	Cosmos Vers.	n.a.	9
5529	D.A.S. Vers.	231,985	10
5343	DA Deutsche Allg. Ver.	n.a.	2
5771	DARAG Dt. Vers. U. Rück	65,607	4
5311	DBV AG	521,958	8
5037	DBV-Winterthur	983,739	33
5549	Debeka Allgemeine	979,314	14
5513	DEVK Allg. Vers.	946,032	21
5344	DEVK Dt. Eisenb. Sach	626,741	3
5582	Dt. Ärzte-Vers. Allg.	n.a.	2
5347	Dt. Herold Allg.Vers.	362,596	2
5350	Dt. Ring Sachvers.	141,623	11
5508	Europa Sachvers.	n.a.	4
5470	Fahrlehrervers.	n.a.	2
5516	Familienschutz Vers.	n.a.	13
5024	Feuersozietät	122,677	6
5364	Frankf. Vers.	1,330,731	18
5505	Garanta Vers.	n.a.	2
5365	Gegenseitigkeit Vers.	n.a.	2
5456	Generali Vers. AG	942,993	55
5442	Gerling G&A	85,190	3
5368	Gerling-K. Allgemeine	829,691	27
5531	Gothaer Allg. Vers. AG	1,415,960	61
5485	Grundeigentümer-Vers.	n.a.	5
5469	GVV-Kommunalvers.	2,727	5
5585	GVV-Privatversich.	n.a.	2

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5374	Haftpflichtk. Darmst.	564,611	17
5420	Hamb. Mannheimer Sach	631,091	40
5501	Hansemerkur Allg.	n.a.	3
5096	HDI Industrie Vers.	21,341	8
5085	HDI Privat	500,532	15
5044	HDNA VVAG	n.a.	1
5384	Helvetia Vers.	389,234	12
5086	HUK24 AG	n.a.	1
5375	HUK-COBURG	1,761,385	16
5521	HUK-COBURG Allg. Vers	793,367	7
5546	Inter Allg. Vers.	63,206	5
5780	Interrisk Vers.	n.a.	4
5401	Itzehoer Versicherung	175,734	3
5078	Janitos Versicherung (früher MLP)	n.a.	4
5509	Karlsruher Vers.	204,578	6
5080	Kravag-Logistic	n.a.	1
5402	LVM Sach	1,070,848	15
5061	Mannheimer Vers.	118,885	4
5412	Mecklenburg. Vers.	250,940	15
5334	Medienvers. Karlsruhe	n.a.	2
5414	München. Verein Allg.	33,396	1
5390	Nova Allg. Vers.	377,517	13
5426	Nürnbg. Allg.	293,386	21
5686	Nürnbg. Beamten Allg.	n.a.	1
5015	NV-Versicherungen	n.a.	3
5787	OVAG - Ostdt. Vers.	n.a.	1
5432	Patria Vers.	n.a.	5
5446	Prov. Nord Brandkasse	370,435	9
5095	Prov. Rheinland Vers.	837,745	18
5583	PVAG Polizeivers.	n.a.	2
5438	R+V Allgemeine Vers.	1,478,424	29
5798	Rheinland Vers. AG	149,337	6
5773	Saarland Feuervers.	n.a.	1
5690	Schwarzmeer u. Ostsee	n.a.	4
5451	Signal Unfall	244,399	3
5772	Staatl. Vers. Der DDR	n.a.	2
5586	Stuttgarter Vers.	n.a.	1
5036	SV Spark. Versicher.	655,676	14
5459	Uelzener Allg. Vers.	118,410	7
5463	Universa Allg. Vers.	n.a.	1
5042	Versicherungsk. Bayern	17,156	3
5400	VGH Land. Brand. Han.	691,126	8
5464	VHV	776,622	25
5472	Victoria Vers.	1,148,216	59
5473	Volksfürsorge Dt. Sach	996,011	37
5484	Volkswohl-Bund Sach	n.a.	1
5461	VPV Allgemeine Vers.	n.a.	3
5093	Westf. Prov. Vers. AG	795,249	8
5525	WGV-Schwäbische Allg.	266,912	3
5479	Württ. Gemeinde-Vers.	250,968	1
5480	Württ. U. Badische	98,259	5
5783	Württ. Vers.	1,023,249	31

5590	Würzburger Versicher.	n.a.	2
5476	WWK Allgemeine Vers.	n.a.	7
5050	Zürich Vers. AG	575,332	35

3.6 Accident insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5342	AachenMünchener Vers.	1,830,608	59
5826	ADAC-Rechtsschutz	n.a.	1
5581	Adler Versicherung AG	143,363	1
5312	Allianz Vers.	5,925,632	87
5405	Alte Leipziger Vers.	95,907	3
5455	ARAG Allg. Vers.	20,980,452	20
5512	Aspecta Versicherung	171,713	14
5515	AXA Vers.	931,816	21
5316	Bad. Gemeinde-Vers.	46,325	1
5792	Baden-Badener Vers.	275,256	18
5317	Barmenia allg. Vers.	125,018	3
5633	Basler Securitas	137,455	6
5310	Bayer. Beamten Vers.	97,757	4
5325	Bayer. Vers. Bank	1,097,932	9
5324	Bayer. Vers. Verb. AG	579,743	5
5098	Bruderhilfe Sach. AG	44,572	2
5040	CIC Deutschland	n.a.	11
5790	CIV Vers.	205,674	13
5831	Concordia RS	n.a.	1
5338	Concordia Vers.	297,739	3
5340	Continentale Sachvers.	741,095	24
5552	Cosmos Vers.	187,668	6
5529	D.A.S. Vers.	265,129	21
5343	DA Deutsche Allg. Ver.	59,568	1
5311	DBV AG	221,495	4
5037	DBV-Winterthur	329,188	10
5549	Debeka allgemeine	1,590,752	10
5513	DEVK Allg. Vers.	615,360	16
5344	DEVK Dt. Eisenb. Sach	284,187	1
5347	Dt. Herold Allg.Vers.	1,315,052	16
5350	Dt. Ring Sachvers.	427,438	41
5508	Europa Sachvers.	99,867	1
5356	Europäische Reisevers.	395,821	1
5470	Fahrlerervers.	29,641	1
5516	Familienschutz Vers.	302,213	44
5364	Frankf. Vers.	1,200,931	17
5365	Gegenseitigkeit Vers.	6,700	2
5456	Generali Vers. AG	853,720	12
5442	Gerling G&A	127,774	1
5368	Gerling-K. Allgemeine	2,506,866	9
5531	Gothaer Allg. Vers. AG	793,152	23
5374	Haftpflichtk. Darmst.	104,232	2
5420	Hamb. Mannheimer Sach	2,385,795	131
5501	Hansemerkur Allg.	114,917	3
5496	Hansemerkur Reise	n.a.	1
5085	HDI Privat	147,215	4
5384	Helvetia Vers.	141,278	2
5375	HUK-COBURG	1,098,789	2

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5083	HVAG Hamburger Vers.	n.a.	2
5546	Inter Allg. Vers.	75,958	10
5780	Interrisk Vers.	387,420	2
5509	Karlsruher Vers.	148,097	5
5562	KarstadtQuelle Vers.	348,740	7
5402	LVM Sach	826,955	6
5061	Mannheimer Vers.	77,907	5
5412	Mecklenburg. Vers.	151,084	9
5334	Medienvers. Karlsruhe	901	1
5390	Nova Allg. Vers.	744,882	42
5426	Nürnbg. Allg.	545,957	81
5686	Nürnbg. Beamten Allg.	105,861	2
5791	Ontos Vers.	3,809	1
5432	Patria Vers.	9,456	1
5074	PB Versicherung	84,119	5
5446	Prov. Nord Brandkasse	363,264	1
5095	Prov. Rheinland Vers.	1,547,344	6
5583	PVAG Polizeivers.	315,107	1
5438	R+V Allgemeine Vers.	1,425,420	27
5798	Rheinland Vers. AG	105,355	3
5690	Schwarzmeer u. Ostsee	4,905	11
5448	Schweizer Nation. Vers.	13,908	4
5451	Signal Unfall	769,953	29
5781	Spark.-Vers. Sachs. All.	50,060	2
5586	Stuttgarter Vers.	262,502	31
5036	SV Spark. Versicher.	344,671	5
5459	Uelzener Allg. Vers.	34,452	2
5463	Universa Allg. Vers.	103,725	3
5511	Ver. Vers. Ges. Dtschl.	197,710	5
5441	Vereinte Spezial Vers.	8,339	1
5400	VGH Land. Brand. Han.	6,138,681	3
5464	VHV	151,448	7
5598	VHV Autoversicherung	88,126	1
5472	Victoria Vers.	1,009,495	50
5473	Volksfürsorge Dt. Sach	567,520	25
5461	VPV Allgemeine Vers.	136,544	2
5484	Volkswohl-Bund Sach	173,945	4
5093	Westf. Prov. Vers. AG	951,416	2
5525	WGV-Schwäbische Allg.	69,296	1
5447	Winterthur Vers. NL Dtld.	n.a.	2
5479	Württ. Gemeinde-Vers.	147,436	2
5480	Württ. U. Badische	199,535	2
5783	Württ. Vers.	664,198	14
5590	Würzburger Versicher.	56,030	6
5476	WWK Allgemeine Vers.	160,260	4
5050	Zürich Vers. AG	1,192,183	12

3.7 Household insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5342	AACHENMüNCHENER VERS.	870,394	38
5581	ADLER VERSICHERUNG AG	n.a.	3
5312	ALLIANZ VERS.	3,201,031	70
5405	ALTE LEIPZIGER VERS.	169,108	6
5068	AMMERLÄNDER VERS.	n.a.	1
5455	ARAG ALLG. VERS.	234,086	27
5397	ASSTEL SACH	n.a.	2
5515	AXA VERS.	1,022,431	27
5317	BARMENIA ALLG. VERS.	n.a.	1
5633	BASLER SECURITAS	254,856	9
5310	BAYER. BEAMTEN VERS.	n.a.	1
5325	BAYER. VERS.BANK	664,879	7
5324	BAYER.VERS.VERB.AG	530,761	7
5098	BRUDERHILFE SACH.AG	202,543	1
5040	CIC DEUTSCHLAND	n.a.	19
5338	CONCORDIA VERS.	223,452	2
5004	CONSTANTIA	n.a.	1
5340	CONTINENTALE SACHVERS	123,256	4
5529	D.A.S. VERS.	146,038	5
5343	DA DEUTSCHE ALLG.VER.	n.a.	3
5311	DBV AG	197,211	1
5037	DBV-WINTERTHUR	315,925	6
5549	DEBEKA ALLGEMEINE	603,593	2
5513	DEVK ALLG. VERS.	789,065	17
5344	DEVK DT. EISENB. SACH	460,494	1
5347	DT. HEROLD ALLG.VERS.	297,433	8
5350	DT. RING SACHVERS.	211,662	1
5508	EUROPA SACHVERS.	n.a.	1
5516	FAMILIENSCHUTZ VERS.	n.a.	11
5024	FEUERSOZIETÄT	n.a.	4
5364	FRANKF. VERS.	885,152	10
5365	GEGENSEITIGKEIT VERS.	n.a.	3
5456	GENERALI VERS. AG	593,477	35
5442	GERLING G&A	n.a.	2
5368	GERLING-K. ALLGEMEINE	391,063	9
5531	GOTHAER ALLG.VERS.AG	859,428	8
5485	GRUNDEIGENTÜMER-VERS.	n.a.	1
5420	HAMB. MANNHEIMER SACH	456,843	21
5501	HANSEMERKUR ALLG.	n.a.	1
5085	HDI PRIVAT	237,923	7
5384	HELVETIA VERS.	303,936	1
5375	HUK-COBURG	1,199,672	14
5521	HUK-COBURG ALLG. VERS	474,997	5
5546	INTER ALLG. VERS.	n.a.	1
5780	INTERRISK VERS.	n.a.	2
5401	ITZEHOER VERSICHERUNG	n.a.	2
5509	KARLSRUHER VERS.	113,519	7
5402	LVM SACH	614,472	16
5061	MANNHEIMER VERS.	98,636	2

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5412	MECKLENBURG. VERS.	157,204	10
5334	MEDIENVERS. KARLSRUHE	n.a.	2
5390	NOVA ALLG.VERS.	269,174	8
5426	NÜRNBG. ALLG.	169,340	10
5015	NV-VERSICHERUNGEN	n.a.	4
5446	PROV.NORD BRANDKASSE	299,750	4
5095	PROV.RHEINLAND VERS.	567,181	16
5583	PVAG POLIZEIVERS.	n.a.	1
5438	R+V ALLGEMEINE VERS.	715,392	4
5798	RHEINLAND VERS. AG	107,944	3
5773	SAARLAND FEUERVERS.	n.a.	1
5491	SCHLESWIGER VERS.V.	n.a.	6
5690	SCHWARZMEER U. OSTSEE	n.a.	1
5781	SPARK.-VERS.SACHS.ALL	n.a.	1
5036	SV SPARK.VERSICHER.	393,060	6
5459	UELZENER ALLG. VERS.	n.a.	1
5400	VGH LAND.BRAND.HAN.	485,813	3
5464	VHV	229,236	5
5472	VICTORIA VERS.	746,054	21
5473	VOLKSFÜRSORGE DT.SACH	912.676	24
5484	VOLKSWOHL-BUND SACH	n.a.	1
5461	VPV ALLGEMEINE VERS.	186,068	10
5093	WESTF.PROV.VERS.AG	2,439,911	7
5525	WGV-SCHWÄBISCHE ALLG.	n.a.	1
5480	WÜRTT. U. BADISCHE	n.a.	2
5783	WÜRTT. VERS.	712,966	29
5476	WWK ALLGEMEINE VERS.	n.a.	7
5050	ZÜRICH VERS. AG	373,410	11

3.8 Residential buildings insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5342	AACHENMüNCHENER VERS.	337,527	14
5312	ALLIANZ VERS.	2,003,108	33
5405	ALTE LEIPZIGER VERS.	143,845	8
5455	ARAG ALLG. VERS.	n.a.	5
5515	AXA VERS.	539,123	22
5316	BAD. GEMEINDE-VERS.	n.a.	2
5633	BASLER SECURITAS	136,794	14
5319	BAYER. HAUSBESITZER	n.a.	1
5325	BAYER. VERS.BANK	321,505	4
5043	BAYER.L-BRAND.VERS.AG	2,627,607	27
5324	BAYER.VERS.VERB.AG	475,181	13
5040	CIC DEUTSCHLAND	n.a.	5
5338	CONCORDIA VERS.	169,495	3
5339	CONDOR ALLG. VERS.	n.a.	3
5004	CONSTANTIA	n.a.	1
5340	CONTINENTALE SACHVERS	56,300	4
5552	COSMOS VERS.	n.a.	1
5529	D.A.S. VERS.	58,781	3
5771	DARAG DT. VERS.U.RÜCK	n.a.	1
5311	DBV AG	90,190	1
5037	DBV-WINTERTHUR	113,237	6
5513	DEVK ALLG. VERS.	274,442	7
5344	DEVK DT. EISENB. SACH	156,880	4
5347	DT. HEROLD ALLG.VERS.	110,325	6
5350	DT. RING SACHVERS.	50,061	2
5508	EUROPA SACHVERS.	n.a.	2
5024	FEUERSOZIETÄT	89,377	9
5364	FRANKF. VERS.	411,863	3
5365	GEGENSEITIGKEIT VERS.	n.a.	4
5456	GENERALI VERS. AG	310,388	17
5442	GERLING G&A	n.a.	1
5368	GERLING-K. ALLGEMEINE	150,869	8
5531	GOTHAER ALLG.VERS.AG	293,063	10
5485	GRUNDEIGENTÜMER-VERS.	49,730	1
5032	HAMB. FEUERKASSE	167,866	4
5420	HAMB. MANNHEIMER SACH	126,543	8
5501	HANSEMERKUR ALLG.	n.a.	1
5085	HDI PRIVAT	87,186	4
5384	HELVETIA VERS.	165,093	7
5375	HUK-COBURG	472,222	10
5521	HUK-COBURG ALLG. VERS	125,963	3
5546	INTER ALLG. VERS.	n.a.	2
5780	INTERRISK VERS.	n.a.	1
5401	ITZEHOER VERSICHERUNG	n.a.	2
5509	KARLSRUHER VERS.	80,063	9
5402	LVM SACH	371,462	13
5061	MANNHEIMER VERS.	49,133	6
5412	MECKLENBURG. VERS.	86,880	2

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5016	NORDHEMMER VERS.	n.a.	1
5390	NOVA ALLG.VERS.	99,148	4
5426	NÜRNBG. ALLG.	70,963	6
5015	NV-VERSICHERUNGEN	n.a.	1
5787	OVAG - OSTDT. VERS.	n.a.	1
5432	PATRIA VERS.	n.a.	1
5446	PROV.NORD BRANDKASSE	329,374	4
5095	PROV.RHEINLAND VERS.	672,272	55
5583	PVAG POLIZEIVERS.	n.a.	1
5438	R+V ALLGEMEINE VERS.	638,668	11
5798	RHEINLAND VERS. AG	72,965	6
5773	SAARLAND FEUERVERS.	81,021	1
5491	SCHLESWIGER VERS.V.	n.a.	2
5690	SCHWARZMEER U. OSTSEE	n.a.	3
5451	SIGNAL UNFALL	n.a.	1
5036	SV SPARK.VERSICHER.	2,825,714	46
5042	VERSICHERUNGSK.BAYERN	n.a.	2
5400	VGH LAND.BRAND.HAN.	492,768	9
5464	VHV	n.a.	2
5472	VICTORIA VERS.	350,875	16
5473	VOLKSFÜRSORGE DT.SACH	191,865	8
5461	VPV ALLGEMEINE VERS.	n.a.	6
5093	WESTF.PROV.VERS.AG	2,060,849	17
5479	WÜRTT. GEMEINDE-VERS.	n.a.	1
5480	WÜRTT. U. BADISCHE	20,104	2
5783	WÜRTT. VERS.	371,415	17
5590	WÜRZBURGER VERSICHER.	n.a.	1
5050	ZÜRICH VERS. AG	239,389	13

3.9 Legal expenses insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5826	ADAC-Rechtsschutz	2,827,381	7
5809	ADVO Card RS	1,541,148	136
5312	Allianz Vers.	2,710,802	138
5825	Allrecht Rechtsschutz	250,027	21
5800	ARAG Allg. RS	1,829,194	188
5455	ARAG Allg. Vers.	n.a.	23
5801	Auxilia RS	531,704	20
5838	Badische Rechtsschutz	119,461	9
5319	Bayer. Hausbesitzer	n.a.	1
5325	Bayer. Vers. Bank	n.a.	2
5098	Bruderhilfe Sach. AG	152,844	14
5338	Concardia Vers.	n.a.	4
5831	Concordia RS	355,491	29
5802	D.A.S. Allg. RS	2,974,570	151
5529	D.A.S. Vers.	n.a.	8
5343	DA Deutsche Allg. Ver.	n.a.	7
5311	DBV AG	n.a.	1
5037	DBV-Winterthur	179,368	14
5549	Debeka Allgemeine	296,419	17
5803	Deurag Dt. RS	553,021	43
5829	DEVK Rechtsschutz	962,882	10
5834	DMB Rechtsschutz	632,906	11
5347	Dt. Herold Allg. Vers.	143,473	14
5516	Familienschutz Vers.	n.a.	1
5364	Frankf. Vers.	n.a.	3
5365	Gegenseitigkeit Vers.	n.a.	7
5368	Gerling-K. Allgemeine	226,539	22
5531	Gothaer Allg. Vers. AG	n.a.	3
5828	Hamb. Mannheimer RS	475,211	33
5420	Hamb. Mannheimer Sach	n.a.	7
5085	HDI Privat	n.a.	1
5827	HDI Rechtsschutz	271,601	36
5521	HUK-COBURG Allg. Vers	n.a.	1
5818	HUK-COBURG RS	1,560,610	52
5401	Itzehoer Versicherung	n.a.	4
5812	Jurpartner Rechtssch.	n.a.	4
5823	Karlsruher RS	102,348	2
5815	LVM Rechtsschutz	652,765	19
5402	LVM Sach	n.a.	2
5821	Mecklenburg. RS	n.a.	1
5412	Mecklenburg. Vers.	122,281	20
5805	Neue Rechtsschutz	445,207	28
5426	Nürnbg. Allg.	n.a.	1
5813	OERAG Rechtsschutz	1,133,302	63
5446	Prov. Nord Brandkasse	n.a.	1
5438	R+V Allgemeine Vers.	n.a.	2
5836	R+V Rechtsschutz	544,369	11
5806	Rechtsschutz Union	463,204	55

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31/12/2004	Complaints
5807	Roland Rechtsschutz	1,130,504	88
5459	Uelzener Allg. Vers.	n.a.	1
5400	VGH Land. Brand. Han.	168,724	2
5464	VHV	n.a.	1
5472	Victoria Vers.	n.a.	3
5093	Westf. Prov. Vers. AG	n.a.	1
5525	WGV-Schwäbische Allg.	n.a.	2
5832	Württ. Gemeinde-RS	346,890	18
5480	Württ. U. Badische	n.a.	1
5783	Württ. Vers.	556,711	24
5050	Zürich Vers. AG	316,533	28

3.10 Insurers based in the EEA

Reg. no.	Name of insurance undertaking	Complaints
5902	ACE European (GB)	7
5487	ACE Insurance S.A. (B)	3
5595	AIG Europe S. A. (F)	8
1306	AIG Life Nieder. (Irl)	1
5551	AIOI (GB)	1
5029	AIOI Motor (GB)	1
7644	Allianz Worldw. (IRL)	1
7230	AMEV Schadeverz. (NL)	1
7253	Assic. Generali (I)	1
7203	Atlanticlux (L)	36
5090	AXA Corporate S. (F)	5
7576	Bankers Life Ass. (GB)	1
1300	Canada Life (IRL)	26
7786	Canada Life A. (IRL)	1
1182	Cardif Leben (F)	1
5056	Cardif Vers. (F)	13
7565	Cardif-Societe Vie (F)	1
5574	Chubb Ins. Comp. (B)	2
7690	Cigna Life (B)	1
1189	Cigna Life Ins (B)	1
7453	Clerical Med. Inv. (GB)	21
7724	Creditlife Inter. (NL)	8
5048	Domestic and Gen. (GB)	3
7309	Donau Allgemeine (A)	1
1161	Equitable Life (GB)	8
7477	Erika FörSäkring. (S)	3
1179	Financial Ass. (GB)	1
7316	Financial Ins. (GB)	1
5053	Financial Insur. (GB)	4
7811	Finaref Life (IRL)	3
7353	Försäkr. Viator (S)	3
7469	Fortis Luxembourg (L)	1
7481	Fortuna Leben (FL)	2
7268	Generali Vers. AG (A)	1
7776	Genworth Financ. (GB)	1
5030	Gouda Vers.-AG (NL)	2
5073	Groupama Zweign. (F)	1
1301	Hannover Stand. (GB)	1
5079	Hiscox Ins. (GB)	1
5057	Interlloyd (D)	4
7685	Landmark Ins. (GB)	1
7734	Liberty Eur. (IRL/E)	25
7007	Lloyd's of London (GB)	3
5592	Lloyd's Vers. (GB)	5
7191	Merkur Vers. (A)	1
7181	Milano Assicur. (I)	1
7237	Mutuelle Des Arch. (F)	3
7579	Nemian Life & P. (L)	2
7806	New Technology (IRL)	9

5423	Northern Ass. C. (GB)	1
7311	Norwich Union (GB)	1
7225	Oberösterr. Vers. AG (A)	1
7723	Prismalife AG (FL)	16
7159	QBE Insurance E. (GB)	2
7761	Reliance Mutual (GB)	1
7730	Rimaxx (NL)	3
1174	Standard Life (GB)	16
7763	Stonebridge (GB)	22
7518	Sun Live Ass. Soc. (GB)	6
7691	The Hullberry (NL)	5
1311	VDV Leben Int. (GR)	7
7456	VDV Leben Intern (GR)	3
7643	Vienna-Life (FL)	1
5046	Volvo Vers. Amazon (B)	1
7483	Vorsorge Luxemb. (L)	22
7251	Wiener Städtische (A)	1
5088	XL Insurance (GB)	1

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Abbreviations

A

ABS	Asset-backed securities
AfS	Available for sale
AG	Aktiengesellschaft (German public limited company) / Amtsgericht (local court)
AG OpR	Working Group – Operational Risk
AHBR	Allgemeine Hypothekenbank Rheinboden
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 (Investment Ordinance)
AnSVG	Anlegerschutzverbesserungsgesetz (Act on the improvement of investor protection)
AntKlV	Anteilklassenverordnung (Unit Class Ordinance)
AnzV	Anzeigenverordnung (Reports Ordinance)
AO	Abgabenordnung (Tax Code)
AP	Assessment process
AS-Fonds	Altersvorsorge-Sondervermögen (Retirement funds)
ASIC	Australian Securities and Investment Commission
ATF	Accounting Task Force
ATS	Alternative trading system
AuslInvestmG	Auslandinvestment-Gesetz (Foreign Investment Act)
AVB	Allgemeine Versicherungsbedingungen (general terms and conditions of insurance)
AVmG	Altersvermögensgesetz (Retirement Savings Act)

B

BA	Bankenaufsicht (banking supervision)
BAC	Banking Advisory Committee
BaFin	Bundesanstalt für Finanzdienstleistungs-aufsicht (Federal Financial Supervisory Authority)
BAG	Bundesarbeitsgericht (Federal Labour Court)
BAKred	Bundesaufsichtsamt für das Kreditwesen (former Federal Banking Supervisory Office)
BAV	Bundesaufsichtsamt für das Versicherungswesen (former Federal Insurance Supervisory Office)
BAWe	Bundesaufsichtsamt für den Wertpapierhandel (former Federal Securities Supervisory Office)
BCBS	Basel Committee on Banking Supervision

BCP	Basel Core Principles for Effective Banking Supervision
BerPensV	Verordnung zur Berichterstattung von Pensionsfonds (Ordinance on reporting by pension funds)
BerVersV	Verordnung über die Berichterstattung von Versicherungsunternehmen (Ordinance on reporting by insurance undertakings)
BetrAVG	Gesetz zur Verbesserung der betrieblichen Altersversorgung (Act to improve occupational retirement provision)
BGB	Bürgerliches Gesetzbuch (Civil Code)
BGBl.	Bundesgesetzblatt (Federal Law Gazette)
BGH	Bundesgerichtshof (German Federal Court of Justice)
BIA	Basisindikatoransatz (basis indicator approach)
BilKoG	Bilanzkontrollgesetz (Accounting Enforcement Act)
BIS	Bank für Internationalen Zahlungsausgleich (Bank for International Settlements)
BkRL	Bankenrichtlinie (Banking Directive)
BMF	Bundesministerium der Finanzen (Federal Ministry of Finance)
bn	Billion(s)
BörsG	Börsengesetz (Exchange Act)
BSC	Banking Supervision Committee
BSpkG	Bausparkassengesetz (Building Societies act)
BSpkV	Bausparkassenverordnung (Building Societies Ordinance)
BVB	Besondere Vertragsbedingungen (special fund rules)
BVerfG	Bundesverfassungsgericht (Federal Constitutional Court)
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 groups)

C

CCP	Central counterparty
CDO	Collateralised debt obligation
CDS	Credit default swap
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CFTC	Commodities Future Trading Commission
CIS	Collective investment schemes
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	**D**	Directive
	DAV	Deutsche Aktuarvereinigung (German Actuarial Society)
	DAX	Deutscher Aktienindex (blue chip index listing the 30 major German companies)
	DeckRV	Deckungsrückstellungsverordnung (Mathematical Provisions Ordinance)
	DerivateV	Derivateverordnung (Derivatives Ordinance)
	DGAP	Deutsche Gesellschaft für Ad-hoc-Publizität mbH (corporate news dispatch service)
	DMBilG	D-Mark–Bilanzgesetz (D-Mark Accounting Act; relates to companies with a registered office in the Former German Democratic Republic as at 1 July 1990)
	DSGV	Deutscher Sparkassen- und Giroverband (German Savings Bank Association)
E	**EBC**	European Banking Committee
	EBK	Eidgenössische Bankkommission (Swiss Federal Banking Commission)
	EC	European Community
	ECJ	European Court of Justice
	ECOFIN	Economic and Financial Council
	EdB	Entschädigungseinrichtung deutscher Banken
	EdW	Entschädigungseinrichtung der Wertpapierhandelsunternehmen (Compensatory Fund of Securities Trading Companies)
	EEA	European Economic Area
	EEC	European Economic Community
	EEU	European Economic Union
	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 act)
	ESAEG	Einlagensicherungs- und Anlegerentschädigungsgesetz (Deposit Guarantee and Investor Compensation Act)
	ESC	European Securities Committee
	ESCB	European System of Central Banks
	EStG	Einkommenssteuergesetz (Income Tax Act)

	EU	European Union
	e.V.	eingetragener Verein (registered society)
F	**FATF**	Financial Action Task Force on Money Laundering
	FEDNY	Federal Reserve Bank of New York
	FESCO	Forum of European Securities Commissions
	FinAV	Finanzanalyseverordnung (Ordinance on the analysis of financial instruments)
	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)
	FINREP	Financial Reporting Framework
	FIRBA	Foundation Internal Ratings Based Approach
	FMA	Finanzmarktaufsicht Österreich (Austrian Financial Markets Authority)
	FMFG	Finanzmarktförderungsgesetz (Financial Market Promotion Act)
	FREP	Financial Reporting Enforcement Panel
	FSAP	Financial Services Action Plan / Financial Sector Assessment Program
	FSC	Financial Services Committee
	FSF	Financial Stability Forum
	FSI	Financial Stability Institute / Financial services institution
	FSS	Financial Supervisory Service
	FSSAP	Financial System Stability Assessment Program
	FST	Financial stability task
	FY	Financial year
G	**GAAP**	Generally Accepted Accounting Principles
	GB BAV	Geschäftsbericht des Bundesaufsichtsamtes für das Versicherungswesen (annual report of the former 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)
	GMG	Gesetz zur Modernisierung der gesetzlichen Krankenversicherung (Statutory Health Insurance Modernisation Act)
	GmbH	Gesellschaft mit beschränkter Haftung (German private limited company)
	GP	Gross premiums

GroMiKV	Großkredit- und Millionenkreditverordnung (Ordinance governing large exposures and loans of 1.5 Million euros or more)
GS I	Grundsatz I (Principle I)
GS II	Grundsatz II (Principle II)
GwG	Geldwäschegesetz (Money Laundering Act)

H

HBG	Hypothekenbankgesetz (Mortgage Bank Act)
HGB	Handelsgesetzbuch (Commercial Code)
HMG	Heilmittelwerbegesetz (Law on advertising in the healthcare system)
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
IBNR reserve	Reserve for claims incurred but not reported
ICAAP	Internal capital adequacy assessment process
IdW	Institut der Wirtschaftsprüfer (Institute of German Certified Public Accountants)
IFRS	International financial reporting standards
IFSC	Integrated Financial Supervisors Conference
IM	Intelligent miner
IMF	International Monetary Fund
InsO	Insolvenzordnung (Insolvency Code)
InvAG	Investment-Aktiengesellschaft (public limited investment company)
InvG	Investmentgesetz (Investment Act)
InvMV	Verordnung des Bundesministeriums der Finanzen über die Meldepflicht nach § 10 Abs. 1 und 2 des Investmentgesetzes, Investmentverordnung (Ordinance of the Federal Ministry of Finance concerning the notification obligation according to section 10 (1) and (2) of the Investment Act)
IOPS	International Organization of Pension Supervisors
IOSCO	International Organization of Securities Commissions
IRB	Internal ratings based
IRBA	Internal ratings based approach
ISD	Investment Services Directive; Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field)

	ISDA	International Swaps and Derivates Association
	IT	Information technology
	IP	Investment portfolio
	IU	Insurance undertaking
J	**JF**	Joint forum
	JGS	Jahresgemeinschaftsstatistik über den Schadenverlauf in der Kraftfahrzeug-Haftpflichtversicherung (Overall annual statistic concerning the claims experience in motor third party liability insurance)
K	**KAG**	Kapitalanlagegesellschaft (investment company)
	KAGG	Gesetz über Kapitalanlagegesellschaften (Investment Companies Act)
	KalV	Kalkulationsverordnung (Calculation Ordinance)
	KfW	Kreditanstalt für Wiederaufbau (Reconstruction Loan Corporation)
	KG	Kommanditgesellschaft (German limited partnership)
	KH-Versicherung	Kraftfahrzeug-Haftpflichtversicherung (motor third party liability insurance)
	KLR	Kosten- und Leistungsrechnung (cost and results accounts)
	KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (Act concerning the control and transparency of companies)
	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)
M	**M & A**	Mergers & acquisitions
	m	Million(s)
	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 internal audit function of credit institutions)
	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 Finance specifying the prohibition of market manipulation)
	MaRisk	Mindestanforderung an das Risikomanagement (Minimum requirements for risk management)
	MCR	Minimum capital requirement
	MD&A	Management discussion and analysis
	MFP	IMF Code of Good Practices on Transparency in Monetary and Financial Policies
	MiFID	Markets in Financial Instruments Directive
	MIS	Management information system
	MoU	Memorandum of understanding
	MMoU	Multilateral memorandum of understanding
N	**NCCT**	Non-cooperative countries and territories
	NPL	Non-Performing Loans
O	**OCC**	Office of the Controller of the Currency
	OECD	Organisation for Economic Cooperation and Development
	OFC	Offshore financial centre
	OJ	Official Journal
	OLG	Oberlandesgericht (Higher Regional Court)
	ÖPG	Gesetz über die Pfandbriefe und verwandten Schuldverschreibungen öffentlich-rechtlicher Kreditanstalten (Act on Pfandbriefe and similar bonds of credit institutions under public law)
	OTC	Over-the-counter
	OVG	Oberverwaltungsgericht (Higher Administrative Court)
	OWiG	Gesetz über Ordnungswidrigkeiten (Act on administrative offences)
P	**PBoC**	Peoples Bank of China
	PfandbrG	Pfandbriefgesetz (Pfandbrief Act)
	PFE	Potential future exposure
	PFKAustV	Verordnung über die Kapitalausstattung von Pensionsfonds (Pension Funds Capital Resources Ordinance)
	PflVG	Pflichtversicherungsgesetz (Compulsory Insurance Act)
	PIOB	Public Interest Oversight Board
	P&L	Profit and loss account
	PKV	Private Krankenversicherung (private health insurance)
	PPV	Pflegepflichtversicherung (compulsory long-term care 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 (provision for impending losses)
	RechVersV	Verordnung über die Rechnungslegung von Versicherungsunternehmen (Ordinance on insurance accounting)
	RfB	Rückstellung für Beitragsrückerstattung (provisions for bonuses and rebates)
	RoE	Return on equity
S	**SchBkG**	Gesetz über Schiffspfandbriefbanken (Act on ship pfandbrief 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
	STA	Standardansatz (standard approach)
	StPO	Strafprozessordnung (Code of Criminal Procedure)
	SWAP	Securities watch applications
T	**Task Force Re**	Task Force on Enhancing Transparency & Disclosure in the Reinsurance Sector
	tba	To be announced
	TCI	The Children´s Investment Fund Management
U	**UCITS**	Undertakings for the collective investment of transferable securities
	US-GAAP	US Generally Accepted Accounting Principles
	UStG	Umsatzsteuergesetz (VAT Act)
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 Finanzdienstleistungsaufsicht (BaFin publications)
	VerkprospG	Verkaufsprospektgesetz (Prospectus Act)
	VermVerkProspV	Vermögensanlagen-Verkaufsprospekt-verordnung (Non-Securities Investment Prospectus Ordinance)
	VG	Verwaltungsgericht (Administrative Court)
	VGH	Verwaltungsgerichtshof (Administrative High Court)
	VVaG	Versicherungsverein auf Gegenseitigkeit (mutual society)

	VVG	Versicherungsvertragsgesetz (Insurance Contract Act)
W	**WpDPV**	Wertpapierdienstleistungs-Prüfungsverordnung (Investment Services Enterprises Examination Ordinance)
	WpHG	Wertpapierhandelsgesetz (Securities Trading Act)
	WpPG	Wertpapierprospektgesetz (Securities Prospectus Act)
	WpÜG	Wertpapiererwerbs- und Übernahmegesetz (Securites Acquisition and Takeover Act)

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