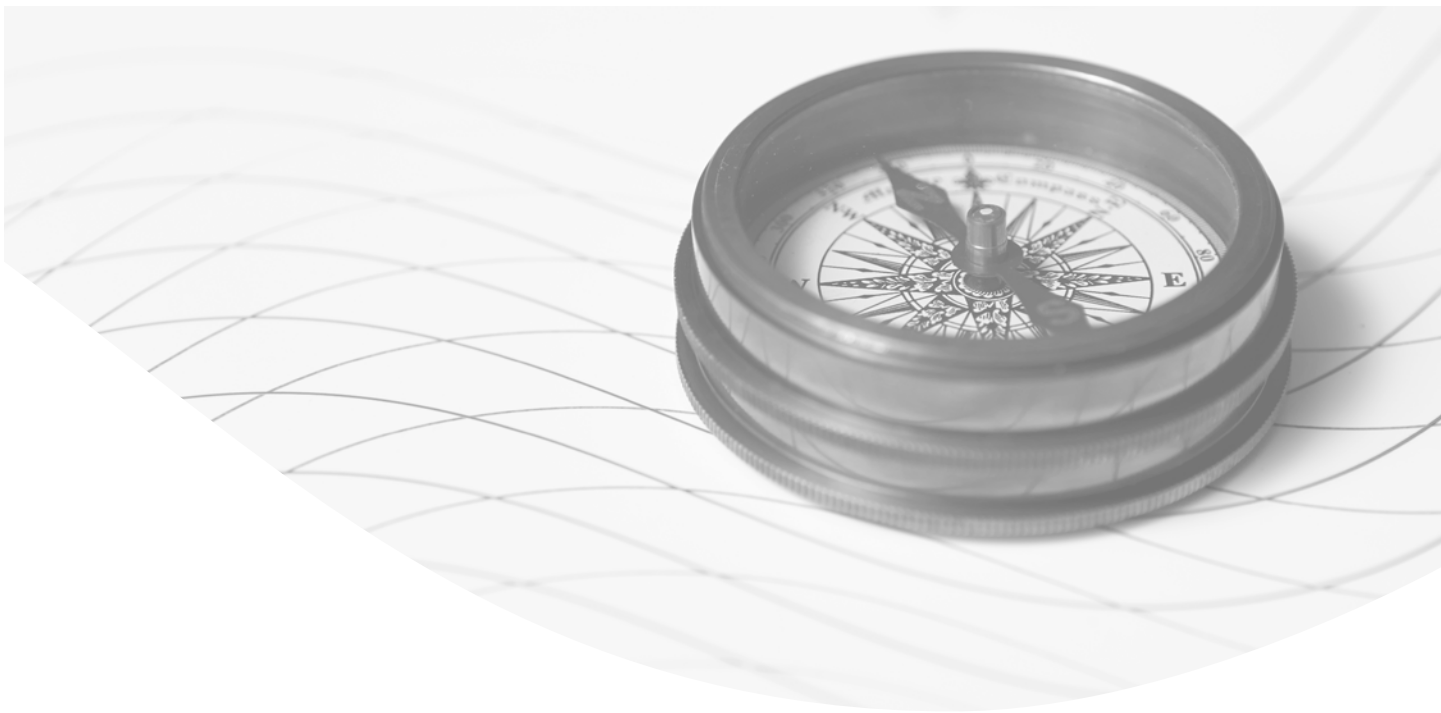


2014



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

Contents



Interview with the Federal Minister of Finance	10
---	-----------

I	Spotlights	14
----------	-------------------	-----------

1	Low interest rates	14
----------	---------------------------	-----------

1.1	Life insurers	14
------------	---------------	----

1.2	Banks	15
------------	-------	----

1.3	Building societies	15
------------	--------------------	----

2	Banking union	16
----------	----------------------	-----------

2.1	New European banking supervision	16
------------	----------------------------------	----

2.2	Resolution mechanism for euro area banks	18
------------	--	----

2.3	Directive on Deposit Guarantee Schemes	19
------------	--	----

3	Consumer protection	20
----------	----------------------------	-----------

4	Opinion: Dr Elke König on how much regulation we need	21
----------	--	-----------

II	Integrated financial services supervision	28
-----------	--	-----------

1	Macroeconomic environment	28
----------	----------------------------------	-----------

2	Financial stability	30
----------	----------------------------	-----------

2.1	Global systemically important financial institutions	30
------------	--	----

2.2	Focus: Macroprudential instruments and strategy	31
------------	---	----

2.3	Cross-Sectoral Risk Committee	33
------------	-------------------------------	----

2.4	Supervision of financial conglomerates	34
------------	--	----

2.5	Regulation of credit rating agencies	34
------------	--------------------------------------	----

2.5.1	Implementation of the Regulation on Credit Rating Agencies	34
--------------	--	----

2.5.2	New functions for BaFin	34
--------------	-------------------------	----

2.5.3	Revision of the Code of Conduct for Credit Rating Agencies	35
--------------	--	----

3	Market-based financing	35
----------	-------------------------------	-----------

3.1	Focus: From bad boy to alternative source of financing: the shadow banking sector	35
------------	--	----

3.2	Focus: A sustainable securitisation market as an alternative source of financing	38
------------	---	----

4	International supervision	41
	<hr/>	
4.1	European System of Financial Supervision	41
4.2	Bilateral and multilateral cooperation	42
4.2.1	Memoranda of understanding	42
4.2.2	Technical cooperation	43
5	Consumer protection	43
	<hr/>	
5.1	International developments	43
5.1.1	Guidelines on the complaints management function and complaints handling	43
5.1.2	Consultation on cross-selling guidelines	44
5.1.3	Key information documents for packaged investment products	44
5.2	Future responsibilities	44
5.2.1	Opinion: Gabriele Hahn on collective consumer protection in the financial sector	44
5.2.2	Financial markets watchdog	47
5.3	Court rulings	48
5.3.1	Handling charges for private loans	48
5.3.2	Cancellation of mortgage loans	49
5.3.3	Ruling on advance charging of costs for multi-year fund savings plans	49
5.4	Consumer Advisory Council	50
5.5	Focus: The new Directive on Deposit Guarantee Schemes	51
5.6	Consumer complaints and enquiries	54
5.6.1	Credit institutions and financial services providers	54
5.6.2	Investment companies and German management companies	56
5.6.3	Insurance undertakings	56
5.6.4	Securities transactions	58
5.6.5	Consumer hotline	58
5.6.6	Consumer protection forum	59
5.7	Dispute resolution	59
6	Authorisation requirements and prosecution of unauthorised business activities	60
	<hr/>	
6.1	Authorisation requirements	60
6.1.1	Focus: Bitcoin – quo vadis?	61
6.1.2	Revision of the Payment Services Directive	64
6.1.3	Focus: Supervisory practice on crowdfunding	64
6.2	Exemption from the authorisation requirement	68
6.3	Illegal investment schemes	68
7	Financial accounting and reporting	69
	<hr/>	
7.1	Financial instruments accounting under IFRS 9	69
7.2	Accounting for insurance contracts	70
7.3	EU regulatory project on audit policy	71

8	Money laundering prevention	72
<hr/>		
9	Risk modelling	73
<hr/>		
9.1	Focus: All change for internal risk models	73
9.2	European harmonisation of model supervision	77
9.2.1	EBA standards	77
9.2.2	SSM expert group on internal models	78
9.2.3	EIOPA measures	79
10	Freedom of Information Act	80
<hr/>		
10.1	Focus: Freedom of Information Act: BaFin obliged to maintain professional secrecy	80
10.2	Submissions in 2014	84
III	Supervision of banks, financial services institutions and payment institutions	86
<hr/>		
1	Bases of supervision	86
<hr/>		
1.1	European banking supervision	86
1.1.1	Focus: BaFin as part of the Single Supervisory Mechanism	86
1.1.2	Opinion: Raimund Röseler on transitioning into a new era of supervision	89
1.2	Focus: Recovery and resolution	91
1.3	Work on the Basel framework	96
1.4	Focus: Corporate governance	97
1.5	Supervisory review and evaluation guidelines	100
1.6	Report on risk culture	100
1.7	Revision of the trading book rules	101
1.8	Amendment to the Pfandbrief Act	101
2	Preventive supervision	103
<hr/>		
2.1	Risk classification	103
2.1.1	Credit institutions	104
2.1.2	Financial services providers	104
2.2	IT security at banks	104
2.3	Securitisation positions	107
2.4	Money laundering prevention	108
3	Institutional supervision	109
<hr/>		
3.1	Authorised institutions	109
3.1.1	Credit institutions	109
3.1.2	Financial services providers	111
3.1.3	Finance leasing and factoring institutions	111
3.1.4	Payment institutions and e-money institutions	111

3.2	Economic environment	112
3.3	Situation at the institutions	115
3.3.1	Institutions subject to direct European supervision	115
3.3.2	Private commercial, regional and specialist banks	116
3.3.3	Savings banks	116
3.3.4	Securities trading banks	117
3.3.5	Building societies	118
3.3.6	Cooperative banks	118
3.3.7	Foreign banks	119
3.3.8	Pfandbrief banks	120
3.3.9	Finance leasing and factoring institutions	121
3.3.10	Payment and e-money institutions	122
3.4	Supervisory activities	122
3.4.1	Credit institutions	122
3.4.2	Financial services institutions	126
3.4.3	Finance leasing and factoring institutions	127
3.4.4	Payment service providers and e-money institutions	128
3.4.5	Account information access procedure in accordance with section 24c of the KWG	130

4 Market supervision 131

4.1	Focus: Employee and Complaints Register marks two-and-a-half years	131
4.2	Investment advice minutes	135
4.3	Fee-based investment advisers	135
4.4	Other focal points of supervision	136
4.5	Rules of conduct for financial instruments analysis	137
4.6	Administrative fines	137

IV Supervision of insurance undertakings and Pensionsfonds 138

1 Bases of supervision 138

1.1	Opinion: Felix Hufeld on modern insurance supervision	138
1.2	New developments in the global framework	142
1.2.1	Global systemically important insurers	142
1.2.2	Capital standards for insurers	143
1.2.2.1	Connection between ICS/BCR and Solvency II	143
1.2.2.2	Connection between ICS/BCR and HLA	144
1.2.3	New structure of the IAIS	144
1.3	Recovery and resolution	145
1.4	Solvency II	146
1.4.1	Continued development of the legal framework	146
1.4.1.1	Amended Framework Directive in force	146
1.4.1.2	Delegated acts, technical standards and guidelines	146
1.4.1.3	Act to Modernise Financial Supervision of Insurance Undertakings	148
1.4.2	Preparations for Solvency II	148

1.4.2.1	Technical Specifications	148
1.4.2.2	BaFin publications on the EIOPA preparatory guidelines	149
1.4.2.3	Results of the "Vollerhebung Leben" survey	152
1.4.2.4	Voluntary test run for reporting	153
1.4.2.5	Internal models	153
1.4.3	Focus: The prudent person principle	154
1.5	Occupational retirement provision	157
1.5.1	Planned amendment to the IORP Directive	157
1.5.2	EIOPA's activities on Pillar 1	158
1.6	Insurance intermediaries	158
1.6.1	Planned amendments to the Directive on insurance mediation	158
1.6.2	EIOPA Guidelines on Complaints Handling by Insurance Intermediaries	158
1.6.3	Focus: Insurance intermediaries – supervisory possibilities and limits	159
1.6.4	Fee-based advice	162
1.7	Life Insurance Reform Act	162
1.8	Regulations	163
1.8.1	RfB Regulation	163
1.8.2	Investment Regulation and Pension Fund Investment Regulation	164
1.9	BaFin circulars	164
1.9.1	Trustees to monitor the guarantee assets (Sicherungsvermögen)	164
1.9.2	Guidance on the operation of ransom insurance	165
2	Preventive supervision	166
2.1	Risk classification	166
2.2	On-site inspections	168
2.3	Areas of emphasis of inspections	168
2.4	Claims settlement practices	168
2.5	Stress tests	170
2.5.1	BaFin stress test	170
2.5.2	EIOPA stress test 2014	171
2.6	Money laundering prevention	171
2.6.1	Focus audit on secondary market buyers of policies	171
2.6.2	Investigation of origin of funds for life insurance policies	172
3	Supervision of undertakings	172
3.1	Authorised insurance undertakings and Pensionsfonds	172
3.2	Economic environment	173
3.3	Position of the insurance sector	175
3.3.1	Investments by insurers – overview	175
3.3.2	Composition of the risk asset ratio	176
3.3.3	Results in the individual insurance classes	176
3.3.3.1	Life insurers	176
3.3.3.2	Private health insurers	182
3.3.3.3	Property and casualty insurers	184
3.3.3.4	Reinsurers	186
3.3.3.5	Pensionskassen	187
3.3.3.6	Pensionsfonds	188
3.4	Supervision of cross-border insurance groups	189

V	Supervision of securities trading and the investment business	190
<hr/>		
1	Bases of supervision	190
<hr/>		
1.1	Opinion: Karl-Burkhard Caspari on the challenges of the revised MiFID	190
1.2	Retail Investor Protection Act	193
1.3	Market Abuse Regulation and Directive on Criminal Sanctions for Market Abuse	197
1.4	Focus: Reform of the sanctioning regime	198
1.5	Transparency Directive	202
1.6	Regulation on improving securities settlement in the EU and on central securities depositories	203
1.7	UCITS V Directive	204
1.8	Investment Code	205
1.8.1	Focus: Initial experience with supervision under the German Investment Code	205
1.8.2	Operating companies	208
1.8.3	Prevention of blind pool structures	209
1.8.4	Standard text modules for cost clauses	209
1.8.5	Reporting obligations for AIF management companies	210
1.8.6	Circular on depositories	211
2	Monitoring of market transparency and integrity	211
<hr/>		
2.1	Market analysis	211
2.2	Market manipulation	213
2.3	Insider trading	217
2.4	Ad hoc disclosures and directors' dealings	218
2.5	Monitoring of short selling	219
2.6	Supervision of OTC derivatives transactions	221
2.7	Voting rights and duties to provide information to security holders	222
2.7.1	Voting rights	222
2.7.2	Duties to provide information to securities holders	222
3	Prospectuses	223
<hr/>		
3.1	Securities prospectuses	223
3.2	Focus: Mittelstand bonds – opportunities and risks for retail investors	224
3.3	Investment prospectuses	227
4	Corporate takeovers	228
<hr/>		
5	Financial reporting enforcement	231
<hr/>		

6	Supervision of investment business	232
6.1	German management companies (Kapitalverwaltungsgesellschaften)	232
6.2	Investment funds	232
6.2.1	Open-ended real estate funds	232
6.2.2	Hedge funds	233
6.2.3	Foreign investment funds	233
7	Administrative fine proceedings	234
7.1	Administrative fines	234
7.2	Selected cases	236
VI	About BaFin	238
1	Human resources	238
2	Organisational developments	240
3	Budget	241
4	Press and Public Relations	243
■	Appendix	246
1	Organisation chart	246
2	BaFin bodies	251
2.1	Members of the Administrative Council	251
2.2	Members of the Advisory Board	252
2.3	Members of the Insurance Advisory Council	253
2.4	Members of the Securities Council	254
2.5	Members of the Consumer Advisory Council	255
3	Complaints statistics for individual undertakings	256
3.1	Explanatory notes on the statistics	256
3.2	Life insurance	257
3.3	Health insurance	259
3.4	Motor vehicle insurance	260
3.5	Residential building insurance	262
3.6	Accident insurance	264
3.7	Legal expenses insurance	266
3.8	Household contents insurance	267
3.9	General liability insurance	269
3.10	Insurers based in the EEA	271

4	Memoranda of Understanding (MoUs)*	272
5	Index of tables	273
6	Index of figures	274



Texts marked with this symbol contain information on investor and consumer protection.



Interview with the Federal Minister of Finance

Dr Wolfgang Schäuble expresses his views

Minister, the political powers-that-be have provided banking supervisors with many new tools in the recent past. Has the time now come to implement these measures or do you still see gaps that need to be plugged?

► I see both. We have introduced fundamental financial market reforms, and supervisors must ensure that they are rigorously implemented. But there are definitely some tools that are still lacking; at the same time we have a permanent duty to preserve the stability of financial markets. To mention just one example: the “too big to fail” problem must be addressed as comprehensively as possible and the resolvability of systemically important banks and other financial institutions must therefore be further improved. One important aspect here is the G20’s agreement on the introduction of what are known as TLAC¹ minimum standards, which means global systemically important banks having to hold enough resources to make it possible for a bail-in to be put in place in the event of a crisis. Further efforts to close regulatory loopholes are also required outside the banking sector.

One of the things we are therefore supporting is further improving the oversight and regulation of the international shadow banking system and rigorous implementation in Europe of the proposals developed by the Financial Stability Board, for instance.

There are increasing demands internationally that supervision should remain independent of political influence. In Germany, BaFin is subject to the legal and technical supervision by your Ministry. How do you see the relationship between government and supervisors?

► In the case of Germany, this question in fact requires quite a complex answer. It is one of the cornerstones of effective supervision that it operates independently, that is, the Ministry does not get involved in the day-to-day supervisory activities of BaFin. Germany is also committed to this principle internationally. However, supervision does not operate in isolation from government. There are two main areas on which the Federal Ministry of Finance focuses. Firstly, we take advantage of the opportunities open to us in drafting financial market legislation – both at the European level

1 Total Loss-Absorbing Capacity.

in the Council as a co-legislator and nationally as the competent ministry for presenting financial market legislation bills. Secondly, we are responsible for ensuring that financial market legislation is applied lawfully and appropriately and that BaFin fulfils the functions delegated to it in this respect. We are also accountable to Parliament for this.

On 4 November 2014, the Single Supervisory Mechanism (SSM) for euro zone banks came into operation. You helped to shape it. Will it actually be able to deliver more than national supervisory authorities could with their own national resources?

► When euro zone Heads of State and Government decided in favour of a single supervisory mechanism for banks, involving the ECB, the European Central Bank, in June 2012, the main motivating force was to reduce the mutual dependency between banks and governments. In addition, it was also intended to ensure that the same supervisory standards are applied equally in all participating Member States so as to restore confidence in the euro and a stable banking system. A centralised single supervisory mechanism can achieve this more readily than decentralised national supervisory authorities, who may possibly have some leeway in implementing the standards.

Are the functions of monetary policy and supervision in the current supervisory mechanism construction separated cleanly enough? Would an independent European banking supervisor, divorced from monetary policy, not be better? What do you think are the prospects of a Treaty amendment becoming necessary in that case?

► As the Federal Government, we argued very strongly in the Banking Union negotiations for a clean separation of monetary policy and supervisory tasks at the ECB. Within the limits of what is possible under European law, the separation of banking supervision and monetary policy is ensured by the creation of the new ECB structures laid down in the SSM Regulation. With the establishment of the ECB Supervisory

Board an oversight body separate from the Governing Council has been created. In terms of content, all decisions on supervisory matters are to be taken by the Supervisory Board, and the Governing Council may only express its objections.

Furthermore, June 2014 saw the establishment of the ECB mediation panel prescribed in the SSM Regulation, which is intended to settle differences of views in the event of any objection from the Governing Council to a draft decision of the Supervisory Board.

So the solution we arrived at was quite acceptable. But that does not alter fact that the Federal Government is seeking to achieve a complete separation of monetary policy and banking supervision that goes beyond what was possible when the SSM was being created, by way of a Treaty amendment. We are seeking the support of our partner countries for this.

Do we now need such a supervisory mechanism for insurers and critical infrastructures as well?

► European cooperation between national insurance supervisors will be strengthened considerably with Solvency II. But there is no need for a single supervisory mechanism for insurers. Supervision by national supervisors, whose work is coordinated on a Europe-wide basis by EIOPA², is more effective, especially because of the considerable differences between national insurance markets.

The situation is similar with financial market infrastructures. The OTC Derivatives Regulation and the planned Regulation on Central Securities Depositories contain rules governing cooperation between all supervisory authorities concerned while at the same time enshrining responsibility for supervision with national authorities.

² European Insurance and Occupational Pensions Authority.

I

II

III

IV

V

VI

Appendix

In view of the persistently low level of interest rates, there are increasing calls for insurers to be allowed to invest more in long-term financing projects. Where do you stand on such calls?

► The first principle governing insurers is that they must be able to meet their benefit obligations to their customers. For that reason insurers must limit the risk of their investments and ensure that they can manage the risks they have assumed effectively. Subject to that, I am naturally pleased if insurers contribute to the long-term financing of the economy and the infrastructure.

What do you think of the EU Commission's plans to create a capital market union? And what role does regulation play in this?

► The new EU Commissioner, Jonathan Hill, would like to establish a capital market union covering all EU member states by 2019. The Commission's objective is to create a diversified market for businesses to raise funds in this way. The pace of European capital market integration would be stepped up and regulation and supervision harmonised more closely. In this way an environment would be created in which businesses, especially medium-sized (*Mittelstand*) businesses, find it easier to raise funds on the capital market.

Specific instruments of a capital market union might include, for example, a common EU securitisation market for prime paper or the promotion of the private placement market – i. e. the placement of the likes of *Schuldscheindarlehen*³ directly with investors without going through a stock exchange.

In principle we welcome the gradual introduction of a capital market union, extending across all Member States, that offers businesses a wider range of funding options. But an analysis needs to be made first of what reforms we actually need and which structures and practices have proved their

worth and should be retained. And financial market stability must not be jeopardised either. If we want to revive the securitisation market in Europe, it must only be with proper regulation that defines for the whole EU what is meant by "high-quality securitisation". As for private placements, the instrument of the *Schuldscheindarlehen* is well established in Germany and should also be maintained in this form.

European and global regulation projects are exerting an ever-increasing influence on national regulation. Do you see limits to harmonisation?

► The financial crisis showed that in global markets, which is what the financial markets are today, risks are no respecters of national boundaries. At the same time we must see to it that internationally active financial firms do not engage in "regulatory arbitrage" and play national supervisory systems off against each other. Proof that one vital lesson has been learnt from the crisis is that the most important industrialised nations and developing countries around the world are now coordinating their regulatory approaches. Regarding the European Single Market, as far as the financial markets in particular are concerned, there is definitely also much to be said for regulation at the European level, with a view to achieving a single legal framework. But as it does everywhere in the Union, the principle of subsidiarity applies here too. If common European regulations are not required to guarantee the free movement of capital and services, financial market stability or equal competition conditions in the European Union, then such matters fall within the legislative jurisdiction of the Member States. And there can be no question either of tried and tested structures in member states being challenged – such as the three-pillar model in Germany, for example.

The Retail Investor Protection Act (*Kleinanlegerschutzgesetz*) is meant to offer investors better protection against dubious or inappropriate offers. How far can and should lawmakers go to protect investors? Should they

3 Promissory note loans.

not also promote the education of investors in financial matters – according to the concept of “informed consumer”?

► By introducing the Retail Investor Protection Act we want to ensure that investors have comprehensive and up-to-date information on investments at their fingertips, so that they can make decisions that meet their wishes and satisfy their needs. But, ultimately, responsibility for investing in particular products and so taking advantage of an opportunity to make money but also accepting the risk of losing money must rest with the individual investor.

The Coalition Agreement also provides for better consumer education. Consumer organisations and the recently created Financial Markets Watchdog are performing this function. The “Federal Government action plan for consumer protection in the financial market” put forward by Federal Minister of Justice Maas and myself provides for a strengthening of financial consumer protection. Through its publicity work BaFin is also providing valuable information on financial products. And I am pleased to say that the Standing Conference of *Länder* Ministers of Education and Cultural Affairs of September 2013 adopted a resolution providing for greater consumer education in school curricula.

Minister, thank you for granting us this interview.

I

II

III

IV

V

VI

Appendix



I Spotlights

1 Low interest rates

The longer low interest rates persist, the more clearly we see negative effects in the financial sector – for all involved enterprises.

1.1 Life insurers

The situation remains difficult, particularly for life insurance undertakings. Although the stress tests and BaFin's projections continue to conclude that the undertakings will be able to meet their benefit obligations in the short to medium term, income from investments is declining faster than the guaranteed interest in the portfolio.

In light of this, BaFin asked all 87 German life insurance undertakings about their own funds situation under Solvency II conditions in its "Vollerhebung Leben" survey in late summer 2014. The findings: on the whole, German life insurance undertakings are able to cope with the new era of supervision – thanks to the transitional measures and the volatility adjustment now introduced under the framework. Only a handful of undertakings were unable to demonstrate that they had

sufficient own funds despite these measures; their collective market share amounts to less than 1%. However, because capital market rates have fallen further since the survey was completed, BaFin intends to have another critical look at the results. What is already evident is that if the interest rates continue to remain so low, the life insurance undertakings will have to make considerable efforts to strengthen their capital base adequately during the 16-year transitional period stipulated under Solvency II.

Zinszusatzreserve

One effective countermeasure is the additional interest provision (*Zinszusatzreserve*), which is meant to ensure that life insurance undertakings will continue to be able to satisfy the terms of their policies going forward despite the low interest rates. Since financial year 2011, the undertakings have been required to build up these provisions in order to reduce the unrealised losses on the liabilities side resulting from falling interest rates. The *Zinszusatzreserve* amounted to approximately €21.2 billion at the end of 2014.

After transferring approximately €5.6 billion to the *Zinszusatzreserve* in the previous year, insurance undertakings increased it in 2014 by approximately €8.5 billion. Despite this far-reaching precautionary measure, the *Zinszusatzreserve* must not remain the sole tool to be used to resolve the problem caused by low interest rates. Relief will come from the various measures implemented under the German Life Insurance Reform Act (*Lebensversicherungsreformgesetz*), which was promulgated in August 2014 and which is designed to ensure that going forward, policyholders will continue to receive the benefits promised to them.

New products

Yet above all, it is up to the industry itself to take appropriate measures. While cost reduction is one key approach, the undertakings must first and foremost offer products which are appropriate in light of the market environment, i. e., not only low interest rates, but also future regulatory requirements and customer needs.

Nowadays, customers are seeking not only security and yields, but also greater flexibility. The undertakings designed new product concepts in 2013. The importance of confidence was once again evident. Objectively speaking, customers can count on promised benefits. Subjectively, they feel that many insurance products are too difficult to understand and too complex. Clarity and transparency in distribution are therefore absolutely essential. The planned revision of the European Distribution Directive will provide new guidance in this area.

1.2 Banks

The low level of interest rates also continues to prove highly challenging for German banks. Traditionally, net interest income makes up approximately 70 % of the German institutions' operating income and is thus by far their most important source of income. The present interest rate level already makes it difficult for institutions to maintain their net interest result,

and the potential to generate income through maturity transformation is likely to continue to shrink. However, a sudden shift in interest rate policy would not necessarily provide relief. It could above all prove problematic to institutions which offer long-term financing.

Search for sources of income

Given the large number of banks per capita in Germany and the resulting fierce competition, the search for new sources of income has proven difficult. At the very least, there is the risk that while institutions will generate profits in the short term, they will build up significant risk exposures over the long run which bear no relation to their short-term profits. The issue at hand is whether banks pursue a sustainable business strategy, a requirement which BaFin has been imposing on them since the publication of its Minimum Requirements for Risk Management in 2009. Banks have since become subject to a legal obligation to do so. They must define a business strategy aimed at ensuring the sustainable success of the institution, as well as a risk strategy that is consistent with it. It is BaFin's responsibility to ascertain whether the institutions satisfy this requirement. BaFin does not dictate the institutions' business model, nor does it generally intervene in their business decisions.

The banks might also be able to resolve their profitability problem by cutting costs. Mergers can be helpful in this regard, but they are not a silver bullet, as the desired synergies are often transitory. Moreover, two weaker institutions do not automatically make a strong one.

1.3 Building societies

Building societies (*Bausparkassen*) have also been suffering for some time now as a result of the low interest rate level. However, in contrast to other institutions, they cannot tap into any new fields of business. The Building and Loan Associations Act (*Bausparkassengesetz*) restricts the group of transactions which building societies may engage in to transactions relating to residential properties, thus limiting their opportunities to making

I

II

III

IV

V

VI

Appendix

low-risk – and hence low-return – investments. What building societies can do is develop new savings plans. A large number of building societies did just that in 2014, introducing new plans featuring lower interest rates. Nevertheless, the low interest rate level means that the existing high-interest building savings contracts (*Bausparverträge*) which are still on their books are putting downward pressure on their results. Many building societies have therefore terminated building savings contracts. They did this not on grounds of over-saving, as in the past, but rather because

building savings customers are not drawing down their building savings loans despite the fact the relevant contracts have already met the requirements for a loan to be granted for at least ten years.

Rumours persisted for weeks that BaFin had ordered the building societies to terminate the contracts, although those rumours were not true. Responsibility for taking such decisions rests solely with the institutions. The courts will have to decide whether the contract terminations were permissible under civil law.

2 Banking union

The creation of a European banking union is considered one of the most important European reforms since the introduction of the euro. This step will have particularly far-reaching consequences for banks in the eurozone. While the CRD IV package¹, the new Directive on Deposit Guarantee Schemes (DGSD) and the Bank Recovery and Resolution Directive (BRRD) apply to all EU countries, the euro area has introduced the Single Supervisory Mechanism (SSM) in November 2014 and the Single Resolution Mechanism (SRM) will assume its full powers from the beginning of 2016 (see Figure 1 “Legal bases for the banking union”, page 17).

2.1 New European banking supervision

Since 4 November 2014, eurozone banks have been subject to supervision by the Single Supervisory Mechanism (SSM), an alliance of supervisors spearheaded by the European Central Bank (ECB). Significant institutions – including 21 from Germany – are now subject to the SSM’s direct supervision. They are supervised by Joint Supervisory Teams, in

which BaFin employees work together with supervisors from the entire euro area. At least at the outset, the SSM’s supervision of the major banks follows a more quantitative approach based on key performance indicators. This makes it possible to better compare institutions and their risks, which in turn also renders it easier to treat them equally. In addition, the SSM will have a closer look at the major banks’ risk management systems and the sustainability of their business models.

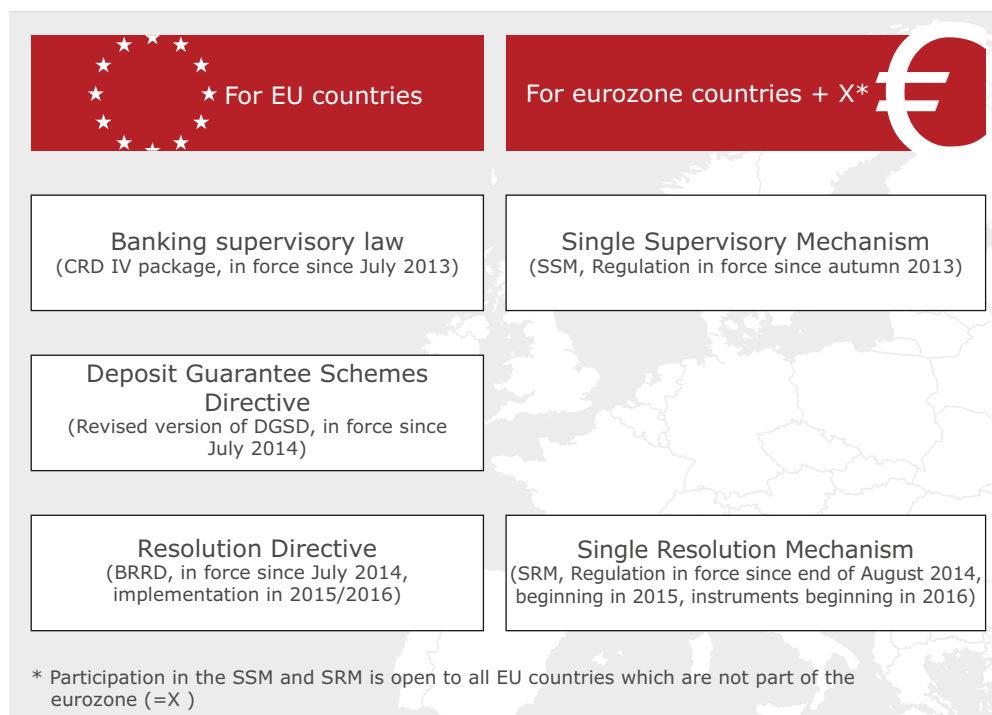
SSM sets the course

The so-called less significant institutions are supervised indirectly by the new European supervisory regime and, quite sensibly, remain subject to national supervision. However, the SSM will standardise the various practices by the national supervisors and ensure that these institutions are subject to supervision in all eurozone countries in accordance with uniform standards. Among other things, if national supervisors fail to comply with the joint supervisory standards, the ECB can assume full responsibility for supervising a less significant institution.

BaFin considers it useful for the SSM to issue uniform standards for the entire euro area. However, the standardisation of regulation and supervision must not go too far. Different things

1 See BaFin’s 2013 Annual Report, Chapter III 1.1. The CRD IV package comprises the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR).

Figure 1 Legal bases for the banking union



Source: Federal Ministry of Finance

should be regulated differently, and unique national features must be taken into account.

Division of roles and decision-making processes

The SSM is a network in which supranational actors and national supervisors work closely together; each must first find its place, which includes initial frictional losses. However, it will also remain important going forward to continue to keep a critical eye on the division of roles in the supervisory teams. The same applies to the SSM's decision-making processes. The Supervisory Board, in which BaFin is also represented, will have to deal with a very large number of proposals. However, under the current legal situation, only the ECB's Governing Council can make binding supervisory decisions. The members of the Governing Council hence also have to address these proposals. In order to strengthen the Board, a non-objection procedure has been introduced. Proposals by the Board are deemed accepted by the Governing Council if they are not objected to within ten working days. Moreover, the Governing Council may not amend the Supervisory

Board's proposals; it may only accept or reject them. Despite this, there is still a risk that it will take too much time for decisions to be made. Consideration should be given to delegating formal decision-making powers to the Supervisory Board, the upper management of the SSM or even to the supervisory teams. This would ensure a stricter separation between monetary policy and banking supervision.

Comprehensive assessment

Prior to the launch of the SSM, the ECB conducted a comprehensive assessment in which it examined 25 German institutions and 105 other European institutions, in order to assess the recoverability of assets reported on and off their balance sheets as well as to assess the institutions' ability to weather a crisis. The institutions assessed were those which would subsequently be subject to direct supervision by the SSM. At peak times, approximately 250 supervisors and 1,700 auditors were involved in the assessment in Germany alone. The assessment consisted of an asset quality review and a stress test. The objective was to create transparency and

I

II

III

IV

V

VI

Appendix

to detect any legacy liabilities and capital shortfalls.

The participating German institutions fared encouragingly well: almost all made it to the finish line without tripping over a single hurdle. The German banks demonstrated their ability to even withstand a stress scenario. In such a scenario, they would have sufficient capital to survive a severe global financial shock. Only Münchener Hypothekenbank eG had a capital gap – amounting to €229 million. However, the key date for the comprehensive assessment was 31 December 2013. Since then, the institution has implemented a €408 million capital increase, closing the gap comfortably. Hence, no German bank had a “net capital gap”.

2.2 Resolution mechanism for euro area banks

At the beginning of 2015, the Single Resolution Mechanism (SRM) commenced preparatory work as a second pillar of the European banking union. At the beginning of 2016, the Single Resolution Board (SRB) – the SRM’s key decision-making body – will take on full powers to resolve significant banks of the eurozone and those with cross-border activities.² In addition, a joint resolution fund will be created starting in 2016; it will be funded through fees paid by the banks.

On the basis of the Bank Recovery and Resolution Directive, the SRM will make possible the orderly resolution of significant, cross-border banks experiencing financial difficulties (see info box “Bank recovery and resolution”). The objective is for this to be done without society at large suffering losses and without taxpayers being asked to contribute.

The bail-in will replace the bail-out as the primary resolution tool because the fundamental market principle of liability must also apply to major banks again. It must be clear to them that the government will not

² Responsibility for less significant banks and banks without cross-border activities will remain with the national resolution authorities.



Bank recovery and resolution

The European Bank Recovery and Resolution Directive implements the requirements laid out in the Financial Stability Board’s “Key Attributes of Effective Resolution Regimes” paper for credit institutions and investment services enterprises in the EU. In turn, the German Act on the Recovery and Resolution of Credit Institutions (*Gesetz zur Sanierung und Abwicklung von Kreditinstituten – SAG*) transposes the Bank Recovery and Resolution Directive into German law. It entered into force on 1 January 2015. One of the key new features of the Directive is that shareholders and creditors may now be required to participate in the losses of an institution and in the cost of resolution. Certain key provisions of the Directive had already been introduced into German legislation in a similar form (Ringfencing Act (*Risikoabschirmungsgesetz*)) in 2013, such as the provisions relating to recovery planning, resolution planning, requirements a review of the institutions’ resolvability and the powers to eliminate impediments to resolvability. Germany has played a significant role in helping to shape key aspects of European standards for recovery and resolution.

bail them out if they experience financial difficulties. Accordingly, they should manage their risks responsibly. Above all, the resolution mechanism is intended to have a preventative and disciplinary effect. To that end, it must develop a detailed and credible resolution plan – based on the institutions’ recovery plan.

Sufficient funds eligible for bail-in

In the worst-case scenario, it will be vital for banks to have sufficient funds which are eligible to be used in a bail-in. Only in that way can owners and creditors bear the bank’s losses and sufficiently recapitalise the institution’s key functions through their contributions. The two constitute the elementary conditions for an orderly resolution. The EU Bank Recovery and Resolution Directive therefore requires

banks to maintain a minimum amount of eligible liabilities. At the G20 level, the Financial Stability Board (FSB) has issued a similar proposal on the total loss-absorbing capacity (TLAC).

In addition, regulations must be created that ensure that liquidity can be secured during the resolution so that it does not become necessary to use public funds from the member states or their central banks. This is also an issue faced by the FSB, as well as by the Single Resolution Board.

The success of the SRM will depend also on it functioning effectively. Here, too, decision-making must not take too long. The collaboration between the SRB and the national resolution authorities, the new European banking supervision, the European Commission and European Parliament must also be effective.

Creating a global regime

The European Union has chosen the only sensible approach for its eurozone resolution regime, namely, a cross-border approach. However, the “too-big-to-fail” problem requires a global solution. Thus it is important to now focus on work to develop a global framework for global systemically important banks and to promote globally harmonised resolution practices. BaFin will continue to work with the FSB to develop a global package of such measures as soon as possible. In the meantime, the EU should work with third countries as quickly as possible in the context of the Bank Recovery and Resolution Directive to harmonise systems and tools and to negotiate for mutual recognition.

2.3 Directive on Deposit Guarantee Schemes



European depositors will in future have an improved legal right to compensation for their covered deposits if a credit institution is unable to repay the deposits itself and there is no

prospect of the deposits being repaid at a later date. This is stipulated in the new European Directive on Deposit Guarantee Schemes, which entered into force in the summer of 2014 and which represents one of the key components of the banking union.

Under the Directive, depositors are to be compensated faster: By no later than 1 January 2024, they will have to receive their compensation within seven days of the compensation event having been determined. Pursuant to the draft German implementing act which will enter into force on 3 July 2015, this will already be the case beginning on 1 June 2016. For comparison's sake: At present, compensation has to be paid within 20 working days of a compensation event having been determined.

As before, amounts of up to €100,000 per depositor per credit institution are covered under the Directive. Savers enjoy special coverage: within three to 12 months from the date of deposit – the draft German implementation act calls for a six-month period – they have the right to also receive compensation for deposits in excess of €100,000 up to a maximum limit of €500,000. The condition is that the deposit is related to specific life events.

Under the new Directive, all credit institutions will in future have to be allocated to a statutory guarantee scheme – or a scheme that is officially recognised. Under the draft of the implementation act, schemes in Germany will be recognised by BaFin. BaFin will also supervise the guarantee schemes in Germany comprehensively, as it already does for the statutory compensation schemes. Despite the new provisions, the deposit guarantee structure in Germany, which has evolved historically, can remain in place. To hold the institutions themselves accountable, the Directive stipulates that all deposit guarantee schemes must be funded ex ante.

I

II

III

IV

V

VI

3 Consumer protection



The financial sector and its supervisors are currently facing a host of new regulations designed to protect consumers.

Retail Investors Protection Act

The planned Retail Investor Protection Act (*Kleinanlegerschutzgesetz*) will expand the prospectus requirement, call for more current information for investors and put in place stricter requirements regarding distribution and marketing. It will provide BaFin with new competences in the field of consumer protection, although BaFin may still not defend the rights of individual investors or customers. Going forward, BaFin will thus continue to act solely in the public interest and to be committed to collective consumer protection. This will now be anchored in law as a further supervisory objective of BaFin in all supervisory areas. This will enable BaFin to better integrate civil-law protections and court rulings in all of its directorates.

MiFID II creates new requirements

The revised version of the European Markets in Financial Instruments Directive (Markets in Financial Instruments Directive II – MiFID II) will set out stricter requirements for documentation. Article 25 (6) stipulates a statement of suitability. In that statement, investment firms will in future have to explain “how investment advice meets the preferences, objectives and other characteristics of the retail client”. Furthermore, all communication relevant to the order must be recorded, including any telephone conversations, e-mails, faxes or one-on-one discussions.

MiFID II sets out a host of further provisions aimed at investor protection, such as those relating to the acceptance of commissions, cost transparency and product design. For instance, under MiFID II, providers will be obligated to align their products with the interests of consumers as early as the product development stage. Issuers subject to MiFID and distributors will have to define in advance the target market on which their product is to be distributed.

The European Securities and Markets Authority (ESMA) provided the European Commission with details on these provisions in December 2014 which are now being used as a basis for developing legislative proposals expected by 2 July 2015.

The field of banking and insurance regulation will soon also have similar product oversight governance (POG) requirements. The European Banking Authority (EBA) and its counterpart for the insurance business and occupational pensions, the European Insurance and Occupational Pensions Authority (EIOPA), are working on corresponding guidelines which are expected to be adopted in the summer of 2015. And the planned revision of the European Insurance Mediation Directive, the Insurance Distribution Directive (IDD), is also tackling the issue.

PRIIPs and IDD

The PRIIPs Regulation introduces a standard key information document for packaged retail and insurance-based investment products (PRIIPs). Beginning at the end of December 2016, providers must distribute this type of informational document to their customers, e.g., for investment funds, certificates and endowment life insurance policies. The PRIIPs Regulation gives new market monitoring and product intervention powers to EIOPA, similar to those of the EBA and ESMA.

The planned revision of the Insurance Mediation Directive focuses on distribution in general and no longer solely on insurance intermediaries, which is why it is being renamed the Insurance Distribution Directive. For instance, the IDD draft contains wide-ranging information obligations relating to the products mediated as well as to potential conflicts of interest and the remuneration of the intermediary. The proposal leaves the question of whether commission payments by third parties – which essentially means the insurers – should be permitted or forbidden to the discretion of the individual member countries.

Balanced consumer protection

In contrast to MiFID II, the IDD grants the member countries leeway in its implementation. BaFin believes it is important to find balanced solutions. What is certain is that consumers need special protection because they are not in as strong a position as providers and professional investors. They do not possess the same knowledge, nor do they have comparable access to information or a legal department to help them decipher the small print and analyse the promises of returns. The state must therefore create a legal environment which puts retail investors in a position to sufficiently inform themselves before making investment decisions. Key elements of consumer protection include documentation, transparency, product design and distribution.

Yet there must be a balance between the legitimate interests of consumers and the equally legitimate interests of the undertakings. Providers should not be crippled by excessive administrative requirements, nor should their innovative spirit be stifled. Furthermore, there must be a balance between government regulation and the consumer's own responsibility. Regulating the unregulated capital market is a good example of this. Consumers have previously enjoyed hardly any protections in this segment. The Retail Investor Protection Act is intended to help in this regard. The German federal government has purposefully avoided taking the radical step of closing the segment off to retail investors because by locking them out it would effectively be depriving them of their right to make their own decisions.



4 Opinion

Dr Elke König on how much regulation we need

How much regulation do we need? Do we need it at all? No. Yes. If so, then only a little. Throughout the past, the economy has time and again offered up different – although not necessarily better – answers to these questions. This would hardly be worth mentioning if politico-economic theories had not repeatedly served as the basis for regulatory approaches, resulting in a cycle of crisis then regulation then deregulation then crisis.

In the decades prior to the outbreak of the global financial crisis, deregulation was clearly favoured. Let the markets sort it out, they said; have faith in the markets. There were lone voices in the desert who warned of the consequences of deregulation, yet hardly anyone paid them any heed. Effective regulation was not in vogue, as long as the profits were pouring in. Any regulation to be had was light-touch. And precisely that



Dr. Elke König

served as BaFin's President until the end of February 2015 and is now Chairwoman of the Single Resolution Board in Brussels.

was the problem: in the period before the crisis, there were in fact a large number of regulatory provisions, although many of those were evidently ineffective. One key reason the 2007/2008 financial crisis came to pass was that the international regulatory standards which many countries had transposed into their national law, thus rendering them binding on supervisors and supervised entities, contained gaps. This is not to say that supervisors did not also commit errors.

I

II

III

IV

V

VI

Appendix

A call for greater regulation

After the crisis broke out, the winds changed – including in the media and in public opinion. All of a sudden, a giant army of regulatory proponents entered the fray. Expectations placed on regulation were accordingly high in some respects: all that needed to be done was to pull back hard on the reins, and that would be enough to stop crises in their tracks. However, that is not and should not be what regulation is all about. Placing excessive faith in the state is in no way better than placing excessive faith in the markets as seen over the past decades.

One thing is certain: financial stability is a public good. Everyone must be able to have confidence that the financial sector is stable: every citizen, every company in the real economy, and every actor on the financial markets. Without regulation and absent any effective government supervisors who enforce this regulation in the public interest without serving any economic interests of their own, there can be no stability, and no confidence in stability. What supervisors need is a comprehensive, stable and coherent framework to guide them in keeping control over financial market risks – one which offers market participants the right incentives and motivates them to act in a risk-conscious manner. What is not acceptable is a situation where the financial sector's profits are privatised while its losses are absorbed by society.

Not overshooting the mark

In their efforts to create such a framework, standard-setters and legislators must avoid overshooting the mark. The G20 heads of state and government were well aware of this when they set their post-crisis regulatory objectives in November 2008 in the wake of the Lehman collapse: they called for regulation of all financial markets, products and market participants, albeit – and this is decisive – “as appropriate to their circumstances”.³

Regulation is appropriate when it helps to mitigate the destructive forces of crises while at the same time granting market participants the necessary flexibility to innovate and do business. The complete elimination of all risk cannot be the objective of regulation, because this would lead to stagnation. Those seeking to curb the financial industry's readiness to take on risks stifle the markets, thus harming society at large. In short, there should be as much freedom as possible and as much regulation as necessary.

Sensitivity to risk

How do you find the right balance? The greatest challenge lies in anticipating potential problems in advance. It is not enough to close the known loopholes. The next crisis will be different than the last – triggered by other events and affecting other parties. The material is complex, the risks manifold. There are no easy solutions for regaining and maintaining control over the situation. This is directed at all apologists of simplification who call for a rejection of risk sensitivity, one of the major regulatory achievements in past years and one of the pillars of appropriate regulation.

Anyone claiming that risk sensitivity primarily helps banks to play down risks and that instead they should be subject to blanket requirements needs to remember how disastrous the inappropriate incentives arising from blanket regulations can be. A return to the sweeping matrix of regulations set out in Basel I, which was one of the reasons for the crisis, would be a tremendous mistake. And anyone claiming that these blanket requirements should be raised to 30% should be reminded that regulation needs to be appropriate, otherwise the economy risks stagnation. Minimum requirements such as the leverage ratio are sensible and necessary – they complement risk-sensitive quantitative requirements and high qualitative requirements placed on risk management. Where risk sensitivity is concerned, there is even some catching up to be done, as illustrated by the way government bonds have been dealt with. Of course, it also bears asking

³ Declaration of the Summit on Financial Markets and the World Economy, Washington D.C., 15 November 2008.

whether certain risks can even be modelled – as for instance operational risk.

Proportionality

Appropriateness also means above all not using a sledgehammer to crack a nut. The principle of proportionality must be applied; that principle is closely related to risk sensitivity. In implementing the Basel framework, the EU was guided by that principle and allowed for distinctions being made. For instance, although all institutions must have sufficient own funds, a greater own funds buffer is required of systemically important banks, which are also subject to stricter supervision.

This also means that different things should be regulated and supervised differently. The Single Supervisory Mechanism (SSM) now issues uniform standards for the entire euro area; this is one of the stated objectives of the new supervisory regime and it is also sensible – to a certain degree. The standardisation of regulation and supervision must not go so far as to provide uniform treatment for different things. Established national peculiarities must be taken into account. The SSM is not intended to eliminate them. This applies for instance to Germany's three-pillar model, which is unique in Europe.

One further aspect of appropriateness: the objective of any regulation is to minimise damage to the general welfare without causing unnecessary costs. EU legislation must therefore anticipate the legal consequences and costs that come with laws. One thing should be clear: greater security and stability has its cost and – as banal as it may sound – those who invest in that are investing in their future.

Desired effect

Each and every individual regulatory step must be appropriate and result in the desired effect. There must be no unintended side effects or interdependencies. Impact studies help to identify these. Some side effects are obvious. For instance, it is well known that we risk swerving into the shadow banking sector if we impose stricter regulation on banks. This cannot lead us to avoid imposing stricter regulation on banks. It can only mean fully regulating the shadow banking sector along with the links between it and the regulated sector, a task we have been working on for some time now. It is also well known that although the obligation to settle standardised OTC derivatives via central counterparties leads to greater transparency and security, it must be ensured that no new systemic risks build up at the central counterparties. The only solution is a framework for recovering and resolving such counterparties, which the FSB and Brussels have already recognised.

How rules work in the real world, whether they are realistic and whether or not they can be monitored can only be assessed after they have been in effect for some time. Certain key regulatory projects must be dealt with quickly – the two aforementioned projects are included therein, as well as the long-overdue global framework for recovering and resolving systemically important banks. However, 7 years after Lehman, we have to move on to implementing them in an even-headed manner and then – after a while – ask the critical questions, whether the efforts to transform the many regulatory units into a single, stable, coherent and appropriate framework for the financial markets have been successful. Therein lies the lofty objective of regulation, and such an objective cannot be realised at the drawing board alone.

I

II

III

IV

V

VI

Financial crisis and regulation: timeline of important events in 2014

January	<ul style="list-style-type: none"> ▶ In a special agreement between the Swiss Financial Market Supervisory Authority (FINMA) and BaFin, the cross-border distribution of German undertakings for collective investment in transferable securities (UCITS) in Switzerland was allowed, as was the distribution of Swiss securities funds in Germany via an electronic notification procedure. ▶ Turkey's central bank raised its key interest rate from 4.5% to 10% in order to stop the sharp depreciation in the Turkish lira.
February	<ul style="list-style-type: none"> ▶ The Federal Constitutional Court (<i>Bundesverfassungsgericht</i>) submitted the decision by the European Central Bank (ECB) relating to the purchase of government bonds to the Court of Justice of the European Union (CJEU) for review. ▶ The requirement that derivatives transactions be reported to the trade repository pursuant to Article 9 of the European Market Infrastructure Regulation (EMIR) entered into force. ▶ In a reaction to the LIBOR scandal, the European Parliament adopted a Directive imposing tougher penalties for market manipulation and insider dealing.
March	<ul style="list-style-type: none"> ▶ The Federal Constitutional Court rejected actions against the establishment of the European Stability Mechanism (ESM). ▶ The ECB published an asset quality review (AQR) manual for banks identified as significant institutions, which will be subject to direct supervision by the Single Supervisory Mechanism (SSM). The AQR constitutes part of the comprehensive assessment prior to the launch of the SSM.
April	<ul style="list-style-type: none"> ▶ The ECB published the SSM Framework Regulation, a cornerstone of the Single Supervisory Mechanism. ▶ BaFin admitted Eurex Clearing AG as a central counterparty (CCP) pursuant to Article 14 of the EMIR.
May	<ul style="list-style-type: none"> ▶ The Omnibus II Directive, amending the Solvency II Directive, entered into force. The effective date for the new supervisory regime under Solvency II will be 1 January 2016. ▶ The German federal government published a plan of action on consumer protection in the financial market. Under the plan, collective consumer protection is to be anchored in the legislation as a supervisory objective of BaFin and the unregulated capital market is to be subject to greater regulation. ▶ Eleven EU member countries, including Germany, agreed on the next steps in relation to the financial transaction tax. ▶ Portugal exited the European Financial Stability Facility (EFSF) as planned.
June	<ul style="list-style-type: none"> ▶ The ECB reduced the key interest rate on main refinancing operations to 0.15%. For the first time ever, it introduced negative interest of -0.1% for the deposit facility. Moreover, targeted longer-term refinancing operations (TLTROs) are intended to stimulate lending to non-financial entities in the private sector. ▶ The German stock index DAX (<i>Deutscher Aktienindex</i>) passed the 10,000-point mark for the first time ever.

	<ul style="list-style-type: none"> ▶ Doubts as to the liquidity of certain banks led to a bank run in Bulgaria. The situation settled down after liquidity support amounting to €1.6 billion was provided. 	I
July	<ul style="list-style-type: none"> ▶ The EU directive on the recovery and resolution of banks entered into force. In the event a bank fails, the owners and creditors must be first to bear losses before a resolution fund financed by the banking industry can step in in exceptional cases. The EU Directive on deposit guarantee schemes, which also entered into force, stipulates that following the occurrence of a guarantee event, deposits of up to €100,000 must be paid out to bank customers within seven working days. ▶ The transitional periods stipulated in the Investment Code (<i>Kapitalanlagegesetzbuch</i> – KAGB) expired. The distribution of open-ended and closed-end investment funds requires the authorisation of BaFin. ▶ The Market Abuse Regulation (MAR) was published. It largely replaced the existing national rules on market abuse and expanded the focus to OTC trading venues. ▶ In response to the crisis in Ukraine, the European Union imposed sanctions on Russia, including restricting Russian banks' access to the capital markets. 	II
August	<ul style="list-style-type: none"> ▶ The Single Resolution Mechanism (SRM) Regulation entered into force; the harmonisation of the deposit insurance systems and the Single Supervisory Mechanism (SSM), along with the SRM, form the backbone of the banking union. The Single Resolution Board (SRB) will receive its full powers in 2016. In addition, a joint resolution fund will be created starting in 2016; it will be funded through fees paid by the banks. ▶ The German Life Insurance Reform Act (<i>Lebensversicherungsreformgesetz</i> – LVRG) was promulgated. The new provisions are intended to counteract the consequences of the persistent low-interest rate level so that policyholders will continue to receive promised benefits in future. The act contains a bundle of measures to ensure that all insurance business players make an appropriate contribution. ▶ The Fee-Based Investment Advice Act (<i>Honoraranlageberatungsgesetz</i> – HAnIBG) entered into force. It contains organisational requirements and information obligations as well as a limitation on inducements for investment services enterprises which provide investment advice for a fee. BaFin maintains a public registry of fee-based investment advisers on its website. ▶ The ECB published a stress testing manual; stress tests are also a component of the comprehensive assessment. ▶ The UCITS V Directive was published. The Directive contains in particular expanded requirements in relation to depositaries and sub-custodians, as well as requirements for the remuneration policy of UCITS management companies. ▶ Portugal supported Banco Espírito Santo, a major bank experiencing financial difficulties, by issuing it a loan funded by the EU bail-out package. ▶ Bank of America paid a record fine of nearly \$17 billion, settling its years-long dispute with US authorities concerning the sale of bad mortgages. ▶ Argentina refused to repay old bond debts to US hedge funds. This led rating agencies to confirm the partial default of the country. 	III
		IV
		V
		VI

<p>September</p>	<ul style="list-style-type: none"> ▶ The Central Securities Depository Regulation (CSDR), designed to improve securities settlement in the EU and on central securities depositories, entered into force. Going forward, central depositories (CSDs) will be subject to harmonised supervision in Europe. ▶ The FSB published its final report on currency benchmarks, including recommendations for methodological improvements and avoiding conflicts of interest in currency trading. The report supplements the review of the key interest rate benchmarks (LIBOR, Euribor, TIBOR) by the IOSCO (International Organization of Securities Commissions). ▶ The ECB lowered its key interest rate for main refinancing operations to 0.05% and its interest rate for the deposit facility to -0.2%. In addition, the ECB announced purchase programmes for asset-backed securities (ABSs) and covered bonds. ▶ The Federal Cabinet adopted the draft Act on the Modernisation of the Financial Supervision of Insurers. The Act transposes the EU's Solvency II Directive into national law.
<p>October</p>	<ul style="list-style-type: none"> ▶ The international financial markets briefly experienced turbulence and panic. The geopolitical risks and concerns surrounding yet another flaring up of the sovereign debt crisis in Europe increased. ▶ The ECB announced the results of the comprehensive assessment (AQR and stress test.) 25 of the 130 eurozone institutions had a capital shortfall (totalling €25 billion), including one German bank. Many institutions – including the affected German bank – had successfully covered the calculated capital shortfall prior to the publication of the results. ▶ BaFin publishes standard text modules for cost provisions for closed-ended retail investment funds. In this way, it ensures a uniform administrative practice and high consumer protection standards in the supervision of products under the KAGB, which had previously been sold on the unregulated capital market.
<p>November</p>	<ul style="list-style-type: none"> ▶ The Bundesrat and Bundestag adopted the package of measures relating to the banking union. This included in particular the German Act on the Recovery and Resolution of Credit Institutions (<i>Sanierungs- und Abwicklungsgesetz – SAG</i>), transposing the Bank Recovery and Resolution Directive into German law, and paved the way for recapitalising banks directly via the European Stability Mechanism. ▶ One year after the SSM Regulation entered into force, the ECB assumed direct supervision of 120 significant groups of banks in the euro area, including 21 from Germany. ▶ BaFin presented the findings of the "Vollerhebung Leben" survey, which examined the own funds situations at all 87 German life insurance undertakings under the future Solvency II supervisory regime: Taking into account the transitional measures and volatility adjustment, the undertakings are well prepared for Solvency II, overall.

	<ul style="list-style-type: none"> ▶ EIOPA published its final report of the Europe-wide stress test for insurance undertakings. The results confirmed that a persistent phase of low interest rates remains a major challenge for the German insurance sector. ▶ The G20 states adopted the Basic Capital Requirements (BCRs), the first global standard for calculating capital requirements for <i>global systemically important insurers (G-SIIs)</i>. The International Association of Insurance Supervisors (IAIS) had published the BCRs in October.
December	<ul style="list-style-type: none"> ▶ The price of crude oil continued to drop, hitting a five-and-a-half-year low. ▶ The ruble suffered extreme depreciation. In response, the Russian central bank raised its key rate from 10.5% to 17% and used currency reserves to support the domestic currency. ▶ Fears of a government crisis in Greece raised concerns that the European sovereign debt crisis could flare up again.

I

II

III

IV

V

VI

Appendix



II Integrated financial services supervision

1 Macroeconomic environment

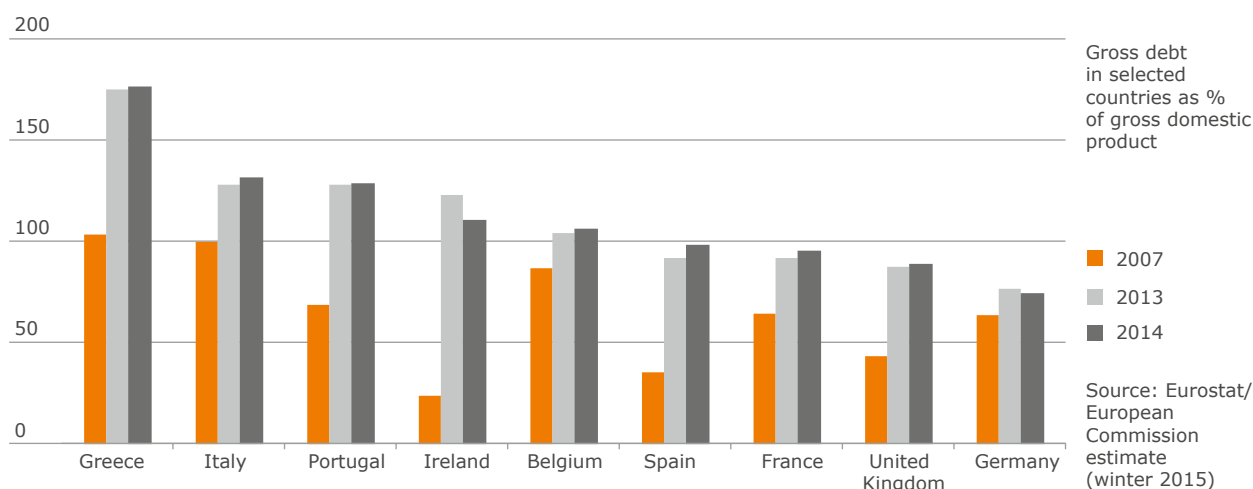
Growing geopolitical tensions and the continued expansionary monetary policy of the European Central Bank (ECB) and other central banks dominated the financial markets in 2014. Through several key interest rate cuts and unconventional measures, such as the purchase of securities, the ECB laid the foundations for ample liquidity supplies. On the money and capital market, interest rates – already at extraordinarily low levels – declined further.

In Germany, economic growth slowed only slightly in the course of the year, despite various negative factors. Towards the end of the year, the collapse in crude oil prices provided fresh impetus for the economy. The number of company insolvencies decreased further, while unemployment remained at a historically very low level. The overall stable condition of the economy also benefited the German financial sector.

Geopolitical risks increased primarily as a result of the Ukraine crisis. In the second half of the year, Russia suffered increasingly from the sanctions imposed on the country, as well

as from the drastic collapse in crude oil prices. The rouble depreciated massively, and capital outflows from Russia accelerated. Because of its strong dependence on oil exports, the Russian economy entered a sharp downturn. The effect of global tensions and declining commodity prices also spread to other major emerging economy countries – albeit to a significantly smaller extent.

In the face of the political events, the European sovereign debt crisis tended to recede into the background in 2014. With the help of structural reforms, most of the struggling eurozone countries managed to improve their competitiveness further, but the ECB's extremely loose monetary policy continued to hide in some cases serious problems in some of the crisis-hit countries. Thus, ten-year government bond yields in Spain, Italy, Portugal and Ireland fell to new record lows towards the end of 2014. In this context, the low interest rates stand in stark contrast to sovereign debt, which continues to rise and will be almost impossible to bear in the long term (see Figure 2 "Sovereign debt ratios in Europe", page 29),

Figure 2 Sovereign debt ratios in Europe

and in some cases faltering enthusiasm for reform. France was likewise unable to make any meaningful headway in consolidating its public finances: the country's debt has grown to almost the same level as its annual gross domestic product; Belgium's debt has already exceeded annual GDP.

Even if some successes have been achieved, it has not been possible to overcome the sovereign debt crisis, which has been smouldering since 2010. A short phase of uncertainty was triggered in October 2014, when Greece announced that it would leave the European bailout facilities, even though this was largely discredited as implausible on the financial markets. Nevertheless, the risk spreads of the crisis-hit countries widened temporarily and share prices in Europe declined significantly. However, fears on the financial markets that the sovereign debt crisis could flare up again were fuelled at the end of December: Greece was forced to schedule early elections for the beginning of 2015, and as a result risk spreads for Greece rose sharply, at least temporarily.

Greece is a striking example of how susceptible the financial markets are to disruptions from both inside and outside. There were concerns that, if investors were to fundamentally reassess the risks, this could trigger sharp price adjustments and increased volatility in

different market segments, which would in turn pose a potential threat to financial stability. For this reason, the expansionary monetary policy of the ECB and other leading central banks was increasingly scrutinised in the course of the year. Because of the persistently low interest rates, risk-averse investors struggled to find financial products with which they could increase or at least maintain their assets in real terms, i. e. net of inflation.

This increased the pressure on investors to take greater risks. The search for returns drove up prices in many asset classes. If prices deviate too far from their fundamentally justified levels and investors take excessive risks in looking for returns, there is a danger of price bubbles. In unfavourable circumstances, such price bubbles may burst suddenly and in an uncontrolled manner, as was witnessed in the case of the subprime mortgage crisis in the United States.

In some market segments, the financing conditions and valuations returned to levels in 2014 that had last been seen shortly before the start of the financial crisis in 2007. In the case of some instruments and investors, such as hedge funds, an increased degree of leverage was observed again in 2014. Highly indebted players are particularly susceptible to crises when there are sudden sharp price falls.

The importance of the market for high-yield bonds has increased significantly in recent years, especially in Europe, driven by a rise in the number of issuances and buoyant demand. Despite the expanded offering, the bond spreads declined in 2014, falling to multi-year lows. In a low interest rate environment, the market benefited from a combination of low default rates, expansionary monetary policy and low market volatility. However, since the default rates of high-yield bonds are very volatile in the long term and are usually significantly higher than those of investment-grade bonds in times of crisis, a less favourable environment could quickly lead to an accumulation of defaults and cause substantial losses for investors.

In the United States, the market for leveraged loans – senior secured loans with variable interest rates granted to borrowers of poor financial standing – expanded significantly in 2014. An especially striking aspect is that the lending conditions in this segment were increasingly relaxed, with risk spreads contracting at the same time.

These examples demonstrate that, in the absence of profitable alternatives, many investors are prepared to take investment risks for which they may not receive adequate compensation.

Should there be a shift in trends on the financial markets resulting in a significant interest rate hike, it is possible that investors could suddenly withdraw their funds from overheated risky markets en masse and move them into lower-risk investment. Market volatility would soar and liquidity would plummet abruptly, especially in tight markets. Issuers that have become accustomed to attractive loans with short maturities could face serious funding problems, especially since the need for funding will be relatively high until 2017. Moreover, if interest rates rise, default rates are expected to increase as well, especially if the higher interest rates coincide with an economic downturn. Ultimately, the explosive mix of market, liquidity and credit risks, with various contamination and feedback effects, could threaten the stability of the financial system itself, if inflated market prices were to experience a sharp correction.

2 Financial stability

2.1 Global systemically important financial institutions

Having specified the frameworks for global systemically important banks and insurance undertakings, the Financial Stability Board has now also categorised financial institutions whose size, interconnectedness or other factors could also lead to turbulence in the global financial system if they were to become distressed, but which are not covered by either of the two frameworks. They are referred to as non-bank, non-insurance global systemically important financial institutions (NBNI G-SIFIs). Together with the International Organization of Securities Commissions (IOSCO), the Financial Stability Board developed a methodology for identifying NBNI G-SIFIs, which was published for consultation at the beginning

of 2014. In addition to a description of transmission channels, factors impacting the institutions' systemic importance and rules for implementing the framework, the consultation paper also contains specific methodologies for finance companies, investment firms and investment funds.

On the basis of the comments received during the consultation process, the framework was revised and specified in greater detail. The FSB also incorporated some new aspects – in particular the idea of examining not only individual investment funds, but also those risks that arise at the higher level of asset managers. The focus is less on the traditional portfolio management business than on non-traditional activities, such as securities

financing. At the beginning of March 2015, the FSB and IOSCO put the revised methodology up for consultation. In this document, they also propose new thresholds for investment funds. Thresholds work like filters: funds are included in the detailed risk assessment only if they exceed certain limits, for example for net assets under management.

The plan is to adopt the framework for global systemically important non-banks and non-

insurers by the end of 2015. Next on the plan is the development of legal consequences, and the last step is to determine which institutions are to be classified as NBNI G-SIFIs. The intention is that the FSB will publish an annual list of non-banks and non-insurance undertakings classified as globally systemically important, as it does for global systemically important banks and insurance undertakings.



2.2 Focus

Macroprudential instruments and strategy

Author: Matthias Heinze, Secretariat of the Cross-Sectoral Risk Committee

Further supervisory perspectives

One of the key lessons learned from the global financial crisis of 2007/2008 is to broaden BaFin's perspective: across individual undertakings and sectors to cover the stability of the entire financial system – irrespective of national borders, if possible.

The first aim of a macroprudential approach is to gather, pool and aggregate up-to-date information across a wide spectrum. The data processed in this way must then form the basis of detailed analyses aimed at identifying developments that threaten stability or at detecting systemic risks. To influence such developments or risks, well-targeted supervisory measures have to be introduced, whose success must subsequently be assessed.

Institutional framework

At the end of 2010, the European Union already concretised this approach by establishing a macroprudential oversight body: the European Systemic Risk Board (ESRB), which is part of the European System of Financial Supervision

(ESFS).¹ The role of the ESRB is to identify developments that may impact on financial stability and to detect systemic risks in the EU and, where necessary, to issue warnings and recommendations to the member states or the competent national authorities. One of the recommendations issued to the member states to date was that authorities should also be given the task of macroprudential financial supervision at the national level. Germany implemented this recommendation by adopting the German Financial Stability Act (*Finanzstabilitätsgesetz – FinStabG*) of 28 November 2012 and by establishing the Financial Stability Commission (*Ausschuss für Finanzstabilität – AFS*, see info box, page 32).

Tasks of the Financial Stability Commission

The Financial Stability Commission institutionalises and improves cooperation of the institutions represented on it – including in, but not limited to, crisis situations. One of its main tasks is to continually monitor and assess the

¹ The European Supervisory Authorities (ESAs) are also members of the ESFS.

Financial Stability Commission

The Financial Stability Commission (*Ausschuss für Finanzstabilität*) started its work at the beginning of 2013, replacing the Standing Committee on Financial Market Stability (*Ständiger Ausschuss für Finanzmarktstabilität*). The Financial Stability Commission comprises representatives from the Federal Ministry of Finance (*Bundesministerium der Finanzen*), the Deutsche Bundesbank and BaFin as well as one non-voting representative from the Financial Market Stabilisation Agency (*Bundesanstalt für Finanzmarktstabilisierung – FMSA*). The Commission meets on a quarterly basis. BaFin's President and Chief Executive Directors for banking and insurance supervision regularly participate in the meetings. BaFin uses the findings of the Commission's work for its microprudential supervision. The Commission reports on its work annually to the Bundestag. The first report, which was published on 16 June 2014, can be accessed on the website of the Federal Ministry of Finance.²

stability of the German financial system (see info box "Financial Stability Commission's focus areas in 2014 and 2015", page 33). Moreover, the Commission discusses ways of dealing with the warnings and recommendations of the ESRB. It can also issue its own public or confidential warnings and recommendations to counter potential threats to Germany's financial stability. These may be issued to BaFin, the federal government or another German public body. The Commission's work is based on the Bundesbank's findings from the macroprudential oversight of the financial system. The Financial Stability Act has given the Bundesbank the appropriate mandate. If the Bundesbank concludes that Germany's financial stability is at risk, it can propose to the Financial Stability Commission that it should issue warnings or recommendations and it can recommend measures it believes are suitable and necessary for countering the threat.

² <http://www.bundesfinanzministerium.de>

Macroprudential strategy

On the basis of the ESRB's recommendations and the requirements of the Financial Stability Act, the Financial Stability Commission developed a macroprudential strategy in 2014,³ which provides a general framework for the work of the Commission. For example, it names three areas that may cause or exacerbate systemic financial crises: the macroeconomic environment, aspects of the regulatory framework and market failure. In the strategy document, the Commission also outlines material risk factors that could threaten the stability of the financial system. They are excessive credit growth and excessive leverage, excessive maturity, currency and liquidity transformation, excessive direct and indirect risk concentrations, the systemic impact of misguided incentives and moral hazards as well as the systemic impact of disruptions to financial market infrastructures. The strategy also defines decision-making principles.

The Financial Stability Commission's strategy represents the latest development stage of macroprudential oversight in Germany. The Commission will review the strategy regularly, because this branch of supervision is a young discipline, which has been created primarily on the basis of experience gathered from the 2007/2008 financial crisis. It is therefore not surprising that so far the banking sector has been the focus of its considerations. As an integrated financial supervisor, BaFin aims to take adequate account of the other sectors as well.

Macroprudential instruments

The macroprudential instruments (MPIs) created to date at the European and national levels also relate to banks. They can be broken down into two categories: one category addresses systemic risks of a structural nature, such as risks associated with the systemic importance of market participants or the way they are interconnected in the financial system. The MPIs in the other category relate to the change in

³ This strategy is covered in the Commission's report of 16 June 2014.

Financial Stability Commission's focus areas in 2014 and 2015

In 2014, the Financial Stability Commission focused primarily on risks that may arise for credit institutions and life insurance undertakings from the low interest rate environment, and on developments on the German residential property market. In other countries, excesses on property markets were often the trigger of financial crises, especially during periods when significant price rises, combined with an excessive increase in real estate loans, also coincided with relaxed lending standards. There are currently no signs of this kind of destabilising mix in Germany. In addition to the ongoing monitoring of financial stability, the Commission will address in particular the preparations for the practical use of macroprudential instruments in 2015. As an authority with macroprudential intervention rights and an integrated financial supervisor, BaFin plays a special role in this context.

systemic risks over time, such as those that can arise in credit and asset price cycles. As from 1 January 2014, BaFin has the power to apply the first MPI, the systemic risk buffer, in accordance with section 10e of the German Banking Act (*Kreditwesengesetz – KWG*), although this has so far not been necessary. The other MPIs, such as the countercyclical capital buffer, which has to be reviewed once a quarter, and the capital buffers for systemically important institutions can be used from January 2016 onwards.

It will require great skill to ensure that these macroprudential instruments are used in a targeted yet carefully measured manner – a new and challenging area of activity for the Financial Stability Commission and its members. Another factor is that, as useful as these instruments may be, they cover, as described above, only the banking sector, not counting the additional interest provision (*Zinszusatzreserve*) required by insurance supervision, even though this is not referred to as a macroprudential instrument. The challenge remains to make the German financial market as a whole more resilient. This is another task facing the Financial Stability Commission.



2.3 Cross-Sectoral Risk Committee

In order to integrate macroprudential and microprudential supervision more closely, a separate Cross-Sectoral Risk Committee was established at BaFin in January 2013 to act as interface with macroprudential supervision by the Deutsche Bundesbank and the Financial Stability Commission.⁴ The Cross-Sectoral Risk Committee, which meets once a quarter, consists of representatives of all BaFin directorates as well as Bundesbank representatives. It deals with cross-sectoral risks and at the same time provides support for BaFin's forward-looking, risk-based

integrated financial services supervision. In 2014, it addressed not only developments in the Financial Stability Commission and the European Systemic Risk Board (ESRB) as well as preparations for the implementation of macroprudential instruments, but also with the comprehensive assessment of the eurozone's largest banking groups carried out before the launch of the Single Supervisory Mechanism (SSM).⁵ In addition, the Committee dealt with, among other things, the effects of the persistently low interest rates, property risks, country risks, risks in selected financial instruments and the issue of asset

⁴ See chapter II.2.2.

⁵ See chapter III.1.1.1.

encumbrance, i. e. third-party claims over assets of financial institutions and companies.

2.4 Supervision of financial conglomerates

The three European Supervisory Authorities (ESAs) have presented new guidelines, outlining their views on how adequate supervision of financial conglomerates should be designed in Europe. The guidelines were up for consultation until the beginning of June 2014 and have been in force since December 2014. The competent national supervisory authorities had to notify the ESAs by the end of February 2015 whether they were implementing the guidelines.

With these guidelines, the Joint Committee of the European Supervisory Authorities aims to complement any existing sectoral agreements and supervisory practices in the member states so that the foundation can be laid for consistent, coordinated supervision for the case that a cross-border group is identified as a financial conglomerate. The guidelines thus define the requirements of the Financial Conglomerates Directive in more detail.⁶

In particular, the guidelines regulate the process for determining a financial conglomerate, coordinating the exchange of information, assessing financial conglomerates by the supervisory authorities as well as planning and coordinating supervisory activities. In addition, they regulate the decision-making process among the authorities involved, thus ensuring that unnecessary overlap and duplication is avoided.

2.5 Regulation of credit rating agencies

2.5.1 Implementation of the Regulation on Credit Rating Agencies

On 30 September 2014, the European Commission adopted three regulatory technical standards to implement key

provisions of the Regulation on Credit Rating Agencies.⁷ BaFin participated in the drafting of the standards in the committees of the European Securities and Markets Authority (ESMA) that were involved.

The three regulatory technical standards set out the disclosure requirements for issuers, originators and sponsors of structured financial instruments, the reporting requirements of credit rating agencies for the European Rating Platform and the requirements for such agencies to inform their customers about costs.

2.5.2 New functions for BaFin

BaFin's area of responsibility expanded in the past year: pursuant to the German Act to Reduce Dependence on Ratings (*Gesetz zur Verringerung der Abhängigkeit von Ratings*), which entered into force at the end of 2014, BaFin now monitors compliance with those provisions of the revised Directive on Credit Rating Agencies that require national supervision, as specified by the European issuer of the Directive. This includes, among other things, regulations on the use of ratings and on excessive reliance on ratings. These issues are dealt with by Banking Supervision, as well as Insurance and Securities Supervision.

BaFin made use of market surveys and other tools to develop consistent standards for this function. For example, as part of one such survey, BaFin's Securities Supervision sections distributed a comprehensive catalogue of questions to over 20 investment services enterprises in the fourth quarter of 2014, asking them for information on how they are handling the regulation on excessive reliance on ratings. The results of the survey are expected to be available in the second quarter of 2015. On its website, BaFin informs certain market participants, for example issuers, about the new requirements under the Regulation.

⁶ Directive 2002/87/EC, OJ EC L 35.

⁷ Regulation (EC) No 462/2013, OJ EU L 146.

2.5.3 Revision of the Code of Conduct for Credit Rating Agencies

In 2014, BaFin also cooperated on updating the global standard for credit rating agencies, the IOSCO Code of Conduct. IOSCO amended the Code to ensure maximum harmonisation of the legal and supervisory regimes around the world. In recent years, a number of countries have introduced a legal or supervisory system for credit rating agencies or expanded existing systems and in this process adopted the Code of Conduct – in some cases a revised version of the Code – as a legally binding document. In particular the introduction of the legal and supervisory system for credit rating agencies and of the endorsement and equivalence

procedures for ratings from third countries in the European Union on the basis of the Credit Rating Regulation of 2009 prompted numerous non-EU member states to adjust their supervisory systems accordingly.

Among the most significant changes to the Code of Conduct are additions to the chapters entitled “Quality and integrity of the rating process” and “Independence and avoidance of conflicts of interest” as well as in relation to guaranteeing the confidentiality of information. In addition, new requirements relating to “governance, risk management and training” significantly extend the scope of the Code of Conduct. Structural changes have also been made.

3 Market-based financing



3.1 Focus

From bad boy to alternative source of financing: the shadow banking sector

Author: Michael Tochtermann, BaFin Section for International Policy/Affairs – Banking Supervision

The 2007/2008 financial crisis was not only a banking crisis; it was also a shadow banking crisis. Special-purpose entities refinanced on a short-term basis, money market funds and markets for securities financing ran into such difficulties that governments and central banks around the globe had to intervene in order to prevent the collapse of the financial system. The banks were first in line when a regulatory response to the crisis was developed. But for more than four years now, the Financial Stability Board (FSB) and the regulatory bodies have been working together to address risks emanating from the global shadow banking system (see info box, page 36). Although significant progress has been made since, the aim to transform it into a robust, sustainable

system of market-based finance has not yet been achieved. Further regulation of the shadow banking sector may additionally be supplemented by measures such as those envisaged in the plans for the creation of a European Capital Market Union.

The approach pursued by the FSB is based on two pillars: oversight and regulation. The oversight pillar builds on an FSB framework that forms part of its recommendations to strengthen the oversight and regulation of the shadow banking system⁸. On the basis of this

⁸ “Shadow Banking: Strengthening Oversight and Regulation – Recommendations of the Financial Stability Board”, 27 October 2011.

Shadow banking system

The Financial Stability Board (FSB) defines the shadow banking system as a system of credit intermediation that involves entities and activities outside the regular banking system. Credit intermediation in this context refers to the transformation of liquid, short-term funds into illiquid, long-term funds. The main focus of the FSB's regulatory efforts is on maturity and liquidity transformation derived from credit intermediation as well as on leverage, imperfect credit risk transfer and regulatory arbitrage.

framework, the Board estimates on an annual basis the size of the global shadow banking sector and determines trends and risks.⁹

The FSB aims to consider the risks of this sector on an increasingly differentiated basis, firstly by deducting activities that are not relevant under the shadow banking definition and secondly by taking a more detailed look at certain shadow banking entities, such as credit funds and finance companies. This approach has helped supervisory authorities to develop a better understanding of the risks of the shadow banking sector, in particular the potential contagion channels between banks and shadow banks.

Oversight and regulation

The insights the FSB gains from its oversight activities may also provide valuable input for the design of the second pillar, regulation. To date, however, very few of them have been incorporated into the FSB's regulatory initiatives. In addition, there are currently no considerations as to whether and how effectively the policy recommendations made to date mitigate the risks of the shadow banking

system. The specific expertise shared by the two committees must be better integrated. The establishment of joint workshops represents a step in the right direction.

Macroprudential instruments: A long way to go

Are macroprudential instruments the tool of choice? This is a tempting thought, because instruments that are effective across the entire shadow banking sector could potentially be well-suited to addressing the risks of this strongly fragmented part of the financial system¹⁰. In practice, however, there are two problems: the FSB framework for overseeing the shadow banking system is based on data that the national authorities gather for flow-of-funds accounts, a subsection of the national account system. By its nature, this data is not ideal for capturing the risks of the shadow banking system. The data is not granular enough and the definitions on which it is based are not consistent. For this reason, the data aggregated by the FSB cannot do more at present than point to any accumulation or shifting of risks. However, the FSB has already begun to supplement the flow-of-funds data with other supervisory data. For example, the results of the hedge fund survey conducted by the International Organization of Securities Commissions (IOSCO) are now included in the analysis.

The second difficulty relates to designing the macroprudential instruments in such a way that they are truly effective throughout the sector, for example by reducing maturity transformation or leverage. This poses a particular challenge, since the shadow banking sector is not a homogeneous system. The number of entity types commonly included in the shadow banking sector is a mid-double-digit figure. Moreover, the same or similar activities are often conducted under different legal forms.

Activities as benchmark

In its Policy Framework for Strengthening Oversight and Regulation of Shadow Banking

⁹ The results are summarised in the "Annual Global Shadow Banking Monitoring Report" and published on the FSB's website.

¹⁰ See also chapter II 2.2.

Entities adopted in August 2013,¹¹ the FSB therefore does not specify the legal form as the decisive criterion, but the functions performed. In this document, the FSB defines five economic functions specific to shadow banks and assigns a number of policy tools to them. This allows supervisory authorities to take a flexible, targeted approach. To ensure nevertheless that they adhere to the “same risk, same rules” principle, the FSB reviews the comparability of the tools used via a mechanism for sharing information among national authorities. This information sharing mechanism is a mandatory, but not an onerous task, because it provides an opportunity to learn from each other and helps to achieve convergence of supervisory practices across borders.

Securities financing

As for the work on the regulatory pillar, the FSB has identified five priority areas in its report of October 2011: indirect regulation, i. e. regulation of the interactions between the banking sector and the shadow banking sector, regulation of money market funds, other shadow banking entities, securitisation and securities financing.

Of particular importance is the package of measures for the regulation of securities financing transactions. Securities lending and repo transactions provide the link between banks, insurance undertakings, investment firms and investment funds. These activities are the life blood of the shadow banking system, as it were. From an economic perspective, they are a type of secured loan. Funds are provided on the basis of collateral. A haircut is normally agreed for the securities pledged or transferred as collateral to cover valuation and other risks. The amount of the haircut is determined on the basis of different criteria, primarily the quality and maturity of the security. But other factors also play a role, such as the counterparty’s reliability and the competitive situation.

The FSB’s analyses have shown that the haircuts have the potential to amplify procyclicality. While under a benign economic environment haircuts tend to be imposed at a lower level and thus contribute to an increase in system leverage, the higher safety margins demanded by market participants in a tense economic environment further contribute to the reduction of system leverage. In extreme situations, such as the 2007/2008 financial crisis, adjustments to the market values of collateral and the corresponding increase in haircuts may give rise to dangerous downward spirals.

To prevent that in a benign economic environment haircuts are imposed which are too low and would therefore turn into the opposite when economic conditions become negative, the FSB in October 2014 introduced specific minimum haircuts for certain types of securities transactions and classes of securities. The FSB has asked the Basel Committee on Banking Supervision to integrate the minimum haircuts into the capital regime by the end of 2015. Moreover, the FSB will extend the requirements to market participants that are not subject to the Basel regulatory framework. It is expedient in principle to cover all relevant market participants as otherwise there remains the risk that securities transactions will be shifted to areas that are less strictly regulated. It is also an issue about maintaining a level playing field.

The minimum haircuts are complemented by other measures, such as qualitative minimum standards for calculating haircuts. Confidence in securities financing markets can also be strengthened by ensuring greater transparency, for example by creating trade repositories. With its proposal for a regulation on reporting and transparency of securities financing transactions, the European Union has assumed a pioneering role in this regard. The draft regulation provides for, among other things, the reporting of securities financing transactions to trade repositories and specific minimum information requirements in connection with rehypothecation. It would be desirable for the countries outside Europe to follow this example.

¹¹ “Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities”, 29 August 2013.

Systemically important shadow banks

Another important issue that the FSB is currently looking at is whether the shadow banking sector, too, hosts globally systemically important institutions (non-bank non-insurance globally systemically important financial institutions) and, if so, how they should be handled from a regulatory and supervisory point of view. The FSB is not expected to

provide any answers to these questions until 2016.

But the mere fact that a regulatory framework is on the horizon is already instilling discipline: the international supervisory community is making it clear that there is no point in evading the regulated banking or insurance sector.



3.2 Focus

A sustainable securitisation market as an alternative source of financing

Authors: Ralf Schneider, BaFin Section for Banking Supervision – Credit Risk, Eva-Christina Smeets, BaFin Section for International Policy/Affairs – Securities Supervision

There are increasing calls for corporate financing to be more strongly based on the capital market – including with the help of securitisation. This may sound surprising at first, given that the image of securitisations suffered a severe blow during the global financial crisis, due to high default rates and losses incurred in the US securitisation segments of residential mortgage-backed securities (RMBS) and collateralised debt obligations (CDO).

These crisis-type developments were supported by the fact that investors relied too heavily on the credit ratings of rating agencies, the securitisation structures were excessively complex, there was a lack of transparency and conflicts of interest between investors and other parties involved in the securitisation were not sufficiently contained. Global standard setters and the European Union responded by imposing tighter regulatory controls (see info box “Tighter regulation in the aftermath of the crisis”, page 39).

Unlike the US securitisation segments mentioned earlier, European securitisations proved to be robust even during the financial crisis. In its plans for the creation of a European Capital Markets Union, the European Commission therefore also proposed to develop a sustainable securitisation market segment as a link between the lending and capital markets. This segment is being created to provide an additional alternative to traditional refinancing of direct bank loans in the medium to long term, especially for small and medium-sized enterprises (SMEs), and to allow banks to transfer the risks arising from these direct bank loans.

Demanding requirements

For the creation of such a qualifying securitisation segment, which is intended to release the potential for financing the economy on a sustainable basis, it is, however, essential to set strict and demanding requirements. This relates to the type of securitisation products

traded there and the question as to how they should be given preferential regulatory treatment.

Preferential regulatory treatment for qualifying securitisations compared with other securitisations and other financial instruments can be considered in particular in the context of own funds and liquidity coverage requirements for banks and the solvency capital requirements for insurance undertakings. Since these requirements serve as a safeguard against different types of risk, in each area of regulation additional specific criteria are required to define qualifying securitisation positions. For example, an important criterion in the context of the liquidity requirements for banks used to mitigate liquidity risk is that qualifying securitisation positions can be disposed of quickly. However, due to the longer-term assessment horizon, this criterion is less relevant to the banks' own funds requirements to cover credit risk.

Incorporating lessons learned from the crisis

BaFin supports the efforts to create a sustainable securitisation market segment that offers an effective refinancing alternative for banks and issuers and is also of interest as an investment opportunity for institutional investors outside the banking sector. A precondition of this is, however, that the criteria for the definition of such a securitisation segment incorporate the lessons learned from the financial crisis, substantially limit the complexity of securitisations and lead to a certain level of standardisation of the securitisation structures used. Moreover, the criteria have to ensure that clear contractual arrangements are in place in all areas relevant for the risk assessment. They also have to formulate demanding transparency requirements. The overarching purpose is that the criteria facilitate and improve – but under no circumstances replace – investors' risk analysis of qualifying securitisation positions. In addition to all other relevant information, investors should also always analyse the historical performance data of the securitisations.

To make it easier for investors to assess the risk of qualifying securitisation positions and to



Tighter regulation in the aftermath of the crisis

European lawmakers responded to the events on the US securitisation market by strengthening the regulatory regime in a number of ways. For example, in line with the corresponding adjustments to the Basel framework, they increased the capital requirements for banks for re-securitisations and introduced comprehensive risk analysis obligations for EU institutions in relation to securitisation positions. In addition, extensive publication obligations entered into force for EU institutions as well as the requirement only to invest in securitisation positions where the originator, sponsor or original lender has committed to a certain risk retention. Moreover, at the global level, the Basel Committee on Banking Supervision resolved a revised framework for securitisation positions in December 2014. The new framework, which banks with international operations have to apply from January 2018, provides for increased own funds requirements for many types of securitisation positions.

ensure that key requirements for securitisation positions in the planned sustainable securitisation segment are applied consistently, fundamental criteria for simple, standard and transparent securitisations are to be defined on a cross-sector basis. The creation of a large market segment by using standard criteria will also benefit the future liquidity of the sustainable securitisation segment. A separate catalogue of criteria should be developed for asset-backed commercial papers, because their risks differ significantly from those of other types of securitisation.

Facilitations not to be extended to all securitisations

Only those securitisations should benefit from facilitations that actually deserve them. Preferential treatment in relation to a certain type of risk should therefore only be considered if the results of empirical analyses and, if

II

III

IV

V

VI

Appendix

possible, historical data justify the preferential treatment of qualifying securitisations over other securitisations and other financial instruments and this kind of treatment is also compatible with the respective sector-specific regulatory targets. An investigation as to whether regulatory facilitations in relation to a specific risk type are justified should also consider whether such facilitations can only be granted if additional sector-specific criteria are met. In BaFin's opinion, the aim of boosting the real economy is in itself not enough to justify any preferential regulatory treatment of qualifying securitisation positions. There must not be an indiscriminate policy of "more growth through less regulation". The delegated acts on qualifying securitisation positions published to date only partially meet these demanding requirements on justifying any preferential regulatory treatment.

To improve the comparability of qualifying securitisations and make a sustainable European securitisation segment more attractive also for investors from outside Europe, BaFin is furthermore in favour of joining the securitisation sector in the search for practicable ways to further standardise the initial and ongoing information about qualifying securitisations and the definitions used for this purpose.

Preferential treatment for qualifying securitisations in European regulation

In March 2014, the European Commission for the first time addressed a communication to the European Parliament and the Council in which it announced, among other things, that it would distinguish high-quality securitisations from other securitisations across regulatory sectors. At the same time, it wanted to explore a possible preferential regulatory treatment of these securitisations compatible with prudential principles. Since then there has been a debate at the European level in all regulatory sectors about giving special treatment to specially qualified securitisations intended to facilitate investments in such securitisations. In summer 2014, the European Central Bank and the Bank of England also voiced their support for exploring preferential

supervisory treatment for qualifying securitisation positions.

A delegated act of the European Commission which provides further details of the Solvency II rules entered into force in January 2015. The act, among other things, differentiates between Type 1 and Type 2 securitisation positions. In addition to the criteria for simple, standard and transparent securitisations, which are also being debated in the context of regulatory initiatives for other segments of the financial sector, the catalogue of criteria for making this distinction also comprises, among other things, additional restrictions on the ranking and credit rating of the securitisation position concerned. Securitisation positions that meet the requirements for treatment as Type 1 securitisation positions receive preferential treatment for spread risk in the standard formula used to determine the solvency capital requirement.

In addition, a delegated act of the European Commission supplementing the liquidity coverage requirement for credit institutions entered into force at the beginning of February 2015. Among other things, this act contains criteria for distinguishing certain securitisation positions that, under the liquidity coverage requirement, are eligible as Level 2B assets up to a limit of 15%. Level 2B assets are assets of high liquidity and credit quality. In addition to criteria for simple, transparent and standard securitisations, the delegated act also contains a restriction to first-ranking securitisation tranches of the highest credit quality that are backed by residential mortgage loans, auto loans, consumer credit or SME loans.

Treatment of qualifying securitisations in the EU's Capital Requirements Regulation

At the request of the European Commission, the European Banking Authority (EBA) is also dealing with the issue of identifying simple, standard and transparent securitisations. In addition to developing quality criteria, the EBA is also investigating whether and under what circumstances it is appropriate to give preferential treatment to such securitisation

positions when determining capital requirements under the Capital Requirements Regulation (CRR). A public consultation process in this regard was conducted until the middle of January 2015. The final report, including specific proposals for the level of the capital requirements for qualifying securitisations, is expected to be presented in the course of 2015.

Global initiatives

Primarily in response to pressure from the Europeans, criteria for identifying simple, transparent and comparable securitisations were also developed at the global level in a cross-sectoral working group of the International Organization of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BCBS). The criteria were subject to a public consultation process until the middle of February 2015. On the whole, market participants welcomed the initiative of IOSCO and the BCBS and generally also supported the proposed criteria. The criteria are now expected to be revised on the basis of the consultation results and finalised in the second quarter of 2015. The Basel Committee

is currently also investigating whether these criteria should be included in the new own funds requirements for securitisations, which it published in December 2014.

ECB's ABS purchase programme motivated by monetary policy

Concurrently with the political and supervisory discussions, the debate centres on the ECB's asset-backed securities (ABS) purchase programme, which is motivated by monetary policy. However, as a way to create a sustainable, market-driven securitisation market that could support the long-term financing of the European economy, this programme should rather be viewed with scepticism, even if it could help to improve the image of ABSs. This is because on the one hand there is the risk of increased lending solely for the purposes of securitisation which is founded exclusively on the ECB's artificial demand. On the other hand, the actual investors on the ABS markets are either being pushed out of the market by the ECB's purchase programme and the associated decline in yields or they have to resort to more risky, subordinated ABS tranches in their search for profits.



4 International supervision

4.1 European System of Financial Supervision

In August 2014, the EU Commission presented its report on the review of the European System of Financial Supervision (ESFS) (see info box, page 42). Pursuant to the regulations establishing the European Supervisory Authorities (ESAs), the Commission had an obligation to review the functioning of the ESFS three years after it entered into force on 1 January 2011. The European Commission's report provides an overview of the activities of the ESAs and of the European Systemic Risk

Board (ESRB) since they were established and contains suggestions as to how its powers can be expanded gradually without fundamentally changing the system.

BaFin is not in support of some of these proposals because it does not believe that they would contribute to improving the ESFS. BaFin welcomes the recommendation that the ESAs should primarily play a regulatory role. However, it rejects the proposal to strengthen the direct supervisory powers of the ESAs, in particular their operational decision-making powers. The

II

III

IV

V

VI

Appendix

European System of Financial Supervision

The three European Supervisory Authorities (ESAs) became operational at the start of 2011: the European Banking Authority (EBA), its insurance industry counterpart the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). The European Systemic Risk Board (ESRB) started work shortly before then, at the end of 2010.

The ESAs and the ESRB together form the European System of Financial Supervision (ESFS). The ESFS aims to promote regulatory and supervisory centralisation in Europe and strengthen the coordination between macroprudential analysis and microprudential supervision.

ESAs could otherwise assume decision-making powers of the national supervisory authorities and would thus become their watchdogs.

BaFin is also against the Commission's proposal to increase direct access to data and information for ESAs, the ESAs' Chairpersons and Management Boards. This could entail dual reporting requirements for the companies and lead to blurred responsibilities. However, where the ESAs have direct supervisory powers, as in the case of ESMA, which supervises credit rating agencies, BaFin also believes that direct access to data and information is useful.

BaFin does not consider it expedient from a supervisory point of view to move the supervision of highly integrated financial market infrastructures, such as central counterparties (CCPs), to ESMA. Due to new regulatory requirements, the systemic importance of CCPs has increased significantly, making fast, responsive and experienced supervision indispensable. The necessary national expertise in the ESFS must be guaranteed. For this reason, the Board of Supervisors should be the body that takes all fundamental decisions

at the European level. BaFin is therefore not prepared to support the motion to transfer responsibilities from the Board of Supervisors to the ESMA Chairman.

BaFin does, however, share the EU Commission's opinion that the ESAs' guidelines and recommendations have to meet all legal requirements. It believes that a legal basis in an EU Directive or Regulation must be created if guidelines or recommendations are to be issued.

4.2 Bilateral and multilateral cooperation

4.2.1 Memoranda of understanding

In 2014, BaFin again negotiated various memoranda of understanding (MoUs) with a number of other supervisory authorities. These memoranda are the formal basis for cooperation among the authorities and for the exchange of information about credit institutions, investment services enterprises and insurance undertakings with cross-border activities. These types of agreement are mostly entered into because the supervised companies are increasingly extending their international reach. MoUs break down into abstract, general agreements – which are the norm – and institution-specific agreements. Both types of MoUs can be sector-specific or cross-sectoral.

BaFin entered into a memorandum of understanding for banking supervision with Moldova's *Banca Națională* in 2014. In addition, it agreed cross-sectoral cooperation with the Vatican's *Autorità di Informazione Finanziaria* (see Annex 4 "Memoranda of Understanding", page 272).

On 4 November 2014, the Single Supervisory Mechanism (SSM) assumed responsibility for the supervision of the eurozone countries' largest banks. The ECB and BaFin will cooperate closely under the SSM. For this reason, at the beginning of October 2014, BaFin submitted a draft MoU governing this cooperation between the ECB and BaFin. The MoU is intended to facilitate the free exchange of information

between SSM and non-SSM areas within BaFin. This is necessary in particular to take effective action against money laundering.

4.2.2 Technical cooperation

BaFin continued to extend its relationships with supervisory authorities outside the euro area in 2014. For example, there were a number of cross-sectoral meetings and projects, including with supervisory authorities in Croatia, Serbia, Albania, Azerbaijan, Kazakhstan, Vietnam, Ghana, Turkey, South Korea and China. Exchange visits helped above all to intensify the cooperation between BaFin and the Chinese supervisory authorities. In some cases, the cooperation was joined or supported by the Bundesbank.

An event of particular interest in 2014 was the organisation and hosting of IOSCO's Mobile Seminar Training Program at BaFin's offices

in Frankfurt am Main. Some 50 securities regulators from 21 countries took part in the two-day seminar, which featured challenges in international securities regulation and investor protection on the agenda.

With support from the European Commission, BaFin in Frankfurt also hosted a study visit by the Securities and Exchange Commission of the Republic of Macedonia in 2014. The issues addressed at the three-day event included primarily aspects of securities and takeover law.

Representatives of the Financial Services Authority of Indonesia (Otoritas Jasa Keuangan – OJK) also attended a training programme over several days at BaFin, which was sponsored by the Bundesbank. The programme's main focus was on banking and conglomerate supervision as well as budget matters.

5 Consumer protection

5.1 International developments

The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) are making increasing use of the Joint Committee Sub-Committee on Consumer Protection and Financial Innovation (JC SC CPFI) to design Europe-wide rules for consumer protection. BaFin is involved in this committee together with the supervisory authorities of other EU member states.

5.1.1 Guidelines on the complaints management function and complaints handling

Through the Joint Committee, EBA and ESMA resolved in summer 2014 to issue guidelines on the complaints management function and on complaints handling also for the banking and securities sector. The intention is to harmonise

the corresponding processes and procedures throughout the EU. The new Complaints Handling Guidelines are closely in line with the existing EIOPA guidelines on the complaints management function and complaints handling in the insurance and occupational pensions sectors.

The guidelines require credit institutions, financial services providers, investment services enterprises, management companies and payment services providers to create a complaints management function in their companies. This includes, for example, a complaints register, which the institutions are required to maintain. This register allows them not only to analyse complaints on an ongoing basis, but also to detect possible risks to consumers early on. In addition, the guidelines set out the requirements for the communication process: in all cases the exchange of information with the complainant must be clear and transparent and consumers

II

III

IV

V

VI

Appendix

must be informed about the procedure for dealing with their complaints. The finance companies affected must report to BaFin annually about their handling of consumer complaints.

BaFin has started its work to implement the requirements on credit institutions, financial services providers, investment services enterprises, management companies and payment services providers in national provisions. This was preceded by the implementation of the guidelines on the complaints management function and complaints handling for insurance undertakings through a circular and a collective administrative act. In accordance with the concept of integrated financial services supervision, the contents of the requirements in the area of banking and securities supervision will, also in Germany, be based on the existing rules for insurance supervision as far as possible.

5.1.2 Consultation on cross-selling guidelines

Consumer protection in relation to cross-selling is another important priority for the European Supervisory Authorities. Cross-selling is the combined selling of two or more financial products or services, which the provider

combines into a new product or markets as a bundle. The consultation process on the cross-selling guidelines started on 22 December 2014 and ended on 22 March 2015. The main purpose of the guidelines is to ensure that the consumer receives relevant information on these products, in particular also on the risks associated with them.

5.1.3 Key information documents for packaged investment products

An EU Regulation aimed at improving the information provided to retail investors about the risks of packaged retail and insurance-based investment products (PRIIPs) entered into force on 29 December 2014. As part of a JC SC CPFI working group, BaFin contributed significantly to the drafting of a discussion paper, which asks interest group representatives to comment on the future requirements. Under the new standards, PRIIP providers, such as credit institutions and investment services enterprises, are required to hand out a separate key information document for the packaged products issued by them. The discussion paper already provides significant preliminary input for the technical standards, on the basis of which the requirements for key information documents will have to be specified in the course of 2015.

5.2 Future responsibilities



5.2.1 Opinion

Gabriele Hahn on collective consumer protection in the financial sector

The German Retail Investor Protection Act (*Kleinanlegerschutzgesetz*), which is expected to enter into force before the summer of 2015, will give BaFin extensive powers relating to collective consumer protection (see info box, page 45). On the basis of article 1 of this Act, collective consumer protection is set to be enshrined in law as an important additional



Gabriele Hahn

is BaFin's Chief Executive Director of Regulatory Services/Human Resources.

supervisory objective for BaFin.¹² It will thus be added alongside the existing supervisory objectives, which consist of guaranteeing the stability of the supervised institutions and ensuring the proper functioning, stability and integrity of the financial system.¹³

All supervisory areas covered

According to the German federal government's draft of 12 November 2014, collective consumer protection will in future cover all of BaFin's supervisory areas: the new rules will provide a consistent basis of authorisation for cases where BaFin in its supervisory activities identifies a material, permanent or repeated violation of legal provisions relating to consumer protection that goes beyond the individual case and requires general clarification.¹⁴ This Act will provide BaFin with an administrative intervention toolset which can be applied to all its supervisory areas and can be used to counter irregularities in the area of collective consumer protection, a very welcome development.

Consistent toolset

Currently, supervision of impropriety relating to consumer interests is governed by different technical supervisory legislation¹⁵. A single basis of authorisation, which applies to the entire financial sector supervised by BaFin, will clear up confusion in the interpretation of these standards, which are still scattered across a number of different laws. BaFin will then be able to apply the same benchmarks to each company it supervises and prevent violations of both public and civil law provisions wherever such violations disadvantage consumers. This would ensure that the law is interpreted and applied consistently and administrative practice

¹² Section 4 (1a) of the Act Establishing the Federal Financial Supervisory Authority (*Finanzdienstleistungsaufsichtsgesetz – FinDAG*).

¹³ For details of other provisions of the draft, see interview, page 12f., chapter II 6.1.3, chapter V 1.2.

¹⁴ Article 1 of the draft Retail Investor Protection Act referring to section 4 (1a) sentence 2 of the FinDAG.

¹⁵ German Banking Act (*Kreditwesengesetz – KWG*), Insurance Supervision Act (*Versicherungsaufsichtsgesetz – VAG*), Securities Trading Act (*Wertpapierhandelsgesetz – WpHG*).



Collective consumer protection

BaFin will remain exclusively responsible for collective consumer protection, i. e. it will protect consumers as an overall group. The protection of individual consumer interests remains the responsibility of the ombudspersons, arbitration bodies and courts.

is performed on an equitable basis when taking measures to protect collective consumer interests. On the basis of these new conditions, BaFin will be able to address consumer interests even more effectively and do more to incorporate them into its supervisory activities. This will further strengthen consumer confidence in the stability of the financial market.

Consumer protection in a global context

The further extension of BaFin's responsibility for consumer protection initiated by the draft Retail Investor Protection Act is in line with regulatory developments at the global level. In the aftermath of the financial crisis, collective consumer protection as an element of financial supervision has become a focal point around the world and has already established itself as an independent branch of supervision in some countries.

In its "High-Level Principles on Financial Consumer Protection", which have also been endorsed by the G20, the Organisation for Economic Co-operation and Development (OECD) emphasised already in 2011 that financial consumer protection would have to be strengthened, since it contributed to bolstering financial stability and was an integral part of financial supervision.

European development

European consumer protection developments are embedded in the global framework. After the financial crisis, the EU Commission explicitly set the objective of rebuilding consumer confidence in the financial services

II

III

IV

V

VI

Appendix

market. The European Supervisory Authorities (ESAs) – the European Banking Authority (EBA), the European Insurance and Occupational Pension Authority (EIOPA) and the European Securities Markets Authority (ESMA) – which are tasked with harmonising supervisory practice in the member states as part of the new European supervisory architecture, were given responsibility for improving consumer protection in the financial sector at the time of their establishment in 2011¹⁶. They were given extensive powers to this end. Article 9 of the ESA Regulations assigns them, among other things, a leading role in promoting transparency, simplicity and fairness in the financial system throughout the EU. All three ESAs perform this mandate meticulously. They see themselves as consumer protection authorities and in this capacity publish, among other things, guidelines on consumer protection issues, analyse consumer trends, organise informational events on consumer protection and publish warnings. Despite the large number of activities, the European Commission concluded in its report on the activities of the ESAs in August 2014 that the ESAs should give even greater priority to consumer protection matters and make more extensive use of their powers in the area of consumer protection.¹⁷ For EIOPA, collective consumer protection is now the no. 1 strategic objective.

European legislation is also giving considerable attention to consumer protection issues. One example is the Alternative Dispute Resolution Directive¹⁸.

Consumer protection nothing new

Even though consumer protection was previously not defined explicitly as one of BaFin's responsibilities, BaFin has always been involved in collective consumer protection in the context of solvency and market supervision.

Although consumer protection is nothing new for integrated financial services supervision, it has increasingly been brought into the public eye in recent years.

BaFin's risk-based solvency supervision is aimed at detecting and mitigating potential risks to the supervised companies at an early stage and limiting the impact of such risks on systemically important institutions. Such a supervisory approach ultimately ensures that the supervised companies can at all times meet their obligations to their customers, including above all consumers. In addition, market supervision protects the integrity of the financial markets and enforces fair market conditions for all participants, including private investors.

Moreover, BaFin has been practicing collective consumer protection for years by handling complaints.¹⁹ It investigates approximately 20,000 individual submissions a year, gaining important insights for its supervisory work in the process. The reason is that, if there are any indications of supervisory irregularities, BaFin investigates them and oversees their elimination. This responsibility, which was already based on the constitutional petition right (article 17 of the Basic Law for the Federal Republic of Germany (*Grundgesetz*)) in conjunction with the respective supervisory laws, is now also set out in section 4b of the FinDAG pursuant to the Act on the Strengthening of German Financial Supervision (*Gesetz zur Stärkung der deutschen Finanzaufsicht*), which entered into force on 1 January 2013²⁰.

In addition, BaFin is involved in consumer education. It continually informs interested consumers, for example on its website, in the BaFinJournal, which is published monthly on the BaFin website, through numerous brochures, at trade and other fairs and at events relating to the latest financial market issues. Moreover, the consumer hotline responds to approximately

¹⁶ Article 1(6)(f) of the ESA Regulations.

¹⁷ Report from the Commission to the European Parliament and the Council on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS), 8 August 2014, COM(2014) 509.

¹⁸ See chapter II 5.7.

¹⁹ See chapter II 5.6.

²⁰ Federal Law Gazette (BGBl.) I 2012, page 2369 (only available in German).

22,000 enquiries a year.²¹ Furthermore, BaFin cooperates with other organisations, such as consumer protection groups and dispute resolution entities. It keeps up a continual exchange with these organisations at events such as the consumer protection forum and the annual meeting of arbitrators.²²

BaFin also cooperates closely with the ESAs on consumer protection matters – in accordance with its statutory mandate. In 2013, for example, it implemented the EIOPA guidelines on complaints handling for insurance undertakings²³ in national law on the basis of a circular and a collective administrative act and defined corresponding requirements for the complaints handling system of insurance undertakings.

²¹ See chapter II 5.6.5.

²² See chapter II 5.6.6 and 5.7.

²³ EIOPA-BoS-12/069, 14 June 2012.

It is also important to note that by law BaFin has various other obligations in support of collective consumer protection, which are not widely known as areas of activity of BaFin. Examples include supervision of the statutory deposit guarantee and investor compensation schemes and the guarantee funds for the insurance sector (Protector Lebensversicherungs-AG and Medicator AG), competence under the Consumer Protection Enforcement Act (*Verbraucherschutzdurchsetzungsgesetz*), product supervision of investment funds, the establishment of the arbitration board based on section 342 (3) of the Investment Code (*Kapitalanlagegesetzbuch – KAGB*) and combatting illegal financial transactions. This means that, for BaFin, collective consumer protection is already of key importance, even today. Through this complex and indispensable cross-sectoral responsibility, BaFin contributes to strengthening consumer confidence in the stability of the financial market.

5.2.2 Financial markets watchdog

Another consumer protection initiative provided for in the coalition agreement of CDU/CSU and SPD of 16 December 2013 is the establishment of a financial market watchdog function in the existing consumers associations. The financial markets watchdog is intended to operate like an early warning system, detecting undesirable developments on the market by systematically capturing and analysing specific consumer problems. In 2014, the Federation of German Consumer Organisations (*Verbraucherzentrale Bundesverband e.V. – vzbv*) began to prepare for setting up the financial markets watchdog.

Detection – information – action

The financial markets watchdog's basic principle is the triad of "detection – information – action". "Detection" is based on systematic,

in-depth observation of the financial market from the consumers' perspective, for example on the basis of the 370,000 consumer enquiries and complaints received by financial services consumer centres, market tests and mystery shopping, i. e. purchases by test customers. Other findings are also expected to be included, such as reports by other consumers, which they can submit through a planned consumer portal, or calls to consumers relating to certain matters.

In the "information" step, the financial markets watchdog passes its findings on to various target groups. Possible recipients are supervisory authorities, politicians, scientists, provider associations as well as consumers themselves. To this end, the financial markets watchdog intends to set up a regular dialogue with consumer protection representatives.

II

III

IV

V

VI

Appendix

The “action” principle covers in particular the transfer of information to the relevant governmental supervisory bodies, in particular BaFin.²⁴

Structure of the financial markets watchdog

The financial markets watchdog, which is coordinated centrally at the vzbv, gathers its findings from the 16 consumer advice centres. Five specialised consumer advice centres are responsible for market observation, statistical analysis and for conducting in-depth investigations for a sub-market; the consumer advice centres provide the primary empirical data source by systematically capturing consumer complaints. The aim of introducing the financial markets watchdog is to raise the quality of consumer-focused market observation to a new level.

Cooperation with BaFin

BaFin welcomes the establishment of the financial markets watchdog and the exchange of information with this body. In addition to the findings based on its internal complaints handling, it will thus be able to use additional sources of information for its supervisory activities. When cooperating and exchanging information with the financial markets watchdog, BaFin is bound by the statutory functions delegated to it and by the non-disclosure obligations imposed on it by law.

5.3 Court rulings

5.3.1 Handling charges for private loans

A very large portion of the complaints received in 2014 related to handling charges for consumer loan agreements. This was due to four landmark rulings by the German Federal Court of Justice (*Bundesgerichtshof* – BGH).

On 13 May 2014, the BGH had handed down two rulings, declaring it impermissible to include provisions on handling charges for consumer loans in general terms and conditions of

business.²⁵ On the basis of these judgements, consumers can demand refunds of such charges from the banks, on the grounds that they have been levied wrongly.

In two further rulings, the BGH on 28 October 2014 dealt with the similarly important issue of when these refund claims become statute-barred.²⁶ As the starting point of the regular three-year limitation period in accordance with section 195 of the German Civil Code (*Bürgerliches Gesetzbuch*), the BGH chose the year 2011. According to the BGH, it was only reasonable to expect borrowers to bring an action for a refund after settled case law had emerged in rulings of the Higher Regional Courts in the course of 2011. In several judgements, they had disapproved of the handling charges in general terms and conditions of business for consumer loan agreements. They argued that only after these rulings would a borrower versed in the law have to expect that banks would no longer be able to refuse the repayment of handling charges by referring back to older BGH rulings.

The absolute limitation period in accordance with section 199 (4) of the BGB allowed consumers until the end of 2014 to claim refunds under legacy agreements that were no older than ten years at the time of assertion.

These four rulings drew a great deal of public interest. They led to a considerable number of submissions, not only at the credit institutions themselves, but also at the various dispute resolution entities and BaFin. The particular urgency caused by the time limitation rulings in the last quarter of 2014 most likely played an important role in this context.

According to BaFin’s observations, most credit institutions met the consumers’ justified refund claims without any major problems. The large number of enquiries led to processing backlogs,

²⁵ Judgements of the Federal Court of Justice dated 13 May 2014 (case ref.: XI ZR 405/12 and XI ZR 170/13).

²⁶ Judgements of the Federal Court of Justice dated 28 October 2014 (case ref.: XI ZR 348/13 and XI ZR 17/14).

²⁴ See: <http://www.vzbv.de>

which caused some uncertainty among consumers. In some cases, however, the banks refrained from pleading the defence of limitation directly by issuing a receipt confirmation, provided the claim had been registered before the end of the limitation period.

Only in a few isolated cases did credit institutions express the view that the fee model they had chosen differed from the constellations on which the BGH had ruled and was therefore not transferable. Some banks also alleged that the claims had been forfeited if the loan had already been repaid in full without any reservations. BaFin has been and still is in close consultation with these banks. Overall, however, the impression is taking hold that the reversal of the charges was processed as expected in the circumstances.

5.3.2 Cancellation of mortgage loans

In 2014, uncertainty was caused by various reports in the media according to which many consumers were allegedly able to cancel their mortgages. An investigation was said to have revealed that 80% of the cancellation policy clauses in mortgage loans were incorrect. For example, they were alleged to have included incorrect information about the start of the cancellation period or critical information was said to have been missing, in particular on the legal consequences of cancellation. In some cases, additional formulations that differed from the text of the standard policy clauses and were confusing and incomprehensible to the borrowers were said to have been used. Allegedly, the exercise of this cancellation right would have provided consumers with an opportunity to get rid of the old loan agreements with high interest rates and, thanks to the low interest rate environment, to save a large amount of money by taking out new loans.

In the case of all consumer loans, and therefore also mortgage loan agreements, consumers always have the right to cancel in accordance with the provisions of the German Civil Code (*Bürgerliches Gesetzbuch*) (section 495 in conjunction with section 355 of the BGB).

According to these provisions, consumers can revoke their declarations of intent to enter into the agreement within a period of 14 days. Upon cancellation, the contractual arrangements are invalidated and any payments already disbursed must be paid back.

However, the 14-day cancellation period only commences once the borrower has been duly informed of the cancellation policy in accordance with certain statutory requirements. If the cancellation policy contains errors or additions that are confusing for consumers or could be misunderstood by them, the start of the period is not triggered. In such cases, borrowers have an indefinite right to cancel, which they may in principle exercise years later.

Against this backdrop, a number of consumers approached BaFin with the request to examine the cancellation policy clauses in their loan agreements or to exert its influence over the respective bank in order to get their agreements unwound.

However, BaFin is not authorised to act in the interest of individual consumers, for example by examining their contract documents. It must not issue any legal advice either. Nevertheless, it remains to be conclusively clarified by the higher courts which deviations from the standard statutory cancellation policy result in the policy containing errors, thus giving consumers an indefinite right of cancellation. Consumers should consult an attorney or the consumer advice centres in order to be able to assess whether a right of cancellation exists in individual cases. Only the civil courts are competent to rule on the legality of cancellation policy clauses.

5.3.3 Ruling on advance charging of costs for multi-year fund savings plans

The Higher Administrative Court of Hesse (*Hessischer Verwaltungsgerichtshof* – HessVGH) ruled on appeal on 1 October 2014 that the regulations on advance charging of costs pursuant to section 125 of the German Investment Act (*Investmentgesetz*) and

II

III

IV

V

VI

Appendix

section 304 of the German Investment Code (*Kapitalanlagegesetzbuch*) must be observed for all multi-year fund savings plans. This applied irrespective of whether the fund savings plans were offered by a management company, an investment company or another credit or financial services institution.²⁷

The decision was based on a case in which the customers of an investment services enterprise agreed to an obligation to pay monthly savings instalments over the term of a savings plan. The financial services provider concerned invested the amounts paid exclusively in investment funds.

Among other things, the investors also paid a so-called set-up fee, which mostly covered the brokerage costs. This charge amounted to 90 % or 80 % of the first monthly savings instalments the investors had to pay and were deducted from them. In response, BaFin prohibited the company from continuing to use the fund rules for the asset management contract if more than one third of each payment agreed for the first year was used to cover costs and the company failed to allocate the remaining costs equally over all subsequent payments.

Section 125 of the Investment Act, valid until 21 July 2013, and section 304 of the Investment Code, valid from 22 July 2013, specify clearly that only up to one third of each payment agreed for the first year may be used to cover costs. The remaining costs must be allocated equally to all subsequent payments.

This limits the companies' freedom to determine their own remuneration. If a company contravenes these legal provisions by entering into a conflicting remuneration agreement, this invariably leads to an infringement of the rules of conduct defined in section 31 (1) of the Securities Trading Act (*Wertpapierhandelsgesetz*).

5.4 Consumer Advisory Council

In line with its commitment to financial consumer protection, BaFin aims to further intensify its exchanges with the players in this area, including at non-public meetings of BaFin's Consumer Advisory Council, which convened three times in 2014.

BaFin's Consumer Advisory Council was established in 2013. Section 8a of the Act Establishing the Federal Financial Supervisory Authority (*Finanzdienstleistungsaufsichtsgesetz*) provides the statutory basis for the Council. The Advisory Council advises BaFin on its collective consumer protection responsibilities by analysing consumer trends and reporting on these activities to BaFin's Executive Board.

The Consumer Advisory Council is entitled to submit fundamental opinions on the procedures by which BaFin issues regulations and administrative provisions, where these are relevant to consumer protection. It can also advise BaFin on the opinions the latter submits during the legislative process.

The 12 members of the Advisory Council are appointed by the Federal Ministry of Finance. Members are drawn from the fields of academia, consumer or investor protection organisations, out-of-court dispute resolution entities, trade unions, as well as the Federal Ministry of Justice and Consumer Protection (*Bundesministerium der Justiz und für Verbraucherschutz*). The chair is held by Dorothea Mohn of the Federation of German Consumer Organisations (*Bundesverband Verbraucherzentrale e. V.*).

²⁷ Ref.: 6 A 923/13.



5.5 Focus



The new Directive on Deposit Guarantee Schemes

Authors: Gitta Greve, Melanie Poduschnik, BaFin Section for Deposit Guarantee and Compensation Schemes

Improved protection of depositors in Europe is the main objective of the new European Directive on Deposit Guarantee Schemes²⁸, which entered into force on 2 July 2014.

Right to compensation

All depositors – private individuals as well as companies – will in future have a legal right to compensation for their covered deposits (see info box “Deposits”, page 52) if a credit institution is unable to repay the deposits itself and there is no prospect of the deposits being repaid at a later date.²⁹ As before, amounts of up to €100,000 per depositor per credit institution are covered. In addition, savers enjoy special coverage: within three to twelve months from the date of deposit – the draft implementation act calls for a six-month period – they have the right to also receive compensation for deposits in excess of €100,000 up to a maximum of €500,000. The condition is that the deposit is related to specific life events, such as marriage, divorce, disability, redundancy pay after the termination of employment or the sale of privately owned property. For depositors in Germany, these new regulations are a considerable improvement: the provisions of the German Deposit Guarantee and Investor Compensation Act (*Einlagensicherungs- und Anlegerentschädigungsgesetz – EAEG*), which are still in force, do not allow for legal coverage in excess of the minimum in certain cases.

Obligation for all institutions

Under the new Directive, all credit institutions will in future have to be allocated to a statutory guarantee scheme – or a scheme that is

officially recognised as a deposit guarantee scheme. The schemes are recognised by the national supervisory authorities, i. e. BaFin in Germany. In future, customers of all institutions will thus have a legal right to compensation. BaFin will also supervise the guarantee schemes in Germany comprehensively, as it already does for the statutory compensation schemes.

Currently, credit institutions are still exempt from allocation to a statutory compensation scheme if they belong to a scheme safeguarding the viability of institutions. In Germany, this applies to savings banks, *Landesbanks*, regional building societies and cooperative banks. Schemes safeguarding the viability of institutions protect an institution from insolvency, because the other members provide support as soon as it gets into financial difficulties. In this way, customer funds are protected indirectly.

German structure can remain in place

Despite this substantial innovation, the deposit guarantee structure in Germany, which has evolved historically, can remain in place. It is unique in Europe and has three pillars: the two statutory compensation schemes, Compensation Scheme of German Banks (*Entschädigungseinrichtung deutscher Banken GmbH – EdB*) and Compensation Scheme of the Association of German Public Sector Banks (*Entschädigungseinrichtung des Bundesverbandes Öffentlicher Banken Deutschlands GmbH – EdÖ*), the schemes safeguarding the viability of institutions of the German Savings Banks Association (*Deutscher Sparkassen- und Giroverband – DSGV*) and the National Association of German Cooperative Banks (*Bundesverband der Deutschen Volksbanken und Raiffeisenbanken – BVR*),

²⁸ Directive 2014/49/EU, OJ EU L 173/149.

²⁹ More information can be found at www.bafin.de

and the voluntary Deposit Protection Fund (*Einlagensicherungsfonds* – ESF) of the private and public-sector banks.

The statutory deposit guarantee schemes, EdB and EdÖ, will remain in place. The schemes safeguarding the viability of institutions of the DSGV and BVR can apply to be recognised as deposit guarantee schemes if they meet all the relevant requirements. This involves, among other things, that they have to grant a legal right to compensation and – as explained below – set aside the necessary target fund level.

As before, deposit-taking credit institutions can voluntarily and additionally belong to the Deposit Protection Fund (*Einlagensicherungsfonds*) of the Association of German Banks (*Bundesverband deutscher Banken e.V.*) or the Association of German Public Sector Banks (*Bundesverband der Öffentlichen Banken e.V.*). In future, however, these schemes will have to indicate expressly and prominently that they do not grant depositors any legal right, i.e. that they are not obliged to pay compensation.

Faster compensation

Moreover, the Directive regulates the compensation process in much greater detail than before – and to much greater benefit of depositors. From 1 January 2024, at the latest, depositors will have to receive their compensation within seven days of the compensation event having been determined. A reduction to seven days is already planned to come into effect in Germany on 1 June 2016. At present, compensation has to be paid within 20 working days of a compensation event having been determined.

For branches of institutions that operate in other member states of the European Economic Area in accordance with section 53b of the German Banking Act (*Kreditwesengesetz* – KWG), the domestic compensation scheme will in future be responsible for the compensation process – on behalf of and in accordance with the instructions of the home-country compensation scheme. This means that the affected parties will no longer

Deposits

Deposits are third-party funds that customers place with banks. Covered deposits include account balances such as current account deposits, savings deposits, overnight and time deposits, registered savings bonds and receivables that the institution has securitised by issuing a certificate, such as registered bonds³⁰. Deposits do not include, for example, bearer and order bonds or liabilities from own bills of exchange.

themselves have to approach the guarantee scheme in the home country of the institutions. Before that, however, the compensation scheme of the home country has to provide to the scheme in the host country in particular the financial resources needed by that scheme to pay the compensation.

Improved information

Another consumer-friendly innovation is that the Directive specifies and extends the requirements for credit institutions to provide information to depositors. In future, the institutions will have to use a standardised information sheet to inform depositors about their membership in a statutory or recognised deposit guarantee scheme and its arrangements, including, for example, the coverage limit, repayment deadlines and how they have to deal with joint accounts. This has to be done before any business relationship is entered into. Customers have to confirm explicitly that they have received this information sheet – before any deposit acceptance agreement is entered into. After that, the depositor's institution has to provide the information sheet at least once a year.

In addition, the credit institutions will in future have to provide ongoing information to their existing customers about the eligibility for

³⁰ The list of examples of financial products that are covered or not covered should be regarded as subject to the specific contractual arrangements and the corresponding claim eligibility. The list is not exhaustive.

compensation of their deposits by confirming this on the statements of account. Moreover, the statutory and recognised deposit guarantee schemes have to provide depositors on their websites with the necessary information, especially on the procedural provisions and the deposit guarantee conditions under the revised Directive. The institutions may not use this information for advertising purposes.

Ex ante funding

To hold the institutions themselves accountable, the Directive stipulates that all deposit guarantee schemes must be funded ex ante. In many EU member states, guarantee schemes have to date been funded ex post. This means that the member institutions only pay contributions when a compensation event has occurred. The consequence is that the deposit-taking credit institution that has caused the compensation event does not pay any contributions, because it is insolvent.

Within the next ten years, all deposit guarantee schemes will thus have to set aside funds

equivalent to at least 0.8% of the covered deposits of their member institutions.

A maximum of 30% of the funding can be made up of irrevocable payment commitments by the institutions. In addition, each year the guarantee schemes may collect a maximum of 0.5% of the covered deposits as special contributions if the funds already collected are insufficient to cover a current compensation event. If they require any additional funding, they have to take out loans, which can be paid off over an extended period through annual special payments. The European Banking Authority (EBA) has developed two guidelines on methods for calculating contributions (see info box).

Alignment with the Recovery and Resolution Directive

The content of the Directive on Deposit Guarantee Schemes has been aligned with the Recovery and Resolution Directive³¹. If resolution tools are used, the deposit

³¹ See chapter III 1.2.

EBA guidelines on methods for calculating contributions

The European Banking Authority has developed two guidelines aimed at specifying the necessary elements for calculating contributions. The final versions are expected to enter into force by the end of the implementation period of the Directive in July 2015 and have to be implemented in all member states by the end of 2015.

A guideline on calculating risk-based contributions will specify the methods deposit-taking credit institutions will have to use to calculate risk-based contributions to deposit guarantee schemes. Under this guideline, institutions whose business model entails an increased risk of a compensation event occurring or would result in an especially high liability for the deposit guarantee schemes in such a case are to pay a proportionately higher contribution. The German deposit guarantee schemes play a pioneering role in this area. Most of

them already apply very detailed risk-weighted contribution methods.

A guideline on irrevocable payment commitments will provide consistent rules throughout Europe for the payment commitments that an institution can use instead of cash to make up the funds to be set aside.

Institutions that make use of the option to provide 30% of their contributions in payment commitments have to enter into a payment commitment agreement with the deposit guarantee schemes. The guideline sets out the structure of such agreements. Deposit guarantee schemes may only authorise the payment commitments of a credit institution if the securities are fully collateralised in favour of the respective deposit guarantee scheme and if the collateral consists of low-risk debt securities, is available to the deposit guarantee scheme at any time and is unencumbered by third-party rights.

II

III

IV

V

VI

Appendix

guarantee schemes share in the costs under certain circumstances because the resolution measures prevent a compensation event from being determined. The maximum contribution to be paid by the deposit guarantee scheme is the amount it would have had to pay as compensation if the institution had not been supported according to the resolution regime of the European Recovery and Resolution Directive. The member states will lay down the particulars at the time of national implementation.

In addition, the Recovery and Resolution Directive grants a senior right of claim in insolvency proceedings to those guarantee schemes that, in the case of insolvency, assume the rights and obligations of the depositors whose deposits are covered. As a result of this seniority, the guarantee schemes receive a higher payment than a regular insolvency creditor.

Proposed Directive of the European Commission

The European Commission, the Council and the European Parliament agreed on a revised version of the Directive on Deposit Guarantee Schemes at the end of 2013. This had been preceded by several years of negotiations. In mid-2010, the European Commission had already submitted a proposal for a directive. However, the negotiations were initially pushed

back in light of the European Commission's proposal for a new Recovery and Resolution Directive. The Commission proposed that a target funding level of 1.5% of eligible deposits should be set aside for the guarantee scheme within a period of eight years. In addition, the European guarantee schemes were to be placed under the obligation to lend to one another.

Less discretion for implementation

The EU member states have to transpose most of the provisions of the new Directive on Deposit Guarantee Schemes into national law by 3 July 2015. In Germany, this affects the Investor Compensation Act (*Einlagensicherungs- und Anlegerentschädigungsgesetz – EAEG*) and the contribution regulations that specify the EAEG in greater detail. The German legislator will implement the Directive on Deposit Guarantee Schemes in the form of a deposit guarantee act. The substance of the investor compensation provisions will not be changed and will be carried over in an investor compensation act.

National legislators will have substantially less discretion for implementing the Directive than they had for its predecessor dating from 1994, because the new Directive significantly specifies and extends the existing requirements. This maximum of harmonisation is aimed at achieving consistent regulation of legal deposit protection in the member states.



5.6 Consumer complaints and enquiries

5.6.1 Credit institutions and financial services providers

In 2014, BaFin processed a total of 7,144 submissions relating to credit and financial services institutions (previous year: 5,918), of which 6,842 were complaints and 229 general

enquiries (see Table 1 "Complaints by group of institutions", page 55). The figure includes 32 cases where BaFin issued statements to the Petitions Committee of the Bundestag (the lower house of the German parliament). In addition, BaFin received 73 information requests about former banks, and especially their legal successors. The complaints were upheld in 1,139 cases.

Table 1 Complaints by group of institutions

Group of institutions	Total number of submissions
Private commercial banks	3,955
Savings banks	910
Public-sector banks	192
Cooperative banks	805
Mortgage banks	40
Building societies (Bausparkassen)	378
Financial services providers (e.g., leasing and factoring companies)	305
Foreign banks	257

The complaints ranged across almost the entire spectrum of the products and services offered by the supervised institutions. Most of the enquiries and complaints BaFin received about the lending business related to the rulings of the Federal Court of Justice (*Bundesgerichtshof – BGH*) on the admissibility of handling charges for consumer loans³²; they related primarily to refunds of the charges and the limitation period for refund claims. Due to the persistence of low interest rates, the issue of how much could be charged in early repayment penalties if a mortgage loan was repaid early was the subject of various complaints.

As in the previous year, most submissions relating to payments were about turnaround times for credit transfers. But BaFin also repeatedly received complaints about garnishment protection accounts (*Pfändungsschutzkonto – P account*); the complaints centred on issues relating to account conversion, fees and the calculation of non-garnishable amounts. As in the past, the focus was usually on issues relating to the unwinding of individual contractual relationships.

32 Judgements of the Federal Court of Justice dated 13 May 2014 (case ref.: XI ZR 405/12 and XI ZR 170/13) and dated 28 October 2014 (case ref. XI ZR 348/13 and XI ZR 17/14).

Termination of building savings contracts with savings levels that exceed the targeted savings amount

On several occasions in 2014, consumers objected to the termination of building savings contracts (*Bausparverträge*) with savings levels that exceeded the targeted savings amount. They hoped that BaFin would respond by exerting its influence over the building society to persuade it to withdraw the termination.

The purpose of building savings plans is to obtain the right to a loan. However, once the credit balance of a building savings contract reaches or exceeds the targeted savings amount, the right to a loan can no longer be obtained. But this also means that the purpose of building savings plans cannot be achieved either.

In most cases, building societies invoke civil-law provisions on building savings contracts in accordance with section 488 of the German Civil Code (*Bürgerliches Gesetzbuch – BGB*) when terminating building savings contracts with savings levels that exceed the targeted savings amount, because during the savings phase the building savings customer is the lender and the building society the borrower. To BaFin's knowledge, the courts and ombudspersons followed this line of argument and in most cases accepted the termination of building savings contracts. BaFin cannot issue any binding decisions in such cases or exert any influence on the building societies.

Termination of the account or business relationship

In 2014, consumers again complained to BaFin that their credit institution had closed their account without providing reasons.

BaFin cannot provide any assistance in such cases. For account management contracts entered into for an indefinite period, credit institutions always have the right to ordinary termination in accordance with section 675h of the BGB. Moreover, the general terms and conditions of business of the institutions normally provide for extraordinary termination

II

III

IV

V

VI

Appendix

rights in addition to ordinary termination rights. If a credit institution exercises its termination rights under its freedom to take business policy decisions, BaFin has no way of exerting any influence. However, if the credit institution terminates the account ordinarily, it has to observe a contractual notice period of at least two months. But the institution is not obliged to provide any reasons for this step to the customer.

Complaints about credit applications

In 2014, BaFin also received complaints from consumers whose loan applications had been rejected by credit institutions.

BaFin is not competent in such cases. It can neither interfere with nor review the individual credit decision, because the German banking sector has freedom of contract. For this reason, the financial institutions can decide independently whether and on what conditions they accept applications and enter into contracts. Consumers do not have an automatic right to obtain a loan. Because of the banking supervision provisions, credit institutions have to examine the credit quality of the respective customer carefully in order to assess potential risks of granting a loan before granting it. If, on examining the application, an institution therefore comes to the conclusion that it cannot grant a loan to the applicant because of the financial situation, this decision is purely based on business policy. BaFin cannot exert any influence on this decision.

5.6.2 Investment companies and German management companies

The investment supervision sections received a total of 149 enquiries and complaints from consumers in 2014.

They related to, among other things, the remuneration collected by German management companies (*Kapitalverwaltungsgesellschaften*) (especially where profit-related), the performance of investment funds, the amount of distributions, redemption prices and periods for fund units and outsourcing arrangements of

management companies. Other issues included the presentation of risk in the sales documents, portfolio decisions relating to retirement provision products, cases of termination of the management rights of a management company and existing distribution authorisations for foreign funds.

Most of the submissions on open-ended real estate funds for retail investors related to the liquidation of a fund. In the majority of cases, consumers asked BaFin about the performance of the market values and fund volume as well as about the timing and volume of distributions.

In each individual case, BaFin followed up on the information and asked the supervised companies to comment as necessary. However, this rarely resulted in the need to take further supervisory measures.

A number of submissions exceeded the supervision competence under the Investment Code (*Kapitalanlagegesetzbuch*). BaFin therefore dealt with these submissions in close consultation with its sections responsible for market supervision under the Securities Trading Act (*Wertpapierhandelsgesetz*). Some of the submissions related to problems with the advice and order execution by intermediaries when acquiring or redeeming fund units, but also suspected insider trading or market manipulation.

5.6.3 Insurance undertakings

In 2014, BaFin processed a larger number of submissions than in the previous year, finalising 11,139 (previous year: 10,868; see Table 2 "Submissions received by insurance class", page 57). The submissions received comprised 9,058 complaints, 487 general enquiries not based on a complaint and 105 petitions that BaFin received via the Bundestag or the Federal Ministry of Finance. In addition, it received 1,489 written submissions that did not fall within its remit.

In relation to the total number of submissions, the complainants were successful in 28.1 % of

Table 2 Submissions received by insurance class since 2010

Year	Life	Motor	Health	Accident	Liability	Legal expenses	Building/household	Other classes	Other complaints*
2014	2,802	1,822	1,545	379	622	675	890	780	1,624
2013	2,874	1,604	1,927	331	550	635	822	570	1,555
2012	2,794	1,312	2,360	383	601	683	766	442	1,612
2011	3,230	1,390	2,218	459	674	741	898	400	1,615
2010	3,512	1,640	2,326	606	755	763	1,118	413	2,125

* Wrong address, brokers, etc.

the proceedings (previous year: 29.7%), while 58.5% of the submissions were unfounded and, in 13.4% of the cases, BaFin was not the competent authority. If only the proceedings for which BaFin is the competent authority are taken into account, the success ratio was 32.5% (previous year: 34.3%).

Selected cases

Under certain circumstances, policyholders can file objections to life insurance policies taken out under the so-called policy model. They have been given this option by more recent rulings of the BGH³³ and the Court of Justice of the European Union (CJEU)³⁴. In the BGH's opinion, policyholders can exercise their right to object also in the future, provided they have not been duly informed about this right and/or have not received any insurance terms and conditions or consumer information. If the objection has been filed effectively, the insurer has to unwind the contract so that the customer always gets back the premiums paid.

Following these decisions by the highest courts, consumers repeatedly approached BaFin in order to enforce repayment claims against their insurers. In one case it was unclear whether the insurer had provided "explicit information in prominent print" on the right to object. According to the BGH's³⁵ ruling, the customer

33 Judgement of the Federal Court of Justice dated 14 May 2014 (case ref.: IV ZR 76/11).

34 Decision of the Court of Justice of the European Union dated 19 December 2013 (case ref. C-209/12).

35 Among others, judgement of the Federal Court of Justice dated 28 January 2004 (case ref.: IV ZR 58/03).

must receive this information separately from the other contract documents. Another condition is that it is made clearly distinct from the rest of the text, for example by making it bold, printing it in a different colour, font or size, or by indenting or framing the text. In BaFin's opinion, the insurer had met these requirements in this specific complaint.

Another complainant objected to her policy after the contract had been in place for a number of years, because she had not been given information about her right to object. The insurer is in such cases obliged to provide proof to the contrary. It was able to prove that the customer had been properly informed: the policy was pledged as collateral, and in this context she herself handed the original policy to the insurer. The document also contained the information about the right to object in prominent print.

So-called cost settlement agreements were also the subject of consumer complaints. Entering into an insurance contract entails costs, which are usually included in the insurance premium. In the case of net policies, the policyholder enters into a separate agreement with the insurance broker, agent or undertaking. According to the BGH's³⁶ ruling, both insurance brokers and agents continue to have rights

36 Among others, judgement of the Federal Court of Justice dated 20 January 2005 (case ref.: III ZR 251/04), judgement of the Federal Court of Justice dated 14 June 2007 (case ref. III ZR 269/06) and judgement of the Federal Court of Justice dated 5 June 2014 (case ref. III ZR 557/13).

II

III

IV

V

VI

Appendix

Table 3 Main reasons for complaints in 2014

Reason	Number
Claims handling/delays	1,426
Amount of insurance payment	1,254
Coverage issues	1,031
Termination	941
Contractual amendments/ extensions	735
Advertising/advice/application processing	659
Tariff issues/no-claim rating	510
Processing quality or duration of complaints processing	442
Bonus payments/profit sharing	391
Premium payments, dunning	369

under the remuneration agreement, even after the insurance contract has been terminated.

However, the situation is different if the policyholder has also entered into the cost settlement agreement with the insurance undertaking. Here the BGH ruled that the insurer must not exclude the termination right from the cost settlement agreement when such an agreement is entered into. In this way, the BGH wants to prevent a situation where the customer remains liable for paying the acquisition costs even after the insurance contract has ended, and this fact stops the customer from terminating the insurance contract.³⁷

5.6.4 Securities transactions

In 2014, BaFin again received numerous complaints about securities transactions. A total of 628 complaints related to credit and financial services institutions (previous year: 671). In addition, there were 379 written enquiries by investors (previous year: 467).

Financial analyses were also the subject of submissions. Moreover, BaFin received six written complaints (previous year: 22). It also responded to 14 written enquiries related to the interpretation of section 34b of the Securities Trading Act (*Wertpapierhandelsgesetz*), the relevant provision applicable to the analysis of financial instruments (previous year: 37 enquiries).

Selected cases

One complainant objected to the fact that he had been charged unusually high custody costs for his securities account. During its investigations, BaFin established that in some constellations the institution in question had not allocated certain classes correctly in its charging system and had therefore charged incorrect fees. In response, the institution reimbursed the affected customers for the amounts charged incorrectly.

In another case, a complainant criticised the fact that the advice she had received about investments in funds had not been consistent with her risk appetite. It turned out that the investment advice minutes compiled originally and the subsequent purchase related to different products. When BaFin confronted the institution with the facts, it offered the customer compensation.

The case of another complainant also ended in compensation. Her complaint was that the meeting during which advice for an initial investment was provided had been unusually short. BaFin asked the institution concerned to comment on whether it was at all conceivable to provide sufficient information in such a short time. In response, the institution offered the customer compensation.

5.6.5 Consumer hotline

Citizens can call BaFin's consumer hotline at +49 (0) 228 299 70 299. Many people again made use of this service in 2014. Hotline staff provided information on financial market topics to 25,681 (previous year: 22,027) callers. Of these, 40 % related to the insurance sector

³⁷ Judgements of the Federal Court of Justice dated 12 March 2014 (case ref.: IV ZR 255/13 and case ref. IV ZR 295/13).

and 44% to the banking sector; 11% of calls concerned securities supervision. The questions posed by consumers varied widely. Many callers wanted to know when the BGH's ruling on handling charges for consumer loans could be expected; after the BGH's ruling in May 2014, there were many questions about the limitation period of these claims. There were large numbers of enquiries from consumers, especially after the publication of a study by the consumer organisation *Stiftung Warentest* conducted in September 2014 on the amount of interest charged for the use of overdraft facilities and on the lack of transparency. Questions on securities supervision related primarily to the providers' obligation to give advice and the informational value of the securities prospectuses. The information on insurers provided by hotline staff related in particular to the total sums paid out by life insurers in light of the interest rate policies of the central banks as well as the tariff changes at health insurers and premium adjustments.

5.6.6 Consumer protection forum

BaFin's third consumer protection forum was held on 9 December 2014. Around 200 high-ranking representatives of consumer protection organisations, financial sector associations and from academia and politics discussed the developments and prospects of integrated financial services supervision in collective consumer protection. Representatives of the Federal Ministry of Finance, the European Supervisory Authorities, the Federation of German Consumer Organisations (*Verbraucherzentrale Bundesverband e.V. – vzbv*) and BaFin itself gave presentations on the current status of regulation in Germany and the EU. In panel discussions, the speakers also discussed with members of the specialist audience what the current and planned regulatory projects mean for BaFin's future collective consumer protection responsibilities. The forum also highlighted the new challenges BaFin faces as integrated financial supervisor in collective consumer protection. BaFin will continue to promote exchanges with the players in consumer protection and invite them to the consumer protection forum.

5.7 Dispute resolution

New rules on alternative dispute resolution to be extended to the financial sector

The German federal government is currently working on implementing the European dispute resolution requirements set out in the Alternative Dispute Resolution (ADR) Directive³⁸ and the supplementary Online Dispute Resolution (ODR) Regulation³⁹. The EU Directive offers consumers the option of out-of-court dispute resolution with financial services institutions. The option of going to court also remains open. No consumer is obligated to accept the arbitration decision proposed.

Implementation of the ADR Directive

The ADR Directive has to be transposed into German law by 9 July 2015. The German federal government has presented a draft bill to this end, under which dispute resolution entities are also to be introduced for financial services throughout Germany. The parties will be able to use these entities to resolve disputes out of court. The German federal government wants this to be implemented in such a way that the existing infrastructure of ombudsman services in this sector is largely retained. In most cases, the ombudsman services already meet the relevant requirements for recognition as consumer dispute resolution entities under the ADR Directive: they have to be independent and have to be able to act independently without being subject to instruction. There must be verifiable evidence that their employees are qualified to mediate in disputes.

Transparency

An important aspect to be observed with regard to the new regulations relates to the transparency of the process. To make their actions transparent, the dispute resolution entities have to provide extensive information on the procedure on their websites, for example. They also have to enable complaints to be accepted online. The providers of financial products are required for their part to

³⁸ Directive 2013/11/EU, OJ EU L 165/63.

³⁹ Regulation (EU) No 524/2013, OJ EU L 165/1.

alert consumers in their standard terms and conditions, on their websites and whenever complaints are filed to the option of using dispute resolution entities in the case of disputes. Conciliation procedures should, if possible, not entail any costs for the customers. Moreover, they must not take longer than 90 days from the date on which the complete complaint file is received by the dispute resolution entity.

Meeting of ombudspersons of the German financial sector

In December 2014, BaFin's Arbitration Board under the Investment Code hosted its third meeting for the exchange of experiences. The meeting, which was held in Bonn, was attended by numerous representatives of the ombudsman services and dispute resolution entities. A fourth meeting for the exchange of experiences is expected to take place in autumn 2015.

The main issues covered in 2014 again related to the ADR Directive and the current status of its transposition into German law. The Federal Ministry of Justice and for Consumer Protection had presented a draft bill in this regard. The

topics of discussion included, among other things, the responsibilities in the recognition procedure, the reporting requirements of the dispute resolution entities and the substitute dispute resolution process.

Meanwhile, the European Supervisory Authorities, ESMA and EBA, have issued complaint handling guidelines, which are based on EIOPA's guidelines. In a presentation, BaFin outlined the development of the guidelines for the insurance sector and explained how the guidelines are being implemented by German undertakings in cooperation with BaFin. The presentation focused in particular on the complaints management function, the complaint report, the process of transferring information to the complainant and the process of responding to complaints.

In another presentation, the Ombudsman Service for Closed-End Funds (*Ombudsstelle Geschlossene Fonds e.V.*) gave meeting participants an overview of day-to-day dispute resolution activities and the most common problems, which are related to the complex structures of fund investments.

6 Authorisation requirements and prosecution of unauthorised business activities

6.1 Authorisation requirements

BaFin examines whether investment and retirement savings offerings require authorisation under the laws whose observance it is responsible for supervising. BaFin investigates any companies that undertake these business activities without the required authorisation and enforces supervisory measures to ensure that the companies comply with the authorisation requirement. In such cases, BaFin works closely with the prosecuting authorities.

Each investment provider has the opportunity to ask BaFin to examine whether authorisation is required for its business

venture. This gives the provider legal certainty as to whether the planned activities require authorisation under the Banking Act (*Kreditwesengesetz*), the Insurance Supervision Act (*Versicherungsaufsichtsgesetz*), the Payment Services Supervision Act (*Zahlungsdiensteaufsichtsgesetz*) or the Investment Code (*Kapitalanlagegesetzbuch*).

If BaFin determines that authorisation is required, the investment services provider may only commence the corresponding activity when BaFin has authorised this in writing. Providers that carry on the activity subject to an authorisation requirement commercially

without having formal authorisation are liable to criminal prosecution. BaFin is authorised to prohibit such business and order it to be wound up, irrespective of any possible criminal prosecution by the competent authorities.

In 2014, BaFin received 988 requests to examine whether an authorisation was required for planned business ventures (previous year: 957). By the end of the year, BaFin finished dealing with 738 such requests (previous year: 653).



6.1.1 Focus

Bitcoin – quo vadis?

Author: Jens Münzer, BaFin Section for the Determination of the Authorisation Requirement, Investigations of Unauthorised Business Operations and the Prosecution of Unauthorised Business Conducted from Abroad

People buying goods, services, IT applications or leisure activities on the Internet pay for them, for example, in euros and US dollars – or, since 2009, using the virtual currency bitcoins (BTC; see info box “Bitcoins as substitute currency”, page 62).⁴⁰

Latest developments

In 2011, BaFin qualified BTC with legally binding effect as financial instruments in the form of units of account in accordance with section 1 (11) sentence 1 of the KWG. These units are comparable to foreign currencies, but are not denominated legal tender. They also include substitute currencies used by virtue of private-law agreements as a means of payment in payment transactions.

BTC are not e-money within the meaning of the German Payment Services Supervision Act (*Zahlungsdiensteaufsichtsgesetz – ZAG*), because no BTC are issued representing a receivable from the issuer. This is different for digital currencies, which are backed by a central issuer. BTC are not legal tender either, and therefore qualify as neither currency nor banknotes and coins.

BaFin has also clarified that the use of BTC as a substitute currency for trade payments is not an activity subject to authorisation under the Banking Act. Mining (see info box “Bitcoins as substitute currency”, page 62) of BTC *per se* is not an activity subject to authorisation either, because miners do not issue or place any BTC themselves. The same applies to the purchase or sale of mined or acquired BTC, which does not require authorisation either. However, an authorisation requirement may arise if there are additional factors. If no authorisation has been obtained in those cases, this may constitute a criminal offence in accordance with section 54 of the KWG.

Banks and financial services providers already holding an authorisation to trade in financial instruments are also permitted to engage in transactions with BTC without being subject to any further authorisation requirements.

Given the possibility of using virtual currencies around the world, over the long term a harmonised international process is required, at least at the European level. That process must also take into account the fact that the technical features of virtual currencies subject them to considerable risk of being used to finance terrorism and for money laundering.

⁴⁰ Although the information in this article refers to BTC, it also applies to similarly structured digital currencies without a central issuer.

Platforms and exchanges

Although one of the ideas of the BTC project was to make financial intermediaries redundant, many companies are currently entering the market to offer BTC-related services.

Often BTC are traded via Internet platforms, some of which are referred to as exchanges. Whether such activities require authorisation can only be determined by analysing the technical and contractual implementation of the transactions in detail:

Chargeable web directories operated by persons offering services for purchasing or selling BTC as a rule constitute investment broking as defined in the Banking Act. Such services are provided, for example, by persons acting as messengers that forward the declaration of intent of a buyer aimed at acquiring financial instruments to the party with which the buyer wishes to enter into such a transaction. This can also be done electronically: persons providing an IT system through which declarations of intent aimed specifically at acquiring or selling financial instruments are forwarded to potential contractual partners carry on investment broking as defined in the Banking Act.

These systems must be distinguished from IT systems where the operators bring together different contractual partners according to set rules, and the parties are not free to decide on a case-by-case basis whether or not they wish to enter into the transaction with a specific contractual partner. Operators of such systems operate a multilateral trading facility, which is a financial service specified in the Banking Act. Especially platforms where providers upload BTC and specify a price threshold at which a trade is to be processed automatically are assumed to be multilateral trading facilities.

Principal broking services, which are subject to authorisation in accordance with the Banking Act, are usually performed on platforms whose participants do not know their trading partners and do not act as agents of the participants but in their own name, and where the economic risks and rewards of the transactions affect the participants who transfer money to platform accounts or transfer BTC to their addresses.

If, by contrast, a platform only establishes general contact between potential buyers and sellers of BTC, this does not constitute investment broking if the contact is merely

Bitcoins as substitute currency

Bitcoins (BTC) are based on the notion of a non-government substitute currency. While the fiat money of the central banks and the book money of commercial banks can be issued in unlimited amounts, the amount of money in BTC is limited. Bitcoins are mined in a computer network using a mathematical process, by solving cryptographic problems. The amount of BTC expands at an increasingly slower rate, until it reaches the maximum number of just under 21 million created in the system. At the end of March 2015, there were approximately 14 million BTC. The BTC project is an open-source project; anyone can participate in the network using programs (clients). In principle, all users have equal rights. There is no central body that conducts or monitors transactions, or generates or manages BTC.

Mined BTC are assigned to addresses in the network consisting of random number sequences. Each user can have several addresses. Users manage these addresses with their clients in wallet files, which also contain the associated private or public key needed to authenticate transactions in the network. BTC are divisible, meaning that it is possible to transfer units smaller than one bitcoin.

The BTC assigned to the addresses and all BTC transactions to date are stored in a central file (blockchain) that is publicly accessible. However, the address does not provide information about the owner. Once carried out, transactions cannot be reversed at all. In addition to the virtual transfer of BTC in the network, addresses and keys can also be transferred physically, for example on data carriers.

established as a referral service. For transactions to qualify as investment broking, an influence must be exerted on the readiness to enter into a transaction. This is normally only the case if specific transactions involving financial instruments are the subject of communication between intermediary and user. If potential buyers and sellers are merely introduced to each other on platforms, this does not constitute the brokering of specific transactions. In such cases, however, the providers on these types of platforms are proprietary traders subject to an authorisation requirement within the meaning of the Banking Act. The sale and purchase of mined or acquired BTC is only exempt from the authorisation requirement if the transactions involve participating in an existing market. If, by contrast, a special effort is made to create or maintain a market, the additional service component means that the activity is proprietary trading within the meaning of the Banking Act. This is the case, for example, if a person advertises the fact on referral platforms or websites that it regularly buys or sells BTC. Providers acting as exchange bureaus that offer to change legal currencies directly into BTC also meet the criterion of proprietary trading subject to an authorisation requirement.

Mining pools

Since each case is different, mining pools, i.e. the pooling of computer processing power in general by several persons for the purpose of jointly generating BTC, are not necessarily subject to supervision. As a general rule, if several persons use processing power with equal rights and subsequently distribute the BTC proportionately, this is not an activity that requires authorisation. Different rules may apply if the pool operator commercially offers a share of the revenue from mined or sold BTC against the provision of processing power and the participants have no control over the specific processes, for example.

Service providers abroad

BaFin assumes that a business is carried on in Germany not only if the service provider's registered office or habitual residence is in Germany, but also if it is located abroad and the service provider targets the market to repeatedly and commercially offer banking or financial services to companies or persons whose registered office or habitual residence is in Germany. However, this does not affect the passive freedom to provide services, i.e. the right of persons and companies resident in Germany to request services from a foreign provider under their own initiative. Transactions that have been entered into because the customer has taken the initiative do not, therefore, require authorisation under the Banking Act. For online offerings relating to financial market products, the relevant criterion is whether analysis of the website as a whole reveals that the services offered are targeted at the German market. A disclaimer is only one of many indicators. Other indications include the domain and top-level domain, the language or other country-specific references and the legal framework.

Other business models

BaFin receives a growing number of enquiries on derivative and fund-like products related to BTC. Again, since each case is different, they are not necessarily subject to supervision. In general, however, if traded commercially, these types of products are subject to the supervisory rules of the Banking Act or the Investment Code (*Kapitalanlagegesetzbuch – KAGB*), because products derived from a financial instrument are themselves financial instruments or at least represent asset management.

The commercial operation of a bitcoin ATM is normally also a banking or financial service subject to an authorisation requirement – depending on the way the purchase processes and legal relationships are arranged between buyer, seller and – in some cases – operator.

II

III

IV

V

VI

6.1.2 Revision of the Payment Services Directive

The EU is in the process of updating the European Payment Services Directive⁴¹ of 2007 on payment services in the European internal market. It seeks to develop the European internal market for electronic payments, which has to adapt to fast-moving technical developments, in a technologically neutral

⁴¹ Directive 2007/64/EC, OJ EC L 319/1.

manner. The aim is to adapt the existing regulations to the emerging innovative online and mobile payment methods. In addition, rules on information and liability are aimed at improving customer protection. BaFin supports the Federal Ministry of Finance in negotiations surrounding the Directive at the European level.

The Directive is currently being negotiated in the triologue procedure between the EU Commission, Parliament and Council.



6.1.3 Focus



Supervisory practice on crowdfunding

Author: V. Müller-Schmale, BaFin Section for Basic Issues Relating to the Authorisation Requirement and Prosecution of Unauthorised Business and Objection and Judicial Proceedings

Start-up companies as well as initiators of creative, cultural and social projects are increasingly using crowdfunding in addition to and also as an alternative to traditional sources of financing. Crowdfunding is the practice of funding a venture by raising contributions from a large number of people. The concept does not have a legal definition yet. In general, it means the direct financing of specific projects by a large number of funders whose contributions are normally collected via Internet platforms. There are many types of crowdfunding; they can be classified into four models: donation-based and reward-based crowdfunding, crowd lending (debt-based) and crowd investing (equity-based) (see info box "Four crowdfunding models").

Supervisory duties

The focus of supervision is on crowd investing and crowd lending, although most crowdfunding platforms currently operating in the market are designed in such a way that they do not require authorisation.

Under section 32 (1) sentence 1 of the Banking Act (*Kreditwesengesetz – KWG*), any

Four crowdfunding models

In practice, four crowdfunding models can generally be distinguished: donation-based crowdfunding is the contribution of funds as a donation without receiving anything in return. By comparison, in reward-based crowdfunding, the contributors usually receive a non-monetary reward, for example their name appears in the credits of a film or they receive personal items from the artist. If the crowd issues loans, the activity is referred to as loan-based crowdfunding or crowd lending. In this case, the people accepting the funds ask for a loan to be issued, and the creditors are given the promise that the capital will be repaid, with or without interest. In the case of crowd investing, the fund provider usually gets a share of the future profits of the company or of the sales proceeds; these claims are normally securitised.

person wishing to conduct banking business or provide financial services in Germany commercially or on a scale which requires a commercially organised business operation requires a written authorisation from BaFin. Depending on the set-up, there may also be an authorisation requirement under the Industrial Code (*Gewerbeordnung* – GewO) (see info box “Individual examination”).

Crowd lending and crowd investing

In principle, pure-play credit intermediation does not require an authorisation under the Banking Act. Therefore, BaFin does not usually supervise lending platforms.⁴² However, the brokerage activity may require authorisation under section 34c of the GewO. Depending on the contractual arrangements, authorisation requirements may be applicable to the operators of the platform.

By granting money loans, lenders might in certain circumstances be carrying on the lending business within the meaning of section 1 (1) sentence 2 no. 2 of the KWG⁴³ or, if they purchase loan receivables under a master agreement, they might be carrying on factoring business within the meaning of section 1 (1a) sentence 2 no. 9 of the KWG.⁴⁴ Borrowers, on the other hand, might be conducting deposit business within the meaning of section 1 (1) sentence 2 no. 1 of the KWG, since they accept funds from others as deposits or other unconditionally repayable funds from the public.⁴⁵

The operator of the lending platform may also conduct deposit business in certain circumstances, for example if they ask potential lenders to deposit the amounts of money these users want to grant as loans via the lending

⁴² See BaFin Guidance Notice on the Authorisation Requirements for Operators and Users of Online Lending Platforms (only available in German).

⁴³ See BaFin Guidance Notice on the Statutory Definition of the Lending Business (only available in German).

⁴⁴ See BaFin Guidance Notice on the Statutory Definition of Factoring (only available in German).

⁴⁵ See BaFin Guidance Notice on the Statutory Definition of the Deposit Business (only available in German).



Individual examination

BaFin can only make a binding statement on whether a platform offering crowd financing requires authorisation in respect of each individual case on the basis of the respective contractual arrangements. Different supervisory requirements must be observed, depending on how a particular crowdfunding model has been set up. Consequently, this article only provides a broad overview of potential authorisation requirements for the different crowdfunding models.

platform, before concrete loan agreements are entered into (for example at the time they register as users or lenders). Irrespective of that, the operators of a lending platform are involved undertakings within the meaning of section 37 (1) sentence 4 of the KWG if one or more borrowers or lenders conduct or intend to conduct banking business subject to an authorisation requirement.

Depending on the specific contractual arrangements, crowd investing may also be subject to prudential authorisation requirements.

Authorisation requirements under the Banking Act

The categories to be considered include investment broking⁴⁶, contract broking⁴⁷ and the placement business⁴⁸, if the equity investments offered via the platform are financial instruments within the meaning of section 1 (11) of the KWG.⁴⁹

⁴⁶ See BaFin Guidance Notice on the Statutory Definition of Investment Broking (only available in German).

⁴⁷ See BaFin Guidance Notice on the Statutory Definition of Contract Broking (only available in German).

⁴⁸ See BaFin Guidance Notice on the Statutory Definition of the Placement Business (only available in German).

⁴⁹ See BaFin Guidance Notice on Financial Instruments pursuant to section 1 (11) sentence 1 nos. 1 to 7 of the KWG (only available in German).

Anyone conducting business involving the purchase and sale of financial instruments conducts investment broking. Broking services within the meaning of this rule are provided by, among others, persons acting as messengers that forward the declaration of intent of an investor aimed at purchasing or selling financial instruments to the party with which the investor wishes to enter into such a transaction. The messenger service can also be provided electronically, for example by providing an IT-based trading system.

If, however, a platform operator does not act as messenger but as agent of the investor, this may be considered a case of contract broking, i. e. the purchase and sale of financial instruments in the name of and for the account of third parties.

Moreover, the placement of the financial instruments may be considered to be the conduct of placement business. In section 1 (1a) sentence 2 no. 1 c) of the KWG, this is defined as the placement of financial instruments in the name of and for the account of third parties. Since the placement business is a special case of contract broking, the placing party is required to issue its own declaration of intent to purchase or sell. In most cases this does not happen, because the platforms do not normally issue declarations of intent, but merely forward declarations of intent.

Exceptions to the authorisation requirement

Even if the authorisation requirements are met, most platforms are currently not subject to an authorisation requirement, because they fall under the exceptions allowed by section 2 (6) sentence 1 no. 8 e) of the KWG or section 2 (6) sentence 1 no. 19 of the KWG. Under these provisions, platform operators do not require authorisation if they conduct investment broking without acquiring ownership or possession of the funds and operate the placement business exclusively for providers or issuers. This means that authorisation pursuant to section 34f of the GewO is normally sufficient.

Authorisation requirements under the ZAG and KAGB

In addition to an authorisation requirement under the KWG, there may also be an authorisation requirement under the Payment Services Supervision Act (*Zahlungsdiensteaufsichtsgesetz – ZAG*) in cases where the platform operator conducts money remittance business by accepting funds from investors and forwarding them to the providers of the equity investment.⁵⁰

Depending on the contractual arrangements, project and pooling companies involved in crowd investing may be subject to authorisation requirements under the Investment Code (*Kapitalanlagegesetzbuch – KAGB*).⁵¹

Section 1 (1) sentence 1 of the KAGB defines the term “investment fund” and defines the scope of the KAGB. An investment fund within the meaning of section 1 (1) sentence 1 of the KAGB is any collective investment undertaking which raises capital from a large number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and which is not an operating company outside the financial sector.

Because its focus is on its operating activities, a typical start-up company that operates the plants, production or project itself in the ordinary course of business will normally not fall within the scope of the KAGB. Even if the company uses external service providers or companies in the same group in its operating activities, it continues to be considered an operating business, providing that the business decisions in the ordinary course of business are made by the company itself because it retains the right to determine the work performed as well as the rights of control and instruction. The capital collected by pooling companies may also be classified as an investment fund.

⁵⁰ See BaFin Guidance Notice on the Payment Services Supervision Act (only available in German).

⁵¹ See BaFin interpretive letter on the scope of the KAGB and the concept of investment fund (only available in German).

Prospectus requirement

Prospectus requirements pursuant to the Securities Prospectus Act (*Wertpapierprospektgesetz – WpPG*) or the Capital Investment Act (*Vermögensanlagengesetz – VermAnlG*) may also be observed for offers to the public of €100,000 or more. If a prospectus is required under the Securities Prospectus Act, a capital investments information sheet has to be prepared before an offer to the public is launched.

Opportunities and risks

Crowdfunding can benefit both the providers and the recipients of funds. Providers can participate in projects from which private investors were previously excluded. For companies – especially start-ups – it makes it easier to access financing. For many it serves as a first market test for new ideas. But crowdfunding also entails risks. These risks, which are already associated with start-up financing, are exacerbated by the typology of crowdfunding and the fact that the group of recipients is larger than in traditional forms of financing and equity investment and individual investors hold lower investment totals. In addition, crowdfunding often involves innovative projects where the investors assume the role of venture capitalists. If the project is not viable, they risk losing the invested capital.

Irrespective of the opportunities and risks associated with crowdfunding, both the operators and the users of the crowdfunding platform have to consider potential authorisation and prospectus requirements.

Investor responsibility

Investors must be aware of the fact that the majority of crowdfunding platforms do not require authorisation, and as such are part of the unregulated, or grey, capital market. This term refers to a situation in which a provider does not require authorisation from BaFin and only has to meet a small number of statutory requirements.⁵² The fact that the offering is

made via the unregulated capital market does not in itself permit any conclusions about the risk associated with the investment. However, the risks typically associated with unregulated capital market products exist. They arise from the fact that there are no product checks, providers and their financial standing are not supervised, the financial statements are not scrutinised and there is no deposit protection.⁵³ In short, investors enter a market segment that is not regulated by the government and where they expose themselves to the free play of market forces, usually as the weaker party. However, each investor is responsible for making an investment decision that corresponds to their personal risk appetite and investment objectives.

Changes resulting from the German Retail Investors Protection Act

The planned Retail Investor Protection Act (*Kleinanlegerschutzgesetz*⁵⁴) is intended to close legal loopholes. Investor protection is to be improved and the risk of losses on investments reduced. For example, investors are to be provided with full capital investments information that is up to date at the time of investment. The aim is to allow investors to make a better assessment of the risks of an investment.

To this end, the definition of capital investments is to be expanded to include the profit participation loans, subordinated loans and all financially comparable types of capital investment typical of crowdfunding, if they do not fall within the definition of deposit business within the meaning of section 1 (1) sentence 2 no. 1 of the KWG because they use loss participation arrangements or qualified subordination clauses. Furthermore, the government draft sets out additional requirements for the sale of capital investments, in particular with regard to marketing and advertising investments. The

⁵³ See BaFin brochure "Grey market and black sheep" (only available in German).

⁵⁴ For details on the Retail Investors Protection Act see also interview, page 12 f., chapter II 5.2.1, chapter V 1.2.

⁵² See www.bafin.de/dok/5023062

new requirements will impact on crowd-funded financing. For crowdfunding, the draft Retail Investor Protection Act provides for some relaxation of the requirements in sections 2a

and 2b of the draft VermAnIG; they will to a certain extent allow crowd-funded financing to be raised without a prospectus.



6.2 Exemption from the authorisation requirement

If the special nature of a company's business makes it seem unnecessary to supervise that company, BaFin can exempt it from the authorisation requirement. This normally relates to transactions that do not seem systemically important and are conducted in connection with principal business activities that do not require authorisation. By comparison to these principal business activities, such transactions are merely regarded as low-level auxiliary or ancillary transactions. In the course of 2014, BaFin exempted nine companies from supervision for the first time, compared with seven in the previous year. This means that a total of 340 institutions were exempt from the authorisation requirement at the end of 2014, as the nature of their business means that they do not require supervision.

The exemption option is in principle also available to providers from third countries outside the European Union that want to commence cross-border business activities in Germany. However, a condition of exemption in Germany is that they are subject to equivalent supervision in their respective home country. In 2014, BaFin granted exemption to four foreign companies (previous year: five).

6.3 Illegal investment schemes

Supervisory and investigative measures

The fight against illegal investment schemes (see info box) is essential for safeguarding Germany's integrity as a financial centre. To this end, BaFin initiated a total of 696 new investigations in 2014 (previous year: 672)

and concluded 625 proceedings (previous year: 497). During its investigations, it issued formal requests for information and the submission of documents to suspicious companies or individuals in 68 cases (previous year: 73). It imposed coercive fines in a total of 29 cases (previous year: 19).

As part of its investigations into unauthorised business operations, BaFin's investigators carried out seven searches of premises and on-site inspections (previous year: 24).



Illegal investment schemes

Illegal investment schemes are all banking, financial services, investment and insurance businesses, as well as payment services operated by providers that do not have the required authorisation. The players involved in illegal investment schemes are therefore by their nature not subject to any government regulation. It can therefore not be assured that they meet the personal, professional or financial requirements for operating such businesses. BaFin has extensive powers of investigation and intervention to uncover and combat unauthorised business activities, even by international standards. As a result, its investigators can not only search the business premises of suspicious companies and confiscate documents, but BaFin can also prohibit business activities with immediate effect, order the winding up of the business, issue instructions and impose coercive fines.

Business of Peter Fitzek being wound up

In 2014, BaFin again took action against the unauthorised business activities of Peter Fitzek. It prohibited him, his front men and the unregistered associations "Cooperative Savings Bank" ("Kooperationskasse"), "Royal Bank of Germany" ("Königliche Reichsbank"), "New German Health Insurance" ("NeuDeutsche Gesundheitskasse") and "Kingdom of Germany" ("Königreich Deutschland") from carrying on the deposit or insurance business. BaFin also prohibited the "Holistic Ways" ("Ganzheitliche Wege e.V.") association, which had been involved in

the business activities, from carrying on its business.

The above-mentioned individuals and associations offered products such as "savings books" ("Sparbücher" and "Sparhefte") and health insurance, long-term care and pension insurance contracts online.

On 26 November 2014, BaFin engaged a liquidator to repay the funds to investors and terminate the insurance contracts. The liquidator is also responsible for corresponding with the affected investors.

In the course of 2014, BaFin issued 18 prohibition orders (previous year: 16) to prohibit the continuation of unauthorised business operations. In addition, it ordered 34 companies to wind up their business (previous year: 26). In 17 proceedings, BaFin appointed a liquidator (previous year: one).

In 2014 a total of 59 recipients – companies as well as individuals – filed objections to formal measures with BaFin (previous

year: 48). BaFin completed 52 objection procedures (previous year: 38), 31 of them by issuing objection notices (previous year: 24). Various affected parties took legal action against supervisory measures. The courts across all levels ruled in a total of 36 cases (previous year: 17), handing down 30 judgements or orders in favour of BaFin (previous year: 14). In six cases, the courts ruled in favour of the affected providers (previous year: 3).

7 Financial accounting and reporting

7.1 Financial instruments accounting under IFRS 9

In July 2014, the International Accounting Standards Board (IASB) announced the final version of the International Financial Reporting Standard on financial instruments accounting (IFRS 9 Financial Instruments). The new rules replace the provisions of the previous International Accounting Standard (IAS) 39, and all previous versions of IFRS 9. Companies that report in accordance with IASs/IFRSs have to apply the revised standards for the first time for financial years beginning on or after 1 January 2018 – in the EU subject to endorsement of the standards by the European Commission.

IFRS 9 completes a number of reforms the IASB has implemented in response to the financial market crisis. The IASB has fundamentally revised the regulations on the classification and measurement, impairment and hedge accounting of financial instruments and adapted them to the requirements of the G20 and the FSB (Financial Stability Board). At the same time, the IFRS 9 project was an important element in the efforts of the IASB and the US Financial Accounting Standards Board (FASB) to harmonise their standards. In the end, however, the IASB and the FASB took different decisions on key aspects, such as the classification model and the impairment concept, so that their

convergence efforts are considered to have failed.

New classification and measurement concept

IFRS 9 divides all financial assets into three measurement categories. They are measured at amortised cost, at fair value through profit or loss or at fair value through other comprehensive income. The assignment to one of the categories is based on the business model and the cash flow properties of the respective financial asset.

For accounting for financial liabilities, IFRS 9 has retained the categorisation of IAS 39. The only relevant new guidance relates to own credit risk, i. e. changes in fair value resulting from the entity's own credit standing. In future, these changes will have to be presented in other comprehensive income. The amounts must not be reclassified to the income statement at a later stage. In this way, the IASB eliminated a key point of criticism levelled at IAS 39: gains resulting from a deterioration in the entity's own credit standing will be excluded in future.

Forward-looking impairment model

The centrepiece of IFRS 9 is the new expected credit loss model, according to which the recognition of impairment losses is not left until they have been incurred. This means that entities will also have to recognise a loss allowance for expected default events on financial instruments that are not yet non-performing. The IASB has thus largely met the request of numerous supervisory authorities to solve the "too-little-too-late" problem of IAS 39.

In general, it is to be expected that IFRS 9 will lead to an increase in write-downs and thus also in loss allowances when it is applied for the first time. Since the new impairment model is forward-looking, it also requires entities to implement additional systems and processes in order to obtain forward-looking information on possible risks. Management is responsible for assessing the appropriateness of the loss allowance to a greater extent than before.

Hedge accounting rules relaxed

The rules of IFRS 9 on general hedge accounting, i. e. on accounting for contracts that are in a hedging relationship and are suitable for offsetting risk because their components move in opposite directions, have also been revised. The aim was to improve the presentation of the entity's risk management in the balance sheet. In doing so, the IASB has largely met the banks' demands to extend the scope of permissible hedged items and hedging instruments. Since the quantitative requirements on hedge effectiveness are also less strict than under IAS 39, hedge accounting will in future be possible to a greater extent.

Meanwhile, as part of a separate project, there is continuing debate about hedge accounting applied to entire companies or a portfolio of assets (macro hedging), which is primarily relevant for financial institutions. Until it has completed its work, the IASB is giving all entities the one-time option to continue to apply the provisions of IAS 39 as an alternative to the hedge accounting rules of IFRS 9.

The impact IFRS 9 will have on the accounts of insurance undertakings will largely depend on how the IASB formulates the rules for insurance contracts in future. From BaFin's point of view, the aim should be to harmonise the interaction between the two standards and in this way avoid volatility in the balance sheets and income statements of insurers.

7.2 Accounting for insurance contracts

The IASB is currently working on standardised international rules on accounting for insurance contracts⁵⁵. It is not yet clear how complex the international requirements will be in their practical application. Issues still to be resolved include the accounting treatment of long-term participating contracts in life insurance as well as considerations as to how possible mismatches in insurers' balance sheets can actually be reduced.

⁵⁵ IFRS draft ED/2013/7.

An initial field test on the practical application of the guidance developed so far has moreover confirmed that the principles-based valuation model for the accounting treatment of technical provisions proposed by the IASB can in principle be implemented in practice. According to this model, provisions are measured at their fulfilment value, based on the three building blocks: discounted, probability-weighted cash flows, risk adjustment and contractual service margin. However, the test participants criticised the IASB's proposal because it provided for an exception to this building block model, known as the mirroring approach, for long-term life insurance contracts. They rejected the proposed exception as too complex and impracticable.

IASB examining insurance industry's proposal

As the discussions progressed, the European insurance industry presented an alternative proposal in the first half of 2014 as to how participating contracts could be accounted for. It has the advantage that it simplifies the practical assessment of the cash flows and remains compatible with the IASB's general building block model. This book yield approach is complemented by a fully flexible contractual service margin and optional recognition of value fluctuations in other comprehensive income. Its objective is to avoid accounting mismatches and short-term volatilities recognised through profit or loss in the presentation of the insurers' long-term business.

The IASB is currently deliberating the submitted proposal and is examining its implementation in the standard-setting process. Although BaFin welcomes this in principle, a convincing theoretical as well as practice-based development of the alternative proposal would make it difficult to complete as necessary the IASB's entire insurance project promptly in 2015.

7.3 EU regulatory project on audit policy

The audit reform process was concluded in May 2014 and resulted in the publication

of a Regulation and a Directive on EU audit regulation. The Directive amending the Audit Directive⁵⁶ relates to audits of company financial statements in general. The accompanying Regulation⁵⁷ governs statutory audits of the financial statements of public interest entities. The new rules are intended to improve the quality and transparency of audits while at the same time ensuring that there is a more active market from which to select the official auditor. The Regulation enters into force on 17 June 2016 and the Directive must be transposed into national law by that time. During the deliberations, which lasted several years, many of the European Commission's original proposals on audit regulation were abandoned.

The most important changes resulting from the Directive include a definition of professional scepticism of auditors and stricter requirements for the independence as well as the internal organisation of auditors and audit firms. In addition, the European Commission is authorised to adopt the International Standards on Auditing for the purpose of applying them in the EU. The Directive also imposes new requirements for the audit report and for the work and powers of audit committees and introduces a prohibition on "Big 4 only" contractual clauses, which restrict the choice of auditors.

Stricter audit requirements for public-interest entities

The new Audit Regulation imposes more specific audit requirements on public-interest entities. For example, an external rotation requirement has been introduced, which means that in principle the auditors have to be changed after ten years. However, the member states have the option to extend this period in the case of a public tendering process or joint audits.

Other provisions relate to the prohibition on non-audit services, which are conclusively defined, as well as a limit on fees for non-audit

⁵⁶ Directive 2014/56/EU, OJ EU L 158/196.

⁵⁷ Regulation (EU) No 537, OJ EU L 158/77.

services of no more than 70% of the average audit fees paid at the level of the engagement. To account for the special function of financial statements of public-interest entities, the Regulation contains even more detailed requirements for the audit reports and for the additional report to the audit committee.

Financial statements to become easier to understand

The new legal requirements define the responsibilities of an auditor more clearly.

The revised requirements on transparency as well as special clarifications are intended to make the results easier to understand for the addressees of the audit. However, the new provisions are also aimed at improving audit quality and strengthening confidence in the propriety and reliability of financial statements. In addition, the newly established Committee of European Audit Oversight Bodies (CEAOB) is expected to contribute to intensifying EU-wide cooperation on auditor supervision and further improving audit quality.

8 Money laundering prevention

BaFin circular on the obligation to report suspicions

Section 11 of the German Money Laundering Act (*Geldwäschegesetz*) sets out an obligation to report suspected cases of money laundering or terrorism financing. In March 2014, BaFin issued a circular to explain in detail how this reporting obligation should be handled.⁵⁸ Previously, the Federal Ministry of Finance had issued application guidelines for all parties subject to the provisions in the financial and non-financial sector. The guidelines had been presented by a working group of representatives of the Federal Ministry of Finance, the Federal Ministry of the Interior and various federal and state authorities. In a number of deliberations and statements, BaFin widely contributed its expertise to this process.

The application guidelines are binding on the parties subject to the provisions and the affected supervisory authorities. They are aimed at standardising the system for reporting suspicions by the affected parties and at optimising it also in the non-financial sector. Suspicious transaction reports due to possible money laundering or terrorism financing are among the main requirements under the Money Laundering Act. Not only do violations of this reporting obligation have

supervisory law implications, but BaFin also imposes administrative fines in such cases. In some circumstances, as in the case of criminal involvement in money laundering by the affected party, this could even be liable to criminal prosecution pursuant to section 261 of the German Criminal Code (*Strafgesetzbuch*).

Prompter, more frequent reports

The application guidelines emphasise the importance of having a prompt reporting system. The parties subject to the reporting obligation will have to report any indications of violation of the Money Laundering Act more promptly and more frequently than before. This is in line with the requirements of the Financial Action Task Force (FATF). In its latest country evaluation, the FATF critically remarked that, especially in view of the size of the German financial sector, there had been relatively few suspicious transaction reports in Germany.

BaFin publishes video identification requirements

In Circular 1/2014 (GW), BaFin published the requirements of the Federal Ministry of Finance on video identification. This type of identification is equated to physical presence identification, provided that certain security requirements are met, for example the fact that this process is limited to certain types of identification documents. This means that the

⁵⁸ Circular 1/2014 (GW), www.bafin.de/dok/5295362

individuals taking part in the identification do not have to be present in person, provided they can be observed by means of video transmission. It provides greater freedom for designing the identification process without media discontinuity, for example when opening

an account, because customers can choose to identify themselves from home or while travelling. Previously, this was only possible if the customer had a new generation identity document with an activated online ID function as well as an identity document reader.

9 Risk modelling



9.1 Focus

All change for internal risk models

Authors: Ottmar Bongers, Michael Bruns, Alexandra Gebauer, Carmen Koberstein-Windpassinger, Dr. Peter Müller, Cross-Sectoral Risk Modelling Department

Banks have been allowed to calculate their capital requirements for market risk using internal models since the Basel Committee on Banking Supervision (BCBS) added the Market Risk Amendment to the Basel framework in 1996. Basel II also introduced this option for credit risk in 2007. The regulation of internal models has been changed and expanded a great deal since then. But supervisors and standard setters have rarely debated this matter as vigorously as they are doing now.

Post-crisis models

Following the global financial crisis of 2007/2008, the capital requirements for market risk were increased significantly on the basis of Basel II.5 and Basel III as well as the European Capital Requirements Directives III and IV (CRD III and CRD IV). In addition, banks were prohibited from using internal models for products with complex structures. Moreover, models experts of the Single Supervisory Mechanism (SSM), the European Banking Authority (EBA) as well as the European Insurance and Occupational Pensions Authority (EIOPA) are working on ways to standardise

supervisory regulation and supervisory practice.

Benchmark comparisons among banks

Because of the continuing debate about the appropriateness of risk-weighted assets (RWAs) and the models used to determine them, the Basel Committee and the EBA conducted benchmark exercises of RWA calculations for credit and market risk (see info box "Benchmark exercises among insurers", page 74).

A Basel working group (Supervision and Implementation Group-Trading Book Task Force – SIGTB) conducted global comparisons to analyse trading book variations; it is currently examining counterparty credit risk. Another working group of the Basel Committee (Supervision and Implementation Group Banking Book Task Force – SIG BB) analysed the credit risk, focusing primarily on internal ratings-based approaches (IRBAs). Its first step was to examine portfolios that had historically experienced few defaults (low-default portfolios). Early in the summer of

Benchmark exercises among insurers

In a comprehensive market risk benchmarking exercise coordinated by EIOPA, 22 insurance undertakings throughout Europe were also examined. The aim was to compare the different models applied to the risk factors and their dependencies and to establish how the results can be used in terms of supervisory assessment and the measures taken. The comparison has identified differences in the way market risk factors are modelled, and thus has provided key starting points for further debate and assessment of the market risk models as part of the Solvency II pre-application phase, in particular for supervisory authorities, which had to date few opportunities to draw comparisons.⁵⁹ The benchmark exercise has again shown very clearly that it is of crucial importance that supervisors have a detailed understanding of the market risk models, including the exposure of the individual insurance undertakings – such as risk profile and portfolio structure – when assessing the results of such comparisons. Against this backdrop, the comparison will be continued in 2016, taking account of further information specific to each undertaking.

2015, the group intends to present a study on retail portfolios and small and medium-sized enterprises. It is also working on a proposal for continual supervisory monitoring of risk-weighted assets of low-default portfolios.

At the same time, the EBA conducted similar benchmark exercises focusing on European banks. In addition, Article 78 of the CRD IV requires to perform annual benchmarking from 2014 for all banks using internal models, the only exception being those used for operational risk. Germany's BaFin will also be closely involved in these benchmark exercises.

All benchmark exercises of the Basel Committee and the EBA have in common that they consist of different components, such as top-down and bottom-up analyses, questionnaires and supervisory visits. For example, SIG BB's analysis has shown that for most of the banks surveyed, risk-weighted assets (RWAs) are in a fairly acceptable range. In particular, the range observed had few outliers. Overall, most of the differences can be attributed to different risks to which the respective banks are exposed, i. e. the risk profiles are different. For some differences, further benchmark exercises and analyses are required. Furthermore, it is important to take adequate account of the simplifications and assumptions that have to be made for the comparisons, as they can influence the variance observed.

A distinction must also be made between intended and unintended differences in the results. If bank-specific risk management processes or assessments lead to different results, this may be intentional because the calculation of capital requirements has to be based on the risks since the introduction of Basel II. In many cases, the differences in RWAs were attributable to options exercised by the national supervisor or the institution. In these cases, too, both parties acted within the specified rules. Although the benchmark exercises did not provide any indications that banks acted improperly when calculating their capital requirements, the individual assumptions and practices require clarification and harmonisation to reduce the incidence of unintended differences and to make the results more comparable.

Internal models criticised

The results of the benchmark exercises for banks triggered calls for standardised methods to ensure better comparability. Some went so far as to demand restrictions or a prohibition on the use of internal models for calculating capital requirements. They claimed that the models gave banks opportunities for manipulation, were too complex, could only be understood by experts and were difficult to validate by supervisory authorities.

⁵⁹ See chapter II 9.2.

Task Force on Simplicity and Comparability

The Basel Committee on Banking Supervision took this criticism on board and mandated the Task Force on Simplicity and Comparability (TFSC) to examine the role of internal models within the framework and to develop proposals for their continued use.

The TFSC is thus dealing with an issue that is of fundamental importance for the future direction of banking supervision. Therefore, it is as important to reflect back on the key elements of the framework since Basel II as to thoroughly examine alternatives and to actively engage in dialogue with the industry.

Stronger risk management

Internal models are not an end in themselves, but exist to strengthen the institution's risk management. For this purpose, they deliver risk-sensitive results and thus enable risks to be managed and resources to be allocated. The parallel use of internal models to control and calculate capital requirements is a fundamental demand of the Basel framework, with the risk sensitivity of capital requirements as an absolute prerequisite.

The calculation of risk using internal models makes high demands on the quality of data, processes and IT support. To implement the risk-sensitive calculation of capital requirements, the banks have made considerable investments and continually have to deploy significant resources to maintain quality standards. Overall, the introduction of internal models has led to a considerable increase in the quality of the information available for managing a bank.

Management responsibility

There are two reasons why it is particularly important to involve the executive management and the supervisory bodies of a bank when using internal models: firstly, in addition to sufficient data, support and IT quality, the development and use of internal models require qualified staff, efficient processes and a risk culture that must be evident throughout the organisation, from the institution's management down to

its business, support and control functions. Secondly, an institution's management can only interpret and use internal models adequately if it has sufficient knowledge of the strengths, weaknesses and limitations of those models. Some of the criticism of models is therefore levelled less at the models themselves, but more at the people who inappropriately use the results the models produce.

Significance of comprehensive model validation

A key requirement for executive management to meet its responsibility in the use of models is the provision of information and management tools by risk and model experts, who have to be deployed by all institutions using internal models. The comprehensive validation of the models is of critical importance; it is used to determine whether a model is suitable for its purpose. Comprehensive model validation cannot be limited to statistical tests, but is based on the insights gained through qualitative risk analysis, during which bankers have to prove their core competence. Qualitative risk management as well as risk modelling and measurement are therefore no opposites; they have to complement each other and hence must not be considered separately. Comprehensive model validation also includes

- critical analysis of data and process quality,
- a review of the suitability of risk reports in the context of the risk management processes,
- a presentation of the strengths, weaknesses and limitations of a model in a way that executive management can understand them and
- recommended actions to eliminate or tolerate these weaknesses.

Model risk management

Bank regulation imposes special requirements on the management of market, credit and operational risk. It has taken banks some time to implement their risk management processes in such a way that they meet these requirements. For some institutions there is still a need to take action in this area. To ensure that banks handle models and the resulting

II

III

IV

V

VI

Appendix

risks appropriately, it may be expedient to place model risks on a par with market, credit and operational risk.

Efficient use of models

The key figures calculated using models do not all provide the same level of information and quality. It is debatable, for example, whether the use of internal models makes sense in situations where only a small amount of historical data is available and therefore statistical processes are of limited use. Another criterion for the use of internal models within the framework may be the benefits they have for risk management processes. If, for assessing specific credit risks, a bank does not have meaningful data and institution-specific insights that an internal model can use, the individual modelling loses meaning and purpose.

Limitations of internal models

If regulation limits internal models or their replacement by specifying methods for calculating capital requirements, it chooses not to require the bank to validate models and adapt them to changing risks. As a result, standard setters themselves assume the responsibility for regularly reviewing and adjusting these requirements for alternative solutions in order to avoid giving the wrong incentives, which could lead to undesirable outcomes. But it takes a lot of time to change the regulatory framework. It is therefore advisable to consider conducting regular tests of the appropriateness of possible restrictions on internal models and to adjust the framework relatively promptly.

Model supervision

When using internal models in accordance with the requirements of the framework, the institutions are not entirely left to their

own resources. The supervisory authority has to validate and approve these models. The initial approval is normally preceded by several months, and in some cases years, of preparations and an on-site examination that takes several weeks. Following model approval, the model supervisor accompanies the institution closely. To this end, the bank's and the supervisory authority's model experts meet regularly, and the supervisory authority analyses the bank's risk and validation reports. However, the supervisory authority also conducts follow-up audits and tracks whether the banks correct the deficiencies it has identified. In addition, the supervisory authority deals with model change applications from the institutions.

The objection raised by critics that the institutions can manipulate models as they please and without supervision is therefore unfounded.

Further investigations and considerations

The current regulatory framework has been developed over many years and banks have made great efforts to implement it. If parts of the framework have not proved successful these have to be changed. The fundamental benefits of risk-based regulation must, however, not be abandoned in this process. Changes must be examined carefully and non-risk-sensitive approaches must be critically assessed.

The regulatory framework has over time grown to a significant size. It is unnecessarily complex in some places, but not clearly formulated in others, triggering considerable need for interpretation. This has increased its size even more. Therefore, a critical review and streamlining can significantly help to simplify the framework and improve comparability.



9.2 European harmonisation of model supervision

Concurrently with the debate on changes to the regulatory framework for the use of internal models, various initiatives were presented at the European level through which the model supervisor wants to harmonise supervisory law and supervisory practice for banks and insurance undertakings.

9.2.1 EBA standards

As part of its mandate to develop a Single Rulebook, the European Banking Authority (EBA) in 2014 continued its comprehensive programme to harmonise supervisory law and harmonise supervisory practice standards. On behalf of the European Commission, various EBA working groups dealt with credit risk, operational risk and market price risk. They developed a number of draft regulatory technical standards and implementing technical standards for the internal ratings based approach (IRBA) for credit risk, the advanced measurement approach (AMA) for operational risk and for market risk models.

The following four sets of rules developed by the EBA in 2014 are particularly significant.

Model extensions and changes

The regulatory technical standard on assessing the materiality of model extensions and changes for IRBA and AMA models published on 12 March 2014 had been created jointly by the Task Force on Model Validation and the Subgroup on Operational Risk. The main focus is on the assessment of materiality, i.e. the severity of changes and extensions. Materiality is the key criterion for the supervisory procedure, i.e. in particular for determining whether authorisation is required from the supervisory authority or whether the model change is only subject to a notification requirement. The categories of "model extension" and "material model change" previously used by BaFin have been merged in the EBA's draft into the "material changes" category, which requires authorisation by the respective supervisory authority.

BaFin considered it important to maintain the category of extensions and changes that require notification to the competent authority before their implementation, which relates to less material changes. This category gives the supervisory authority the necessary flexibility to adopt a risk-based approach. BaFin also considered it important to include in the annex to the regulatory technical standard a list of abstractly formulated criteria structured by topic. Originally, the EBA had intended – especially for the IRBA – to specify all the requirements for the authorisation procedure in an exhaustive list.

The fact that qualitative criteria have been given greater weight than quantitative criteria was also successfully negotiated by BaFin. The qualitative criteria are intended to capture as many changes as possible for which a bank needs a new authorisation from the competent supervisory authority. However, the possibility cannot be ruled out that changes with a material impact may not be identified as requiring authorisation, even if the qualitative criteria are applied. This residual supervisory risk is to be mitigated by applying a quantitative threshold as a backstop.

BaFin also prevailed in setting significantly higher quantitative thresholds in the IRBA, at least for the level of individual institutions, than most member states had originally requested.

Supervisory review of IRBA models

The EBA has also developed a regulatory technical standard on the assessment methodology for IRBA models, which determines the assessment methods and the procedures for reviewing the IRBA requirements. It covers issues such as internal governance and validation, use testing, definition of default and loss, risk quantification, stress testing, data requirements and the calculation of capital requirements.

The impact on German institutions using the IRBA is significant in some cases, because the consultation paper contains a number of requirements that BaFin had not previously

II

III

IV

V

VI

Appendix

expressly specified for the institutions in Germany.

The provisions in the current draft of the standard according to which institutions are expected to establish a validation unit whose staff is separate from the staff responsible for designing the models will be particularly labour-intensive and costly for the institutions. This will affect mainly *Landesbanks* and, along with them, all institutions that use a variety of different rating systems as part of a pooling system (see info box). The pool leader is responsible for performing the validation on behalf of the pool. The institutions conduct downstream validation activities for their own data, but only to the extent that they receive the corresponding data from the pool leader.

Requirements for the loan-to-value ratio of real estate

Due to negative experience with mortgage loans in some EU member states, the European Commission instructed the EBA to introduce a European loan-to-value ratio. In response, it drafted a regulatory technical standard on the requirements for the loan-to-value ratio. The standard currently proposes that an EU regulation should replace the existing national valuation rules to achieve maximum harmonisation. The EBA interprets the regulatory text of the Capital Requirements Regulation (CRR) in such a way that the standard is to be applied not only to the equity weighting, but also to the valuation of *Pfandbriefe*. The EBA argues that member states that use a loan-to-value ratio for this purpose must also be mandated to use this ratio for their capital requirements and that this means that the planned regulatory technical standard also applies to the valuation of *Pfandbriefe*. The European Commission is currently examining this interpretation.

In Germany, this interpretation could mean that the German Loan-to-Value Regulation (*Beleihungswertverordnung*) will be superseded by the regulatory technical standard. In that case, it would be applicable to both capital



Pooling system

Internal models require sufficient underlying data, but this data is not always available in a single institution. Pooling systems are designed to solve this problem. Several institutions combine their data and use the shared underlying data to develop individual rating systems. Normally a shared service partner is responsible for designing the models for all participating institutions. Each institution is responsible for introducing the model and integrating it into its own risk management system.

requirements and *Pfandbrief* refinancing. The supervisory authorities of several EU member states, including BaFin, have urged the European Commission to finalise the unresolved interpretational issues before the draft is published for consultation. The consultation phase is planned to start in April 2015.

Nature, severity and duration of an economic downturn

The draft regulatory technical standard on determining the nature, severity and duration of an economic downturn is about to enter the consultation phase. As a result of Germany's initiative in particular, the standard follows a fundamentally principles-based approach. According to current plans, a final version of the draft is expected to be available by the end of 2015.

9.2.2 SSM expert group on internal models

The specialists of the European Central Bank (ECB) and national supervisory authorities for internal models hold regular meetings in the Network of Internal Model Experts of the Single Supervisory Mechanism (SSM). With a total of around 6,000 credit risk models, 50 market risk models, 20 AMA models for operational risk and ten models for counterparty risk, the banks in the SSM area have a large number of different internal models, at least by international standards. The significance of internal models

for the banks and the model supervisors in the SSM is accordingly large.

In terms of supervising banks that use their internal models in several European countries, the relevant competent authorities have been cooperating closely for a number of years in areas such as cross-border audits and joint decisions. The resulting positive and constructive rapport can now be enhanced further within the new framework of the SSM. To date, the expert group has in most cases been able to agree a common line quickly whenever there have been queries, but the respective countries have implemented this common line in supervisory processes that differ in the detail. One of the objectives of the model expert group is to harmonise most aspects of technical and procedural supervision of internal models as part of the SSM. BaFin organised a workshop to promote dialogue with SSM banks that use internal models (see info box “BaFin workshop on the internal model methodology”).

For the future, the German supervisory authority is particularly interested in maintaining and extending the high-quality supervision of internal models practised to date by BaFin and the Deutsche Bundesbank. The same also applies to the technically demanding requirements on internal models in German banks. The SSM offers new opportunities in this regard, because the higher number of similar models and model banks facilitates benchmark exercises. These benchmark exercises should be used – although it should be noted that benchmarking, which is only one of several supervisory tools, cannot replace supervision of internal models. The results of benchmark exercises should therefore always be considered in connection with other findings the supervisory authority has made in relation to individual institutions. For this reason, BaFin now aims to strike the right balance between centrally organised benchmarking and the more decentralised supervisory activities, such as supervisory interviews, audits and the analysis of risk or model validation reports. It is important in this context to observe

the principle of proportionality as well as to adequately reflect the specific characteristics of the institution in question.

9.2.3 EIOPA measures

Due to its nature, the harmonisation of European supervision of models of insurance undertakings is dominated by the supervisory regime of Solvency II, which will enter into force on 1 January 2016. Model experts from BaFin played a key role in a comprehensive market risk benchmarking study coordinated by the European Insurance and Occupational Pensions Authority (EIOPA). They also prepared for a new industry-wide consultation process relating to the EIOPA guidelines on the use of internal models, which was held as part of the third phase of the legislative procedure. In addition, with significant involvement of BaFin model experts, a number of good practice papers were completed, which promote the consistent assessment of internal models throughout Europe. They include, among other things, several documents on modelling the underwriting risk in property and casualty insurance, on modelling the loss-reducing

BaFin workshop on the internal model methodology

Today, an increasingly tightly meshed network and the growing importance of supervisory benchmarking impose ever stricter requirements on a well-functioning dialogue between supervisor and banks. This dialogue was therefore the focal point of a two-day workshop hosted by BaFin in October 2014. The invited delegates included experts for counterparty risk models from eight SSM banks as well as their supervisors. The representatives of both sides discussed issues relating to modelling and model validation, exchanged possible solutions and experience, and compared their expectations. BaFin intends to continue this productive form of technical dialogue between banks and supervisors in the future.

II

III

IV

V

VI

Appendix

effect of deferred taxes, on aggregation and diversification and on expert estimates.

Furthermore, the European Supervisory Authorities made preparations for dealing with applications from insurance undertakings that intend to use internal models for determining

their solvency capital requirements. Several informal supervisory meetings (ISMs), an ISM seminar with delegates from 14 countries of the European Economic Area and the ongoing communication of (interim) results played an important role in the assessment of test applications.

10 Freedom of Information Act



10.1 Focus

Freedom of Information Act: BaFin obliged to maintain professional secrecy

Author: Markus Heine, BaFin Section for Litigations/Objection Procedures/Legal Service

As the national financial supervisor, BaFin can invoke the obligation of professional secrecy as set out in Article 54(1) and (2) of the Markets in Financial Instruments Directive⁶⁰, by which it is bound, in response to enquiries under the German Freedom of Information Act (*Informationsfreiheitsgesetz* – IFG). This was handed down on 12 November 2014 by the Court of Justice of the European Union (CJEU) in a preliminary ruling procedure⁶¹ (see info box “Preliminary ruling procedure at the CJEU”, page 81). Under the IFG, which entered into force at the beginning of 2006, anyone has the right to request access to official information from the federal authorities. The main function of the IFG is to improve the supervision and acceptance of government actions.

The CJEU’s preliminary ruling procedure had been preceded by extensive proceedings involving several hundred plaintiffs before the Administrative Court (*Verwaltungsgericht*) in Frankfurt am Main. In 2012, these plaintiffs

applied pursuant to the IFG for the release of information or access to documents contained in the files held by BaFin on Phoenix Kapitaldienst GmbH (Phoenix; see info box “Phoenix Kapitaldienst GmbH”, page 81). BaFin rejected this with reference to its obligation of confidentiality pursuant to section 9 of the Banking Act (*Kreditwesengesetz* – KWG) and section 8 of the Securities Trading Act (*Wertpapierhandelsgesetz* – WpHG). The request for access to documents and for information was pursued further in the subsequent proceedings.

In this and other comparable parallel proceedings, the competent court has to date tended to interpret the law in such a way that BaFin cannot invoke the non-disclosure obligation imposed on it if the business concept of the company concerned is based on large-scale fraud with the intent to cause losses to the investors concerned, several persons in positions of responsibility have been sentenced to jail terms of several years, insolvency proceedings have been opened and the company is in liquidation. In such a case, there

60 Directive 2004/39/EC, OJ EU L 145/1.

61 Case ref. C-140/13.



Preliminary ruling procedure at the CJEU

Pursuant to Article 267 of the Treaty on the Functioning of the European Union (TFEU), the Court of Justice of the European Union (CJEU) decides by way of preliminary rulings on the interpretation of EU Treaties and on the validity and interpretation of acts of the institutions, bodies, offices or other agencies of the Union. This also includes questions about the extent to which national (German) law is compatible with EU law. Where such a question is raised before any court of a member state, that court may, if it considers that a decision on the question is necessary to enable it to give judgement, request the Court to give a ruling on this question and suspend its own proceedings until the Court has ruled.

is no protectable interest in keeping secret the information BaFin has obtained in the course of its supervisory activities.

Nevertheless, the court expressed doubts – which were justified, as it turned out – whether this interpretation was compatible in particular with the aforementioned Markets in Financial Instruments Directive and submitted this legal question to the CJEU. On 12 November 2014, after hearing all member states, the European Commission and all parties involved in the proceedings, the CJEU gave its ruling, following the Advocate General’s opinion of 4 September 2014.

Grounds of the judgement

According to the CJEU’s interpretation, BaFin can – specifically in the Phoenix case – invoke the obligation of professional secrecy pursuant to Article 54(1) and (2) of the Markets in Financial Instruments Directive if the underlying real-life context is not subject to criminal law or does not relate to civil law or commercial law proceedings. It argued that this in particular was not the case in administrative law proceedings under the IFG.

The obligation to maintain professional secrecy applied in administrative law proceedings even if the company’s main business concept was based on large-scale investment fraud in combination with the intent to cause losses to the investors, and several persons in positions of responsibility in the company had been sentenced to jail terms. By contrast, BaFin cannot invoke its obligation of professional secrecy if criminal law proceedings are involved. This interpretation is supported by the legal provisions of section 9 (1) sentence 4 no. 1 of the KWG, under which BaFin is required, in criminal proceedings against persons in positions of responsibility, to disclose information obtained in the performance of its supervisory functions.

Significance of the CJEU ruling for BaFin

The CJEU’s ruling confirms the existing interpretation of the law by BaFin and the Federal Ministry of Finance that requests for information and access to documents under the IFG in relation to files held by BaFin have to be rejected with reference to the applicable non-disclosure obligations (professional secrecy as defined by the CJEU). Otherwise the BaFin officials would expose themselves to the risk of

Phoenix Kapitaldienst GmbH

Phoenix was a securities trading firm that had been subject to supervision by BaFin since 1998. The Managing Director of Phoenix died in a plane crash in 2004. His heirs uncovered fraudulent business activities, which had been hidden up to that point, involving a pyramid scheme with forged bank statements. BaFin responded immediately by withdrawing the firm’s authorisation. Several employees in positions of responsibility were convicted and sentenced to jail terms of several years in some cases. Phoenix has been in liquidation since the beginning of 2005. Investors who had suffered losses received compensation pursuant to the German Deposit Guarantee and Investor Compensation Act (*Einlagensicherungs- und Anlegerentschädigungsgesetz*).

II

III

IV

V

VI

Appendix

criminal prosecution pursuant to section 203 of the German Criminal Code (*Strafgesetzbuch – StGB*). Moreover, the release of information would normally be associated with unjustified interference with the basic rights protected by the German Basic Law (*Grundgesetz – GG*), namely the right to property (article 14 of the GG), the right to occupational freedom (article 12 of the GG) and – if natural persons were affected – the right to determine the use of personal information pursuant to article 2 (1) of the GG.

Following this ruling, plaintiffs will in future not be able to argue that section 9 of the KWG cannot be applied in the case of Phoenix or similar companies because the business concept is based on fraud, insolvency proceedings have been opened and the company has been liquidated. Confidential information remains confidential and therefore has to be protected. It remains to be seen whether this will also lead to an amendment of the definition of business and trade secrets of the Federal Administrative Court (*Bundesverwaltungsgericht – BVerwG*) and the Federal Constitutional Court (*Bundesverfassungsgericht – BVerfG*). According to the established practice of these courts, business and trade secrets are only relevant and protectable if they retain any

relevance under competition law or have a value that can be measured in monetary terms. Under the established practice of the Federal Administrative Court, this does not apply to the vast majority of companies in liquidation.⁶²

It must be assumed that the CJEU considers “confidential information” to include all data that BaFin has obtained or been provided with as part of its supervisory activities pursuant to the Markets in Financial Instruments Directive. In the subsequent proceedings it will have to be clarified how BaFin can provide proof that the information in the files held by BaFin is “confidential information”. In view of the CJEU’s ruling, it is to be expected that the Federal Administrative Court will not be able to adhere to its interpretation of section 99 of the Rules of the Administrative Courts (*Verwaltungsgerichtsordnung – VwGO*) in in camera proceedings (see info box), according to which section 9 of the KWG is not an act within the meaning of section 99 of the VwGO, or it will at least recognise the limitation of discretion to only one possible lawful decision pursuant to the discretionary review

62 See, e.g., Federal Administrative Court, decision dated 5 October 2011, BVerwG 20 F 24.10 – juris margin no. 11 f.; decision dated 27 August 2012, BVerwG 20 F 3.12 – juris margin no. 11 f.



In camera proceedings

If a court deems the submission of files held by the authorities necessary for evidentiary purposes, it requests the authority to submit the relevant files. Pursuant to section 100 of the Rules of the Administrative Courts (*Verwaltungsgerichtsordnung – VwGO*), the party to the complaint can then have access to the files, because they become part of the judicial proceedings files. Consequently, the proceedings under the IFG normally become devoid of purpose, because the party to the complaint in this way gets access to the files held by BaFin without a court having established as final the right under the IFG, thus anticipating the outcome of the proceedings. To counteract this, the authority can refuse to submit

the files in the competent trial court pursuant to section 99 of the VwGO – for example because a law requires the files to be kept secret. According to higher court rulings, the authority has to explain the refusal in detail, using its discretion. The competent specialised division responsible for decisions pursuant to section 99 (2) of the VwGO at the Higher Administrative Court (*Verwaltungsgerichtshof*) in Hesse or the Federal Administrative Court (*Bundesverwaltungsgericht*) compares the explanation with the contents of the files held by BaFin without letting the party to the complaint have sight of the files. The proceedings are held without allowing the parties or the public to be present, i. e. in camera (Latin for “in a chamber”).

in section 99 of the VwGO. Since only one specific decision is possible, there is no room for discretion (discretion limited to only one possible lawful decision).

CJEU strengthens BaFin's efficiency

In its work, BaFin gains access to a large amount of confidential business information. The supervised parties submit the information to BaFin that they have to submit by law. But they also provide additional information to BaFin on a voluntary basis. This allows BaFin to supervise with the same access to information as the players in the financial market. This kind of supervision can only work if both sides – the supervised parties and the competent authority – can be sure that confidential information will always remain confidential.⁶³

In its ruling, the CJEU takes the view that the absence of such trust could jeopardise the seamless submission of confidential information, which is necessary to perform the supervisory functions.⁶⁴ This view strengthens section 3 no. 1d of the IFG, under which the right to access to information does not exist if releasing the information could have a negative impact on the control and supervisory functions of the financial, competition and regulatory authorities. In the past, BaFin invariably invoked this reason for exclusion without success.

The court also held the opinion that Article 54(1) of the Markets in Financial Instruments Directive laid down the basic rule that professional secrecy had to be maintained – not only for the protection of the companies directly affected, but also to ensure the normal functioning of the markets for financial instruments in the European Union.⁶⁵ Deviations are only possible for closely defined exceptions.

⁶³ CJEU, judgement of 12 November 2014, C-140/13, margin no. 31.

⁶⁴ CJEU, judgement of 12 November 2014, C-140/13, margin no. 32.

⁶⁵ CJEU, judgement of 12 November 2014, C-140/13, margin no. 33.

Volte-face in rulings concerning Freedom of Information Act and outlook

The CJEU ruling will initially only affect securities trading firms that fall under the scope of the Markets in Financial Instruments Directive. At their core, the reasons for the ruling are also applicable to other Directives (for instance, the UCITS Directive⁶⁶, Capital Requirements Directive IV⁶⁷ and the Recovery and Resolution Directive⁶⁸) since the reasons for refusal and non-disclosure obligations have a significantly narrower catalogue of exceptions than those in the Markets and Financial Instruments Directive.

The Higher Administrative Court of Hesse (*Hessischer Verwaltungsgerichtshof* – HessVGH) in Kassel has also confirmed this interpretation of the law. In several appeals heard on 11 March 2015, the complainants' request to access to the files held by BaFin was denied. In its grounds for its decisions, the Higher Administrative Court of Hesse essentially stated that pursuant to the decision by the Court of Justice of the European Union dated 12 November 2014, a national supervisory agency – such as BaFin – usually need not grant a right to access to information which is governed purely by national law. Pursuant to the Markets in Financial Instruments Directive – subject to a few narrow exceptions – financial service and banking supervisors are forbidden from making professional secrets public, i. e., providing information or making information available. The parties to the complaint unsuccessfully attempted to invoke an exception to this prohibition. The decision by the Court of Justice of the European Union hence overturns higher court rulings. On account of the fundamental importance of this case, an appeal to the Federal Administrative Court was permitted. The decisions are therefore not yet final.

⁶⁶ Directive 2009/65/EC, OJ EU L 302/32; UCITS stands for "Undertakings for collective investment in transferable securities".

⁶⁷ Directive 2013/36/EC, OJ EU L 176/338.

⁶⁸ Directive 2014/59/EU, OJ EU L 173/190.

II

III

IV

V

VI

Appendix

However, it remains to be seen how the Federal Administrative Court will react to the ruling from Luxembourg and the decisions dated 11 March 2015 in Kassel. Among other things, it will depend to a great degree on

whether the Federal Administrative Court will share the Higher Administrative Court of Hesse's interpretation of the national duty of confidentiality in conformity with European law.



10.2 Submissions in 2014

In 2014, a high number of applications were made under the IFG (see Table 4 "IFG statistics"). Notwithstanding the reasons for the CJEU's ruling described under 10.1, a German law firm again submitted mass requests for information under the IFG, some of which contained more than 1000 requests. Where the legal requirements were met beyond reasonable doubt, BaFin rejected these requests in full or in part, including in objection proceedings, taking

into account the reasons for the CJEU's ruling. The total number of pending proceedings rose again significantly in 2014. One reason is that the Administrative Court in Frankfurt am Main suspended the mass proceedings pending the expected ruling of the CJEU. BaFin expects that these proceedings will commence and will be brought before the courts in the course of 2015 and contribute to further clarifying unresolved legal issues.

Table 4 IFG statistics

Super- visory areas	Number of new submis- sions in 2014	Applica- tion with- drawn	Access to information granted	Partial access to information granted	Access to information denied	Objection filed	Appeal lodged	Total number of pending proceedings
BA*	1,708	104		1,486	5	1,086	440	1,605
VA*	4	3		2	1			1
WA*	141	2	24	84	28	76	5	13
Q/IV*	16	1	4	1	5	1		1
Total	1,869	110	28	1,573	39	1,163	445	1,620

* BA=banking supervision, VA=insurance supervision, WA=securities supervision, Q/IV=cross-sectoral issues.

II

III

IV

V

VI

Appendix



III Supervision of banks, financial services institutions and payment institutions

1 Bases of supervision

1.1 European banking supervision



● 1.1.1 Focus

BaFin as part of the Single Supervisory Mechanism

Authors: Thomas Konschalla and Andreas Schneider, BaFin Banking Supervision

On 4 November 2014, the Single Supervisory Mechanism (SSM) started its work.¹ The 123 significant institutions and groups of institutions (SIs) – including 21 German groups – are directly supervised and the less significant institutions (LSIs) are indirectly supervised by the SSM²; the latter are thus still subject to

direct national supervision (see info box “An overview of operational supervision”, page 87).³

Supervisory alliance

The defining feature of the SSM is that the European Central Bank (ECB) and the national supervisory authorities work closely together on supervision. This close collaboration is the result of Article 6 of the SSM Regulation, which states that the ECB “shall carry out its

1 In principle, the non-eurozone EU countries may also join the SSM.

2 An up-to-date list of these institutions is available at the following link: <https://www.bankingsupervision.europa.eu>

3 See also chapter III 1.1.2 and the ECB Annual Report on Supervisory Activities.

tasks within a single supervisory mechanism composed of the ECB and national competent authorities". It further states that "[b]oth the ECB and national competent authorities shall be subject to a duty of cooperation in good faith, and an obligation to exchange information". Hence the SSM is an alliance led by the ECB.

The ECB's Governing Council functions as the supreme decision-making body of the SSM. However, a new supervisory body – the Supervisory Board – was created at the ECB to plan and exercise supervisory activities. BaFin represents Germany as a voting member of the Supervisory Board. The Supervisory Board prepares all supervisory decisions and presents them to the Governing Council for resolution. The non-objection procedure applies: the Governing Council may not amend the Supervisory Board's proposals; it may only accept or reject them. If the Governing Council does not reject a proposed resolution within ten working days, it is deemed accepted.

This division of duties clearly shows the prominent role the Supervisory Board plays in the SSM. The Board consists of the chief eurozone bank supervisors and takes decisions either at the fortnightly meetings or by way of written procedures. The frequency of issues is high: according to current estimates, some 2,000 proposals can be expected per year – more than 80 per meeting. Proposals are passed by simple majority of voting members.

Joint Supervisory Teams

Since the ECB is not able to ensure direct supervision of the more than 120 significant institutions and groups of institutions of the eurozone on its own, it has established a Joint Supervisory Team (JST) for each group of institutions, composed of the ECB along with the national competent authorities (NCAs). Each JST is led by an ECB coordinator who is from a country other than the relevant group's home country. In addition, each national supervisory agency on the JST nominates a sub-coordinator to serve as a point of contact for the national supervisory authority. Together with the ECB coordinator, the sub-coordinators form the core



An overview of operational supervision

The European Central Bank (ECB) has established four Directorates General (DGs) for operational supervision. DG I and DG II are responsible for direct supervision of significant institutions and have established Joint Supervisory Teams (JSTs) comprising ECB employees and employees of national supervisory authorities. DG III is responsible for indirect supervision, i. e., it monitors the supervision of less significant institutions by the national supervisory authorities. DG IV is responsible for cross-sectoral issues, particularly as they relate to general regulatory issues. In addition to the DGs, there are a large number of supervisory networks which, among other things, work on concepts pertaining to fundamental questions – for instance the question of supervisory quality assurance.

JST which coordinates the division of duties within the JST in light of the specific supervisory examination plan. Supervisors from BaFin and the Deutsche Bundesbank work in the 21 JSTs which supervise the most significant German bank groups, as well as in 13 JSTs which supervise German subsidiaries of foreign SSM institutions.

Direct supervision of LSIs

Approximately 3,500 banks in the eurozone are classified by the SSM as less significant institutions (LSIs). They continue to be subject to direct supervision by the national supervisory authorities. Thus, BaFin remains the primary point of contact for the vast majority of approximately 1,600 German banks. However, the ECB is partially involved in the supervision of these institutions. It exercises indirect supervisory powers, which consist primarily of monitoring the national supervisory authorities in their direct supervision. The ECB places a particular emphasis on certain banking sectors and on those banks which, despite their status as less significant institutions, remain of

III

IV

V

VI

Appendix

particular importance – the high-priority less significant institutions.

Furthermore, in accordance with the principle of proportionality, it will issue uniform, high-quality regulatory standards for all eurozone countries and ensure that these standards are applied uniformly. DG III is responsible for these standards (see info box “An overview of operational supervision”, page 89) and works closely with the national supervisory authorities. This exchange takes place primarily through the Senior Management Network (SMN), a quarterly meeting of high-ranking representatives from the ECB and the national authorities. In addition, a host of bilateral contacts exists between the ECB and the national competent authorities.

Supervision of the supervisors

In order to supervise the supervisors, the ECB first gains a more precise overview of the supervisory practices of the various national authorities. Its primary focus is on supervisory planning and dealing with business models. Based on a cross-border comparison, best practices will be identified and common standards will be developed. These will then be incorporated in the SSM supervisory manual, making them applicable to all national supervisory authorities. In the spring of 2015, a “Report on LSI Supervision” will be completed, summarising the findings of the comparison. BaFin introduces its many years of experience in supervising around 1,600 LSIs into this process.

Focal points of supervision of LSIs

The ECB has established country desks to monitor certain banking sectors and individual high-priority LSIs; these country desks are intended to facilitate active dialogue between the ECB and national supervisory authorities. In a first step, large-scale analyses will be conducted in 2015 in cooperation with national supervisors, focusing on the accounting standards applied, as well as on cross-guarantee schemes and the real estate

markets in each eurozone country. These topics will be of particular relevance to Germany due to the wide-scale application of the Commercial Code (*Handelsgesetzbuch*) and the cross-guarantee schemes of cooperative banks and savings banks. In addition, principles will be developed to apply to cases where the ECB assumes responsibility for direct supervision of high-priority LSIs and infrastructure providers such as multi-client service providers. It remains to be seen what this will mean for supervisory practice. At any rate, the ECB can under certain circumstances assume direct supervision over such institutions or service providers, primarily to ensure compliance with coherent regulatory standards. BaFin will participate in this process and contributes to the development of these principles.

Work on methodologies

The ECB is interested in refining the methods of supervision of LSIs. These include the identification of LSIs and distinguishing them from high-priority LSIs. To date, the ECB has classified 108 institutions as high-priority LSIs, including 16 German institutions. Furthermore and with an eye to LSI, uniform principles and early warning indicators for the supervisory risk assessment systems and the Supervisory Review and Evaluation Process (SREP) will be developed and used to identify problematic banks early on.

Dealing with basic issues

DG IV deals with general and cross-sectoral issues pertaining to the SSM. Department names reflect the topical diversity: “Crisis Management”, “Enforcement & Sanctions”, “Methodology & Standards Development”, “Supervisory Policies”, “Risk Analysis” or for instance “Supervisory Quality Assurance”. DG IV is highly interested in an active exchange with national supervisory authorities: for every key set of issues, it established a supervisory network consisting of employees of the national supervisory authorities such as BaFin. The networks develop the (conceptual) cornerstones for the joint supervision under the SSM.





1.1.2 Opinion

Raimund Röseler on transitioning into a new era of supervision

The launch of the Single Supervisory Mechanism⁴ (SSM) on 4 November 2014 represents a new start: the old, highly fragmented supervisory tapestry of the eurozone now belongs to the past. Does this mean that the national supervisory authorities will soon also be relics of the past? Is BaFin now no longer needed in Germany? This question can be answered with a clear “no”. The SSM is a supervisory alliance headed by the European Central Bank (ECB) in which the national supervisory authorities will continue to play a vital role. Without their cooperation and their expertise accumulated over years, the new European supervisory regime could not function effectively because there are still approximately 3,500 institutions in the eurozone which must be supervised. This was made clear most recently with the comprehensive assessment, in which the ECB subjected the largest institutions from the eurozone to a balance sheet assessment and a stress test. The successful completion of the exercise hinged on the tremendous effort of the national supervisory authorities. And the work is not completed yet. For BaFin and its longstanding partner in banking supervision, the Deutsche Bundesbank, there remains much to do even after 4 November 2014 – even more than before in many areas. BaFin is a firm believer in the idea of a European banking supervision and will do everything in its power to support the SSM.

BaFin participates in Supervisory Board decision-making

BaFin represents Germany as a voting member in the Supervisory Board, the SSM’s key decision-making body composed of banking supervisors. The Supervisory Board handles a variety of issues relating to individual institutions – such as the approval of capital planning – as well as fundamental issues



Raimund Röseler

is BaFin’s Chief Executive Director of Banking Supervision.

with broad impact such as the annual SSM supervisory strategy and shaping uniform supervisory standards and practices. BaFin will also highlight issues in the Supervisory Board which are still relatively difficult to convey on the international stage, such as the uniform application of the Commercial Code for accounting purposes and the particular features of Germany’s three-pillar model. BaFin will develop solutions in line with the principle whereby different things should be regulated differently, thus taking appropriate account of the variety of the German banking sector.

BaFin’s role in day-to-day supervision

BaFin will also play a vital role in the direct operational supervision of significant German institutions (SIs). BaFin employees participate in a total of 34 Joint Supervisory Teams (JSTs), where they work side by side with ECB colleagues. BaFin’s contribution to the JSTs will be decisive to the success of supervision of the major German banks. Based on the expertise gained through years of supervision, German supervisors are best-positioned to assess the business model, risk culture and risk appetite of these institutions. They also ensure that the JSTs take sufficient account of unique features of the German banking market. One only needs to mention the development banks or major banks which serve as central institutions of banking associations. The ECB has already benefited from the national supervisors’ detailed knowledge during the comprehensive

⁴ For details, see chapter III 1.1.1.

assessment. Now this expertise must be transmitted to the JSTs.

The approximately 1,600 less significant institutions (LSIs) remain subject to direct supervision by BaFin. This makes sense since the supervision of smaller institutions requires an in-depth understanding of the local markets. In addition, BaFin supports the initiatives of the ECB aimed at standardising regulatory standards and practices for these institutions across member states. BaFin employees work in various working groups at the ECB in order to support its ambitious programme. In these groups, too, BaFin hopes to raise awareness of specific German features – such as the cross-guarantee schemes and auditing associations of the cooperative banks and savings banks.

General issues

BaFin also plays a part in resolving many policy and cross-sectoral issues faced by the SSM. The ECB has established supervisory networks for all high-priority issues. The range of issues dealt with by these networks extends from relatively new issues such as supervisory quality assurance to general regulatory questions. BaFin is pleased to accept the ECB's offer to participate in the networks. On the one hand, the networks allow BaFin to contribute its own experience and expertise to shaping regulatory trends. On the other hand it enables BaFin to ensure that the characteristics of the German banking sector are adequately reflected in decisions of general importance.

2015 Supervisory programme

The SSM has set itself ambitious objectives for 2015. Details are laid out in the supervisory programme, which covers all relevant areas, i. e., significant and less significant institutions as well as basic issues. BaFin and the Bundesbank have adapted their own supervisory strategies accordingly so as to

ensure consistency with the objectives of the SSM. One priority of the SSM programme is to monitor the implementation of capital planning by those banks with a capital shortfall detected during the CA. The banks' IT and data management systems also form part of the new supervisory focus as a result of experiences from the comprehensive assessment. It became evident that many banks had difficulties merging data from different systems. The SSM will also deal with the transitional arrangements for capital requirements pursuant to the Capital Requirements Regulation (CCR). In the comprehensive assessment, it became clear that different national transitional arrangements in the countries of the eurozone had resulted in different outcomes. For instance, there were divergent regulations concerning the deduction of deferred tax assets from Core Tier 1 capital. Harmonising the transitional arrangements of the CCR will therefore be a high-priority issue on the SSM's agenda for 2015. The fact that the SSM will moreover examine the business models of banks in 2015, particularly the issue as to where they intend to earn their money in the future is a welcome development, particularly in light of the ECB's monetary policy measures, which entail risks such as market excesses or even bubbles.

Whether on the Supervisory Board, the Joint Supervisory Teams, the working groups or networks of the new supervisory authority, BaFin is committed to the SSM and directly contributes to the SSM achieving its objectives. Since BaFin has already implemented the necessary organisational measures,⁵ it is well prepared to enter the new supervisory era. This arose from the conviction that the SSM is carrying out important work for the stability of the entire eurozone.

⁵ See chapter VI 2.





1.2 Focus

Recovery and resolution

Authors: Dr Esther Brisbois, BaFin Section for Cross-Sectoral Affairs, Robert Dübbers, BaFin Section for Financial Market Infrastructure Supervision, Arne Buscher, Adam Ketessidis, Vivien Link, Ingo Wallenborn, BaFin Restructuring Group

How do you deal with banks that are too big to fail? In 2014, standard-setters and legislators again wrestled with the “too big to fail” issue (see also info box “Recovery and resolution of financial market infrastructures”, page 92).

International developments

In 2013, the heads of state and government of the G20 met in St. Petersburg and agreed to transpose into national law the “Key Attributes of Effective Resolution Regimes for Financial Institutions” of the Financial Stability Board (FSB), which dated back to 2011. It also took the opportunity to call on the FSB to address the impediments to resolution remaining at the time in order to credibly improve the resolvability of global systemically important banks (G-SIBs).

Against this background, the focus was on four developments in 2014: G-SIBs would in future have to have sufficient eligible assets to ensure the ability to absorb losses and recapitalise in the event of resolution. Furthermore, they had to implement measures to recognise resolution tools in third countries and for the temporary suspension of call rights attaching to certain financial instruments. And finally, the EU member states were to transpose into national law the key attributes of the European Bank Recovery and Resolution Directive⁶. In addition, the FSB’s crisis management groups (CMGs) were called on to step up their efforts to increase the resolvability of G-SIBs.

In the CMG, the key supervisory and resolution authorities of a G-SIB assesses the institution’s

recovery plan. In addition, they work together to develop a resolution strategy and search for ways to remedy identified impediments to resolution. All this is done with an eye to ensuring that in an emergency all affected countries and authorities work closely with each other and do not isolate themselves. In the summer of 2014, the FSB looked into the resolvability assessments and thus into the CMGs’ work. BaFin successfully represented German positions in the CMGs.

Ability to absorb losses and recapitalise

In November 2014 the FSB published a proposal by which global systemically important institutions would be required to set aside sufficient own funds and eligible liabilities for a potential resolution. In the event of a resolution, the own funds which are intended to absorb unforeseen losses on a going-concern basis would likely be depleted. This would result in the bank’s uncontrolled insolvency, with familiar consequences for the financial market or taxpayer. In order to avoid these unintended consequences, banks must in future set aside sufficient capital and eligible liabilities to absorb losses and recapitalise (Gone-Concern Loss-Absorbing Capacity – GLAC). According to the FSB, the capital requirements pursuant to Basel III and GLAC are to be combined in a standard minimum requirement, the Total Loss-Absorbing Capacity (TLAC). The minimum requirement will be calculated based on either risk-weighted assets (RWA) or total liabilities used to calculate the leverage ratio pursuant to Basel III, depending on which gives the highest result. The uniform requirements serve to harmonise the capital requirements pursuant to Basel III and GLAC and to ensure that the functioning of the capital buffer is not impaired.

6 Directive 2014/59/EU, OJ EU L 173/190.



Recovery and resolution of financial market infrastructures

The recovery and resolution of financial market infrastructures was another topic which preoccupied international standard-setters in 2014. The Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) published a report containing international standards on the recovery of financial market infrastructures (FMIs) and in particular of central counterparties (CCPs). The objective is to further improve the stability of the FMIs and to equip them for times of crisis, since they perform services that are critical

for the functioning of the international financial markets. The standards add to the Principles for Financial Market Infrastructures (PFMIs) published by the CPMI, still known at that time as the Committee on Payment and Settlement Systems (CPSS), and IOSCO in April 2012. In addition, the FSB has prepared Annexes to its Key Attributes. A new Annex now also contains specific guidelines for the resolution of financial market infrastructures. While the Key Attributes were always intended to apply to all financial institutions, they have so far been oriented primarily towards banks.

Minimum requirement

The FSB proposes a TLAC minimum requirement of 16 to 20 per cent of risk-weighted assets and double the leverage ratio. Both requirements must be met at the same time. The TLAC requirement based on RWA is comprised of the Basel III minimum capital requirements of 8 per cent (once fully implemented) and a further 8 to 12 per cent to be met pursuant to the GLAC proposal using eligible liabilities or surplus own funds. The common equity tier 1 capital buffers introduced with Basel III must also be met in addition. They must be used to absorb losses prior to the joint TLAC minimum capital. If an institution does not have sufficient liabilities or own funds to meet the TLAC requirements, the capital buffers will be written down as far as necessary in order to cover the difference. It is therefore only possible to breach the TLAC once the capital buffers have been depleted. The competent authorities can stipulate additional institution-specific requirements above and beyond the minimum requirements.

Eligible liabilities

The purpose of the TLAC is to ensure that a minimum of capital instruments are available in the event of a resolution which can be converted or written down quickly and without practical or legal difficulty. Not all liabilities are suitable for this; for instance, covered deposits, secured liabilities, derivatives and operating

liabilities, particularly those which are not contractually agreed, cannot be counted as TLAC. The liabilities eligible for use as TLAC include unsecured bonds and deposits from major customers. However, these liabilities must have a remaining term of no less than one year and be subordinate to non-eligible liabilities. This is to ensure that the risk is ruled out that the pari-passu principle under insolvency law is breached, which could entail claims for compensatory damages. The liabilities may be subordinated from a statutory, contractual or structural perspective.

Internal TLAC

TLAC must be held and set aside by those companies within a group of institutions for which the resolution authorities would initiate measures in accordance with the resolution plan in the event the institution runs into difficulties. A portion of the assets must be internally made available to significant foreign subsidiaries. If these subsidiaries encounter difficulties, the liabilities to the parent may be used for recapitalisation purposes. This occurs as a result of conversion or write-down as per contractual provision and without the resolution measures being applied. The concept of internal TLAC and the transfer of losses of material foreign subsidiaries is aimed at strengthening the host country authorities' confidence in the fact that the subsidiary would not be abandoned

in the event it comes into difficulties. This is intended to provide foreign jurisdictions with fewer incentives to engage in ringfencing.

The amount of the minimum requirement will be set at the end of 2015 on the basis of a comprehensive impact study conducted by the FSB together with the Basel Committee on Banking Supervision (BCBS) and the Bank For International Settlements since the beginning of 2015.

Removal of legal impediments to resolution

In the event of a resolution, the TLAC helps make it possible to continue carrying out critical functions and to implement the necessary restructuring measures. However, this could amount to nothing if there remain legal impediments to an orderly resolution. Therefore the FSB examined the treatment of derivatives and the recognition of legislative acts in third countries in 2014. One key step on the path to overcoming resolution impediments was completed in mid-November 2014: The 18 largest global systemically important banks signed a supplementary protocol to the “Master Agreement” of the International Swaps and Derivatives Association (ISDA), which eases restrictions on the treatment of derivatives in the event of a resolution (see grey box “ISDA Master Agreement”).

Master Agreement

Under this agreement, the institutions have voluntarily undertaken to recognise the suspension of early termination rights by foreign resolution authorities in the case of over-the-counter (OTC) derivatives that fall within the scope of the Master Agreement. If such an early termination right were to be exercised automatically when resolution proceedings are initiated by a resolution authority, the consequence would be that all offsetting positions would become due and would be closed out at market values. These net liabilities becoming due immediately could be substantial for an institution in resolution and could hinder the resolution process. The reason: as soon as the instruction to liquidate had been issued, the resolution authority would find itself

faced with substantial demands for payment arising from a terminated portfolio of financial derivatives contracts. However, the voluntary commitment given by the institutions ensures that the resolution authority can temporarily suspend early termination rights. As a result, it will be able to arrange an orderly resolution.

The national supervisory authorities have given notice of their intention to extend the scope of application of the supplementary protocol for the 18 largest global systemically important banks to other financial market participants by means of additional regulatory measures. The objectives are to broaden market coverage and achieve the greatest possible harmonisation. There is also a desire to prevent migration effects and the fragmentation of the contracts normally used in the market.

Legal actions in third countries

If resolution actions are not recognised in third countries, an impediment arises which prevents a credible threat of resolution. In September 2014, the FSB therefore published proposals for consultation covering both statutory and contractual recognition regulations. Given the significant impact of resolution actions on assets, particularly in the form of write-downs and conversions, it is expected that they will be regularly subject to legal review by the courts in the future. For that reason, the FSB prefers the statutory option for recognition



ISDA Master Agreement

The “Master Agreement” of the International Swaps and Derivatives Association (ISDA) is a standard contractual framework for derivatives trading which lays down the fundamental obligations of the trading parties for all individual transactions. This voluntary agreement is supported by annexes and supplements, as well as other materials. Supplementary protocols expand the provisions of the agreement for signatories entering into transactions with each other under the agreement.

III

IV

V

VI

Appendix

regulations since it has greater legal certainty. The implementation of statutory regulations, however, is likely to be an extensive and time-consuming exercise, and the FSB therefore recommends the development of contractual approaches. If such approaches are structured in a manner that achieves legal certainty and are adopted by a large number of significant issuers and contractual partners, they are likely to represent an appropriate interim solution.

National developments

On 1 January, the German Act on the Recovery and Resolution of Credit Institutions (*Gesetz zur Sanierung und Abwicklung von Kreditinstituten – SAG*) came into force together with a number of accompanying laws. The SAG implements the European Recovery and Resolution Directive which in turn implements the provisions of the FSB's Key Attributes in the EU. The shared objective is to manage distressed institutions in future without endangering financial stability and without the use of taxpayer funds.

The SAG builds on the Ringfencing Act (*Risikoabschirmungsgesetz*), which had already introduced a number of important provisions of the European directive into German law in 2013. These consisted primarily of provisions relating to recovery and resolution planning, requirements for resolvability assessments and powers to deal with impediments to resolution. Even before the Ringfencing Act BaFin had prepared draft minimum requirements for the structuring of recovery plans (*Mindestanforderungen an die Ausgestaltung von Sanierungsplänen*) and issued them for consultation, and on that basis had requested recovery plans from institutions.

Recovery plans

A fundamental principle of the SAG is to avoid the resolution of institutions. This is intended to be achieved by means of a recovery plan which provides the institution with sufficient possible courses of action to enable it to deal with a crisis on its own. As in the past, BaFin will subject the recovery plans to an intensive review process and play an active role in further



Preconditions for resolution

Pursuant to section 62 of the SAG, the resolution of an institution is subject to the initial condition that the existence of the institution is threatened. An institution's existence is threatened, for example, if it is in breach of regulatory requirements to the extent that the rescission of its licence would be justified. The same applies if the institution is over-indebted or insolvent or threatens to become so. The grant of extraordinary financial support from public funds also indicates in principle that an institution's existence is threatened. This does not apply, however, if the funds are provided on a preventative basis to avoid major disruption to the economy and safeguard financial stability. Such funds may be granted in the form of liquidity guarantees or a precautionary recapitalisation. Resolution action generally represents a significant encroachment on the legal positions of owners, creditors and other third parties. Under the provisions of the SAG, therefore, resolution action may only be taken if it is necessary and proportionate in order to avoid a systemic risk, i. e. if it is in the public interest. Furthermore, it must not be possible to deal with the threat to the institution's existence using another equally effective method within the time available.

improving their quality. For this purpose, BaFin is requesting institutions to prepare a recovery plan. The institutions have six months to prepare their plans. This period can be extended on request by up to a further six months.

At the time of making the request, BaFin informs the institutions whether they comply with simplified requirements and what those consist of. In agreement with the Deutsche Bundesbank BaFin can stipulate simplifications for the content of the recovery plan, the time limit for preparing it and the frequency with which it has to be updated. The primary consideration in this context relates to the effects that a threat to the existence of an institution could have. Relevant factors include

the size of the institution, its complexity, its risk profile and its interconnectedness with other institutions. The supervisory authorities also take account of whether the institution is a member of a scheme safeguarding the viability of institutions and whether it could be resolved in normal insolvency proceedings without having any negative effects on the financial system. The European Banking Authority (EBA) will establish more detailed criteria for determining which institutions are only required to comply with simplified requirements in guidelines which will be published in 2015. On the other hand, the content of the simplified requirements is determined by the relevant supervisory authorities. In agreement with the Bundesbank, BaFin may exempt institutions from the obligation to prepare a recovery plan if they are members of an institutional protection scheme and have not been assessed as posing a potential systemic risk. In such cases the protection scheme will prepare a recovery plan.

Early intervention and intra-group financial support

The SAG grants BaFin wide-ranging powers for early intervention. These supplement the intervention rights already provided for in the German Banking Act (*Kreditwesengesetz*). For example, BaFin can now require an institution to implement possible courses of action from the recovery plan or to revise its business strategy. Should it become clear that an institution could encounter financial difficulties, BaFin will apply pressure at an early stage for it to adopt corrective measures. If a restructuring of the institution is necessary, BaFin will also be closely involved in this process. Under the provisions of the SAG, cross-border groups may also enter into internal agreements whereby the individual companies within the group provide mutual support to each other in the event that the conditions for early intervention by the supervisory authorities exist. Such agreements are intended to make it easier for the group to manage crises on its own.

Resolution of institutions

A further, central element of the SAG, in addition to resolution planning, is the possibility

of resolving institutions and financial groups. In order for resolution action to be taken, certain preconditions for resolution must be met (see info box "Preconditions for resolution", page 94).

Resolution action

If the conditions for a resolution are met, there are essentially four resolution tools available: the sale of the entity, transfer to a bridge institution or to an asset management company and a bail-in of the creditors. The SAG also creates the possibility of taking further, as yet unspecified measures that could become necessary in a crisis. In addition, the resolution authority has further powers which render the resolution tools referred to applicable. Sale of the entity, transfer to an asset management company and bail-in of creditors are new resolution tools. The bridge institution tool has been available as a tool in Germany since the Restructuring Act (*Restrukturierungsgesetz*) came into force in 2011.

Bail-in of shareholders and creditors

The bail-in of creditors will be the most important tool. In the event of a crisis, shareholders and creditors can now be required to participate in the institution's losses and recapitalisation. The bail-in tool gives the resolution authority the power to write down the institution's liabilities in part or in full and convert them into shares or other instruments of the institution's common equity tier 1 capital. This does not apply to some liabilities, however, in particular covered deposits up to €100,000 and secured liabilities. As in the case of the considerations on TLAC, the SAG also provides for a minimum amount of eligible liabilities in order to ensure that sufficient eligible resources are available in a crisis. The proportion of eligible liabilities will be determined for each institution individually.

Cross-border resolution of groups

In many cases the resolution planning and resolution of a financial group is likely to have an international dimension. For this purpose, the SAG creates a framework of regulations within which these resolution tasks can be

III

IV

V

VI

Appendix

managed. The resolution colleges constitute an essential component of this framework. Furthermore, EU-wide harmonisation means that actions within the scope of the European

directive on the recovery and resolution of financial institutions will be recognised in each member state.



1.3 Work on the Basel framework

The Basel Committee on Banking Supervision (BCBS) published the standards for the Net Stable Funding Ratio (NSFR) on 31 October 2014. In doing so, the Basel Committee laid a further cornerstone for the capital and liquidity requirements for banks agreed on by the heads of state and government of the G20 in order to reduce economic risks arising from financial transactions. Material regulatory weaknesses that became evident in the financial market crisis of 2007 and 2008 can now be regarded as having been dealt with from a regulatory point of view. For example, the quantity and quality of capital banks are required to maintain in order to cover risks arising in the ordinary course of business has been increased in recent years, and a measure of indebtedness, the Leverage Ratio, has been introduced, initially as an observation ratio. Furthermore, uniform short- and medium- to long-term liquidity requirements have been developed for the first time in the form of the Liquidity Coverage Ratio (LCR) and the NSFR, while the large exposure rules have been overhauled. The call for a higher loss absorption capacity for systemically important banks also emerged from this process, and the risk weightings for securitisations, counterparty default risks and interbank financings were updated.

One of the central tasks of the Basel Committee is to monitor the implementation of the standards it has developed into the national supervisory laws of its member states.

Up to the close of 2014, international teams have reviewed nine jurisdictions: Japan, Singapore, Switzerland, China, Brazil, Australia,

Canada, the USA and the European Union. Seven nations were able to demonstrate that they had implemented the Basel standards in full, while the USA had achieved full implementation in most areas. On the other hand, divergences were noted in the case of the EU.

The Basel Committee has also commenced the process of comparing the respective national regulations with the calculation of capital requirements on the basis of model portfolios. The results have produced a differentiated picture which, from a German point of view, can be clearly attributed to the supervisory rules and the methodology used for the comparison. Nevertheless, this provided the starting point for two of the Basel Committee's key themes for the future: simplicity and comparability. In 2014, the committee therefore initiated or continued with projects intended to adapt the existing standards to the most recent developments in the financial markets and in the concept of supervision. The standard approaches to credit risk, market risk and operational risk are particularly important in this context. They will play a central role when it comes to ways of further simplifying the regulatory regime.

The fact that the Basel Committee has modified its supervisory philosophy can be seen especially clearly from its consultation paper on capital floors⁷. The paper argues that the capital requirements for banks should become simpler overall and therefore easier to compare.

⁷ Capital Floors: The Design of a Framework Based on Standardised Approaches.

The right way to achieve this is the subject of considerable debate. One option consists of tying the minimum capital requirements to standard approaches that are not based on

banks' internal ratings. Another possibility is to improve internal models and, at the same time, remove the link between internal modelling and regulatory capital requirements.



1.4 Focus

Corporate governance

Authors: Ludger Hanenberg, Ira Steinbrecher, BaFin Section for Risk Management

2014 was not only the year in which a new era of European banking supervision began. 2014 was also the year in which banks were faced with a large number of new or tighter requirements introduced by the Capital Requirements Directive IV⁸ (CRD IV) and the Capital Requirements Regulation (CCR)⁹. A major role was played by the topic of corporate governance, to which the German supervisory authorities had already paid close attention in the past. The new requirements relating to the corporate governance of banks include in particular the provisions in Articles 74 to 76, 88 and 91 to 92 of the CRD IV, which have been implemented into German law in the Banking Act (*Kreditwesengesetz*) and in the Remuneration Ordinance for Institutions (*Institutsvergütungsverordnung* – *InstitutsVergV*). Examples include the requirements relating to the business organisation of the institutions in section 25a of the Banking Act, the requirements for management boards (*Geschäftsleiter*) and supervisory boards (*Verwaltungs- und Aufsichtsrat*) in the newly implemented sections 25c and 25d of the Banking Act and the increased requirements relating to institutions' remuneration systems in section 25a (5) of the Banking Act and in the revised *InstitutsVergV*.

Need for further improvement

As a result of these provisions, the requirements for corporate governance under German law have been increased and a good foundation has been laid for sustainable corporate governance. However, there remains a need for further improvement – including with respect to risk management. Corporate culture must be strengthened by appropriate standards of responsibility and conduct¹⁰, including a strong risk culture derived therefrom with a clearly agreed risk appetite and clearly defined responsibilities for the control functions in general as well as for risk management in particular¹¹. A good corporate governance culture should support the bank's internal system of checks and balances and its risk awareness, so that the institutions prevent risks arising or are at least able to identify them sufficiently early that they are able to take countermeasures before the risks materialise.

Inappropriate behaviour

This is a topic that standard-setters should address in the near future. Especially in recent years, a considerable number of cases have come to light in the banking sector, which at least raises doubts as to whether the banks

8 Directive 2013/36/EU, OJ EU L 176/338.

9 Regulation (EU) No. 575/2013, OJ EU L 176/1.

10 Basel Committee on Banking Supervision, "Guidelines Corporate governance principles for banks", Consultative document, 9 October 2014 (referred to in the following as: BCBS 294), margin no. 27.

11 BCBS 294, margin no. 31.

consistently have a good culture of corporate governance. As an example, only the discussion about the manipulation of various reference rates should be mentioned.

Problems of this nature are still relevant, as demonstrated in a 2014 study by the University of Zurich.¹² According to the study, bank employees' responses to questions asked were significantly more likely to be dishonest when the questions were asked in the context of their occupational roles than they were against the background of the employees' non-occupational lives. In the light of these findings, the researchers at the University of Zurich have put forward the hypothesis that the prevailing business culture in the banking industry promotes dishonest behaviour¹³.

This conclusion is unsettling to the extent that the effects of inappropriate behaviour are not only restricted to the individual institutions. Such behaviour results in a loss of confidence not just in the particular bank but in the banking sector as a whole, i. e. it has implications for financial stability¹⁴.

Rapid changes in the markets

The improvement of corporate governance, however, is not just limited to combat inappropriate behaviour. The requirements for banks are increasing: the markets are changing at an ever-increasing pace and are becoming ever more complex. The banks must be prepared for these developments and must be able to react quickly to (new) risks arising. In particular, weaknesses in the corporate governance of banks that play a major role in the financial system may result in problems

12 Cohn, Fehr, Maréchal: "Business culture and dishonesty in the banking industry", 19 November 2014 (download available at: <http://www.nature.com/nature/journal/v516/n7529/full/nature13977.html>); see also George Szpiro "Von (un)ehrlichen Bankiers und pragmatischen Frauen" ("Of (dis)honest bankers and pragmatic women") in *Neue Zürcher Zeitung*, edition dated 4 July 2014.

13 Cohn, Fehr, Maréchal, loc. cit., p. 3.

14 On this subject, among other references, see also the GPRA confidence index for November 2014, according to which only 12% of the representative sample of interviewees trust statements made by banks and insurance companies: download available at <http://www.gpra.de> (only available in German).

being transmitted not just within the banking sector, but across the entire economic system¹⁵.

Further initiatives are therefore necessary in order to improve corporate governance. For this reason, BaFin is currently working together with the Deutsche Bundesbank on extending the Minimum Requirements for Risk Management (MaRisk) and defining them in greater detail. These revisions are expected to be made available for consultation before the end of 2015.

Risk culture

The changes to be expected relate, among other things, to the more specific requirements set out by the Basel Committee¹⁶ for the establishment of an appropriate risk culture, which should be a collective responsibility of management. The risk culture describes the manner in which employees of the institution deal with risks. In future, management board members (*Geschäftsleiter*) should be obliged to develop, promote and integrate an appropriate risk culture. An appropriate risk culture should enable the institution's risk management to be firmly anchored in its corporate culture, and create a risk awareness, on the part of both management and employees, which shapes everyday thought and action. In addition, the risk culture is intended to make clear to employees which behaviour is desirable and which is not and – in keeping with that – the risks the institution can take and those it cannot.

Internal reporting

When it comes to being able to identify and deal with risks quickly, internal reporting within an institution plays an essential role. This is why the MaRisk pertaining to reporting are also being specified in greater detail and thus the requirements laid out in the Basel Principles for effective risk data aggregation and risk reporting are being implemented.¹⁷ This will

15 BCBS 294, margin no. 1.

16 BCBS 294.

17 See Basel Committee on Banking Supervision "Principles for effective risk data aggregation and risk reporting", January 2013 (referred to in the following as: BCBS 239).

imply, especially for larger institutions, that they are required to prepare their risk reports more timely. In addition, reporting intervals will be shortened, particularly in periods of stress, however, BaFin will take care to observe the principle of proportionality. Risk reporting must be comprehensible and meaningful and become a more powerful management tool. The essential consideration here is that the reports are complete, accurate and up-to-date, and are based on (risk) data that can be prepared, adjusted and accessed in a flexible manner to meet the demands of risk management.

Data management

Appropriate data management, data quality and aggregation of risk data are also of fundamental importance for effective risk management. Therefore, at least systemically important institutions will in future need to ensure under the new MaRisk requirements that data structure and data hierarchy guarantee an unambiguous identification, pooling and assessment of data. These enhanced requirements are intended to generate improvements both in the IT-supported process of preparing information required by management for the identification, monitoring and control of risks, and also in the decision-making processes across the institution and the group¹⁸. As far as risk data is concerned, there are further provisions institutions have now and will in future have to implement¹⁹. The improved procedures for

¹⁸ BCBS 239, margin no. 10.

¹⁹ For example, reporting requirements arising from Basel III and Solvency II, revised reporting requirements for financial reporting (Financial Reporting Framework – FINREP), the solvency and capital adequacy reports under the Common Reporting Framework (COREP) and amendments to International Financial Reporting Standards (IFRS) and the Foreign Account Tax Compliance Act (FATCA) should be mentioned; see BCBS 239, margin no. 7.

aggregating risk data and for risk reporting under the revised MaRisk requirements should ensure in addition that the institutions are also in a position to comply with these further requirements for risk data.

Outsourcing

The strengthened requirements relating to the outsourcing, for example, of processes, organisational units and services should also be highlighted; their purpose is to enable the management of special risks associated with outsourcing to be structured more effectively. In future, only smaller institutions will be allowed to completely outsource individual control functions such as risk control and internal auditing. The objective is to keep the control functions within the institutions to the furthest extent possible, thereby preventing the loss of urgently needed expertise. In addition, under the MaRisk management will in future have to appoint a central outsourcing officer, with responsibilities including the implementation and ongoing development of an appropriate outsourcing management function, as well as monitoring compliance with internal and statutory requirements for outsourcing. The aim of this is to ensure that the institutions have a central office to maintain a general overview of outsourced activities and processes and thereby to support the management in steering and monitoring the associated risks.

Many of the planned changes are likely to already be self-evident for a large number of institutions. All other banks shall be encouraged by the MaRisk adjustments to structure their internal risk management systems in such a way that they too will have good corporate governance in the foreseeable future.



III

IV

V

VI

Appendix

1.5 Supervisory review and evaluation guidelines

On 19 December 2014, the European Banking Authority (EBA) published guidelines for the Supervisory Review and Evaluation Process (SREP). This was the first time that the EBA had made the internal evaluation standards of banking supervisory authorities available to a broad public. The guidelines are intended to improve the quality of the SREP and generate a consistent supervisory culture in the member states. They should not be understood as minimum standards; nevertheless they respect the principle of proportionality. The SREP guidelines are addressed solely to the banking supervisory authorities – including the Single Supervisory Mechanism (SSM). These guidelines form an integral component of the EU Single Rulebook.

The SREP guidelines are mandatory from 1 January 2016, although not for the areas of capital and liquidity requirements. The provisions for the SREP capital assessment must be applied at the latest on 1 January 2019. The standards for the evaluation of liquidity requirements are linked to the implementation of the Net Stable Funding Ratio (NSFR).

Elements of the SREP guidelines

The SREP guidelines adopt an integrated approach. The core elements are the monitoring of key indicators (Title 3), standards for the business model analysis (Title 4), the assessment of internal governance and controls (Title 5), risks to capital (Title 6) and liquidity risks (Title 8), the quantification of own funds (Title 7) and the liquidity assessment (Title 9).

The most important new features of the SREP are the inclusion of liquidity-related topics and above all the quantification of capital and liquidity requirements; the supervisory authorities are expected to undertake their own quantitative assessment. It is also intended that each evaluation should conclude with a scoring exercise. The individual results feed into a final overall score. The SREP guidelines also contain definitions (Title 1), details relating to proportionality (Title 2), discussions of

supervisory measures (Title 10) and cross-border groups (Title 11).

Determination of own funds and liquidity requirements

National supervisory authorities are expected to build up a picture of the financial institutions' own funds and liquidity. The starting point for the determination of own funds requirements is the relevant institution's Internal Capital Adequacy Assessment Process (ICAAP). Supervisory risk assessments and reference values are then added to the determination process. Together they form the basis upon which the supervisory authorities determine the necessary capital required to cover unexpected risks, the Total SREP Capital Requirement (TSCR).

In the next step, the supervisory authorities establish the Overall Capital Requirement (OCR). This includes the capital buffer requirement and possible additional buffers.

The ability of an institution to absorb liquidity and funding risks adequately using its existing liquidity, on the other hand, is evaluated using the Internal Liquidity Adequacy Assessment Process (ILAAP). The results of the assessment are then expanded to include the evaluation of risk by the supervisory authority, reference value calculations and other tools, such as stress tests. Consideration of the respective business model and possible systemic liquidity risks may give rise to additional liquidity requirements.

1.6 Report on risk culture

The group of topics relating to risk culture again constituted one of the fundamental areas of work for the Supervisory Intensity and Effectiveness (SIE) group of the Financial Stability Board in 2014. The SIE group's declared aim is to further improve the intensity and efficiency of the supervision of systemically important financial institutions (SIFIs). The group has been working intensively on the risk culture of SIFIs since 2010. In the final analysis, shortcomings in risk culture do not just represent one of the triggers of the global

financial crisis; they also contribute to other irregularities in the financial markets, such as the fraudulent manipulation of the London Interbank Offered Rate (LIBOR) reference rate of interest.

The SIE group had already delivered its initial recommendations on risk culture to supervisory authorities in 2011 and 2012. In 2013, it then published its “Principles for an Effective Risk Appetite Framework”. Risk appetite represents a central component of an institution’s risk culture. The Principles therefore define specific requirements for risk appetite frameworks. The issues addressed include the consistency of the framework with a bank’s business model and strategy as well as with its capital planning. The purpose of the risk appetite framework is to prevent a financial institution entering into excessive risks, and at the same time to establish effective rules for risk limits and compliance with them – such as by means of monitoring and sanctions.

At the end of 2013 the FSB presented the consultative document “Guidance on Supervisory Interaction with Financial Institutions on Risk Culture”. The document addresses the wide range of topics relating to risk culture in financial institutions. In the light of the importance of risk culture for financial stability, it stresses the necessity, for institutions as well as for individual employees, of establishing a prudent and appropriate risk culture.

The SIE group of the Financial Stability Board published the final version of these guidelines in April 2014. It takes account of external suggestions and comments. The intention is to provide supervisors with detailed guidelines as a tool to enable them to record and evaluate a bank’s risk culture in practice, and to use that as a basis for working towards an appropriate risk culture. To that end, the document identifies four central elements of a risk culture: the tone from the top, accountability, effective communication and challenge and incentives. Each aspect is assessed using a variety of indicators. In order to reflect the complexity of the concept of risk culture, the SIE group

recommends that the indicators should not be regarded as elements of a checklist, but should be assessed from an overall perspective.

1.7 Revision of the trading book rules

In December 2014 the Basel Committee presented a consultative document on outstanding questions for a fundamental review of trading book rules²⁰. In particular, the document puts forward suggestions for material changes to the standardised approach for market risk, which had arisen with respect to the previous consultative document dated October 2013. It is now suggested that institutions’ own valuation models should govern how changes in the value of financial instruments are determined. This will simplify the rules and reduce implementation costs for the financial institutions. With respect to the specific risks attaching to options (such as curvature and vega risks) –, it is now proposed that the capital requirements should be calculated taking into account empirically estimated correlations between the changes in a variety of risk factors. At the same time, the range of risk factors has been significantly widened to enable basis risks, for example between different yield curves, to be taken into account in detail. For institutions with a lower volume of trading business, the consultative document also proposes an alternative procedure, which will include a smaller number of risk factors in the assessment. This disallowance factor method represents a more approximate calculation of the capital banking for basis risks. The method is not only based on net sensitivities to the risk factors measured across the portfolio, but also includes the sensitivities of the individual instruments to the risk factors in the capital requirements.

1.8 Amendment to the Pfandbrief Act

As part of the process of adapting banking supervisory law to the Single Supervisory Mechanism, some parts of the German

²⁰ Fundamental review of the trading book: outstanding issues.

Pfandbrief Act (Pfandbriefgesetz) have been substantively amended by the German Act on the Recovery and Resolution of Credit Institutions (*Sanierungs- und Abwicklungsgesetz*) dated 10 December 2014²¹. The original intention had been only to make various editorial changes for the purpose of harmonisation in the form of the Act Adjusting Financial Market Legislation (*Gesetz zur Anpassung von Gesetzen auf dem Gebiet des Finanzmarkts*) dated 15 July 2014²². The amendment of December 2014 now affects the following material substantive areas of regulation:

- The power granted to BaFin by section 44 (1) sentence 1 of the Banking Act (*Kreditwesengesetz*) is now also incorporated in section 3 (2) of the *Pfandbrief Act*: the supervisory authority has the right to require *Pfandbrief* banks to provide information and submit documentation relating to their economic cover position.
- The *Pfandbrief Act* now provides for additional possibilities of using receivables from banks as cover:
 - a) Deposits with banks of credit quality level 2 are generally permitted as cover in section 4 (1) sentence 2 no. 3 of the *Pfandbrief Act*, provided that the original term of the deposits does not exceed 100 days and the bank is domiciled in an EU member state.²³
 - b) Section 4 (1) sentence 4 of the *Pfandbrief Act* creates the basis of authorisation for BaFin, following consultation with the European Banking Authority (EBA), to order on the basis of a general administrative act that, in derogation from section 4 (1) sentence 2 no. 3 of the *Pfandbrief Act*, deposits with domestic banks may also be used as cover if those banks have been allocated a risk

weighting corresponding to credit quality level 2 in accordance with table 3 of Article 120(1) of Regulation (EU) No 575/2013. This means that the risk weighting for the relevant bank is determined on the basis of its available external credit ratings. The supervisory authority may only make such an order, however, if retaining the requirement for a risk weighting corresponding to credit quality level 1 would involve a significant danger of single-obligor concentrations in the case of receivables from domestic banks. The same applies to monetary receivables from banks pursuant to sections 19 (1) sentence 1 no. 2, 20 (2) no. 2, 26 (1) no. 3 and 26f (1) no. 3 of the *Pfandbrief Act*. BaFin has now made use of the option to issue a general administrative act²⁴.

- c) The provisions of sections 19 (1) sentence 1 no. 2, 20 (2) no. 2, 26 (1) no. 3 and 26f (1) no. 3 of the *Pfandbrief Act* create the possibility of including in cover the relevant balance from an account relationship with one of the institutions described thereunder as eligible as cover, including credit institutions within the meaning of section 4 (1) sentence 2 no. 3 of the *Pfandbrief Act*. This avoids the risk – which arises especially in connection with high-volume repayments of cover assets – that the existing cover asset may expire upon repayment and that the cash payment received, for example on the *Pfandbrief* bank's general account for payment transactions, may not automatically form part of the cover pool. In this event, it may therefore be necessary to include the amount of the cash payment in cover in order to maintain matching cover.
- On the basis of section 4 (3a) and (3b) of the *Pfandbrief Act*, BaFin is now authorised to order higher minimum cover requirements in specific cases than those stipulated under section 4 (1) sentence 1 and (2) of the *Pfandbrief Act*. The precondition for this, however, is that the recoverability of liabilities arising from *Pfandbriefe* in circulation

²¹ See Federal Law Gazette I 2014, p. 2091.

²² See Federal Law Gazette I 2014, p. 934.

²³ The requirement to demonstrate a registered office in the EU reflects the precondition for privileged risk weighting from Article 129(1)(c) of Regulation (EU) No 575/2013. This is intended to be included in the next amendment to the *Pfandbrief Act*.

²⁴ See chapter III 3.3.8.

seems to the supervisory authority not to be assured (section 4 (3a) of the *Pfandbrief* Act) or that the supervisory authority has established deficiencies relating to the organisational requirements under the laws affecting *Pfandbrief* banks (section 4 (3b) of the *Pfandbrief* Act). These cover add-ons represent a close reflection in *Pfandbrief* law of tools for general institutional supervision – the capital add-ons pursuant to section 10 (3) of the Banking Act. They mean that it is now possible to insist on compliance with higher requirements, if it appears doubtful, given the individual risk profile of the cover pool or in the event of any mismatches between the cover pool and the *Pfandbrief* liabilities, whether economic recoverability can be assured if the institution complies only with the statutory minimum cover requirement (100% of the nominal value, 102% of the present value and risk-adjusted present value). In the light of the large number of potential cover assets and associated risk factors, the construction of a cover model in accordance with *Pfandbrief* law is a complicated undertaking. It is therefore conceivable that BaFin will gradually introduce this innovative cover add-on instrument into its supervisory practice in parallel to its ongoing refinement, and will do so over and above its immediate function of counteracting risks.

- The effect of section 13 (1) sentence 2 of the amended *Pfandbrief* Act is to include Australia, New Zealand and Singapore in the group of countries in which real estate for receivables secured by mortgages or other land charges may be used as cover for mortgage *Pfandbriefe*.
- The provisions of section 15 of the *Pfandbrief* Act relating to the insurance of cover assets for mortgage *Pfandbriefe* have also been revised. The classic procedure of insuring the cost of reconstructing the building is now joined – as is normal practice in international insurance against damage caused by natural forces – by insurance of the maximum probable loss and/or of the outstanding amount of the loan.
- Finally, the amended legislation contains the basis for a reporting system in accordance with *Pfandbrief* law which also includes the economic cover position. Section 27a of the *Pfandbrief* Act establishes an authorisation to issue the relevant regulation, which can be delegated to BaFin. The design of such a reporting regulation under *Pfandbrief* law will be closely linked to the concept for the structure of the cover add-on pursuant to section 4 (3a) of the *Pfandbrief* Act and the associated information requirements.

2 Preventive supervision

2.1 Risk classification

For ten years now, BaFin has performed a risk classification of all credit institutions, securities trading banks and financial services providers within its area of responsibility. The risk classification brings together all of the findings and assessments relating to individual institutions that are available to BaFin's banking supervision sections.

The quality of the institution is graded within a range from "A" to "D". This grading bears no relation to the ratings awarded by external

rating agencies, however. A D-rated institution should therefore not necessarily be regarded as "in default" in the sense used by the supervisory authorities.

BaFin also estimates the systemic importance of an institution for the financial sector as a whole. The assessment ranges from "low" to "high" and is an indicator of the likely effects if the respective institution hypothetically falls into financial difficulties. The criteria include size, the intensity of interbank relationships and the extent of international interdependence.

III

IV

V

VI

Appendix

The risk classification is based on a risk profile that is prepared individually for each institution and is continually updated. The risk profile is based on the reports on the audits of the annual financial statements for each institution assessed by the Bundesbank. In other respects, BaFin mainly takes into account current risk analyses and their possible effects on risk-bearing capacity. The findings of any special audits and requests for information are also taken into consideration. The most important elements of an institution's risk profile are its risk situation and capital adequacy, its risk management and the quality of its organisation and management. The Bundesbank and BaFin base the intensity of their supervisory activities on this individual risk profile.

2.1.1 Credit institutions

In most cases, there has been only a marginal change in the systemic importance classification of German credit institutions over the past eight years. Accordingly, the percentage of credit institutions with high and medium systemic importance fell only slightly compared with 2013. The qualitative results of the risk classification once again remained at a stable level overall. The supervisory authority assessed a lower percentage of the institutions as being of low quality in 2014.

The classification of the credit institutions with respect to their quality and systemic importance are summarised in a matrix (see Table 5 "Risk classification results of credit institutions in 2014", page 105).

Overall, the institutions' quality ratings recorded only marginal changes with respect to the assessment of their systemic importance. Savings banks and cooperative banks again recorded stable results. Conclusion: the situation of German banks continues to be encouragingly stable.

2.1.2 Financial services providers

BaFin's risk classification of German financial services providers in 2014 covered a total

of 754 institutions. In the previous year 688 institutions were assessed (see Table 6 "Risk classification results of financial services providers in 2014", page 105).

2.2 IT security at banks

Cybercrime threats are increasing globally and are becoming more complex as the attackers adopt ever more professional methods. This problem also affects the institutions supervised by BaFin. Their assets and data represent attractive targets for criminals. The additional IT risks resulting from these threats strike at the heart of the IT-intensive banking business. It is therefore vital, among other things, for every institution to appoint an IT security officer.

In 2014, criminals obtained access to sensitive data using the Heartbleed bug. This showed once again that the use of secure software is indispensable for the IT systems of banks. In particular, every institution must have a functioning patch management system. BaFin surveyed a sample of institutions to check whether they are complying with this requirement. The result was encouraging: there was no need for action on the part of BaFin. The fact that the Heartbleed bug was able to emerge in the first place, however, makes it quite clear that the institutions had not sufficiently included open source software in their security testing of installed software programs. This is an area where there is particular potential for quality assurance to achieve improvements.

A number of legislative initiatives on IT issues are in the pipeline in the European Union and in Germany. In Brussels, the Directive on Network and Information Security (NIS) will be concluded shortly. It is intended to help establish high IT standards across the EU and is aimed at all market participants i. e., among others, at operators of critical infrastructures such as banks. The market participants will be required to adopt technical and organisational measures. The NIS assumes, in this context, that the market participants have control of

information systems and that they also make use of them. The objective of the measures is to manage the risks for the security of the networks and information systems. At the same time, the measures are intended to reflect the latest state of the technology. The extent of the measures is determined in turn by the extent of the risks. The intention is to enable market participants to react to security incidents and safeguard the continuation of their services. Finally, under the NIS Directive major security incidents must be reported to the relevant authorities, which in Germany would be the Federal Office for Information Security (*Bundesamt für Sicherheit in der Informationstechnik – BSI*).

The German federal government intends to implement the NIS rules into German law by means of the IT Security Act (*IT-Sicherheitsgesetz*). The Act is already available in draft form. The expanded BSI Act (*BSI-Gesetz*) sets out the responsibilities and powers of the BSI with the objective of counteracting current threats and reflecting the increasing

importance of information and communication technology in society today. It provides for ongoing IT supervision for operators of critical infrastructures. In future, institutions will be required to report significant disruptions in their IT systems. The question of which specific entities are to be classified as operators of critical infrastructures will be clarified in a subsequent legal regulation.

At the European level, further progress has been made with the revision of the European Payment Services Directive II (PSD II). BaFin expects the Directive to be adopted by the end of the second quarter of 2015. A central topic covered by the provisions of PSD II is the authorisation of third-party payment service providers. A number of additional new provisions of PSD II are relevant from an IT point of view: it provides for strong customer authentication in internet payment transactions, the introduction of reporting obligations in the event of major disruptions to payment systems and special protection for the login data of users of payment services. BaFin is the competent authority

Table 5 Risk classification results of credit institutions in 2014

Institutions in %		Quality				Total
		A	B	C	D	
Systemic importance	High	0.2	0.7	1.3	0.2	2.5
	Medium	4.1	4.9	1.6	0.6	11.2
	Low	38.1	37.5	9.3	1.4	86.3
Total		42.4	43.1	12.2	2.3	100

Table 6 Risk classification results of financial services providers in 2014

Institutions in %		Quality				Total
		A	B	C	D	
Systemic importance	High					
	Medium	11.9	15.5	2.8	0.4	30.6
	Low	26.1	37.6	5.0	0.7	69.4
Total		38.0	53.1	7.8	1.1	100

III

IV

V

VI

Appendix

for the implementation of the regulations in Germany. The EBA is expected to formulate more detailed requirements with a neutral effect on competition once PSD II has been adopted.

BaFin has been actively assisting the EBA in preparing the "Guidelines on the Security of Internet Payments". The guidelines were published on 19 December 2014²⁵ and replace the "Recommendations for the Security of Internet Payments" of the European Forum on the Security of Retail Payments (SecuRe Pay), which date from 2013 and cover the same areas. The SecuRe Pay Forum has continued its work and has now also developed requirements for software quality in internet payment transactions entitled "Recommendations for the Security of Mobile Payments".

In 2014, IT service providers sought information from BaFin in greater numbers about the requirements relating to cloud computing²⁶.

Where services are purchased externally, the provisions of sections 25a (1) and 25b of the Banking Act (*Kreditwesengesetz*) together with AT 7.2 and 9 of the Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement – MaRisk*) must also be observed in such cases. There are no more extensive requirements for cloud computing, but also no simplified requirements compared with other organisational forms of outsourcing services.

In September 2014 BaFin conducted a survey on behalf of the Federal Ministry of Finance of 70 selected institutions and IT service providers on emergency power supplies. The responses showed that 86 % of the entities questioned are in a position to maintain their critical business processes in the event of a power failure. Around 43 % of the institutions surveyed can continue to provide cash for more than 24 hours if the power supply is interrupted.

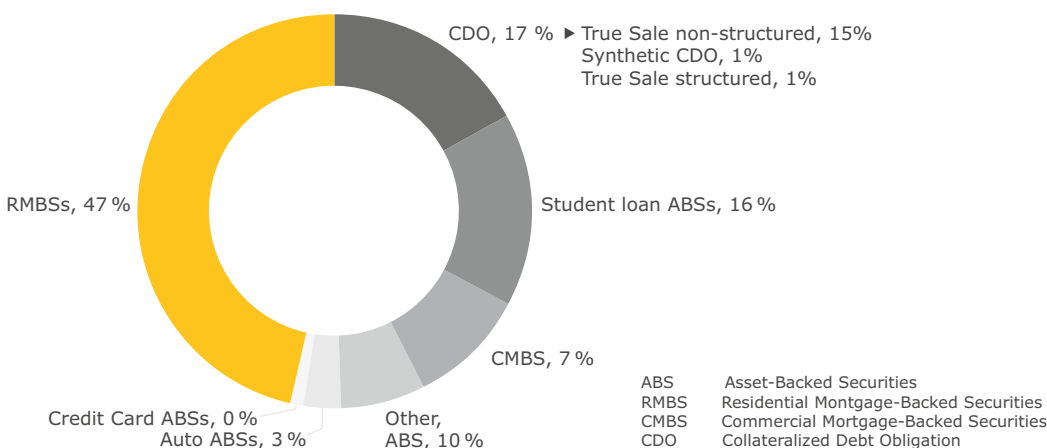
In October 2014 BaFin once again hosted an information technology event on the subject of IT supervision. Almost 300 attendees from the banking industry, audit firms and the IT services sector took advantage of the opportunity to improve participants' awareness of the risks involved in modern information technology.

25 <https://www.eba.europa.eu/-/eba-issues-guidelines-to-strengthen-requirements-for-the-security-of-internet-payments-across-the-1>

26 The BSI defines cloud computing as a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources, e.g. networks, servers, storage, applications and services. These can be rapidly provisioned and released with minimal management effort or service provider interaction. See <https://www.bsi.bund.de>.

Figure 3 Securitisation positions by type of collateral

As at 30 June 2014



Source: Deutsche Bundesbank/BaFin.

In 2014 BaFin also stepped up its cooperation in the fight against cybercriminality with the Federal Criminal Police Office (*Bundeskriminalamt*), selected regional criminal police offices and the Federal Office for the Protection of the Constitution (*Bundesamt für Verfassungsschutz*). At the same time, it continued its intensive participation in the implementation plan for critical infrastructures (UP KRITIS) as in 2013.

2.3 Securitisation positions

For several years now, BaFin has been using a survey to calculate the securitisation positions held by selected German credit institutions, in cooperation with the Bundesbank. In mid-2014, the survey included a total of 13 institutions.

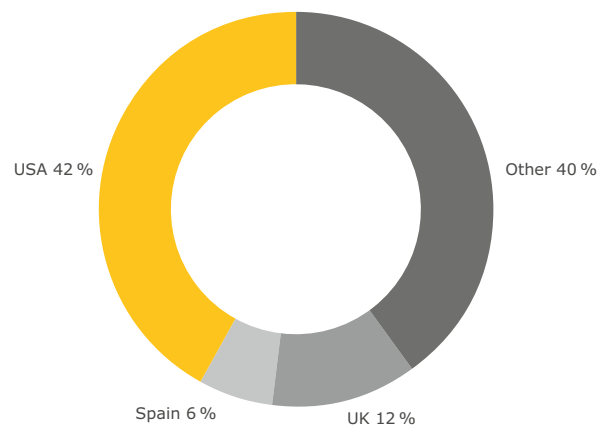
The year-end data for the banks' positions were not available in a suitable form at the time of writing this annual report and the banks' positions have therefore been presented below as at the 30 June 2014 reporting date.

The securitisation positions of the 13 reporting banks had a total book value in mid-2014 of €77.9 billion. This represents a decline of around 12% compared with the value for the prior year of €88.4 billion. The reduction in the securitisation positions was caused in almost equal amounts by maturities, repayments, redemptions and amortisation, as well as by the netting of long and short positions. It is important to bear in mind that these figures represent the positions before hedging. After deducting hedging positions, the banks' net exposure is therefore lower.

Over half of the securitisation positions held by German banks (around 54%) comprised residential mortgage-backed securities (RMBSs) and commercial mortgage-backed securities (CMBSs, see Figure 3 "Securitisation positions by type of collateral", page 106). RMBSs accounted for almost 80%, and therefore just under nine-tenths, of the mortgage-backed securities. The quality of the securities held continues to be very heterogeneous and, as before, they cover a broad spectrum ranging

Figure 4 Regional breakdown of underlyings

As at 30 June 2014



Source: Deutsche Bundesbank/BaFin

from sound European residential securitisations through to heavily credit-impaired US subprime securities. In mid-2014, around 49% of the mortgage-backed securities were rated AAA or AA. However, the proportion of the tranches with a rating below investment grade rose slightly, reaching 25%. The rating structure therefore deteriorated to a small extent.

Collateralised debt obligations (CDOs) accounted for one-sixth of the total securitisation positions of German banks in mid-2014. They therefore also received a higher weighting as a result. As before, most of these were true sale transactions. At around €8 billion, collateralised loan obligations (CLOs) formed the largest single category within this segment. The banks surveyed also held securitised student loans in their securitisation portfolio amounting to around €12.5 billion. By contrast, other forms of investment, such as auto loan and credit card asset-backed securities, played a minor role as before.

Analysed by geographical region, most of the securitised loans once again originated from the USA (42%) (see Figure 4 "Regional breakdown of underlyings"), and by mid-2014 the proportion had again increased somewhat since the 2013 year-end (39%). However, the regional breakdown varies considerably from bank to bank depending on the individual

III

IV

V

VI

Appendix

investment strategy. Accordingly, the proportion of securitisations backed by US collateral ranged from just under 72% to 9% across the institutions. The regional breakdown by asset class also continued to be heterogeneous.

2.4 Money laundering prevention

Through money laundering prevention, BaFin aims to prevent the financial system from being misused for the purposes of money laundering, terrorist financing and other punishable offences that may compromise an institution's assets. BaFin ensures that the enterprises and individuals being supervised implement the legal requirements that exist for this purpose. These requirements on institutions result primarily from the Money Laundering Act (*Geldwäschegesetz*) and the Banking Act (*Kreditwesengesetz*) and are intended to ensure transparency over business relationships and financial transactions using a risk-based approach. Parties subject to the provisions must meet customer due diligence requirements, for example. As well as identifying the client and, if different, the beneficial owner, these include verifying the background to the business relationship and carrying out continual monitoring wherever possible. It is also necessary to establish whether the client is a politically exposed person requiring enhanced due diligence in managing the business relationship. The aim of these measures is to enable cash flows to be understood and any unusual or suspicious transactions or business relationships to be spotted. Suspicious transactions must be reported to the Financial Intelligence Unit (FIU) at the Federal Criminal Police Office (*Bundeskriminalamt*) and the competent criminal prosecution authorities.

Financial Action Task Force guidelines

BaFin contributed to the development of guidelines on the application of a risk-based approach in the banking sector which were approved and published by the Financial Action Task Force (FATF) at the end of October 2014. The guidelines are not just concerned with the application of the risk-based approach on the part of the institutions, but also deal

with the implementation in practice of risk-based supervision. The document is addressed both to the private sector and to the federal states and/or authorities involved in the fight against money laundering. The FATF is the most significant international body involved in combating money laundering and the financing of terrorism.

Basel Committee issues recommendations

In cooperation with the anti-money laundering experts of the Basel Committee on Banking Supervision, BaFin has also produced recommendations for the sound management of risks related to money laundering and financing of terrorism. The recommendations are aimed in particular at banks with international operations. They were published in January 2014²⁷.

Interpretation and application guidelines of the German Banking Industry Committee

In February 2014 BaFin published the revised interpretation and application guidelines of the German Banking Industry Committee (*Deutsche Kreditwirtschaft*). It issued a circular at the same time informing the affected parties. The Federal Ministry of Finance and BaFin had previously approved the guidelines as complying with their administrative practice.

The existing subject matter was not only revised by a Joint Working Group of the Ministry of Finance, BaFin and the Banking Industry Committee, but was expanded with the addition of chapters on further topics. The new additions to the interpretation and application guidelines include in particular sections on the detailed requirements for operating data processing systems. This relates mainly to the identification and investigation of dubious or unusual transactions (section 25h (2) and (3) of the Banking Act)

The Joint Working Group also updated the guidance notice for checking the identity of a beneficial owner. This involves a multi-stage process for establishing which natural person is

²⁷ <http://www.bis.org/publ/bcbs275.pdf>

behind a transaction or business relationship or is pulling the strings, in order to prevent money laundering and tax evasion.

Audit focus on prepaid credit cards

For the 2014 audit period, the auditors of the annual financial statements were to investigate how widespread prepaid credit cards are at the credit institutions, and what measures the banks are taking to prevent money laundering using these means of payment.

A prepaid credit card is a payment card used on the basis of an existing credit balance. The user must pay for the credit balance in advance. This distinguishes it from a genuine credit card with an agreed credit facility. This type of card also enables payments to be made worldwide. However, the card must have a large enough credit balance to cover the amount of the respective transaction. Prepaid credit cards are sold by the established credit card companies via banks. The banks determine the permitted level of the credit balance and the procedure for crediting and charging the card individually. In Germany, prepaid credit cards are generally linked to bank accounts and are issued to customers who are at least 12 years of age.

Overall, no serious shortcomings have so far been detected in this area.

Administrative fines

In 2014, BaFin initiated proceedings for administrative fines against payment

agents in a total of 41 cases. Of these – and proceedings still pending from prior years – a total of seven cases were finally concluded; five further cases ended with the discontinuation of proceedings pursuant to section 47 (1) of the Act on Breaches of Administrative Regulations (*Ordnungswidrigkeitengesetz*)

Proceedings under the Act on Breaches of Administrative Regulations were brought in a further 29 cases as a result of breaches of provisions of the Money Laundering Act (*Geldwäschegesetz*), the Payment Services Supervision Act (*Zahlungsdiensteaufsichtsgesetz*) and the Banking Act (*Kreditwesengesetz*) that are punishable by a fine. They related to credit institutions, payment institutions and institutions engaged in finance leasing and/or factoring (section 1 (1a) sentence 2 nos. 9 and 10 of the Banking Act) and, where relevant, their responsible employees. Of these and the proceedings for administrative fines still open from prior years, a total of six cases were finally concluded, two of them on the basis of a court judgment. Two cases are currently awaiting a decision from the competent Higher Regional Court (*Oberlandesgericht*) as the result of appeals against the judgment of the Local Court (*Amtsgericht*). Opposition proceedings are still underway in five cases. Four cases were discontinued by BaFin on legal or factual grounds.

3 Institutional supervision

3.1 Authorised institutions

3.1.1 Credit institutions

In 2014, as in previous years, the number of authorised institutions declined slightly. It fell from 1,820 in 2013 to 1,780 (see Table 7 “Number of banks by group of institutions”, page 110). This represents a year-on-year decline of approximately 2.2%.

The institutions supervised by BaFin are divided into four groups: commercial banks, institutions belonging to the savings bank sector, institutions belonging to the cooperative sector and other institutions. The group comprising commercial banks include major banks, private commercial banks and subsidiaries of foreign banks. The savings bank sector comprises public-sector and independent savings banks

III

IV

V

VI

Appendix

Table 7 Number of banks by group of institutions

	2014	2013	2012
Commercial banks	182	184	183
Institutions belonging to the savings bank sector	425	426	432
Institutions belonging to the cooperative sector	1,052	1,083	1,106
Other institutions	121	127	133
Total	1,780	1,820	1,854

together with the *Landesbanks*. In addition to the primary credit cooperatives, the cooperative sector also includes DZ Bank and WGZ Bank due to their financial ties. The group of other institutions comprises building societies (*Bausparkassen*), *Pfandbrief* banks, securities trading banks and development banks operated by the federal government and the federal states.

In the savings bank sector, BaFin supervised a total of 416 savings banks, eight *Landesbanks* and DekaBank, the central provider of fund services for the Savings Banks Finance Group (*Sparkassen-Finanzgruppe*), at the end of 2014. The pace of mergers slowed compared with the prior year. The number of savings banks declined

by one institution to 416 (0.24%) (2013: 417; see Figure 5 “Number of savings banks”).

At the end of 2014, BaFin was supervising a total of 1,049 primary cooperative institutions (see Figure 6 “Number of primary cooperative institutions”, page 111) as well as 49 housing cooperatives with a savings scheme, which also belong to the cooperative segment. The number of primary institutions therefore declined by 30 or 2.8% in comparison with 2013. The pace of mergers among cooperative credit institutions increased slightly from a low level.

Number of Pfandbrief banks

At the end of 2014, a total of 80 institutions were authorised to issue *Pfandbriefe* – four more than in the previous year. All of the additional authorisations granted in 2014 related to mortgage *Pfandbriefe*. During the year under review, one institution waived the authorisation to issue mortgage *Pfandbriefe* it had previously been granted but to date had not used. The current proceedings and preliminary discussions show that there continues to be keen interest in a *Pfandbrief* authorisation.

Number of building societies

The number of supervised building societies (*Bausparkassen*) declined from 22 to 21 in the year under review. At the close of 2014, BaFin was supervising 12 private and nine public-sector building societies.

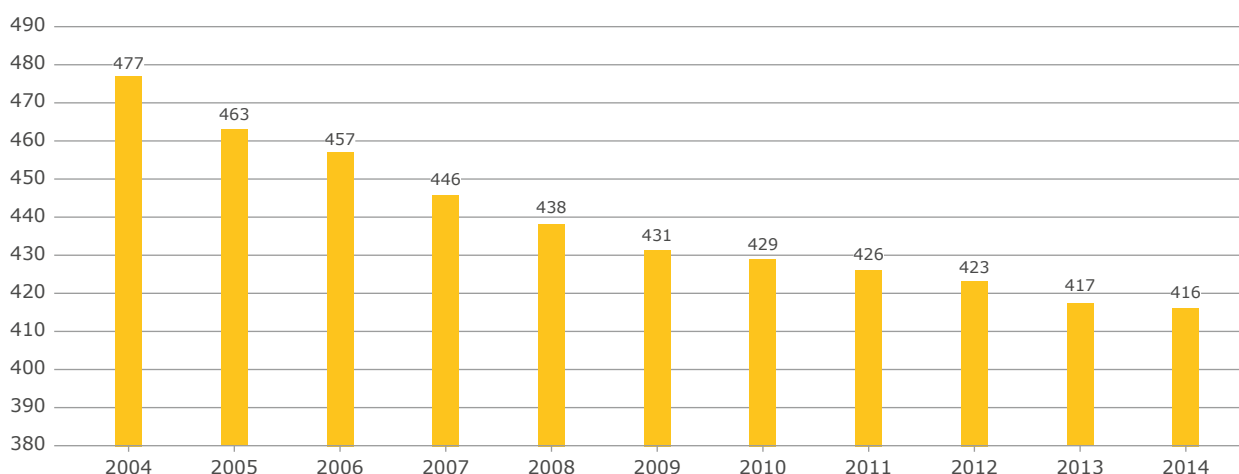
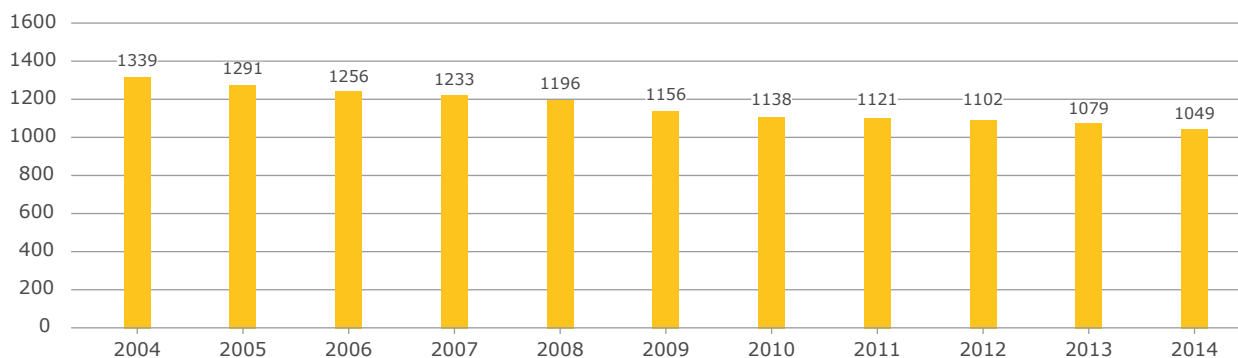
Figure 5 Number of savings banks

Figure 6 Number of primary cooperative institutions

3.1.2 Financial services providers

At the end of 2014, BaFin was supervising 676 financial services institutions (previous year: 702). 80 German branches of foreign institutions were also under its oversight (previous year: 89).

A total of 32 enterprises applied for authorisation to provide financial services in 2014 (previous year: 39). A further 10 financial services institutions applied to have the scope of their authorisation extended (previous year: 10).

The number of tied agents amounted to around 36,000 at the close of 2014. It therefore rose slightly in comparison with the previous year (around 34,500).

3.1.3 Finance leasing and factoring institutions

In 2014, the following institutions held an authorisation from BaFin and were subject to its ongoing supervision: 362 pure finance leasing institutions (65%; previous year: 383) and 170 pure factoring institutions (30%; previous year: 176), as well as 27 institutions engaged in both finance leasing and factoring (5%; previous year: 27). Overall, a slight decline in these financial services providers (known as "Group V institutions") was recorded (see Figure 7 "Breakdown of Group V institutions", page 112).

As in the previous year, fewer authorisations were granted than were terminated. However,

no significant discrepancy arose as had occurred in the past. Even if there is still movement in the market as before, since the beginning of 2013 there has been a noticeable easing in changes in authorisations. During the year under review, BaFin approved twelve new applications for authorisation pursuant to section 32 of the Banking Act. In total, 31 authorisations ended in 2014, in 26 of those cases as the result of waivers. In four further cases, the authorisation ended as the result of a merger with another institution. In addition, one institution lost its authorisation as a result of expiry pursuant to section 35 (1) sentence 1 of the Banking Act, since the authorisation had not been used.

3.1.4 Payment institutions and e-money institutions

As at 31 December 2014, a total of 32 payment institutions and four e-money institutions held an authorisation for their financial services in accordance with the Payment Services Supervision Act (*Zahlungsdienstenaufsichtsgesetz*). E-money institutions are entitled to provide payment services without requiring special authorisation as a payment institution. This also applies to deposit-taking credit institutions. Eight of the institutions authorised under the Payment Services Supervision Act, known as hybrid institutions, also held an authorisation in accordance with the Banking Act for particular banking transactions or financial services (foreign currency business). Institutions may provide factoring services within the

III

IV

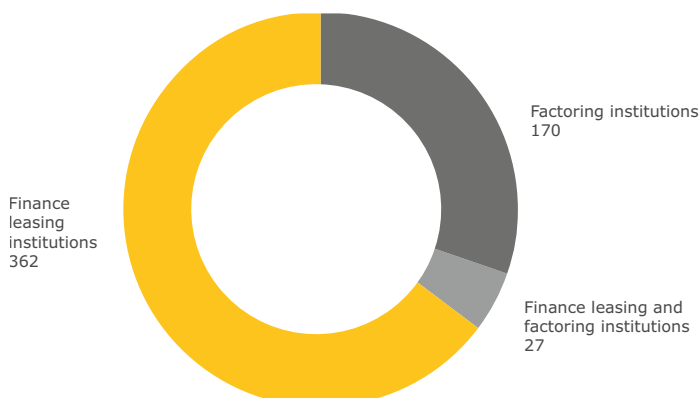
V

VI

Appendix

Figure 7 Breakdown of Group V institutions

As at 31 December 2014



meaning of section 1 (1a) sentence 2 no. 9 of the Banking Act without any such specific authorisation.

3.2 Economic environment

The continuing low level of interest rates was once again the main factor affecting the banking sector and its environment in 2014. In June 2014, the European Central Bank (ECB) initially reduced its key interest rate from 0.25% to 0.15% in order to halt the progress of disinflation in the eurozone. In a further step, it cut the key interest rate to its record low of 0.05% in September. In June 2014, there was another new development: for the first time in the history of the ECB, negative interest was applied to deposits by institutions in excess of the minimum reserve requirement with the central bank. The purpose of this move by the ECB was to create an incentive for banks to increase their lending. It also established programmes for the purchase of covered bonds and asset-backed securities in order to enhance the transmission of monetary policy, according to the information provided. As a consequence, yields on these types of securities fell noticeably.

The low level of interest rates had the effect of reducing net interest income in the German banking sector. This particularly affected those institutions whose business model is oriented towards interest business. The fact that

individual banks passed on the ECB's negative rate of interest on deposits not only to their major and corporate clients but also in some cases to wealthy private clients with deposits above a certain level, clearly shows the scale of the pressure on the institutions' earnings. The persisting low level of interest rates has also magnified the interest rate risk in the banking sector. This is because, in an environment of rising interest rates, new business at higher rates can only be built up in stages, while at the same time the short-term refinancing of existing business at a lower interest rate rapidly becomes more expensive. The difficult interest rate environment increased the pressure on the banking sector to enhance earnings by means of more extensive maturity transformation.

The regulatory environment had a pronounced effect on the sector index for German banking shares in 2014. For example, the publication of new standards on leverage ratios, in a framework issued by the Basel Committee on Banking Supervision requiring leverage ratios to be disclosed at the latest from 1 January 2015, set off a brief explosion in share prices. Investors interpreted the new rules as less onerous for banks' capital and reflected this in forecasts of a higher return on equity. Subsequently, profit-taking and a publication relating to the stress test for banks brought prices down again. At the end of January 2014, the European Banking Authority (EBA) set the capital ratio required for the stress test

at 5.5%. In the previous stress test in 2011, the ratio had been only 5%.

In spring and summer 2014, the uncertainty about the outcome of the European Central Bank’s comprehensive assessment exercise affected the banking sector with the result that share prices fell steadily without recovering. Rumours in August and September that the banking sector could have a smaller capital shortfall than expected once again generated a noticeable upward movement in share prices. In the final analysis, however, the outcome of the comprehensive assessment did not result in a sustainable increase in the share prices

of German credit institutions in 2014. Looking at the year as a whole, the sector index for German banking shares declined by 16.4% in 2014, a long way behind the modest positive performance of the DAX index of German shares (see Figure 8 “German banking shares index”).

The spreads on German banks’ credit default swaps (CDS) again fell noticeably in the first half of 2014 compared with the previous year (see Figure 9 “Credit default swap spreads for major German banks”). In the second half of the year, they remained stable at a level between 50 and 90 basis points with

Figure 8 German banking shares index

End-of-week levels, end of 2012 = 100

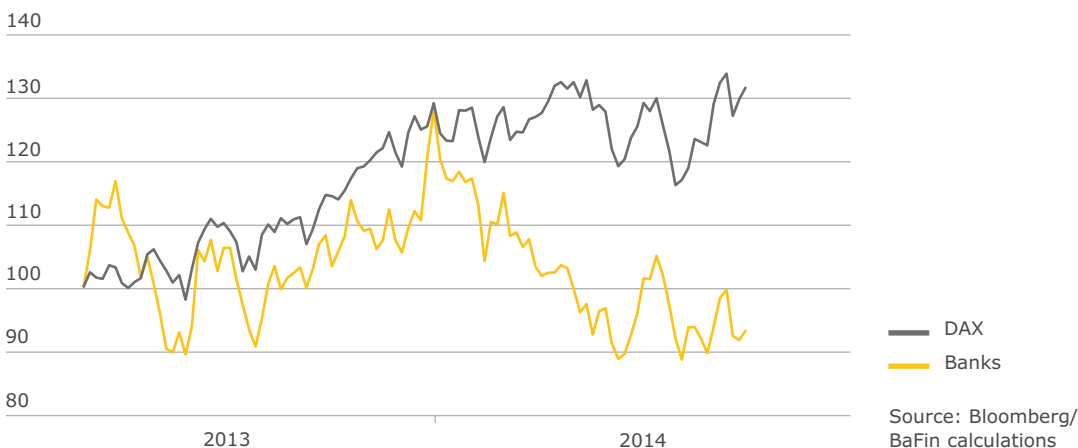
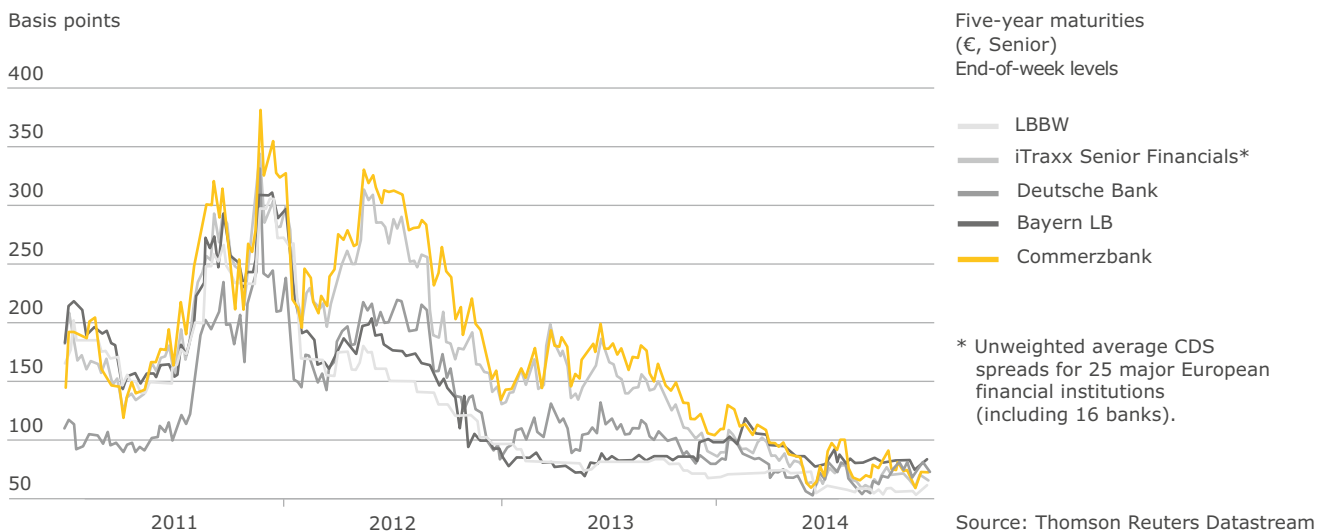


Figure 9 Credit default swap spreads for major German banks



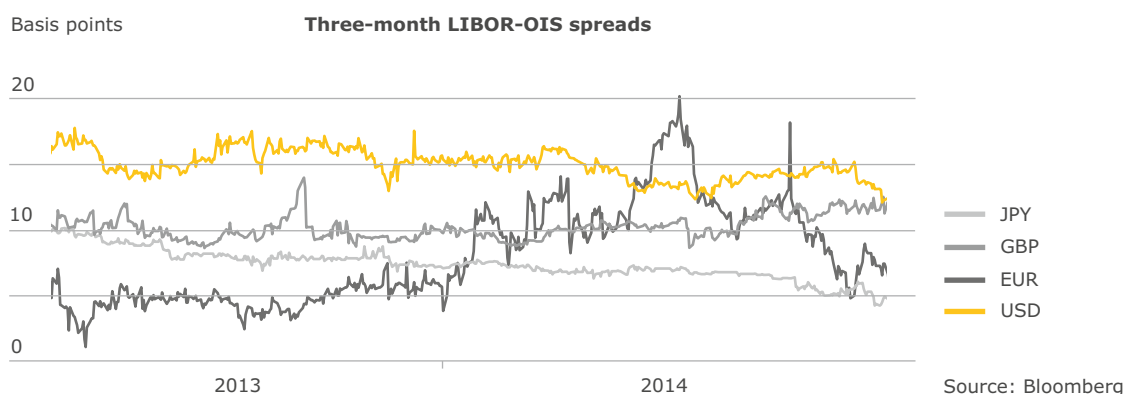
III

IV

V

VI

Appendix

Figure 10 Interbank market indicators

no significant fluctuations in price. The performance of CDS spreads on the one hand and the negative trends of share prices on the other illustrate the fact that market participants consider the banking sector to be increasingly safe from an investment point of view, but also less profitable.

The banks benefited from a favourable refinancing environment in 2014. Although banks in the eurozone were still dependent on central bank liquidity in differing degrees, the differences between them decreased noticeably. The outstanding amounts of the ECB's current three-year tenders fell substantially in 2014. Banks in the crisis-hit countries increasingly launched issues of shares and bonds. In autumn 2014, the ECB introduced an additional source of refinancing for banks in the eurozone, the targeted longer-term refinancing operations (TLTROs). The ECB provides these funds to the institutions for a maximum of four years – depending on their net lending to non-financial companies and private households. The programme reflects the central bank's objective of providing a new impetus for lending in the real economy. Interest in the programme from German institutions was muted even at the start. The main users of the programme were institutions in the peripheral states which are more dependent on refinancing via the central bank.

The LIBOR-OIS spread recorded stable performance throughout 2014 and showed little sign of tensions in the interbank market

(see Figure 10 "Interbank market indicators"). The spread remained firmly in the moderate region under 20 basis points at all times. Even the crisis involving the major Portuguese bank Banco Espírito Santo did not generate disturbances in the interbank market. The LIBOR-OIS spread denotes the difference between the three-month London Interbank Offered Rate (LIBOR) and the interest rate for a three-month revolving overnight index swap based on the overnight indexed swap (OIS) rate. The spread can therefore be regarded as an indicator of the credit risk in the interbank market.

Following the tendency of German and European institutions to tighten credit standards for corporate clients in previous years, 2014 saw a slight relaxation again for the first time. Demand for credit was particularly strong at the year-end. Companies were primarily interested in long-term loans while demand for short-term loans declined. This was the finding of the quarterly Bank Lending Survey conducted by the ECB and the Deutsche Bundesbank. Private households in Europe also demonstrated an increased need for residential building and consumer loans again for the first time in 2014. In Germany, the trend towards higher borrowing requirements on the part of private households continued in 2014.

Non-performing loans

In 2013 – the audit reports for the 2014 annual financial statements were not yet available in all cases at the time of writing

Non-performing loans (NPLs)

There is no statutory definition of non-performing loans (NPLs) in Germany. BaFin and the Deutsche Bundesbank therefore used impaired loans reported in accordance with the German Audit Report Regulation (*Prüfungsberichtsverordnung*) as an approximation for the purpose of determining the volume of NPLs.

BaFin's annual report – the volume of NPLs in the German banking sector had declined by 8.2% in comparison with the previous year to €154 billion (see info box "Non-performing loans"). This represented a continuation of the downward trend. Measured against the total volume of loans to non-banks, the share of NPLs fell slightly to 2.7%, compared with just under 2.9% in 2012. The ratio of NPLs to reported equity declined from 27.4% to 23.8%. The NPL figures refer to net amounts less risk provisions already recognised. The total lending volume used to calculate the NPL ratio is a gross amount before the deduction of risk provisions.

The decisive factor in the renewed improvement in credit quality is likely, as in the previous year, to have been the continuation of stable economic growth in Germany in 2013. The further reduction in insolvencies and a low unemployment rate by historical standards also helped. In addition, a number of banks succeeded in reducing their portfolios of non-performing loans through sales to financial investors.

3.3 Situation at the institutions

3.3.1 Institutions subject to direct European supervision

In many respects, 2014 was a highly challenging year for the largest institutions in Germany, i.e., those institutions amongst all German banking groups with total assets in excess of €30 billion. 21 institutions have been

subject to direct supervision under the Single Supervisory Mechanism²⁸ since 4 November 2014. For the most part, their results were at a lower level than in the previous year, in some cases even lower than originally expected by the institutions. On average, their total assets remained relatively stable. By contrast, the large majority of the institutions were able to strengthen their equity base, which improved the equity and leverage ratios.

Results were rather heterogeneous depending on the line item and institution in question. As in the previous year, the persistence of the low interest rate environment again put pressure on net interest income in 2014. By contrast, the institutions experienced a largely stable, albeit rather inconsistent, trend in net fee and commission income.

By contrast, allowances for losses on loans and advances declined overall, having a positive impact on overall results. This development was attributable in part to the relatively robust economic situation, among other factors. It was also attributable to the portfolio optimisation and risk reduction measures implemented in the previous year, particularly in the lending segments on which the focus had been placed. As a result, allowances for losses on loans and advances remained at a comparatively moderate, albeit inconsistent, level overall.

The ongoing efforts on the part of institutions to reduce and optimise their administrative expenses also led to varying results. Among other things, the need to recognise additional provisions for legal risks weighed down results at individual institutions.

According to the most recent macroeconomic forecasts, the economic environment can be expected to remain highly challenging for the banking sector in 2015 as well. Specifically, the persistence of the low interest rate environment and financial market uncertainty in light of the difficult geopolitical situation will continue to influence developments.

²⁸ See chapter III 1.1.1 and 1.1.2.

Another major issue which dominated the year 2014 was the comprehensive assessment of institutions previously classified as significant prior to the launch of the Single Supervisory Mechanism (SSM).²⁹ A total of 130 European institutions – including 25 German institutions – participated in the comprehensive assessment, which consisted of an asset quality review and a stress test. 21 of those institutions fell under the direct supervision of the ECB as the SSM went live in early November 2014. The assessment kept banking supervisors, auditors and institutions busy for some twelve months. The results, published at last on 26 October 2014, revealed that the balance sheets of the 25 participating German institutions were sound and that the banks' capital adequacy was sufficient to enable them to withstand a severe economic shock.

One institution fell short of the minimum requirements for common equity Tier 1 capital in the stress test. However, that bank (Münchener Hypothekbank) had thus far not been classified as a nationally systemically important institution. Given that the stress test was conducted on the basis of the institutions' 2013 annual financial statements, it was not able to factor in the capital increase which had been successfully implemented in 2014 within the Cooperative Financial Services Network (*Genossenschaftliche Finanzgruppe*). Otherwise, the institution would have satisfied the minimum requirements under both stress test scenarios.

3.3.2 Private commercial, regional and specialist banks

As in the previous year, the sustained low interest rate level again affected the situation of the regional private commercial banks in 2014. Refinancing at non-matching maturities exposed individual institutions to considerable interest rate risk. Some institutions also faced earnings risks due to regional concentrations.

The focus remained on the capital resources of the banks in light of the provisions of

the Capital Requirements Regulation (CRR). The implementation of the new reporting requirements also presented challenges to some of the relatively small institutions.

3.3.3 Savings banks

Savings banks are also increasingly feeling the effects of the persistently low interest rate environment. For instance, net interest income – given the banks' business model, the most important earnings indicator by far – has been declining for years now. At the same time, net fee and commission income remains at the same level, however. Buoyed by the strong mortgage lending business, the member institutions have nonetheless managed to build on the positive business trend of previous years, again generating satisfactory results overall in 2014. However, that success was attributable in part to the relatively low allowances for losses on loans and advances and in the securities business. The savings banks used the good operating results from the previous financial year to significantly strengthen their contingency reserves again, thus realising net profits at the same level as in the previous year.

Regulatory and technical challenges

The SSM classifies the vast majority of German savings banks as less significant credit institutions. BaFin therefore continues to play a lead role in their supervision. Nonetheless, the ECB can be expected to gather an increasing amount of data across all bank groups. This will result in an increased technical burden on the smaller institutions in particular. As the digitalisation of the banking business progresses, this will also give rise to new challenges. In order to ensure that their branch operations can remain cost-effective, the savings banks need to dovetail their online services with those offered by their local branches.

Savings banks currently maintain the most extensive branch network of all banking groups in Germany. Going forward, by their own account, they will continue to maintain

²⁹ See chapter III 1.1.1 and 1.1.2.

a wide branch presence in keeping with their public mission to provide banking services to all groups of the population.

First interstate savings bank merger in Germany

In 2014, the number of savings banks was reduced further by various mergers. One special case was the merger of Kreissparkasse Wesermünde-Hadeln with Sparkasse Bremerhaven. In order to pave the way for the first interstate merger of savings banks from different savings bank associations in Germany, the federal state of Lower Saxony and the Free Hanseatic City of Bremen first had to conclude a corresponding state treaty. Then it was necessary to modify the regulations of the cross-guarantee scheme. Following the merger, the institution now operates under the name Weser-Elbe Sparkasse and is a member of the Lower Saxony Savings Banks Association (*Sparkassenverband Niedersachsen*) and the Hanseatic Savings Banks Association (*Hanseatischer Sparkassen- und Giroverband*).

3.3.4 Securities trading banks

Securities trading banks and stockbrokers

The business environment also again proved difficult for securities trading banks and stockbrokers in the past year. As expected, the process of consolidation continued in 2014 for the mainly small, owner-operated institutions. Although Germany's DAX index again reached record highs in the past year, retail investors remained hesitant despite low interest rates. Trading volumes therefore only increased slightly. The institutions continued to feel an extremely high degree of competitive pressure as a result. This development was also fuelled by other factors, such as the ongoing advances in exchange trading, the entry into the market of more algo traders, the expansion of alternative trading platforms, increased supervisory requirements and the potential introduction of a financial transaction tax. This also led larger institutions to step up their search for new lines of business and sources of income. The environment for corporate finance

improved slightly, particularly for small and medium-sized enterprises, even though not every institution was able to benefit from this.

Energy derivatives traders

The turnover generated by energy derivatives traders authorised by BaFin again fell short of the institutions' original expectations in 2014. In light of falling energy prices, demand for hedging operations has decreased. The European Energy Exchange (EEX) continued to expand and cement its role. European Commodity Clearing (ECC), the clearinghouse affiliated with the EEX, has been admitted as a central counterparty pursuant to the European Market Infrastructure Regulation (EMIR) since June 2014 and was also successful in expanding its position.

High-frequency trading

High-frequency trading on German exchanges is limited to European Exchange (Eurex) Deutschland and the Frankfurt Stock Exchange. It is currently not possible to engage in high-frequency trading on Germany's regional exchanges and there exist no plans to make this possible in the future. The number of exchange participants which engage in high-frequency trading is quite low. To date, no institution has applied for the newly created licence to conduct high-frequency trading within the meaning of section 1 (1a) sentence 2 no. 4 of the Banking Act. Traders operating in Germany already possessed a licence from BaFin to trade on an own-account basis or were able to engage in cross-border trading because they held a corresponding licence from a European member state. In addition, some traders have scaled back their trading activities to cover areas not subject to authorisation requirements due to market circumstances.

As in previous years, BaFin again found organisational weaknesses at various institutions in 2014 and called on their management and members of the supervisory boards to remedy the situation. Problems related in particular to deficiencies found in risk management and control, in the risk-bearing capacity concepts applied and in the documentation of transactions.

III

IV

V

VI

Appendix

3.3.5 Building societies

Building savings schemes remain popular with Germans even in times of lower interest rates. Both the number of new contracts and home savings volumes again reached a high level in 2014. However, the number of new contracts also declined in isolated cases. This was caused primarily by clearance sale effects. Such effects occur from time to time if a building society replaces an existing – higher-interest – home savings plan with a new, lower-interest plan.

The effects of the low interest rate environment thus weigh down the building societies' (*Bausparkassen*) financial performance. This is due in particular to the fact that interest rates on building savings deposits and loans remain constant over the entire term of a contract and the existing higher-interest plans bear interest at rates which are significantly higher than market rates of interest.

Many customers with older contracts therefore prefer to take out a low-interest mortgage, forgoing disbursement of their deposits or a relatively high-interest home savings loan. This in turn results in a situation where building savings deposits have for some time now been less and less likely to be invested in home savings loans.

The options available to building societies for reacting to this situation are limited. The Building and Loan Associations Act (*Bausparkassengesetz*) restricts the group of transactions which building societies may engage in to transactions relating to residential properties, thus limiting their opportunities to low-risk – and hence low-return – investments. Therefore, in contrast to other financial institutions, building societies cannot leverage any new, more profitable, fields of business.

In 2014, many building societies introduced new home savings plans at lower interest rates to reflect the current low interest rate environment. However, by doing so the institutions did not resolve the problem caused by the existing high-interest plans, which represent a drag on their earnings.

Thus a number of building societies have in recent years terminated building savings contracts on the grounds of over-saving. A building savings contract is deemed to be over-saved if the building society saver's savings have already reached or even exceeded the contractually agreed amount. Once the full targeted amount has been saved, there is no longer any scope to extend a building savings loan. In such cases, the building societies usually terminate the building savings contract because it has failed to achieve its original purpose. Current case law has confirmed this interpretation under civil law.

In addition, in 2014 the building societies terminated contracts on the grounds, *inter alia*, that home savings loans had not been drawn down although the relevant contracts had already met the requirements for a loan to be granted for at least ten years. Building savings schemes are ultimately dedicated savings schemes. Although it is objectively still possible for the purpose of the savings scheme to be achieved, the respective building society savers evidently no longer desire this. The existence of the right to terminate building savings contracts under civil law remains to be clarified by the highest instance or in established case law.

The termination of building savings contracts which had already met the requirements for a loan to be granted for at least ten years was covered widely by the press in the past year. Contrary to what was reported in the press on various occasions, BaFin did not call on the building societies to terminate building savings contracts. The termination of contractual relationships with customers constitutes a business decision on the part of the respective building society. Such decisions are taken at the sole responsibility of the management of the institutions.

3.3.6 Cooperative banks

According to the available information, the German cooperative banks will have to expect their earnings to decline slightly in 2014 as compared to in 2013. It is not expected that

they will be able to match the extremely good level of the five preceding years (2009 to 2013). This development was caused mainly by the ECB's policy of low interest rates. Yet despite a large number of regulatory challenges and the persistent low-interest rate environment, the financial year is expected to still be satisfactory overall. The primary institutions will therefore be able again to recognise adequate provisions in the form of reserves.

Due to the excess supply of liquidity at low interest rates caused by the ECB, the cooperative banks will have to expect to generate lower income for the foreseeable future. The reduction in interest income expected by the sector is being virtually offset by the sharper fall in interest expenses during the same period. On the whole, net interest income will therefore remain high. Notwithstanding an unfavourable yield curve and the associated decline in income from maturity transformation, the primary cooperatives were able to generate an adequate profit margin on net interest income. In addition, for almost ten years now, the cooperative banks have been chalking up clear successes on the cost management front, which has reduced their expenses significantly relative to their total assets. The merger of the cooperatives' computer centres provides the most recent example of a targeted cost reduction. Thanks to the reduced cost base, the institutions of the cooperative banking sector have reported satisfactory earnings power despite the factors discussed above. The stable economic situation, increase in employment figures and reduction in insolvencies also had a beneficial effect. According to current forecasts, the cooperative banks will have a below-average valuation expense for 2014, so that the earnings after valuation are likely to be noticeably above-average. The cooperative banks' achievements have also been acknowledged by the rating agencies FitchRatings and Standard & Poor's: They awarded the cooperative banking sector long-term ratings of A+ and AA- respectively.

However, there will be additional regulatory initiatives, and thus new foreseeable expenses

are set to impact the cooperative banking sector and its institutions.

3.3.7 Foreign banks

As before, foreign banks are a significant factor in Germany. Their business activities are concentrated primarily on the lending business, private banking and custodian bank operations. Trade finance and payments also play a significant role in the business activities of these institutions. In 2014, deposits with foreign banks remained disproportionately high, and were trending upwards. Given their major significance to the German financial market and their infrastructural relevance, BaFin has classified various foreign banks as systemically important or as posing a potential systemic risk. These institutions are therefore obliged to develop recovery plans.

The partial takeover of banking supervision by the ECB also entails changes affecting foreign banks which operate in Germany. At present, BaFin employees are participating in 14 Joint Supervisory Teams which supervise banking groups with foreign banks operating in Germany. By collaborating in these Joint Supervisory Teams, BaFin has not only taken on additional supervisory duties, but also exerts a significant influence over the supervision of these banking groups. The overwhelming majority of the foreign banks are classified as less significant as far as the Single Supervisory Mechanism is concerned. BaFin therefore is the lead supervisor of these institutions.

Since the ECB does not have supervisory powers over third-country branches, BaFin remains solely responsible for monitoring this group of institutions. In Germany, branches from third countries are deemed to be credit institutions in Germany pursuant to section 53 of the Banking Act (*Kreditwesengesetz*). Accordingly, these institutions are largely subject to the same regulatory standards applicable to legally independent credit institutions. As previously, the supervision of third-country branches is not harmonised throughout Europe; as such, differences in

III

IV

V

VI

Appendix

Table 8 Gross Pfandbrief sales

Year	Mortgage <i>Pfandbriefe</i> (€ billion)	Public-sector <i>Pfandbriefe</i> (€ billion)	Total sales (€ billion)
2007	27.5	108.0	135.3
2008	63.4	89.5	152.9
2009	58.1	52.3	110.4
2010	45.4	41.6	87.0
2011	41.1	30.5	71.6
2012	42.2	14.3	56.6
2013	33.9	15.6	49.5
2014	30.6	15.3	45.9

national supervisory frameworks persist in the member states of the European Economic Area.

3.3.8 Pfandbrief banks

Persistent uncertainties as to the stability of the eurozone and the continued low-interest rate environment are affecting the business of the *Pfandbrief* banks. Nonetheless, solid market development and new issues in the *Pfandbrief* market were seen in 2014. The *Pfandbrief* is not only a cost-effective and comparatively crisis-proof source of funding, it is also a particularly safe and transparent financial product. The continuous revision of the *Pfandbrief* Act (*Pfandbriefgesetz*) ensures the highest standard of quality in the international legal framework for covered bonds. Given this, there was further sustained interest among institutions in acquiring a *Pfandbrief* licence in 2014.

In 2014, BaFin authorised five institutions to conduct *Pfandbrief* business. In each case, authorisation was granted to issue mortgage *Pfandbriefe*. One institution opted not to renew its authorisation, granted in previous years, to issue mortgage *Pfandbriefe* since it had to date not exercised its right to do so.

The number of active benchmark issuers also increased slightly again in 2014. Benchmark *Pfandbriefe* were over-subscribed by a factor of approximately 1.5 in 2014, underscoring the unabated interest of investors in this product.

In addition to the predominant mortgage *Pfandbriefe*, a second aircraft *Pfandbrief* was also issued in 2014. The German *Pfandbrief* fared well in an international comparison of competing foreign covered bonds: with a gross issue volume of €19.6 billion, German *Pfandbrief* banks were the frontrunners, ahead of France (€18.5 billion) and Canada (€12.5 billion).

Decline in the number of issuances

As in previous years, the number of issuances continued to decline (2014: €45.9 billion; 2013: €49.5 billion; 2012: €56.6 billion – up to 2009 even significantly higher than €100 billion; see Table 8 “Gross *Pfandbrief* sales”). This trend is largely attributable to the decline in the significance of the public-sector *Pfandbrief* because many institutions whose core area of business had been in the government finance sector have reduced or even discontinued this business. New issues are usually only tailored towards and launched for insurance undertakings and fund investors. This trend has also been amplified by the relatively cheaper supply of liquidity from the European Central Bank. However, where residential real estate financing and commercial financing are concerned, the abundant market liquidity has benefited the *Pfandbrief* banks on the assets side. The available liquidity has resulted in an increase in investment, particularly from abroad. The *Pfandbrief* banks are facing competition from

foreign institutions which are increasingly offering real estate financing in Germany; new players in this area, particularly insurance undertakings, are putting pressure on margins. However, the persistently high volume of real estate financing offers potential for mortgage *Pfandbriefe*. Demand for ship *Pfandbriefe* also picked up again in 2014.

Continued decrease in outstanding *Pfandbriefe*

The persistent decline in the volume of outstanding *Pfandbriefe* was due to high maturities and relatively lower new issuance activity. Moreover, there continue to be sufficient options for obtaining alternative refinancing, for instance in the covered bonds sector. The volume of public-sector *Pfandbriefe* outstanding declined to €206.5 billion (previous year: €246.0 billion), while mortgage *Pfandbriefe* (including ship and aircraft *Pfandbriefe*) fell to €195.8 billion (previous year: €206.2 billion). The total volume of *Pfandbriefe* outstanding amounted to €402.3 billion.

The changes in volumes of outstanding *Pfandbriefe* in recent years and the increasing relative importance of mortgage *Pfandbriefe* are reflected in Table 9 ("Volumes of outstanding *Pfandbriefe*"). Forecasts for 2015 call for the share of mortgage *Pfandbriefe* to increase to over 50%. However, on the whole, the pace at

which the volume of *Pfandbriefe* outstanding is reduced is expected to slow in the future. The volume of outstanding *Pfandbriefe* is likely to stabilise in coming years and again increase in the medium term.

General administrative act pursuant to section 4 (1) sentence 4 of the *Pfandbrief Act* (n. v.)

By general administrative act of 22 December 2014, BaFin has decided to permit institutions to also use receivables from domestic credit institutions whose creditworthiness is rated as "level 2" as cover pursuant to the *Pfandbrief Act*. BaFin otherwise saw the potential risk of a considerable concentration of borrowers in the case of receivables from domestic credit institutions. BaFin is authorised to take such measures by virtue of the Act Implementing the EU Bank Recovery and Resolution Directive in section 4 (1) sentence 4 of the *Pfandbrief Act*.

3.3.9 Finance leasing and factoring institutions

The increasing willingness of German companies to invest has given new momentum to finance leasing and factoring institutions in the past year. According to a forecast by the *ifo Institut* in December 2014, gross capital investment in Germany can be expected to increase by 2.8% year on year in 2014 overall. By contrast,

Table 9 Volumes of outstanding *Pfandbriefe*

Year	Mortgage <i>Pfandbriefe</i> (€ billion)	Public-sector <i>Pfandbriefe</i> (€ billion)	Total outstanding (€ billion)
2007	217.1	699.4	916.5
2008	217.9	620.6	838.6
2009	231.9	524.9	756.8
2010	231.3	444.4	675.7
2011	230.3	355.7	586.0
2012	223.8	301.1	524.9
2013	206.2	246.0	452.2
2014	195.8	206.5	402.3

III

IV

V

VI

Appendix

investments declined by 0.6% in 2013. The leasing and factoring institutions, which are classified as Group V institutions for supervisory purposes, accounted for a disproportionate share of this increase: according to calculations by the Federal Association of German Leasing Companies (*Bundesverband deutscher Leasingunternehmen*), new leasing business grew by 6.1% from €48.5 billion in 2013 to an estimated €50.2 billion in 2014. Factoring revenues will have increased even more significantly year on year in 2014 if the positive trend identified in surveys by the German Factoring Association for the first half of the year continued: the revenues generated by association members increased by more than 11% over the prior half year. Taken as a whole, these financial services institutions thus – as in previous years – managed to slightly increase their share of corporate finance compared with other forms of finance.

3.3.10 Payment and e-money institutions

The development of the payment and e-money institutions was somewhat more mixed in 2014. Various niche providers in the traditional remittance business ceased their activities. By contrast, payment services providers for online retailers expanded their businesses and one provider received a licence. Institutions active in acquiring contracting parties who are prepared to accept payments by credit card had to adapt to the impacts of new regulations, as well as the upcoming adoption of the EU Regulation on interchange fees for card-based payment transactions and the Federal Cartel Office's order pertaining to charges for retailers in electronic cash card payment systems. Providers planning to issue e-money were confronted with the requirements of section 25n of the Banking Act. Payment institutions and e-money institutions provide a wide variety of services, from the transfer of amounts accepted in cash to recipients in third countries via payment transactions by operating payment accounts to the transfers and debits business and issuing and processing credit cards and e-money in various forms.

3.4 Supervisory activities

3.4.1 Credit institutions

Section 44 (1) sentence 2 of the Banking Act provides for the option of conducting special audits. A distinction is drawn between special audits initiated by BaFin and scheduled audits. In addition, there are also requested audits. While special audits initiated by BaFin and scheduled audits are conducted at BaFin's initiative, the initiative for requested audits comes from the institution that is the subject of the audit.

Special audits initiated by BaFin are conducted either on the basis of information, such as from the report on the audit of the annual financial statements, or serve as sample audits of institutions. Scheduled audits are conducted in compliance with statutory audit intervals, such as cover audits of *Pfandbrief* banks.

Requested audits include acceptance tests for internal risk measurement procedures used by institutions, e.g. for rating systems in the lending business in accordance with the Internal Ratings Based Approach (IRBA). They also include audits of advanced methods for measuring operational risk under the Advanced Measurement Approach (AMA), market risk models, or internal procedures for measuring liquidity risk.

Special audits in 2014

In preparation for the Single Supervisory Mechanism (SSM), the 24 largest German institutions were required to undergo a comprehensive assessment in 2014. At the same time, BaFin continued to carry out its audit activities at a high level at the remaining institutions. In total, BaFin ordered 203 special audits (previous year: 305; see Table 10 "Breakdown of special audits by area of emphasis", page 123), of which 155 were initiated by BaFin (previous year: 220). 47 special audits were conducted for a specific reason. The remaining 108 audits were conducted as scheduled examinations. In addition, BaFin conducted 45 requested special

Table 10 Breakdown of special audits by area of emphasis

As at 31 December 2014

	2014	2013
Impairment-related special audits	24	38
Section 25a (1) of the KWG (MaRisk)	131	182
Cover	3	18
Market risk models	1	7
IRBA (credit risk measurement)	42	58
AMA (operational risk measurement)	2	2
Liquidity risk measurement	0	0
Total	203	305

audits (previous year: 67) and 3 statutory cover audits (previous year: 18).

In addition to special audits, BaFin exercised the authority granted by it under section 30 of the Banking Act to order expanded-scope audits in 2014. In four cases, such audits focused on following up on audits of compliance with the Minimum Requirements for Risk

Management (*Mindestanforderungen an das Risikomanagement – MaRisk*), as well as the review of selected carrying amounts in the balance sheet and the proper operation of IT systems.

Table 11 (“Breakdown of special audits in 2014 by groups of institutions”) shows a breakdown of the audits by groups of institutions. The table also includes the respective central banks for the individual groups of institutions, i.e., the audits of the *Landesbanks* are included in the data for the savings banks sector, the audits of DZ Bank and WGZ Bank are included in the data for the cooperative bank sector. The “other institutions” group includes, for example, the former mortgage banks, building and loan associations, special-purpose banks, guarantee banks and certain other specialist banks as well as financial services institutions that are authorised to obtain ownership or possession of customer funds and securities or to perform proprietary business or trading.

Risk matrix as an element of risk-based supervision

A comparison of the audit figures with the classifying risk matrix clearly reveals that the special audits were risk-based.

Table 11 Breakdown of special audits in 2014 by groups of institutions

As at 31 December 2014

	Commercial banks	Savings bank sector	Credit cooperative sector	Other institutions
Impairment-related special audits	6	3	12	3
Section 25a (1) of the KWG (MaRisk)	23	25	79	4
Cover	0	3	2	0
Market risk models	0	1	0	0
IRBA (credit risk measurement)	17	13	2	10
AMA (operational risk measurement)	2	0	0	0
Liquidity risk measurement	0	0	0	0
Total	48	45	95	17
Audit ratio in % (excluding cover audits)	26.4	9.9	8.7	14.0

III

IV

V

VI

Appendix

Table 12 Breakdown of special audits initiated by BaFin in 2014 by risk class

As at 31 December 2014

Special audits initiated by BaFin		Quality of the institution*				Total	Institutions in %**
		A	B	C	D		
Systemic importance	High	1	9	37	6	53	120.5***
	Medium	3	14	13	4	34	17.1
	Low	41	46	25	3	115	7.5
	Total	45	69	75	13	202****	11.4
	Institutions in %**	6.0	9.0	34.7	32.5	11.4	

* Including the 17 financial services institutions that are authorised to obtain ownership or possession of customer funds and securities or to perform proprietary business or trading.

** Percentage of the total number of institutions in the respective quality/importance category accounted for by the audits.

*** Some institutions with high systemic importance were audited more than once.

**** One audited institution does not currently have a risk classification.

Table 12 (“Breakdown of special audits initiated by BaFin in 2014 by risk class”) contains only those audits initiated by BaFin. Only in the case of these audits is there a link to the risk classification of the supervised institutions.

The more critical BaFin’s rating of an institution’s quality, the more closely it supervises that institution. This can be seen simply by the fact that it has ordered an audit for roughly every third institution it deems problematic (“D” rating). The audit ratio for institutions which are of high systemic importance was high again in 2014 at 120.5% (previous year: 109.3%); however, this figure is also due to the comprehensive assessment described above since all significant institutions were subjected to a balance sheet assessment in this connection in 2014, which resulted in an increase in the figures overall.

In 2014, random-sampling audits were again conducted at institutions which BaFin rates as good (“A” rating). However, audit activity was much less intense in this case: only 6.0% of the banks within this group were audited in 2014.

Supervisory law objections and sanctions

In 2014, the findings of special audits and requests for information resulted in a total of 178 supervisory law objections and sanctions.

Table 13 (“Supervisory law objections and sanctions in 2014”, page 125) presents a breakdown of the objections and sanctions by groups of institutions.

Use of IRBAs

In order to calculate their capital requirements for counterparty risk, a total of 51 institutions and groups of institutions were using internal securitisation rating systems and assessment approaches (IRBAs) as at 31 December 2014. Four of those institutions were in the cooperative sector and one in the savings banks sector. With the IRBA, a distinction is made between whether, outside the retail business, an institution must itself estimate only the probability of default (basic approach) or the loss given default and conversion factor as well (advanced approach). A total of 18 of the 51 institutions using IRBA used the advanced IRBA on a group or individual basis.

Use of AMAs

At the end of 2014, a total of 14 institutions and groups of institutions were using an Advanced Measurement Approach (AMA) to calculate their operational risk. BaFin was responsible for the approval procedures in six cases as home supervisor and in eight cases as host supervisor. The 14 institutions and groups of institutions that are permitted to use the AMA

are mainly commercial banks; two belong to the group of savings banks, one institution was a cooperative bank and one was in the group of "other institutions".

In 2014, BaFin conducted follow-up audits of several institutions and groups of institutions which use the AMA. During these audits, BaFin took action in particular to ensure that the institutions improve their models and procedures for legal risks.

A total of 58 institutions and groups of institutions used a standardised approach for operational risk. Two further institutions are authorised to apply an alternative indicator in the standardised approach. The approximately 1,700 remaining institutions used the Basic Indicator Approach to calculate their operational risk.

Authorisation of internal market risk models

As in 2013, BaFin had confirmed to a total of 11 credit institutions that their internal market risk models met the supervisory requirements for determining capital adequacy in 2014 (see Table 14 "Risk models and factor ranges", page 126).

The number of backtesting exceptions fell significantly, from seven in the previous year to three in 2014. The number of exceptions due to hypothetical value changes remained low, as in the previous year (2013: 7; 2012: 4).

In the 2014 calendar year, the Bundesbank conducted a follow-up audit of the internal market risk model for two institutions.

Due to a markedly high number of complaints, BaFin ordered an audit of a securities trading

Table 13 Supervisory law objections and sanctions in 2014

As at 31 December 2014

Type of sanction		Group of institutions				Total	
		Commercial banks	Savings bank sector	Cooperative sector	Other institutions		
Substantial objections/letters		9	22	46	0	77	
Sanctions against managers	Dismissal requests	Formal	0	0	0	0	
		Informal	0	0	0	0	
		By third party	0	0	1	0	1
	Cautions	0	2	0	0	2	
Sanctions against members of supervisory board/ board of directors	Dismissal requests	Formal	0	0	0	0	
		Informal	0	0	3	0	3
		By third party	0	0	0	0	0
	Cautions	0	0	0	0	0	
Sanctions related to own funds/liquidity, exceeding the large exposure limit (sections 10, 13 and 45 of the KWG)		7	2	4	2	15	
Sanctions in accordance with section 25a of the KWG		3	1	0	0	4	
Sanctions in accordance with sections 45, 45b and 46 of the KWG*		4	0	1	1	6	
Total		23	27	55	3	108	

* Measures to improve own funds and liquidity (section 45 of the KWG), in the case of organisational deficiencies (section 45b of the KWG) and in the case of specific danger (section 46 of the KWG).

Table 14 Risk models and factor ranges

Year	New applications	Applications withdrawn	Rejections	Number of model banks	Minimum add. factor*	Maximum add. 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
2006	0	1	0	15	0.0	1.0	0.2
2007	0	0	0	15	0.0	1.0	0.2
2008	1	1	0	15	0.0	1.0	0.2
2009	0	0	0	14	0.0	2.5	0.3
2010	0	0	0	14	0.0	2.5	0.4
2011	1	1	0	12	0.0	2.5	0.5
2012	0	0	0	11	0.0	1.2	0.2
2013	0	0	0	11	0.0	1.2	0.4
2014	0	0	0	11	0.0	1.0	0.4

* Including additional factors effective as at 31 December 2014. Excluding the additional factor component due to backtesting exceptions in accordance with Article 366 of EU Regulation No 575/2013. This is the backtesting or quantitative additional factor; this factor can be between 0.00 and 1.00 pursuant to Article 366, table 1 of EU Regulation No 575/2013.

bank in 2014 pursuant to section 35 (1) of the Securities Trading Act and section 44 (1) of the Banking Act; the audit covered an entity for which the securities trading bank was liable.

BaFin's auditors made an unannounced visit to the securities trading bank as the enterprise that accepts liability for tied agents at the same time as they made a visit to the tied agent. The audit identified a number of severe violations. For instance, BaFin found that the tied agent was conducting financial portfolio management without the requisite authorisation to do so. Furthermore, the auditors discovered clear evidence of violations of the provisions pertaining to advertisement in the form of cold calling pursuant to the general administrative act pursuant to section 6b (1) and (2) of the Securities Trading Act. There were also

indications of excessive trading in financial instruments to the detriment of customer accounts. BaFin also detected substantial organisational deficiencies in the selection and control of the tied agents for which the securities trading bank was liable. The findings of the audit resulted not only in the termination of the collaboration between the bank and the tied agent, but also in the securities trading bank being required to participate in a hearing to prohibit the integration of tied agents.

3.4.2 Financial services institutions

In the course of 2014 BaFin participated in 59 audits at financial services institutions (previous year: 145) and conducted 135 supervisory interviews with senior managers or management board members (previous

year: 131). A total of 28 authorisations held by financial services institutions ended (previous year: 39), in most cases because they were returned.

In 2014, BaFin prohibited one investment services enterprise from marketing a certain registered bond in the event that such marketing took place in the course of providing investment advice to retail clients. In BaFin's view, such investment was inappropriate for retail investors. This was due in its opinion to the following circumstances: the investment entailed an inordinately high risk, which extended all the way to the total loss of invested funds. This was the result of the interplay of several material factors, such as in particular the nature of the economic activity of the group of companies issuing the instrument, the insolvency risk of several companies involved, the lack of transparency surrounding the highly complex nature of the group of companies and the cash flows involved, as well as the absence of any option for selling the investment once it had been acquired.

In BaFin's view, the overall circumstances surrounding the investment product in question rendered it impossible for retail investors to assess the inherent risk and to make their own investment decision based on such an assessment.

BaFin's prohibitive order did not constitute a general prohibition on the marketing of the debt securities; rather, it merely contains marketing restrictions. Specifically, the order merely prohibited the securities from being marketed to retail investors, and only in instances where the enterprise would have sold the instruments as a result of having actively recommended them. Accordingly, the prohibition did not affect the product being marketed to professional clients or the sale of the product to retail investors in the absence of an active recommendation.

The investment services enterprise sought legal remedies, prompting a court to review the prohibition order. Although the scope of

the prohibition was restricted as discussed in the foregoing, the court ruled that a general prohibition of the securities being marketed to retail investors was improper. Rather, it must be assessed whether a specific investment is appropriate for each investor on an individual basis.

This interpretation by the court prevented BaFin from preventively restricting the product from being marketed to retail investors, although it deemed this group of persons in particular to merit protection.

3.4.3 Finance leasing and factoring institutions

Holder controls and appointments of senior executives and supervisory board members

BaFin initiated a total of 69 holder control procedures in accordance with section 2c of the Banking Act in conjunction with the Holder Control Regulation (*Inhaberkontrollverordnung*) in 2014. In these proceedings, which have to be completed by a certain deadline, BaFin is required, among other things, to build up a comprehensive picture of the integrity and aims of the potential purchaser of a qualifying holding and to verify the existence and origin of the funds to be used to make the purchase. In 2014, BaFin again received a large number of notifications from Group V institutions signalling their intent to appoint 113 new members of executive management or commercial attorneys-in-fact and 66 supervisory board or advisory board members. BaFin has a duty to review the reliability and suitability of these persons. In ten instances, it addressed warnings to executives of Group V institutions and in ten instances it expressed in writing its disapproval of ten supervisory board or advisory board members.

Auditor workshops

In the past year, BaFin conducted three workshops for auditors together with the Chamber of Public Accountants and the Deutsche Bundesbank. The one-day workshops were designed to increase participants'

III

IV

V

VI

Appendix

awareness of the requirements for the audit of small and medium-sized financial services institutions and investment services enterprises. The event organisers provided information on current developments in supervisory law and supervisory practice. Due to persistent demand and positive feedback, additional workshops will be held in 2015.

New developments in supervisory law for leasing and factoring institutions

The introduction of the Act Amending Acts Pertaining to the Financial Market (*Gesetz zur Anpassung von Gesetzen auf dem Gebiet des Finanzmarktes*) dated 19 July 2014³⁰ permitted leasing and factoring institutions to exempt themselves from the formal requirement to establish a risk control and compliance function. By the end of the year, a large number of small and medium-sized institutions had exercised this option.

A legislative amendment opened up a new field of business to domestic leasing and factoring institutions which are subsidiaries of a credit institution within the meaning of the Capital Requirements Regulation (CRR) in mid-2014: under the European Passport, they are now able to offer their services in other European member states via a branch or in exercising their freedom to offer services, without being required to have a physical presence in those countries. The European Passport is merely a notification procedure which is initiated via the supervisory authority in the home country. Once the notification process has been completed, the institution may also use the authorisation it received in its home country in other states of the European Economic Area without having to apply for an additional comparable national authorisation. Domestic leasing and factoring institutions had previously been excluded from this provision. Until the new provision entered into force, by virtue of the European Passport the foreign leasing and factoring institutions were permitted in Germany to render their services which were subject to an authorisation requirement;

by contrast, German institutions were not permitted to provide their services abroad. This competitive distortion was not eliminated until the aforementioned legislative amendment had been passed.

Additional changes were brought about by the Act Implementing the Capital Requirements Directive IV (CRD IV). The implementation act imposed stricter requirements, among other things, on the appointment of members of executive management, the board of directors and the supervisory board. Thus greater focus was placed on the amount of time the executive management of financial services institutions is available. However, the rigid limitations on terms of office introduced for the significant CRR institutions do not apply to Group V institutions.

Market survey of settlement agents

In 2014, BaFin conducted its first systematic market survey of all medical settlement agents subject to its supervision. The objective was to gain an overview of how specific problems are handled in practice. The survey found that the problem areas examined were handled according to a highly homogeneous practice. Approximately 80% of the supervised institutions participated in the voluntary survey. In light of the positive experience, it is conceivable that this tool will be used again to prepare cross-section analyses in the future and to determine market practices.

3.4.4 Payment service providers and e-money institutions

In the course of 2014, a total of 382 payment and e-money institutions domiciled in another EU member state or another EEA signatory state notified BaFin that they intended to provide payment services – primarily in connection with financial transfers business – or e-money business in Germany. Of these institutions, 22 have thus far established a branch office in Germany.

As at 31 December 2014, 5,297 registered agents (hereinafter: payment agents) were

³⁰ Federal Law Gazette I 2014, p. 934 ff.

operating on behalf of these institutions. BaFin is responsible for ensuring anti-money laundering supervision over these agents and the branch offices. Since there are no statutory notification and submission duties, as before only audits conducted in accordance with the Payment Services Supervision Act (*Zahlungsdiensteaufsichtsgesetz – ZAG*) serve as an expedient source of information.

BaFin therefore ordered a total of 123 audits of payment agents in 2014 on the basis of section 26 (4) of the ZAG in conjunction with section 14 (1) sentence 2 of the ZAG. In the past year, the focal point of the audit lay on agents of institutions with a relatively low volume of business. In addition, BaFin audited one branch office.

BaFin was able to complete 39 of those 123 ordered audits. BaFin was forced to terminate one audit due to the refusal of the payment agent to cooperate. The other audits revealed that the registers kept by the payment institutions' home supervisors continue to exhibit considerable shortcomings. Their entries are often not up-to-date. For instance, it was not possible to conduct audits of 57 payment agents merely because those agents were not, were no longer, or had never been operating at the address entered for them in the relevant register. A further 26 audits had to be cancelled for other reasons, in many cases due to the absence of the payment agent.

In addition, in its audits primarily of agents of smaller institutions conducted in 2014, BaFin found that these agents often did not fully satisfy their obligations to prevent money laundering, particularly obligations relating to their duty to make and keep records. This was also evident in the large number, as in the previous year, of proceedings against payment agents in accordance with the Act on Breaches of Administrative Regulations (*Ordnungswidrigkeitengesetz*). By contrast, audits of payment agents which were already subject to supervision by BaFin for other reasons revealed that these agents performed significantly better when it came

to satisfying their obligations as payment agents.

In 2014, the number of suspicious transaction reports in accordance with sections 14 and 11 of the Money Laundering Act (*Geldwäschegesetz*) again increased sharply year on year from 58 to 201. As in the previous years, anti-money laundering obligations were often not satisfactorily complied with. The large number, as in the previous year, of proceedings against payment agents pursuant to the Act on Breaches of Administrative Regulations is clear confirmation of this.

In 2014, BaFin prohibited nine institutions from conducting unauthorised financial transfer business in the context of prosecuting an internationally active ring of drug dealers. Several groups of offenders imported the drugs to Europe and generated millions in proceeds from their sales in cash.

The prohibition orders were addressed to members of the drug rings who settled the financial transactions relating to the illegal dealings. They received proceeds in cash in order to transfer them back to the ringleaders of the drugs trade, thus obscuring the origin of the funds.

A further prohibition order was issued by BaFin in 2014 against a payment agent who processed payment orders in his own name for third parties via the payment institution's computerised transfers system. By doing so, the agent was attempting to conceal the true identity of the party issuing the order.

Certain payment institutions have since not only expressly forbidden their agents from executing payment orders in their own name for third parties, but have also prohibited them in general from executing payment orders – even their own – in their own name. It cannot be conclusively ascertained thus far whether this has curtailed the criminal activities on the part of the agents who abuse the systems of payment institutions to operate unauthorised financial transfers business.

III

IV

V

VI

Appendix

Table 15 Requests for account information

As at 10 December 2014

Account information recipients	2014		2013	
	Absolute	in %	Absolute	in %
BaFin	353	0.3	1,218	1.0
Tax authorities	13,401	10.2	13,397	10.9
Police authorities	85,740	65.1	75,296	61.4
Public prosecutors	25,304	19.2	25,434	20.7
Customs authorities	6,672	5.1	7,052	5.7
Others	283	0.2	267	0.2
Total	131,753	100	122,664	100*

* Deviations in the total figures are due to rounding differences.

In seven additional cases, BaFin issued prohibition orders to persons and entities which were not agents of an authorised payment institution due to the unauthorised conduct of financial transfers business. In one instance, the prohibition was issued following audits conducted on the basis of section 5 (2) of the ZAG.

The focus of supervision over the distribution of e-money in 2014 was on audits of persons conducting unauthorised trading in e-money and involved enterprises. Audits were conducted against persons not directly acting on behalf of the issuers in accordance with section 1a (6) of the ZAG, but rather

distributed e-money in their own name and on their own account.

3.4.5 Account information access procedure in accordance with section 24c of the KWG

All credit institutions, asset management companies and payment institutions are required by section 24c (1) of the Banking Act to keep a file in which certain account master data are stored, such as the account number, name and date of birth of account holders and authorised users and the date of opening and closure,. BaFin may request individual items of data from this file insofar as this is necessary to fulfil its supervisory functions. Upon request, BaFin also provides information from the account information access file to the authorities named in section 24c (3) of the KWG. The number of corresponding requests increased in 2014 by approximately 7% year on year (see Table 15 "Requests for account information"). This was due in particular to the significant increase in the number of requests for information from police authorities.

The institutions and BaFin were faced with the particular challenge arising in connection with the conversion of account information to enable the use of International Bank Account Numbers (IBAN) as necessitated by the implementation of the Single Euro Payments Area (SEPA) Regulation³¹. It has now been possible to research account numbers in the form of IBAN throughout Germany using the automated account information access procedure.

31 Regulation (EU) No 260/2012, OJ EU L 94, p. 22.

4 Market supervision



4.1 Focus

Employee and Complaints Register marks two-and-a-half years

Authors: Frederik Knobloch, BaFin Section for rules of conduct of credit institutions, and Anna-Leonie Müller, BaFin Section for litigations/objection procedures

For many investment advisers and sales officers, the Employee and Complaints Register represents the first instance where BaFin becomes visible. On 1 November 2012, the provisions relating to the Register were included in the Securities Trading Act (*Wertpapierhandelsgesetz – WpHG*). Since then, undertakings which provide investment services have been required to enter their investment advisers and their sales officers, as well as their compliance officers, into the Employee and Complaints Register maintained by BaFin. What is noteworthy for investment advisers is that BaFin also receives reports whenever retail clients complain about investment advice they have received. Five investment advisers lodged a complaint with the Frankfurt am Main Administrative Court (*Verwaltungsgericht*), seeking to prevent their personal data being stored, although that complaint was unsuccessful (see also info box “Data storage deemed constitutional”, page 132).

Complaints as an indicator of irregularities

BaFin regularly evaluates the complaints entered into the register. The overall number of complaints per group of institutions, undertaking or sales officer in and of itself is of limited significance. A cluster of complaints does not at first glance indicate whether this stems from the regional focus of activities, a particularly large number of clients, or an actual irregularity, for example. For instance, individual private banking institutions are more active in the investment services business than other undertakings and therefore possess greater potential to receive complaints.

Furthermore, the average investment volume and client structure are different, meaning that undertakings pursue different sales strategies and sell different financial instruments. This can also explain a cluster of complaints. The number of complaints and the relation of that number with other indicators is therefore one indicator amongst many.

Review by BaFin

However, a relatively high number of complaints prompts BaFin to compel the investment services enterprise to provide it with information on the individual complaints and analyses that information. In addition to data from the Register, the documents BaFin requests include client disclosures pursuant to the WpHG – such as disclosures relating to the client’s knowledge, experience and investment objectives – as well as the investment advice minutes and product information sheets. BaFin also meets with investment advisers and sales officers at their local office to discuss the complaints. Based on the documents and statements provided by the interviewed employees, BaFin is able to systematically and realistically reconstruct the investment advising processes and review the advising situation and investment recommendations from a supervisory perspective. For example, 55 complaints were submitted to the Employee and Complaints Register for a single investment adviser within a brief period of time. The bank pre-empted any measures BaFin might have taken by terminating the adviser’s employment. In addition, the institution is examining any compensation to be paid to the clients.

III

IV

V

VI

Appendix



Data storage deemed constitutional

The Frankfurt am Main Administrative Court refused the petition of several investment advisers to have their personal data deleted from the Employee and Complaints Register maintained by BaFin pursuant to section 34d of the Securities Trading Act (*Wertpapierhandelsgesetz – WpHG*). In so doing, the court confirmed BaFin's notices by which it refused to delete the personal data of the investment advisers, citing its statutory obligation pursuant to section 34d of the WpHG. The court also deemed that the investment advisers' doubts as to the constitutionality of the provision were unfounded.

In its grounds for its ruling, the court stated that the legislators had complied with the formal constitutional law requirements. The legislators themselves had set out the provisions of section 34d of the WpHG relating to the protection of fundamental rights and stipulated that the Federal Ministry of Finance was permitted to transfer to BaFin the power to issue regulations. The legislators had provided for a sufficient statutory authorisation to do so.

In addition, at a material level, the court also stated that the provisions do not result in an unconstitutional encroachment on the right to determine the use of personal information. Specifically, section 34d of the WpHG in conjunction with the WpHG Employee Notification Regulation (*WpHG-Mitarbeiteranzeigeverordnung – WpHGMAAnzV*) sets out when which personal data concerning individual employees must be recorded. The entering of data in the Employee and

Complaints Register in no way constitutes a case of retention of data. The uncertainty of the affected parties, typical in such cases, concerning the collection and use of their data is not even remotely founded in this case. Given the clear statutory requirements, data are by no means generally and arbitrarily stored in unlimited amounts and without a specific cause. The reason for collecting and storing data is deemed to be the assumption and exercise of activities which the legislators consider to be particularly fraught with risks. The court also rejected the risk that an employee or personal profile could be generated on the basis of the data stored in the Register. By stipulating that the collection of data would be limited to the small amount of data collected in accordance with section 34d of the WpHG in conjunction with section 8 *et seq.* of the WpHGMAAnzV, the legislators had restricted themselves to the slightest possible intrusion. It was not evident in what way storing this data could even remotely impact the privacy of the affected employees or their freedom to conduct themselves. At any rate, the intrusion was justified in light of the objective pursued by the statutory provisions.

Finally, the court noted that the storage of any complaints pursuant to section 34d of the WpHG did not represent an unconstitutional infringement on the fundamental rights of the complainants. The storage of the complaints as such was not associated with any further measures taken against the employees. The complaints could only serve as a starting point for further consideration and investigations by BaFin. The storage of data for this purpose was appropriate and proportionate. The judgment is not yet final.

Further causes for on-site visits

In addition to complaint hot spots, BaFin visits sales offices throughout Germany on a random basis in order to assess the quality of the advice provided, both in urban centres and in rural areas. BaFin also conducts risk-oriented investigations of the sale of closed-end equity investments and bonds issued by small and

medium-sized enterprises, among other things. This provides a large number of opportunities to review the business processes of investment services enterprises and the skills of their employees in real-world situations in the interest of consumer protection.

Since the Register was launched on 1 November 2012, BaFin has investigated 1,316 complaints relating to different institutional groups and

visited 528 head offices, branches and tied agents, interviewing a total of 2,786 subjects.

Number of complaints

The number of entries into the Employee and Complaints Register has changed since the inception of the Register as shown in Table 16 ("Number of complaints"). The number of employees reported has changed as presented in Table 17 ("Number of employees", page 134) since the inception of the Register.

Table 16 Number of complaints*

Complaints per year	2012	2013	2014
Private and foreign banks	1,077	4,019	2,382
Savings banks/ <i>Landesbanks</i>	370	3,234	2,003
Cooperative banks	282	2,246	1,528
Financial services institutions	11	221	137
Total	1,740	9,720	6,050

* The respective total number of complaints was adjusted to reflect corrections. The table does not include complaints relating to investment services enterprises which were no longer subject to supervision pursuant to Part 6 of the WpHG at the time the database was queried. The figures presented here may therefore deviate from previously published data.

Expertise

Investment services enterprises must ensure and document that their investment advisers, sales officers and compliance officers are competent and reliable. Expertise is generally ensured through qualifying training and continuing education. It has been shown that both smaller institutions and large banks with branch offices tend to have well-trained advising staffs.

However, in individual cases, BaFin has encountered investment advisers during supervisory visits whose expertise was called into question during the course of their interview. In such instances, BaFin has compelled both the undertaking and the relevant employees to remedy this lack of expertise as quickly as possible. Both generally

tend to comply with this requirement without BaFin needing to take further measures; they otherwise risk BaFin imposing a ban on them exercising their activities.

Reliability

Whether or not an employee possesses the requisite reliability is questionable if he or she has been convicted of any of the following in the last five years prior to taking up a reportable activity: theft, embezzlement, extortion, fraud, breach of fiduciary duty, money laundering, forgery, receiving stolen goods, usury, insolvency offences, tax evasion, insider dealing, market manipulation, or any crime punishable with imprisonment of not less than one year. Reliability can also be called into question on the basis of other circumstances.

BaFin is currently involved in nine proceedings in which the reliability of the relevant investment adviser has been called into question. For example, one institution had entrusted an employee with providing investment advice who was later convicted of violating the prohibition on insider dealing. As in most cases, the undertaking imposed disciplinary consequences before BaFin was required to take further measures. Since the employee was no longer entrusted with providing investment advice, BaFin was prevented from taking a final decision as to whether or not to impose a prohibition order. However, the Register enables BaFin to determine whether an investment adviser who has become the subject of suspicions has begun working for another investment services enterprise.

Formal measures imposed by BaFin

In total, the knowledge gained from the Employee and Complaints Register in conjunction with on-site activities carried out by BaFin have resulted in 12 formal warnings and 15 proceedings for the imposition of administrative fines. These include insufficient advising documentation and unsuitable investment recommendations, as well as breaches of reporting obligations. BaFin thoroughly investigated one irregularity at a

III

IV

V

VI

Appendix

Table 17 Number of employees*

Total number of employees	31 December 2012	31 December 2013	31 December 2014
Private and foreign banks	48,685	51,181	48,900
Savings banks/ <i>Landesbanks</i>	66,763	66,360	64,427
Cooperative banks	44,170	45,688	45,090
Financial services institutions	4,955	6,133	5,438
Total	164,573	169,362	163,855
Investment advisers	31 December 2012	31 December 2013	31 December 2014
Private and foreign banks	47,455	50,254	48,125
Savings banks/ <i>Landesbanks</i>	63,887	63,392	61,481
Cooperative banks	41,025	42,494	41,980
Financial services institutions	4,449	5,561	4,864
Total	156,816	161,701	156,450
Sales officers	31 December 2012	31 December 2013	31 December 2014
Private and foreign banks	8,021	8,734	8,555
Savings banks/ <i>Landesbanks</i>	8,817	9,736	9,875
Cooperative banks	6,991	7,380	7,301
Financial services institutions	331	441	450
Total	24,160	26,291	26,181
Compliance officers	31 December 2012	31 December 2013	31 December 2014
Private and foreign banks	114	114	118
Savings banks/ <i>Landesbanks</i>	421	424	423
Cooperative banks	1,075	1,061	1,014
Financial services institutions	735	751	754
Total	2,345	2,350	2,309

* The respective number of employees was adjusted to reflect corrections. The table does not include employees of investment services enterprises which were no longer subject to supervision pursuant to Part 6 of the WpHG at the time the database was queried. The figures presented here may therefore deviate from previously published data. Employees may exercise several activities (investment adviser, sales officer and compliance officer). Please note: with the exception of the total number of employees, the figures presented are not counted by individual person, but rather by activities exercised, so the total of the different activities may be greater than the number of persons. This data is subject to constant change in line with the ongoing change and correction reports submitted by the investment services enterprises. This, too, may result in the figures presented here deviating from previously published data.

bank with branch offices. That bank had issued sales targets which could have put client interests in jeopardy. BaFin made it clear that

the sales targets were improper and issued formal warnings to the bank and six sales officers.



4.2 Investment advice minutes

In June 2014, the *Institut für Transparenz* (ITA) published a report in which the documentation of investment and insurance advice was evaluated. The report was commissioned in October 2012 by the former Federal Ministry of Food, Agriculture and Consumer Protection (*Bundesministerium für Ernährung, Landwirtschaft und Verbraucherschutz*). The ITA report was based on 119 mystery shopping reports extending to four types of advisers (bank advisers, insurance agents/multiple agents, insurance and financial brokers, fee-based advisers/insurance advisers).

The mystery shopping reports related to securities, investment funds, capital investments, life insurance, private healthcare insurance, liability insurance and property insurance. In its analysis of the advice provided, the ITA concluded that advisers and agents failed to comply with the provisions of the Securities Trading Act (*Wertpapierhandelsgesetz*) because they did not provide investment advice minutes at all or the minutes were insufficient. BaFin cannot confirm this impression. In 2014, it evaluated approximately 2,600 sets of investment advice minutes. These evaluations showed that the quality of the minutes continued to increase year-on-year. Moreover, the annual audits by the statutory auditors and association auditors found a relatively low error ratio of 5.88 %. The auditors examined 32,570 sets of investment advice minutes on a sample basis across all groups of institutions to determine whether the requirements for documenting advice were complied with and found errors in 1,916 instances.

In BaFin's view, the meaningfulness of the ITA investigation is limited because for one thing the investigation also examined minutes from commercial advisers which are not subject to supervision by BaFin. For another, the report does not always distinguish between investment advice and insurance advice where the minutes from mystery shopping are concerned. However, since the provisions of the Securities Trading Act only apply to investment advice,

such a distinction is necessary. The extremely low number of mystery shopping reports also means that the statements derived from them are not representative.

In November 2014, the Federal Ministry of Justice and Consumer Protection (*Bundesministerium der Justiz und für Verbraucherschutz*), which has been placed in charge of consumer protection, held a symposium with the relevant stakeholder groups to discuss the issue investment advice minutes, at which representatives from BaFin presented their experiences from supervisory practice and the European regulatory projects to record conversations with clients. The Markets in Financial Instruments Directive II (MiFID II), which entered into force at the beginning of July 2014, calls for a statement on suitability and for conversations to be taped when orders are accepted. The new requirements under MiFID II will at least in part correspond to those of the investment advice minutes.³³

4.3 Fee-based investment advisers

As at 1 August 2014, the legislators issued regulations pertaining to fee-based investment advice. Investment advisers who recommend products in return for a fee may receive payment only from clients, because fee-based investment advice should be given solely in the client's interests. In exceptional cases, commissions may in fact be paid out, but only if a narrow set of requirements has been met – and any commissions must be passed on to the client in full immediately after they are received. Advisers wishing to call themselves "fee-based investment advisers" must comply with special information obligations and increased organisational requirements. For instance, the array of products offered by the fee-based investment advisers is subject to special requirements and must also be sufficiently diversified in terms of financial instrument sellers and issuers. Moreover, fee-based investment advisers must base

³³ See chapter V 1.1.

their recommendations on sufficient market knowledge, which they are required to obtain. In order to prevent conflicts arising between the interests of clients and those of institutions for which the fee-based investment adviser works or issuers/sellers, providers of fee-based investment advice are prohibited from offering only instruments which they issued themselves. The new requirements also prohibit providers of fee-based investment advice from offering only financial instruments from sellers or issuers who are closely affiliated with the advisers' investment services enterprise or with which they are otherwise economically linked.

A register on BaFin's website provides information as to which institutions (also) provide investment advice on a fee-based basis.³⁴ By the end of 2014, 11 financial services institutions were included in the register.

4.4 Other focal points of supervision

Safe custody business

In 2014, supervision focused on whether and to what extent investment services enterprises complied with the rules of conduct and organisational requirements when carrying out safe custody business. Insufficient processes, procedures, criteria and/or insufficient monitoring of such can result in considerable adverse consequences for the financial markets and shake the confidence of market participants in the provision of securities custody and management services.

In order to review the relevant processes and the quality of such processes, BaFin determined main points of emphasis for the examination of 16 investment services enterprises. The objective was to gain insight into the quality of business and monitoring processes and to counteract any undesired developments. Furthermore, BaFin hopes to gain an overview of how institutions structure their safe custody business and how they are implementing the requirements of the Markets in Financial

Instruments Directive II. The examinations began in 2014 and the evaluation of all findings is slated to be completed in 2015.

Marketing and other client information

In 2014, BaFin again issued objections to individual customer information materials which banks made available to clients and which did not satisfy the requirements set out in the Securities Trading Act. For instance, the website of one bank contained information sheets for forward exchange deals which did not satisfy the statutory requirements, as they were not unambiguously worded. After being made aware of this, the institution removed the relevant documents from its website. In a different case, one institution had published marketing communications relating to a financial instrument on its website. The advantages offered by this financial instrument were discussed at the beginning of the page, while the comparison of opportunities and risks which is mandated by law did not appear until the very bottom of the page. However, since the opportunity to subscribe the product was already provided before the risks were discussed, BaFin urged that the client be alerted to the risks before being given the option to place an order. In the current advertisement, the institution has placed the order function at the very end of the page. Beyond this, BaFin also intervened in further instances where client information materials did not include the proper disclosures: for example, where order invoices contained indemnity clauses or fees figures were misleading. In the case of one investment services enterprise which used flyers to market its own certificates, BaFin objected to the practice whereby any early return of the investment amount was presented as a special opportunity. The undertaking modified its marketing materials.

Compliance workshop

In December 2014, BaFin hosted its biannual compliance workshop, which mainly garners the participation of representatives from the member institutions of the Association of German Public Sector Banks (*Bundesverband Öffentlicher Banken Deutschlands – VÖB*), which function as investment services

34 www.bafin.de/dok/5448082

enterprises. Representatives from banks and from BaFin gave presentations concerning current issues in compliance, such as quality-based compliance management systems, the compliance function set out in the Minimum Requirements for the Compliance Function and Additional Requirements Governing Rules of Conduct, Organisation and Transparency pursuant to sections 31 et seq. of the Securities Trading Act for Investment Services Enterprises (MaComp), the Minimum Requirements for Risk Management (MaRisk), compliance culture and other current developments. Algorithmic trading was also discussed.

4.5 Rules of conduct for financial instruments analysis

At the end of 2014, BaFin supervised a total of 346 credit and financial services institutions that either produced their own research or acquired third-party research for their clients or for public dissemination (previous year: 315).

In addition, 192 independent natural or legal persons who had notified BaFin of their activities in accordance with section 34c of the Securities Trading Act were subject to supervision by BaFin (previous year: 169).

4.6 Administrative fines

In 2014, BaFin initiated 27 new administrative fine proceedings because investment services enterprises had breached the rules of conduct, organisation and transparency (previous year: 33). It concluded two proceedings by issuing an administrative fine (previous year: 7), one of which due to a breach of duties in connection with investment advice minutes. BaFin discontinued ten proceedings.

Five proceedings were discontinued due to discretionary considerations.

Contravention of an enforceable order

BaFin fined one bank €12,500 because it had contravened an enforceable order (section 4 (3) of the Securities Trading Act). A current account held with this bank was involved in transactions over a certain period. As part of its duty to monitor compliance with the prohibition on market manipulation, BaFin sent the bank two requests for information relating to details of said current account. Moreover, the institution was requested to produce statements pertaining to balances and changes in balances for the current account during the relevant period. In addition to data about postings and amounts, BaFin also requested information on the payment recipients and senders and the reasons for postings/reference. In an initial letter, the bank communicated the address of the branch office at which the account was held, the account holder and authorised users. However, that letter did not include a statement of balances or changes in balances held in the current account, nor did it include the additional information requested. In a second letter, the bank stated that there had been no transactions on the relevant current account during the period in question. BaFin's requests for information and submission of documentation are immediately enforceable orders. The bank reacted by sending a first letter, in which it failed to provide all information as requested. In a second letter, the bank provided inaccurate and incomplete information. This is because, contrary to the assertion by the bank, there were transactions during the relevant period. In its second response, the bank also failed to produce the requested documents and information.


III

IV

V

VI

Appendix



IV Supervision of insurance undertakings and Pensionsfonds

1 Bases of supervision



1.1 Opinion

Felix Hufeld on modern insurance supervision

What is the nature of modern insurance supervision? It should not just restrict itself to analyses and assessments of current circumstances and respond to them in an efficient and flexible manner. Modern insurance supervision is increasingly focussed on the future. It should be in a position to recognise potential risks and developments affecting the market or the industry environment in advance. In doing so, it should also identify systemic risks going beyond individual insurance undertakings and have joint-up thinking: at the level of individual legal entities or insurance groups, in a European context, globally! The supervisory authority must also pay close attention to interdependencies and reciprocal effects between the financial sectors and bear in mind the resulting implications



Felix Hufeld

was Chief Executive Director of Insurance and Pension Funds Supervision until the end of February 2015 and is President of BaFin since March 2015.

for supervision. Similarly, modern insurance supervision always takes the protection of consumers into account when making its decisions. That is the outline of modern insurance supervision as demanded by an increasingly complex financial world, and we can only welcome the fact that the regulatory changes achieved to date and still in the

pipeline are creating an appropriate framework for supervision of this nature.

Lessons learned from the crisis

On 15 September 2008, an application for insolvency was made on behalf of the US investment bank Lehman Brothers. This date has remained in the collective memory of all participants in the financial markets as an unwelcome high point in the financial markets crisis. Although the traditional insurance business did not trigger the crisis, the disturbances in the financial markets were not without consequences for the insurance sector. Entire asset classes – in particular structured financial products and bank bonds – suffered a dramatic fall in value. In the meantime, trading came to a complete standstill. Illiquidity in the markets on such an extensive, international scale had not occurred in the post-war period until that time. This situation created great difficulties for the insurers as major investors of financial assets. Even though the situation has now stabilised again, the crisis and its effects have left such a strong impression that they influence practically all important regulatory projects to this day.

At a European level, the crisis led to the establishment of the European System of Financial Supervision (ESFS), and a series of material amendments to the Solvency II project, which is so important, can also be directly attributed to lessons learned in the crisis. At a global level, mention must be made of the work on ComFrame, the common supervisory framework and global capital standard for internationally active insurance groups, taking shape under the aegis of the International Association of Insurance Supervisors (IAIS).

Or the topic of restructuring and resolution occupying international regulators, which can also be described as a product of the financial markets crisis. The underlying objective here is to limit damage to the economy and remove any liability for taxpayers in future by means of the rapid implementation of recovery measures or a coordinated and controlled resolution for

entities in financial difficulties. As far as insurers are concerned, the concept of restructuring and resolution is limited to the group of undertakings identified by the IAIS as Global Systemically Important Insurers (G-SIIs); however, there are already suggestions that the requirement to draw up recovery and resolution plans should be extended beyond the group of G-SIIs in future.

Other examples could be given showing that the financial markets crisis has been a driving force for the further development of financial supervision. Behind all these efforts stands the principal objective of making the financial markets more resilient overall in a globalised world, strengthening the risk-bearing capacity of undertakings by means of improved capital resources and risk management processes, as well as identifying and managing risks of contagion at an early stage thanks to better coordinated and more effective supervision.

New supervisory partners

From a national perspective, insurance supervision has seen another, very significant change. While for many decades it fell within the remit of BaFin and its predecessor authority at a federal level, BaFin has been supported for a good two years by the *Deutsche Bundesbank*, which takes responsibility for macroprudential supervision. Macroprudential analysis must necessarily cover all sectors of the financial market and it was therefore logical that the essentially microprudential supervision of the insurance industry was expanded to include this perspective. Since 2013, BaFin and the Bundesbank have therefore also been working closely together on questions relating to the insurance industry and play an active role alongside the Federal Ministry of Finance in the Financial Stability Commission (*Ausschuss für Finanzstabilität* – AFS). This important national body represents a forum where all of the institutions involved in maintaining financial stability can work together and ensures that macro- and microprudential supervision are closely integrated.¹ Just like its European

¹ See chapter II 2.2.

counterpart, the European Systemic Risk Board (ESRB), the AFS discusses the major issues relating to financial stability, delivers warnings or recommendations where necessary and thus contributes to a forward-looking supervisory regime.

Solvency II will radically change the supervisory culture

The completion of the most comprehensive regulatory project in the history of European insurance supervision is imminent. From 1 January 2016 Solvency II will become applicable supervisory law across the EU. Much has already been written about the new requirements which Solvency II as a risk- and principles-based supervisory system will impose on the industry, and the relevant buzzwords are well known. Nevertheless, the thoroughgoing nature of the pending changes is frequently underestimated. In addition to the fact that it is principles-based, the main characteristic of the new supervisory regime is that it introduces requirements for risk assessment on a prospective basis.

Certain forward-looking elements are of course already firmly established in insurance supervision today. For example, the implementation of section 64a of the Insurance Supervision Act (*Versicherungsaufsichtsgesetz – VAG*) and of the Minimum Requirements for Risk Management in Insurance Undertakings (*Mindestanforderungen an das Risikomanagement VA – MaRisk VA*) introduced risk management with forward-looking elements into supervisory practice some years ago, and risk-based analyses such as risk reports and ALM studies² are now part of the insurers' standard repertoire. BaFin's annual surveys of German life and health insurers' projections are another example; they are now based on a planning horizon of five years. However, the Solvency II requirements will go well beyond the prospective supervisory tools already in use today.

More responsibility for undertakings themselves

The centrepiece of the new requirements will undoubtedly be the Own Risk and Solvency Assessment (ORSA) for which undertakings must assess their risks and solvency themselves. The ORSA involves determining current and future capital requirements on the basis of the business strategy and the effects of potential external factors, and comparing them with own funds. Management are therefore called upon to analyse their undertaking's capital requirements and risk drivers in much greater detail and to incorporate the insights gained into their strategic business planning.

Supervisors must adopt a more entrepreneurial approach

Solvency II will leave considerable scope for the industry and its supervisors to determine how the requirements are interpreted and implemented in detail – subject to the principle of proportionality. In general, this will affect all the areas to which the new supervisory regime will apply and not just the ORSA.

The insurers will initially be required to take responsibility themselves for developing guidelines, structures and processes that are appropriate to their particular circumstances and to establish a dialogue with us on the subject. For supervisors this will mean that in future they will need to further improve their understanding of what actually takes place in the respective undertaking or group. A modern supervisory function, consequently, must learn to adopt a more entrepreneurial way of thinking itself. Solvency II will therefore result in more intensive and improved interaction between the supervisory authorities and undertakings.

Many insurers will feel their new freedom to be a burden in the initial phase. But the real purpose of the new supervisory philosophy lies precisely in addressing the difficult question of the correct and appropriate way of dealing with the undertaking's risks.

It can nevertheless be expected that, over the course of time, large numbers of specific

2 Asset-Liability Management studies.

cases will result in the emergence of more detailed guidance based on good practices. This guidance will also never be fixed once and for all, however, but will be subject to a process of continuous improvement. As a result, supervision will become more flexible and adaptable. The new concept of supervision already contains within itself the key not just to adopting a modern approach but to staying up-to-date as well.

Consumer protection is more than the supervision of solvency

Collective consumer protection has always been a central objective of German insurance supervision. In keeping with its statutory responsibility, BaFin ensures that the interests of policyholders are adequately protected and monitors the insurers' ability to fulfil their obligations under the insurance contracts at all times from a financial supervisory point of view. But the principle that a supervisory authority must constantly renew its focus in order to carry out its responsibilities in the best possible manner and remain up-to-date also applies in the context of consumer protection. The active supervision of solvency will of course retain its great importance for protecting the interests of consumers also in the future. Insurance customers frequently have long-term requirements and the ability of an insurance undertaking to survive financially is a fundamental precondition for meeting customers' interests. Consumer protection, however, is not just concerned with the issue of whether the undertaking is objectively in a position to fulfil the benefits promised, but also with how this takes place.

It is not only at a national level, with the commitments in the coalition agreement and the federal government's plan of action, that political developments have lent new urgency

to the topic of consumer protection. Work on consumer protection issues continues to gather pace at a European level as well. Many of the questions raised by this process are focused on sales and marketing, where problems are particularly likely to arise given that this represents a direct point of contact with the customer. Another major topic is product development.

The overriding objective consists of offering insurance customers products that correspond to their requirements via an advisory process that is fair and tailored to meet their specific needs. And in order to ensure that the attainment of this objective can be monitored, the regulations in question are generally linked to significantly higher transparency and documentation requirements. BaFin's insurance supervision is firmly of the opinion that vigorous consumer protection is the right perspective to adopt and is fully committed to supporting the work required.

The right balance is key

Even important and legitimate objectives must not be optimised in a one-sided manner, however: excessive regulatory measures or overwhelming administrative requirements imposed on the industry may lead to undesirable effects on competition and the desire to innovate – and thus also on the supply of financial products and pension and insurance products. This is not just a question of the balance between the legitimate interests of the service providers on the one hand and the legitimate interest of the customers in protection on the other. It also frequently involves the difficult task of weighing the legitimate interests of a variety of consumer groups against each other. A modern insurance supervisory function also keeps an eye on these differing areas of conflict.



1.2 New developments in the global framework

A centrepiece for a uniform supervisory framework for internationally active insurance groups (IAIGs) is provided by the Common Framework, or ComFrame. This is being developed by the International Association of Insurance Supervisors (IAIS) together with its members. The most recent public consultation on the framework was carried out at the end of 2013/start of 2014; the IAIS has reflected the resulting feedback in textual amendments. At the present time, most of ComFrame is undergoing field testing. Further consultation exercises on the entire framework are planned for 2015 and 2017. It is then intended to be implemented from 2019 onwards.

ComFrame consists of three modules. ComFrame Module 1 establishes the criteria for identifying an IAIG and the identification process. The criteria comprise key indicators for measuring both the size of the insurance group and the extent of its international activity. Supervisors will be able to exercise an element of discretion in this respect. The module also deals with the scope of supervision and the identification of the group-wide supervisor.

ComFrame Module 2 comprises the supervisory requirements for the IAIGs. It deals with legal structures, governance and risk management, as well as requirements for the risk management strategy that an IAIG is expected to develop and implement. Module 2 also currently includes a draft section for the global insurance capital standard (ICS), whose development was begun in 2014 and which is intended to be fully worked out in 2015 and 2016.

ComFrame Module 3 is concerned with the requirements for the supervisors of an IAIG and describes the group-wide supervisory process as well as requirements for the supervisory colleges³ and for cooperation and interaction. The third module also addresses

³ Financial undertakings with cross-border activities are intended to be supervised jointly by their home-country and host-country supervisors, working together in supervisory colleges.

the resolution of IAIGs. However, this section is currently being redrafted in the light of the “Key Attributes of Effective Resolution Regimes for Financial Institutions” published by the Financial Stability Board (FSB) and the related Annex dealing specifically with insurers.

Both the competent committee of the European Insurance and Occupational Pensions Authority (EIOPA) and BaFin have reviewed ComFrame for consistency with Solvency II as part of the public consultation and have submitted their opinions.

1.2.1 Global systemically important insurers

The Financial Stability Board focused on completing the supervisory requirements for global systemically important insurers (G-SIIs) in 2014. In July 2013, the FSB had for the first time identified nine insurers to be classified as systemically important on the recommendation of the IAIS. A uniform global basis for applying capital add-ons for the G-SIIs was established as a first step in 2014 with the Basic Capital Requirement (BCR). In parallel to that, the IAIS worked on the calculation of the capital add-ons themselves, the Higher Loss Absorbency (HLA) requirements, during 2014 and put its proposals out for consultation at the beginning of 2015.

Moreover, in a second step the details of two further requirements for the G-SIIs were set out in guidance published by the IAIS. These consist firstly of a plan for managing systemic risk and secondly of improvements in the management and planning of liquidity. With respect to the plan for managing systemic risk, the G-SIIs reported to BaFin and the IAIS in July 2014 on their procedures for dealing with systemic risks. The guidelines on liquidity management were approved in October 2014. Among other things, they include provisions for the preparation of a liquidity risk management plan (LRMP). The requirements rely expressly on national rules and regulations, however, to the extent that these are already in existence. The relevant group-wide supervisor will determine their specific form. The G-SIIs must comply with all the requirements of the IAIS

relating to liquidity risks by the beginning of 2015. At the same time, the FSB is pushing ahead with its work on issues relating to recovery and resolution. Once this is complete, the final element in the package of supervisory measures for the G-SIIs will be available.

The list of global systemically important banks is published annually in November. The IAIS and FSB have decided to publish the list of G-SIIs in November as well from 2014 onward, in order to keep to the same timing. Since the data are currently still being collated and analysed, the G-SII list for 2014 names the same nine insurers as in the previous year. The FSB has also asked the IAIS to review its methodology for classifying G-SIIs. The aim is to ensure that the IAIS adequately records all of the systemic risks applying to insurers.

1.2.2 Capital standards for insurers

In addition to ComFrame, the IAIS is working on three more building blocks of a uniform supervisory framework for internationally active insurance groups: the Basic Capital Requirement (BCR), the Higher Loss Absorbency (HLA) requirements and the Insurance Capital Standard (ICS). Both the BCR and the HLA requirements will only apply to global systemically important insurers, the G-SIIs; the BCR is intended to form the basis for calculating the HLA requirements until the ICS is completed and implemented. In contrast, the ICS will be implemented for all IAIGs and will therefore constitute part of ComFrame.

In 2014, the work of the IAIS focused mainly on the BCR, since that is planned to be completed first according to the FSB's schedule, i.e. by the end of 2014. Accordingly, the proposals of the IAIS for the BCR were accepted in autumn 2014, firstly by the FSB and then by the G20. In the course of preparing the BCR, the IAIS arranged two public consultations during 2014 and collected data from G-SIIs and IAIGs which participated voluntarily in the ComFrame field testing.

The BCR is a factor-based approach which identifies risks at the consolidated level arising

from the insurance segment – traditional and non-traditional business – and from non-insurance activities, such as banks and investment firms. Since the BCR, however, is “only” intended to represent the common basis of calculation for the HLA requirements, the overall capital requirement for G-SIIs is determined from the total of the BCR and HLA requirements.

In 2015, a start is now expected to be made with confidential BCR reporting. The IAIS intends to use this to make fine adjustments to the BCR, if required. In addition, the development of the HLA requirements will be completed in 2015 as scheduled. The IAIS is planning a public consultation on this subject for summer 2015. The final version is expected to be ready for submission to the FSB in autumn 2015.

In addition, an initial consultation paper on the ICS was presented in December 2014. The period for consultation ran until February 2015. Finally, the ICS will also be subjected to field testing, in the same manner as ComFrame, in spring and summer 2015. It is intended to specify the proposals for the ICS in greater detail during the course of 2015, but in any event by the year-end, so that it can be integrated into the next phase of consultation together with ComFrame from the close of 2015 going forward. The objective is to provide a risk-based approach to calculating internationally comparable capital requirements on a uniform, global basis in the form of the ICS.

1.2.2.1 Connection between ICS/BCR and Solvency II

The BCR should be seen as a supervisory measure only in connection with the capital add-ons and the HLA requirement, as it was developed as a uniform method for their calculation. The current consensus in the IAIS is that the BCR cannot be understood as a capital requirement in its own right, independently of the HLA requirement, which could serve as the basis for intervention by the supervisory authorities. If the ICS is available as planned in 2016, the IAIS will need to renew the discussion, without any foregone conclusion, on whether

there is a place for the BCR in the future regulatory environment and, if so, in which form.

To date, Solvency II does not contain any provision which can serve as the basis for the imposition of capital add-ons for G-SIIs solely because of their status. BaFin's view is therefore that the future introduction of Europe-wide and national regulations relating to mandatory compliance with the total of the BCR and the HLA requirement and the associated reporting must be considered. In BaFin's opinion, it is important that such regulations do not result in the loss of the ability to manage risk using Solvency II. For example, a low total for the BCR and the HLA requirement should not mean that the solvency capital requirement under Solvency II is weakened.

The objective of the IAIS is to use the ICS to set a global minimum standard, not to harmonise the maximum requirements. There must therefore be no question of withdrawing national regulations which result in stricter requirements than the ICS. Solvency II is expected to be more conservative than the ICS in some areas and can therefore be understood as an implementation of the ICS in the European Union in line with actual practice.


1.2.2.2 Connection between ICS/BCR and HLA

The BCR was completed as planned in 2014. The confidential reporting from 2015 onwards may yet give rise to the need for fine adjustments. Work on the HLA requirements, the second part of the future capital standard for G-SIIs, will be stepped up during the course of 2015.

The IAIS consultation exercise is expected to take place in mid-2015 and to be completed by the end of 2015. An initial consultation by the IAIS for the development of the ICS which is planned to run in parallel is currently underway. Further consultation phases are scheduled for 2015 and 2017 together with the consultation on the entire ComFrame framework. It is anticipated that the ICS will be adopted together with ComFrame at the end of 2018. This will be followed by the implementation

phase from 2019 onwards. As soon as the new global, risk-based capital standard for insurers has been completed, it will replace the BCR as the basis for calculating the HLA requirement.

1.2.3 New structure of the IAIS



The responsibilities of the International Association of Insurance Supervisors (IAIS) have become ever more extensive over time, partly due to the eruption of the financial crisis. In view of the increasing demands placed on it, working processes within the IAIS have increasingly shown a decline in effectiveness and efficiency, with the result that at the end of 2013 consideration was given to a new structure and organisation for the working groups. It was discussed whether they should be dissolved, merged or retained.

An initial major package of restructuring measures was implemented on 1 July 2014 and is now being put to the test in practice. The IAIS produced a members' handbook to accompany these purely organisational changes which explains clearly the way in which the association functions. In addition, the General Meeting of members in October 2014 approved a strategic plan for the years 2015 to 2019 as an aid for mapping out the upcoming assignments. From this, the IAIS has derived its programme of work, which was agreed for the first time in accordance with detailed project management rules for 2015 and 2016.

The General Meeting resolved a second wide-ranging package in the form of a change to the by-laws. As of 1 January 2015, "observer" status in the IAIS was abolished, with the result that since then there has no longer been any financial commitment on the part of the industry (or its representatives) within the IAIS. Instead, the Bank for International Settlements (BIS) has joined the financing of the IAIS in order to support the independence of the association and its work towards a global capital standard. Industry representatives will be involved in the IAIS's working processes in future as "stakeholders".

1.3 Recovery and resolution

The FSB classified nine insurance groups as global systemically important insurers (G-SIIs) for the first time in July 2013. Of the insurance groups with cross-border activities and significant operations in Germany, these were the Allianz Group, the AXA Group and the Generali Group.

Regulation of G-SIIs

Also in July 2013, the IAIS published its proposals for suitable measures for the supervision of G-SIIs under the title "Global Systemically Important Insurers: Policy Measures".⁴ It also set out a detailed timetable for their implementation.

Under the IAIS framework, the group-wide supervisor of a G-SII is required, among other things, to set up a crisis management group (CMG) by July 2014. This group is intended to coordinate the crisis and resolution planning for the GSII on an international basis, and ensure that information is shared confidentially between the parties involved. In addition to the group-wide supervisor, the crisis management groups include the representatives of other

jurisdictions in which the G-SII has significant risk positions. As the responsible group-wide supervisor, BaFin is setting up a CMG for the Allianz Group and is involved as a member in the CMGs for the AXA Group and the Generali Group.

The IAIS also expected the G-SIIs to draw up a number of comprehensive plans. In 2014, for example, they were supposed to submit not only a systemic risk management plan (SRMP), but also a liquidity risk management plan (LRMP) and a recovery plan. The IAIS's objectives behind these plans are firstly to ensure that the G-SIIs address the possible consequences of conceivable crisis scenarios on their own undertakings in extensive detail. Secondly, the intention is that the insurance undertakings work out potential measures for reducing the impact of these consequences or preventing them from occurring in the first place. BaFin actively assisted and contributed to quality assurance in this process in the various CMGs in 2014.

The IAIS set the group-wide supervisors the task of developing a resolution plan for the



Symposium on systemic importance

Insurance supervision continued with the series of symposiums initiated in the previous year and arranged a symposium on the systemic importance of insurance undertakings in February 2014. Invitations were issued to high-ranking representatives of the insurance industry and the academic community, as well as of the Bundesbank and the IAIS.

Among other topics, the participants discussed suitable approaches to make it easier to tackle systemic issues in the insurance industry. They also emphasised the differences from systemic importance in the banking sector: insurance undertakings could not be assessed using the same methods as those applied to banks. This

was because there was only limited scope for transferring the assessment criteria as a result of the different business models of banks and insurers.

The symposium participants were united in the view that the insurance industry as a whole is in any event especially important for the financial markets and the real economy. Wide-ranging regulatory tools were therefore necessary in order to safeguard its stability. The question of the extent to which individual insurers could pose a risk of contagion to the financial system as a whole and, in particular, what consequences for supervisors arise from that in practice, is currently being addressed in regulatory work at a national and international level.

⁴ www.iaisweb.org

relevant G-SII. This is intended to ensure that, in the event of a crisis, the relevant insurance provider can be resolved in an orderly manner, and any possible negative external effects can be kept to a minimum. As the responsible group-wide supervisor for the Allianz Group, BaFin therefore took the lead responsibility for preparing the resolution plan. BaFin provided support in this respect in the relevant CMGs as the competent supervisor for the German subgroups of the AXA Group and the Generali Group.

1.4 Solvency II

1.4.1 Continued development of the legal framework

1.4.1.1 Amended Framework Directive in force

Solvency II is a new, risk-based supervisory regime setting standards for insurance supervision across Europe. The Omnibus II Directive⁵, which came into force on 22 May 2014, amended the Solvency II Directive⁶ and specified 1 January 2016 as the start date for the new framework. Figure 11, “Legislative process up to the implementation of Solvency II” on page 147, gives a brief overview of the progress made in 2014 on the provisions supporting the Directive. It also highlights the additional preparatory work required which must be completed in 2015.

1.4.1.2 Delegated acts, technical standards and guidelines

After the Omnibus II Directive came into force in mid-2014, progress was also made in developing the other levels of legislation.

Delegated acts

On 10 October 2014, the EU Commission adopted delegated acts (see info box “Delegated acts”, page 147) with the implementing rules for

Technical standards

Technical standards relate purely to technical matters and may not contain strategic or political decisions. Furthermore, the standards call for the specialist knowledge of experts in supervision. The EU Commission adopts the standards on the basis of drafts prepared by EIOPA, which is required to hold a public consultation. The EU Commission must then make a decision on the drafts within three months.

The technical standards are divided into regulatory technical standards (RTS) and implementing technical standards (ITS). Regulatory technical standards are adopted by the Commission as delegated acts while implementing technical standards are approved as implementing acts. Accordingly, regulatory standards may supplement or amend non-essential aspects of the other provisions, while implementing standards may only define provisions in greater detail.

Solvency II that came into force on 18 January 2015.⁷

Implementing technical standards

The European Insurance and Occupational Pensions Authority (EIOPA) developed an initial comprehensive package as of 31 October 2014 with implementing technical standards (ITS, see the info box “Technical Standards”) to Solvency II, and submitted it to the EU Commission which adopted them as implementing acts. These standards are intended to assist the practical implementation of the provisions of the Solvency II Directive and the delegated acts. Their application is legally binding for supervisory authorities and undertakings.

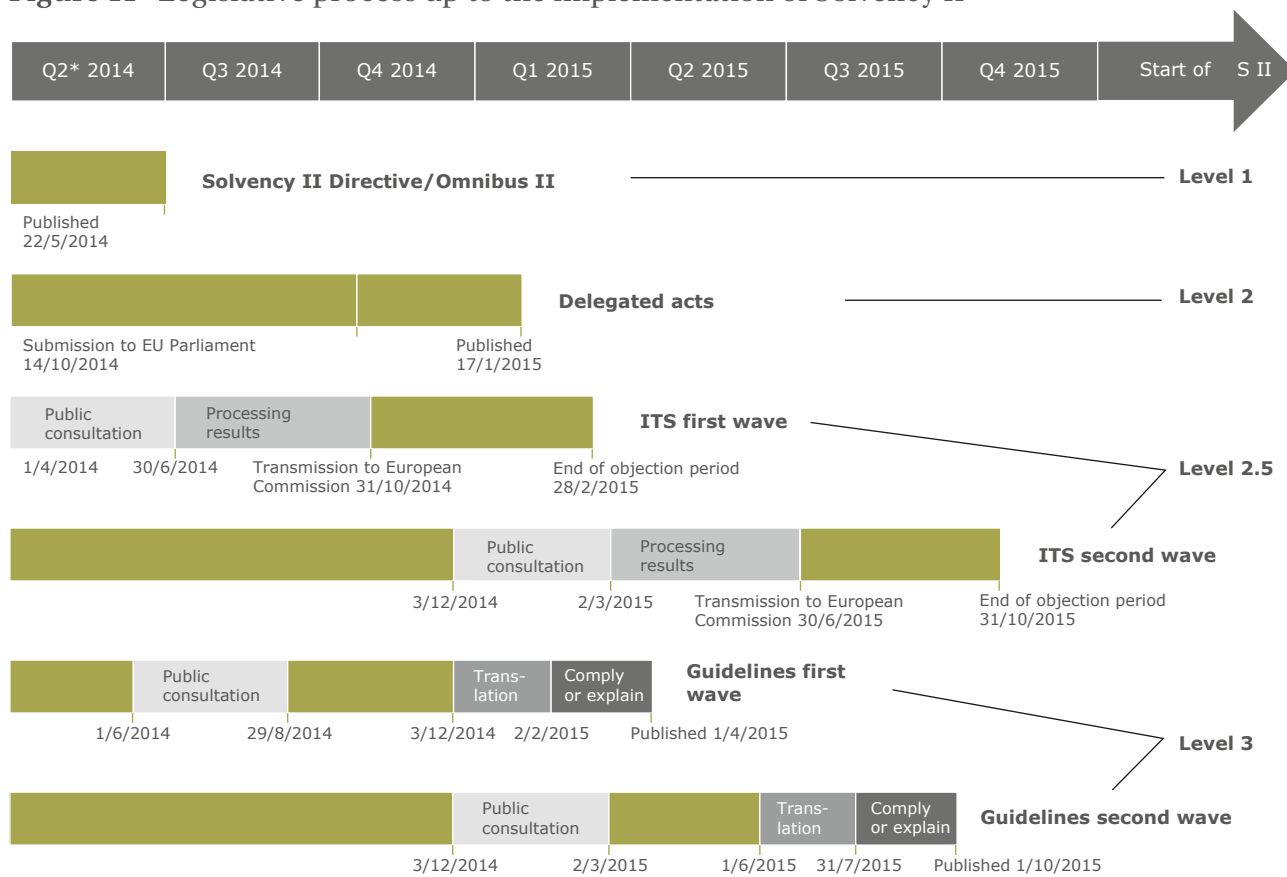
EIOPA is developing the standards in two waves (see also Figure 11 “Legislative process up to the implementation of Solvency II”, page 147):

⁵ Directive 2014/51/EU, OJ EU L 153/1.

⁶ Directive 2009/138/EC, OJ EU L 335/1.

⁷ Commission Delegated Regulation (EU) No 2015/35, OJ EU L 12/1.

Figure 11 Legislative process up to the implementation of Solvency II



* Q: Quartal; ITS: Implementing Technical Standards
Source: BaFin

the first wave deals with the authorisation processes for various application procedures provided for under Solvency II. These relate to internal models, matching adjustments, ancillary own funds, undertaking-specific parameters and special purpose entities. In the second wave, for example, the formats for reporting to the supervisory authority are stipulated and the process for setting capital add-ons is defined. The consultation took place between 2 December 2014 and 2 March 2015. EIOPA will submit its proposals to the EU Commission at the end of June.

Guidelines

On 3 December 2014 following a public consultation, EIOPA published its final reports with the first wave of guidelines (see info box "Guidelines", page 148) to Solvency II. These guidelines supplement the first wave of ITS and deal with a variety of topics, including own funds, the solvency capital requirement (SCR)

Delegated acts

Pursuant to Article 290 of the Treaty on the Functioning of the European Union (TFEU), power can be transferred to the Commission to supplement or amend non-essential elements of a legislative act by means of delegated acts. The delegated acts, introduced by the Treaty of Lisbon, do not require comitology committees and are adopted by the Commission. They are under the control of the EU Parliament and of the Council, however, whose powers on this point were generally strengthened by the Treaty of Lisbon. Each of these bodies can revoke both individual measures passed by the Commission and the transfer of power to the Commission.

Guidelines

Pursuant to Article 16 of the EIOPA Regulation (EU Regulation 1094/2010), the European insurance supervisory authority may issue guidelines in order to generate coherent, efficient and effective supervisory practices within the European financial supervisory system, and to ensure the collective, uniform and coherent interpretation and application of EU law. These guidelines are addressed to the competent national supervisory authorities, who must state in the comply-or-explain process whether they intend to apply the guidelines in their supervisory practice or not. If a supervisory authority does not want to implement the guidelines, it must give reasons. These are published by EIOPA.

on the basis of the standard formula, technical provisions and group solvency. EIOPA published the guidelines in all the official languages of the EU member states on 2 February 2015.⁸ The explanatory texts accompanying the guidelines, however, were not translated. This was immediately followed by the beginning of the comply-or-explain phase for the national supervisory authorities, which lasted two months.

1.4.1.3 Act to Modernise Financial Supervision of Insurance Undertakings

To implement the Solvency II Directive, the Act to Modernise Financial Supervision of Insurance Undertakings (*Gesetz zur Modernisierung der Finanzaufsicht über Versicherungen*) (revised Insurance Supervision Act) was promulgated in the Federal Law Gazette on 10 April 2015.⁹ It will enter into force on 1 January 2016 – with the exception of one provision relating to decisions by the supervisory authority in the lead-up to Solvency II, which becomes applicable starting from 11 April 2015.

Solvency II was originally scheduled to be transposed into German law by means of the Tenth Act Amending the Insurance Supervision Act (*Zehntes Gesetz zur Änderung des Versicherungsaufsichtsgesetzes*)¹⁰. However, the national implementation process had to be interrupted as a result of the negotiations relating to the Omnibus II Directive on the amendment of the Solvency II Directive. The Act to Modernise Financial Supervision of Insurance Undertakings is based on the draft for the Tenth Act Amending the Insurance Supervision Act, but also contains the new provisions from the Act to Ensure Stable and Fair Benefit Payments for Life Insurance Policyholders (*Gesetz zur Absicherung stabiler und fairer Leistungen für Lebensversicherte*) dated 1 August 2014¹¹, known as the Life Insurance Reform Act (*Lebensversicherungsreformgesetz – LVRG*).

1.4.2 Preparations for Solvency II

During the preparatory phase for Solvency II, the Technical Specifications published by EIOPA play an important role: they are intended to ensure that there is a common understanding of the quantitative Solvency II requirements across Europe. The Technical Specifications reflect the status of the legal framework of Level 1 and Level 2 in spring 2014 (see Figure 11 on page 147) and also address individual matters in the EIOPA guidelines. Their application is limited to the preparatory phase, since the final provisions relating to Level 1, Level 2 and Level 3 will supersede them in 2016.

1.4.2.1 Technical Specifications

BaFin and EIOPA have published important documents in connection with the application of the Technical Specifications in practice which are explained in the following.

BaFin explains the specifications

In addition, BaFin has published explanatory notes to the Technical Specifications intended

⁸ <https://eiopa.europa.eu>

⁹ Federal Law Gazette I 2015, p. 434.

¹⁰ Bundestag printed paper 17/9342 dated 18 April 2012.

¹¹ Federal Law Gazette I 2014, p. 1330.

to provide undertakings with guidance for their application.¹² A major focus of the explanatory notes relates to the valuation of future discretionary bonuses and the treatment of the provision for bonuses and rebates in life and health insurance. The notes also apply to accident insurance with premium refunds. They furthermore include guidance on the choice and application of methods for horizontal groups.

Assumptions for the standard formula

As a supplement to the Technical Specifications, EIOPA published a further paper¹³ on 31 July 2014 setting out the assumptions on which the standard formula is based. As with the Technical Specifications, this publication is based on the status of the legal framework for Solvency II in spring 2014.

In the preparatory phase for Solvency II, from 2015 onward undertakings must evaluate their overall solvency needs as part of the Forward Looking Assessment of Own Risks (FLAOR). In addition, they must investigate whether the risk profile of their own undertaking deviates significantly from the assumptions on which the standard formula is based. The preparatory guidelines relating to the FLAOR apply in anticipation of the Own Risk and Solvency Assessment (ORSA) which insurance undertakings must carry out from 2016 onward.

To enable them to fulfil the requirements of the FLAOR, undertakings calculating their SCR using the standard formula must compare the assumptions on which the standard formula is based with the individual risk profile of their undertaking. The EIOPA paper assists the undertakings in making this comparison. BaFin has therefore published a translation of the document, as well as of the Technical Specifications, on its website.

¹² www.bafin.de/dok/5228502 (only available in German).

¹³ The Underlying Assumptions in the Standard Formula for the Solvency Capital Requirement Calculation, 25 July 2014.

1.4.2.2 BaFin publications on the EIOPA preparatory guidelines

EIOPA has published comprehensive guidelines on the preparations for Solvency II. BaFin has allocated these guidelines to 15 thematic blocks. It issued publications on nine of these subjects in 2014. The publications explain what undertakings should take into account during the preparatory phase and what implementation will involve. Further publications on risk management, the actuarial function, outsourcing and ORSA will be issued by mid-2015.¹⁴

With the start of Solvency II, these publications will form the basis on which existing circulars can be revised, new circulars prepared and collective decrees or interpretative decisions issued. The undertakings themselves can decide which subjects they wish to give the highest priority to during the preparatory phase.

BaFin followed up each publication with a survey on the current state of affairs, in which the undertakings participated very actively.

General governance requirements

The first thematic block "General governance requirements" deals with EIOPA guidelines 3 to 10 on the system of governance. Since this group of subjects was highly complex, BaFin divided it into a number of individual topics.

Guidelines 3, 6 and 7 are concerned with the general provisions relating to the administrative, management or supervisory body (AMSB), the central authority in an undertaking's governance system. They mainly deal with the internal interaction of the AMSB within the undertaking, decision-making processes and documentation requirements.

Guideline 5 requires individual undertakings and groups to establish the four key functions prescribed by the Solvency II Directive: the internal audit function, the compliance function, the actuarial function (see info box "BaFin hosts q_x-club actuaries", page 150) and the

¹⁴ www.bafin.de/dok/5187770

independent risk management function. The first thematic block addresses the overall organisational aspects of these issues. Thematic blocks 3, 6 and 7 discuss the details relating to the individual key functions.

Guidelines 4, 8 and 9 cover the organisational and operational structure, the internal review of the system of governance and the undertaking's internal policies. Finally, guideline 10 turns to the issue of contingency plans.

Professional qualification and personal reliability

On 30 April 2014, BaFin announced its publication on the evaluation of the professional qualifications and reliability of persons who effectively run the undertaking or are responsible for other key functions, including members of the supervisory board, during the preparatory phase for Solvency II.

In its guidelines on the system of governance, EIOPA had provided a closer definition of the fit and proper requirements as formulated in Article 42(1)(a) and (b) of the Solvency II Directive. The wording of the two requirements

corresponds to the concepts of "professional qualification" and "reliability" established in the German Insurance Supervision Act (*Versicherungsaufsichtsgesetz – VAG*).

The requirements are mandatory for all persons effectively running the undertaking or exercising other key functions. Under Solvency II, the requirements, which only applied to management and members of the administrative or supervisory body in the past, are therefore extended to all persons responsible for or carrying out other key functions. Furthermore, the scope of application covers persons, in addition to the management, who have a significant influence on business decisions.

The specific fit requirements depend on the relevant key function and the particular responsibility – taking into account the principle of proportionality. In contrast, the standards do not make any such differentiation in the proper requirements.

The undertakings therefore have the responsibility of establishing their own procedures for ensuring that the relevant



BaFin hosts q_x -club actuaries

In May 2014, BaFin hosted an event arranged by the Cologne/Bonn/Düsseldorf q_x -club on the subject of "The actuarial function under Solvency II".

The q_x -club is a local branch of the German Actuarial Association (*Deutsche Aktuarvereinigung e. V. – DAV*). The club acts as a discussion forum for actuaries. At the club's meetings, presentations are made on topical actuarial subjects, information from the DAV committees is passed on and the findings of the DAV's working groups are discussed. The q_x -club's name is derived from the symbol q_x which stands for the probability that a person x years old will die within one year.

A representative of BaFin explained the actuarial function, as distinct from the appointed actuary, to the 140 participants.

He also showed how BaFin is tackling this subject in the preparatory phase for Solvency II.

With the introduction of Solvency II, the actuarial function is intended to ensure the reliability and quality of the technical provisions in the solvency balance sheet as part of the system of governance. The scope of its responsibilities will not be restricted to coordination, monitoring, advisory and supporting roles but will include, among other things, evaluating whether the methods of calculation and assumptions employed are appropriate. The forum also held discussions on the differences and similarities between the actuarial function and the appointed actuary in life and health insurance, as well as in specific areas of liability and casualty insurance. The event concluded with an extensive technical debate between the actuaries and BaFin.

persons meet the requirements. They must document this process in written internal guidelines which are also regularly reviewed and, if necessary, amended to reflect current developments within the undertaking.

Internal controls and internal audit

In its publication on internal controls and internal audit, BaFin deals with guidelines 33 to 37 on the preparations for Solvency II. They form part of the sixth thematic block of the 15 referred to above.

Guidelines 33 and 34 address the question of internal controls: from 1 January 2016, insurance undertakings must have set up an effective internal control system, going beyond the previous supervisory requirements. The internal control system represents a central component of the system of governance. It is complemented by an appropriate and effective compliance function which monitors the undertakings' compliance with the provisions.

Guidelines 35 to 37 are concerned with the internal audit function, especially its independence and objectivity. All undertakings falling within the scope of Solvency II must have an internal audit function at the latest from 1 January 2016. The previous exemptions pursuant to section 64a (5) of the Insurance Supervision Act no longer apply under Solvency II.

Assessment of overall solvency needs and general principles

BaFin opened its series of publications on the preparatory guidelines for Solvency II with information and supplementary notes relating to the assessment of overall solvency needs. This assessment constitutes one of the three parts of the Own Risk and Solvency Assessment (ORSA). Undertakings were expected to implement this first part for the first time in 2014 and report the results of the assessment to the supervisory authority.

The assessment of the overall solvency needs involves the insurers calculating, independently of the regulatory capital requirements, how

much capital they need according to their own estimation in order to be adequately protected against the realisation of material risks. The undertakings' own risk and solvency assessment therefore links risk management and capital management together. The methods employed must be appropriate to the nature, extent and complexity of the risks. In contrast to the solvency capital requirement and the minimum capital requirement later on, the capital requirement calculated is not just based on a one-year time horizon, but must also cover a perspective extending several years into the future. It may be higher or lower than the capital requirements prescribed by supervisory law and plays an important role in the management of the undertaking.

The publication also provided general guidance on matters that the undertaking must comply with in connection with the ORSA – for example in relation to documentation, the frequency of the assessment, reporting obligations, the role of the management board and proportionality.

Quantitative and qualitative reporting

The BaFin publication on thematic blocks 12 and 13, which appeared on 20 June 2014, addressed specialist and technical aspects of reporting in the preparatory phase for Solvency II. It is divided into one general part and three further sections. The general part contains details of the publication's addressees and BaFin's expectations with respect to the submission of information by the insurance undertakings and groups in the preparatory phase for Solvency II.

The second section is concerned with specialist aspects. These include information on the substantive requirements for quantitative and narrative reporting and on the principle of proportionality, details of the timeframe for the submission of information and specific information for insurance groups.

Sections three and four provide information on the technical aspects of quantitative and narrative reporting. For example, BaFin expects the insurance undertakings and groups to submit quantitative information only in

electronic form using the XBRL¹⁵ format and narrative reports as PDF files. Both types of report will need to be submitted via BaFin's reporting and publishing platform¹⁶.

Own funds and governance

On 26 June 2014, BaFin published supplementary guidance on own funds and governance. This publication deals firstly with the EIOPA capital management policies that the undertakings have to develop (guideline 31 of the preparatory EIOPA guidelines on the system of governance), and secondly with the medium-term capital management plan (guideline 32).

The capital management policies should principally contain descriptions of the procedures to ensure that own fund items meet the applicable own funds requirements, and that issuances of own fund items are in accordance with the medium-term capital management plan. The objective of the medium-term capital management plan is to ensure that the capital requirements are met at all times. This is intended to be linked to a forward-looking plan which also addresses the transition to Solvency II.

1.4.2.3 Results of the "Vollerhebung Leben" survey

In 2014, BaFin asked all German life insurers about their own funds situation under Solvency II conditions in the "Vollerhebung Leben" survey. In the current low interest rate environment, the transition to market-consistent valuation under Solvency II represents a particular challenge for the life insurers. This is because German life insurance undertakings have traditionally focused their business on policies with long-term interest guarantees. It was therefore important both for BaFin and for the undertakings to obtain a clear picture of their expected own funds situation under Solvency II at the earliest possible date. This is the only way of ensuring that it will be possible to introduce any countermeasures that may be required in good time.

BaFin wanted to use the "Vollerhebung Leben" survey to achieve the most realistic possible estimate of the own funds situation of German life insurers at the start of Solvency II on 1 January 2016. The survey therefore contributed to the best possible preparations for Solvency II and to the analysis of the effects of the transitional measures provided for in the Solvency II framework (transitionals on discount curves and technical provisions) and of the volatility adjustment. The transitional measures were particularly important. They permit insurers to introduce the new capital requirements in stages over a period of 16 years.

The "Vollerhebung Leben" survey showed that German life insurers on the whole are well prepared: they are able to cope with the introduction of the capital requirements stipulated by Solvency II due to the future European supervisory regime's transitional measures and volatility adjustment. The measures in question are therefore having the desired effect. Only a handful of undertakings with a collective market share of less than 1% were unable to demonstrate that they had sufficient own funds at the 31 December 2013 reference date despite having applied the prescribed measures. BaFin has already discussed the initial steps necessary with these undertakings.

At the 31 December 2013 reference date, the own funds of around 25% of the undertakings, together representing a market share of approximately 10%, would have been less than the requirements, if the transitional measures had not been applied. This figure is likely to have risen higher in the meantime as a result of the further decline in interest rates. BaFin estimates that on the basis of capital market interest rates as at 30 September 2014, German life insurance undertakings were short some €15 billion in own funds without the application of the transitional measures. However, this gap in own funds is strongly tied to capital market interest rates and the performance of the insurance portfolios. It can therefore only be used as an indicator. Nevertheless, if the low interest rate

15 eXtensible Business Reporting Language.

16 www.bafin.de/dok/2996718

phase persists, life insurers will have to make considerable efforts to strengthen their capital base during the 16-year transitional period.

The Solvency II coverage ratios were very sensitive to changes in spreads and interest rates. The life insurance undertakings will therefore have to brace themselves for the possibility that their own funds situation could change sharply within a short period of time.

In parallel to the BaFin survey for the life insurers, the Association of Private Health Insurers (*Verband der Privaten Krankenversicherung e. V.*) organised a survey of health insurance undertakings on the basis of various comparable scenarios. The Association made the results available to BaFin for analysis. Almost all of the health insurers falling within the scope of the new Solvency II framework took

BaFin Solvency II conference

BaFin arranged its sixth conference on future insurance supervision legislation on 13 November 2014 under the heading "Preparatory phase for Solvency II – industry and supervisors in discussion". Representatives of the insurance undertakings and industry associations brought themselves up to date on current developments in lectures and panel discussions. The panel members were representatives of the EU Commission, EIOPA, the Federal Ministry of Finance, the German Insurance Association (*Gesamtverband der Deutschen Versicherungswirtschaft – GDV*), the industry generally and BaFin staff members. The participants discussed the current status of the regulatory projects at national and European level, the preparatory phase for Solvency II and the results of the *Vollerhebung Leben* survey. In their judgment, the most significant challenges for the coming year were the extensive reporting regime and the applications for the approval of an internal model. The application process will involve an enormous expenditure of effort for the insurers and for the supervisory authorities.

part in the survey. On the basis of the current state of knowledge, they are in a position to meet the new requirements. The survey showed clearly that the health insurers, like the life insurers, are reacting negatively to the current low level of interest rates. However, the health insurers are much better placed to compensate for the adverse consequences, since they have the possibility to adjust their premiums.

1.4.2.4 Voluntary test run for reporting

The two test runs for qualitative and quantitative reporting planned for 2015 are an important step in the preparations for Solvency II – both for the insurance undertakings and groups and for BaFin itself. BaFin therefore expects the insurers to take part in the test runs for the annual and quarterly reports.

With respect to the submission of the annual quantitative and qualitative information, BaFin assumes that the insurance undertakings involved will submit the information for the year ended 31 December 2014 to BaFin at the latest 22 weeks after the end of the undertaking's financial year. For groups, this period is extended by six weeks.

The participating insurers must forward the quarterly quantitative information for the quarter ended 30 September 2015 to BaFin at the latest eight weeks after the end of that quarter. The six weeks' additional period for groups also applies in this case.

The requirements during the preparatory phase will assist both the participating insurers and the supervisory authority in making adequate preparations for the future reporting requirements under Solvency II. This is exceptionally important, especially for Day 1 reporting – the first reporting obligation after Solvency II comes into force.

1.4.2.5 Internal models

The modelling of risk under Solvency II is closely linked to the development of internal models.

Continuation of the pre-application phase for internal models

In 2014 BaFin continued the pre-application phase for internal models. It offered the undertakings concerned the opportunity to submit test applications early in October. Officially, the insurers cannot submit an application for the use of an internal model to calculate the solvency capital requirement until April 2015. The pre-application phase has two advantages: firstly, BaFin as the supervisory authority can prepare itself for processing the applications and, at the same time, the undertakings achieve greater certainty as far as the formal aspects of the application process are concerned. The test applications are therefore an important and useful exercise for both parties in preparing for the actual application phase from spring 2015.

BaFin's offer was taken up by all of the undertakings developing internal models. The size of the test applications ranged between 6,000 and 100,000 pages. All of the national supervisory authorities involved contributed to the processing of the applications and drew up individual timetables in the supervisory colleges, depending on the planned application date. BaFin will provide all of the undertakings with feedback on their test applications.

For undertakings using internal models, quantitative reporting starts at the same time as the application is made. In future, they will have to submit an individually agreed set of data to BaFin in addition to the general information. The supervisory authority held exploratory discussions on this subject with the insurers concerned.

Internal Models Working Group

The Internal Models Working Group (*Arbeitskreis Interne Modelle – AKIM*) met twice in the course of 2014. The supervisors, the insurers and the German Insurance Association (*Gesamtverband der Deutschen Versicherungswirtschaft – GDV*) exchange information in this forum, to which BaFin invites representatives of the undertakings. In 2014, the focus was on issues relating to the conduct and the details of the upcoming application process. Since it is likely that not all of the outstanding questions will have been answered by the earliest possible application date, 1 April 2015, BaFin explained its proposed administrative practice to the members of the AKIM. The participants regarded this as helpful in general terms, even if the decisions made were not exactly as they would have liked in every respect.



1.4.3 Focus

The prudent person principle

Authors: Michael Göddecke and Nadine von Saldern, BaFin Section for Basic Issues on Investments

When Solvency II¹⁷ comes into force on 1 January 2016 with the associated transition from rule-based supervision to a primarily

principles-based supervisory regime, the area of insurers' investments will be affected by far-reaching changes: the insurance undertakings will be required to take more responsibility themselves. The centrepiece will be a standard of conduct and not the primary focus on quantitative supervisory rules. Both

¹⁷ Directive 2009/138/EC, OJ EU L 335/1, amended by Directive 2014/51/EU (Omnibus II Directive), OJ EU L 153/1.

the insurance undertakings affected and BaFin itself have gained experience with the future principles and qualitative requirements in the preparatory phase for Solvency II.

Background

Section 54 of the Insurance Supervision Act (*Versicherungsaufsichtsgesetz – VAG*) currently forms the basis for insurers' investment activities. Under its provisions, insurers must invest the guarantee assets and other restricted assets in such a way as to achieve the greatest possible security and profitability while maintaining liquidity at all times, and ensure that there is an appropriate mix and diversification of investments. These principles are currently defined in greater detail by the Investment Regulation (*Anlageverordnung – AnIV*) as well as by various circulars and pronouncements. The Investment Regulation and in particular Circular "Guidance on Investing Restricted Assets held by Insurance Undertakings"¹⁸ contain a large number of quantitative rules as well as qualitative requirements. For example, section 2 (1) of the Investment Regulation contains a list of investments that are suitable for restricted assets. Quantitative limits for individual investment classes and limits on exposures to individual debtors – known as spread and diversification limits – can be found in sections 3 and 4 of the Investment Regulation.

Once Solvency II comes into force, there will no longer be a legal basis corresponding to the current section 54 (3) of the Insurance Supervision Act for the issue of an Investment Regulation. Quantitative rules will no longer apply. For example, in future undertakings will be required to draw up their own lists of suitable investments together with limits for individual investment classes and debtors (internal investment list).

But the resulting general freedom for insurers to choose their own investments will not be unqualified. Instead – in addition to the existing regulatory own funds requirement – a number

18 Circular 4/2011 (VA), www.bafin.de/dok/2831354

Preparations for Solvency II

On 1 January 2014, the Europe-wide preparatory phase for Solvency II began. The European Insurance and Occupational Pensions Authority (EIOPA) has published accompanying guidelines. The purpose of the guidelines is to ensure that the undertakings affected will comply with the Solvency II requirements as at 1 January 2016. BaFin divided the guidelines into 15 thematic blocks and published pronouncements on individual blocks in 2014. In the course of 2015, further publications will follow on the outstanding thematic blocks.

of qualitative provisions will play a central role in future, some of which go well beyond the existing qualitative requirements under Solvency I.

Guidelines 25 to 30 on the system of governance

The prudent person principle is based at European level on Articles 132 ff. of the Solvency II Directive. The principles established in the Directive are defined in more detail firstly in the implementing directives and regulations and secondly in the guidelines published by the European Insurance and Occupational Pensions Authority (EIOPA) (see info box "Preparations for Solvency II").

In October 2014, BaFin published a pronouncement on the prudent person principle on its homepage as part of the preparations for Solvency II.¹⁹ This publication provides further details of the provisions in EIOPA guidelines 25 to 30 on the system of governance.

These guidelines specify the prudent person principle. Guideline 25 addresses the prudent person principle established in Solvency II as it applies to the management of investments and sets out the characteristics associated

19 See "Vorbereitung auf Solvency II: Grundsatz der unternehmerischen Vorsicht", www.bafin.de/dok/5503146 (only available in German).

with it. Guidelines 26 to 30 contain qualitative requirements for investment activities relating to non-routine investments, unit-linked and index-linked contracts, assets not admitted for trading on a regulated financial market, derivatives and securitised instruments.

BaFin engaged in an intensive debate with the insurers prior to publication. The insurers had an opportunity to tell BaFin where they saw a need for further explanation in guidelines 25 to 30 on the system of governance. BaFin also conducted a number of joint workshops on the prudent person principle with the German Insurance Association (*Gesamtverband der Deutschen Versicherungswirtschaft – GDV*), in which participants were able to question the supervisors directly.

This discussion made it clear to the insurance undertakings that most of the requirements set out in the guidelines already form part of the current supervisory regime. Circular 4/2011 (VA) in particular provides a foundation for the undertakings' work in the preparatory phase for Solvency II. For example, the investment principles of security, liquidity and profitability referenced in the explanatory notes to EIOPA guideline 25 on the system of governance already constitute integral components of the supervisory regime pursuant to section 54 of the VAG in conjunction with the provisions of Circular 4/2011 (VA).

The requirement contained in EIOPA guideline 25 on the system of governance that the undertaking should not solely depend on the information provided by third parties also corresponds to the provisions of Article 5a (1) of the amended Regulation on Credit Rating Agencies (CRA III).²⁰ BaFin has already defined these European regulations in more detail in its interpretative decision "Notes on the use of external ratings and on making own credit risk assessments"²¹, published on 23 October 2013 and last amended on 14 April 2014. The

undertakings are therefore already familiar with this requirement as well.

Some of the provisions in the guidelines are new to the undertakings, however. For example, the requirements for investments in securitised instruments set out in the explanatory notes to EIOPA guideline 30 on the system of governance go significantly further than the requirements currently applicable in accordance with the Circular "Investments in asset-backed securities and credit-linked notes"²². While at the moment the investment-grade rating of the cash market instrument is the main determinant of whether the investment is permitted from a supervisory point of view, in future the insurance undertaking will have to pay particular attention to the interests of the originator. In accordance with the explanatory notes to EIOPA guideline 30 on the system of governance, the insurance undertaking must ensure in future that its own interests and those of the originator are aligned. The explanatory notes also contain a series of measures which the insurance undertaking could take in order to ensure that the objective of aligned interests is achieved.

The industry must also be prepared for changes relating to unit-linked and index-linked contracts. For example, the relevant EIOPA guideline 27 on the system of governance provides that an undertaking's investments in unit-linked and index-linked contracts must be selected in the best interest of the policyholders and beneficiaries. The implication of this is that undertakings must identify and deal with any potential conflicts of objectives between their own interests and those of the policyholders. The undertaking is expected to document appropriate procedures and actions in a corresponding set of rules.

SRP handbook

The transition from rule-based supervision to a principles-based supervisory regime described above will also result in a number of changes for supervisors from 2016 onwards,

20 Regulation (EU) No. 462/2013, OJ EU L 146/1.

21 www.bafin.de/dok/5609002

22 Circular 1/2002 (VA), www.bafin.de/dok/2677578 (only available in German).

not just for the undertakings. EIOPA has therefore set up a working group tasked with preparing a handbook for the supervisory review process, known as the SRP Handbook. The supervisory review process is derived from Article 36 of the Solvency II Directive. It requires the supervisory authorities to review and evaluate the strategies, processes and reporting procedures which are established by the insurance and reinsurance undertakings to comply with the provisions of Solvency II.

The SRP Handbook represents a standard reference work by supervisors for supervisors, which is intended to facilitate the implementation of the requirements of Article 36. Since it is directed at the national supervisory authorities and only makes recommendations for supervisory practice, it does not give rise to any new requirements for the undertakings. The requirements are set out in implementing directives, implementing regulations and guidelines. One of the chapters bears the heading "PPP". This chapter contains suggestions intended to

assist in evaluating whether an undertaking's investments have been made in accordance with the prudent person principle. It does not constitute comprehensive guidance on how compliance with the prudent person principle should be reviewed. Instead, it helps the supervisor to assess whether the prudent person principle has been adequately taken into account.

The PPP chapter does not deal only with the investment process. It also considers aspects of asset-liability management (ALM), risk management and the valuation of investments. In addition to the general requirements relating to investments, the handbook also looks at compliance with the investment principles (security, profitability, liquidity and quality) and individual asset classes (such as fixed-interest investments and derivatives). The information is kept at a very general level, however, and does not reflect the circumstances in any particular national context. The national supervisory authorities will need to give thought to this themselves.



1.5 Occupational retirement provision

1.5.1 Planned amendment to the IORP Directive

On 27 March 2014, the European Commission published a proposed amendment to the Directive on the activities and supervision of institutions for occupational retirement provision (IORP II Directive). The proposed amendment aims to remove remaining supervisory hurdles for IORPs which have cross-border activities, to ensure a good business organisation and appropriate risk management, to provide understandable and relevant information to the beneficiaries and to provide the supervisory authorities with the necessary tools to effectively monitor

IORPs. The EU Commission's proposal does not change the quantitative requirements in comparison with the current Directive (IORP I).

On 10 December 2014, the member states approved a compromise proposal for the IORP II Directive, which the European Council will take into the trilogue negotiations. In contrast to the EU Commission's proposal, the proposed compromise does not envisage any delegated acts for remuneration policy, risk evaluation for pensions and the pension benefit statement. Further material differences from the Commission's proposal relate to cross-border activities and transfers, the fit and proper requirements, the depositary and the pension projections.

The European Parliament will consider the proposal for the IORP II Directive in 2015.

1.5.2 EIOPA's activities on Pillar 1

On 13 October 2014, the European Insurance and Occupational Pensions Authority (EIOPA) published a consultation paper²³ on the quantitative requirements for IORPs. In Germany, the latter include *Pensionskassen* and *Pensionsfonds* within the meaning of the Insurance Supervision Act (*Versicherungsaufsichtsgesetz*). The consultation period for the EIOPA paper ran until 13 January 2015. It dealt with the further development of various aspects of the holistic balance sheet²⁴, which EIOPA had presented in the context of the Quantitative Impact Study for IORPs.

The consultation paper firstly addresses the issue of how items in the holistic balance sheet should be valued, such as sponsor support or pension protection schemes. Secondly, it dealt with the fundamental question of what a supervisory system based on a holistic balance sheet might look like.

EIOPA took the opinions expressed on the consultation paper into account in the development of the Technical Specifications for the second quantitative study on the solvency of IORPs. This will be conducted in mid-2015.

1.6 Insurance intermediaries

1.6.1 Planned amendments to the Directive on insurance mediation

On 3 July 2012, the EU Commission published the draft of the Insurance Mediation Directive (IMD 2). This is intended to replace the existing Insurance Mediation Directive IMD 1 (2002/92/EC). IMD 2 covers not just the sale of insurance products via intermediaries (mediation) – as did IMD 1 – but also selling in general (distribution)

including direct sales, i. e. including sales by the insurers and their employees. The Council is therefore proposing to change the name of the draft directive to “Insurance Distribution Directive” (IDD).

In contrast to the European Markets in Financial Instruments Directive II (MiFID II), IDD 2 aims to achieve a minimum level of harmonisation which leaves scope for more detailed regulations in the individual member states. The Council negotiations were completed in December 2014. The trilogue between the Council, the Commission and the European Parliament was then able to begin in February 2015. The negotiations are expected to be concluded by mid-2015.

The current IDD 2 drafts of the Commission, Council and Parliament contain wide-ranging information obligations relating to the products mediated as well as to potential conflicts of interest and the remuneration of the intermediary. The proposals leave the question of whether commission payments by third parties – which essentially means the insurers – should be permitted or forbidden to the discretion of the relevant jurisdiction. It would therefore be permissible to continue to practise this business model. Article 21a of the Council draft deals with processes for product development. All providers developing an insurance product must undergo a process in which the planned product and the related distribution channels are evaluated for their suitability. A number of member states expressed the view that these matters do not properly belong in a directive on distribution. Since the regulations were felt to be appropriate, however, they continue to form part of the draft.

1.6.2 EIOPA Guidelines on Complaints Handling by Insurance Intermediaries

To complement its Guidelines on Complaints Handling by Insurance Undertakings dated June 2012, EIOPA also published guidelines relating to insurance intermediaries in 2014. Their contents correspond to the guidelines

²³ [https://eiopa.europa.eu/Pages/Consultations/Consultation-Paper-on-Further-Work-on-Solvency-of-IO-RPs-\(CP-14040\).aspx](https://eiopa.europa.eu/Pages/Consultations/Consultation-Paper-on-Further-Work-on-Solvency-of-IO-RPs-(CP-14040).aspx)

²⁴ See 2013 Annual Report, p. 122.

on complaints relating to insurers. BaFin has already implemented a number of the considerations in the Guidelines on Complaints Handling by Insurance Intermediaries in a

circular²⁵, at least to the extent that they relate to tied agents within the meaning of section 34d (4) of the German Industrial Code (*Gewerbeordnung* – GewO).

25 Circular 3/2013 (VA), www.bafin.de/dok/4594978



1.6.3 Focus



Insurance intermediaries – supervisory possibilities and limits

Author: Olaf Temmen, BaFin Competence Centre for Sales, Consumer Protection and Remuneration Systems

The working practices of insurance intermediaries are a subject that generates heated debate from time to time – and one which also concerns BaFin, but not just BaFin. This is because responsibility for this area is divided between the German federal government and the federal states, specifically: between BaFin, the Chambers of Commerce and Industry (*Industrie- und Handelskammern* – IHKs) and the Trade Licensing Offices (*Gewerbeämter*).

Multi-firm agents and insurance brokers must be authorised pursuant to section 34d (1) of the Industrial Code (*Gewerbeordnung* – GewO). The authorisation is granted by the locally responsible IHK after it has evaluated their reliability and expertise, in particular. There is no special requirement for authorisation for tied agents who only sell the products of a single insurer or, for example, group (section 34d (4) of the Industrial Code). The evaluation of their reliability and expertise is a matter for the insurer, which is also responsible for their entry in the register of insurance intermediaries²⁶.

Insurance intermediaries are subject to a large number of requirements under commercial and civil law. In addition

to section 34d of the Industrial Code, these are primarily the provisions of the Regulation on Insurance Mediation (*Versicherungsvermittlungsverordnung* – VersVermV) and the Insurance Contract Act (*Versicherungsvertragsgesetz* – VVG). The supervision of independent intermediaries, i. e. multi-firm agents and insurance brokers, is the responsibility of the competent authorities under the laws of the federal states, such as the IHK and the Trade Licensing Office. They are equipped with various powers for that purpose under commercial law.

Indirect supervision

As far as tied insurance intermediaries are concerned, BaFin checks whether the insurance undertakings are fulfilling their obligations referred to above. There is therefore an indirect supervisory process as part of the supervision of the insurance undertakings. In addition, BaFin monitors the insurers' compliance with the statutory requirements relating to their cooperation with all types of insurance intermediaries, and whether they are taking adequate account of risks that may arise from the intermediaries' activities in their risk management systems and business organisation (see info box "BaFin supervision: regulatory environment", page 160).

26 www.vv-register.de



BaFin supervision: regulatory environment

Status quo

The regulatory environment for the sale of insurance products has not changed materially in Germany since the implementation of the European Insurance Mediation Directive²⁷ at the national level in 2007. Since that date, special sales-related provisions have been introduced only in a few places in the Insurance Supervision Act (*Versicherungsaufsichtsgesetz – VAG*). These include the cap on commissions in substitutive health insurance (section 12 (7-9) of the VAG) and the provision on the periods during which intermediaries are liable to repay commissions if the policy is cancelled in the life and health insurance sectors (section 80 (5) of the VAG).

The central provision governing risk management and business organisation is currently section 64a of the VAG. In accordance with that section, insurance undertakings must have a proper business organisation which ensures compliance with the laws, regulations and regulatory requirements they must observe. In BaFin's opinion this means that, in relation to sales, the undertakings must take account of, monitor and document sales risks in an adequate manner. It is not sufficient for an insurer to take a close look at its sales

activities only when there is a particular reason to do so, such as when it has suffered a loss as a result of the actions of an intermediary.

Changes

Beginning in 2016, the implementation of the Solvency II Directive²⁸ will also change the supervisory requirements placed on sales. Pursuant to Article 27 of the Directive, the main objective of supervision is the protection of policyholders and beneficiaries. However, this must be implemented accordingly by the member countries. This measure would also have to be linked to sales activities. Furthermore, the sales operations as a component of operational risk can also affect the insurers' capital requirements. This is expected to change the way in which insurers handle their sales risks and be reflected in tighter control over sales in general.

Further changes will result – possibly as soon as 2015 – from the amended version of the European Insurance Mediation Directive, the Insurance Distribution Directive (IDD). The IDD will cover not only the sale of insurance products via intermediaries – as in the Insurance Mediation Directive dating from 2002 – but also sales in general, i.e. direct sales by insurance undertakings using their own employees.²⁹

In addition, the insurers must report misappropriations of funds to BaFin³⁰, e.g. if they suspect that their intermediaries, irrespective of their status under commercial law, have been involved in irregularities. BaFin will then conduct an investigation and – if necessary – take measures against the insurer in the context of the supervision of irregularities (section 81 of the VAG).

Consumers expect more from intermediaries than reliability and expertise. For example, it is also important to them that the methods of acquiring customers and the quality of the advice provided at least comply with the statutory requirements³¹ and market standards. Additionally, there is often the need for intermediaries to be available to give advice when benefits are payable or a claim is made. However, there are only a few statutory provisions relating to activities of this nature, which go beyond mediation *per se*, with the result that the possibilities for supervisory

27 Directive 2002/92/EC, OJ EC L 9/3.

28 Directive 2009/138/EC, OJ EU L 335/1.

29 See chapter IV 1.6.1.

30 Collective administrative act – Order to report irregularities in insurers' administrative and sales operations of 23 November 2007, www.bafin.de/dok/2684292

31 One example is section 61 of the Insurance Contract Act, intermediary's duty of advice.

intervention by the IHKs or BaFin in these circumstances are limited.

BaFin's requirements

BaFin is only able to formulate more detailed provisions if it has the statutory powers to do so. However, it can nevertheless make clear – e.g. by means of pronouncements – what it expects from insurers by way of the fair treatment of consumers and proper business organisation in sales on the basis of section 64a of the VAG.³² Another example is provided by the supervisory authority's requirements in the revised insurance intermediaries circular dated 23 December 2014.³³ Here BaFin gives detailed guidance on the problems relating to insurance introducers, but without removing the scope for the insurers to take action themselves.

For seven years, BaFin's previous circular on insurance intermediaries³⁴ was the benchmark for how insurance undertakings should structure their working relationships with intermediaries in order to comply with the statutory requirements, in particular those set out in section 80 of the VAG. Dubious sales practices on the part of individual undertakings formed the background for the revised version. They provided the motivation for BaFin to integrate sales activities even more closely into the requirements for insurance undertakings' risk management systems and business organisation. The opinions of the insurance industry and other interested groups have been incorporated in the final version of the circular, with the objective of implementing the statutory provisions in a way that reflects actual practice and is also proportionate.

Intermediaries and compliance

Standard market practice today is for insurance undertakings to stipulate their own regulations, which their sales partners – such as the tied

agents – must comply with under civil law on the basis of a binding agreement. These include rules on obtaining customers and dealing with policyholders. Contractual agreements of this nature and compliance with them are just as much an issue for the compliance function as statutory provisions and compliance with them. Even though there will be a greater focus on sales under Solvency II anyway (see info box "BaFin supervision: regulatory environment", page 160), insurers should already be paying more attention to the regulations relating to sales.

A widespread argument against increased regulation of sales and more compliance that should not be underestimated is that it would involve higher costs. But those in positions of responsibility should not lose sight of the fact that these costs are a worthwhile investment in the future. One only has to remember how the media seize upon sales practices that may be illegal or whose legality is at least seen as borderline. The reputational damage can be immense – not just for individual undertakings or groups, but for the industry as a whole. Insurance undertakings should therefore define in advance how intermediaries should conduct themselves, as well as how their conduct will be monitored and sanctioned within the undertaking. The public will then be able to recognise excessive practices in sales for what they are – namely isolated cases that have occurred despite the undertaking's own regulations.

Regulations of industry associations

The insurance industry associations also make recommendations on how insurance undertakings should define standards for the sales function over and above the statutory requirements, and in doing so make a contribution to sales compliance. However, internal regulations within the associations must always remain within the limits imposed by antitrust law; agreements which have the effect of restricting competition are therefore not permitted. Accordingly, the regulations must firstly be formulated and structured with great care, but the members must also perceive

32 www.bafin.de/dok/4569228

33 Circular 10/2014 (VA), www.bafin.de/dok/6145200

34 Circular 9/2007 (VA) – Guidance on the application of sections 80 ff. of the VAG and section 34d of the GewO (insurance intermediaries legislation) dated 23 November 2007.

them to be binding to some extent, for example if they are evaluated by auditors. In the final analysis, however, it is the responsibility of the individual insurance undertaking to decide on its

own regulations on the basis of the associations' recommendations and to implement them in practice.



1.6.4 Fee-based advice



German federal government plan of action on consumer protection

In spring 2014, the federal government published a plan of action on consumer protection in the financial market. It declares the government's intention to promote fee-based advice as an alternative to advice on a commission basis for all financial products. The plan of action is also intended to cover insurance activities. It plans to take into account the consultations on IMD 2/IDD 2 taking place at a European level.

Current legal position

There are currently no statutory provisions on fee-based advice applying to insurance intermediaries. There is only an exemption for insurance brokers pursuant to section 34d (1) of the Insurance Code if undertakings or their employees receive advice in the sense of legal advice.

More fee-based advice – good for consumers?

Fee-based advice is intended to ensure that customers receive more-qualified advice. That is the hope of its advocates, since the fee is payable solely on the basis of the provision of advice. In their opinion, this is because, in contrast to commission-based sales, the adviser would then have no incentive to encourage the customer to enter into an insurance contract. When it comes to the legislative implementation of this plan, however, the following points should be taken into account to ensure that fee-based advice actually becomes an attractive alternative for consumers to advice on a commission basis.

Risk of cancellation transferred to the consumer

A fee-based adviser, as that activity is currently understood, is not exposed to the danger of cancellation, in contrast to a commission-based system. Under the existing contract terms and conditions, the customer must pay the fee without deductions – irrespective of whether any insurance policy is actually entered into or how long it lasts. The adviser's fee is payable even if the policy is cancelled prematurely. This is an unusual feature for many consumers; attention must therefore be clearly drawn to it. This should also apply to possible future consultations if advice entailing the payment of a fee again becomes necessary due to, for example, a change in life circumstances or a claim.

Double payment and costs for consumers



At least until fee-based advice for insurance is firmly established, there is likely to be another problem: upon concluding an insurance contract, the customer will also have to pay the commission factored into the insurance premium, in addition to the explicitly agreed fee. In future, it should be made possible to offset the two against each other. Otherwise, by implication the offering of net tariffs should be supported.

1.7 Life Insurance Reform Act

Life insurers provide long-term interest guarantees. Since they invest over a long horizon, life insurers still have sufficient investments earning a good rate of interest in their portfolios from the past, and thus generate sufficient investment income to

be able to satisfy the guarantees. In an environment of persistent low interest rates, however, it must be feared that they will no longer be able to generate the guaranteed rate of interest over the medium to long term unless countermeasures are taken.

Adapting to risks in the low interest rate environment

In the past, the statutory provisions applying to life insurers did not adequately reflect the risks associated with a low level of interest rates that persists for a long period of time. These risks only become evident in the insurers' balance sheets and solvency calculations after a lengthy delay. There was the risk of outflows of assets that are needed for the long term to meet guarantees for policyholders. Such outflows of assets could occur in particular in the form of generous distributions to shareholders, a high level of costs in the undertakings, or because discretionary bonuses were set favourably for a small group of departing policyholders but unfavourably for the majority of policyholders remaining, and were therefore inappropriate from an economic point of view.

The Act to Ensure Stable and Fair Benefit Payments for Life Insurance Policyholders, the Life Insurance Reform Act (*Lebensversicherungsreformgesetz – LVRG*)³⁵, protects policyholders by changing the statutory requirements imposed on life insurers to take into account the consequences of the low level of interest rates. The LVRG has created a solid and sustainable regulatory framework which is intended to secure the policyholders' contractually guaranteed claims over the long term. The statutory provisions were amended in a number of places in order to provide effective solutions to the problems identified. In particular, all parties involved – the insurers, the insureds and the intermediaries – were required to make an adequate contribution to the safeguarding of fair and stable benefit payments in the life insurance industry.

³⁵ Act dated 1 August 2014, Federal Law Gazette I, Part 38, p. 1330.

Dividend restriction for insurers

Due to the LVRG, section 56a of the Insurance Supervision Act now includes a restriction on dividend payments. Dividends may not be paid to shareholders of life insurance undertakings until the undertaking's ability to meet guaranteed commitments in a low-interest environment is funded. This means that, if there is no change in the low level of capital market interest rates, many life insurers will no longer be permitted to pay dividends until further notice. In addition, the rules for policyholders' participation in the valuation reserves were modified. Where valuation reserves funded by fixed-income securities are necessary to safeguard the return guaranteed to existing policyholders, they should not be paid out to policyholders whose policies mature.

For new policies entered into from 2015, the LVRG has reduced the maximum Zillmer rate from 40‰ to 25‰ of the total premiums. The consequence of this is a reduction in the amount of acquisition costs incurred at the start of the contract that can be credited in the insurer's balance sheet. A change of this nature creates incentives to cut acquisition costs. At the same time, the maximum technical interest rate for new contracts entered into from 2015 was reduced from 1.75 % to 1.25 %.

In addition, the LVRG also adjusted the minimum participation of policyholders in surpluses. In future, the participation of policyholders in risk surpluses will be at least 90 % instead of 75 % as previously. Thus, the position of policyholders has been strengthened.

1.8 Regulations

1.8.1 RfB Regulation

The partial collectivisation of the provision for premium refunds (*Rückstellung für Beitragsrückerstattung – RfB*) is a key component to ensuring inter-generational equity in life insurance. As has become evident in recent years, the segregation in 1994 of legacy and new policies has had a negative impact on this inter-generational equity.

Section 56b (2) of the VAG therefore allows life insurance undertakings to establish one or more collective portions within the provision for premium refunds. These are allocated to the insurance contracts entitled to participate in surpluses collectively and are not linked to specific policies. Furthermore, the Federal Ministry of Finance (*Bundesministerium der Finanzen*) is authorised to issue provisions regulating the structure of the collective portions of the RfB in greater detail for the purpose of protecting the interests of policyholders. The RfB Regulation (*RFB-Verordnung – RfBV*) was promulgated on 23 March 2014.³⁶

1.8.2 Investment Regulation and Pension Fund Investment Regulation

The Act Implementing the Alternative Investment Fund Managers Directive (*AIFM-Umsetzungsgesetz – AIFM-UmsG*) entered into force on 22 July 2013. It fundamentally reformed investment law. The Investment Act was replaced by the Investment Code (*Kapitalanlagegesetzbuch – KAGB*).

The Investment Regulation (*Anlageverordnung – AnIV*) and the Pension Fund Investment Regulation (*Pensionsfonds-Kapitalanlagenverordnung – PFKapAV*) must be amended to comply with the new legal framework under investment law. The opportunity is being used to improve options for long-term investments, e.g., in infrastructure. The German federal government's amendment regulation entered into force on 7 March 2015.³⁷

Guidance on the diversification requirements pursuant to section 4 of the Investment Regulation

In an interpretative decision dated 7 May 2014³⁸, BaFin issued guidance on the interpretation of the limit on investments with one and the same issuer (debtor) in the case of

the EU, the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF). The guidance provides additional detail on the diversification requirements pursuant to section 4 of the Investment Regulation.

Under the Investment Regulation, insurers can invest up to 30% of their restricted assets with an international organisation of which the Federal Republic of Germany is also a full member (section 4 (2) sentence 1 of the AnIV).³⁹ The higher limit is justified by the low counterparty default risk. The generally applicable diversification limit is no more than 5% (section 4 (1) sentence 1 of the AnIV).

In the opinion of BaFin, the EU and the ESM qualify as international organisations within the meaning of the Investment Regulation. BaFin also amended its administrative practice with respect to the EFSF, a corporation under private law, at the beginning of May 2014: the EFSF is now also classified as an international organisation within the meaning of insurance supervisory law. Accordingly, a higher diversification limit of 30% of restricted assets applies to the EU, ESM and EFSF.

1.9 BaFin circulars

1.9.1 Trustees to monitor the guarantee assets (Sicherungsvermögen)

Following a public consultation, BaFin published the Circular on trustees appointed to monitor the guarantee assets on 30 May 2014 (see also info box "Information event for trustees", page 165)⁴⁰ and revoked the predecessor Circular R 13/2005 (VA). This updated the old circular to reflect the current legal position.

³⁶ Federal Law Gazette I 2015, p. 300.

³⁷ Federal Law Gazette I 2015, p. 188.

³⁸ www.bafin.de/dok/5173200 (only available in German).

³⁹ In addition to international organisations of which the Federal Republic of Germany is a full member, the higher diversification limit of 30% of restricted assets also applies to the Federal Republic of Germany, its federal states, local authorities and local authority associations, as well as to other states belonging to the European Economic Area (EEA) or full member states of the Organisation for Economic Co-Operation and Development (OECD).

⁴⁰ Circular 4/2014 (VA), www.bafin.de/dok/6189456

BaFin took the opportunity both to bring the circular more into line with actual practice and to give it a clearer structure.

The new circular lays down the rules as to which insurance undertakings and *Pensionsfonds* must appoint a trustee in order to monitor the guarantee assets. It also contains guidance and basic principles relating to the appointment of these trustees as well as to their responsibilities and powers. It therefore provides additional detail to the statutory provisions of sections 70 to 76 of the Insurance Supervision Act.

Trustees of this kind monitor the guarantee assets, protect the policyholders' interests and operate to that extent as an extended arm of the insurance supervisory authority. The purpose of the guarantee assets is to ensure that insurance benefits and surrender values can be paid in full even in the event of insolvency.

A further new feature is that the deputy trustee is now more closely involved in the monitoring of the guarantee assets. In principle, the deputy trustee has the same rights and obligations as the trustee itself and must therefore be provided with the same facilities. As far as the performance and allocation of their responsibilities is concerned, however, the deputy is bound by the instructions of the trustee. In the event of a dispute between the trustee and the deputy, both have an equal voting right. In such cases, they are expected to request a decision on the matter from BaFin.

Explicit requirements for *Pensionsfonds* and guidance on the contractual relationship between trustees and insurance undertakings were also introduced in the new circular. For example, a clause should be added to the service contract to the effect that the trustee must be familiar with all relevant publications. Moreover, with respect to the supply of information, there is no longer simply an obligation to obtain information on the part of the trustee. There is now also an explicit obligation to provide information on the part of the insurance undertaking.

Information event for trustees

BaFin organised its first information event on the subject of trustees appointed to monitor the guarantee assets on 3 June 2014 in Bonn. The supervisory authority presented the new Circular 4/2014 (VA) to more than 300 participants and illustrated the basic principles already in force. BaFin's objective in arranging the event was also to raise awareness of the importance of the trustee's function.

The participants took a positive view of the exchange of information between the insurance supervisors and the trustees and are keen for it to continue. BaFin published a Guidance Notice for trustees on its homepage, which contains basic information and details of specific contact persons⁴¹. BaFin is planning another information event for trustees in 2015.

1.9.2 Guidance on the operation of ransom insurance

Insurance against product extortion and ransom demands has been permitted in Germany only since 1998. In 2014, BaFin revised the principles for the operation of such ransom insurance business drawn up by the former Federal Insurance Supervisory Office (*Bundesaufsichtsamt für das Versicherungswesen*) in a circular at that time.⁴² This provided, among other things, that the policyholder was not allowed to inform more than three persons about insurance cover of this nature. BaFin now permits exceptions in the commercial sector, to the extent that they are unavoidable. For example, the nature of the business activities may play a role in this respect, as in cases where a number of service providers are involved, such as charterers or crew agents. The setting up of an emergency task force could also be the decisive factor.

⁴¹ www.bafin.de/dok/5025634 (only available in German).

⁴² www.bafin.de/dok/2677920

BaFin had already amended its supervisory practice in 2008. Since then, it has also been permissible for the term of the insurance policies to exceed one year. One-year renewal clauses are allowed in place of sunset clauses, if the policyholder submits a renewal statement. However, if the renewal statement is not received by the proper time, the general terms and conditions of insurance must still provide that the insurance cover will then expire. These provisions enable the insurer to reassess the risk situation and the appropriateness of the sum insured at short intervals.

The circular has proved to be a success in practice. The fact that for a long time it was not permitted to carry on ransom insurance business in Germany was justified on the basis of the incompatibility of this business model with fundamental principles of German law. In 1998, this strict point of view was abandoned: since that time, insurance against product extortion and ransom demands has been permitted, provided that certain preconditions are met. The limitations are intended to reduce the risk of kidnapping for the purpose of extortion. But it is also a question of not hindering police investigation work and of preventing collusion between perpetrators,

victims or employees of the insurance undertaking. For that reason, the marketing of ransom insurance and product recall and protection insurance is not allowed in Germany and combining the insurance cover with other insurance policies is prohibited. In addition, insurers have to comply with high standards of data protection in this sensitive business activity. For example, they are required to use encryption techniques for communications with the policyholder. The policyholder is responsible in turn for keeping its insurance cover secret. The sum insured must be in keeping with the economic circumstances of the policyholder.

The principles set out in the circular are binding for all primary insurance undertakings authorised to offer direct insurance in Germany. It therefore applies to insurers domiciled in Germany, to branches in third countries pursuant to section 105 of the Insurance Supervision Act and to all insurers from other EU member states or EEA signatory states that are active in Germany either by exercising their freedom to offer services or through the establishment of a branch. Undertakings engaged solely in the provision of health, life or legal expenses insurance are exempt.

2 Preventive supervision

2.1 Risk classification

BaFin allocates the insurance undertakings it supervises to risk classes that it uses to define how closely the insurers are supervised. Insurers are allocated to classes using a two-dimensional matrix that reflects their market relevance and quality. The market relevance of life insurers, *Pensionskassen*, funeral expenses funds and *Pensionsfonds* is measured on the basis of their total investments. The relevant parameter for health insurers, property/casualty insurers and reinsurers is those undertakings' gross premium income. Market

relevance is measured on a three-tier scale of "high", "medium" and "low".

The quality of the insurers is rated based on an assessment of the following factors: net assets, financial position and results of operations; growth; and quality of management.

BaFin assesses the first two factors using insurance-specific indicators, while it assesses management quality using qualitative criteria. The rating system adds together the ratings of the individual factors to form an overall rating

on a four-tier scale from "A" (high quality) to "D" (low quality).

Table 18 ("Risk-classification results for 2014") shows the assessment based on the data as at 31 December 2014.

Number of good-quality insurers on a level with the previous year

In the course of the risk classification, BaFin rated 71.3% of the insurers as "A" or "B". This means that the proportion of insurance undertakings in the upper quality segment was on a level with the previous year. The proportion of undertakings with "B" and "C" ratings increased moderately year-on-year, while the proportion of undertakings with "D" ratings was unchanged. As in previous years, BaFin did not rate any insurers with high market relevance as having a low quality.

Results in the individual insurance classes

BaFin rated around 64% of the health insurers as "B". The proportion of undertakings with a "C" rating rose year on year. There were no health insurance undertakings rated "D" in the year under review.

Both the life insurers and the funeral expenses funds were classified in the medium quality rating. The proportion of life insurers with a "B" rating rose slightly by around 2 percentage points compared with the prior year. The proportion of funeral expenses funds with a "C" rating rose year on year.

The proportion of property/casualty insurers with a "B" rating also increased. As in previous years, the overall proportion of property/casualty insurers rated "A" or "B" was in excess of 80%.

The number of reinsurers with an "A" rating fell year on year. A large majority of around 76% of the assessments were in the upper quality rating.

There were no significant shifts for *Pensionskassen* and *Pensionsfonds*.

Number of insurers continues to decline

As in previous year, the number of undertakings classified in the year under review declined further, continuing the downward trend in the number of insurers observed in past years. There were no significant changes in the allocation of insurance undertakings to the three ratings for market relevance.

Classification of insurance groups

As well as classifying the risks associated with individual insurance undertakings, BaFin again additionally classified the largest insurance groups at group level in 2014. In contrast to a purely mathematical aggregation of the classification results of the individual undertakings, this quality assessment uses additional qualitative and quantitative group-specific inputs, such as profit and loss transfer and control agreements. The annual group-level risk classification reflects the growing importance of insurance group supervision. It

Table 18 Risk-classification results for 2014

Undertakings in %		Quality of the undertaking				Total
		A	B	C	D	
Market relevance	high	0.9	7.3	3.3	0.0	11.5
	medium	1.5	14.4	6.4	0.0	22.3
	low	8.5	38.7	17.1	1.9	66.2
	Total	10.9	60.4	26.8	1.9	100.0

Table 19 Breakdown of on-site inspections by risk class in 2014

On-site inspections		Quality of the undertaking				Total	Undertakings in %
		A	B	C	D		
Market relevance	high	1	26	13	0	40	47.1
	medium	0	12	5	0	17	20.0
	low	2	20	5	1	28	32.9
	Total	3	58	23	1	85	100.0
Undertakings in %		3.5	68.2	27.1	1.2	100.0	

provides BaFin with additional information and serves as a tool for assessing a group's overall position.

2.2 On-site inspections

On-site inspections are planned on the basis of a risk-based approach. As well as the results of the risk classification, one of the factors that BaFin takes into account is whether an insurer or *Pensionsfonds* was subject to an on-site inspection in the recent past. Ad hoc on-site inspections are also conducted. In the year under review, the insurance supervision directorate conducted a total of 85 on-site inspections. The higher number of on-site inspections compared with the previous year reflected both increases in internal model reviews and a higher number of regular inspections.

The risk matrix in Table 19 shows the breakdown of the inspections by risk class.

2.3 Areas of emphasis of inspections

Effective and efficient supervision in accordance with the principle of risk orientation requires areas of emphasis to be defined on a coordinated basis. Insurance supervision develops these areas of emphasis annually based on the overall objectives of the directorate, and incorporates them into a programme of supervision for the following year. Insurance supervision's short-term

supervision programme focusing on the following year is therefore closely interlinked with BaFin's medium-term strategies and the overall long-term objectives.

During the year under review, the insurance supervision directorate intensified its efforts to inspect those insurance undertakings that had not received an on-site inspection for a long time as a result of increased demands on BaFin's resources due to the implementation of Solvency II. BaFin will continue this process in 2015: after almost twice as many on-site inspections were carried out in 2014 as in the previous year, the projected number of inspections in 2015 is being increased by a further 10%. In addition to the economic position, the inspections will focus on the concept of risk-bearing capacity in accordance with section 64a of the Insurance Supervision Act and the BaFin Circular on the Minimum Requirements for Risk Management in Insurance Undertakings (*Mindestanforderungen an das Risikomanagement VA – MaRisk VA*)⁴³ as well as insurers' state of preparation for Solvency II.

2.4 Claims settlement practices



The media have repeatedly alleged that insurance undertakings have increasingly been delaying payments on a systematic basis

43 BaFin Circular 3/2009, www.bafin.de/dok/2675780

and even refusing to make any payment at all despite the fact that the claims of their policyholders are legitimate.

The Insurance Supervision Act explicitly defines the protection of policyholders' interests as one of the principal objectives of the supervision of insurance undertakings. Consumer protection is therefore a central concern for insurance supervision. As the competent authority, BaFin has therefore always subjected claims settlement and benefit processing by the insurers to scrutiny. Insurance supervision took up the accusations in the media and used them as an opportunity to focus on claims settlement and benefit processing practices of insurers in 2013 and 2014.

BaFin's evaluation of the complaints made by consumers provided no evidence of an increase in justified complaints since 2010 which would be material from a supervisory point of view or of a concentration of complaints relating to claims settlement.

Survey of undertakings

Nevertheless, BaFin subjected the insurers' settlement practices, both before the courts and out of court, to closer examination. For this purpose, it wrote to a number of large life insurers, health insurers and property and casualty insurers at the end of 2013/ start of 2014. BaFin analysed the relevant settlement practices for occupational disability insurance, comprehensive health insurance and accident insurance over the period from 2004 to 2013. The process involved reviewing both the quantitative and the qualitative aspects of the practices. The examination of settlement practices before the courts focused in particular on the proportion of cases where legal proceedings were brought and the percentages of cases settled, lost or won. In those cases that were decided out of court, BaFin concentrated its attention on noticeable variations in rejection rates and considered whether there was any link with the amount of the disputed claim in the particular case. It also determined the average periods of time for processing claims.

BaFin was also concerned with obtaining information on whether or which qualitative management techniques were used by insurers to optimise claims settlement – such as in connection with internal requirements or incentives for employees which might have an effect, for example, on their remuneration.

As a result of the investigation, BaFin was unable to establish indications of any systematic refusal or delay in paying benefits or of any abuses in the management of claim settlement practices by the insurers. The survey led to the following findings, among others:

- The rejection rates calculated by BaFin on the basis of the information provided by the undertakings did not appear sufficiently high to justify the conclusion that there was a systematic practice of non-payment.
- The figures quoted by the undertakings on the proportion of claims resulting in legal proceedings, and the percentages of cases settled and lost were in line with expectations. They were broadly consistent with the existing data published by the industry.
- The average time required to process a claim did not indicate that insurers were systematically delaying claims settlement.
- According to the information provided by the undertakings, measures to optimise the claims management process do not include any direct or indirect requirements or incentives aimed at achieving a high rejection rate.

More on-site inspections of claims processing

Over and above the survey of undertakings described, BaFin conducted a closer examination in 2014 of whether individual insurers are using abusive practices to manage their claims settlement or benefit processing. In 2014, therefore, it made claims settlement and benefit processing the central focus of the regular on-site inspections.

The findings obtained by BaFin to date from these on-site inspections also provide no confirmation of the accusations in the media cited above. The work processes observed, the

average processing time and the documentation examined in the on-site inspections gave rise to no indications that the relevant undertakings were endeavouring to delay or refuse payments systematically.

Nevertheless, BaFin will continue to investigate whether individual insurers are using abusive practices to manage their claims settlement procedures. To this end, it will also take a close look in future at claims settlement and benefit processing in on-site inspections on a regular basis. In cases where suspicions arise for a specific reason, such as in the case of complaints, it will investigate the accusations thoroughly. If it proves to be the case that individual undertakings are deliberately attempting to prevent or delay the settlement of a claim, BaFin will take appropriate countermeasures.

2.5 Stress tests

2.5.1 BaFin stress test

BaFin conducted a stress test for German insurers as at the 31 December 2013 balance sheet date. The stress test required the undertakings to calculate the following – rule-based – scenarios:

- bonds-only scenario: 10% decrease in the price of fixed-income securities
- equities-only scenario: 22% decrease in the price of shares
- bonds and equities scenario: 5% decrease in the price of fixed-income securities and simultaneous 15% decrease in the price of shares
- equities and property scenario: 15% decline in the price of shares and simultaneous 10% decline in the market value of property

The level of the EURO STOXX 50 share price index as at 31 December 2013 (3,109 points) formed the basis for the calculation of the equities scenarios.

BaFin revised the concept underlying the stress test as against the previous year:

from 2014, additional information relating to hidden reserves, the rating structure of the fixed-income investments and market values is recorded. Since the market values reflect the current value of individual investments, the greater focus on market value gives BaFin deeper insight into whether and to what extent insurance undertakings' exposures entail market risks.

Life and health insurers

A total of 88 life insurers were required to report the results of the stress test to BaFin. BaFin exempted two undertakings from the stress test due to the low-risk nature of their investments. All 88 participating life insurers reported positive results in the four stress test scenarios, without having applied undertaking-specific parameters.

BaFin also included 42 health insurers in the stress test and assessed the results. Six undertakings were not required to participate in the stress test due to the low-risk nature of their investments. All of the private health insurance undertakings would have had sufficient assets to cover their technical provisions and statutory capital requirements, even when faced with significant price losses or interest rate hikes.

Property and casualty insurers

BaFin asked 181 in total of the 215 property and casualty insurers supervised by it to submit the results of the stress tests they had carried out. 34 undertakings were exempted from this requirement. 174 property and casualty insurers reported positive results in all four scenarios; seven undertakings failed the stress test in one or more scenarios.

The reason for this in six cases was the greater extrapolation of the target values for the dynamic variables required by the stress test model, combined with special factors at the undertaking concerned. This related to changes in net premium income or net claims provisions, as well as the change to solvency requirements, for example. In one case, the results were negative because of a shortfall in the

undertaking's minimum guarantee fund. BaFin initiated supervisory measures in this instance and discussed them with the undertaking concerned.

Pensionskassen

BaFin exempted 18 of the 146 *Pensionskassen* it supervised at the beginning of 2014 from their obligation to submit stress tests because of the low-risk nature of their investments. Three undertakings submitted their results nonetheless. In 120 of the 131 cases, the results were positive in all four scenarios. The eleven *Pensionskassen* with negative results generally reported minor shortfalls. BaFin is in close contact with these *Pensionskassen* to ensure that they improve their risk-bearing capacity.

Outlook

Stress tests will continue to apply under Solvency II from 2016 onward. Firstly, EIOPA will carry out stress tests on a regular basis. Secondly, insurance undertakings falling under the new supervisory regime will have to conduct internal stress tests and report the results in detail to the public as well as to the supervisory authorities.

2.5.2 EIOPA stress test 2014

The European Insurance and Occupational Pensions Authority (EIOPA) has also conducted regular EU-wide stress tests for insurers since 2009 to test the resilience of the European insurance sector. In contrast to BaFin's stress test, the European stress test is performed on the basis of Solvency II and in some cases also at group level. It takes both assets and liabilities into account and only selected insurers are required to participate.

The EIOPA test is a macro stress test and so the analysis and publication of the results are restricted to aggregates and therefore in particular to comparisons between specific countries and insurance classes across the EU. Individual results are not published. In 2014, EIOPA used the stress test – the "double

whammy" – to investigate in particular capital market risks in the context of a persistent low interest-rate environment.

From the point of view of German insurance supervision, the results of the EIOPA stress test confirmed the fact that a persistent low-interest phase is likely to remain a major challenge for the German insurance sector.

EIOPA recommends that national supervisory authorities continue to evaluate the significance of the results for the relevant markets, especially with respect to preparations for Solvency II. For this purpose, BaFin will make use of the extensive measures already determined in the guidelines for preparation for Solvency II, for example the forward-looking assessment of own risks (FLAOR).

2.6 Money laundering prevention

2.6.1 Focus audit on secondary market buyers of policies

In the past year, BaFin investigated eight insurance undertakings in relation to the prevention of money laundering and the financing of terrorism. On the basis of a large number of reports of suspicious activity and its own experience, BaFin paid particularly close attention in 2014 to insurance policies sold by policyholders to buyers in the secondary market. In recent years, the secondary market has seen an increasing number of dubious participants offering to buy policies in addition to genuine buyers. The former frequently have non-transparent shareholding arrangements or use lawyers as intermediaries. As a result, it is difficult to identify the persons operating behind the firms. The objective in such cases is evidently to obscure the owner of the beneficial interest behind the transactions. The amounts paid to the sellers also bear no economic relation in some cases to the potential future return from the insurance policies. This suggests that the true intentions behind these transactions are even more questionable.

2.6.2 Investigation of origin of funds for life insurance policies

The audits conducted in 2014 repeatedly showed that in some cases life insurers do not make adequate inquiries into the economic background of the premium payers. This applies particularly

in the case of high one-off or monthly premiums. BaFin's auditors made the insurers aware of the importance of paying closer attention to whether the premium payments could originate from critical sources, for example in the case of noticeably high monthly premiums.

3 Supervision of undertakings

3.1 Authorised insurance undertakings and *Pensionsfonds*

The number of insurance undertakings supervised by BaFin declined slightly. At the end of the year under review, BaFin supervised a total of 573 insurance undertakings (previous year: 584) and 31 *Pensionsfonds*. Out of the total number of insurance undertakings, 548 were engaged in business activities and 25 were not. In order to give as full a picture as possible of the insurance market in Germany, all of the information in the rest of this chapter also includes ten public-law insurance

undertakings supervised by the federal states – nine conducting business activities and one without business activities. The breakdown by insurance segment is shown in Table 20 (“Number of supervised insurance undertakings and *Pensionsfonds*”).

Life insurers

Three German life insurers supervised by BaFin ceased operating in 2014. Two life insurance undertakings from Slovakia and Luxembourg established branch offices in Germany. Two branches of undertakings from the United

Table 20 Number of supervised insurance undertakings and *Pensionsfonds**

As at 31 December 2014

	Insurers with business activities			Insurers without business activities		
	BaFin supervision	federal states supervision	Total	BaFin supervision	federal states supervision	Total
Life insurers	87	3	90	9	0	9
<i>Pensionskassen</i>	142	0	142	3	0	3
Funeral expenses funds	36	0	36	1	0	1
Health insurers	47	0	47	0	0	0
Property/casualty insurers**	206	6	212	8	1	9
Reinsurers	30	0	30	4	0	4
Total	548	9	557	25	1	26
<i>Pensionsfonds</i>	31	0	31	0	0	0

* These figures do not include the relatively small mutual insurance associations whose activities are mostly regionally based and that are supervised by the federal states (BaFin 2013 statistics – Primary insurers and *Pensionsfonds*, p. 9, table 5, only available in German).

** One property/casualty insurer primarily offers Non-SLT health insurance (health insurance operated on a similar technical basis to that of non-life insurance) and is included in the stress test and projection for health insurers in chapters IV 2.5 and IV 3.3.3.2.

Table 21 Registrations by EEA life insurers in 2014

As at 31 December 2014

Country	CBS*	BO**
Austria	1	
Bulgaria	1	
France	2	
Luxembourg	2	1
Malta	1	
Slovakia	0	1
Spain	1	
United Kingdom	3	

* Cross-border provision of services within the meaning of section 110a (2a) of the VAG.

** Branch office business within the meaning of section 110a (2) of the VAG.

Kingdom and Ireland ceased operating. Eleven insurers from the EEA registered for the cross-border provision of services in Germany (see Table 21 "Registrations by EEA life insurers in 2014").

Health insurers

One German life insurer supervised by BaFin ceased operating in 2014.

Property and casualty insurers

Two property/ casualty insurance undertakings terminated their activities. Four undertakings established a branch office in Germany. One branch of an undertaking from the United Kingdom ceased operating. 21 insurers from the EEA registered for the cross-border provision of services in Germany. Other insurers that had already registered for the cross-border provision of services in Germany reported an expansion in their business activity.

Reinsurers

The number of active reinsurers increased to 29 in the year under review. In addition, six branches of undertakings from the EEA (Ireland, Spain, Luxembourg and three from France) and one third-country branch (USA) were operating in Germany. Four reinsurers were not taking on new business.

Pensionskassen, Pensionsfonds and funeral expenses funds

Three *Pensionskassen* ceased operating. One new *Pensionsfonds* fund was established and one ceased operations.

3.2 Economic environment

In its eighth year, the financial crisis continued to generate enormous challenges for the insurance sector. However, the insurance sector in Germany again proved robust in this difficult environment. Steady demand for insurance cover led to stable growth in premium income at primary insurers and *Pensionsfonds*. Following €193.7 billion in 2013, these undertakings posted 2.5% growth to €198.7 billion in 2014.

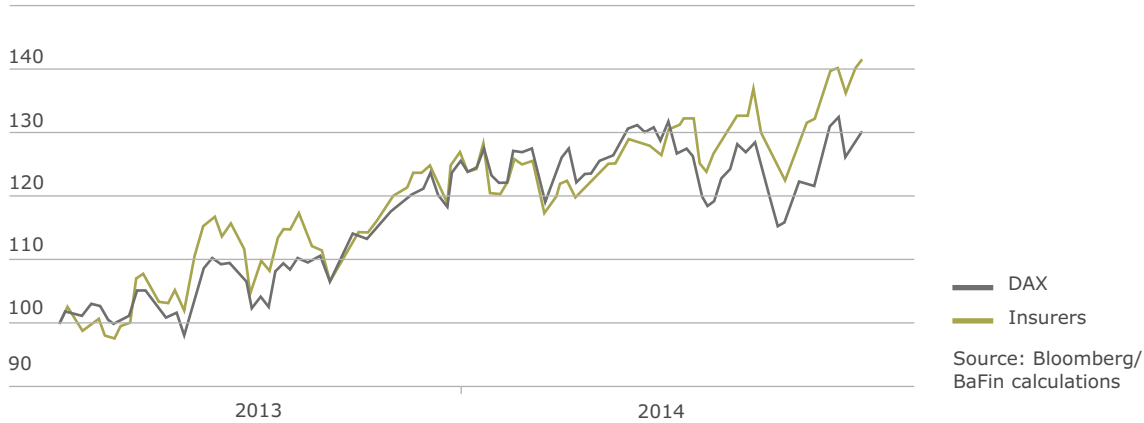
The low level of interest rates continues to pose problems for the German insurance sector. For example, it is becoming significantly more difficult to generate the high guarantee payments declared in the past. In 2014, the yield on the 10-year Bund fell steadily. At the beginning of the year, it still amounted to 1.93%, but by the close of the year it had fallen to a new record low of 0.54%. The reason for this is firstly that investors are continuing to look for security. Secondly, the European Central Bank (ECB) further loosened its monetary policy, among other things by purchases of *Pfandbriefe* and asset-backed securities. It also announced its intention of achieving significant balance-sheet growth by means of a wide-ranging securities purchase programme.

Insurance shares

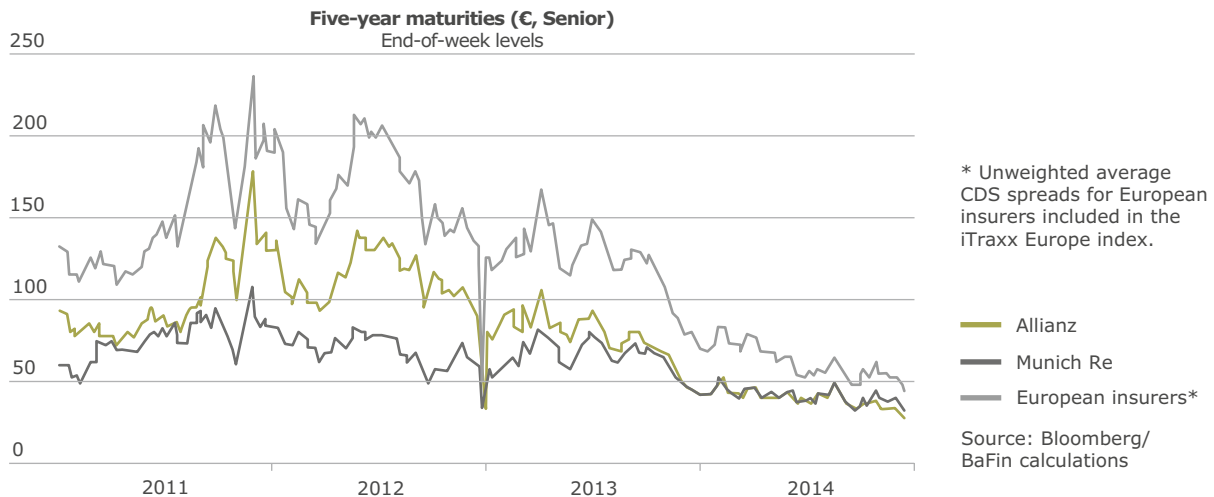
The policies pursued by the central banks, revised business models and attractive dividend yields resulted in the share prices of German insurers once again outperforming the market as a whole in 2014, as the German DAX index shows (see Figure 12 "Sector index for German insurance shares", page 174). In the second half of 2014 in particular, the insurance sector index recorded a more positive performance than the DAX. In comparison with 2013, the insurance index rose by 11.5% while the market as a whole achieved an increase of only 3.5%. The insurers performed far better than the banks, which

Figure 12 Sector index for German insurance shares**DAX and insurance index**

End-of-week levels, End of 2012 = 100

**Figure 13** CDS spreads for selected insurers

Basis points



lost more than 16% of their value in 2014. The insurers actually achieved combined total price growth for 2013 and 2014 of almost 41.7% (DAX: 30.3%; banks: -6.8%) compared with 2012.

Further contraction in credit default swap spreads

CDS spreads for European insurers continued to narrow steadily in 2014. They once again became cheaper on average by 28%. This was attributable, among other things, to the continuing accommodative monetary policy of the central banks, stable economic data and revised business models. The CDS spreads for the two major German insurers, Allianz and

Munich Re, were again below the average for other comparable European insurers throughout the entire year (see Figure 13 "CDS spreads for selected insurers"). While Allianz's CDS spread fell by 27%, Munich Re's spread narrowed by 13%. In the final analysis at the end of 2014, the CDS spreads were almost identical at 32 basis points for Allianz and 37 basis points for Munich Re.

Rating agencies assessed the outlook for German life insurers in 2014 as stable to negative, in particular as a result of the persistent low level of interest rates. This is expected to reduce the capital buffers further, but not to jeopardise the guarantee

Table 22 Registrations by EEA property and casualty insurers in 2014

As at 31 December 2014

Country	CBS*	BO**
Bulgaria	0	1
Croatia	1	
Czech Republic	3	1
France	4	
Hungary	1	
Ireland	3	
Luxembourg	1	
Malta	2	
Netherlands	2	
Romania	2	1
Spain	0	1
Hungary	1	
United Kingdom	1	
of which: Gibraltar	1	

* Cross-border provision of services within the meaning of section 110a (2a) of the VAG.

** Branch office business within the meaning of section 110a (2) of the VAG.

payments promised in the short to medium term. The German Life Insurance Reform Act (*Lebensversicherungsreformgesetz – LVRG*), which was approved in 2014, is expected to have a beneficial long-term effect on the insurers, as is the *Zinszusatzreserve* (an additional provision to the premium reserve introduced in response to the lower interest rate environment) required to be established since 2011. In the short term, however, it is likely to have a negative impact on earnings. The rating agencies took a positive view of the trend in favour of shifting the product mix towards products such as unit-linked life insurance that are not sensitive to interest rate movements. The rating agencies assessed the outlook for German property insurers in 2014 as stable.

Moderate loss levels

For the third year in succession, worldwide losses from natural disasters in 2014 were below the long-term average and were therefore moderate. Loss levels in 2014

amounted to US\$110 billion while insured losses were US\$31 billion. The loss levels were 12% lower than in the previous year and 42% below the ten-year average. Insured losses remained at the same level as in the prior year. They were 47% below the ten-year average. The largest individual economic loss amounting to a total of US\$5.9 billion or insured losses of US\$3.1 billion was caused by the snow storms in Japan. Improvements in the precautionary measures taken against natural disasters were reflected in a comparatively low figure of 7,700 deaths due to natural disasters being recorded in 2014 (second-lowest figure since 1980).

3.3 Position of the insurance sector

The principal factors affecting the overall situation of the insurance industry in 2014 were the persistence of the low interest rate environment and the changes to capital requirements resulting from the introduction of Solvency II. BaFin's insurance supervision directorate achieved deeper insight into the effects on individual undertakings using various tools such as the EIOPA stress test, the "*Vollerhebung Leben*" survey and projections for several years ahead. Following the introduction of the *Zinszusatzreserve* in 2011, the German Life Insurance Reform Act (*Lebensversicherungsreformgesetz – LVRG*), which was approved in 2014, incorporated further necessary measures for the life insurance sector in order to ensure that contractual guarantees can be fulfilled over the long term for the benefit of policyholders.

3.3.1 Investments by insurers – overview⁴⁴

As at 31 December 2014, the carrying amount of the aggregate investments by German insurers supervised by BaFin amounted to €1,591.2 billion (previous year: €1,522.7 billion). Broken down by insurance classes, health insurers (+6.6%) and *Pensionskassen* (+6.0%) recorded the largest percentage increases. Aggregate investments by all primary insurers supervised

⁴⁴ See chapter IV 3.3.3 for details on investments by individual insurance classes and pension funds.

by BaFin increased by 4.2% in 2014 to €1,352.4 billion (+€54.2 billion). Aggregate investments by reinsurers increased by 5.0% in 2014 to €238.8 billion (+€11.3 billion).

As in previous years, investments continued to focus on fixed-income securities and promissory note loans. There were minor shifts in fixed-rate investments. The share of directly held listed debt instruments rose by 12.0% to €245.9 billion in the year under review, while the share of investments at credit institutions again declined, not least due to the persisting very low interest rate environment.

Indirect investments held by insurance undertakings via investment funds recorded above-average growth in 2014, rising by +10.8%, and – as in the previous year – now account for over a quarter of all investments or €446.9 billion (see Table 23, “Investments by insurance undertakings”, page 177). The assets acquired via investment funds relate predominantly to listed securities.

Aggregate direct investments in property rose by 5.2% year on year to €34.7 billion.

3.3.2 Composition of the risk asset ratio

Primary insurers report the aggregate amount and composition of their investments to BaFin each quarter. The evaluations in table 25 are based on the data for life, health and property/casualty insurers, as well as for *Pensionskassen*. The carrying amount of all investments contained in the restricted assets belonging to these classes amounted to €1,308.7 billion as at 31 December 2014 (previous year: €1,252.1 billion).

In accordance with section 3 (3) sentence 1 of the AnIV, insurance undertakings can invest up to 35% of their restricted assets in investments associated with a higher level of risk. Specifically, these risk investments include directly or indirectly held investments in equities, profit participation rights and subordinated debt assets, as well as hedge funds and investments linked to commodity

risks. In addition to high-yield bonds and investments in default status, the risk asset ratio also includes certain units in funds that are risky or cannot be clearly assigned to other investment types.

The risk asset ratio for primary insurers at the end of 2014 was 11.8% of their restricted assets, slightly higher in comparison with the previous year (11.3%). Insurance undertakings again fell well below the risk asset cap of 35% of the restricted assets stipulated in the AnIV. The risk asset ratio varies from class to class, ranging from 9.4% for health insurers to 15.7% for property/casualty insurers.

The largest individual item within risk assets was investments in equities (mostly listed) held through funds, which accounted for 3.9% of restricted assets (previous year: 3.5%). The trend seen in previous years of primarily acquiring shares via funds continued.

There were minor changes in alternative investments compared with the figures for the previous year: directly and indirectly held asset-backed securities and credit-linked notes as well as investments in hedge funds and commodities fell slightly.

3.3.3 Results in the individual insurance classes

The following figures for 2014 are only preliminary. They are based on the interim reporting as at 31 December 2014.

3.3.3.1 Life insurers

Business trends

New direct life insurance business rose by 3.4% year on year, from 5.2 million to 5.4 million new policies in 2014. The total value of new policies underwritten rose accordingly by 4.4% to €250.6 billion compared with €239.8 billion in the previous year.

The share of the total number of new policies accounted for by term insurance policies

Table 23 Investments by insurance undertakings

Investments by insurance undertakings	Portfolio as at 31 December 2014		Portfolio as at 31 December 2013		Change in 2014	
	in € m	in %	in € m	in %	in € m	in %
Land, land rights and shares in real estate companies, REITs and closed-end real estate funds	34,659	2.2	32,939	2.2	1,720	5.2
Fund units, shares in investment stock corporations and investment companies	446,857	28.1	403,292	26.4	43,565	10.8
Loans secured by mortgages and other land charges and shareholder loans to real estate companies	55,513	3.5	56,188	3.7	-675	-1.2
Securities loans and loans secured by debt securities	519	0.0	551	0.0	-32	-5.8
Loans to EEA/OECD states, their regional governments and local authorities, and international organisations	127,251	8.0	123,288	8.1	3,963	3.2
Corporate loans	16,391	1.0	15,044	1.0	1,347	9.0
ABSs/CLNs	7,610	0.5	5,984	0.4	1,626	27.2
Policy loans	3,794	0.2	4,174	0.3	-380	-9.1
<i>Pfandbriefe</i> , municipal bonds and other debt instruments issued by credit institutions	236,930	14.9	247,031	17.4	-10,101	-4.1
Listed debt instruments	245,867	15.5	219,520	14.4	26,347	12.0
Other debt instruments	23,449	1.5	20,516	1.3	2,933	14.3
Subordinated debt assets/profit participation rights	29,697	1.9	27,718	1.8	1,979	7.1
Book-entry securities and open market instruments	627	0.0	1,027	0.1	-400	-38.9
Listed equities	6,778	0.4	7,603	0.5	-825	-10.9
Unlisted equities and interests in companies, excluding private equity holdings	129,941	8.2	129,392	8.5	549	0.4
Private equity holdings	12,902	0.8	11,585	0.8	1,317	11.4
Investments at credit institutions	180,647	11.4	187,736	12.3	-7,089	-3.8
Investments covered by the enabling clause	19,072	1.2	19,102	1.3	-30	-0.2
Other investments	12,708	0.8	13,008	0.9	-300	-2.3
Total investments	1,591,215	100.0	1,525,699	100.0	65,516	4.3
Life insurers	822,743	51.7	796,072	52.2	26,671	3.4
<i>Pensionskassen</i>	138,994	8.7	131,089	8.6	7,905	6.0
Funeral expenses funds	2,050	0.1	2,007	0.1	44	2.2
Health insurers	233,181	14.7	218,820	14.3	14,360	6.6
Property/casualty insurers	155,439	9.8	150,233	9.8	5,207	3.5
Reinsurers	238,808	15.0	227,479	14.9	11,330	5.0
All insurers	1,591,215	100.0	1,525,699	100.0	65,516	4.3
Primary insurers	1,352,407	85.0	1,298,220	85.1	54,187	4.2

The figures are based on the insurance undertakings' quarterly reports and are only preliminary.

Table 24 Composition of the risk asset ratio

As at 31 December 2014

Investment type pursuant to section 2 (1) no. ... of the AnIV	Restricted assets									
	Life insurers		Health insurers		Property/casualty insurers		<i>Pensionskassen</i>		Total of 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*	803,121	100.0	230,492	100.0	137,029	100.0	138,033	100.0	1,308,675	100.0
of which attributable to:										
Securities loans (no. 2), where equities (no. 12) are the subject of the loan	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
Subordinated debt assets and profit participation rights (no. 9)	14,146	1.8	3,690	1.6	2,114	1.5	2,175	1.6	22,125	1.7
Listed equities (no. 12)	1,090	0.1	156	0.1	478	0.3	24	0.0	1,748	0.1
Unlisted equities and interests in companies (no. 13)	14,643	1.8	4,023	1.7	3,726	2.7	1107	0.8	23,499	1.8
Fund units (nos. 15-17, incl. hedge funds) that										
– include equities, profit participation rights, etc.	27,476	3.4	5,842	2.5	9,119	6.7	8,258	6.0	50,695	3.9
– cannot be clearly assigned to other investment types; fund residual value and non-transparent funds	13,350	1.7	2,622	1.1	2,430	1.8	1,912	1.4	20,314	1.6
High-yield bonds and investments in default status	11,737	1.5	4,611	2.0	2,207	1.6	2,852	2.1	21,407	1.6
Increased fund market risk potential **	10,170	1.3	432	0.2	1323	1.0	1478	1.1	13,403	1.0
Investments linked to hedge funds (partly already contained in other nos. of the AnIV)	526	0.1	190	0.1	97	0.1	493	0.4	1,306	0.1
Investments linked to commodities risks (partly already contained in other nos. of the AnIV)	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
Total investments subject to the 35% risk asset ratio	93,138	11.6	21,566	9.4	21,494	15.7	18,299	13.3	154,497	11.8

The figures are based on the insurance undertakings' quarterly reports and are only preliminary.

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

** This refers to the market risk potential exceeding 100% that must be included in the calculation of the risk asset ratio under section 3 (3) sentence 1 of the AnIV.

Source: Sector totals as at 31 December 2014 for life, health and property/casualty insurers, as well as *Pensionskassen*, from financial statement forms 670 and 673, collective decree dated 21 June 2011.

Table 25 Share of total investments attributable to selected asset classes

As at 31 December 2014

Investment type	Total assets									
	Life insurers		Health insurers		Property/casualty insurers		<i>Pensionskassen</i>		Total of 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*	822,743	100.0	233,181	100.0	155,439	100.0	138,994	100.0	1,350,357	100.0
of which attributable to:										
Investments in private equity holdings	7,811	0.9	1,282	0.5	2,266	1.5	750	0.5	12,109	0.9
Directly held asset-backed securities and credit-linked notes	2,625	0.3	700	0.3	864	0.6	332	0.2	4,521	0.3
Asset-backed securities and credit-linked notes held via funds	3,691	0.4	907	0.4	1,150	0.7	1,081	0.8	6,829	0.5
Investments in hedge funds and investments linked to hedge funds (held directly and via funds)	1,592	0.2	500	0.2	337	0.2	649	0.5	3,078	0.2
Investments with commodity risks (held directly and via funds)	914	0.1	276	0.1	235	0.2	35	0.0	1,460	0.1

The figures are based on the insurance undertakings' quarterly reports and are only preliminary.

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

Source: Sector totals as at 31 December 2014 for life, health and property/casualty insurers, as well as *Pensionskassen*, from financial statement forms 670 and 673, collective decree dated 21 June 2011.

increased by 0.6 percentage points year on year to 32.6%. The share accounted for by endowment insurance policies declined by 0.5 percentage points in the same period, to 10.8%. This represents a decline from 594,262 policies to 585,384. While the share attributable to pension and other insurance contracts recorded a slight decrease, falling by 0.1 percentage points to 56.6%, in absolute terms this represented an increase from 2,973,686 policies in the previous year to 3,074,497.

Early terminations of life insurance policies (surrender, conversion to paid-up policies and other forms of early termination) declined slightly from 2.8 million contracts in 2013 to 2.6 million contracts in the year under review. The total sum insured under contracts terminated early also fell

to €104.2 billion (previous year: €111.3 billion). The proportion of early terminations of endowment policies declined from 26.0% in the previous year to 24.7%, and the proportion of the total sum insured decreased from 15.4% to 15.1%.

There were a total of 87.8 million direct insurance contracts in 2014, representing a 1.1% increase compared with the previous year. The sum insured also rose to €2,871 billion (+2.8%). Term insurance policies recorded an increase both in the number of contracts – from 12.6 million to 14.1 million – and in the sum insured, which rose from €668.7 billion to €714.0 billion. Pension and other insurance policies continued their positive trend, with the proportionate number of contracts growing from 48.1% to 49.1%. The share of the total sum insured rose from 51.1% to 52.2%.

Gross premiums written in the direct insurance business of the life insurers supervised by BaFin amounted to €88.6 billion in the year under review (previous year: €86.2 billion). This represents a 2.7% increase as against the previous year.

Investments

Aggregate investments increased from €793 billion to €820 billion (+3.3%). Since interest rates on the capital market fell significantly, net hidden reserves at the end of the year increased to €163.8 billion (previous year: €72.0 billion). This corresponds to 19.9% of the aggregate investments, following 9.1% in the previous year.

Preliminary figures put the average net investment return at 4.60% in 2014, on level with the prior-year figure of 4.6%. The reason for the high net return is that the insurers have increasingly liquidated valuation reserves in order to fund the high cost of establishing the *Zinszusatzreserve*.

Projections

BaFin surveyed the life insurers using one projection as at 30 September 2014 in the year under review. BaFin uses projections to analyse how four different capital market scenarios it stipulates affect the insurers' performance for the current financial year.

The insurers had to simulate in each case the impact of a 24% drop in equity prices and a 50 basis point rise in interest rates on their current profit for the year.

The insurers were also required to run the projections for the four subsequent financial years.

In a period of continuing low interest rates, it is to be expected that the economic position of the undertakings will deteriorate further. BaFin will also continue to pay close attention to ensuring that the insurers analyse their future financial development at an early stage and in a forward-looking and critical manner in a persistently low interest rate phase. It is essential that the life insurers introduce appropriate measures in

time and make the relevant preparations. Many insurers will therefore have to ask themselves in the coming years whether further reducing discretionary bonuses is not only necessary, but in fact inevitable.

In addition to the BaFin stress test, the projections represent another risk-based supervisory tool that allows BaFin to assess changes in the life insurers' business performance, solvency and valuation reserves.

Solvency

All life insurers comply with the solvency requirements according to the projection as at 31 December 2014. The downward trend of the past years continued, however. Whereas the solvency coverage ratio was still 162% in the previous year, it declined slightly in 2014 to a projected figure of 160%.

Life insurers reduce discretionary bonuses

Because interest rates for new investments are still very low, many life insurers have further reduced their discretionary bonuses for 2015. The current total return, i.e. the sum of the guaranteed technical interest rate and the interest surplus, for the tariffs available in the market for endowment insurance contracts is an average of 3.06% for the sector. This figure was 3.31% in 2014 and 3.51% in 2013.

Zinszusatzreserve

Since 2011, life insurers have been required to establish a *Zinszusatzreserve* to provide for the lower investment income in the future and the guarantee obligations, which remain high. They spent a good €8.5 billion on this in 2014 alone. In the year under review, policies with a guaranteed return of 3.25% were also included in the *Zinszusatzreserve* for the first time because the reference interest rate fell to 3.15%.

The cumulative *Zinszusatzreserve* therefore stood at an absolute amount of €21.2 billion at the end of 2014. Establishing the *Zinszusatzreserve* is a heavy burden on the sector, but it is the right tool for securing policyholders' guarantees for the long term in low interest rate periods.

Decisions of the Federal Court of Justice on the policy model

The Federal Court of Justice (*Bundesgerichtshof* – BGH) dealt with the “policy model” pursuant to section 5a of the Insurance Contract Act (*Versicherungsvertragsgesetz* – VVG, old version) in two cases in 2014.

Functioning of the policy model

Under this model, it sufficed if the insurance undertaking supplied the relevant terms and conditions of insurance and consumer information only when the insurance policy document was sent. The policyholder had a right to object for 14 days. The contract became effective on the basis of the documents sent only after that period had expired. The date on which the period for making an objection began was determined in accordance with section 5a (2) sentence 1 of the VVG (old version). The period for making an objection did not begin, therefore, until the date on which the policyholder received the necessary documentation together with written details of the arrangements relating to the right to object. Under section 5a (2) sentence 4 of the VVG (old version), however, the right to object expired automatically one year after the payment of the first premium, irrespective of the receipt of the documents referred to.

BGH ruling on the policy model

The BGH decided in a judgement dated 7 May 2014⁴⁵, that section 5a (2) sentence 4 of the VVG (old version) did not apply to life insurance because it was not compatible with European law. The ruling had been preceded by a request from the BGH to the Court of Justice of the European Union (CJEU) for a preliminary decision dated 28 March 2012. The BGH had enquired whether the correct interpretation of the life-insurance directives meant that they were in conflict with a provision such as that contained in section 5a (2) sentence 4 of the VVG (old version). The latter states that the right of withdrawal or objection expires at the latest one year after payment of the first insurance premium, and does so even if the policyholder was not informed about the

right to withdraw or object. In its ruling dated 9 December 2013, the CJEU answered the BGH’s enquiry in the affirmative. The BGH now had to decide what the implications of the Luxembourg judgement were.

Case 1 – proper information about right of objection not provided

In its judgement dated 7 May 2014, the BGH declared that in certain circumstances a policyholder can in principle still file an objection against the contract – even after the one-year period has expired – if they entered into a life insurance contract in accordance with the policy model between mid-1994 and the end of 2007, and were not properly informed about the right of objection and/or did not receive the general terms and conditions of insurance or the consumer information. If the policyholder makes use of this right of objection, they can assert a claim for repayment of the premiums paid in respect of the contract on the grounds of unjust enrichment. However, the policyholder must deduct the insurance cover obtained as an economic benefit.

Case 2 – proper information about right of objection provided

In the second case on which the BGH gave a ruling, the facts of the matter were rather different. In contrast to the first case, this time the policyholder had received the general terms and conditions of insurance and the consumer information when the insurance policy document was sent, and had been properly informed of the right of objection in accordance with section 5 of the VVG (old version). The policyholder did not give notice of objection to the contract within the correct period of 14 days after the provision of the documentation pursuant to section 5a (1) sentence 1 of the VVG (old version). In its judgement dated 16 July 2014⁴⁶, the BGH declared that in this case the policyholder had no right to repayment of the premiums on the grounds of unjust enrichment. The life insurance contract entered into by the parties was not invalid as a result of the fact that section 5a of the VVG (old version) was in conflict with

⁴⁵ BGH judgement dated 7 May 2014 (case ref. IV ZR 76/11).

⁴⁶ BGH judgement dated 16 July 2014 (case ref. IV ZR 73/13).

Community law. In the view of the BGH, there was no need to obtain a preliminary decision from the CJEU. Even where there is a presumption that the policy model is in violation of Community law, a policyholder is barred in good faith from relying on the invalidity of the contract and basing claims for unjust enrichment on it after the contract has been in force for several years because that would constitute a contradictory exercise of a right. A policyholder would not be acting in good faith if, having been properly informed of their right to prevent the contract becoming effective without detriment, they nonetheless allowed the contract to run for several years and only then invoked the invalidity of the contract in order to demand repayment of all premiums.

3.3.3.2 Private health insurers

Business trends

The 47 private health insurers supervised by BaFin generated premium income of around €36.2 billion in 2014. This represents a year-on-year increase of approximately 0.7%. The growth in premiums was therefore lower than in the previous year for the fourth time in succession. The main reason for the smaller rise in premiums is that the level of new business in comprehensive health insurance was more moderate overall. An explanation for this is the fact that since 2012 the sector has largely ceased to promote starter tariffs. These tariffs were subject to increasing public criticism in the past.

Nevertheless, comprehensive health insurance, with around 8.9 million persons insured and premium income of €25.9 billion, continued to be the most important business line for the private health insurers in 2014. It accounts, namely, for around 72% of all premium income. Together with the other types of insurance, such as compulsory long-term care insurance, daily benefits insurance and the other partial insurance types, the private health insurance undertakings insure more than 39 million people.

Investments

The health insurers increased their investment portfolio by 6.6% to approximately €232

billion in the year under review. Investments remain focused on fixed-income securities. *Pfandbriefe*, municipal bonds and other debt instruments accounted for approximately 20% of all investments. These were also the largest single item in the portfolio of direct investments. Listed debt instruments accounted for a further 15%, while promissory note loans and registered bonds issued by credit institutions accounted for 19%. The health insurers invested around 23% of their portfolio in investment funds. BaFin did not identify any significant shifts between the asset classes.

The main macroeconomic factor affecting private health insurers is currently the low interest rate environment, reflecting measures taken by the European Central Bank (ECB), and the simultaneous bull market in equities. Both the *Deutsche Aktienindex* (DAX), the leading German index, and the EURO STOXX 50, the European equity index, were in positive territory at the close of 2014. Interest rates fell significantly during the year under review, starting from a level in the previous year that was already low. The health insurers' reserve situation therefore remains comfortable, especially in light of high valuation reserves in fixed-income securities. The net hidden reserves contained in the investments amounted to almost €47 billion as at 31 December 2014. They therefore rose substantially in comparison with the prior year as a result of the fall in interest rates.

Preliminary figures put the average net investment return at around 3.8% in the year under review, and therefore below the previous year's level (4.0%).

Projections

The health insurers also prepared projections that were submitted to BaFin during the year under review. The objective of the exercise was to simulate the effects of unfavourable developments on the capital market on their performance and financial stability. Projections also represent a further risk-based and forward-looking supervisory tool – in addition to the BaFin stress test – in this area.

The projection as at the 30 September 2014 reference date focussed on examining the medium-term impact of the low interest rates on the health insurers. For this purpose, BaFin collected data on the developments forecast for the 2014 financial year and the following four years in different adverse capital market scenarios. In one scenario, it assumed that new investments and reinvestments were made exclusively in ten-year *Pfandbriefe* with an interest rate of 1.3%. In a second scenario, the health insurers could simulate new investments and reinvestments according to their individual corporate planning.

Forty insurers participated in the projection as at 30 September 2014. BaFin exempted just eight insurers that offer Non-SLT health insurance from participating. The undertakings involved do not have to establish a provision for increasing age and do not have to generate a specific technical interest rate.

The overall conclusion is that a continuation of the low interest rate environment would be tolerable for the health insurers from an economic perspective. As expected, the data presented demonstrate that a low interest rate scenario results in a (further) materialisation of reinvestment risk and therefore in a reduction in the returns from investments. This conclusion implies the need to lower the technical interest rate in stages in the context of adjusting premiums. The premium adjustment mechanism has a significant beneficial effect for the health insurers even in the current low interest rate environment, which has intensified further since the date of the projections as at 30 September 2014 and may continue at this level.

Solvency

All health insurers comply with the solvency requirements according to the projection as at 31 December 2014. The target solvency margin ratio for this sector is expected to be around 280% and therefore higher than the 258% reported in the previous year. The sector continues to have a good level of own funds.

Technical interest rate developments

The health insurers' business model is based on tariffs which permit the undertakings to adjust the premiums in accordance with the relevant statutory provisions. However, an adjustment may not be made in accordance with section 12b (2) sentence 4 of the VAG if the calculation of the insurance benefits was inadequate at the time of first or subsequent calculation, and a prudent and conscientious actuary should have recognised this, in particular by using the statistical basis for the calculation available to him/her at that time.

In BaFin's opinion, it is therefore necessary that, when introducing new insurance tariffs, the insurers take into account expected developments in the net return on their investments and, where necessary, reduce the technical rate of interest compared with its previous level. It is not necessary to adjust the highest technical interest rate of 3.5% stipulated in the Calculation Regulation (*Kalkulationsverordnung – KalV*) for this purpose. Most of the health insurers already applied a lower technical rate of interest than the existing rate on the introduction of the unisex tariffs on 21 December 2012 (see section entitled "Discrimination ban").

Results of the ACIRP

In addition, the insurers must submit their actuarial corporate interest rate (ACIR) to BaFin annually in the context of the actuarial corporate interest rate process (ACIRP). The outcome of this process determines whether the undertakings are also required to lower the technical rate of interest for existing tariffs when they adjust their premiums. The ACIRP is a forward-looking, preventive supervisory tool. It is capable of forecasting the current return achievable in the next two financial years with a particular degree of certainty. In the 2014 ACIRP (forecast for financial year 2015), 36 insurers were unable to demonstrate that they would also generate the technical interest rate used in the calculation in the future with the required high degree of certainty. The undertakings should therefore lower the technical interest rate accordingly in all tariffs when premiums are adjusted.

In principle, it is a matter for the actuary to consider whether the specific tariff should also take account of those risks not explicitly mentioned in the ACIR Guideline. The reasons for the technical interest rate approach chosen must be documented in a comprehensible manner in the technical documentation supporting the calculation. The scope and extent of the documentation must be in keeping with the particular circumstances.

In addition, working groups of the German Actuarial Association (*Deutsche Aktuarvereinigung e. V.* – DAV) are currently discussing ways of ensuring that the underlying assumptions are complied with in the future as well. Those assumptions state that sufficient excess yield should be generated to keep private health insurers' premiums stable for older policyholders.

Discrimination ban

Since 21 December 2012, private health insurers may offer only premiums and benefits calculated independently of the gender of the policyholder, as a result of the ruling of the Court of Justice of the European Union dated 1 March 2011 in the *Test-Achats*⁴⁷ case. The health insurers therefore introduced unisex tariffs on that reference date.

BaFin nevertheless received suggestions that these tariffs may still be subject to conditions which may not fully exclude the possibility of discrimination. BaFin therefore reviewed the general terms and conditions of insurance and tariffs submitted to it in 2014 in accordance with section 13d no. 7 of the Insurance Supervision Act. It investigated the possibility that these documents might contain elements that could result directly or indirectly in discrimination and that could have an adverse effect on policyholders or insured persons. However, BaFin has not identified any such discriminatory features in the terms and conditions submitted to it so far.

Stability of premiums in old age

Stable premiums for members of private health insurance schemes constitute a significant topic, particularly for older policyholders. The problem is exacerbated by the current low interest rate environment and the adjustments to the technical interest rate that have become more common since this environment arose, which directly increase the premiums of older insureds. BaFin therefore intends to launch a new initiative on this topic in 2015 in line with its responsibility for collective consumer protection. In the first place, this will assess the magnitude of the challenge to be overcome. But it will also investigate the effectiveness of the tools in existence to date, possible ways of developing them further and the appropriateness of measures already discussed which could be implemented in future.

3.3.3.3 Property and casualty insurers

Business trends

Property and casualty insurers recorded a year-on-year increase in gross premiums written in the direct insurance business in 2014 to €66.1 billion (previous year: €64.7 billion).

Gross expenditures for claims relating to the year under review declined by 10.8% to €21.4 billion (previous year: €24.0 billion). Gross expenditures for claims relating to prior years rose by 15.2% to €17.4 billion. Provisions recognised for individual claims relating to the year under review amounted to €17.9 billion, compared with €18.9 billion in the previous year; provisions recognised for individual claims relating to prior years amounted in total to €55.7 billion, compared with €50.8 billion in the previous year.

With gross premiums written amounting to €23.6 billion, motor vehicle insurance was by far the largest insurance class rising by 4.9% compared with the previous year. As in the previous year, the increase is attributable both to a rise in the number of policies and to higher average premiums. Gross expenditures for claims relating to the year under review fell by 7.0% year on year, while expenditures for claims relating

⁴⁷ Case ref. C-236/09.

to previous years were up 13.0% and thus recorded a comparatively large increase. Overall, gross provisions recognised for individual claims relating to the year under review declined by 1.6% year on year, while they increased by 2.2% for outstanding claims relating to 2013.

Property and casualty insurers collected premiums of €8.8 billion (+4.8%) for general liability insurance. At €0.97 billion, claims relating to the year under review rose by 1.8% year-on-year. Property and casualty insurers paid out €2.9 billion (+11.5%) for claims relating to previous years. Gross provisions for individual claims, which are particularly important in this line of business, rose by 3.7% to €2.8 billion for outstanding claims relating to the year under review. Gross provisions for outstanding individual claims relating to the previous year rose to €16.2 billion (+6.6%).

Insurers recorded gross fire insurance premiums written of €1.9 billion (+2.2%). Gross expenditures for claims relating to the year under review rose by 2.3% to €488.6 million.

Insurers collected premiums for comprehensive residential buildings insurance and comprehensive contents insurance contracts of €8.5 billion (+4.9%). Expenditures for claims relating to the year under review declined significantly by 20.5% year on year, while provisions for individual claims also fell by 23.1%. Expenditures for claims relating to prior years were 57.1% higher, on the other hand. Provisions for claims relating to previous years also recorded a substantial increase of 71.4%.

Premium income for general accident insurance contracts remained unchanged compared with the prior year at €6.3 billion. Gross expenditures for claims relating to the year under review amounted to €371.8 million. €2.2 billion was reserved for outstanding claims relating to the year under review (+4.8%).

Lower losses from natural events

Germany experienced a lower number of serious natural events during the year under review than in the previous year. The overall claims

expenditures of the property and casualty insurers in financial year 2014 declined as a result. A number of smaller regional storms⁴⁸ however, resulted in expenses for specific insurers with a particularly high exposure in the regions concerned. This applies to the public insurers, for example, which are traditionally heavily represented in comprehensive residential building insurance.

The mild weather in the winter months benefited the property and casualty insurers who are especially heavily involved in motor vehicle insurance. This business line also profited from the absence of a price war and higher average premiums around the deadline for changing motor insurance in November 2013.

A further positive factor for the sector was the encouraging development of premiums overall. The average combined ratio of the property and casualty insurers is therefore expected to be below 100%.

Solvency

At 311%, the solvency margin ratio for property and casualty insurers at the end of 2013 was marginally higher than the previous year's figure of 308%. This increase is attributable to two offsetting trends: on the one hand, the insurers' expenses for settling claims were higher. This resulted in particular in a significant rise in the claims index. On the other hand, the insurers recorded growth in their own funds due to capital contributions by shareholders and profits retained. This increase was slightly higher than that of the solvency margin required to be established, causing the solvency margin ratio to rise slightly overall.

Overall, four property and casualty insurers did not comply with the solvency requirements as at 31 December 2013. BaFin immediately took steps to restore the solvency margin coverage. However, the sector's own funds are still at a very high level and significantly higher than the minimum capital requirements.

⁴⁸ Examples include the June storm "Ela" and the "Quintia" torrential rainstorm.

3.3.3.4 Reinsurers

Business trends

Reinsurers experienced a relatively low level of claims in 2014. Natural disasters caused total economic losses amounting to US\$110 billion worldwide. This amount was lower than the prior-year figure of US\$140 billion and also below the 30-year international average of US\$130 billion.⁴⁹ Of the total economic losses for 2014 of US\$110 billion, losses amounting to US\$31 billion were insured, again significantly less than the figure for the previous year of US\$39 billion and below the 30-year average of US\$33 billion. The main contributory factor to this was a comparatively mild hurricane season. For nine years now, the US mainland has not been hit by a severe hurricane.

The most significant individual event for the insurance industry in 2014 was a winter storm with heavy snowfall in Japan which caused losses of US\$3.1 billion. Low temperatures and heavy snowfall also gave rise to substantial insured losses in the USA and Canada, amounting in total to around US\$1.7 billion. In addition, a series of violent hail storms swept across the USA in May, leaving insured losses of US\$2.9 billion in their wake.

By far the most expensive natural event in Germany for the insurance sector was the June storm "Ela". "Ela" was also the third most expensive disaster event in 2014 from an international point of view, with insured losses across Europe amounting to US\$2.8 billion.

The below-average claims expenditures worldwide in 2014 generated more than sufficient capacity in the reinsurance market. This applied in particular to the coverage of natural disaster risks, which was reflected in a noticeable fall in prices. Another major factor putting pressure on insurance rates, in addition to the lack of claims affecting the market, was the continuing inflow of alternative capital.

Hedge funds and pension funds are increasingly investing in catastrophe bonds and collateralised reinsurance. The market for catastrophe bonds (insurance-linked securities – ILS) achieved an issue volume of over US\$9 billion in 2014, the highest figure in the history of that market. The total amount of catastrophe bonds in circulation also reached a record high of more than US\$25 billion.⁵⁰ The relatively handsome returns in the ILS market are increasingly attracting investors whose search for yield – intensified by the continuing low interest rate environment – does not stop at new and unfamiliar market segments. The next rise in interest rates and future natural disasters causing heavy losses will show whether these investors are committed for the long term.

Although investors in the capital markets increasingly also took into consideration other risks such as longevity risk in the search for returns, the ILS market in 2014 continued to be heavily dominated by natural disaster risk, especially in the USA. The increase in competitive pressure triggered by the inflow of alternative capital therefore particularly affected those reinsurers which, just like the ILS market, had focused specifically on the coverage of natural disaster risks.

Overall, competitive pressure in the reinsurance sector intensified. At the same time, there was greater pressure on profitability in the reinsurance business due to the continuing low interest rate environment. The challenge for reinsurers is to maintain prices at a level that is adequate to cover the risks insured and to resist downward pressure on prices at the expense of returns.

Solvency

At the end of 2013, the supervised reinsurers in Germany had own funds amounting to €73.3 billion (previous year: €72.2 billion). As at the same date, the solvency margin was €7.7 billion (previous year: €7.4 billion). This reduced the solvency margin ratio slightly to 954.3% (prior year: 971.8%).

49 Munich Re: NatCatSERVICE.

50 ARTEMIS, accessed on 03.03.2015: www.artemis.bm/library/catastrophe_bonds.html

As before, the reason for the high level of own funds was a feature specific to the sector: reinsurers also frequently assume the function of holding company for an insurance group or financial conglomerate. A considerable proportion of these undertakings' own funds serves to finance their holding company function, rather than backing their reinsurance activities with capital. Eliminating the figures relating to the holding companies produced an average solvency margin ratio of 259.6% in 2013 for reinsurers supervised in Germany (previous year: 269.2%). The lower average solvency ratio was attributable to disproportionately increased solvency margins.

3.3.3.5 Pensionskassen

Business trends

According to projections, growth in premium income for all *Pensionskassen* was lower in 2014 than in the previous year. The final figures are not yet available. Premium income amounted in total to approximately €6.7 billion in the year under review, a year-on-year rise of around 1.5%. The increase was 3.9% in 2013.

The premium income of the *Pensionskassen* competing on the open market (*Wettbewerbspensionskassen*), which have been established since 2002, grew less rapidly than in the previous year, amounting to approximately €2.8 billion.

In the case of *Pensionskassen* funded largely by employers, premium income trends depend on the headcount at the sponsoring company. The premium income of these *Pensionskassen* was also higher. It rose to around €3.9 billion compared with €3.7 billion in the previous year.

Investments

The aggregate investment portfolio of the 145 *Pensionskassen* supervised by BaFin increased by around 6.1% in 2014 to approximately €139.0 billion (previous year: €131.0 billion). The dominant investment types are still investment units, bearer bonds and other fixed-income securities, as well as registered bonds, notes receivable and loans.

The sector's valuation reserves, especially in interest-bearing securities, rose as a result of the further reduction during the year under review in the existing low level of interest rates. Based on preliminary figures, the *Pensionskassen* reported hidden reserves across all investments of approximately €25.3 billion at the end of the year (previous year: €12.5 billion). This corresponds to roughly 18.1% of the aggregate investments, following 9.5% in the previous year.

Projections

BaFin asked the *Pensionskassen* to prepare projections as at 30 September 2014 in which they projected their profit for the financial year in four equity and interest rate scenarios. As in the previous year, the projections also encompassed the four following financial years in view of the continuing low level of interest rates.

The projections revealed that the solvency margin ratio was slightly higher than the prior-year level. As a general rule, the undertakings meet the solvency requirements; the sector's short-term risk-bearing capacity therefore seems to be assured as before. Based on the projections, the net return on investment for all *Pensionskassen* was approximately 4.1% in 2014, lower than the figure for the previous year (4.4%). The persistently low interest rates are proving to be a particular challenge for the sector. The projections reveal clearly that the gap between the current return on investments and the average technical interest rate for the premium reserve is narrowing. If it should be necessary for individual *Pensionskassen* to reinforce their biometric actuarial assumptions or reduce the technical interest rate, it may become increasingly difficult for these *Pensionskassen* to finance increases in reserves that then prove to be necessary.

Solvency

The forecast solvency margin ratio for the *Pensionskassen* was an average of 138% as at the 2014 reporting date, slightly higher than the figure for the previous year of 135%. According to the estimates, one *Pensionskasse* was unable to meet the solvency margin ratio in full as at

31 December 2014. This *Pensionskasse* has already developed a solution to this problem in close consultation with BaFin.

Impact of the low interest rate environment

The low level of interest rates, which fell further in 2014, represents a substantial burden for the *Pensionskassen*. If interest rates remain at their current level, *Pensionskassen* will be hit even harder than the life insurers due to the longer-term nature of their business. Unlike life insurers, the contracts held by *Pensionskassen* are almost exclusively policies that provide for the payment of lifelong pensions to the insureds.

BaFin is therefore supervising and supporting the *Pensionskassen* intensively so that they can retain and further strengthen their risk-bearing capacity even in a long-term low interest rate environment, and will continue to do so.

Pensionskassen should take measures to strengthen their risk-bearing capacity as early as possible; this is also underlined by the results of the projection mentioned above.

As a rule, *Pensionskassen* with the legal form of stock corporations belong to guarantee schemes in accordance with section 124 of the Insurance Supervision Act. If an employer appoints a *Pensionskasse* to be responsible for occupational retirement provision for its employees, the employer is obliged to pay the benefits to the employees itself if necessary, in accordance with its subsidiary liability under the Occupational Pensions Act (*Betriebsrentengesetz – BetrAVG*). This gives the affected employees additional security.

3.3.3.6 Pensionsfonds

Business trends

Pensionsfonds recorded gross premium income of €1,648 million in the year under review. This represents a substantial increase over the prior year (€742 million). The fluctuations in premium income are attributable in particular to the fact that, in the case of *Pensionsfonds*, the

premiums are often paid as single premiums, depending on the type of commitment agreed.

The total number of beneficiaries rose in the year under review to 949,038 persons compared with 927,240 persons in the prior year. Of those, 622,564 were vested employees who were members of defined contribution pension plans while 35,958 vested employees were members of defined benefit plans. The majority of *Pensionsfonds* newly authorised in previous years focused on pension plans with non-insurance-based benefit commitments in accordance with section 112 (1a) of the VAG. With this form of benefit commitment, the employer is also obliged to pay premiums in the payout phase. Benefit payouts increased from €1,280 million to €1,900 million in the year under review. The payouts were made to 287,812 persons who drew benefits.

Investments

Investments for the account and at the risk of pension funds grew from €1,602 million to €1,780 million in the year under review. This corresponds to an increase of 11.1% in investments (previous year: +16.8%). *Pensionsfonds* portfolios were dominated by contracts with life insurers, bearer bonds, other fixed-income securities and investment units. At the 31 December 2014 balance sheet date, net hidden reserves in the investments made by *Pensionsfonds* amounted in total to approximately €154 million. All 31 *Pensionsfonds* supervised by BaFin at the end of the 2014 reporting year were able to cover their technical provisions in full.

Assets administered for the account and at the risk of employees and employers increased only slightly in 2014, from €26.6 billion in the previous year to approximately €29.5 billion. Roughly 92.9% of these investments consisted of investment units. These investments are measured at fair value in accordance with section 341 (4) of the Commercial Code (*Handelsgesetzbuch – HGB*). The technical provisions for the account and at the risk of employees and employers are recognised retrospectively in line with the assets

administered for the account and at the risk of employees and employers. This means that balance-sheet cover for these technical provisions is guaranteed at all times.

Projections

In 2014, BaFin asked all 31 *Pensionsfonds* to submit a projection as at 30 September 2014. The particular focus of the projection was the expected profit for the year, the expected solvency and the expected valuation reserves at the end of the current financial year. The scenarios defined by BaFin were the capital market situation at the reference date and a negative equity scenario with a 24% drop in prices. In addition, it required scenarios to be calculated that combined each of the two above-mentioned scenarios with a 50 basis point increase in the yield curve.

The assessment of the projections indicated that the 31 *Pensionsfonds* included are able to withstand the defined scenarios financially.

Solvency

According to the 2014 projection, all *Pensionsfonds* supervised had sufficient free uncommitted own funds. They therefore complied with the solvency requirements. At most of the *Pensionsfonds*, the own funds required by supervisory law equalled the minimum guarantee funds of €3 million for stock corporations or €2.25 million for mutual pension fund associations. The individual solvency margin for these *Pensionsfonds* is below the minimum guarantee funds. This is due either to the relatively low volume of business engaged in or the type of business concerned.

3.4 Supervision of cross-border insurance groups

At the end of 2014, BaFin was involved in supervising a total of 31 insurance groups that have cross-border business activities via subsidiaries. The importance and size of the groups varied considerably: they ranged from insurance and reinsurance groups with

worldwide operations to very small groups of undertakings.

For 17 of the 31 groups, BaFin was the group supervisor. This meant that it had the lead role in exercising group supervision. It also had to ensure that the supervisors involved worked together effectively and efficiently. To achieve this, BaFin coordinated the exchange of information between the supervisors involved in institutionalised working groups, the supervisory colleges.

Focus of the EEA supervisory colleges

In 2014, the EEA supervisory colleges were already making intensive preparations for Solvency II coming into force. Following the publication by the European Insurance and Occupational Pensions Authority (EIOPA) of the preparatory guidelines for Solvency II, EIOPA assessed whether the individual work programmes of the supervisory colleges needed to be revised. The supervisory colleges also supported and commented on the insurance groups' preparations for the future requirements under Solvency II.

EIOPA guidelines on operational functioning of the colleges

BaFin was closely involved in the development of the EIOPA guidelines on the operational functioning of colleges of supervisors. EIOPA published the guidelines on 31 October 2014. They will enter into force on 1 January 2016.

The guidelines are divided into two sections: the first part comprises the guidelines themselves, while the second contains explanatory notes. The annexes contain coordination agreements templates and emergency plans which the supervisory authorities in the college are required to put in place, together with specimen lists of information and data intended to be exchanged in the college.

The objective of the guidelines is to enable the supervisory authorities to work together in an improved and more efficient manner.

V Supervision of securities trading and the investment business

1 Bases of supervision



1.1 Opinion

Karl-Burkhard Caspari on the challenges of the revised MiFID

When the revised Markets in Financial Instruments Directive (MiFID II) was published in the Official Journal of the European Union on 12 June 2014¹ and entered into force together with the Markets in Financial Instruments Regulation (MiFIR²) on 2 July 2014, outsiders could easily get the impression that most of Europe's regulatory work in the secondary market and intermediaries areas had been completed. In fact, the opposite is true! This is because the Directive level (Level 1) only sets out a relatively abstract framework of regulations, which have to be transposed into



Karl-Burkhard Caspari

was Chief Executive Director of Securities Supervision/ Asset Management until the end of March 2015.

national law and in many places additionally require further specification in the form of delegated acts of the European Commission or technical standards of the European Securities and Markets Authority (ESMA) (Level 2 measures). In total, 100 such Level 2 measures will have to be developed.

¹ Directive 2014/65/EU, OJ EU L 173/349.

² Regulation (EU) No. 600/2014, OJ EU L 173/84.

Challenges posed by tight schedule and changes in terms of content

A two-year period has been allowed for national implementation of MiFID II, which puts the latest implementation date at 2 July 2016. Since market participants will have to prepare for the new legal situation, the new rules are only planned to become applicable as from 3 January 2017. In reality, the time pressure is even greater than the dates mentioned suggest. This is because the Level 2 measures to be developed by ESMA will have to pass through a time-consuming procedure to obtain the approval of the Commission, the European Parliament and the Council, and ESMA will have to submit the drafts to the Commission with an appropriate lead time (see info box “Timeframe for Level 2 measures”).

For example, in the context of Commission delegated acts, ESMA is normally mandated by the Commission to develop the requested technical advice together with a draft of such delegated acts. These drafts had to be submitted to the Commission by no later than the end of 2014. The deadlines for regulatory technical standards are slightly more generous. ESMA will submit these to the Commission only at the beginning of July 2015.

The tight schedule resulted in a large amount of work to be done within a short space of time, not only by ESMA, but also by the national supervisory authorities and market participants. To prepare for the drafts, ESMA conducted a consultation process in summer 2014, which required hundreds of detailed technical questions to be answered and then analysed within a few months.

The new regulations set out in MiFID II will moreover transfer new practical supervisory responsibilities to the supervisory authorities. In Germany, it has not yet been finally clarified in this context to what extent the exchange supervisory offices of the *Länder*, in addition to BaFin, will be affected by the implementation of these new responsibilities. For example, the new responsibilities to be imposed as a result of MiFID II include rules on commodity

derivatives, for which MiFID II introduces a position reporting and supervision regime. In addition, MiFID II establishes a new category of trading venues, the organised trading facilities (OTFs), which will have to be supervised, similar to stock exchanges.

Commodity derivatives

In terms of content, new regulations on commodity derivatives are among the highlights of MiFID II. Since the markets for commodity derivatives are of significant importance for the real economy and entire national economies, MiFID II sets out an intensified supervision regime for these products in order to curb excessive speculation, extreme price fluctuations and manipulation opportunities.

The position limits stipulated in Article 57 are a relatively powerful measure that the competent supervisory authority can impose in order



Timeframe for Level 2 measures

Pursuant to the ESMA Regulation, the Commission has to approve regulatory technical standards within three months of submission by ESMA. The Council and the European Parliament can raise objections during this three-month period; the period could be extended by another three months. If this timeframe is fully utilised, the earliest the regulatory technical standards are expected to be published in the Official Journal of the European Union is at the beginning of 2016. The situation is similar for Commission delegated acts. Although the Commission uses technical advice obtained from ESMA, it always creates these legislative acts independently. This means that it has correspondingly more time to develop these acts and subsequently submit them to the Council and the Parliament; in the present case, it has six months from publication by ESMA on 19 December 2014, i.e. until the middle of 2015. Pursuant to Article 290 of the Treaty on the Functioning of the European Union, a three-month period again applies thereafter, which can likewise be extended.

to limit the number of derivative contracts a person can hold. The ESMA has to develop the requisite calculation methodology in the form of regulatory technical standards.

Furthermore, Article 58 requires market operators to report regularly on the existing positions of market participants to the public and to supervisory authorities; the reports to supervisory authorities are subject to more detailed reporting requirements. These requirements will have to be specified further in the form of Level 2 measures. Guidance is offered by the USA, where similar supervisory tools are already in use. However, because of the complexity of the subject matter and different responsibilities, practical implementation in Germany poses many challenges.

Trade transparency in the non-equity segment

MiFID II extends the trade transparency obligations, which currently only apply to shares, to include other asset classes. In terms of trade transparency, a distinction is made between the publication of bids and offers, specifying price and volume before a transaction (pre-trade transparency) and immediately afterwards (post-trade transparency). This requirement does not normally pose any problems in the case of highly liquid shares of large international companies.

The situation in the non-equity segment is more problematic. Although this segment also has highly liquid instruments, such as *Bunds*, bonds issued by smaller countries are correspondingly less liquid, and in many cases significant volumes of many corporate bonds are only traded shortly after issuance. The challenge facing the Level 2 measures is to establish a balanced transparency regime that actually increases trade transparency while taking adequate account of the liquidity profiles of different financial instruments, which vary widely in some cases.

Publication and consolidation of market data

On the basis of MiFID II, providers of market data will be subject to regulation for the first time. Producers of market data, i.e. essentially

pre- and post-trade transparency data, will have to be authorised as approved publication arrangements (APAs) and meet detailed organisational requirements, aimed in particular at ensuring high data quality and reliability.

Another regulatory change relates to the consolidation of market data. The introduction of alternative trading platforms, the multilateral trading facilities (MTFs), in MiFID I, which is currently still in force, led to the emergence of a large number of different trading venues, whose trading data has to be merged (consolidated) in order to make the Europe-wide pricing process transparent. This function will in future be performed by consolidated tape providers (CTPs), which, similar to APAs, will require authorisation and supervision. This aspect will likewise require extensive further specification on the basis of Level 2 measures.

Acceptance of commissions

Adjustments will probably have to be made to the way inducements are received and used. Even under the current version of MiFID, the receipt of inducements, i.e. payments by third parties for the provision of investment services to the customer, such as commission payments for financial instruments, is only permitted, if, in addition to other requirements being met, the inducement is aimed at improving the quality of the service provided to the customer. This requirement has been confirmed in principle in MiFID II. The criterion of improved quality is to be specified further in the implementing acts. The final version of the technical advice that ESMA submitted to the Commission differs significantly from the draft put up for consultation only a few months earlier and only takes some of the suggestions of the German financial industry into account.

Cost transparency

The revised conduct of business obligations now include extended cost transparency provisions: customers will in future have the right to disclosure of all product and service costs, aggregated as a total, or itemised on request, before the investment service is provided. In addition, the investment



services enterprise will have to explain how the total costs will impact on the return of the investment. A challenge in this regard will probably be how to estimate those components and cost elements that have not been finalised before the investment service is provided or will only become apparent retrospectively, such as the expected return of an investment or transaction costs that are based on the price and volume of the final order.

Product development

In order to improve consumer protection, MiFID II will impose product development and product governance obligations on those developing and launching financial products (manufacturers) and those distributing them (distributors). Specifically this means that an issuer has to define a target market for the product it has developed and inform the distributor accordingly. The aim is to ensure a product offering tailored to individual requirements.

The product development obligations will be supplemented by ongoing governance obligations. The issuer will have to monitor the product for any negative changes in the risk profile over time. If necessary, the issuers will then have to take appropriate action, which may even entail abandoning the product.

Documentation requirements

MiFID II also comprises a documentation requirement, which is not dissimilar to the

German investment advice minutes: the statement on suitability, which has to be used during the provision of investment advice to document in writing whether a recommendation is suitable for the customer. The implementation of this requirement is expected to enhance the current legal provisions relating to the investment advice minutes, which are not based on EU law, transforming them from a factual record of the points discussed during the provision of advice into a written document that provides reasons for the suitability of an investment recommendation. This documentation requirement is supplemented by an obligation to document all telephone conversations, electronic conversations and face-to-face conversations relevant to orders in order to retain evidence of the detailed circumstances of an order. During the consultation process for the revision of MiFID, market participants had already drawn attention to the considerable technical implementation effort that this would require.

Summary

Similar to its predecessor MiFID I, the revised MiFID II is expected to change the existing market structures. It will pose implementation challenges for both market participants and supervisors. These challenges will have to be overcome so that, as intended, MiFID II provides another pillar for fair and effective financial markets and the protection of the interests of consumers and the real economy.



V

1.2 Retail Investor Protection Act



The new German Retail Investor Protection Act (*Kleinanlegerschutzgesetz*)³ implements the package of measures intended to improve retail investor protection. The Federal Ministry of Finance (*Bundesministerium der Finanzen*) and

the Federal Ministry of Justice and Consumer Protection (*Bundesministerium der Justiz und für Verbraucherschutz*) presented the regulations on 22 May 2014. The Bundesrat commented on the government draft on 6 February 2015 and the federal government did so on 11 February 2015. After the final readings in the Bundestag, the Act is expected to enter into force in summer 2015. The various

VI

Appendix

³ See chapter II 5.2.1.

legislative changes are intended to, among other things, help investors to make a better assessment of the prospects for success of a capital investment in future. To this end, some key aspects of the Capital Investment Act (*Vermögensanlagegesetz* – VermAnlG) will be amended.

Prospectus requirements extended

A prospectus will in future also have to be prepared for investment classes that were not previously subject to the prospectus requirement under section 6 of the VermAnlG. Firstly, profit participation loans and subordinated loans will be added to the catalogue of capital investments in section 1 (2) of the VermAnlG and thus included in the scope of this Act. Secondly, the catch-all nature of section 1 (2) no. 7 of the draft VermAnlG will then also capture other investments that grant a right to interest and redemption or grant a right amounting to cash settlement in exchange for the temporary provision of funds. This relates to investments that are economically equivalent to capital investments, which have already been subject to the prospectus requirement. The aim of the draft Capital Investment Act is to ensure that classes of investments that in the past turned out to be structures set up to circumvent the prospectus requirement of offerings will either fall under supervision pursuant to the Banking Act (*Kreditwesengesetz*) or will be subject to the prospectus requirement under the VermAnlG or the Securities Prospectus Act (*Wertpapierprospektgesetz*).

Minimum term for capital investments and notice period

A new provision is a minimum term for capital investments of 24 months from the date of initial acquisition (section 5a of the draft VermAnlG). In addition, investments must allow for a notice period of at least 12 months for ordinary termination. In addition, shares that confer the right to participate in the earnings of a company and units in a trust fund (section 1 (2) nos. 1 and 2 of the VermAnlG) may only be terminated as at the end of a financial year. However, this applies only if the articles of

association or the fund rules do not specify anything to the contrary. The provision contains a warning to investors as it makes them aware that their capital investment is a business commitment for a certain period. In the past, non-matching maturities of capital investments had proved problematic in some cases.

Prohibition on obligation to make additional contributions

Pursuant to the newly introduced prohibition in section 5b of the draft VermAnlG, capital investments are not authorised for public offers or distribution in Germany, if they specify an investor's liability for losses in excess of the investment amount, i.e. an obligation to make additional contributions. The prohibition on such investments thus protects investors from demands for additional contributions – irrespective of whether they result from the legal form of the capital investment or positive contractual arrangements.

Validity of the prospectus

Pursuant to section 8a of the draft VermAnlG, prospectuses will in future be valid for 12 months from the date of approval, providing the offeror adds the supplements required under section 11 of the VermAnlG. The aim is to ensure that investors only have access to information that is not older than one year. Offerors that want to continue the public offer beyond this period are required to submit a new prospectus to BaFin for approval. It is then mandatory for this prospectus to contain up-to-date minimum disclosures allowing investors to adequately assess the capital investment and its issuer.

Details of obligation to issue supplements

The draft Retail Investor Protection Act specifies the obligation to issue supplements under section 11 (1) sentence 2 of the draft VermAnlG. An important new factor necessitating a supplement is considered in particular any circumstance that significantly impacts on the issuer's business prospects for at least the current financial year and that may considerably hamper the issuer's ability to meet its obligations to the investor. In addition, any new publication of annual financial statements and

management report as well as of consolidated financial statements by the issuer is considered an important new factor.

Information to be contained in prospectus broadened

The additional requirements on prospectuses are intended to help provide more and higher-quality information to investors. This includes in particular mandatory disclosures of termination options and maturities for capital investments already issued, disclosures on affiliated companies and the inclusion of a cash flow statement of the issuer, unless the issuer meets the classification of "small" within the meaning of section 267 of the Commercial Code (*Handelsgesetzbuch*).

Another change is that, pursuant to section 15a of the draft VermAnlG, BaFin has the right to demand as part of the prospectus approval procedure that additional disclosures be included in the prospectus, if this seems necessary to protect the public. This gives BaFin the right to demand, over and above the requirements of the Investment Prospectus Regulation (*Vermögensanlagen-Verkaufsprospektverordnung*) and the minimum disclosures standardised there, that the offeror or issuer include further information – for example if the disclosures made in the prospectus are unclear or incoherent.

Targeted class of investors to be specified

Offerors of capital investments are to determine the group of retail clients for whom a financial product is intended already during the development phase of the product. This class of investors will have to be specified in future both in the prospectus and in the capital investments information sheet. Accordingly, the prospectus will have to contain information in particular about the investors' investment horizon and their ability to bear losses arising from the capital investment. This amendment will, however, only enter into force as at 3 January 2017.

Capital investments information sheet

Pursuant to section 13 (5) of the draft VermAnlG, the information sheet will have to

reveal when the document was last amended. It also has to disclose how many times it has been revised since it was first compiled.

Section 13 (6) of the draft VermAnlG specifies that the first page of information sheet has to contain the following warning in prominent print: "Capital investments are made subject to not inconsiderable risks and may lead to the total loss of the capital employed. As a general rule, the higher the return or reward, the greater the risk of loss." Investors will have to confirm that they have received and taken note of the information sheet by signing the document before any contract is entered into (section 15 (3) of the draft VermAnlG).

Restriction on advertising capital investments

There will be a restriction on advertising capital investments. The draft VermAnlG contains a broad definition of the term "advertising" as any statement made with the aim of promoting the sale of capital investments. Among other things, pursuant to section 12 of the draft VermAnlG, advertisements for capital investments will only be allowed in the print media; there will be no more advertising in public spaces, such as on posters. Advertisements will also be allowed in media that feature predominantly economic and financial matters, at least occasionally, providing the advertisement is placed in connection with such features. In all cases, the advertisement will have to include a prominent warning that draws attention to the not inconsiderable risks of the capital investment, especially the risk of total loss of the assets invested, and also alert to the link between risk and reward of a loss.

Publication requirements on termination of public offer

Section 11a of the draft VermAnlG contains another change: the issuer will have an obligation to provide information about developments relevant to the investment it has issued. For example, between the completion of the public offer and the full redemption of the capital investment, the issuer has to publish all the facts that could considerably hamper its ability to meet its obligations to the investor.

The obligation exists if these facts are not publicly known and directly relate to the issuer or the capital investment it has issued. The new notification requirement begins at the end of the public offer, i. e. the date from which the offeror is no longer obliged to add supplements to the prospectus for its financial product pursuant to section 11 of the VermAnlG. This ensures for the residual maturity of a capital investment that investors who are already invested and potential subsequent investors have access to up-to-date information about the issuer's net assets, financial position and results of operations at any time.

Exemptions from the prospectus requirement

To promote the financing of small and medium-sized enterprises (SMEs), offerors of crowd investments⁴ will, under certain circumstances, be exempted from specific obligations under the VermAnlG. The exemptions under section 2a of the draft VermAnlG will for example relate to subordinated loans and profit participation loans brokered exclusively through investment advice or investment broking via an Internet service platform. The platforms marketing the capital investments will need an authorisation to do so as investment services enterprises under the Banking Act or as financial intermediaries under the Industrial Code (*Gewerbeordnung*). However, the company may use crowd investment only to raise a maximum of €1 million, whereby each investor can invest up to a limit of €1,000 without any further disclosures. If an amount in excess of €1,000 and up to €10,000 is invested, the investors have to disclose in a self-declaration that they have assets of at least €100,000 at their disposal or confirm that they are not investing more than twice their average monthly net income.

As soon as the total amount of investments acquired or to be acquired from the same issuer exceeds €250, the offeror is obliged to send an information sheet to each investor.

In addition, the operator of the Internet service platform offering the capital investment will

in all cases need an authorisation to do so as an investment services enterprise under the KWG or as a financial intermediary under the Industrial Code. Otherwise it will not qualify for the exemption.

Pursuant to section 2b of the draft VermAnlG, subordinated loans and profit participation loans for social or charitable projects are also exempt from the prospectus requirement. This exemption from the prospectus requirement will apply only if these loans are issued by a micro corporation within the meaning of section 267a of the Commercial Code and the selling price of all capital investments of the same issuer offered by the offeror does not exceed €1 million. Moreover, the agreed debt interest rate must be below the standard market issue yield for capital market investments in mortgage *Pfandbriefe* with matching maturities.

Finally, exemptions from the prospectus requirement also apply to certain other subordinated loans and profit participation loans. This exemption applies if the issuer is a cooperative, the loans are offered exclusively to members of the cooperative and the cooperative provides its members with key information on the capital investment.

Prohibition of the public offer by BaFin

Through section 18 of the draft VermAnlG, the draft Retail Investor Protection Act extends BaFin's power to prohibit the public offer of capital investments. BaFin can issue such a prohibition in particular in cases where there are indications that the offeror has failed to publish a required supplement. However, BaFin can also prohibit the public offer of a capital investment if it contravenes the minimum term or the prohibition on the obligation to make additional contributions. But beyond that BaFin does not conduct any review of the content of the investment prospectus. This means that it does not have any more extensive prohibition powers. However, for capital investments, BaFin also has the product intervention options set out in section 4b of the Securities Trading Act (section 18 (2) of the draft VermAnlG).

⁴ See chapter II 6.1.3.

Order to undergo an audit of the financial statements

Section 24 of the draft VermAnlG also increases BaFin's powers. According to this provision, it can order an audit of the financial statements by an external auditor if there are specific indications of violations of any financial reporting rules – especially if this is to be assumed on the basis of submissions by third parties. This is intended to increase the pressure on companies to produce proper financial statements every year.

Finally, provisions have been added to the VermAnlG that govern the announcement of measures and administrative fine decisions.

Restrictions on marketing, distribution and sale

As additional guidance for the distribution of financial products, the Securities Trading Act anticipates the product intervention provisions of the Regulation of the European Parliament and of the Council on markets in financial instruments (Markets in Financial Instruments Regulation – MiFIR). For example, they give BaFin the power under certain conditions to restrict or prohibit the marketing, distribution or sale of financial instruments, structured deposits or certain types of financial activities or financial practice, if they trigger significant reservations in relation to consumer protection.

1.3 Market Abuse Regulation and Directive on Criminal Sanctions for Market Abuse

The Market Abuse Regulation (MAR)⁵ entered into force on 2 July 2014. The Regulation, which will be directly applicable in all member states of the European Union from 3 July 2016, harmonises the rules prohibiting market abuse behaviour. In addition, the EU member states will also have to transpose the Directive on Criminal Sanctions for Market Abuse (CRIM-MAD)⁶ into national law by 3 July 2016. Serious deliberate breaches of the prohibition on

market abuse will thus be a criminal offence in future.

Prohibition on market abuse for reference rates

The MAR tightens and extends the provisions of the Market Abuse Directive of 2003 in several ways. The scope of the prohibitions on market abuse, i.e. market manipulation and insider dealing, now also extends to financial instruments traded on multilateral or organised trading facilities. The manipulation of reference rates is now expressly prohibited, which was previously not a criminal offence under European and national law.

In addition, MAR tightens the regulations that are to counteract insider dealing and market manipulation preventively: this means that from 3 July 2016 issuers are subject to ad hoc disclosure requirements if they are traded on a multilateral or organised trading facility with their consent or if they themselves have applied for admission to or inclusion in such a facility. In Germany, this covers in particular the regulated unofficial market segments of the stock exchanges. The option to seek temporary exemption from publication requirements under certain conditions will continue to be available. If a credit or financial services institution is involved, the publication of inside information relating to the issuer may also be postponed if the stability of the financial system is at risk, the postponement is in the public interest, the secrecy of information can be guaranteed, and the competent authority has approved this postponement.

Obligation to report directors' dealings for debt securities

Managers at issuers within the scope of MAR as well as persons closely related to them will have to report dealings for their own account within three – instead of previously five – business days. In the past, this reporting requirement for directors' dealings only related to share transactions. In future, dealings in debt securities will also be included. Moreover, the group of reportable transactions will be extended to include the pledging and lending of financial instruments. 30 days prior to

5 Regulation (EU) No 596/2014, OJ EU L 173/1.

6 Directive 2014/57/EU, OJ EU L 173/179.

the publication of interim or annual financial statements, this group of persons will be prohibited from trading altogether. However, for sales that cannot be postponed, the issuer can exempt the parties concerned from the prohibition on trading. The requirement will only apply to issuers that are traded on a regulated market or on a multilateral or organised trading facility with their consent or if they themselves have applied for admission to or inclusion in such a market or facility.

Market soundings and financial analyses

Provisions relating to market soundings are another new element of the MAR. Market soundings are conducted by giving potential investors specific information prior to the announcement of a transaction in order to gauge their interest in this transaction. If the disclosing party meets detailed organisational and record-keeping obligations, it can counter the allegation that it has unlawfully disclosed inside information in the process of conducting market soundings. For example, the disclosing party has to inform the recipient of the

information that the disclosed information has to be kept confidential and that the use of the information for insider dealing is prohibited. The disclosing party has to keep a record of the fact that the recipient has been informed.

The MAR will also bring changes for the preparation of financial analyses. Previously, only persons who prepare financial analyses as part of their professional employment had to comply with regulations. One of the most significant changes is probably that in future the regulations for the preparation of financial analyses may also be binding on private individuals. This is relevant for all those who distribute investment recommendations via the Internet, for example through social networks.

More severe sanctions

The new rules against market abuse will also provide for significantly more extensive sanctions. The CRIM-MAD will contain the corresponding minimum requirements.⁷

⁷ See chapter V 1.4



1.4 Focus

Reform of the sanctioning regime

Author: Anja Rodde, BaFin Section for administrative offence procedures

The intention of European legislators is to complete the implementation of significant reforms of European financial and capital market law in the EU member states by January 2017. The reforms will entail changes in the transparency requirements and the law on market abuse, as well as in relation to the markets for financial instruments. This will result in a tightening of the German sanctioning regime.

The reform of the sanctioning regime is based on three directives and one regulation:

the Transparency Directive II⁸, the Market Abuse Regulation (MAR)⁹, the Directive on Criminal Sanctions for Market Abuse (CRIM-MAD)¹⁰ and the recast Directive on Markets in Financial Instruments (MiFID II)¹¹. While the Transparency Directive II mainly contains changes to publication and notification

⁸ Directive 2013/50/EU, OJ EU L 294/13.

⁹ Regulation (EU) No 596/2014, OJ EU L 173/1.

¹⁰ Directive 2014/57/EU, OJ EU L 173/179.

¹¹ Directive 2014/65/EU, OJ EU L 173/349.

requirements (transparency requirements), such as the notification requirements pursuant to section 21 *et seq.* of the Securities Trading Act (*Wertpapierhandelsgesetz* – WpHG) and the financial reporting requirements pursuant to section 37v *et seq.* of the WpHG, the MAR covers the areas of market manipulation, insider trading, ad hoc disclosures, directors' dealings and the obligation to maintain insider lists. MiFID II comprises a large number of requirements for investment firms, such as the obligation to keep a record of electronic communications with customers. MiFID II is also intended to improve the transparency of trading in complex financial instruments¹².

Status quo in the EU member states

To date, there have been major differences between the individual member states in the sanctioning of infringements of the requirements of capital market law, both in terms of what is legally possible and what happens in practice. This is because the existing European regulations – the Transparency Directive I, the Market Abuse Directive (MAD) and MiFID I – were very vague on the question of sanctions and went no further than imposing an obligation on member states to establish “effective, proportionate and dissuasive” sanctions¹³. The consequence of this is that there are significant differences in the amount of the maximum administrative fine in national regulations. For example, the maximum amounts for infringements of the transparency requirements vary between a few thousand euros and €10 million.¹⁴ For violations of the ban on insider dealing, the maximum fines in some member states amount to €200,000, in others to €1 million or more.¹⁵

In contrast to the position in Germany, it is also not possible to impose sanctions on natural and

legal persons in all European member states. In some countries, sanctions can be imposed either only on natural persons or exclusively on legal persons. If, for example, a member of management contravenes the relevant laws in carrying out their management activities, this contravention may result in the imposition of a fine on the member of management personally in one member state, while in another country the sanction can be imposed only on the stock corporation.

Not all member states have criminal sanctions for particularly serious offences. This relates in particular to the punishment of insider dealing and market manipulation. These activities are not treated as criminal offences in all member states and in some countries are not subject to administrative fines either.¹⁶ Other countries which did have the power to impose sanctions did not do so for more than two years.¹⁷

Reforms of the sanctioning regime

Against this background, the European Commission considered the sanctions in national legal provisions to be inadequate as they “do not seem always optimal in terms of effectiveness, proportionality and dissuasiveness”.¹⁸ This finding resulted in far-reaching changes in European sanctions law. The Transparency Directive II, the MAR and MiFID II now include significant requirements for national sanctioning regimes, which are described in the following.

Responsibility of natural and legal persons

The disparity between member states in the sanctioning of natural and legal persons is intended to be addressed by a uniform ruling. This will enable the person responsible – irrespective of whether that is a legal person or a natural person – to be

¹² See chapter V 1.1.

¹³ See Article 28 of the Transparency Directive I, Article 14 (1) of the MAD, Article 51 (1) of the MiFID I.

¹⁴ Committee of European Securities Regulators (CESR), Document 09-058 (on the Transparency Directive), p. 42.

¹⁵ European Commission, Communication on reinforcing sanctioning regimes in the financial services sector, 8.12.2010, COM 2010 716 final, p. 7.

¹⁶ Loc. cit., p. 14; European Council, Council document 17895/13 of 19.12.2013, compromise proposal, point 4.

¹⁷ European Commission, Communication on reinforcing sanctioning regimes in the financial services sector, 8.12.2010, COM 2010 716 final, p. 6.

¹⁸ Loc. cit., p. 9.

sanctioned for violations.¹⁹ In Germany, the law on infringements of administrative regulations already enables this to be done. Under that law, fines can be imposed on legal persons if members of management have committed an offence (section 30 of the Act on Breaches of Administrative Regulations (*Ordnungswidrigkeitengesetz* – OWiG)) or are in breach of their duty of supervision (section 130 of the OWiG). On the other hand, a natural person can be sanctioned if the person has not complied with their primary obligations such as the notification of changes in voting rights (section 21 of the WpHG), but also if the person has acted as the representative or agent of a legal person (section 9 of the OWiG).

Minimum criteria for type and level of sanctions

European legislation has provided member states with assessment criteria to be taken into account when determining the sanction. They include, among other things, the gravity and duration of the infringement, the degree of responsibility of the person responsible for the infringement, the financial strength (in particular of a legal person), the level of co-operation of the person responsible with the competent authority and previous breaches by the person responsible.²⁰ These criteria are not final. Member states may provide for additional criteria to be used in determining the sanctions. The assessment criteria mentioned are already required to be taken into account under German law on breaches of administrative regulations pursuant to section 17 (3) of the OWiG.

Minimum maximum amounts for administrative fines

In accordance with the provisions of the European directives and regulation, the amount of the fines is intended to be significantly increased compared with the maximum amount of €1 million previously applying in Germany (see Table 26 “New minimum maximum amounts for sanctions”, page 201).

¹⁹ See, for example, Article 28b(1)(a) of the Transparency Directive II.

²⁰ Article 28c of the Transparency Directive II, Article 31(1) of the MAR, Article 72(2) of the MiFID II.

Member states have the option of providing for higher maximum amounts. The amounts quoted in table 28 can in any event be exceeded under the European regulations if the maximum amount is not sufficient to cover the financial benefit obtained. The Transparency Directive II and MiFID II set the maximum fine at twice the amount of the profits gained or losses avoided because of the infringement²¹, while the MAR stipulates a maximum of three times that amount²².

Publication of sanctions and measures

The European legislation also provides for the publication of administrative sanctions and measures imposed.²³ The background to this is provided by general considerations relating to the prevention of breaches, since the publication of decisions imposing sanctions is intended to have a dissuasive effect on the public at large.²⁴ Publication is also intended to enable the competent authorities to inform market participants of what behaviour is considered to be an infringement. This should serve to promote good behaviour among market participants.

In principle, a decision must be published and discretion on the part of the authority is not envisaged. As far as the content of the mandatory publication is concerned, both directives and the regulation provide that it should include information on the type and nature of the breach and on the identity of the (natural or legal) person responsible.²⁵ This basic principle can only be disregarded if the publication of personal data would be disproportionate or where publication would jeopardise the stability of the financial markets

²¹ Article 28b(1)(c) of the Transparency Directive II; Article 70(6)(h) of the MiFID II.

²² Article 30(2)(h) of the MAR.

²³ Article 28b(1)(a) of the Transparency Directive II; Article 30(2)(c) of the MAR; Article 70(6)(a) of the MiFID II.

²⁴ See Recital 17 of the Transparency Directive II, Recital 73 of the MAR, Recital 146 of the MiFID II.

²⁵ Article 29(1) of the Transparency Directive II; Article 34(1) of the MAR; Article 71(1) of the MiFID II.

Table 26 New minimum maximum amounts for sanctions

	Legal person	Natural person
Transparency Directive	up to €10 million or 5% of total turnover	up to €2 million
MAR	up to €15 million or 15% of total turnover	up to €5 million
MiFID II	up to 10% of total turnover	up to €5 million

or an ongoing official investigation.²⁶ In such cases, publication may be delayed or the decision may be published on an anonymous basis. Under the provisions of the MAR and MiFID II, there is also the possibility, subject to certain preconditions, of not publishing sanctions or measures imposed at all. This option is not present in the Transparency Directive II.

The intention of the European legislation is that decisions should be published without undue delay and irrespective of whether they may be subject to appeal. If an appeal is submitted, the competent authority may be required to issue a new publication or an amendment to the original publication.

The CRIM-MAD also provides for the harmonisation of minimum rules for criminal sanctions for the most serious infringements relating to market abuse, supplementing the provisions of the MAR. Member states are therefore required to provide criminal sanctions for particularly serious infringements, for example, of the ban on market manipulation. In principle, the penalties are again intended to apply to natural and to legal persons. However, member states whose legal systems do not recognise criminal liability for legal persons are not obliged to introduce criminal penalties. In these cases, administrative law sanctions are sufficient. Accordingly, there is no need for Germany to introduce criminal law for companies.

²⁶ Article 29(1) subsection 2 of the Transparency Directive II; Article 34(1) subsection 3 of the MAR; Article 71(1) subsection 2 of the MiFID II.

The CRIM-MAD does not define the term “most serious infringements” in relation to market abuse or insider dealing. It does cite a series of criteria; but a detailed definition will have to emerge in the course of implementation in the member states.

Effects on German financial market and capital market law

German legislators are currently engaged in transposing the directives into national law. The intention of the European legislators is that the Transparency Directive II must be implemented as early as November 2015. The CRIM-MAD is expected to be implemented by July 2016, while national regulations in accordance with MiFID II must apply by January 2017. Since the MAR is a regulation, it applies directly in all EU member states from the start of July 2016.

As far as the sanctions incorporated in German financial market and capital market law are concerned, the most noticeable change will be the increase in the maximum amounts for fines. The parties concerned will also have to be prepared for the decision imposing sanctions to be published.

BaFin’s prosecution practice

BaFin will prepare for the European requirements and adapt its prosecution practice accordingly. In particular, it is considering making changes to the WpHG Administrative Fine Guidelines in order to reflect the increase in the maximum amounts. BaFin will also publish decisions imposing sanctions in accordance with the new regulations.



1.5 Transparency Directive

The recast EU Transparency Directive entered into force on 26 November 2013. It will have to be transposed into national law by all member states by the end of 2015. The changes will primarily affect financial reporting and voting rights reporting.

Abolition of interim management statements

In future, the Transparency Directive will no longer require management to publish interim management statements in the first and second six months of the financial year. The aim is to reduce the administrative expense in particular for listed small and medium-sized enterprises (SMEs) in order to improve their access to capital. In addition, the Transparency Directive aims to promote sustained value creation and the development of investment strategies with a long-term horizon by reducing the short-term pressure on companies and giving investors an incentive to take a longer-term view.

More time to publish half-yearly financial reports

The period within which half-yearly financial reports have to be published will be extended from two to three months after the end of the reporting period. In this way, the Transparency Directive wants to promote greater flexibility and reduce the administrative expense, especially for SMEs. In addition, the longer publication period is intended to get market participants to take a greater interest in the reports of SMEs.

Introduction of country-by-country reporting

Publicly traded companies in the extractive and logging of primary forest industries will in future report annually on payments to government bodies. They will have to disclose this report on payments by no later than six months after the reporting date. The new reporting requirement, which has its origin in the European Accounting Directive²⁷, is intended to ensure greater transparency in these areas and curtail corruption.

Notification of financial instruments

The existing reporting requirements for voting rights notifications will be modified. Previously, financial instruments fell within the scope of section 25 of the Securities Trading Act (*Wertpapierhandelsgesetz* – WpHG), while other financial instruments, including in particular financial instruments which confer a right to a cash settlement, fell under section 25a of the WpHG. The two requirements will now be combined. The future reporting criteria will therefore apply to voting rights (section 21 of the WpHG), all financial instruments (section 25 of the WpHG) and the total of these two items (section 25a of the WpHG).

When reporting on financial instruments that only make provision for a cash settlement, the actual delta will have to be taken into account. Previously, a fixed delta of 1 was applied. The exact details of how to calculate the delta is set out in a regulatory technical standard, which ESMA developed in 2014.

Regulatory technical standards

In the year under review, ESMA developed a number of regulatory technical standards on the exact interpretation of individual provisions relating to the voting rights notification system. Together with a final report, the standards were submitted as a draft Regulation to the European Commission in September 2014. The Commission published the Regulation on 17 December 2014. The regulatory technical standards it contains will enter into force on 26 November 2015 and will be directly applicable; national implementation will not be required. The Regulation provides for the following regulatory technical standards:

- Horizontal and vertical aggregation of voting rights when calculating trading book and market maker holdings

Trading book and market maker holdings not subject to reporting requirements (section 23 of the WpHG) will have to be calculated by aggregating voting rights and financial instruments (horizontal aggregation). Corporate groups will additionally have to

²⁷ Directive 2013/34/EU, OJ EU L 182/19.

aggregate the different holdings throughout the group, i.e. at the highest level of the parent company (vertical aggregation).

- Calculation of the share of voting rights in the case of baskets of shares or indices

When calculating the number of voting rights held through baskets of shares or indices, only those shares should be included whose weighting in the basket or index accounts for 20% or more, or those that represent 1% or more of the share in the underlying issuer held through baskets or indices.

- Calculation of the share of voting rights in the case of financial instruments conferring a right to a cash settlement

ESMA's draft contains regulations for the future calculation of the number of voting rights when financial instruments conferring cash-settlement rights are held. These regulations determine the requirements to be met when calculating the delta. The key requirement is the use of a generally accepted calculation formula that takes into account factors such as volatility, time to maturity of the financial instrument and the price of the underlying instrument. The item will have to be calculated daily.

- Exemption for client-driven transactions

For client-driven transactions of financial institutions, the exemption of trading book holdings from the notification requirement will also apply to these transactions.

- Indicative list of financial instruments subject to notification requirements

ESMA's report to the Commission also includes an indicative list of financial instruments subject to notification requirements. Since the list is not a regulatory technical standard, it does not form part of the draft Regulation, nor is it binding on the member states. The indicative list is not exhaustive either and merely

serves to inform the market participants. Binding information about whether a financial instrument is subject to notification requirements in a specific case can therefore only be provided by the competent national supervisory authority.

1.6 Regulation on improving securities settlement in the EU and on central securities depositories

The Regulation on improving securities settlement in the European Union and on central securities depositories (Central Securities Depository Regulation – CSDR) was published in August 2014; it entered into force on 17 September 2014.²⁸ The CSDR will lead to permanent changes to the German supervisory regime over central securities depositories (CSDs). ESMA and the European Banking Authority (EBA) intend to develop the corresponding technical standards by 18 June 2015.

Provisions of the CSDR

The CSDR is aimed at regulating the supervision of central securities depositories at the European level, which has not been harmonised to date. The provisions of the CSDR include specific rules on settlement fails, which include both monitoring and measures to be taken in response to settlement fails, such as penalties for settlement fails and the initiation of a buy-in process, if the settlement fail is not remedied within a set period.

In addition, regulatory requirements will be imposed on central securities depositories, relating to aspects such as their authorisation, supervision, organisation and capital adequacy.

Authorisation of the central securities depository and of banking-type ancillary services

The CSDR will require central securities depositories to apply for the necessary authorisations within six months of the

²⁸ Regulation (EU) No 909/2014, OJ EU L 257/1.

relevant regulatory technical standards entering into force. The competent supervisory authorities will then also have six months to review the application and then to grant or refuse the authorisation. In addition to the competent supervisory authority – for Germany probably BaFin – the respective national central bank and, under certain circumstances, other European central banks will also have to be involved in the authorisation procedure.

The CSDR also provides for central securities depositories to provide banking-type ancillary services themselves or to engage a credit institution to do so. This will make it possible for a CSD to have two authorisations within the same legal entity, one for its activities as central securities depository and the other for banking-type ancillary services. This is referred to as the 1+2 model. However, because of the requirements on the authorisation procedure for banking-type ancillary services in the CSDR, there are already indications that many European authorities and central banks will be involved in the authorisation procedure for banking-type ancillary services.

Technical standards

Numerous enabling provisions in the CSD Regulation have given ESMA and the EBA the mandate to develop binding technical standards to define some of the provisions in greater detail. Thus the EBA is developing regulatory technical standards on capital requirements for all central securities depositories as well as additional capital requirements for those CSDs that also provide banking-type ancillary services. In addition, for credit institutions providing banking-type ancillary services and for central securities depositories that perform these services themselves, it is drafting regulatory technical standards in relation to credit and liquidity risks.

ESMA, too, has been tasked with developing a number of regulatory technical standards. This involves, among other things, establishing the criteria according to which other central banks are determined for participation in the

authorisation procedure of a CSD or the specific organisational requirements it has to meet. ESMA also has to compile criteria for the case that, due to the situation in the local securities markets, the activities of a central securities depository in another EU member state are of systemic importance for the functioning of the securities markets and for investor protection in that member state. But it also has to draft regulatory technical standards for measures in response to settlement fails. This relates to, among other things, the buy-in process as well as specific measures to be taken if the settlement fail is not remedied within a certain period, i. e. the penalty regime.

1.7 UCITS V Directive

In 2014, a number of requirements on securities funds and their EU management companies were revised. The new Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS V Directive)²⁹ amends the UCITS IV Directive³⁰ with regard to depositary functions, remuneration policies and sanctions. The EU member states have until 18 March 2016 to transpose the UCITS V Directive into national law. The draft of the German Act Implementing the UCITS V Directive is in progress.

Remuneration policies of management companies

Under UCITS V, the management companies of investment funds are to be required to establish and maintain remuneration policies and practices consistent with sound and effective risk management for those categories of staff whose professional activities have a material impact on the risk profiles of the UCITS they manage. The management companies will be subject to certain principles: for example, fixed and variable components of total remuneration must be appropriately balanced. Variable remuneration will only be

²⁹ Directive 2014/91/EU, OJ EU L 257/186.

³⁰ Directive 2009/65/EU, OJ EU L 302/32.

possible, if this is generally feasible in terms of the financial position of the management company and justified by the performance of the operating department concerned, the UCITS and the employee concerned. The principles of the remuneration policy and the way they are set out in the UCITS V Directive are broadly in line with the provisions of the Alternative Investment Fund Managers Directive (AIFM Directive).

Depositary functions

The UCITS V Directive also specifies the depositary's functions and obligations. For example, it requires a distinction to be made between assets that are capable of being held in custody and those that are not. The group of assets that can be held in custody should be clearly differentiated, since the duty to return lost assets should apply only to that specific category of assets. Assets that cannot be held in custody are instead subject to record-keeping and ownership verification requirements. In this respect, the provisions also broadly correspond to the depositary regulations of the

AIFM Directive. However, this does not apply to liability of depositaries: the UCITS Directive specifies that the depositary's liability cannot be discharged or limited by way of an agreement. By contrast, the AIFM Directive specifies that the depositary can be discharged of the liability under certain circumstances if financial instruments held in custody by a third party are lost.

Sanctions

Finally, the UCITS V Directive includes comprehensive provisions on sanctions. Among other things, sanctions are to be published in all cases – firstly in order to inform the public about infringements that may be detrimental to investor protection and secondly to strengthen their dissuasive effect. Sanctions may be published on an anonymous basis where publication has the potential to cause a disproportionate damage to the parties involved. All publicly disclosed sanctions have to be reported to ESMA at the same time, which in turn also publishes an annual report on all sanctions imposed.

1.8 Investment Code



1.8.1 Focus

Initial experience with supervision under the German Investment Code

Author: Hans-Georg Carny, BaFin Section for Policy Issues relating to Investment Funds

Despite the steady refinement of financial market regulation on all levels over the years – from global standard-setters to the European Union and local trade supervision – it is not every day that ongoing government supervision is introduced for an entire segment of the financial market on a completely new basis. Closed-ended collective investments were a feature of the unregulated, or grey, capital market until the transposition into German law of the Directive on Alternative

Investment Fund Managers (AIFM Directive)³¹ brought them under comprehensive control in the form of the newly created German Investment Code (*Kapitalanlagegesetzbuch*)³². It should surprise nobody that this undertaking inevitably requires great efforts to be made by

³¹ Directive 2011/61/EU, OJ EU L 174/1.

³² Act Implementing the AIFM Directive (*AIFM-Umsetzungsgesetz*), Federal Law Gazette I 2013, page 1981.

all participants – providers, investors and the supervisory authority – especially during the initial phase.

Substantive definition of investment fund

After the Investment Code came into force on 22 July 2013 and the transitional phase for “old” funds expired one year later, all open-ended and closed-ended investment funds, their management companies and the depositaries for their assets have in principle fallen within the scope of BaFin’s supervision. The first hurdle facing the practical application of the new legislation is the substantive definition of investment fund. In innumerable cases, it was necessary to clarify on the basis of the criteria set out in the interpretive letter on the scope of the Investment Code and on the definition of “investment fund” whether the regulations of the Investment Code applied. The problem of distinguishing investment vehicles forming part of the financial markets from enterprises with operating activities in the real economy arises both in existing cases and in the formulation of new business strategies. This applies especially in relation to real estate investment and management, since the activities of investment funds and those of operating property companies are closely related. On the other hand, the objective is to deter avoidance strategies and prevent distortions of competition arising as a result of the unequal treatment of economically similar cases.

New distinction between open-ended and closed-ended investment funds

The distinction between open-ended and closed-ended investment funds changed once again in July 2014. In keeping with the new provisions of European law, all funds where investors can request the units to be redeemed prior to the commencement of the liquidation phase or wind-down are now considered in principle to be open-ended. The requirement previously contained in the Investment Code that redemptions must be possible at least once a year therefore no longer applies. Accordingly, closed-ended funds may no longer include provisions for ordinary redemption rights.

This change also entailed a revision of the transitional provisions governing the treatment of old funds and of new funds established in the meantime under the Investment Code. From the point of view of legal consequences, the distinction between open-ended and closed-ended investment funds is especially significant for the type and extent of liquidity management and for the valuation of the assets.

Transition problems for closed-ended investment funds

Many registration or authorisation procedures for German management companies of closed-ended investment funds, or pre-approvals in respect of those procedures, proved to be far more protracted than the undertakings, and BaFin itself, had originally expected. This reflected among other things the large number of sometimes highly complicated questions of law and interpretation that had to be decided on the basis of specific applications, but also in some cases in response to general inquiries from advisers and industry associations.

Since the business models, assets and other legal circumstances, such as tax and corporate law, of closed-ended funds differ in many respects from the open-ended funds well known by BaFin’s supervisors, clarification of the legal issues required a detailed examination of these general factors and practices. In many cases, companies also used the initial application as a pilot test to sound out the limits of the new regime in as many respects as possible and so to prepare the way for the development of future programmes. In the course of this ongoing process of redefining its administrative practice on the part of BaFin, the undertakings also continually updated their submissions, so that the cases had to be evaluated again.

Secondly, it became clear that companies coming from the unregulated segment of the capital market frequently underestimated the extent of the adjustments necessary to comply with the Investment Code. Many companies evidently assumed initially that while the new regime would impose stricter requirements

on internal organisation and documentation, no fundamental changes would be needed with respect to their established products and business relations with their business partners. On occasions, this was reflected in fierce resistance to the administrative practice of the new supervisors, who called these traditional models into question as they are not compatible with the legal framework created by the legislation. As a result, some companies were only able to complete the process of adaptation in stages and over a long period of time.

A clear example of this was provided by the provisions relating to costs in the fund rules of closed-ended investment funds which have a direct impact on the financial interests of the German management companies. The supervisors responsible and members of BaFin's internal working group on costs discussed current administrative practice in many individual cases and in extensive telephone conferences with the companies and their legal and financial advisers, and worked out proposed solutions.³³

BaFin examines funds' cost provisions very closely, not least because of the considerable critical attention they have long received from politicians, the media and consumer groups. It is possibly easier in the case of the cost provisions of closed-ended funds than in many other areas of investment fund supervision for BaFin to achieve clearly visible improvements for investors in comparison to the pre-Investment Code era.

Organisational restructuring

The changes required by the Investment Code in organisation, processes and contract structures relating to investment companies were in many respects highly significant for the existing companies under supervision. They include the strict separation of portfolio management from risk management, and the setting up of additional internal functions for compliance and internal audit. They also

include the obligation to appoint a depositary with extensive supervisory responsibilities and to agree with it the necessary mutual exchange of information and assessment procedures.

The German management company has final responsibility for all aspects of collective portfolio management. To the extent that it makes use of the expertise of third parties for this purpose, it must enter into outsourcing agreements with them and supervise their work. It was not immediately clear to all undertakings that, where fund management is outsourced, responsibilities cannot be divided between the investment company and the German management company appointed in any manner desired, but that the latter must assume all of the operational responsibilities and risks. This was frequently not reflected in processes and contract structures in the past.

In addition to the external cost agreements with investors already referred to, the development of internal remuneration schemes for employees poses a particular challenge for undertakings. The remuneration systems must not create incentives for senior management and risk takers that conflict with the company's risk management policy. The identification of the relevant risk takers in particular cases was the subject of considerable discussion.

Analysis of systemic risks

In contrast, only the future will be able to show the extent to which the primary objective of the AIFM Directive, identifying systemic risks for the financial markets, can achieve greater importance. The data obtained from the German management companies' reporting requirements are intended to play a major role in this respect. The companies submit information at intervals ranging from quarterly to annual, including details of the most important markets and instruments in which they are trading for the account of AIFs under their management. This includes information on the total leverage employed, liquidity resources and the greatest risks and concentrations of each AIF managed.

³³ On cost provisions, see chapter V 1.8.4.

Further discussion is needed on the question of what meaningful statements about the situation of the investment industry can be derived from this information, and whether supervisory

measures – such as a limit on the leverage employed by AIFs – based on this data can assist in fine-tuning the stability of the financial system.



1.8.2 Operating companies

The interpretation of what is to be considered an investment fund under the Investment Code centred on the criterion that it must not be an operating company outside the financial sector. Accordingly, a company's main activity must not be operational. According to the information provided by ESMA³⁴, operating companies are in particular companies that develop or construct real estate, that produce, buy, sell or exchange goods or merchandise, or that provide other services outside the financial sector. If an operating company transfers parts of its operating activities to third-party service providers or companies in the same group, it outsources these activities. However, a company is only classified as an operating company for as long as it retains responsibility for the business decisions in the ordinary course of business. This has to be ensured by expressly agreeing the right to determine the work performed as well as the rights of control and instruction. If there are specific indications, BaFin examines whether these requirements are in fact permanently met. In August 2014, it amended the guidance on this detail in its interpretive letter on the scope of the Investment Code and the concept of investment fund ("*Auslegungsschreiben zum Anwendungsbereich des KAGB und zum Begriff des Investmentvermögens*" – only available in German).

In principle, there is also the risk that a company that initially engages in operating activities raises capital and then uses the option it had already reserved for itself to use

the capital to acquire extensive investments in other companies. In any case, at that stage the option to acquire or hold equity investments without limitation no longer predominantly represents an operating activity: the operational nature of the company thus becomes of secondary importance.

If a company wants to retain the option to acquire equity investments in its articles of association, this must not be the main purpose of the company. If an operating company, in addition to its operating activities, also makes investments for investment purposes (for example in financial instruments), this is harmless, if according to the articles of association the equity investment is of negligible interest or merely represents a subordinate auxiliary or ancillary activity. Otherwise, the company has to amend its articles of association accordingly to avoid being classified as an investment fund within the meaning of the Investment Code.

In addition to operating companies outside the financial sector, holding companies do not fall under the Investment Code either. The Code is not applicable to companies that hold an equity investment in one or several other companies and whose corporate purpose is, through the subsidiaries, affiliated companies or equity investments they hold, to pursue a business strategy of promoting their long-term value. Another requirement is that, according to their annual report or other official documents, they were not established for the main purpose of generating a return for their investors by selling their subsidiaries or affiliated companies.

34 ESMA/2013/600, p. 29.

The implementation of this kind of promotional business strategy requires that the company can in fact exercise permanent control over the other companies in order to benefit from their activities for its own account. In this context, it is not enough to contractually agree the right to determine the work performed as well as the rights of control and instruction. Accordingly, a company can only qualify as a holding company if the following conditions are met:

- From an overall perspective, it must hold majority interests, at least predominantly; minority interests in individual cases do not preclude the use of the holding company privilege, providing they are clearly of minor significance.
- The company has to have the actual ability to control the subsidiaries, affiliated companies or equity investments, for example through voting rights.
- It has to have a long-term rather than merely temporary intention to increase the value of the subsidiaries or affiliated companies.

Unlike in the case of private equity funds, the main purpose of the company must therefore not be to generate a return by selling other companies.

1.8.3 Prevention of blind pool structures

On 6 November 2014, BaFin published the “Catalogue of criteria to prevent pure-play blind pool structures in closed-ended retail AIFs” (alternative investment funds) (*“Kriterienkatalog zur Verhinderung von reinen Blindpool-Konstruktionen bei geschlossenen Publikums-AIF”* – only available in German). For these types of investment in closed-ended investment funds, the investors do not have (full) certainty yet about the target investments in which they are investing at the time the investment decision is made. However, in BaFin’s opinion, the fund rules have to include information on certain investment criteria, if the target investments have not yet been specified.

BaFin’s catalogue of criteria therefore specifies that in the fund rules for closed-ended retail

AIFs the German management companies (*Kapitalverwaltungsgesellschaft*) define investment criteria for at least 60% of the invested capital. The remaining 40% can be invested in assets that may be acquired in principle for the investment fund concerned, but do not have to meet explicitly agreed criteria. Minimum investment thresholds of other assets, such as bank deposits, are counted towards the 60% threshold. For example, if according to its fund rules a closed-ended retail AIF invests at least 10% in bank deposits, the investment criteria will only have to be met for another 50% of the invested capital.

The selection criteria for assets defined pursuant to the catalogue included in the Guidance Notice have to be met by no later than the end of the investment phase. The investment phase, which is specified in the fund rules, can last up to three years, depending on the fund duration. The specified length of the investment phase may be extended by another 12 months on the basis of a resolution taken by the unit holders with a majority of 75% of the votes cast, if permitted by the fund rules.

Because of the different performance scenarios in the management phase and the start of disinvestment, it is de facto impossible to maintain the investment strategy and investment thresholds over the entire duration. When closed-ended retail AIFs sell an asset and reinvest the proceeds, the investment phase starts again. In this case, specific criteria apply to the option of reinvestment.

1.8.4 Standard text modules for cost clauses



In the fund rules agreed with the investors in a fund, the management company also has to make arrangements for the cost of remuneration and the reimbursement of expenses that is charged to the investment fund. As part of the authorisation process for fund rules of UCITS and retail AIFs, BaFin examines these arrangements to establish whether they contain transparent information on the method, amount and calculation of

remuneration and expense reimbursements. It also ensures that the management companies do not breach their obligation to avoid prejudice to investors' interests through inappropriate costs, fees and practices. However, BaFin does not examine the amount of the remuneration, because this is subject to the management companies' business decision.

Following extensive discussions with industry associations, auditors and consumer protection groups, BaFin published its administrative practice in the form of standard text modules for closed-ended retail investment funds as at 1 October 2014. In the lead-up to this, the debate had focused primarily on the issue of what calculation base is suitable for calculating adequate ongoing remuneration for a management company. The amount of the ongoing management fee must not – as was previously widely practised in the industry – be a fixed percentage of the limited partner's contribution, but has to be linked to the fund's annual net asset value, and thus to the performance of the assets and general market trends.

This calculation method has been common practice at open-ended funds for some time now. It ensures that financial risks are not borne exclusively by investors while the management company collects a fixed income year after year. This would be inappropriate especially in constellations where the value of the assets is significantly lower than the capital initially raised.

Alternatively, the text module provides for a calculation base under which the payments made to the investors to date are added to the current net asset value. This solution is intended to deal with the problem of continuous depreciation charges to reflect the declining value of tangible assets. Regardless of the quality of portfolio management, asset management or general market developments over the duration of the term, these charges can lead to considerable losses in value in the portfolio of closed-ended funds, even though

these losses are not offset by lower costs for the management of the fund. In addition, this calculation method avoids providing misdirected incentives to portfolio management to delay the sale of assets or the distribution of the proceeds to the detriment of investor interests.

To create a secure financial basis for the starting phase of a closed-ended fund, the text modules allow a fixed minimum fee to be agreed for an initial period of up to 36 months. For the calculation of performance-related remuneration, the standard text modules propose two alternatives. Both grant the management company a share of the generated profits, after the investors have received back their initial investment plus interest at an agreed annual rate.

BaFin does not require that the fund rules use the standard text modules verbatim. It accepts different wordings, but only if they are no less transparent and appropriate than the benchmarks established by the standard text modules.

1.8.5 Reporting obligations for AIF management companies

The changeover to the provisions of the Investment Code places many different requirements on funds and their managers. In a Guidance Notice dated 16 July 2014³⁵, BaFin explains the reporting process for AIF management companies under section 35 of the Investment Code. The reporting obligations set out there relate to reports at both management company and investment fund level. The specific requirements, including those relating to the contents of the data to be reported, are set out in Article 110 and Annex IV of Commission Delegated Regulation (EU) No 231/2013. To ensure a harmonised reporting process throughout Europe, ESMA has published additional standards on its website; they deal with the process, content and form of the reports.

35 www.bafin.de/dok/5415654 (only available in German).

In particular, the Guidance Notice specifies the format, the reporting channel and the start of the transfer of the reports. Unless specified otherwise in the Guidance Notice, the report content and further reporting process follow ESMA's guidelines on AIFMD reporting. ESMA has published explanatory notes on this subject in the form of a Questions and Answers document.

1.8.6 Circular on depositaries

BaFin published the draft new circular on depositaries, which is to replace the existing circular on custodian banks, for consultation until 27 March 2015. A working group of about 30 practitioners and association representatives were involved in its development.

The issue of how the requirement for asset separation should be dealt with at the level of a sub-custodian has so far not been addressed. ESMA will issue guidelines in this regard, which will be incorporated into the circular on depositaries. To this end, ESMA deliberated a solution according to which, at the level of a sub-custodian, the assets of alternative investment funds may only be held together with assets of other AIFs in an omnibus account. It would then not be permissible to

mix them with assets of other funds or other customers of the depositary.

Another issue to be covered by the new circular on depositaries is the application of the look-through approach by the depositary to the activities and assets of special purpose vehicles, which are used, for example for tax reasons, to structure and implement the investment strategy between an investment company and the assets it has under management. From the depositary's perspective, the activities of this special purpose vehicle and the assets it holds are to be treated as if they were activities and assets of the investment fund or management company. The rights and obligations of the depositary, in particular the custody and control obligations, extend to the assets and activities of these special purpose vehicles without restrictions. The circular will also specify details of the obligations, especially with regard to the intensity of the examinations that a depositary has to maintain when verifying ownership, i. e. when it scrutinises the acquisition by an AIF of assets that cannot be held in custody. Other important topics to be covered are the timing of the review of the legality of instructions the management companies issue to the depositaries and permissible methods for monitoring investment limits.

2 Monitoring of market transparency and integrity



2.1 Market analysis

The number of new market manipulation or insider trading analyses launched increased significantly to 721 in 2014, compared with 425 in the previous year. In a total of 162 cases (previous year: 119), there were initial indications of market abuse. They break down into 105 (previous year: 79) cases of market manipulation and 57 (previous year: 40) proceedings relating to insider trading.

The analyses were triggered by, among other things, suspicious transaction reports under

section 10 of the WpHG. The number of these reports declined from 503 in the previous year to 435 in the year under review. However, the figure was distorted considerably in 2013 because of the large number of suspicious transaction reports in connection with individual scalping campaigns. 2014 did not see any cases where so many suspicious transaction reports referred to the exact same financial instrument. In total, 323 different financial instruments were affected by suspicious transaction reports, up significantly from the 248 reports



Future requirements for suspicious transaction reports

The rules applicable to suspicious transaction reports have changed as a result of the Market Abuse Regulation (MAR). In accordance with the principle of proportionality, the extent of the new active surveillance process to be implemented will be based on the nature and extent of the business of a party subject to reporting requirements.

In the view of the European Securities and Markets Authority (ESMA), an effective surveillance process hardly seems possible without support from an automated system. Such a system in turn requires human monitoring.

In addition, the reporting requirement will be extended to include mere orders, turning the existing suspicious transaction reports (STRs) into suspicious transaction and order reports (STORs). In order for a party subject to the reporting requirements to decide whether or not to create an STOR, it has to use all accessible information and in the process take the size, nature and scope of the company into account. The annex to the consultation paper also includes

a notification template showing the content of suspicious transaction and order reports, including mandatory disclosures.

Finally, there is a requirement to keep records so that decisions can be traced at a later stage. The requirements on suspicious transaction and order reports affect, among others, the market operators and investment services enterprises operating a trading venue. They have to establish and maintain effective arrangements, systems and procedures that can prevent and detect market abuse or attempted market abuse. Suspicious orders and transactions, including their cancellation or modification, must be reported to the competent authority immediately.

The obligation also applies to persons that broker or execute transactions on a commercial basis. They, too, have to establish and maintain effective arrangements, systems and procedures, but unlike the first group, only for the purpose of detecting market abuse and attempted market abuse. In these cases, too, justified suspicions have to be reported immediately, regardless of whether the order or transaction is executed at a trading venue.

received in the previous year (see info box “Future requirements for suspicious transaction reports”).

Market manipulation analyses

If the 105 (previous year: 79) positive manipulation analyses are broken down by underlying subject matter, the majority related to sham activities in the year under review. In 2014, BaFin uncovered 58 such cases (previous year: 25), for example wash sales and pre-arranged trades.

At 43, the number of information offences, i.e. incorrect, misleading, or withheld information, and above all scalping, was at the previous year’s level, while manipulation of the order situation or of reference prices declined significantly, from ten in the previous year to two in 2014.

Broken down by segment, the focus was again on the regulated unofficial market, which accounted for 74 analyses (previous year: 65). However, the number of cases relating to the regulated market increased significantly to 31 (previous year: 12).

As in previous years, BaFin continued its proven practice of publishing warnings on its website as soon as it observed the beginning of concerted manipulation attempts, for example in the form of telephone calls, spam e-mails and faxes. BaFin thus issued a total of eight warnings in 2014 (previous year: 9) and at the same time informed affected credit and financial institutions as well as the trading venues where the financial instruments can be traded. Thanks to this warning network, the institutions and trading venues can immediately take their own precautions to protect investors.

Insider analyses

Insider analyses followed a similar trend to the market manipulation analyses. The number of positive analyses rose year-on-year, from 40 to 57.

Broken down by underlying subject matter, the analyses again focused on companies' earnings figures, with 19 cases (previous year: 15), followed by mergers and acquisitions (2014: 14; previous year: 13). Analyses relating to liquidity problems, overindebtedness etc. increased significantly in 2014, from three in the previous year to nine. With reference to the affected market segments, however, the relative overweight of the regulated market declined sharply. 35 cases (previous year: 34) related to financial instruments admitted to trading on the regulated market, while the regulated unofficial market was affected in 21 cases (previous year: 4).

2.2 Market manipulation

Investigations

In 2014, BaFin investigated 224 cases of suspected market manipulation (see Table 27 "Market manipulation investigations"). After the number of new investigations launched had declined to 218 in 2013, the first year-on-year decline in many years, this trend was reversed again in the year under review. In another 143 cases, public prosecutors' offices or police authorities asked BaFin to provide support in ongoing investigations.

More than half of the formal investigations launched – 130 analyses in total – were based on referrals by the trading surveillance units at the German exchanges (previous year: 136). In terms of subject matter, the investigations related to trade-based manipulation activities, such as reference market manipulation, wash sales and pre-arranged trades. Another priority area related to investigations initiated by public prosecutors' offices or police authorities. A total of 14 investigations were attributable to such requests (previous year: 32). In most of these cases, complaints were filed with the prosecuting authorities by investors who had followed manipulative recommendations and bought shares. The prosecuting authorities in turn involved BaFin.

In 2014, BaFin again cooperated closely with foreign supervisory authorities. BaFin requested administrative assistance from them in 169 cases (previous year: 172), contacting the supervisory authorities of a total of 36 different countries to this end. Most of the contacts related to customers who had engaged in suspicious trading activities on a German exchange via a foreign institution. Foreign authorities from 16 countries requested assistance from BaFin in 45 cases (previous year: 33).

BaFin found evidence of market manipulation in 156 cases completed in 2014. It filed complaints against 311 suspects with the relevant public prosecutor's office. In six other cases involving a total of nine persons there was evidence

Table 27 Market manipulation investigations

Period	New investigations	Discontinued	Results					Pending	
			Referred to public prosecutors or BaFin's administrative fines section				Total (Cases)		Total
			Public prosecutors		Administrative fines section				
			Cases	Individuals	Cases	Individuals			
2012	250	30	121	229	6	6	127	208	
2013	218	66	142	281	10	18	152	208	
2014	224	33	156	311	6	9	162	237	

that an administrative offence had been committed; these cases have been passed on to BaFin's administrative fines section for further processing. In 33 cases, the investigation did not find any evidence of violations. The number of investigations still pending at the end of 2014 was 237.

Sanctions

In 2014, a total of three people were convicted of market manipulation following a full public trial; the courts passed sentences against four people following summary proceedings (see Table 28 "Public prosecutors' and court reports, and reports by BaFin's administrative fines section on completed market manipulation proceedings"). The public prosecutors' offices discontinued 194 preliminary investigations. In 77 cases, a conviction was not sufficiently probable to bring a charge. The public prosecutors' offices discontinued these proceedings pursuant to section 170 (2) of the Code of Criminal Procedure (*Strafprozessordnung* – StPO). Another 22 investigations were provisionally discontinued in accordance with section 154f of the StPO because the defendant's place of abode was

unknown. In addition, the public prosecutors' offices discontinued 29 cases in accordance with section 153 of the StPO, because they considered the perpetrator's degree of fault minor and there was no public interest in criminal prosecution. In another 52 cases, the investigations launched were discontinued in accordance with section 153a of the StPO, after the defendants had made a payment as part of out-of-court settlements. Moreover, proceedings were discontinued in 14 cases in accordance with section 154 or 154a of the StPO. These provisions allow the prosecuting authorities to concentrate on substantively serious allegations and to deal efficiently with complex matters involving a large number of infringements of the law, thus contributing to accelerating proceedings. Proceedings can be discontinued, for example, if the importance of the expected punishment for the offence to be discontinued is not substantial compared to the legal consequences of another punishable offence. The fact that several investigations were discontinued in 2014 on the basis of these provisions documents clearly that violations of the ban on market manipulation increasingly also involve other serious criminal offences.

Table 28 Public prosecutors' and court reports, and reports by BaFin's administrative fines section on completed market manipulation proceedings

Decisions made by public prosecutors' offices							
Period	Total	Discontinued				Discontinued in accordance with section 153a of the StPO	
		Discontinued in accordance with section 170 (2) of the StPO	Discontinued in accordance with section 153 of the StPO	Discontinued in accordance with sections 154, 154a of the StPO	Discontinued in accordance with section 154f of the StPO		
2012	127					74	19
2013	135					100	21
2014	211	77	29	14	22		52
Final court decisions in criminal proceedings							Decisions in administrative fine proceedings
Period	Total	Discontinued by court in accordance with section 153a of the StPO	Convictions following summary proceedings	Convictions following full trial	Acquittals	Discontinued	
						Discontinued	Final administrative fines
2012	127	0	10	14	2	6	2
2013	135	1	4	4	0	2	3
2014	211	2	3	3	1	0	7

BaFin receives regular information from the public prosecutors about the results of preliminary investigations. In cases where BaFin had filed complaints before 1 January 2013, but not yet received any information about the outcome of the proceedings, it followed up with the public prosecutors' offices in 2014. In the process, it was revealed that some preliminary investigations had meanwhile been completed. For this reason, all figures also include investigations completed in previous years, but of which BaFin only became aware in 2014.

Selected cases

Swiss FE Group AG and others

On 7 November 2014, the Regional Court (*Landgericht*) in Kleve sentenced a former German Board member of a securities trading bank from North Rhine-Westphalia, which has since been liquidated, to a term of imprisonment of three years and three months, because he had violated the ban on market manipulation in the form of scalping. The subject of the judicial proceedings was that he had advertised the shares of Swiss FE Group AG, Metriopharm AG and Prime Beteiligungen AG in 2006 to 2008 without disclosing his own shareholdings. This is probably the first court ruling on scalping to relate not only to the advertising of shares through two e-mailed market letters and an Internet portal, but also to telephone marketing through a call centre. Call centre employees and injured parties were among the parties questioned in court proceedings lasting several days and involving numerous witnesses. The public prosecution proceedings had been prompted by a complaint filed by BaFin in 2010. The investigation into market manipulation had been triggered by a special audit under the Banking Act at a securities trading bank and its tied agents regarding proper business organisation and telephone marketing of penny stocks. The judgement is not yet final.

LetsBuyIt Group AG

On 25 February 2014, the Regional Court in Frankfurt am Main sentenced a book author and former host of the TV programme "MoneyMoney"

Settlement price

In options and futures trading, the settlement (or closing) price is the price determined at the end of each trading day for the purpose of contract valuation. The central clearing agent of the European Energy Exchange (EEX) is European Commodity Clearing AG (ECC), which also determines the margins the trading participants are required to post on the basis of the settlement prices. This margin, which is determined daily, leads to a cash flow between the buyer and the seller of the position, referred to as variation margin.

The settlement prices are calculated and published according to fixed rules. EEX describes how settlement prices are calculated in a document entitled "Settlement Pricing Procedure".³⁶ The calculation is product-specific. Depending on the order book situation and the transaction history, there are a total of five calculation methods for gas futures, which are used in meeting the specified requirements. The settlement prices determined are published after the close of trading.

For gas futures, which tend to be illiquid, the calculation is based on orders that were on the market during the settlement window. The determination process only includes an order if it comprises at least ten contracts and is on the order book for at least three minutes.

to a jail term of two years and seven months. In addition, in a final judgement, the Regional Court sentenced an accomplice to a suspended jail term of one year and six months. In the course of the full trial, the court discontinued the proceedings against another person accused initially in return for a payment of €25,000 as part of an out-of-court settlement.

The judges considered it proven that the convicted individual, who had previous relevant

³⁶ www.eex.com



Cooperation with the Market Transparency Unit Electricity/Gas

The Market Transparency Unit for Wholesale Electricity and Gas Markets (MTU Electricity/Gas), which falls under the Federal Network Agency (*Bundesnetzagentur*), is to ensure transparent and competitive pricing for marketing and trading electricity and gas on a wholesale basis. Another purpose of this unit is to meet the implementation requirements of the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT). Under the REMIT, the MTU Electricity/Gas, among other bodies, has an obligation to supervise the wholesale energy markets in order to prevent insider trading (Article 3 of REMIT) and market manipulation (Article 5 of the REMIT).

For its surveillance function, the MTU Electricity/Gas will in future receive transaction and fundamental data collected by the Agency for the Cooperation of

Energy Regulators (ACER) at the European level on the basis of the REMIT. Moreover, the MTU Electricity/Gas can collect additional data pursuant to the provisions of the German MTU Act (*MTS-Gesetz*).

The MTU Electricity/Gas analyses the electricity and gas market not only for potential violations of Articles 3 and 5 of the REMIT, but also for indications of violations of the prohibitions on market abuse under the Securities Trading Act (*Wertpapierhandelsgesetz*). In terms of trading wholesale energy products, violations of the prohibition on insider trading and market manipulation pursuant to sections 14 and 20a of the WpHG can be considered, for example, if financial instruments such as gas futures are involved. If in future the MTU Electricity/Gas determines an initial suspicion of insider trading or market manipulation during its analysis, it will inform BaFin, which will then pursue the case further.

convictions, had, among other things, driven the share price of LetsBuyIt Group AG higher with his recommendations. He had recommended these shares in his e-mail newsletter and in return received €1.9 million from clients, who were able to sell their shares at inflated prices. He had given the recommendations in the e-mail newsletters using a false identity. The judgement is not yet final.

Reference price manipulation in settlement prices of gas futures

Four traders of the trading department of a gas utility influenced the settlement prices for several gas futures at the European Energy Exchange (EEX) in Leipzig by entering orders (see info box "Settlement price", page 215).

The investigation stemmed from information provided by the trading surveillance unit of EEX, which conducted an extensive investigation of settlement prices on the gas futures market and made the trading data available to BaFin. The investigation extended over a two-week period in August 2012. During this period, the traders entered 88 orders in 15 exchange-traded gas

futures contracts shortly before the start of or during the settlement pricing phase. The traders subsequently deleted these orders again.

The traders were therefore accused of having manipulated the reference price. With this type of trading-based market manipulation, the perpetrator enters orders whose timing and size ensure that they are included in the determination of the reference price. However, since settlement prices are different from quoted or market prices within the meaning of section 38 (2) of the Securities Trading Act (*Wertpapierhandelsgesetz*), the manipulative activities did not actually have any effect on a quoted or market price. That would have been a requirement for considering the activities a criminal offence. The case therefore had to be prosecuted as an administrative offence. BaFin, the competent authority, did so by imposing a fine of €160,000 on the utility (see info box "Cooperation with the Market Transparency Unit Electricity/Gas"). The decision became final on 25 September 2014.³⁷

³⁷ See chapter V 7.2.

Drägerwerk AG & Co. KGaA

This case involved an attempted pre-arranged trade between the managing director of a German financial institution and his son. For tax reasons, this trade was to result in price gains being offset against declines in prices in the accrued losses of the custodian institution.

The two individuals concerned colluded with regard to trading venue, volume and limits for the financial instrument and placed offsetting orders within a short space of time. The buy order was placed by the father, who was an authorised user of his son's securities account. The sell order was placed by the son, using his second securities account. Both securities accounts were held at the credit institution where the father worked as managing director. However, because of the order situation at the Stuttgart trading venue, the offsetting orders placed by the two individuals concerned were not executed against each other, so that the market price was not actually affected. BaFin imposed administrative fines of €25,000 each on the two individuals concerned.

2.3 Insider trading

Investigations

BaFin launched 50 investigations into suspected insider trading (see Table 29 "Insider trading investigations"). It contacted foreign supervisory authorities in 27 cases (previous year: 63) and processed 36 enquiries from foreign supervisory authorities (previous year: 32). In this context, it also joined the foreign supervisory authorities in questioning

suspects and took part in an on-site investigation.

BaFin filed complaints against 22 cases involving a total of 45 suspects with the relevant public prosecutor's office. No evidence of insider trading was found in 11 cases investigated. A total of 43 investigations had not been completed at the end of 2014, some of which related to previous years.

Sanctions

In 2014, two people were convicted of insider trading (see Table 30 "Public prosecutors' reports on completed insider trading proceedings", page 218). A total of 39 cases were discontinued by the public prosecutors' offices, five of them as part of out-of-court settlements.

Selected cases

D+S europe AG

On 15 April 2008, a public takeover offer to the shareholders of D+S europe AG was published, in which they were offered €13 per share. The managing director of a subsidiary of D+S europe AG, who was included on the insider list of this stock corporation, acquired 3,000 shares of D+S europe AG on 11 April 2008 for a total amount of €29,596.89. He sold the securities on 16 April 2008, generating a profit of €9,103.11.

The public prosecutor's office in Lübeck discontinued the proceedings against the managing director in return for a payment of €26,000 as part of an out-of-court settlement

Table 29 Insider trading investigations

Period	New investigations	Results			Pending
		Discontinued	Referred to public prosecutors		
	Insiders	Insiders	Cases	Individuals	Total
2012	26	12	11	25	32
2013	42	13	35	99	26
2014	50	11	22	45	43

Table 30 Public prosecutors' reports on completed insider trading 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
2012	51	34	10	2	2	3	0
2013	27	12	5	0	8	0	2
2014	46	39	5	1	1	0	0

in accordance with section 153a of the Code of Criminal Procedure (*Strafprozessordnung* – StPO).

Praktiker AG

On 30 August 2012, Praktiker AG, which had been in an acute earnings and liquidity crisis since the end of 2011, published an ad hoc disclosure, in which it declared that it was entering into promising negotiations about raising a recovery loan. About one hour before the disclosure was published, the wife of a governing body member bought 9,500 shares of Praktiker AG for €10,389.29 and sold them again for €12,255 on 10 September 2012. She generated a profit of €1,865.71 in the process.

The public prosecutor's office in Essen discontinued the proceedings in return for a payment of €18,000 as part of an out-of-court settlement in accordance with section 153a of the StPO.

Fresenius Medical Care AG

On 4 April 2013, Fresenius Medical Care AG published an ad hoc disclosure according to which preferred shares of the company were to be converted into ordinary shares. One man bought a total of 1,250 preferred shares of the stock corporation at a price of €53,940 on 28 March 2012. He financed this unlimited order by selling other shares and in this way generated a special advantage of €11,847.50. The public prosecutor's office in Frankfurt discontinued the proceedings in return for a payment of €36,847.50 as part of an out-of-court settlement.

Centrosolar Group AG

Centrosolar Group AG announced in an ad hoc disclosure on 19 February 2013 that the preliminary revenue figures for financial year 2012 had declined by 22 per cent compared with the previous year. The disclosure revealed that the company had resolved an extensive restructuring programme. As a result, Centrosolar AG's share price fell by 20%. One of the company's advisers had placed a sell order for 244,949 shares of Centrosolar Group AG on 13 February 2013. By selling the shares early, he avoided a loss of €50,998. His wife sold 173,611 shares, also before the ad hoc disclosure was published, and thus avoided a loss of €33,030.67.

The public prosecutor's office in Paderborn discontinued the proceedings against the member of the advisory council and his wife in return for a payment of €75,000 and €50,000 respectively as part of an out-of-court settlement in accordance with section 153a of the StPO.

2.4 Ad hoc disclosures and directors' dealings

Ad hoc disclosures

A total of 1,564 ad hoc disclosures were published in 2014 (see Figure 14 "Ad hoc disclosures", page 219). The bank stress test conducted at the end of October 2014 made bank issuers face the question of whether to publish an ad hoc disclosure and what information to include. BaFin also followed the sequence of events closely and investigated which banks had inside information and at

what time they had this information, which they would have had to publish pursuant to section 15 (1) sentence 1 of the Securities Trading Act (*Wertpapierhandelsgesetz*). Some banks made use of the option under section 15 (3) of the Securities Trading Act to exempt themselves from publication.

They therefore scrutinised the information disclosed to them with the requisite sensitivity. In this context, they paid particular attention to the requirement to disclose information without undue delay, irrespective of exchange opening hours. A noteworthy positive aspect in general is that the banks had judged the ad hoc disclosure requirements correctly.

There were irregularities with regard to the disclosures of various Chinese issuers. For example, some of them published ad hoc disclosures that did not include inside information. Instead, they contained information on corporate philosophy or simply advertising. BaFin intervened to explain the meaning of ad hoc disclosures.

In 2014, BaFin again focused on the publication of financial results that represented inside information. In this context, it had and still has to be pointed out that the fact that the supervisory board's approval of the financial results is still outstanding is not normally a reason for exemption, because the effectiveness of annual financial statements prepared by the management board does not depend on the approval by another governing body. Moreover, the corresponding inside information has normally reached the required

level of detail even before the annual financial statements are prepared by the management board.

Directors' dealings

In 2014, executive managers and their related parties reported a total of 1,800 securities transactions for their own account (see Figure 15 "Directors' dealings", page 220).

2.5 Monitoring of short selling

Since November 2012, when the EU Short Selling Regulation became effective, there has been a ban on short sales in shares and certain types of sovereign debt. The same applies to taking positions in or entering into sovereign credit default swaps (CDSs) other than for hedging purposes. In addition, transparency requirements for net short positions in shares and certain types of sovereign debt have to be complied with.

Prohibitions

In 2014, BaFin completed all investigations relating to violations of the old national bans on short selling, which expired at the end of October 2012. 89 investigations out of a total of 98 were discontinued, and in nine cases, the investigation was passed on to the administrative fines section.

In addition, in response to suspicious transaction reports and on the basis of its own evidence, BaFin investigated a large number of cases for violations of the ban on short selling under the EU Short Selling Regulation. Suspicious transaction reports

Figure 14 Ad hoc disclosures

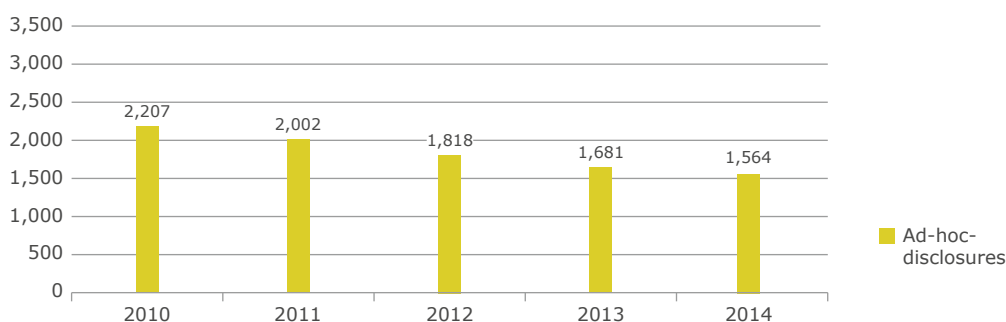
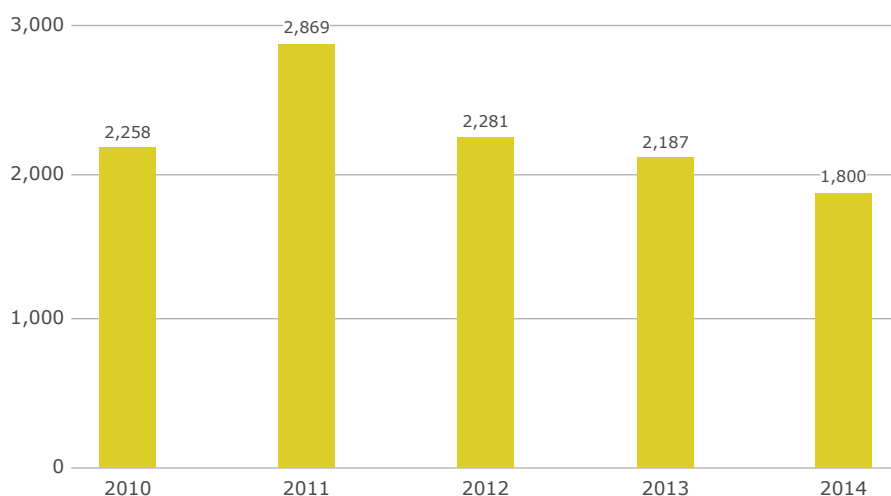


Figure 15 Directors' dealings

related to sales by both companies and private individuals; BaFin also received voluntary self-reports.

BaFin discontinued 17 investigations (previous year: 6). As at 31 December 2014, the investigation of 60 cases had not yet been completed; of this total, ten date from 2013 and 50 from 2014. BaFin referred 44 cases to other EU authorities for reasons of competence.

Transparency requirements

In 2014, BaFin investigated a large number of violations of the transparency requirements for net short positions under the EU Short Selling Regulation. It discontinued a total of 31 investigations (previous year: 5). As at 31 December 2014, the investigation of 19 cases had not yet been completed, ten of which date from 2013 and nine from 2014.

Net short positions are notified using BaFin's reporting and publication platform. By the end of 2014, BaFin had received a total of 1,811 applications for authorisation from 896 companies and 12 private individuals. As in previous years, most parties subject to notification requirements came from the United Kingdom and the USA. For shares admitted to trading on an organised market or multilateral trading facility, 247 parties subject to notification requirements notified BaFin of a total of 8,568 net short positions (previous year: 6,702) in 199 different shares (previous year: 166). This corresponds to an average of 34 notifications per trading day. 1,507 notifications (previous year: 2,778) had to be published in the Federal Gazette because the threshold of 0.5% of the share capital in issue had been crossed or reached. In addition, BaFin received 86 notifications for federal government debt securities (initial

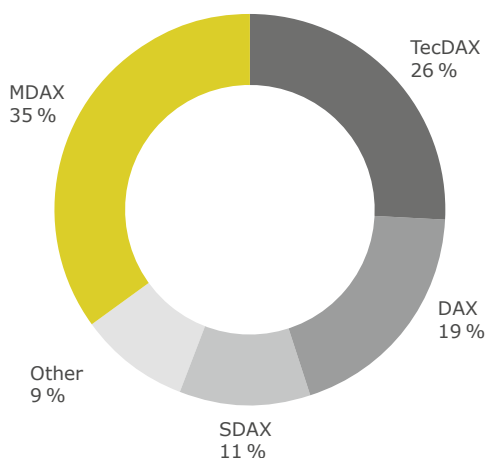
Table 31 Notifications by market makers and primary dealers

EU Short Selling Regulation	Market makers	Primary dealers
Total number of companies	49	33
of which from Germany	45	9
of which from abroad	4*	24**
Total number of notifications in 2014	2,448	35

* Non-EU third country.

** Domiciled outside Germany.

Figure 16 Distribution of notifications by index



threshold: 0.5%) (previous year: 109); there were no notifications for debt securities of the federal states (initial threshold: 0.1%) (previous year: 9).

Notifications by market makers

In the period up to the end of 2014, 49 market makers (previous year: 49) and 33 primary dealers (previous year: 33) notified BaFin of their activity and made use of the exemptions from the ban on short selling and transparency requirements (see Table 31 “Notifications by market makers and primary dealers”, page 220). 46 of the 49 market makers submitted further notifications of intent, which are required if market makers extend their activities to include a new instrument or primary dealers extend their activities to include public-sector debt securities from another issuer. In 2014, BaFin received a total of 1,160 notifications of intent from market makers (previous year: 1,001) and 36 notifications of intent from primary dealers (previous year: 3).

2.6 Supervision of OTC derivatives transactions

Since February 2014, counterparties and central counterparties (CCPs) have had to report to a trade repository any derivative contracts entered into, modified or terminated. Six such trade repositories are currently authorised in the EU. The reporting requirement applies to both

OTC (over-the-counter) and exchange-traded derivatives transactions. The reports have to be submitted to a trade repository registered with or recognised by ESMA. The European Market Infrastructure Regulation (EMIR)³⁸, which entered into force in 2012, defines the requirements for the trade repositories and those for the central counterparties. At present, however, some key regulatory standards, such as those governing the margining of bilateral OTC derivatives transactions and the obligation to clear certain derivative classes via a central counterparty, are not yet in force.

BaFin conducted extensive market analyses in 2014 and examined the compliance by larger regulated companies with the requirements on OTC derivatives transactions of financial counterparties (insurance undertakings, investment services enterprises as well as banks and funds). The process revealed that Germany’s financial counterparties want non-financial counterparties to meet their obligations as well.

In addition, BaFin issued the German Counterparty Review and Certification Regulation (*Gegenpartei-Prüfbescheinigungsverordnung*) in 2014. This Regulation specifies the auditor’s audit obligations for the certificate in accordance with section 20 of the WpHG. Under section 20 of the WpHG, corporations, other than small corporations or financial counterparties within the meaning of EMIR, whose OTC derivatives are above certain thresholds have to engage an external auditor to review their compliance with the EMIR requirements. If the review identifies any deficiencies, the company has to submit the auditor’s certificate to BaFin. The enhanced review requirements have been in force since the 2014 financial year. They give BaFin the power also to monitor so-called non-financial counterparties to establish whether they comply with the provisions of EMIR.

BaFin had a number of discussions with the Institute of Public Auditors in Germany (*Institut der Wirtschaftsprüfer in Deutschland e.V.* –

³⁸ Regulation (EU) No 648/2012, OJ EU L 201/1.

IdW) in order to explain its requirements for reviews.

In connection with EMIR, BaFin issued various important interpretative decisions, which are published on its website. They explain, for example, how local authorities have to distinguish their sovereign activities, which are not subject to EMIR, from business activities, such as those performed by a limited liability company (GmbH). In addition, in close consultation with the other European supervisory authorities, it debated and ruled on a large number of other interpretative issues arising from the preparation and revision of ESMA's Questions and Answers on EMIR. For example, ESMA has clarified that parties based in the EU have to meet the requirements on bilateral risk management pursuant to Article 11(1) of EMIR even in cases where they enter into OTC contracts with counterparties from non-EU countries.

2.7 Voting rights and duties to provide information to security holders

2.7.1 Voting rights

In 2014, BaFin received 6,111 voting rights notifications, slightly more than in the previous year (see Figure 17 "Voting rights notifications"). In the same period, the number of notifications on financial and other instruments, such as call options with

physical settlement and rights of redemption under securities loans, received pursuant to section 25 of the Securities Trading Act (*Wertpapierhandelsgesetz*) increased significantly to 1,237. The number of notifications on financial and other instruments, such as call options with cash settlement and rights of first refusal, received pursuant to section 25a of the Securities Trading Act remained relatively stable, at 1,503.

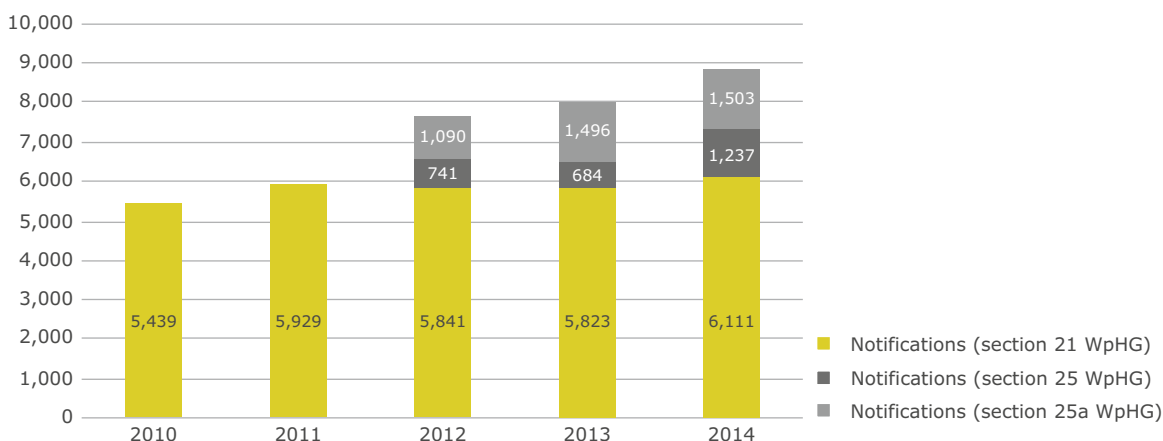
BaFin received a total of around 8,000 notifications in accordance with sections 21, 25 and 25a of the Securities Trading Act and monitored their publication.

The number of companies admitted to trading on the regulated market declined from 773 in the previous year to 716 in 2014, while the number of notifications these companies published on changes in their voting share capital rose to 386 (previous year: 346). At the end of 2014, three real estate investment trusts (REITs) were subject to reporting requirements to BaFin.

2.7.2 Duties to provide information to securities holders

In 2014, issuers of listed securities reported a total of 255 planned changes in the legal basis of their activities to BaFin (previous year: 265). In addition, in 520 cases, they published the attendance rights, the agenda and the total number of shares and voting

Figure 17 Voting rights notifications



rights when convening their annual general meeting (previous year: 510). Moreover, a large number of resolutions and events in connection with the annual general meeting are subject to publication requirements. Issuers

notified BaFin of changes in rights attached to securities admitted to trading, bond issuance and the publication of material information in third countries in 2,751 cases in the year under review (previous year: 2,097).

3 Prospectuses



3.1 Securities prospectuses

In 2014, BaFin approved 1,718 securities prospectuses, registration documents and supplements, significantly fewer than in the previous year (see Table 32 “Number of approvals in 2014 and 2013”). BaFin declined to grant approval in four cases.

The noticeably lower number of documents approved relates mainly to supplements and reflects the expiry of the transitional provisions at the end of 2013. Until then, it was possible to continue to offer securities to the public that were issued on the basis of a prospectus approved by BaFin prior to 1 July 2012. In the absence of these prospectuses, the related supplements were also no longer issued.

In parallel with the reduction in the number of documents approved, the number of securities prospectuses and supplements notified to other national supervisory authorities under the European Passport also fell and amounted to 3,281 notifications issued (prior year: 5,738, see Table 33 “Notifications”).

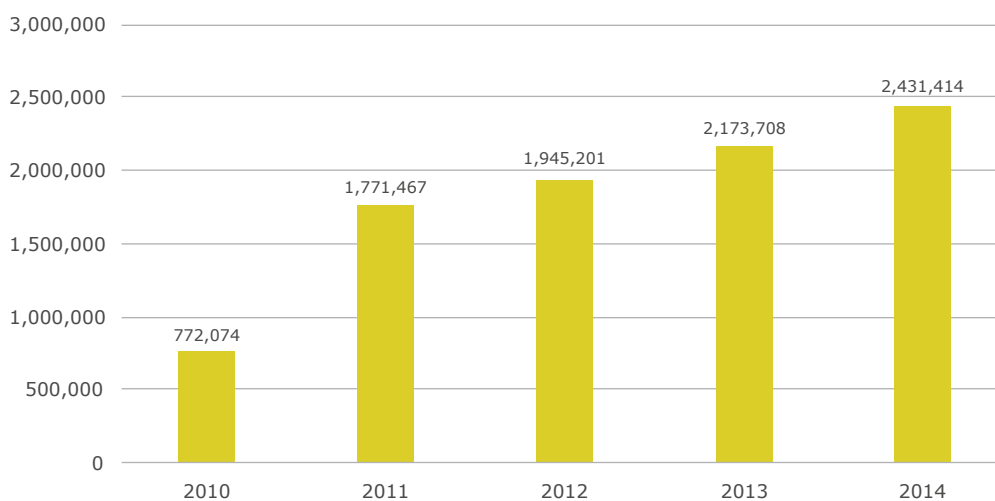
Table 32 Number of approvals in 2014 and 2013

Product	2014	2013
Shares (IPOs/capital increases)	69	75
Derivatives	246	223
Debt securities	138	168
Registration documents	34	33
Supplements	1,231	2,725
Total	1,718	3,224

In contrast, the trend of steady growth in the total volume of issues continued in 2014. During the course of the year, offerors submitted 2,431,295 final terms alone to BaFin.

Table 33 Notifications

Country	Notifications issued	Notifications received
Belgium	57	8
Bulgaria	1	0
Denmark	22	0
Finland	65	0
France	101	121
Greece	1	0
United Kingdom	193	131
Ireland	66	135
Italy	94	0
Liechtenstein	220	1
Luxembourg	879	882
Netherlands	201	51
Norway	114	0
Austria	1,142	123
Poland	7	0
Portugal	21	0
Sweden	61	3
Spain	33	0
Czech Republic	3	0
Others	0	0
Total	3,281	1,455

Figure 18 Total issue volume

It is expected that the total issue volume will continue to grow modestly in the next few years.

BaFin has informed ESMA of all securities prospectuses and supplements it approves since mid-2014. Since then, investors have also been able inspect all securities prospectuses and related supplements approved in the European Economic Area (EEA) on the ESMA homepage.

The Retail Investor Protection Act (*Kleinanlegerschutzgesetz*) has limited the period of validity of base prospectuses to twelve months. Previously, it was possible to continue to use final terms for offers to

the public for a maximum of twelve months after their submission to BaFin, even if the underlying base prospectus had already exceeded its period of validity of twelve months. In future, a public offer of securities will only be permitted within the twelve-month period of validity of the prospectus; the date on which the issuer files the relevant final terms with BaFin is not important for this purpose. It is expected that base prospectuses will no longer be updated only annually, but before the end of the year, to enable issues of securities to continue without interruption. This is likely to be reflected in an increase in the number of prospectuses.



3.2 Focus



Mittelstand bonds – opportunities and risks for retail investors

Author: Dr Kerstin Henningsen, Section PRO 1 – Prospectuses

Bonds have become increasingly significant in recent years as a form of financing for *Mittelstand* (German mid-sized) companies. In particular, a bond issue, which does not necessarily require collateral to be provided,

represents an alternative to a bank loan for *Mittelstand* companies.

On one hand, there is certainly a desire to make the capital market more accessible for

Mittelstand companies – many measures have been put in place to this effect. For example, stock exchanges have created their own market segments for bonds issued by *Mittelstand* companies. Moreover, since the most recent revision of the Prospectus Directive, small and medium-sized companies and companies with a reduced market capitalisation (see info box) have enjoyed simplified requirements as compared with larger companies with respect to the disclosures in securities prospectuses. The European Union has also made easier access to the capital markets for small and medium-sized companies a priority in its plans for the creation of a capital market union.

Caution required

On the other hand, however, caution is also required. Various cases of the insolvency or restructuring of *Mittelstand* companies with investment grade ratings that had issued bonds show that, despite the contractually guaranteed payment of interest and principal, this instrument involves risks.

Mittelstand bonds are issued by a range of very different companies from a large number of sectors. The terms and conditions of their bonds also cover a wide spectrum. There is therefore no typical *Mittelstand* bond. The evaluation of the opportunities and risks also depends on each individual case; it is not possible to make judgments that are applicable generally. *Mittelstand* bonds generally have maturities of between five and ten years and offer annual interest payments of 4.8% to 8.5% (or more in individual cases). Some provide collateral whereby independent trustees are appointed to manage specific assets on behalf of investors, in order to secure the payment of interest and principal.

At first sight, *Mittelstand* bonds appear attractive in view of the relatively high coupon. But as a general rule, a higher rate of interest is also matched by an increased level of risk. It is therefore advisable to obtain detailed information about the issuer and the security being offered prior to making a purchase.

Transparency prior to purchase

The securities prospectus represents a good source of information before making a purchase. Any entity intending to make an offer of securities to the public must first publish a securities prospectus which has been approved by BaFin or another competent authority in a member state of the European Economic Area. There are exemptions from the obligation to publish a prospectus, for example if the minimum denomination or minimum subscription price per investor amounts to €100,000.

The regulated unofficial market on the stock exchange also lists bonds for which no prospectus has been published and whose ongoing disclosures only meet the minimum requirements for unlisted companies. This is perfectly permissible in accordance with the law. In such cases, investors should make a particular effort to obtain as much comprehensive information as possible. Enquiries directly to the company itself may also prove fruitful.

In addition to a detailed presentation of the risk factors, the prospectus contains all the material disclosures relating to the issuer and to the



SMEs and companies with reduced market capitalisation

Small and medium-sized enterprises (SMEs) within the meaning of prospectus law are companies which meet at least two of the following three criteria on the basis of their most recent annual financial statements or consolidated financial statements: an average number of employees in the most recent financial year of less than 250, a total balance sheet not exceeding €43 million and an annual net turnover not exceeding €50 million. Companies with reduced market capitalisation within the meaning of prospectus law are companies listed on a regulated market that had an average market capitalisation of less than €100 million on the basis of the year-end quotes for the previous calendar years.

terms and conditions of the bond. Accordingly, the issuer must not only provide an overview of the business and information about its most significant current and future investments and organisational structure. It must also reproduce the audited annual financial statements for the two most recent financial years together with the auditor's reports. Any conflicts of interest and material contracts outside the ordinary course of business which may affect the issuer's ability to make payments of interest or principal must also be disclosed. Finally, the issuer must indicate how the proceeds of the issue are intended to be applied. Experience shows that in practice some companies give more extensive and detailed information in the securities prospectus about the purposes for which the funds received are intended to be used than others.

However, small and medium-sized companies and companies with reduced market capitalisation are subject to less onerous requirements. Among other things, they are not obliged to reproduce the annual financial statements in the prospectus; it is sufficient for them to indicate where the most recent audited annual financial statements can be inspected. In such cases, investors should nonetheless make the effort to consult the annual financial statements – they are normally published on the issuer's website.

They should also be clear about the terms and conditions of the issue. For example, the terms and conditions may provide that a majority of the bondholders can pass a resolution agreeing to reduce the amount of interest payments or repayments of principal, defer the maturity date of the bond or take other measures. On the one hand, this may be a useful method in particular cases of averting an insolvency on the part of the issuer that would otherwise occur, which is certainly also in the interests of investors as creditors. On the other hand, investors must accept that they may have to waive some of their entitlements.

Transparency after purchase

Throughout the duration of the public offer, the offeror must keep the prospectus up-to-date and, if necessary, issue supplements to the prospectus. In the latter case, investors have the benefit of a little-known right: the right of revocation. Investors may revoke their declaration of intent in respect of the purchase of the securities given prior to publication of the supplement and thus cancel the purchase, provided that the event giving rise to the need for a supplement occurs before the securities are delivered. It is necessary to act quickly, however: the right of revocation can only be exercised within two working days of the publication of the supplement. Investors should keep in mind that Saturday counts as a working day.

The extent of the information that the issuer is required to publish during the term of the bond also depends on whether the securities are listed on a stock exchange and – if yes – in which market segment. A listing in the regulated market has the highest publication requirements. Less stringent standards, which vary from one exchange to another, generally apply for a listing in the regulated unofficial market, since it is subject to the regulations of the particular stock exchange. Some *Mittelstand* bonds are not listed on a stock exchange. This reduces the issuer's costs, but on the other hand there is a low level of transparency; investors should also bear in mind that as a result it is likely to be difficult to sell the securities prior to maturity.

Summary

Mittelstand bonds are not suitable for everyone. An investment depends on an assessment of the opportunities and risks and an understanding of the circumstances of the particular case. But investors who are ready to accept a certain amount of risk attaching to the investment and who make their selections with care, may generate attractive returns.



3.3 Investment prospectuses

In 2014, BaFin examined a total of 104 non-securities investment prospectuses (see Figure 19 "Prospectuses received, approvals, withdrawals and prohibitions"). It approved 53 prospectuses (previous year: 197) and prohibited two offerings. Issuers withdrew their applications in 59 cases. The number of withdrawals in 2014 continued to be at a relatively high level. The reason for this, as in the previous year, was the change in the legal position since the coming into effect of the Investment Code (*Kapitalanlagegesetzbuch*). As before, offerors are having difficulties presenting the issuers' predominantly operating activities within the contractual framework.

Analysing the prospectuses received during 2014 by type of participation, the greatest share was represented by participations in limited partnerships, accounting for around 56%, followed by registered bonds with around 28% and participation rights with around 13%. 2% of prospectuses received related to foreign types of participation outside the EU, and 1% to typical silent participations.

Investments in renewable energy easily took first place among the target investments offered, accounting for around 52% (previous year: 45%) of prospectuses received. The proportion represented by wind power (41%) was roughly the same as in the previous year (39%).

Investments in solar power facilities rose significantly to 10% (previous year: 5%), while the proportion accounted for by biogas was 1%, as in the previous year. Real estate investments, on the other hand, fell sharply to around 10% (previous year: 20%); 5% (previous year: 17%) of the investments related to domestic real estate and 5% (previous year: 3%) to foreign real estate. No new ship funds were launched during the reporting period (previous year: 3%).

This is due to the fact that, following the entry into force of the Investment Code, many classic investment models are no longer classified as non-securities investments, but as investment funds. Investment offers relating to these sectors generally fall within the scope of the Investment Code as a result of their investment structure. In the real estate sector, for example, only the operation and project development of a property are regarded as operating activities within the meaning of section 1 (1) of the Investment Code and therefore constitute non-securities investments, but this is not the case for the acquisition, letting, leasing, management or sale of real estate. Other target investments continued to represent a significant proportion of prospectuses received alongside the traditional target investments, accounting for 38% (previous year: 21%).

The number of supplements fell significantly compared with the previous year: a total

Figure 19 Prospectuses received, approvals, withdrawals and prohibitions

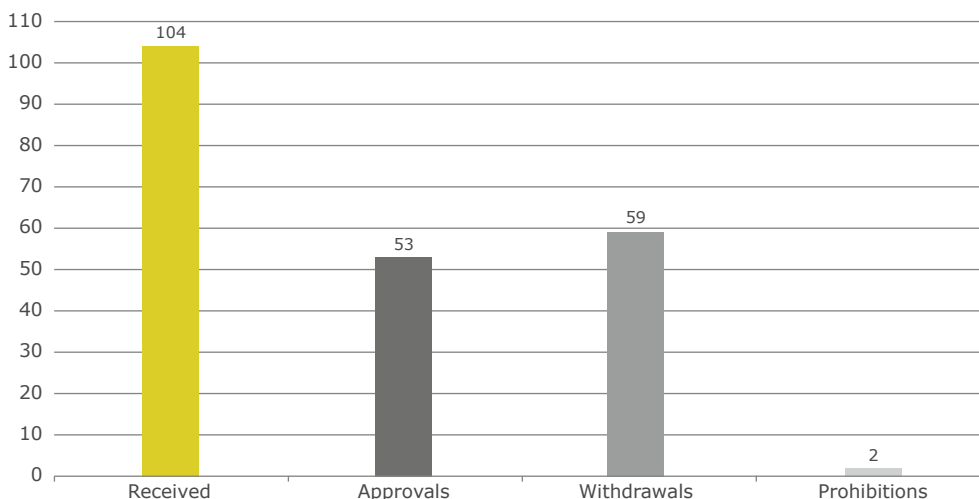
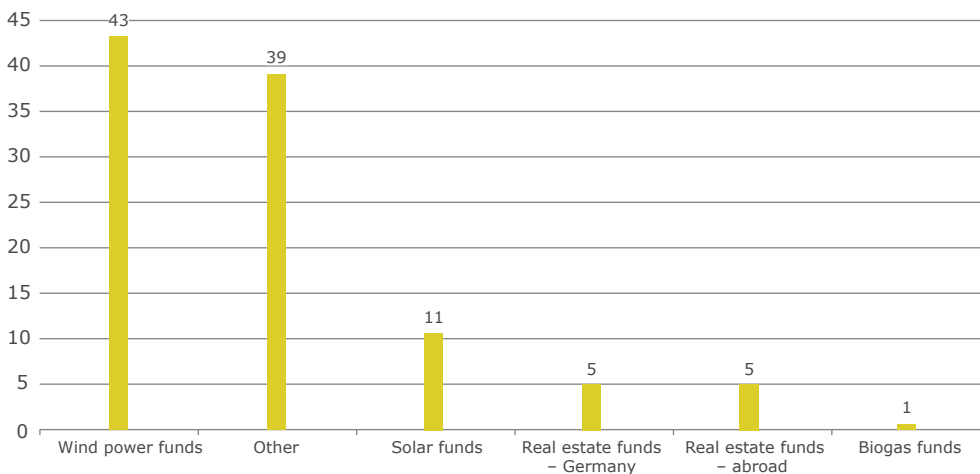


Figure 20 Prospectuses by target investment

of 70 applications for the approval of supplements under the Capital Investment Act (*Vermögensanlagegesetz*) were submitted. In 2014, BaFin approved 64 supplements and prohibited four. In a further four cases, the offerors withdrew the application for approval

themselves as the transitional period ended on 21 July 2014. Since that date, public offers have been permitted under the Capital Investment Act only for non-securities investments and those investment funds that have made no additional investments since 21 July 2013.

4 Corporate takeovers

Offer procedures

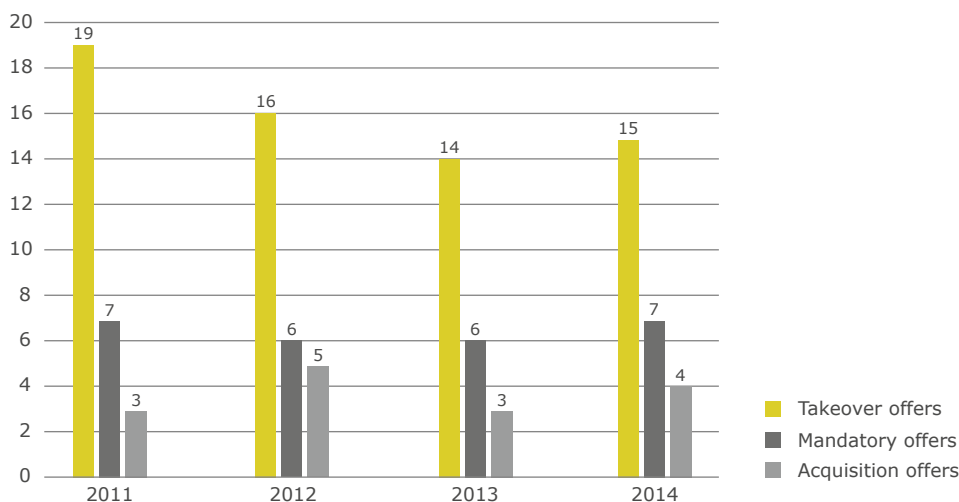
In 2014, BaFin examined a total of 27 offer documents and approved their publication in 26 cases (see Figure 21 "Offer procedures from 2011 to 2014", page 229). In one case, BaFin initially prohibited a mandatory offer. In the initial review process, the bidder had been unable to produce confirmation of financing from an independent investment services enterprise by the end of BaFin's examination. It complied with its obligations only in response to an express demand from BaFin and several months late. To compensate for the delay, the bidder was required to increase its offer to shareholders to include default interest at 5% over the basic rate of interest in accordance with the Civil Code (*Bürgerliches Gesetzbuch*).

Purchase of convertible bonds in an offer for shares

On 5 December 2013 Dragonfly GmbH & Co. KGaA in Frankfurt am Main published a

takeover offer to the shareholders of Celesio AG in Stuttgart. Dragonfly GmbH & Co. KGaA was unable to complete the offer since it did not reach the minimum threshold for acceptances on which it was conditional. It therefore published a new takeover offer for the shares in Celesio AG on 28 February 2014. In the offer document, Dragonfly GmbH & Co. KGaA indicated that in the run-up to the offer it had acquired shares in the target company as well as bonds convertible into shares in the target company.

If a bidder acquires shares in a target company prior to a takeover offer or mandatory offer, this can affect the minimum price that the bidder must offer to the shareholders of the target company. This is because the minimum price that must be offered in a takeover or mandatory bid is determined, among other things, from prior purchases. Under these rules, the price

Figure 21 Offer procedures from 2011 to 2014

offered in a takeover or mandatory bid must be at least equal to the highest price paid or agreed by the bidder as consideration for the purchase of shares in the target company during the last six months prior to publication of the offer document. BaFin's administrative practice therefore regularly includes a check on whether all prior purchases have been accurately disclosed in the offer document.

Against this background, the question arose in the case of the Celesio offer whether the acquisition by the bidder of bonds giving it the right to subscribe for shares in the target company also counts as a prior purchase. BaFin rejected this view.

The wording of section 4 of the Offer Regulation to the Securities Acquisition and Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz*) is quite clear in that it applies only to purchases of shares, and not to the purchase of other securities. This ruling therefore provides more detail on the practical interpretation of the principle of equal treatment that applies generally in takeover law. The principle imposes an obligation on the bidder to treat holders of securities of the same class in the target company equally (section 3 of the Securities Acquisition and Takeover Act). However, shares and rights entitling the holder to acquire shares, such as call options and convertible bonds, represent different classes of security.

It was also not possible to treat the acquisition of existing convertible bonds as a prior purchase in accordance with the meaning and purpose of the minimum price rules. The rule on prior purchases is intended to prevent individual shareholders receiving preferential treatment.³⁹ However, the purchase by a bidder of an existing convertible bond does not of itself result in the unequal treatment of shareholders. The sale of the bond does not affect the underlying shares. Any increase in value from exploiting a special negotiating position is received in principle only by the seller of the bond, not by a shareholder in the target company.

The bidder acquires shares in the target company only when the convertible bond is exercised. This event is then certainly a prior purchase if it occurs in the relevant period. The same applies to the agreement, i.e. the subscription for a convertible bond. It is true that the bidder does not directly acquire shares in the target company through subscribing for the bond either. But it enters into an agreement whose purpose is the acquisition of those shares. Section 31 (6) of the Securities Acquisition and Takeover Act treats agreements of this nature as equivalent to purchases of shares in the target company.

³⁹ See *Bundestag* publication 14/7477, p. 79 *et seq.*



Own shares of subsidiaries

BaFin changed its administrative practice relating to the attribution of voting rights attaching to own shares held via subsidiaries in 2014. In doing so, it was reacting to problems facing bidders in takeover procedures relating to the attribution of target companies' own shares.

Under section 71b of the Stock Corporation Act (*Aktiengesetz*), if a German stock corporation holds its own shares, it has no rights in respect of those shares, and therefore no voting rights, either. Previously, own shares held by subsidiaries were attributed to the parent company's share of the voting rights pursuant to section 30 (1) sentence 1 no. 1 of the Securities Acquisition and Takeover Act or section 22 (1) sentence 1 no. 1 of the Securities Trading Act (*Wertpapierhandelsgesetz*). Under the new administrative practice, this is no longer the case.

The previous rule had resulted in difficulties, in particular in relation to the tight time limits for applications for exemption pursuant to section 37 of the Securities Acquisition and Takeover Act

and notifications pursuant to section 21 of the Securities Trading Act. In order to comply with these time limits, shareholders had to determine the exact date from which the shares were attributable. This was particularly difficult if the status of the stock corporation as a subsidiary of the shareholder only emerged from the fact that the shareholder consistently had a majority at the stock corporation's annual general meeting. It is often the case in practice that even a share of less than 30% of the voting rights results in the bidder having a consistent majority of those present at the annual general meeting. If, in addition, the shareholder did not know exactly how many shares the entity held, a small oversight on the part of the shareholder could result in a breach of the rules. Since such a breach of the rules would be of a purely technical nature, BaFin has revised its administrative practice.

This does not impair transparency in the capital markets, as the target company is required to publish the amount of own shares in accordance with section 26 (1) sentence 2 of the Securities Trading Act. This always applies when the own shares held reach, exceed or fall below the 3%, 5% or 10% thresholds.

BaFin also confirmed its existing administrative practice whereby the seller of a block of shares does not become a person acting in concert with the bidder within the meaning of takeover law merely by entering into a purchase and sale agreement with it.⁴⁰ It is not relevant in this context whether the seller is aware of the bidder's intentions and has only acquired the shares with a view to selling them to the bidder at a later date. But this would not be the case if, for example, the bidder and the seller of the block of shares have already agreed in advance that the seller will acquire shares in the target company for the bidder, and is therefore effectively acting on its behalf.

Exemption procedures

In 2014, BaFin reviewed 100 applications for exemption or non-consideration of voting rights (previous year: 111). In 59 cases, holders of voting rights requested non-consideration in accordance with section 36 of the Securities Acquisition and Takeover Act (previous year: 49), while 41 applications for exemption were made in accordance with section 37 of the Securities Acquisition and Takeover Act (previous year: 62). BaFin approved 53 applications. 14 applications were withdrawn. A total of 33 applications were still being processed at the end of 2014.

⁴⁰ On the definition of a person acting in concert, see: Annual Report 2010, p. 219.

5 Financial reporting enforcement

Monitoring of financial reporting

As at 1 July 2014, 756 companies from 21 countries (previous year: 751 companies from 19 countries) were subject to the two-tier enforcement procedure performed by BaFin and the Financial Reporting Enforcement Panel (FREP).

The FREP completed a total of 104 examinations in 2014 (previous year: 110), of which 99 were sampling examinations. BaFin itself performed financial reporting enforcement procedures at eleven companies (previous year: 16) and ordered the publication of errors in ten cases.

The FREP had previously identified errors in consultation with the relevant companies in eight of the eleven cases (see Table 34 "Enforcement procedures in 2014"). The remaining three cases were based on error identification procedures performed by BaFin, two of which concluded with errors being identified. The company had not accepted the FREP's findings in these cases. In all cases that ended with the finding of errors, BaFin ordered their publication. BaFin's cases related to a variety of accounting matters, such as the quality of goodwill, revenue recognition, the measurement of real estate and the recognition of gains from the disposal of assets. Eight

cases were still pending at BaFin at the end of 2014.

Publication of financial reports

In 2014, BaFin examined in approximately 1,900 cases whether the issuers had published their online annual and half-yearly financial reports as well as interim management statements on time (previous year: 2,100). 51 issuers had not published a financial report on their homepage (previous year: 52); in some cases, no webpage with financial information could be identified at all. BaFin initiated administrative fine proceedings in these cases.

In addition, it launched 21 administrative procedures to enforce the financial reporting requirements (previous year: 12). A total of 13 proceedings were still pending from 2013. BaFin closed 11 administrative procedures (previous year: 9) after the issuers subsequently met their obligations. In four cases, it was initially obliged to threaten coercive fines of up to €62,500 in order to achieve the publication of the financial reports, and in one case to impose a coercive fine amounting to €32,500. A total of 23 administrative procedures were still pending at the end of 2014. BaFin has to date threatened coercive fines of up to €100,000 in twelve cases and already imposed such fines in ten cases.

Table 34 Enforcement procedures in 2014

	Error findings: yes	Error findings: no	Error publication: yes	Error publication: no
Company accepts FREP's findings	8		8	0
Company does not accept FREP's findings	2	1	2	0
Company refuses to cooperate with FREP	0	0	0	0
BaFin has material doubts as to the accuracy of the FREP examination findings/ procedure	0	0	0	0
BaFin takes over the examination (banks, insurance undertakings)	0	0	0	0
Total	10	1	10	0

6 Supervision of investment business



6.1 German management companies

In 2014, BaFin authorised 97 German management companies (*Kapitalverwaltungsgesellschaften*) in accordance with the Investment Code (*Kapitalanlagegesetzbuch*) to manage investment funds (previous year: 6). Three German management companies surrendered their authorisations. This meant that, at the end of 2014, 113 German management companies were authorised in accordance with the Investment Code. In addition, 143 German management companies had been registered pursuant to section 44 of the Investment Code by the end of 2014. In 22 cases, German management companies established a branch in another EU member state or offered cross-border services for the first time. At the same time, 54 companies from other EU countries notified BaFin that they had established a branch or started providing cross-border services in Germany.

BaFin performed a total of 80 supervisory visits and annual interviews on site in 2014 (previous year: 96). In addition, it accompanied nine audits and special audits at German management companies and depositaries.

During 2014, BaFin asked a number of German management companies about their organisational arrangements for the purpose of protecting against cybercriminality. The responses of the companies selected to the survey indicated that they were well positioned. BaFin will continue to pay close attention to developments in the future – especially in view of the increase in the number of interfaces as the result of outsourcing.

6.2 Investment funds

In 2014, BaFin approved a total of 87 new retail investment funds in accordance with the Investment Code, including 57 UCITS, seven open-ended retail AIFs and 23 closed-ended

retail AIFs. It permitted 734 retail investment funds to transition to the Investment Code, of which 585 were UCITS and 149 open-ended retail AIFs.

6.2.1 Open-ended real estate funds

BaFin's supervisory activities with respect to open-ended real estate funds in 2014 were mainly focused on the authorisation procedures under the Investment Code. In accordance with the transitional provisions of section 345 of the Investment Code, companies that held an authorisation as an asset management company (*Kapitalanlagegesellschaft*) under the Investment Act (*Investmentgesetz*) by 21 July 2013 were required to apply for authorisation as a German AIF management company (*AIF-Kapitalverwaltungsgesellschaft*) under the Investment Code at the latest by 21 July 2014. These companies were permitted to continue their existing activities until authorisation had been granted on the basis of the application submitted, but not beyond 21 January 2015. The majority of the 42 companies authorised to manage open-ended real estate funds under the



Notification procedure for foreign AIFs

A new Guidance Notice on marketing dated 30 September 2014⁴¹ sets out the basic features of the notification procedure pursuant to section 330 of the Investment Code. It also explains the conditions for marketing units or shares in foreign AIFs or EU AIFs managed by a foreign AIF management company to professional or semi-professional investors in the Federal Republic of Germany. Specifically, the Guidance Notice lists the particulars and documents generally required by section 330 of the Investment Code for notifications of the intended marketing of units or shares in EU AIFs or foreign AIFs to professional and semi-professional investors.

41 www.bafin.de/dok/5516232

Table 35 Risk classification of German management companies in 2014

German management companies*		Quality				Total
		A	B	C	D	
Impact	High	30	1	0	0	31
	Medium	12	3	0	0	15
	Low	16	7	0	0	23
	Total	58	11	0	0	69

* Risk classification of German management companies in 2014

Investment Act did not submit their applications for authorisation under the Investment Code until 2014. BaFin granted all of the companies authorisation to continue managing open-ended real estate funds by the end of 2014. In addition to this, there were other applications from new companies not previously under supervision, of which one received authorisation to manage open-ended real estate funds for retail investors in 2014.

The number of open-ended real estate funds for retail investors fell to 47 in 2014 (previous year: 53); the funds were managed by a total of 20 German management companies (previous year: 20). BaFin approved three open-ended real estate funds for retail investors (previous year: 5), of which one was actually established during the reporting period. In two cases, management companies were forced to trigger the liquidation of open-ended real estate funds for retail investors by terminating their management of the fund (previous year: 2).

At the end of 2014, 18 of the 47 open-ended real estate funds for retail investors (previous year: 16) with a fund volume of €13.7 billion were being liquidated. In the case of one open-ended real estate fund for retail investors, redemption of units was temporarily suspended. In total, therefore, 19 open-ended real estate funds for retail investors had temporarily suspended unit redemptions or were being liquidated (previous year: 18). The management rights for four open-ended real estate funds for retail investors were transferred to the depositary after the notice period expired.

The trend towards investments in open-ended real estate special funds continued in 2014. Although the number of open-ended real estate special funds declined to 326 in 2014 (previous year: 342), at the same time the aggregate net asset value under management continued to rise.

6.2.2 Hedge funds

In 2014, BaFin once again participated in the hedge fund survey conducted by the International Organization of Securities Commissions (IOSCO). The survey is carried out every two years. On the basis of a wide-ranging list of topics, IOSCO asks hedge funds questions relating to their significant risk indicators, relationships with counterparties and investment strategies, among other things. The IOSCO committees then evaluate the aggregated results collated by the national supervisory authorities. The overall findings of the 2014 study are expected to be published in the spring/summer of 2015. With respect to the German market, however, it can already be reported that, at the 30 September 2014 reference date, twelve German management companies had made use of their authorisation to set up hedge funds. The volume of funds under management in Germany at that reference date amounted to around €1.7 billion.

6.2.3 Foreign investment funds

The number of EU UCITS authorised for marketing amounted to 9,003 in 2014 (previous year: 12,787). BaFin processed a total of 1,087 new notifications by companies

wanting to market EU UCITS in Germany (previous year: 1,104). As in previous years, most of the notifications came from Luxembourg (686). In addition, 260 notifications were received from Ireland, 56 from France and 46 from Austria. Marketing was discontinued for 438 EU UCITS.

In addition, 609 EU AIFs and 92 AIFs from foreign third countries were authorised to conduct marketing in Germany (previous year: 134 in total). Of the total number, 330 originated from Luxembourg, 123 from the United Kingdom, 98 from Ireland, 37 from the Cayman Islands, 28 from the USA, 17 from France, eleven from Switzerland and ten from the Netherlands. 529 AIFs started marketing in Germany in 2014, including 215 from Luxembourg, 95 from the UK, 87 from Ireland, 38 from the Cayman Islands and 30 from the USA. 37 EU AIFs and foreign AIFs ceased marketing, including 18 from Luxembourg and five each from the UK and the Cayman Islands.

On 1 January 2014, an agreement between BaFin and Switzerland came into force whereby Swiss securities funds (*Effektenfonds*) may be marketed in Germany on the basis of the same electronic notification procedure as for UCITS. Conversely, German UCITS can complete a corresponding notification procedure for Switzerland. The same requirements and guidance notices therefore apply to the Swiss securities funds as to the cross-border marketing of UCITS. Additionally, a certificate from the Swiss supervisory authority to the effect that the Swiss securities fund is managed in accordance with the AIFM Directive must be submitted to BaFin. For the cross-border marketing of German UCITS in Switzerland, the provisions of the Swiss Federal Act on Collective Investment Schemes (*Schweizer Bundesgesetz über die kollektiven Kapitalanlagen*) and of the Ordinance on Collective Investment Schemes (*Kollektivanlagenverordnung*) that a foreign management company must comply with when marketing units or shares in a UCITS in Switzerland are applicable accordingly.

7 Administrative fine proceedings

7.1 Administrative fines

In 2014, BaFin instituted 514 new proceedings for the imposition of administrative

fines (see Table 36 "Administrative fine proceedings", page 235) relating to violations of the provisions of securities law (previous

Figure 22 Number of administrative fines

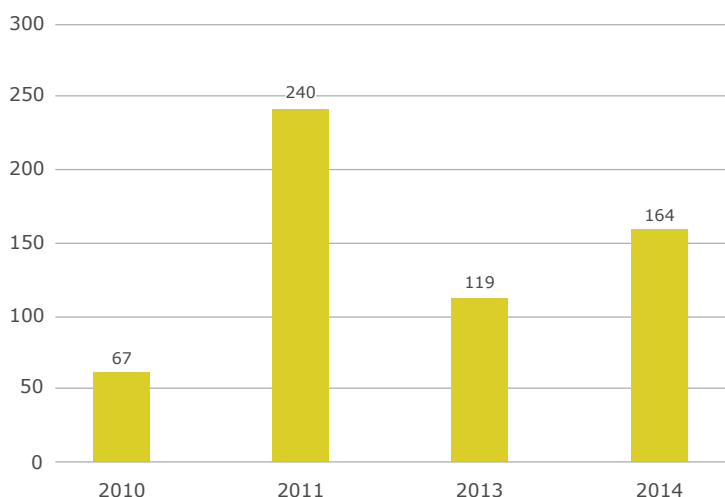


Table 36 Administrative fine proceedings

	Number of cases pending at the beginning of 2014	Number of new cases in 2014	Administrative fines*	Highest administrative fine imposed (€)	Discontinued for		Number of cases pending at the end of 2014
					factual or legal reasons	discretionary reasons	
Reporting requirements (section 9 of the WpHG)	3	2	3	24,000	0	0	2
Ad hoc disclosures (section 15 of the WpHG)	75	25	16	125,000	2	3	79
Directors' dealings (section 15a of the WpHG)	8	2	3	15,000	0	0	7
Market manipulation (section 20a of the WpHG)	32	11	10**	160,000	0	0	33
Notification and publication requirements (sections 21 et seq. of the WpHG)	650	327	82	220,000	21	188	686
Duties to provide information to security holders (sections 30a et seq. of the WpHG)	73	46	21	18,000	5	21	72
Short selling (section 30h of the WpHG)	3	2	1	60,000	1	0	3
Financial reporting requirements (sections 37v et seq. of the WpHG)	113	63	25	100,000	0	14	137
Securities Prospectus Act	9	3	1	30,000	0	1	10
Capital-Investment Act/ Prospectus Act	12	3	0	0	1	0	14
Takeovers (WpÜG)	28	29	2	24,000	0	2	53

* Proceedings closed by imposing an administrative fine.

** The discrepancy between table 30, page XY, and table 38 is due to the fact that table 30 shows the number of administrative fines imposed, whereas this table details the number of proceedings ending in a fine. If BaFin institutes several administrative fine proceedings, e.g. against natural persons, these may, in individual cases, only result in a single fine, e.g. against the legal person.



Questioning of witnesses

Under the provisions of the Act on Breaches of Administrative Regulations (*Ordnungswidrigkeitengesetz*), BaFin has the right to question witnesses in administrative fine proceedings. This enables it to throw (further) light on the matter thanks to the description of the facts perceived by the witness and to confirm or refute initial suspicions. At the same time, the formal questioning of witnesses is admissible evidence of whether particular facts of the case are true or not.

In proceedings for breaches of administrative regulations, the provisions of the Code of Criminal Procedure (*Strafprozessordnung*) are applied analogously. The witness is under an obligation to be present for questioning and to make truthful statements. The witness also has the right, however, to refuse to give a statement in part or in full, subject to certain conditions. The date of questioning depends on the position

with respect to evidence in the particular proceedings, but it should normally take place as soon as possible after commencement of the proceedings in order to avoid lapses of memory on the part of the witness. Witnesses may be questioned either in writing or orally. Questioning is frequently conducted in writing as a more efficient use of resources. However, witnesses must appear to be credible and must be expected to be able to provide complete information. Written questioning of witnesses is especially appropriate if the witness requires files, business reports or other substantial documents for the purposes of making a statement.

In the case of the oral questioning of witnesses, the witness is invited to visit BaFin's premises. BaFin can arrange for the oral questioning of witnesses if, among other reasons, an important matter must be clarified, there is a need to assess the credibility of the witness or it is desired to confront the witness with contrary findings or evidence.

year: 519).⁴² A total of 1,006 cases were still pending from previous years. It concluded 164 proceedings with administrative fines amounting in total to around €3.8 million (see Figure 22 "Number of administrative fines", page 234). BaFin regularly questions witnesses orally or in writing in proceedings for the imposition of administrative fines (see info box "Questioning of witnesses").

The prosecution ratio in 2014 amounted to approximately 38.7%. BaFin discontinued 259 proceedings, 229 for discretionary reasons. 1,101 cases were still pending at the end of 2014. In 2014 around 30% of all securities supervision proceedings ending with an administrative fine were brought to a conclusion by means of a settlement (see info box

"Securities supervision settlement practice", page 237).

7.2 Selected cases⁴³

BaFin imposed an administrative fine of €60,000 on a British investment management company as a result of naked short sales. The company managed a number of funds and had sold shares in a total of 18 transactions over a period of around four months. The company did not own the securities, and had no unconditionally enforceable rights to them, either on the date of the securities sales or in the period until the settlement of the transactions. The company's traders nevertheless placed orders for the sales without ensuring that they had adequate cover. Contrary to the view of the company in question, parallel positions held in the same

⁴² With respect to proceedings for the imposition of administrative fines in relation to violations of investment services enterprises against the rules of conduct, organisation and transparency obligations under the WpHG, see chapter III 4.6.

⁴³ For details of selected administrative fine proceedings due to breaches of the prohibition on market manipulation, see chapter V 2.2.

issuer's shares of a different class, e.g. ordinary shares as compared with preference shares, do not constitute an adequate form of cover. The company's management should have taken organisational steps against the uncovered sales in order to prevent breaches of statutory norms of this nature. However, it had not given its traders adequate training in relation to the ban on naked short sales and had also not set up adequate internal control mechanisms. The technical precautions incorporated in the company's processes aimed at preventing breaches of the rules were also unsatisfactory. However, those processes could have been organised in such a way that it would have been impossible in any case to order the sale of securities without corresponding cover or that, in the event of planned sales of securities, detailed evidence of the relevant positions held as cover would always have had to be provided.

BaFin imposed an administrative fine of €30,000 on the managing director of a limited

liability company (GmbH) for breaches of its obligations under the Securities Prospectus Act (*Wertpapierprospektgesetz*). The company had sent an e-mail to the shareholders of a stock corporation, offering them a kind of exchange with its own bonds or the bonds of a third party. The e-mail included as an attachment a document described as a securities prospectus, which had the same structure in most respects as a securities prospectus under the WpPG, but which had not been approved by BaFin. The GmbH was also marketing its own bonds on its website. It described an "attractive, fixed-interest bond, which is not subject to price risk and is therefore particularly suitable for security-oriented investors with high income expectations". Since these actions amounted to a public offer in accordance with the WpPG, the company was in breach of its obligations under the WpPG. This was because the GmbH should have published a prospectus complying with the statutory requirements and approved by BaFin before making an offer on the Internet and by e-mail.

Securities supervision settlement practice

Settlements between BaFin and the parties concerned to bring individual proceedings or groups of proceedings to a conclusion are usually reached in order to reduce the time and expense involved. The earlier conclusion of proceedings and the lower cost of the administrative fine proceedings may result in the administrative fine being less than the amount that would otherwise be determined. BaFin's internal rules allow for a discount of up to 30%. However, this depends to a large extent on the stage of the proceedings at which a settlement is

reached. The basis for reaching a settlement is the principle of discretionary prosecution. This requires the administrative authority to conduct proceedings for breaches of administrative regulations using due discretion. For BaFin, the principal advantage of a settlement is that the administrative fine proceedings are brought to a rapid conclusion. The main benefits for the party concerned are likely to be the smaller administrative fine, the shorter time required to achieve legal certainty and the fact that public judicial proceedings are avoided.



VI About BaFin

1 Human resources

As at 31 December 2014, BaFin had a total of 2,535 employees (previous year: 2,398) at its offices in Bonn (1,881) and Frankfurt am Main (654). Approximately 72.4% are civil servants (*Beamte*) and approximately 27.6% are public service employees covered by collective wage agreements (*Tarifbeschäftigte*) (700, see Table 37 "Personnel").

As a modern employer, BaFin attaches great importance to equality of opportunity: almost

half of BaFin's employees are female (1,202). The total proportion of management positions held by women amounts to around 24%.

BaFin employees are on long-term assignment to international institutions and supervisory authorities. At the close of 2014, more than half that number, namely 33 employees, were delegated to the European Central Bank (ECB).

Table 37 Personnel

As at: 31 December 2014

Career level	Employees			Civil servants	Public service employees
	Total	Female	Male	Total	Total
Higher Civil Service	1,159	455	704	1,025	134
Upper Civil Service	776	354	422	650	126
Middle/Basic Civil Service	600	393	207	160	440
Total	2,535	1,202	1,333	1,835	700

Table 38 Recruitment in 2014

Career level	Qualifications						
	Total	Female	Male	Fully qualified lawyers	Economists	Mathematicians/statisticians	Other
Higher Civil Service	96	44	52	43	39	6	8
				Business lawyers	Economists	IT specialists	Other
Upper Civil Service	21	9	12	7	11	1	2
Middle/Basic Civil Service	40	26	14				
Candidates for entry to the Upper Civil Service/ Vocational trainees	30	14	16				
Total	187	93	94				

A total of 187 new staff recruited

BaFin's workload is growing steadily; it therefore recruited a total of 187 new members of staff in 2014, 51 more than in the previous year (see also Table 38 "Recruitment in 2014").

The majority of the new recruits were fully qualified lawyers and economists, as well as university of applied sciences graduates and graduates in other disciplines, but a large number were also candidates for entry to the Upper Civil Service, vocational trainees and temporary staff.

Career entry at BaFin

Those starting their careers at BaFin may either prepare for the Upper Civil Service or complete vocational training. 15 candidates for entry to the Upper Civil Service began preparing for their careers with BaFin in 2014, while the same number of trainees commenced their vocational training. The corresponding figures for 2013 were 14 candidates for the civil service and eight vocational trainees.

In collaboration with the Deutsche Bundesbank, BaFin is currently preparing 29 candidates for entry to the Upper Civil Service for their future responsibilities. Vocational training is available in five different careers at the present time: office communication specialists (16 vocational trainees), administration specialists (nine vocational trainees), IT specialists for system integration (three vocational trainees), business

administration specialists for office management (two vocational trainees) and media and information services specialists (one vocational trainee). At the end of 2014 BaFin had a total of 60 vocational trainees and candidates, seven more than in the previous year.

Emphasis on continuing professional development (CPD)

BaFin attaches great importance to an extensive CPD offering for its employees. In 2014, 1,593 employees (previous year: 1,530) took part in at least one of a total of 651 internal and external CPD events (previous year: 645). On average, each BaFin employee attended a CPD session on 3.89 days in 2014 (previous year: 5.03 days).

The events held in 2014 focused on specialist supervisory topics in particular. For example, BaFin offered CPD sessions in connection with the introduction of the Single Supervisory Mechanism for banks (SSM) and multipart seminars on the reform of European insurance supervision law by Solvency II.

The sessions designed to enhance employees' foreign language skills were expanded in 2014 to include new specialist English courses lasting several days. The sessions offered also included various courses on soft skills, with the aim of developing cooperation between employees and the ability to work in a team.

2 Organisational developments

New structure of Banking Supervision

In preparation for the start of the Single Supervisory Mechanism on 4 November 2014, BaFin's banking supervision activities were restructured at the beginning of April last year. BaFin established two departments with primary responsibility for supervision of the SSM institutions with the aim of enabling it to coordinate its activities relating to the SSM efficiently. Department BA 1 is responsible for major commercial banks, while department BA 2 covers public-sector institutions, cooperative institutions and specialist banks.

As a result of the new structure, the responsibilities for various institutions within the Banking Supervision directorate have also changed. Department BA 3 is now responsible for institutions within the savings bank sector – except for the SSM banks – and for regional and small private commercial banks. As before, department BA 4 supervises the cooperative sector, although also with the exception of the SSM banks. Department BA 4 now also includes a *Pfandbrief* competence centre. The centre is responsible for basic issues, but also for the examination of cover assets of the financial institutions.

To enable it to manage its extensive new responsibilities, BaFin received an additional 39 temporary staff positions. It was able to fill those positions in a short amount of time.

New structure of Insurance Supervision

On 1 July 2014, BaFin also reorganised its insurance supervision activities. The background to this was mainly preparation for the reform of European insurance supervision by means of Solvency II. The reorganisation enables BaFin to respond to the demands of the future supervisory regime and also to changes in the requirements relating to consumer protection. A further objective was to prepare for new types of risks, for example those associated with information technology.

Under Solvency II, the supervision of insurance groups will assume even greater importance.

This is reflected in the new organisational structure: BaFin places group-wide supervision at the centre of its supervisory activities. The focus on individual insurance classes and specialist knowledge remains in place, however. At the same time, BaFin is strengthening its group-wide supervision by further improving the way in which its existing specialist capabilities are combined. Units with different specialisations work on the supervision subject areas and thus complement each other's abilities.

Insurance supervision is therefore divided into three basic types of section: those dealing with basic issues, those focused on specific undertakings subject to supervision and those with specialist knowledge. As before, the sections dealing with basic issues focus on superordinate issues such as legislation and risk management, and produce analyses. Since July 2014, the operating supervision activities have been carried out jointly by the undertaking-related sections and the competence-related sections (competence centres). However, both types of section have their own, clearly defined areas of responsibility. Around three-quarters of staff employed in insurance supervision are engaged in operating supervision.

The undertaking-related sections are responsible for the supervision of insurance groups and all insurance undertakings belonging to those groups. They therefore represent the core of the reorganised insurance supervision activities. These sections have created a central point of contact for the insurance groups. This enables BaFin to communicate with the insurers on a significantly more efficient basis.

At the same time, insurance supervision has established competence-related sections which also have operating responsibilities. They bring together specialist knowledge relating to particular issues or insurance classes and play a role in the operating supervisory activities across all departments. Examples are the competence-related sections "Life insurance actuarial office" and "Distribution, consumer

protection and remuneration systems". The competence-related sections carry out the operating supervision activities in their respective areas of responsibility themselves, working together closely with the relevant undertaking-related section.

The improvements to the organisation of the insurance supervision directorate mean that – with few exceptions – the supervisory activities

are in principle no longer based on insurance classes. Only entities engaged in occupational retirement provision and funeral expenses funds are brought together, as before, in departments based on insurance classes as a result of their special features. This also applies to insurance undertakings that do not belong to an insurance group and which therefore fall within the responsibility of the supervision department focusing on the relevant insurance class.

3 Budget

BaFin's Administrative Council approved a budget of €224.4 million for 2014 (previous year: €190.7 million). Personnel expenses accounted for around 67.9% of the projected expenditure (€152.4 million; previous year: €130.1 million) and non-staff costs for around 26% (€58.4 million; previous year: €31.6 million). The projected IT expenses (previous year: 22.4%) were included in non-staff costs and capital expenditure in 2014 as a result of a change in the budgeting systems. Capital expenditure represented 3.9% of the budget (previous year: 1.2%). Cost reimbursements and grants remained at the prior-year level, accounting for 2.2% of the budget (see also Figure 23 "2014 budget expenditure").

Financing through cost allocations and fees

BaFin is independent of the federal budget and is fully self-financed from its own income. A large proportion of this was attributable to cost allocations levied on the supervised companies, a special levy with a financing function (projected figure for 2014: €200.8 million; previous year: €170.5 million). BaFin also generates administrative income such as fees and interest (projected figure for 2014: €23.6 million; previous year: €20.2 million; see also Figure 24 "2014 budget income", page 242).

The final cost allocation for 2013 was performed in 2014. The banking industry contributed 44.9% of the total income from cost allocations.

Figure 23 2014 budget expenditure

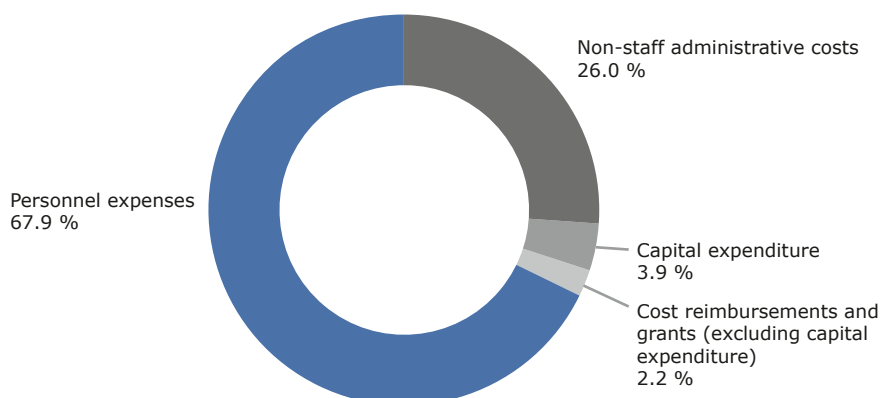
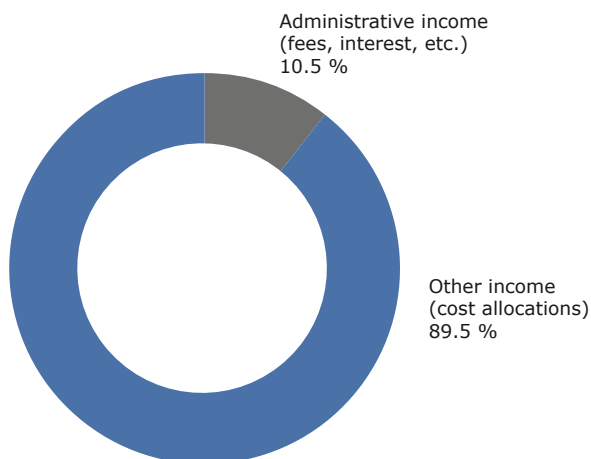


Figure 24 2014 budget income



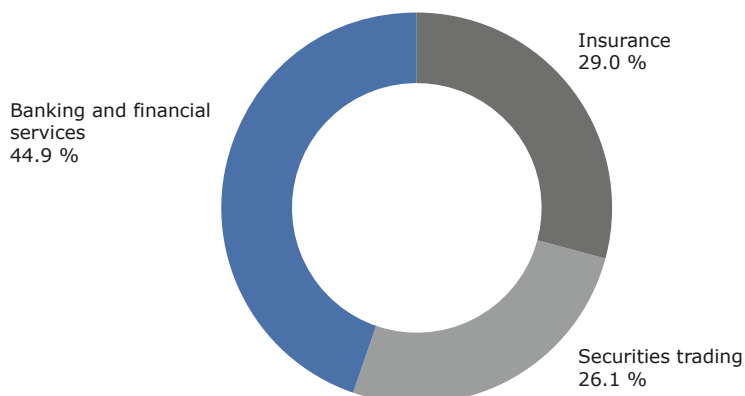
The insurance sector financed 29.0% and the securities trading sector 26.1%. The final cost allocation for 2014 will be performed in the course of 2015 (see Figure 25 “Cost allocations by supervisory area in 2013”).

BaFin’s actual expenditure in 2014 was approximately €217.6 million (previous year: €190.7 million). This was set against income of around €220.7 million (previous year: €191.6 million). The Administrative Council still has to approve the annual financial statements.

Separate enforcement budget

BaFin drew up a separate enforcement budget of €8.2 million (previous year: €8.1 million). This included a cost reimbursement to the German Financial Reporting Enforcement Panel (*Deutsche Prüfstelle für Rechnungslegung*) at the prior-year level (€6 million). Actual expenditure amounted to around €7.7 million (previous year: €7.6 million), while income – including advance cost allocation payments for 2015 – stood at approximately €14.9 million, as in the previous year.

Figure 25 Cost allocations by supervisory area in 2013



4 Press and Public Relations

BaFin answered a total of 3,782 press enquiries in 2014. The dominant topic in the area of banking supervision was the comprehensive assessment of banking groups in the eurozone carried out by the European Central Bank (ECB), in preparation for the introduction of the Single Supervisory Mechanism. In many cases journalists requested information on the conduct of the exercise, and on the performance of individual banks.

The results of the 25 German institutions which participated in the assessment were presented by BaFin President Dr Elke König and Dr Andreas Dombret, member of the Executive Board of the Deutsche Bundesbank, at a joint press conference in Frankfurt am Main at the end of October.

During the last year, media representatives were also interested in the way in which BaFin, the Bundesbank and the ECB would work together in the future. A particularly large number of enquiries related to the changes in BaFin's areas of responsibility after the start of the Single Supervisory Mechanism on 4 November 2014.

Another important topic related to building society commissions passed on to customers: BaFin lifted its general prohibition on brokers passing on a portion of their commission earned from building society savings contracts to their customers. It now reviews individual cases instead.

The media also showed great interest during the past year in BaFin's ongoing investigations into possible manipulation of the LIBOR reference rate of interest.

Investment Code and Market in Financial Instruments Directive

Enquiries relating to securities supervision focused on the Investment Code (*Kapitalanlagegesetzbuch*). The Investment Code entered into force on 22 July 2013. Journalists' enquiries related, for example, to

the number of investment companies authorised and registered and the time limits within which BaFin has to process the entities' applications for authorisation and registration. A further issue was which companies fall within the scope of the Investment Code.

There were also numerous questions relating to the revised version of the European Markets in Financial Instruments Directive (MiFID). With respect to MiFID II, which came into force on 3 July 2014, the media representatives were especially interested in the possible ban on commissions and in the German Retail Investor Protection Act (*Kleinanlegerschutzgesetz*). The latter anticipates parts of the Markets in Financial Instruments Directive.

Criticism of sales practices in the insurance sector

Many of the enquiries received from the press by BaFin in 2014 were concerned with sales practices in the insurance sector. Critical reports on this subject are repeatedly carried in the media. Achieving greater transparency in sales and marketing was therefore an important priority for BaFin. Following a phase of consultation with the public, BaFin issued a revised circular on insurance brokers and sales of insurance products.

The German Life Insurance Reform Act (*Lebensversicherungsreformgesetz*), which came into force on 6 August 2014, also received a lot of attention in the media. The new regulations resulted in a number of important changes for consumers, such as the reduction in the guaranteed return for new contracts from 1 January 2015.

Own funds and additional interest provision (*Zinszusatzreserve*) of life insurers

Many journalists also sought information on the results of the "*Vollerhebung Leben*" survey of the life insurance sector. For the purposes of the survey, BaFin had asked all 87 German life insurers about their expected own funds position under the requirements of Solvency II.

Another major topic for the media during the past year was the additional interest provision (*Zinszusatzreserve*). Given the persistence of the low interest rate environment, the level of the additional interest provision in the life insurance sector continued to be high.

Questions on the grey capital market

BaFin also received a large number of press enquiries in 2014 relating to the grey capital market. The questions focused mainly on the obligations to obtain authorisation and to publish a prospectus and the question of where BaFin's areas of responsibility begin and where they end.

The media were also preoccupied once again with BaFin's proceedings against the unauthorised banking and insurance business of Peter Fitzek and his "Kingdom of Germany" (*"Königreich Deutschland"*) association. In particular, the extensive search of his residential and business premises by BaFin and the investigative arm of the Halle tax authorities in November 2014 received widespread coverage in the media.

Many press enquiries also related to the process of introducing video technology for the purpose of identifying customers, which is compatible with the German Money Laundering Act (*Geldwäschegesetz*) in the opinion of BaFin. In addition, there were questions on the issue of whether online loan brokers require authorisation.

Forum on White-collar Crime and the Capital Market

In November 2014, BaFin issued invitations to what is now its 11th forum on "White-collar Crime and the Capital Market". Around 400 police officers, public prosecutors and

representatives of trading surveillance offices and supervisory authorities attended in order to discuss their experiences. The topics covered in the two-day event ranged from a judgment on a matter of principle regarding market manipulation by the Federal Court of Justice (*Bundesgerichtshof*) to insider trading in the wholesale markets for gas and electricity and unauthorised investment transactions. BaFin hosts the forum every year. In 2014 the event was held in the Frankfurt Congress Center for the first time.

Information for investors

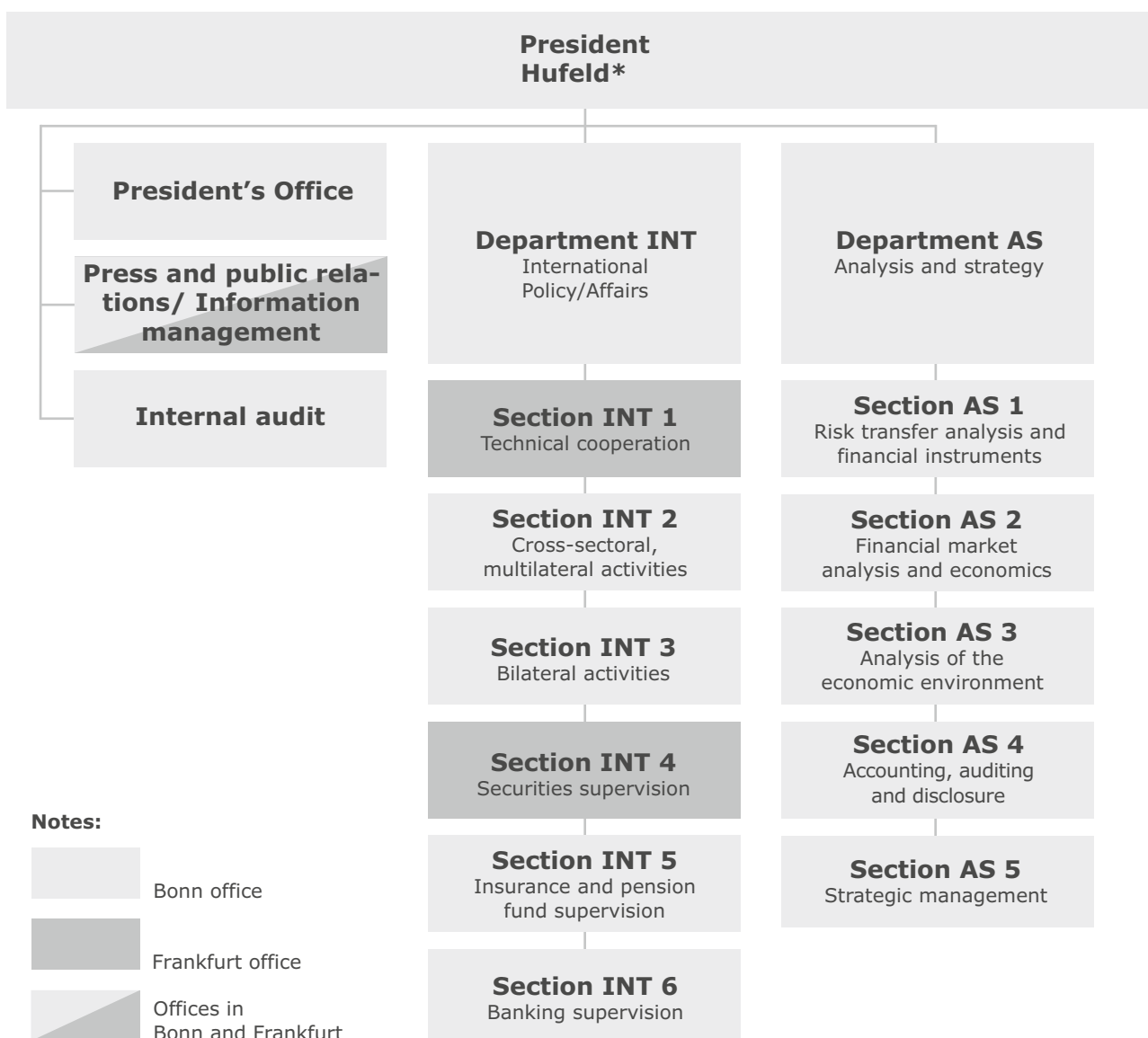
BaFin also provides information intended for the general public. It therefore once again participated in the "Invest" trade fair held in Stuttgart in April 2014. Almost 11,000 private and institutional investors took the opportunity to obtain information from BaFin first hand at the leading trade fair for finance and investment. This year's theme for the fair was "*Chancen nutzen, gezielt handeln*" (taking opportunities, acting effectively). BaFin had published its new flyer "Grey market and black sheep" in time for the fair.¹ The leaflet employed an easily comprehensible format to provide answers to questions on the grey capital market, such as how consumers can recognise the products offered on the market and where there are dangers lurking for investors. BaFin also arranged talks on the subject at the fair.

BaFin also had a presence with its own information service at the stock exchange days in Dresden, Munich, Berlin, Hamburg and Frankfurt am Main, as well as at the Deutsche Bundesbank's "Open House" in Frankfurt am Main.

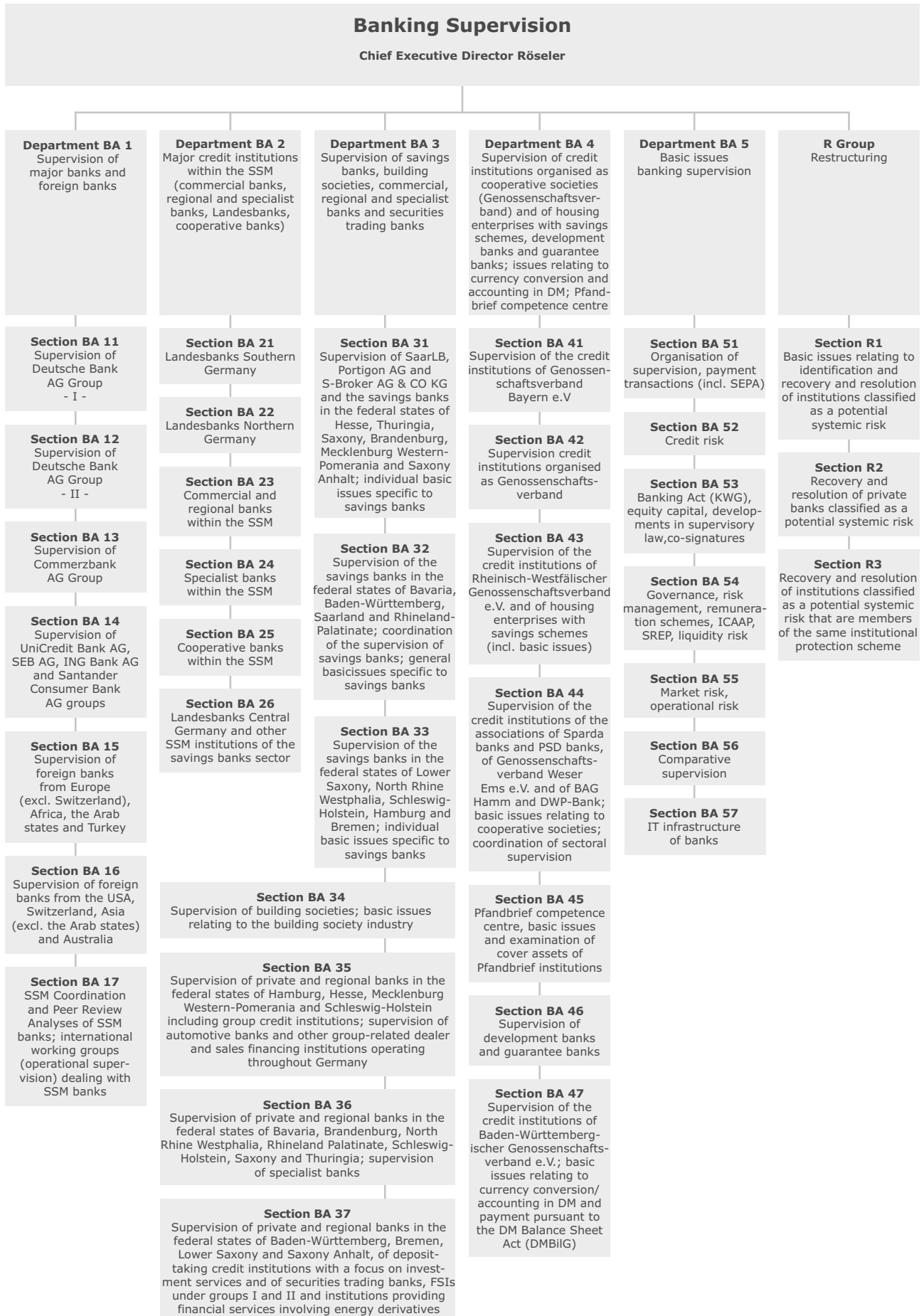
¹ <http://www.bafin.de/dok/5034932> (only available in German).

Appendix

1 Organisation chart

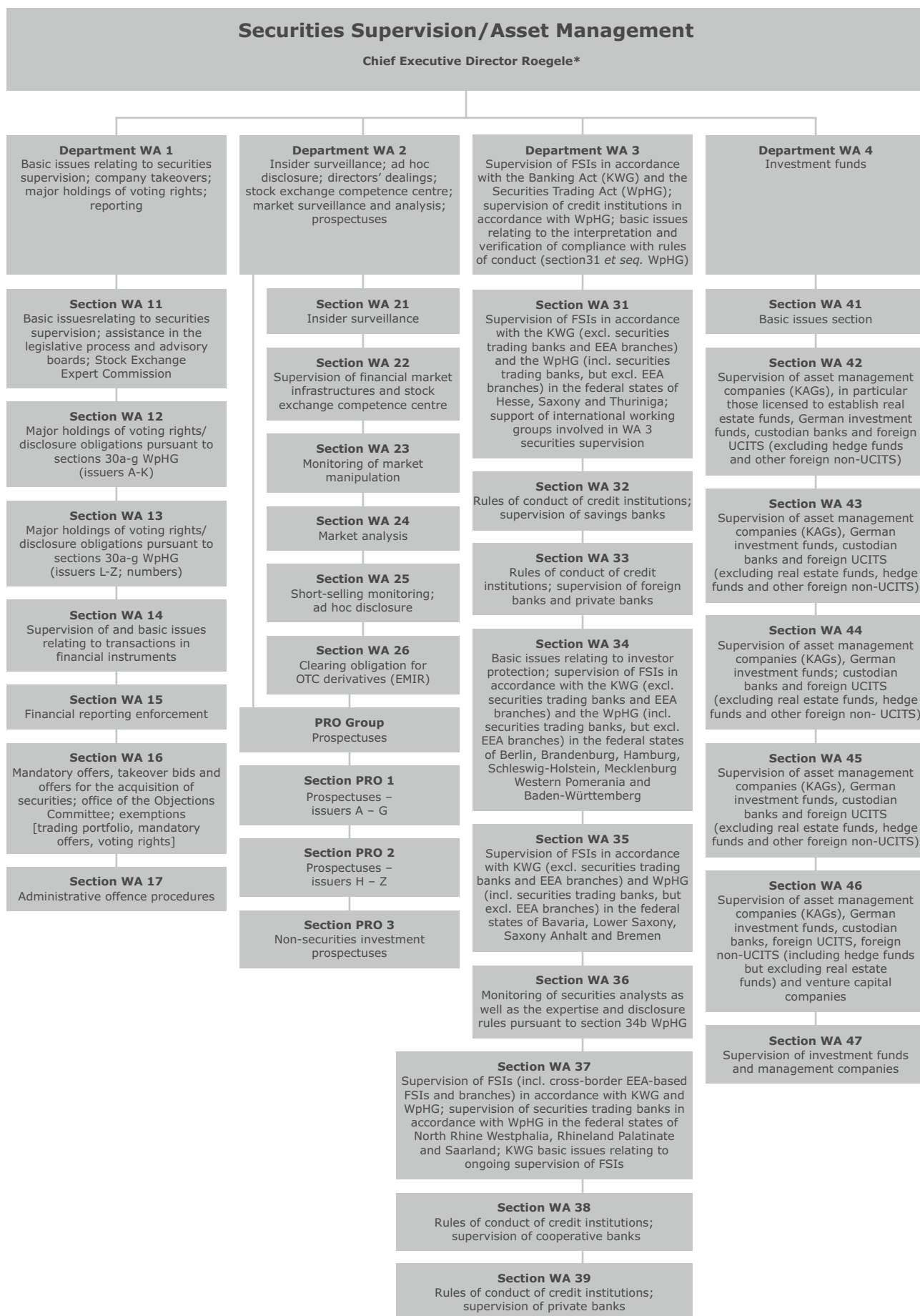


* Since 1 March 2015. Until the end of February 2015, Dr Elke König was BaFin President.

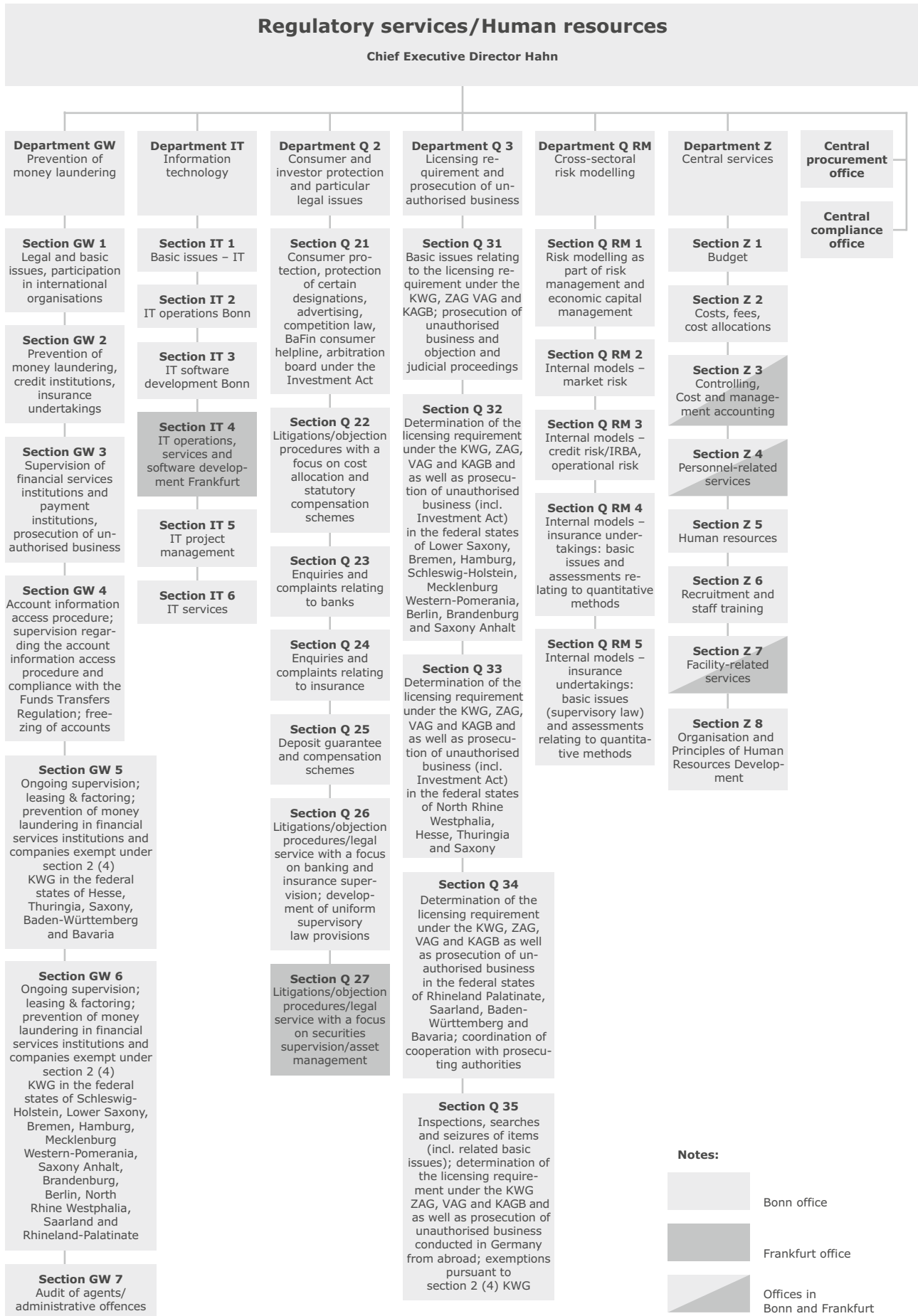




* The former Chief Executive Director of Insurance and Pension Funds Supervision, BaFin President Felix Hufeld, will be interim head of BaFin's insurance supervision directorate until a successor is appointed.



* Karl-Burkhard Caspari was Chief Executive Director of Securities Supervision/Asset Management until the end of March 2015. Elisabeth Roegele assumed office at the beginning of May.



2 BaFin bodies

2.1 Members of the Administrative Council

Representing Federal Ministries

Dr Thomas Steffen (Chair – BMF)
Dr Levin Holle (Deputy chairman – BMF)
Reinhard Wolpers (BMF)
Christian Dobler (BMWf)
Erich Schaefer (BMJV)
Dr Rainer Metz (BMEL)

Representing the Bundestag

MdB Klaus-Peter Flosbach
MdB Bartholomäus Kalb
MdB Manfred Zöllmer
MdB Dr Jens Zimmermann
MdB Dr Axel Troost

Representing credit institutions

Georg Fahrenschon

Representing insurance undertakings

Dr Jörg Freiherr Frank von Fürstenwerth

Representing asset management companies

Thomas Richter

Representing the academic community

Prof. Isabel Schnabel
Prof. Brigitte Haar
Prof. Fred Wagner

As at: March 2015

2.2 Members of the Advisory Board

Representing credit institutions

Dr Hans-Joachim Massenbergh (Chairman)
Dr Karl-Peter Schackmann-Fallis
Gerhard P. Hofmann
Dr Oliver Wagner
Prof. Liane Buchholz
Jens Tolckmitt

Representing insurance undertakings

Dr Wolfgang Weiler
Dr Jörg Schneider
Dr Maximilian Zimmerer
Dr Jörg Freiherr Frank von Fürstenwerth

Representing asset management companies

Rudolf Siebel

Representing the Bundesbank

Erich Loeper

Representing the Association of Private Health Insurers

Reinhold Schulte

Representing the academic community

Prof. Andreas Hackethal
Prof. Andreas Richter
Prof. Isabel Schnabel (Deputy chairwoman)

Representing the Working Group on Occupational Retirement Provision

Heribert Karch

Representing consumer protection organisations

Stephan Kühnlenz (Stiftung Warentest)
Prof. Günter Hirsch (ombudsman for insurers)
Dr h.c. Hans-Joachim Bauer (DSGV ombudsman)

Representing the liberal professions

Frank Rottenbacher (AfW)

Representing associations for SMEs

Ralf Frank (DVFA)

Representing the trade unions

Mark Patrick Roach (ver.di)

Representing industry

Folkhart Olschow

As at: March 2015

2.3 Members of the Insurance Advisory Council

Dr Helmut Aden

Dr Alexander Barthel

Lars Gatschke

Ira Gloe-Semler

Norbert Heinen

Michael H. Heinz

Werner Hölzl

Sabine Krummenerl

Uwe Laue

Katharina Lawrence

Dr Ursula Lipowsky

Adelheid Marscheider

Dr Torsten Oletzky

Prof. Petra Pohlmann

Holger R. Rohde

Prof. Heinrich R. Schradin

Ilona Stumm

Prof. Manfred Wandt

Michael Wortberg

Dr Maximilian Zimmerer

Prof. Jochen Zimmermann

As at: April 2015

2.4 Members of the Securities Council

Baden-Württemberg State Ministry for Finance and Economics

Bavarian State Ministry for Economics, Infrastructure, Transport and Technology

Berlin Senate Department of Economics, Technology and Research

Ministry of Economics and European Affairs of the State of Brandenburg

Free Hanseatic City of Bremen

Senator for Economic Affairs, Labour and Ports

Free and Hanseatic City of Hamburg

Departmental Authority for Economic Affairs, Transport and Innovation

Ministry of Economics, Energy, Transport and Regional Development of the State of Hesse

Ministry of Economics, Construction and Tourism of the State of Mecklenburg-West Pomerania

Ministry for Economics, Labour and Transport of the State of Lower Saxony

Ministry of Finance of the State of North Rhine-Westphalia

Ministry of Economics, Transport, Agriculture and Viniculture of the State of Rhineland-Palatinate

Ministry of Economics and Science of the State of Saarland

Ministry of Economics, Labour and Transport of the State of Saxony

Ministry of Science and Economics of the State of Saxony-Anhalt

Ministry of Finance of the State of Schleswig-Holstein

Ministry of Finance of the State of Thuringia

As at: March 2015

2.5 Members of the Consumer Advisory Council

Representing the academic community

Prof. Brigitte Haar (Deputy chairwoman)

Prof. Kai-Oliver Knops

Prof. Udo Reifner

Representing consumer and investor protection organisations

Jella Benner-Heinacher

Stephan Kühnlenz

Dorothea Mohn (Chairwoman)

Katharina Lawrence

Representing out-of-court dispute settlement systems

Wolfgang Arenhövel

Prof. Günter Hirsch

Dr Gerda Müller

Representing the Federal Ministry of Justice and for Consumer Protection

Dr Erich Paetz

Representing the trade unions

Christoph Hahn

As at: March 2015

3 Complaints statistics for individual undertakings

3.1 Explanatory notes on the statistics

For many years, BaFin has published complaints statistics in its annual report classified by insurance undertaking and class. The Higher Administrative Court in Berlin (*Oberverwaltungsgericht – OVG*) issued a ruling on 25 July 1995 (case ref.: OVG 8 B 16/94) ordering the Federal Insurance Supervisory Office (*Bundesaufsichtsamt für das Versicherungswesen – BAV*), one of BaFin's predecessors, to include this information.

The complaints statistics list how many complaints BaFin processed in full in 2014 for Insurance Supervision.

The statistics do not take into account whether the complaints processed are justified, and hence are not indicative of the quality of insurance business.

In order to provide an indicator of the volume of insurance business, the number of complaints that BaFin processed in full in 2014 is compared with the number of policies in the respective insurance class as at 31 December 2013. The individual undertakings report their existing business data. The information on existing business puts those insurers that recorded strong growth in the reporting period, often newly established undertakings, at a disadvantage because the new business written in the course of the year giving rise to the complaints is not adequately accounted for in the complaints statistics.

In the life insurance class, the existing business figure specified for group insurance relates to the number of insurance contracts. Existing health insurance business is based on the number of natural persons with health insurance contracts, rather than the number of insured persons under each premium scale, which is usually higher. As in the past, these figures are not yet entirely reliable.

The information on property and casualty insurance figures relates to insured risks. The existing business figure increases if undertakings agree group policies with large numbers of insured persons. Due to the limited disclosure requirements (section 51 (4) no. 1 sentence 4 of the Regulation on Insurance Accounting (*Verordnung über die Rechnungslegung von Versicherungsunternehmen – RechVersV*), only the existing business figures for insurers whose gross premiums earned in 2013 exceeded €10 million in the respective insurance classes or types can be included. The tables give no information on existing business (n.a.) for undertakings below the limit in the individual insurance classes.

The statistics do not include insurance undertakings operating within one of the classes listed that have not been the subject of complaints in the year under review.

As undertakings domiciled in other countries in the European Economic Area (EEA) were not required to submit reports to BaFin, no data is given for the existing business of these insurers. The number of complaints is included in order to present a more complete picture.

3.2 Life insurance

Reg. no.	Name of insurance undertaking	Number of life insurance policies in 2012	Complaints
1001	AACHENMÜNCHENER LEB.	5,266,153	75
1006	ALLIANZ LEBEN	10,380,239	188
1007	ALTE LEIPZIGER LEBEN	1,233,224	26
1035	ARAG LEBEN	336,794	5
1303	ASSTEL LEBEN	296,467	15
1020	AXA LEBEN	3,134,436	115
1011	BARMENIA LEBEN	239,639	13
1028	BASLER LEBEN	733,741	27
1012	BASLER LEBEN (CH)	129,233	2
1013	BAYER. BEAMTEN LEBEN	245,528	10
1015	BAYERN-VERS.	1,809,174	21
1122	CONCORDIA LEBEN	139,696	2
1177	CONCORDIA OECO LEBEN	35,937	1
1021	CONDOR LEBEN	218,465	3
1335	CONTINENTALE LV AG	643,286	5
1022	COSMOS LEBEN	1,419,355	39
1115	CREDIT LIFE AG	50,173	1
1023	DEBEKA LEBEN	3,458,690	76
1167	DELTA DIREKT LEBEN	78,929	1
1017	DELTA LLOYD LEBEN	368,763	8
1136	DEVK ALLG. LEBEN	802,829	11
1113	DIALOG LEBEN	274,660	2
1180	DT. ÄRZTEVERSICHERUNG	206,417	5
1148	DT. LEBENSVERS.	524,861	2
1130	ERGO DIREKT LEBEN AG	1,175,023	25
1184	ERGO LEBEN AG	5,299,777	107
1107	EUROPA LEBEN	466,077	9
1310	FAMILIENFÜRSORGE LV	256,921	12
1139	GENERALI LEBEN AG	4,712,978	139
1108	GOTHAER LEBEN AG	1,114,164	35
1040	HAMB. LEBEN	21,336	4
1312	HANNOVERSCHE LV AG	919,859	17
1114	HANSEMERKUR LEBEN	244,965	8
1033	HDI LEBEN AG	2,464,885	96
1158	HEIDELBERGER LV	416,428	34
1137	HELVETIA LEBEN	147,361	12
1055	HUK-COBURG LEBEN	698,500	28
1047	IDEAL LEBEN	567,409	10
1048	IDUNA VEREINIGTE LV	1,856,371	34
1128	ITZEHOER LEBEN	69,329	1
1045	KARLSRUHER LV AG	101,507	3
1054	LANDESLEBENSILFE	18,067	3
1062	LEBENSVERS. VON 1871	698,371	23
1112	LVM LEBEN	793,247	10
1109	MECKLENBURG. LEBEN	166,208	2
1064	MÜNCHEN. VEREIN LEBEN	137,938	3
1162	MYLIFE DEUTSCHLAND	106,584	1
1134	NEUE BAYER. BEAMTEN	102,327	1
1164	NEUE LEBEN LEBENSVERS	898,003	21
1147	NÜRNBG. LEBEN	2,862,325	113
1194	PB LEBENSVERSICHERUNG	1,171,211	31
1309	PROTEKTOR LV AG	124,430	14
1081	PROV. LEBEN HANNOVER	834,513	8

! Please refer to the "Explanatory notes on the statistics" on page 256.

Reg. no.	Name of insurance undertaking	Number of life insurance policies in 2012	Complaints
1083	PROV.NORDWEST LEBEN	1,718,597	26
1082	PROV.RHEINLAND LEBEN	1,325,092	34
1141	R+V LEBENSVERS. AG	4,206,628	44
1157	SKANDIA LEBEN	317,154	9
1153	SPARK.-VERS.SACHS.LEB	526,455	4
1104	STUTTGARTER LEBEN	449,673	8
1089	SÜDDT.LEBEN	67,662	4
1091	SV SPARKASSENVERS.	1,706,327	37
1090	SWISS LIFE AG (CH)	870,426	19
1132	TARGO LEBEN AG	1,612,011	31
1092	UNIVERSA LEBEN	182,198	5
1093	VER.POSTVERS.	22	1
1314	VHV LEBENSVERSICHER.	14,894	1
1140	VICTORIA LEBEN	1,289,999	67
1099	VOLKSWOHL-BUND LEBEN	1,391,822	16
1151	VORSORGE LEBEN	165,341	2
1160	VPV LEBEN	882,601	27
1005	WÜRTT. LEBEN	2,373,246	71
1103	WWK LEBEN	924,891	46
1138	ZURICH DTSCH. HEROLD	3,547,947	151

! Please refer to the "Explanatory notes on the statistics" on page 256.

3.3 Health insurance

Reg. no.	Name of insurance undertaking	Number of persons insured as at 31, Dec, 2012	Complaints
4034	ALLIANZ PRIV.KV AG	2,562,739	105
4112	ARAG KRANKEN	533,912	19
4095	AXA KRANKEN	1,595,334	142
4042	BARMENIA KRANKEN	1,237,781	34
4134	BAYERISCHE BEAMTEN K	1,091,219	40
4004	CENTRAL KRANKEN	1,766,699	87
4118	CONCORDIA KRANKEN	91,602	2
4001	CONTINENTALE KRANKEN	1,294,071	38
4028	DEBEKA KRANKEN	3,881,742	82
4131	DEVK KRANKENVERS.-AG	340,041	3
4044	DKV AG	4,418,377	124
4013	DT. RING KRANKEN	640,032	25
4121	ENVIVAS KRANKEN	385,742	3
4126	ERGO DIREKT KRANKEN	1,393,846	22
4119	GOTHAER KV AG	575,335	31
4043	HALLESCHER KRANKEN	650,297	53
4144	HANSEMERKUR KRANKEN_V	1,410,553	55
4122	HANSEMERKUR S.KRANKEN	5,636,206	4
4117	HUK-COBURG KRANKEN	984,955	44
4031	INTER KRANKEN	367,266	28
4011	LANDESKRANKENHILFE	385,171	25
4051	LIGA KRANKEN	3,832	2
4109	LVM KRANKEN	326,709	6
4123	MANNHEIMER KRANKEN	77,247	2
4037	MÜNCHEN.VEREIN KV	276,243	16
4125	NÜRNBERG. KRANKEN	251,084	3
4116	R+V KRANKEN	695,896	8
4002	SIGNAL KRANKEN	1,968,536	51
4039	SÜDDEUTSCHE KRANKEN	644,472	15
4108	UNION KRANKENVERS.	1,123,073	26
4045	UNIVERSA KRANKEN	359,773	12
4115	VIGO KRANKEN	18,429	1
4139	WÜRTT. KRANKEN	302,376	1

! Please refer to the "Explanatory notes on the statistics" on page 256.

3.4 Motor vehicle insurance

Reg. no.	Name of insurance undertaking	Number of persons insured as at 31, Dec, 2012	Complaints
5342	AACHENMÜNCHENER VERS.	2,191,895	23
5135	ADAC AUTOVERSICHERUNG	1,064,399	19
5498	ADAC – SCHUTZBRIEF VERS.	n. a.	2
5581	ADLER VERSICHERUNG AG	n. a.	3
5312	ALLIANZ VERS.	13,129,723	132
5441	ALLSECUR DEUTSCHLAND	808,121	47
5397	ASSTEL SACH	194,285	7
5155	AXA EASY	n. a.	4
5515	AXA VERS.	4,311,519	55
5593	BAD. ALLG. VERS.	220,448	1
5317	BARMENIA ALLG. VERS.	209,038	5
5633	BASLER SACH AG	436,659	17
5310	BAYER. BEAMTEN VERS.	224,880	10
5324	BAYER.VERS.VERB.AG	1,755,967	5
5098	BRUDERHILFE SACH.AG	401,671	5
5338	CONCORDIA VERS.	1,061,296	4
5339	CONDOR ALLG. VERS.	280,235	6
5340	CONTINENTALE SACHVERS	666,522	11
5552	COSMOS VERS.	755,820	8
5343	DA DEUTSCHE ALLG.VER.	1,248,895	46
5311	DBV DT. BEAMTEN-VERS.	696,554	7
5549	DEBEKA ALLGEMEINE	794,787	5
5513	DEVK ALLG. VERS.	3,618,429	39
5344	DEVK DT. EISENB. SACH	1,000,099	4
5055	DIRECT LINE	1,008,828	33
5562	ERGO DIREKT	n. a.	8
5472	ERGO VERSICHERUNG	2,415,497	26
5508	EUROPA VERSICHERUNG	517,955	26
5470	FAHRLEHRERVERS.	313,821	4
5024	FEUERSOZIJETÄT	142,476	2
5505	GARANTA VERS.	666,104	3
5473	GENERALI VERSICHERUNG	2,557,586	31
5858	GOTHAER ALLGEMEINE AG	1,315,448	3
5469	GVV-KOMMUNALVERS.	147,256	1
5585	GVV-PRIVATVERSICH.	217,811	2
5131	HANNOVERSCHE DIREKT	n. a.	4
5085	HDI VERSICHERUNG	3,342,676	117
5096	HDI-GERLING INDUSTRIE	1,080,920	24
5044	HDNA VVAG	n. a.	1
5384	HELVETIA VERS. (CH)	314,570	2
5521	HUK-COBURG ALLG. VERS	7,270,571	90
5375	HUK-COBURG UNTER.	7,055,871	48
5086	HUK24 AG	2,792,395	32
5401	ITZEHOER VERSICHERUNG	1,208,954	16
5078	JANITOS VERSICHERUNG	221,651	3
5058	KRAVAG-ALLGEMEINE	1,437,853	17
5080	KRAVAG-LOGISTIC	946,491	22
5402	LVM SACH	5,428,219	29
5084	MANNHEIMER AG HOLD	n. a.	5
5061	MANNHEIMER VERS.	209,227	7
5412	MECKLENBURG. VERS.	827,445	3
5426	NÜRNBERG. ALLG.	189,784	6
5787	OVAG – OSTDT. VERS.	n. a.	42

! Please refer to the “Explanatory notes on the statistics” on page 256.

Reg. no.	Name of insurance undertaking	Number of persons insured as at 31, Dec, 2012	Complaints
5446	PROV.NORD BRANDKASSE	760,840	3
5095	PROV.RHEINLAND VERS.	1,383,587	6
5798	RHEINLAND VERS. AG	238,016	7
5438	R+V ALLGEMEINE VERS.	3,912,957	28
5137	R+V DIREKTVERSICHER.	293,158	14
5051	S DIREKTVERSICHERUNG	242,907	7
5690	SCHWARZMEER U. OSTSEE	n. a.	1
5125	SIGNAL IDUNA ALLG.	1,051,408	16
5781	SPARK.-VERS.SACHS.ALL	176,050	1
5036	SV SPARK.VERSICHER.	864,140	3
5463	UNIVERSA ALLG. VERS.	n. a.	1
5042	VERSICHERUNGSK.BAYERN	158,369	2
5400	VGH LAND.BRAND.HAN.	2,008,741	11
5862	VHV ALLGEMEINE VERS.	4,298,856	67
5169	VOLKSWAGEN AUTO AG	186,550	7
5093	WESTF.PROV.VERS.AG	1,397,641	3
5525	WGV-VERSICHERUNG	1,059,945	18
5479	WÜRTT. GEMEINDE-VERS.	1,001,552	2
5783	WÜRTT. VERS.	2,794,061	32
5476	WWK ALLGEMEINE VERS.	224,242	1

! Please refer to the "Explanatory notes on the statistics" on page 256.

3.5 Residential building insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31 Dec. 2012	Complaints
5342	AACHENMÜNCHENER VERS.	373,797	13
5581	ADLER VERSICHERUNG AG	n. a.	1
5312	ALLIANZ VERS.	2,181,901	58
5405	ALTE LEIPZIGER VERS.	122,042	6
5397	ASSTEL SACH	n. a.	2
5515	AXA VERS.	659,702	24
5317	BARMENIA ALLG. VERS.	n. a.	1
5633	BASLER SACH AG	192,085	12
5319	BAYER. HAUSBESITZER	24,485	1
5043	BAYER.L-BRAND.VERS.AG	2,190,948	11
5324	BAYER.VERS.VERB.AG	719,346	12
5146	BGV-VERSICHERUNG AG	53,019	0
5338	CONCORDIA VERS.	193,045	6
5340	CONTINENTALE SACHVERS	110,866	4
5311	DBV DT. BEAMTEN-VERS.	173,792	2
5549	DEBEKA ALLGEMEINE	242,089	1
5513	DEVK ALLG. VERS.	359,366	6
5344	DEVK DT. EISENB. SACH	177,989	1
5472	ERGO VERSICHERUNG	505,500	29
5024	FEUERSOZIJETÄT	80,591	2
5473	GENERALI VERSICHERUNG	588,073	25
5858	GOTHAER ALLGEMEINE AG	311,615	7
5485	GRUNDEIGENTÜMER-VERS.	71,803	1
5032	HAMB. FEUERKASSE	159,628	2
5085	HDI VERSICHERUNG	284,182	29
5384	HELVETIA VERS. (CH)	165,038	2
5126	HÜBENER VERSICHERUNG	n. a.	1
5521	HUK-COBURG ALLG. VERS	228,388	2
5375	HUK-COBURG UNTER.	629,558	9
5546	INTER ALLG. VERS.	n. a.	1
5057	INTERLLOYD VERS.AG	53,041	1
5078	JANITOS VERSICHERUNG	n. a.	4
5402	LVM SACH	561,285	14
5061	MANNHEIMER VERS.	55,236	5
5412	MECKLENBURG. VERS.	104,936	2
5014	NEUENDORFER BRAND-BAU	n. a.	1
5446	PROV.NORD BRANDKASSE	308,780	5
5095	PROV.RHEINLAND VERS.	550,750	19
5798	RHEINLAND VERS. AG	42,530	2
5121	RHION VERSICHERUNG	n. a.	1
5438	R+V ALLGEMEINE VERS.	1,021,362	23
5773	SAARLAND FEUERVERS.	75,167	2
5491	SCHLESWIGER VERS.V.	n. a.	7
5690	SCHWARZMEER U. OSTSEE	22,105	1
5125	SIGNAL IDUNA ALLG.	162,530	5
5781	SPARK.-VERS.SACHS.ALL	35,325	2
5036	SV SPARK.VERSICHER.	1,885,448	34
5459	UELZENER ALLG. VERS.	n. a.	2
5042	VERSICHERUNGSK.BAYERN	n. a.	9
5400	VGH LAND.BRAND.HAN.	472,054	3
5862	VHV ALLGEMEINE VERS.	122,607	4
5461	VPV ALLGEMEINE VERS.	66,622	6
5093	WESTF.PROV.VERS.AG	597,396	5

! Please refer to the "Explanatory notes on the statistics" on page 256.

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31 Dec. 2012	Complaints
5525	WGV-VERSICHERUNG	74,498	2
5479	WÜRTT. GEMEINDE-VERS.	82,952	1
5783	WÜRTT. VERS.	456,691	13
5476	WWK ALLGEMEINE VERS.	n. a.	3

! Please refer to the "Explanatory notes on the statistics" on page 256.

3.6 Accident insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31 Dec. 2012	Complaints
5342	AACHENMÜNCHENER VERS.	2,493,081	15
5498	ADAC - SCHUTZBRIEF VERS.	4,120,096	3
5135	ADAC AUTOVERSICHERUNG	n. a.	2
5581	ADLER VERSICHERUNG AG	122,584	1
5312	ALLIANZ VERS.	4,230,673	26
5405	ALTE LEIPZIGER VERS.	70,937	2
5455	ARAG ALLG. VERS.	21,042,297	2
5397	ASSTEL SACH	n. a.	2
5515	AXA VERS.	730,727	7
5792	BADEN-BADENER VERS.	281,730	4
5633	BASLER SACH AG	434,480	8
5310	BAYER. BEAMTEN VERS.	102,843	6
5324	BAYER.VERS.VERB.AG	813,100	1
5098	BRUDERHILFE SACH.AG	n. a.	1
5338	CONCORDIA VERS.	329,563	2
5340	CONTINENTALE SACHVERS	623,265	4
5552	COSMOS VERS.	182,694	1
5343	DA DEUTSCHE ALLG.VER.	n. a.	1
5311	DBV DT. BEAMTEN-VERS.	213,577	3
5549	DEBEKA ALLGEMEINE	1,888,489	2
5513	DEVK ALLG. VERS.	889,352	3
5129	DFV DEUTSCHE FAM.VERS	n. a.	1
5562	ERGO DIREKT	259,108	7
5472	ERGO VERSICHERUNG	2,354,996	41
5024	FEUERSOZIJETÄT	n. a.	2
5473	GENERALI VERSICHERUNG	3,475,279	15
5858	GOTHAER ALLGEMEINE AG	700,802	13
5372	GOTHAER VERS.BANK	n. a.	1
5501	HANSEMERKUR ALLG.	74,948	5
5085	HDI VERSICHERUNG	505,119	14
5384	HELVETIA VERS. (CH)	122,894	3
5521	HUK-COBURG ALLG. VERS	561,988	1
5375	HUK-COBURG UNTER.	961,461	1
5573	IDEAL VERS.	n. a.	2
5780	INTERRISK VERS.	422,656	2
5078	JANITOS VERSICHERUNG	159,145	5
5399	KRAVAG-SACH	n. a.	2
5402	LVM SACH	924,445	3
5061	MANNHEIMER VERS.	69,510	1
5412	MECKLENBURG. VERS.	148,064	2
5414	MÜNCHEN. VEREIN ALLG.	n. a.	1
5591	NEUE LEBEN UNFALL	115,211	2
5426	NÜRNBG. ALLG.	537,498	15
5015	NV-VERSICHERUNGEN	73,965	1
5017	OSTANGLER BRANDGILDE	n. a.	1
5074	PB VERSICHERUNG	n. a.	1
5095	PROV.RHEINLAND VERS.	2,552,320	3
5583	PVAG POLIZEIVERS.	318,589	1
5438	R+V ALLGEMEINE VERS.	1,471,253	6
5773	SAARLAND FEUERVERS.	n. a.	1
5448	SCHWEIZER NATION.VERS	n. a.	1
5125	SIGNAL IDUNA ALLG.	1,705,329	12
5586	STUTTGARTER VERS.	441,027	18

! Please refer to the "Explanatory notes on the statistics" on page 256.

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31 Dec. 2012	Complaints
5036	SV SPARK.VERSICHER.	266,472	1
5790	TARGO VERSICHERUNG	102,687	4
5463	UNIVERSA ALLG. VERS.	61,526	2
5511	VER. VERS.GES.DTSCHL. (US)	n. a.	1
5400	VGH LAND.BRAND.HAN.	5,459,331	1
5862	VHV ALLGEMEINE VERS.	341,324	1
5484	VOLKSWOHL-BUND SACH	171,787	3
5525	WGV-VERSICHERUNG	n. a.	3
5783	WÜRTT. VERS.	721,395	6
5590	WÜRZBURGER VERSICHER.	n. a.	7
5476	WWK ALLGEMEINE VERS.	244,011	4

! Please refer to the "Explanatory notes on the statistics" on page 256.

3.7 Legal expenses insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31 Dec. 2012	Complaints
5826	ADAC-RECHTSSCHUTZ	2,431,751	9
5809	ADVOCARD RS	1,548,283	53
5312	ALLIANZ VERS.	2,351,132	52
5405	ALTE LEIPZIGER VERS.	422,280	53
5455	ARAG ALLG. VERS.	n. a.	2
5800	ARAG SE	1,345,438	67
5801	AUXILIA RS	515,820	7
5792	BADEN-BADENER VERS.	n. a.	1
5310	BAYER. BEAMTEN VERS.	n. a.	12
5319	BAYER. HAUSBESITZER	n. a.	1
5098	BRUDERHILFE SACH.AG	96,131	2
5831	CONCORDIA RS	409,396	7
5340	CONTINENTALE SACHVERS	108,028	3
5802	D.A.S. ALLG. RS	2,601,853	43
5343	DA DEUTSCHE ALLG.VER.	n. a.	3
5549	DEBEKA ALLGEMEINE	388,812	5
5803	DEURAG DT. RS	1,181,455	43
5513	DEVK ALLG. VERS.	n. a.	2
5829	DEVK RECHTSSCHUTZ	1,062,955	12
5834	DMB RECHTSSCHUTZ	856,443	17
5818	HUK-COBURG RS	1,620,231	16
5086	HUK24 AG	102,031	5
5573	IDEAL VERS.	n. a.	2
5401	ITZEHOER VERSICHERUNG	n. a.	2
5402	LVM SACH	736,782	14
5412	MECKLENBURG. VERS.	144,052	3
5805	NEUE RECHTSSCHUTZ	450,336	17
5813	OERAG RECHTSSCHUTZ	1,582,905	42
5807	ROLAND RECHTSSCHUTZ	1,776,331	53
5438	R+V ALLGEMEINE VERS.	735,285	12
5400	VGH LAND.BRAND.HAN.	193,614	1
5525	WGV-VERSICHERUNG	433,834	16
5479	WÜRTT. GEMEINDE-VERS.	n. a.	1
5783	WÜRTT. VERS.	664,125	6

! Please refer to the "Explanatory notes on the statistics" on page 256.

3.8 Household contents insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31 Dec. 2012	Complaints
5342	AACHENMÜNCHENER VERS.	909,828	11
5581	ADLER VERSICHERUNG AG	n. a.	1
5312	ALLIANZ VERS.	2,446,230	25
5405	ALTE LEIPZIGER VERS.	130,651	3
5068	AMMERLÄNDER VERS.	211,237	7
5455	ARAG ALLG. VERS.	745,211	1
5397	ASSTEL SACH	n. a.	5
5515	AXA VERS.	1,053,840	6
5357	BAD. BEAMTENBANK	n. a.	1
5633	BASLER SACH AG	345,458	9
5310	BAYER. BEAMTEN VERS.	n. a.	1
5324	BAYER.VERS.VERB.AG	538,691	3
5098	BRUDERHILFE SACH.AG	185,859	3
5338	CONCORDIA VERS.	229,221	2
5340	CONTINENTALE SACHVERS	192,790	2
5343	DA DEUTSCHE ALLG.VER.	n. a.	2
5311	DBV DT. BEAMTEN-VERS.	302,299	1
5549	DEBEKA ALLGEMEINE	768,879	3
5513	DEVK ALLG. VERS.	890,999	3
5344	DEVK DT. EISENB. SACH	432,033	1
5129	DFV DEUTSCHE FAM.VERS	n. a.	1
5328	DOCURA VVAG	n. a.	3
5472	ERGO VERSICHERUNG	1,105,094	18
5024	FEUERSOZIJETÄT	105,911	3
5473	GENERALI VERSICHERUNG	1,317,141	13
5858	GOTHAER ALLGEMEINE AG	718,460	6
5374	HAFTPFLICHTK.DARMST.	147,825	2
5012	HAMB. LEHRER-FEUERK.	n. a.	1
5085	HDI VERSICHERUNG	698,637	24
5375	HUK-COBURG UNTER.	1,390,606	3
5086	HUK24 AG	205,425	2
5780	INTERRISK VERS.	162,195	2
5078	JANITOS VERSICHERUNG	116,609	7
5404	LBN	n. a.	3
5402	LVM SACH	750,919	5
5061	MANNHEIMER VERS.	69,026	3
5412	MECKLENBURG. VERS.	178,464	2
5070	NECKERMANN VERS.	n. a.	1
5426	NÜRNBG. ALLG.	159,086	2
5017	OSTANGLER BRANDGILDE	n. a.	1
5787	OVAG – OSTDT. VERS.	n. a.	2
5446	PROV.NORD BRANDKASSE	281,513	2
5095	PROV.RHEINLAND VERS.	505,596	4
5583	PVAG POLIZEIVERS.	n. a.	2
5438	R+V ALLGEMEINE VERS.	993,223	14
5491	SCHLESWIGER VERS.V.	n. a.	1
5125	SIGNAL IDUNA ALLG.	326,391	5
5036	SV SPARK.VERSICHER.	475,458	5
5459	UELZENER ALLG. VERS.	n. a.	1
5463	UNIVERSA ALLG. VERS.	n. a.	1
5862	VHV ALLGEMEINE VERS.	348,323	3
5484	VOLKSWOHL-BUND SACH	n. a.	3
5461	VPV ALLGEMEINE VERS.	165,141	1

! Please refer to the “Explanatory notes on the statistics” on page 256.

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31 Dec. 2012	Complaints
5093	WESTF.PROV.VERS.AG	562,478	5
5525	WGV-VERSICHERUNG	148,972	1
5479	WÜRTT. GEMEINDE-VERS.	184,738	1
5783	WÜRTT. VERS.	750,588	4
5476	WWK ALLGEMEINE VERS.	n. a.	3

! Please refer to the "Explanatory notes on the statistics" on page 256.

3.9 General liability insurance

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31 Dec. 2012	Complaints
5342	AACHENMÜNCHENER VERS.	1,269,168	10
5035	AGILA HAUSTIER AG	n. a.	1
5312	ALLIANZ VERS.	4,349,216	52
5405	ALTE LEIPZIGER VERS.	206,639	5
5397	ASSTEL SACH	n. a.	5
5515	AXA VERS.	2,839,356	27
5593	BAD. ALLG. VERS.	n. a.	2
5792	BADEN-BADENER VERS.	n. a.	1
5317	BARMENIA ALLG. VERS.	147,524	1
5633	BASLER SACH AG	372,886	11
5310	BAYER. BEAMTEN VERS.	n. a.	3
5324	BAYER.VERS.VERB.AG	1,090,148	7
5146	BGV-VERSICHERUNG AG	115,405	1
5098	BRUDERHILFE SACH.AG	218,034	1
5338	CONCORDIA VERS.	349,799	10
5340	CONTINENTALE SACHVERS	387,074	4
5343	DA DEUTSCHE ALLG.VER.	n. a.	1
5311	DBV DT. BEAMTEN-VERS.	585,271	5
5549	DEBEKA ALLGEMEINE	1,292,322	4
5513	DEVK ALLG. VERS.	1,151,395	5
5344	DEVK DT. EISENB. SACH	594,039	1
5129	DFV DEUTSCHE FAM.VERS	n. a.	1
5472	ERGO VERSICHERUNG	1,738,611	45
5508	EUROPA VERSICHERUNG	n. a.	2
5024	FEUERSOZIJETÄT	153,775	1
5366	GEMEINN. HAFT	n. a.	1
5473	GENERALI VERSICHERUNG	1,751,765	26
5858	GOTHAER ALLGEMEINE AG	1,339,819	15
5485	GRUNDEIGENTÜMER-VERS.	n. a.	1
5469	GVV-KOMMUNALVERS.	2,951	5
5374	HAFTPFLICHTK.DARMST.	1,137,918	7
5085	HDI VERSICHERUNG	1,403,549	62
5096	HDI-GERLING INDUSTRIE	15,782	7
5044	HDNA VVAG	n. a.	1
5384	HELVETIA VERS. (CH)	350,222	5
5521	HUK-COBURG ALLG. VERS	1,353,127	2
5375	HUK-COBURG UNTER.	1,972,099	8
5086	HUK24 AG	378,758	3
5573	IDEAL VERS.	n. a.	1
5546	INTER ALLG. VERS.	126,017	4
5780	INTERRISK VERS.	n. a.	3
5078	JANITOS VERSICHERUNG	207,668	8
5402	LVM SACH	1,246,804	4
5061	MANNHEIMER VERS.	152,463	3
5412	MECKLENBURG. VERS.	277,061	4
5334	MEDIENVERS. KARLSRUHE	n. a.	1
5426	NÜRNBG. ALLG.	325,587	7
5140	OBERÖSTERREICH. V.(A)	n. a.	2
5787	OVAG - OSTDT. VERS.	n. a.	5
5446	PROV.NORD BRANDKASSE	380,445	4
5095	PROV.RHEINLAND VERS.	826,832	4
5583	PVAG POLIZEIVERS.	n. a.	1
5438	R+V ALLGEMEINE VERS.	n. a.	31

! Please refer to the "Explanatory notes on the statistics" on page 256.

Reg. no.	Name of insurance undertaking	Number of insured risks as at 31 Dec. 2012	Complaints
5798	RHEINLAND VERS. AG	95,665	2
5121	RHION VERSICHERUNG	137,977	1
5690	SCHWARZMEER U. OSTSEE	n. a.	1
5438	R+V ALLGEMEINE VERS.	1,785,189	31
5125	SIGNAL IDUNA ALLG.	678,979	11
5781	SPARK.-VERS.SACHS.ALL	122,851	3
5036	SV SPARK.VERSICHER.	993,706	10
5459	UELZENER ALLG. VERS.	197,888	2
5042	VERSICHERUNGSK.BAYERN	16,052	1
5400	VGH LAND.BRAND.HAN.	756,598	2
5862	VHV ALLGEMEINE VERS.	1,213,725	24
5484	VOLKSWOHL-BUND SACH	140,167	2
5461	VPV ALLGEMEINE VERS.	n. a.	5
5093	WESTF.PROV.VERS.AG	n. a.	3
5525	WGV-VERSICHERUNG	n. a.	4
5093	WESTF.PROV.VERS.AG	816,399	3
5525	WGV-VERSICHERUNG	343,462	4
5783	WÜRTT. VERS.	1,178,747	8
5476	WWK ALLGEMEINE VERS.	134,414	3

! Please refer to the "Explanatory notes on the statistics" on page 256.

3.10 Insurers based in the EEA

Reg. no.	Abbreviated name of insurance undertaking	Complaints
9019	ACE EUROP.GROUP (GB)	6
5902	ACE EUROPEAN (GB)	21
5636	AGA INTERNATION. (F)	34
5163	AIG EUROPE LIMITED (GB)	18
5029	AIOI NISSAY (GB)	4
7265	ALLIANZ LIFE (L)	4
7671	ASPECTA ASSUR. (L)	1
5119	ASSURANT ALLG. (GB)	1
7203	ATLANTICLUX (L)	13
1324	ATLANTICLUX LEBEN (L)	1
5090	AXA CORPORATE S. (F)	1
7775	AXA FRANCE VIE (F)	1
1319	AXA LIFE EUR.LTD(IRL)	7
5145	BTA INS. (LV)	2
7687	BUPA (GB)	1
7811	CACI LIFE LIM. (IRL)	4
7807	CACI NON-LIFE (IRL)	1
7786	CANADA LIFE (IRL)	5
1300	CANADA LIFE (IRL)	9
1182	CARDIF LEBEN (F)	3
5056	CARDIF VERS. (F)	6
7690	CIGNA LIFE (B)	5
1189	CIGNA LIFE INS. (B)	1
7453	CLERICAL MED.INV.(GB)	17
7724	CREDIT LIFE INT. (NL)	11
7715	CREDIT SUISSE (FL)	4
7985	CSS VERSICHERUNG (FL)	13
5048	DOMESTIC AND GEN.(GB)	21
7309	DONAU VERSICHERUNG(A)	1
1161	EQUITABLE LIFE (GB)	1
7813	FINANCELIFE (A)	2
7481	FORTUNA LEBEN (FL)	1
7814	FRIENDS PROVID. (GB)	5
7268	GENERALI VERS.AG (A)	1

Reg. no.	Abbreviated name of insurance undertaking	Complaints
5116	GENWORTH FIN (GB)	1
9104	GLOBALITY S.A. (LU)	1
7270	HANSARD EUROPE (IRL)	2
7214	HELVETIA VERS. (A)	6
7956	INTER PARTNER (B)	2
5788	INTER PARTNER ASS.(B)	3
9031	LIBERTY EURO.(IRL/E)	6
5130	MAPFRE ASISTENC.(E)	4
1323	MONUTA VERS. (NL)	5
9040	NATIONALE SUISSE(B)	1
7806	NEW TECHNOLOGY (IRL)	3
5140	OBERÖSTERREICH. V.(A)	2
7723	PRISMALIFE AG (FL)	8
7455	PROBUS INSURANCE(IRL)	5
5120	QBE INS. LTD.(GB)	5
7183	QBE REINSUR. (IRL)	1
7894	QUANTUM LEBEN AG(FL)	2
7415	R+V LUXEMBOURG L (L)	5
9158	RCI INSURANCE (M)	4
7730	RIMAXX (NL)	15
9307	SANTANDER INS. LIFE (IRL)	9
5128	SOGECAP DNL (F)	1
5127	SOGECAP RISQUES (F)	2
1320	STANDARD LIFE (GB)	7
7763	STONEBRIDGE (GB)	3
1328	SWISS LIFE PROD.(L)	2
5157	TELEFONICA INSURANCE (L)	9
1311	VDV LEBEN INT. (GR)	3
7456	VDV Leben International	1
7643	VIENNA-LIFE (FL)	6
7483	VORSORGE LUXEMB. (L)	7
5152	W.R. BERKLEY (GB)	1
5151	ZURICH INSURANCE (IRL)	137
7659	ZURICH LIFE ASS.(IRL)	2

! Please refer to the "Explanatory notes on the statistics" on page 256.

4 Memoranda of Understanding (MoUs)*

Banking Supervision	
Albania	2012
Argentina	2001
Armenia	2011
Australia	2005
Austria	2000
Belgium	1993
Brazil	2006
Canada	2004
China	2004
Croatia	2008
Czech Republic	2003
Denmark	1993
Dubai	2006
El Salvador	2011
Estonia	2002
Finland	1995
France	1992
Georgia	2011
Greece	1993
Guernsey	2011
Hong Kong	2004
Hungary	2000
Ireland	1993
Italy (BI)	1993
Italy (BI-Unicredit)	2005
Jersey	2000
Kosovo	2011
Latvia	2000
Lithuania	2001
Luxembourg	1993
Macedonia	2011
Malta	2004
Mexico	2010
Moldova	2014
Netherlands	1993
Nicaragua	2011
Norway	1995
Philippines	2007
Poland	2004
Portugal	1996
Qatar	2008
Romania	2003
Russia	2006
Serbia	2011
Singapore	2009
Slovakia	2002
Slovenia	2001
South Africa	2004
South Korea	2006
Spain	1993
Sweden	1995
Turkey	2011
United Kingdom (BE/FSA)	1995
United Kingdom (BSC)	1995
United Kingdom(SIB/SROs)	1995
USA (FDIC)	2006
USA (FedBoard/OCC)	2003
USA (NYSBD)	2002
USA (OCC)	2000
USA (OTS)	2005
USA (SEC)	2007
Vatican	2014
Vietnam	2010

Securities Supervision	
Argentina	1998
Australia	1998
Brazil	1999
Canada	2003
China	1998
Croatia	2008
Cyprus	2003
Czech Republic	1998
Dubai	2006
Estonia	2002
France	1996
Guernsey	2011
Hong Kong	1997
Hungary	1998
Italy	1997
Jersey	2012
Jersey	2001
Luxembourg (Clearstream)	2004
Monaco	2009
Poland	1999
Portugal	1998
Qatar	2008
Russia	2001
Russia	2009
Slovakia	2004
South Africa	2001
South Korea	2010
Spain	1997
Switzerland	1998
Taiwan	1997
Turkey	2000
United Arab Emirates	2008
USA (CFTC)	1997
USA (SEC)	1997
USA (SEC)	2007
Vatican	2014

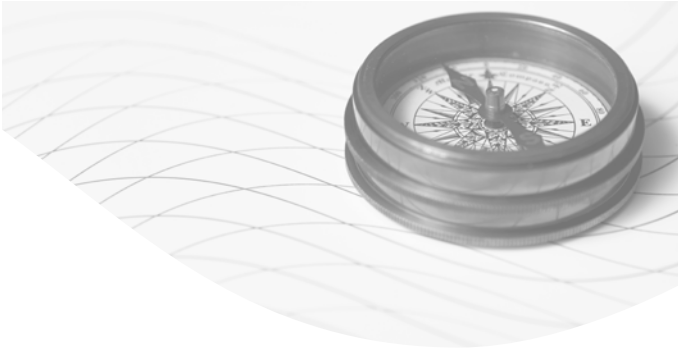
Insurance Supervision	
Australia	2005
California (USA)	2007
Canada	2004
China	2001
Connecticut (USA)	2011
Croatia	2008
Czech Republic	2002
Dubai	2006
Egypt	2010
Estonia	2002
Florida (USA)	2009
Georgia (USA)	2012
Guernsey	2011
Hong Kong	2008
Hungary	2002
Jersey	2012
Latvia	2001
Lithuania	2003
Malta	2004
Maryland (USA)	2009
Nebraska (USA)	2007
New Jersey (USA)	2009
New York (USA)	2008
Qatar	2008
Romania	2004
Singapore	2009
Slovakia	2001
South Korea	2006
Thailand	2010
USA (OTS)	2005
Vatican	2014

5 Index of tables

Table 1	Complaints by group of institutions	55
Table 2	Submissions received by insurance class since 2010	57
Table 3	Main reasons for complaints in 2014	58
Table 4	IFG statistics	84
Table 5	Risk classification results of credit institutions in 2014	105
Table 6	Risk classification results of financial services providers in 2014	105
Table 7	Number of banks by group of institutions	110
Table 8	Gross Pfandbrief sales	120
Table 9	Volumes of outstanding Pfandbriefe	121
Table 10	Breakdown of special audits by area of emphasis	123
Table 11	Breakdown of special audits in 2014 by groups of institutions	123
Table 12	Breakdown of special audits initiated by BaFin in 2014 by risk class	124
Table 13	Supervisory law objections and sanctions in 2014	125
Table 14	Risk models and factor ranges	126
Table 15	Requests for account information	130
Table 16	Number of complaints*	133
Table 17	Number of employees*	134
Table 18	Risk-classification results for 2014	167
Table 19	Breakdown of on-site inspections by risk class in 2014	168
Table 20	Number of supervised insurance undertakings and Pensionsfonds*	172
Table 21	Registrations by EEA life insurers in 2014	173
Table 22	Registrations by EEA property and casualty insurers in 2014	175
Table 23	Investments by insurance undertakings	177
Table 24	Composition of the risk asset ratio	178
Table 25	Share of total investments attributable to selected asset classes	179
Table 26	New minimum maximum amounts for sanctions	201
Table 27	Market manipulation investigations	213
Table 28	Public prosecutors' and court reports, and reports by BaFin's administrative fines section on completed market manipulation proceedings	214
Table 29	Insider trading investigations	217
Table 30	Public prosecutors' reports on completed insider trading proceedings	218
Table 31	Notifications by market makers and primary dealers	220
Table 32	Number of approvals in 2014 and 2013	223
Table 33	Notifications	223
Table 34	Enforcement procedures in 2014	231
Table 35	Risk classification of German management companies in 2014	233
Table 36	Administrative fine proceedings	235
Table 37	Personnel	238
Table 38	Recruitment in 2014	239

6 Index of figures

Figure 1	Legal bases for the banking union	17
Figure 2	Sovereign debt ratios in Europe	29
Figure 3	Securitisation positions by type of collateral	106
Figure 4	Regional breakdown of underlyings	107
Figure 5	Number of savings banks	110
Figure 6	Number of primary cooperative institutions	111
Figure 7	Breakdown of Group V institutions	112
Figure 8	German banking shares index	113
Figure 9	Credit default swap spreads for major German banks	113
Figure 10	Interbank market indicators	114
Figure 11	Legislative process up to the implementation of Solvency II	147
Figure 12	Sector index for German insurance shares	174
Figure 13	CDS spreads for selected insurers	174
Figure 14	Ad hoc disclosures	219
Figure 15	Directors' dealings	220
Figure 16	Distribution of notifications by index	221
Figure 17	Voting rights notifications	222
Figure 18	Total issue volume	224
Figure 19	Prospectuses received, approvals, withdrawals and prohibitions	227
Figure 20	Prospectuses by target investment	228
Figure 21	Offer procedures from 2011 to 2014	229
Figure 22	Number of administrative fines	234
Figure 23	2014 budget expenditure	241
Figure 24	2014 budget income	242
Figure 25	Cost allocations by supervisory area in 2013	242

**Publisher**

Bundesanstalt für Finanzdienstleistungsaufsicht
Stabsstelle Presse- und Öffentlichkeitsarbeit
Press and Public Relations Department
— Graurheindorfer Str. 108 | 53117 Bonn
— Marie-Curie-Straße 24–28 | 60439 Frankfurt am Main

Phone: +49(0)228 41 08-0
Internet: www.bafin.de
E-Mail: poststelle@bafin.de

Bonn and Frankfurt am Main | May 2015
ISSN 1611-910X

Editing

Press and Public Relations Department
Heimbüchel PR, Köln

Copy deadline

31 March 2015

Typesetting

Da-TeX Gerd Blumenstein, Leipzig

Printed by

Projekt-PR, Bonn

Photos

© Ilja C. Hendel/BMF (p. 10)
© Frank-Beer.com (cover, p. 21, 28,
44, 86, 89, 138, 190)
© Ute Grabowsky/photothek.net/BaFin
(p. 14, 138, 238)