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Germany: Financial Sector Assessment Program—Detailed Assessment of Observance on Basel Core Principles for Effective Banking Supervision

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

GERMANY

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

DETAILED ASSESSMENT OF OBSERVANCE

JULY 2011

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

Contents Page

Glossary

AML	Anti-money laundering
AML/CFT	Anti-Money Laundering/Financing of Terrorism
AnzV	Anzeigenverordnung
BaFin	German Federal Financial Supervisory Authority *(Bundesanstalt für Finanzdienstleistungsaufsicht)*
BAKIS	Bankaufsichtliches Informationssystem
BBG	Bundesbeamtengesetz
BCBS	Basel Committee for Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BdB	Association of German Banks *(Bundesverband Deutscher Banken)*
BGB	Burgerliches Gesetzbuch
BMF	Federal Ministry of Finance (*Bundesministerium der Finanzen)*
BVR	National Association of German Cooperative Banks *(Bundesverband der Deutschen Volksbanken und Raiffeisenbanken)*
Bundesbank	Deutsche Bundesbank
CDD	Customer due dilligence
CEBS	Committee for European Banking Supervisors
CP	Core Principle
CRD	Capital Requirements Directive
DSGV	German Savings Banks Association *(Deutscher Sparkassen- und Giroverband)*
EAEG	Deposit Guarantee and Investor Compensation Act (Einlagensicherungs- und Anlegerentschadigungsgesetz)
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
ESCB	European System of Central Banks
FATF	Financial Action Task Force
FinDAG	Finanzdienstleistungsaufsichtsgesetz
FinDAGKostV	Verordnung über die Erhebung von Gebühren und die Umlegung von Kosten nach dem Finanzdienstleistungsaufsichtsgesetz
FIU	Financial Intelligence Unit
FMVAStärkG	Act for the Strenghtening of the Financial Markets and Insurance Supervision *(Gesetz zur Starkung der Finanzmarkt- und der Versicherungsaufsicht)*
FMSA	Agency for the Stabilization of the Financial Markets *(Bundesanstalt für Finanzmarktstabilisierung)*
FREP	Financial Reporting Enforcement Panel (*Deutsche Prüfstelle für Rechnungslegung*)
FSAP	Financial Stability Assessment Program
FTE	Full time equivalents
GroMiKV	Grosskredit- und Millionenkreditverordnung
GwG	Anti Money Laundering Act (*Geldwäschegesetz*)
HGB	Commercial Code **(***Handelsgesetzbuch*)

ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
InhKontrollV	Inhaberkontrollverordnung
IRBA	Internal Ratings-Based Approach
JRAD	Joint Risk Assessment and Joint Decision
LiqV	Liquidity Regulation (*Liquiditätsverordnung*)
LvR	Country Risk Exposure Regulation (*Länderrisikoverordnung*)
KWG	German Banking Act *(Kreditwesengesetz)*
MaRisk	Minimum Requirements for Risk Management *(Mindestanforderungen an das Risikomanagement)*
ML	Money laundering
MonAwV	Monatsausweisverordnung
MoU	Memorandum of understanding
PEPs	Prominent public functions
PrüfbV	Prüfungsberichtsverordnung
ROSC	Report on Standards and Codes
RPS	Retail Payment System
RStruktG	Act on the Orderly Restructuring and Liquidation of Banks (*Restrukturierungsgesetz*)
RTGS	Real Time Gross Settlement
SEPA	Single Euro Payments Area
SoFFin	Special Fund for Financial Market Stabilization *(Sonderfonds Finanzmarktstabilisierung)*
SolvV	Solvency Ordinance *(Solvabilitätsverordnung)*
SRP	Supervisory Review Process
SSP	Single Shared Platform
STR	Suspicious transaction reporting
TF	Terrorist financing
T2S	TARGET2-Securities
TARGET2	Trans-European Automated Real-time Gross settlement Express Transfer system
WpHG	Securities Trading Act *(Wertpapierhandelsgesetz)*
ZAG	Zahlungsdiensteaufsichtsgesetz

I. Summary, Key Findings and Recommendations

1. **This assessment focuses on the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) (BaFin), which is responsible for the regulation and supervision of the financial system including banks, and the Deutsche Bundesbank, which undertakes much of the detailed and quantitative supervision.** The Federal Ministry of Finance (*Bundesministerium der Finanzen*) (BMF) retains responsibility for issuing regulations under the German Banking Act (*Gesetz uber das Kreditwesen*) (KWG) for questions of policy and politics, but has delegated rule-making powers to BaFin. Individual banks' external auditors have responsibilities for checking compliance with regulations. The various banking associations actively oversee their members.

2. **In general, the design of the German banking supervision framework is structurally sound, with a robust legislative and operational framework that largely complies with the Basel Core Principles for Effective Banking Supervision (BCP).** This framework must cope with a large and complex banking system of domestic and international systemic importance.[1] Given that importance, and the impact that the financial crisis has had on the German banking sector, the standard to which the effectiveness of banking supervision in Germany is judged must be very exacting. It is in this context that the conclusions of this detailed assessment should be interpreted.

3. **The German authorities have implemented various improvements to the German supervisory framework since the 2003 FSAP, acting on multiple recommendations from that Financial Sector Assessment Program (FSAP) and initiating improvements in supervisory practices on the basis of lessons from the global financial crisis.** Especially noteworthy has been the increased emphasis on proactive supervision by the authorities and the more sophisticated identification of bank-specific and systemic risk factors. Many regulations have been revised, reflecting amendments to European Union (EU) directives (which themselves incorporate input from the German authorities.

4. **As the authorities acknowledge, further improvement is needed, mainly to make fully operational the improvements initiated in light of the lessons from the global financial crisis.** In many cases, the supervisory authorities have already identified certain weaknesses and are in the process of addressing them. In other cases, changes in legislation are needed, or full operationalization must wait for final agreement on supervisory standards at the EU or international level. The main areas for improvement—as determined under a relatively broad application of the BCP commensurate with Germany' situation, and based on the situation at the time of the assessment—are as follows:

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[1] Germany is ranked No. 2 on IMF's ranking of jurisdictions with systemically important financial sectors (IMF press release September 27, 2010. http://www.imf.org/external/np/sec/pr/2010/pr10357.htm).

- German legislation contains no rules requiring a German institution to obtain BaFin's prior approval before acquiring a participating interest or establishing corporate ties with another entity, not being a credit institution licensed in Germany. Although in specific cases BaFin is notified of acquisitions, the supervisory authorities have no power to *ex ante* prohibit such acquisitions. Given the inherent risks that such participating interests may entail, the assessors deem a larger and more direct role for BaFin to be advisable.[2]

- While it is acknowledged that the capitalization of the German banking sector has seen an upward trend during the past years, BaFin has to date made only limited use of its formal powers to impose higher capital requirements that are commensurate with risk profiles of individual institutions. BaFin's legal powers to impose higher capital requirements has been expanded and specified through the enactment of the Act for the Strengthening of the Financial Markets and Insurance Supervision (*Gesetz sur Starkung der Finanzmarkt-und der Versicherungsaufsicht*) (FMVAStärkG) in August 2009, but specific guidance for supervisors on how to make effective use of the new powers has only very recently become available, and has not yet been extensively tested in practice. The use of stress tests as instruments to closely scrutinize the capital adequacy of individual institutions, taking into account forward-looking elements, needs to be further enhanced. Prior to the recent national transposition of the EU Capital Requirement Directive (CRD) II package, relevant provisions defining the components of capital did not fully ensure that proper emphasis was given to the loss absorbing character of regulatory Tier 1 capital as German legislation lacked detailed provisions, including strict limits, for hybrid Tier 1 instruments. The importance of improvements in this area is underscored by events during the global crisis, when some banks were revealed to be severely under-capitalized, as well as by the vulnerability assessment undertaken as part of this FSAP Update and analyses from market participants, suggesting that some banks are still relatively weakly capitalized.

- Lessons drawn from the financial crisis must be used to further strengthen German institutions' risk management practices and the day-to-day supervision of such practices by the supervisory authorities. The financial crisis has exposed severe shortcomings in the risk management practices at banks on a global level, including at certain German banks. Therefore, the German supervisory authorities are encouraged to further their own inspection work, focusing on areas where the financial crisis has revealed significant shortcomings, in particular the areas of liquidity risk management, senior management's risk oversight, stress testing capabilities and the IT infrastructure supporting the risk management process. Moreover, the German

[2] Comparable comments were made as part of the 2003 FSAP and the accompanying BCP assessment.

authorities should deepen their analytical assessments of institutions' risk bearing capacity; more rigorous and tailored stress tests are needed to identify weaknesses and urge individual institutions to strengthen their regulatory capital (in terms of both quantity and quality) to a level that is commensurate with their risk profiles.

- More timely information needs to be gathered, and the data series compiled should be reviewed to ensure that relevant data are available. For example, recent strains in interbank markets suggest that supervisors should track liquidity in both euros and U.S. dollars. In this connection, the sharing information with supervisory authorities in other countries—including those outside the EU—could be further strengthened.

- The authorities need to stand ready to demand progressively stronger remedial action as the situation of a particular institution becomes more precarious, to which end it would be useful to have a more formalized "ladder" of actions, ensuring that timely and appropriate supervisory actions are taken, commensurate with the nature and seriousness of the identified issues. Such a ladder, even if it does not rely on simple quantitative criteria, would help resist pressure from special interest groups, promote appropriate consistency in the treatment of different banks, and contribute to public confidence in the ability of the authorities to preempt emerging strains in the financial system.

A. Introduction

5. **An FSAP for Germany was conducted in 2003.** The assessment concluded that the supervision of banks in Germany is based on a well developed and comprehensive system of financial sector regulation and supervision, and has been implemented with appropriate institutional capacity. All but 2 criteria were assessed as "compliant" (16 criteria) or "largely compliant" (7 criteria); the 2 criteria that were assessed as materially noncompliant related to investment criteria and connected lending.[3]

6. **Significant changes have taken place since the initial assessment:**

- The regulatory framework has undergone material changes with, inter alia*,* the implementation of Basel II in the CRD (and subsequently in domestic German legislation) and the publication of numerous recommendations and guidelines from the various international standard setting bodies.

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[3] The assessors recommended to set-up criteria for both pre-notification and information-after-the-event for significant acquisitions and investments conducted by credit institutions, and to implement stronger rules on connected lending to minimize the risk of a related party abusing a credit institution.

- In 2006, the BCP and the associated methodology were revised, incorporating new regulatory issues, and experiences gained with the self assessments conducted on the basis of the original BCP.

- The regulatory landscape in Europe has undergone change, with the establishment of the Committee for European Banking Supervisors (CEBS) and, very recently, the European Systemic Risk Board.[4]

- The financial crisis has revealed important lessons for financial supervision and thus spurred the debate on further strengthening of financial regulation, both at an international level as well as domestically.

B. Information and Methodology Used for Assessment

7. **This Detailed Assessment of Observance Report was prepared as part of the FSAP Update mission to Germany, that took place between January 19 and February 4, 2011.** The assessment team reviewed the legal framework for banking supervision, held extensive discussions with staff from BaFin, the Deutsche Bundesbank (Bundesbank) and the BMF, as well as the Association of German Banks (*Bundesverband Deutscher Banken*, (BdB), the German Savings Banks Association (*Deutscher Sparkassen- und Giroverband)* (DSGV), the National Association of German Cooperative Banks (*Bundesverband der Deutschen Volksbanken und Raiffeisenbanken)* (BVR), and private sector participants in the banking and financial markets.[5, 6, 7, 8] The team examined the current practice for on- and off-

[4] CEBS has meanwhile been reformed into the European Banking Authority (EBA), established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of November 24, 2010. The EBA has officially come into being as of January 1, 2011 and has taken over all existing and ongoing tasks and responsibilities from CEBS.

[5] The assessment was performed by William Ryback (Former Special Advisor (Deputy Governor Level) at the Korean Financial Supervisory Service, Deputy Chief Executive at the Hong Kong Monetary Authority and Senior Associate Director at the Board of Governors of the Federal Reserve System) and Constant Verkoren (IMF, Senior Financial Sector Expert at the Financial Sector Oversight Division and former Head of Department in the Division Banking Supervision of the Dutch Central Bank).

[6] The BdB represents more than 210 private commercial banks and 11 member associations. The private commercial banks affiliated include the largest German banks (e.g., Deutsche Bank and Commerzbank), various regional and private banks, as well as the local subsidiaries of foreign banks active in Germany. The BdB also operates a voluntary deposit protection scheme, offering the customers of its member banks virtually full deposit protection. http://www.germanbanks.org/.

[7] The DSGV is the umbrella organization of the Sparkassen-Finanzgruppe, one of the largest banking groups in the world with 50 million customers. It is funded by the regional savings banks associations together with the Landesbanken. It represents the interests of the Sparkassen-Finanzgruppe on banking policy, regulatory law, and other banking industry issues on a national and international level. It also organizes decision making and stipulates strategic direction within the group, acting in cooperation with the regional associations and other group institutions. It furthermore operates a joint liability scheme, offering a safeguard to the affiliated banks and thus providing a maximum degree of reliability for its customers. http://www.dsgv.de/en/about-us/index.html.

site supervision by the German authorities, using the comprehensive self assessment completed by the authorities as a starting point. The team extends its thanks to the staff of the authorities for their participation in the process and for their comprehensive self assessment.

8. **The assessment is based on several sources:** (i) the afore-mentioned self-assessment, received in November 2010; (ii) detailed interviews with staff from BaFin and the Bundesbank; (iii) reading of laws, regulations, and other documentation on the supervisory framework and on the structure and development of the German financial sector; (iv) reading of anonimized supervisory materials provided to the assessors during and after the fieldwork in Germany; (v) meetings with other authorities and independent bodies, such as the BMF; and (vi) meetings with the banking industry in the form of the various banking associations as well as with individual institutions representing different categories, such as large private, public, and cooperative banks.

9. **The assessors had the full cooperation from the German authorities and received all information necessary for the assessment.** The team extends its thanks to the management and staff of the various agencies and institutions for their openness and participation in the process. The authorities provided comments on a draft version of this assessment, which are reflected in the final assessment.

10. **The assessment has been conducted in accordance with the guidelines described in the Core Principles (CP) Methodology published in October 2006 by the Basel Committee on Banking Supervision (BCBS).**[9] It assessed compliance with both the "essential" and the "additional" criteria, but the ratings assigned were based on compliance with the "essential" criteria only. The methodology requires that the assessment be based on (i) the legal and other documentary evidence; (ii) the work of the supervisory authority; as well as (iii) the implementation in the banking sector. Full compliance requires that all these three prerequisites are met. The guidelines allow that a country may fulfill the compliance criteria in a different manner from the ones suggested as long as it can prove that the overriding objectives of each CP are reached. Conversely, countries may sometimes be required to fulfill more than the minimum standards, e.g., due to structural weaknesses in that country. The Methodology also states that the assessment is to be made on the factual situation of the date when the assessment is completed. However, where applicable, the assessors made note of regulatory initiatives, which have yet to be completed or implemented.

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[8] The BVR is the central organization of the Volksbanken and Raiffeisenbanken, a cooperative banking group with over 16 million members and 30 million customers. The BVR functions as a promoter of, a representative for, and a strategic partner of its members. Furthermore, the BVR operates a protection scheme, aimed at preventing and/or remedying impending and/or existing economic difficulties for the member banks and to prevent any diminution of the confidence vested in cooperative credit institutions. http://www.bvr.coop/coop/index.html.

[9] http://www.bis.org/publ/bcbs130.htm.

11. **To determine the level of observance of each CP, the assessment has made use of five rating categories:** compliant; largely compliant; materially noncompliant, noncompliant, and nonapplicable. An assessment of "compliant" is given when all essential criteria are met without any significant deficiencies, including instances where the relevant CP has been achieved by other means. A "largely compliant" assessment is given when there are only minor shortcomings, which do not raise serious concerns about the authorities' ability to achieve the objective of the CP and there is clear intent to achieve full compliance with the CP within a prescribed period of time. A CP is considered to be "materially noncompliant" in case of severe shortcomings, despite the existence of formal rules and procedures and there is evidence that supervision has clearly not been effective, the practical implementation is weak or that the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance. A CP is assessed "noncompliant" if it is not substantially implemented, several essential criteria are not complied with, or supervision is manifestly ineffective. Finally, a category of "nonapplicable" is reserved (though not used in this assessment) for those cases where the criteria would not be relevant for the German situation.

12. **An assessment of compliance with the BCPs is not, and is not intended to be, an exact science; reaching conclusions require judgments by the assessment team.** Banking systems differ from one country to another, as do domestic circumstances. Also, banking activities are changing rapidly around the world after the crisis and theories, polices, and best practices are rapidly evolving. Nevertheless, by adhering to a common agreed methodology, the assessment should provide the German authorities with an internationally consistent measure of quality of their banking supervision in relation to the 2006 Revision of the BCPs,[10] which are internationally recognized as minimum standards.

13. **For completeness' sake, it should be noted that the ratings assigned during this assessment are not necessarily directly comparable to the ones assigned in terms of an FSAP performed using the pre-2006 BCP Methodology.** Differences may stem from the fact that the bar to measure the effectiveness of a supervisory framework was raised by the 2006 update of the BCP Methodology, as well as by lessons drawn from the financial crisis that may have a bearing on supervisory practices.

C. Institutional and Macro Prudential Setting, Market Structure

14. **Germany's financial system is complex and highly diversified.** The banking system is based on a "Three Pillar" system (private banks, savings banks and the associated *Landesbanken*, and cooperative banks) with a relatively high portion of public banking.[11] The

[10] http://www.bis.org/publ/bcbs129.htm.

[11] In addition to savings banks and Landesbanken that are largely owned by regional bodies and the states, the federal government owns a number of institutions, such as the Kreditanstalt für Wiederaufbau.

banking sector accounts for the majority of total financial sector assets, serving as a backbone to the German industry, which is more reliant on bank financing than in many other advanced economies. However, household credit is low compared to that in many other industrialized countries.[12] The private commercial banks, which hold less than 30 percent of system-wide assets, can be considered relatively concentrated in the two largest, internationally active banks. Contrary to the cooperative and savings banks that are domestically oriented, the major banks have large exposures abroad through branches and subsidiaries, cross-border lending, and market operations, both in Europe and worldwide. Some German insurance and reinsurance companies are among the largest in the world. Securities markets are active and assets under management are large.

15. **The main supervisory responsibilities and tasks in Germany have been split over the Bundesbank, being a member of the European System of Central Banks (ESCB), and BaFin.** The Bundesbank is the central bank of the Federal Republic of Germany. Its Executive Board currently comprises six members, half of which are nominated by the Federal Government and half by the *Bundesrat*, with all members being appointed by the President of the Federal Republic. Some 10,000 people are employed at the Bundesbank.

16. **BaFin was established in May 2002, bringing together the supervision of banks and financial services providers, insurance undertakings, and securities trading under one roof,[13] with a view to ensuring the proper functioning, stability, and integrity of the German financial market.** It employs around 1,900 staff who work from its offices in Bonn and Frankfurt am Main. BaFin is managed by an Executive Board consisting of a President and four Chief Executive Directors. BaFin is funded solely out of fees and contributions from the institutions and businesses that it supervises and is thus independent of the Federal budget.

17. **The cooperation between the Bundesbank and BaFin has been formalized through a memorandum of understanding (MOU)[14] and an accompanying Supervision**

[12] Both consumer loans and mortgages are proportionately lower than in many other advanced economies. Real estate prices have been flat over the last decade, in part because the sector has recovered slowly from the post-reunification boom and because of slow growth in real household income.

[13] BaFin supervises approximately 2,000 banks, 710 financial service providers, approximately 620 insurance companies, and 28 pension funds as well as around 6,000 domestic investment funds and 73 asset management companies.
http://www.bafin.de/cln_171/SharedDocs/Downloads/EN/Service/Broschueren/100608__flyer__aboutus,templateId=raw,property=publicationFile.pdf/100608_flyer_aboutus.pdf .

[14]
http://www.bafin.de/cln_171/nn_721606/SharedDocs/Veroeffentlichungen/EN/BaFin/Internationales/GemeinsameStandpunkte/mou__021031__en.html.

Guideline.[15] The MOU, in short, outlines that (a) the off-site analysis of banking business documents will be done by the Bundesbank who will notify BaFin of the results; and (b) audits at supervised institutions will typically be carried out by the Bundesbank, but potentially with BaFin's participation.

Recent developments

18. **Parts of Germany's banking sector were hit hard during the financial crisis, mainly because of the economy's international connections.** Germany felt the force of the first shocks from the subprime mortgage markets in July 2007. In August 2007, two smaller banks had to be rescued at significant costs to the German taxpayer. Following the failure of Lehman Brothers, the liquidity rollover requirements at another institution in early October 2008 constituted another threat to financial stability. Also, major private banks suffered from market losses and difficult access to financing and, as the recession deepened, faced deteriorating loan quality. The financial crisis has furthermore revealed serious and systemic risks to financial stability across the *Landesbanken* sector. To date, the much needed structural reform of the *Landesbanken* sector remains outstanding.

19. **The authorities prevented widespread financial stress in Germany during the crisis, provided stimulus, and initiated an overhaul of the financial stability framework.** Bold support measures were promptly provided to weaker banks in order to safeguard financial stability. Support measures comprised of guarantees, recapitalization, and asset purchases; the gross amount made available exceeded 20 percent of GDP, of which less than half was actually used. Much of the support was channeled through the Special Fund for Financial Market Stabilization (*Sonderfonds Finanzmarkt-stabilisierung*) (SoFFin), administered by the Agency for the Stabilization of the Financial Markets (*Bundesanstalt für Finanzmarktstabilisierung*) (FMSA). The total volume of potential support was capped at EUR 400 billion for guarantees and EUR 80 billion in capital support.[16] The debt-to-GDP ratio reached 80 percent in 2010 after including the support to the financial sector.

20. **At the time of the mission, the health of the financial sector has stabilized via strong policy support, channeled through exceptional measures.** After initial support through exceptional measures, a more comprehensive approach was introduced to address the impact of the crisis. Since then the financial system has strengthened further on the back of improving macroeconomic prospects. Financial stresses have meanwhile abated, but pockets

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[15] Guideline on the execution and quality assurance of the ongoing supervision of credit and financial services institutions by the Bundesbank, http://www.bafin.de/nn_721606/SharedDocs/Aufsichtsrecht/EN/Richtlinie/aufsichtsrichtlinie__en.html.

[16] At its peak, outstanding guarantees reached EUR 174 billion; at the time of the mission, approximately EUR 110 billion had already been paid back.

of vulnerability remain and the restructuring process for the weaker institutions is yet to be completed.

D. Preconditions for Effective Banking Supervision

Sound and sustainable macroeconomic policies

21. **Germany has a solid institutional framework supporting the conduct of sound macro-economic policies.** Monetary policy is conducted within the ESCB framework. Budgetary policy is conducted within a fiscal framework based on predefined rules and within the requirements of the European Stability Pact.

A well-developed public infrastructure

22. **The German legal framework for the banking sector is comprehensive and regularly updated.** The German regulations on banking supervision provide a framework of minimum standards that is determined by the Basel II standards (as implemented in Europe through the CRD). Since its original adoption in 1961, the KWG has been regularly updated and amended in order to take into account developments in the banking industry and advancements in supervisory practices.

23. **The auditing and accounting rules applicable to financial institutions generally comply with international standards.** In the late 1990s, the Accounting Standards Committee of Germany (*Deutsche Rechnungslegungs Standards Committee*) was appointed as private standard setter for financial reporting within the meaning of the German Commercial Code (*Handelsgesetzbuch*) (HGB). The German Accounting Standards Board (*Deutsche Standardisierungsrat*) is the independent standardization body established by the Accounting Standards Committee of Germany, tasked with the elaboration of recommendations on the application of German accepted group accounting principles, the provision of advice to the Federal Ministry of Justice on accounting regulations and representation of the Federal Republic of Germany in international standard-setting bodies. German listed companies apply as required the International Financial Reporting Standards (IFRS) since 2005.

24. **The German legislative framework with regard to the audit profession requires external auditors to be independent in both fact and appearance.** The existing independence requirements are further bolstered by the introduction in the German Public Auditors' Act (*Wirtschaftsprüferordnung*) of disciplinary oversight investigations, conducted randomly and without indication of misconduct, and specific requirements on mandatory rotation from audit engagements within a maximum period of seven years from the date of appointment. The judicial system, including that for bankruptcy and the enforcement of property rights, is well-developed.

25. **The payment and settlement system is reliable and efficient.** Overseeing payment systems is assigned to the Bundesbank. The European TARGET 2 system, the real time gross settlement (RTGS) system of the ESCB, is considered to be fast and secure. The Bundesbank offers its bank and nonbank customers a procedure for the processing of nonurgent domestic and cross-border euro payments through the Single Euro Payments Area (SEPA) system, in which all payments are treated as domestic transactions.

26. **On July 17, 2008, the Bundesbank was instructed by the European Central Bank's (ECB) Governing Council to develop, together with Banque de France, Banca d'Italia and the Banco de España, TARGET2-Securities (T2S).** T2S is being developed to offer a new, harmonized and centralized method of settling securities in central bank money, thus replacing the current fragmented and predominantly nation-centric European securities settlement market. T2S will be run on the existing Single Shared Platform (SSP) on which TARGET2 is already operated and is expected to go live in September 2014.

Effective market discipline

27. **The German legislative framework contains various safeguards with regard to disclosure and transparency.** As part of its responsibilities for securities market supervision, BaFin has to maintain fair and transparent conditions in the markets. The Securities Trading Act (*Wertpapierhandelsgesetz*) (WpHG) requires listed companies to publish with the least possible delay, new facts relating to their company or business of which the public are not aware if this information has the potential to influence the price of the financial instrument and affect the issuer directly. Furthermore, the reliability of financial disclosures is safeguarded through the afore-mentioned auditing and accounting rules.

28. **The structure of financial institutions in Germany is governed by company law, namely, the German HGB and various other laws.** Detailed corporate governance requirements have been laid down in the German Corporate Governance Code, prepared by the *Regierungskommission Deutschen Corporate Governance Kodex* and adopted in February 2002. The provisions of the Code are not mandatory, but rather recommendations with a "comply or explain" regime, as well as suggestions from which a firm may deviate without further disclosure. The Code only applies to listed companies but is deemed to "influence the practice in other companies."[17]

29. **Enforcement of financial reporting is performed in Germany in two stages:** the first stage involves a government-appointed privately organized institution, the Financial Reporting Enforcement Panel (*Deutsche Prüfstelle für Rechnungslegung*) (FREP) with the Enforcement Panel as its active body, while the second stage is performed by BaFin, which

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[17] http://www.corporate-governance-code.de/index-e.html.

has sovereign authority. FREP has been examining financial reporting of companies listed in the regulated market in Germany since July 2005.

Public safety nets

30. **The existence of the Three Pillar system has resulted in a fairly complex structure of deposit insurance schemes.** Three categories of deposit schemes can be distinguished:

- Two Statutory Deposit Guarantee Schemes, one for private banks, operated by the BdB (the association of German private banks), and one for public banks, operated by the VÖB (the association of German public banks). These Statutory Schemes adhere to the current European Directive on minimum requirements for deposit insurance and cover (as per the end of December 2010) up to EUR 100.000 per customer per bank.[18] Thus, the functions and powers of these two schemes are assigned by law to a private-law entity fulfilling public-law functions as an "entrusted compensation scheme." Membership in these Schemes is mandatory for all deposit taking credit institutions with their registered office in Germany. The Scheme is funded, ex ante, although the Deposit Guarantee and Investor Compensation Act (*Einlagensicherungs- und Anlegerentschadigungsgesetz*) (EAEG) allows for additional/extraordinary contributions.

- Two voluntary private-law schemes offer institutional protection for the members that are associated with the BVR and the DSGV, the associations for German cooperative banks and German savings banks, respectively. The member institutions of these schemes are not assigned to the Statutory Deposit Guarantee Schemes, as, by virtue of their statutes, they protect the member credit institutions by safeguarding the viability of the institutions through various arrangements and guarantees. Contribution payments for these Schemes are also paid ex ante.

- Two voluntary Deposit Guarantee Schemes exist, one for private deposit taking credit institutions which is operated by the BdB and one for public deposit taking institutions which is operated by the VÖB. The protection offered by these voluntary schemes supplements the legal compensation stemming from the afore-mentioned Statutory Schemes.

Legal framework

31. **The German legal framework for banking supervision comprises legislation and regulation at various levels.** The most fundamental is the KWG that reflects relevant EU

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[18] Previously, the maximum amount covered had already been increased from EUR 20.000 to EUR 50.000 (as per EU Directive 2009/14/EC).

directives, including the CRD[19] (and thus the Basel II framework). The KWG consists of seven parts, dealing, inter alia*,* with the organization and modus operandi of BaFin, with requirements applicable to supervised institutions (e.g., solvency, liquidity, large exposures, and reporting requirements) and with provisions on the supervision of institutions (e.g., licensing, information and audit rights, and formal measures). On the basis of the KWG, various supplementary regulations and/or circulars have been issued. For example (i) the Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement*) (MaRisk), issued on the basis of Section 25a of the KWG, provides for a holistic framework for the management of all material risks; (ii) the Solvency Regulation (*Solvabilitätsverordnung*) (SolvV), issued on the basis of Section 10 of the KWG, contains detailed provisions on the capital requirements for credit, market, and operational risks; and (iii) the Liquidity Regulation (*Liquiditätsverordnung*), issued on the basis of Section 11(1) of the KWG, provides provisions on the liquidity of credit institutions.

32. **More recently, in August 2009, the FMVAStärkG was enacted.** Through this Act, the early intervention powers of BaFin were greatly enhanced. Other major legislative developments in Germany relate to the establishment of the German Federal Agency for Financial Market Stabilization and the accompanying Financial Market Stabilization Fund to support financial institutions that experience financial difficulties stemming from the financial crisis, and the Restructuring Act (*Restrukturierungsgesetz*) (RStruktG) that introduced, inter alia, mechanisms for the orderly restructuring or resolution of troubled institutions. As a consequence of the enactment of the Restructuring Act the KWG has been amended, allowing BaFin—under certain circumstances—to order an institution to sell all assets or systemically critical business segments to another institution or a government owned bridge bank; it also allows BaFin to temporarily order the transfer of assets.

Supervisory approach

33. **In the day-to-day supervision, the German supervisory authorities rely on a system of on- and off-site supervision, founded on analysis of the auditor's reports, scrutiny of institutions' regular returns, and information acquired in other ways (e.g., ad hoc meetings and inspections).** Annually, the Bundesbank proposes by October 31 of each year the supervision schedule for the following year, based on (i) the individual risk profile; (b) the importance of the institution for the stability of the financial markets; and (c) the anticipated urgency of the need for individual cases to be dealt with. This schedule is submitted to BaFin for review and jointly finalized by December 15 of each year, with the joint understanding that deviations from the supervision schedule, agreed between BaFin and the Bundesbank, are always possible.

[19] Directive 2006/48/EC of the European Parliament and of the Council of June 14, 2006 relating to the taking up and pursuit of the business of credit institutions (recast).

34. **BaFin and Bundesbank have established a preventive, risk-oriented supervisory process for holistically monitoring German institutions' risks.** This process involves the creating of so-called "risk profiles" i.e., analyses (updated at least once a year) prepared for each institution whereby the risks of that institution are mapped across four risk categories and three systemic stability (significance) categories. In accordance with its responsibility for ongoing monitoring of credit institutions, the risk profiles are prepared by the Bundesbank and subsequently forwarded to BaFin for final decision making. Two features allow the risk profile to be a decisive instrument in planning and conducting supervisory measures. First, the profile helps supervisors to deploy their resources efficiently and in a risk-oriented manner by helping to identify those institutions which, owing to their risk profile classification, represent a heightened risk to the stability of the financial sector. Second, risk profiling reveals those areas of institutions where weaknesses have either come to light or which cannot be judged owing to a lack of information.

35. **In the case of the smaller institutions (for example, cooperatives and savings banks), the risk profile is compiled on the basis of statistical analysis, using data available through BAKIS (*Bankaufsichtliches Informationssystem*), the prudential information system in which ratios relating to the market and credit risks, as well as the liquidity, earnings and asset and liability situation of an institution are recorded and compared with the scores of various pre-defined peer groups.** Through statistically well-founded processes, institutions are assigned to one of five categories (A-E), whereas membership of a category indicates the risk of certain pre-defined "critical event" occurring at that institution, such as the loss of a large share of liable capital. The bank rating procedure thus acts as an early warning instrument and should enable supervisors to react to prevent impending risks from actually materializing. Experience of the German authorities has shown that it is possible for the relatively homogeneous cooperatives and savings bank sectors to obtain highly accurate forecasts with a purely statistically based process. For commercial banks (regional banks and branches of foreign banks), supervisors have found that, although useful results can be obtained with the help of statistically based procedures, the more heterogeneous nature of this group means that additional expert opinions are a must in order to achieve valid outcomes. In the group of big banks, the differences between institutions are too great, and the pool of data too small, to develop statistically valid procedures.

36. **Under the second pillar of the Basel II framework—the Supervisory Review Process (SRP)—banking supervisors are tasked with assessing the quality of banks' internal governance, risk management, and internal control processes, taking due regard to each institution's specific circumstances.** In accordance with this, the supervisory framework in Germany obliges licensed institutions to establish an internal process in order to identify all material risks and to ensure these risks are sufficiently covered by its "risk-bearing capacity," i.e., its capacity to identify, assess, mitigate, monitor, and communicate these risks. This analysis and the accompanying risk-bearing capacity is reviewed by the supervisory authorities; in Germany, SRP forms part of the risk profile that is prepared on at least an annual basis by the Bundesbank and is subsequently provided to

BaFin for final decision making. When determining their risk-bearing capacity, German institutions are obligated to take into consideration all relevant risks, as well as any risk concentration that may exist. The institution itself is responsible for selecting methods and procedures used to determine the risk-bearing capacity, but the methods and procedures used have to reflect the size of the institution and the nature, scale, complexity and risk content of the activities conducted.

E. Main Findings

Objectives, Independence, Powers, Transparency, and Cooperation (CP 1)

37. **In general, the assessors note that the structure of the German system, with a relatively large proportion of German banks being (partly) owned by public bodies (regional government, municipalities), encompasses the risk of explicit or implicit interference in the day-to-day activities of the supervisory authorities, potentially leading to regulatory forbearance.** It should be noted that since BaFin has been trusted with exercising public duties and wielding the accompanying powers, it is—as per the German Constitution—subject to oversight of the BMF. In theory, such oversight could lead to interference in BaFin's day-to-day activities. In practice, however, the legal and technical supervision of BaFin by the BMF is solely focused on the legality and fitness for purpose of BaFin's administrative actions *ex post*. It does not provide for *ex ante* involvement in supervisory decisions and/or actions, nor for *ex post* powers to rescind decisions taken by BaFin. In exercising this duty, BMF relies on information that is in the public domain, as well as on reports from BaFin on *"internal organizational matters, significant events occurring in the exercise of financial services supervision and important topics in connection with activities at an international level."*

38. **Based on a review of the relevant provisions and interviews with stakeholders, the assessors are of the opinion that the design of the German supervisory framework offers sufficient safeguards against government and/or political interference in the day-to-day practices of the authorities.** In this context, the assessors note that, inter alia, (i) the independent character of BaFin is clearly anchored in the legislative framework; (ii) BaFin is clearly mandated to decide on individual cases without having to consult the BMF[20] or other government bodies; and (111) BaFin is not reliant on government funding. In practice, there are no indications of any interference in the supervisory processes and/or decision making; even though BaFin defers to the BMF on what is deemed to be "political." It is in this context that the assessors have determined that Bafin has considerable *de jure* and *de facto* independence.

[20] As per the guidelines governing the exercise of legal and technical supervision of BaFin by the BMF, there may be a need for BaFin to report to the BMF, inter alia, in the case of supervisory measures intended or already introduced that are of material importance in the exercise of supervision.

39. **Notwithstanding the aforementioned, the assessors note that the reporting requirements from BaFin to the MBF currently laid down in the guidelines for the control of BaFin by the BMF place a large burden on both authorities.** The German authorities may wish to re-assess whether the reporting requirements can be reduced without hampering the BMF in overseeing the legality and fitness for purpose of BaFin's administrative actions.

40. **Moreover, the assessors note that there is room for improvement with regard to the protection of the position of the President and Executive Directors of BaFin.** There are currently no provisions in the German legislation offering protection against arbitrary and/or obligatory transfers of BaFin's President and Executive Directors (being civil servants) to other functions within the Federal Public Service, nor provisions that require public disclosure of the reasons for dismissal of the President and/or Executive Directors. Notwithstanding, the civil servant status of most BaFin and Bundesbank staff reduces the scope for regulatory capture. This applies in particular to the President and Executive Directors of BaFin, who are appointed for life. Also, while the public ownership of a sizable part of the German banking sector may increase the risk of political interference, it provides insulation against capture by commercial interests.

41. **The KWG allows BaFin to employ a broad range of instruments aimed at ensuring compliance with relevant laws and regulations by German institutions.** While BaFin's suite of remedial and corrective powers is comprehensive, it seems to rely largely on moral suasion and informal—albeit, if necessary—strong pressure being exerted by the banking supervisors, instead of on formal regulatory interventions. The assessors recognize the potential effectiveness of moral suasion and informal pressure being brought to bear, but they are also cognizant of the inherent limitations of such instruments. Also see the assessment of CP 23.

42. **Although the assessors are comfortable that supervisory staff designated as civil servants have sufficient legal safeguards, improvements are necessary to ensure full legal protection.** First of all, there remains some legal uncertainty as to the legal protection of BaFin staff members that are not classified as civil servants as their protection does not stem from formal legislation, but from the Collective Agreement for the Public Service. It is also recommended that the authorities review the legal position of the supervisory authorities themselves and that they be provided with explicit protection for their official actions as an institution, except in cases of gross negligence or willful misconduct.

Licensing and Structure (CPs 2-5)

43. **The KWG clearly defines permissible activities of credit institutions, opting for a definition that goes beyond the definition used in the CRD.** The KWG contains detailed provisions on the granting of banking licenses that are broadly compliant with the relevant CP. Among the criteria to be considered are criteria on the qualifications and trustworthiness

of senior managers and supervisory board members. The authority to assess the qualifications and trustworthiness of supervisory board members was only granted to Bafin in August 2009 through the enactment of the FMVAStärkG. In February 2010, BaFin issued a guidance note on this topic, elaborating on what these requirements entail.

44. **German legislation contains no rules requiring a German institution to obtain BaFin's prior approval before acquiring a participating interest or establishing corporate ties with another entity, not being a credit institution licensed in Germany.**[21] Although in specific cases acquisitions are notified to BaFin, the supervisory authorities have no power to ex ante prohibit such acquisitions. Given the inherent risks that such participating interests may entail, the assessors deem a larger and more direct role for BaFin to be advisable. The authorities are therefore recommended to amend the KWG in such way that at least acquisitions that may have a material impact on the risk profile of an institution are made subject to prior approval. For completeness' sake, the assessors note that comparable comments were made as part of the 2003 FSAP and the accompanying CP assessment.

Prudential Regulation and Requirements (CPs 6-18)

45. **The KWG and SolvV require all institutions to calculate and consistently maintain a minimum capital adequacy ratio.** The relevant provisions define the components of capital, in line with CRD requirements; German institutions are required to hold at least an overall capital ratio of 8 percent, but their capital buffers typically exceed this regulatory minimum. However, until the transposition of the CRD II package (completed as of December 31, 2010), the German supervisory framework did not fully ensure that proper emphasis was given to the loss absorbing character of regulatory Tier 1 capital, as neither the KWG nor the SolvV contained detailed provisions, including strict limits, for hybrid Tier 1 instruments. Prior to this transposition, Basel standards on such instruments only found their way into German supervisory practice through a gentlemen's agreement with the internationally active credit institutions, whereby they undertook to continuously meet all requirements regarding the adequacy of own funds laid down in the Basel standards. This gentlemen's agreement, however, expired in 2007 with the transposition of Basel II in the SolvV.

46. **Historically, BaFin lacked strong legal powers to impose higher capital requirements.** The main provision, Section 10b of the KWG, allowed BaFin to only impose such higher ratios in the case of *"institutions which, by the virtue of their asset or business profile, have a risk structure which compares unfavorably with that of most other institutions engaged in similar business,"* whereas Section 45b only allowed for imposing higher

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[21] Acquisitions of shares in German credit institutions are dealt with through the provisions on transfer of significant ownership, which are in line with the relevant BCP requirements.

requirements if it could be determined that an institution did not have a proper business organization within the meaning of the KWG, and if it had failed to remedy the deficiencies on the basis of a formal order within an appropriate period set by BaFin. Through the enactment of the FMVAStärkG in August 2009, the authorization to impose higher capital requirements has been expanded and specified.

47. **The assessors strongly support the aforementioned amendment of the legal framework, but also note that BaFin has to date made limited use of its powers to impose higher capital requirements that are commensurate with risk profiles of individual institutions.** Specific guidance for supervisors on how to make effective use of the new powers has only very recently become available, and has not yet been extensively tested in practice.[22] Assessors, however, have no doubt as to BaFin's clear desire to strengthen its supervisory practices in this regard, as evidenced by the recent finalization of supervisory guidance on the sound and consistent application of the aforementioned new powers, as well as recent interventions vis-à-vis individual institutions.[23] BaFin is strongly recommended to continue its efforts in developing guidance on the relevant provisions of the KWG, allowing it to avoid forbearance and simultaneously to ensure a consistent application across all relevant institutions.

48. **While the German supervisory authorities are making use of stress tests to detect vulnerabilities of financial institutions and the financial system as a whole, the assessors are of the view that their use as instruments to closely scrutinize the capital adequacy of individual institutions, taking into account forward-looking elements, needs to be enhanced.** Stringent stress testing requirements that are laid down in the MaRisk cannot fully replace comprehensive, consistent and independent assessments of the authorities themselves, aimed at independently identifying vulnerabilities in the capital position of individual institutions. Thus, the authorities will be better able to incorporate in their assessments and supervisory decision-making potential changes or developments that may have a materially adverse effect on German institutions.

49. **Ensuring a high level and quality of capitalization is a central element of prudential supervision.** The importance of improvements in this area is underscored (i) by events during the global crisis, when some banks were revealed to be severely undercapitalized; (ii) by the vulnerability assessment undertaken as part of this FSAP; as well as (iii) analyses from market participants, suggesting that some banks are still relatively

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[22] Prior to the FSAP Update mission, the German authorities had issued guidelines on capital add-ons for organizational deficiencies pursuant to Section 45b of the KWG; moreover, assessors understood that the Germany authorities reached agreement on a set of guidelines dealing with interest rate risk in the banking book. At the time of the mission, other guidelines were being developed, relating to, inter alia, the provisions of Section 45 KWG as amended by the Restrukturierungsgesetz (RStruktG) of December 16, 2010.

[23] Assessors have, for example, observed instances where BaFin mandated increases of risk factors in quantitative models, thus increasing capital charges for relevant positions/portfolios.

weakly capitalized. The considerably stricter rules on capital adequacy to be imposed under Basel III may have a big impact on the capitalization of German banks for the following reasons (i) their profitability remains relatively weak; (ii) leverage remains relatively high in comparison to international peers; (iii) some banks rely relatively heavily on hybrid capital; and (iv) sizeable capital support has to be phased out. Continued close monitoring of recapitalization efforts in anticipation of the new Basel III requirements remains imperative.

50. **The MaRisk provide the German supervisory authorities with a sound foundation for the supervision of risk management practices.** Nonetheless, the financial crisis has revealed severe shortcomings in the risk management practices at banks on a global level and, even though the areas where such deficiencies have been revealed are typically addressed in the MaRisk requirements, the German supervisory approach has not always been succesful in proactively identifying and remediating these issues in a timely manner. The assessors are encouraged by various new initiatives from the German supervisory authorities, but more work remains to be done to strengthen German institutions' risk management practices and the day-to-day supervision of such practices by the supervisory authorities. In particular, the German supervisory authorities are encouraged to proactively increase the scope and frequency of their own inspection work, focusing on areas that seemingly have remained relatively underexposed in the past and/or where the financial crisis has revealed significant shortcomings, in particular the areas of liquidity risk management, senior management's risk oversight, stress testing capabilities and the IT infrastructure supporting the risk management process.

51. **The analytical assessments with regard to institutions' risk bearing capacity need to be enhanced, inter alia, by more firmly embedding stress testing in the supervisory practices.** Stringent requirements for stress testing imposed on individual institutions through the MaRisk cannot replace comprehensive, consistent and independent assessments of the authorities, aimed at independently identifying (future) vulnerabilities and making sure that the institutions' capital positions (in terms of both quantity and quality) remain commensurate with these risks. Partly based on comments received from industry players in Germany on the depth of on-site inspections conducted by the supervisory authorities since the financial crisis, assessors have no doubt as to the German supervisory authorities' ability and willingness to vigorously seek improvements in the risk management capabilities of German banks as well as to their desire to enhance their own capabilities in supervising these practices and ensure that any weaknesses identified are resolutely addresses by the institutions' senior management. At the time of the mission, however, this process was still ongoing and sustainable effectiveness could thus not yet be determined.

52. **Credit risks are adequately supervised through a combination of reliance on comprehensive activities performed on an annual cycle by external auditors, and inspections performed by the supervisory authorities themselves.** While recognizing the inherent vulnerabilities of the strong reliance on the work performed by external auditors such as (i) the time lag between the end of the accounting year and the delivery; (ii) review of

the audit reports; as well as (iii) the need to rely more on interpretations of third parties than on own observations, the assessors are of the opinion that the external auditors' comprehensive and extensive efforts, together with the inspections commissioned by BaFin and typically performed by teams from the Bundesbank, provide for a sound basis for the supervision of credit risks. However, diverging practices of audit firms on the review of asset classifications and provisioning for example, may hamper consistent comparisons by the supervisory authorities across German institutions. Notwithstanding, it should be noted that the relatively swift recovery of the German economy has, in general, contributed to a relative decrease of the overall credit risk profile of German banks.

53. **The design of the supervisory framework with regard to problem assets, provisions and reserves is comprehensive.** Nonetheless, the assessors note that the German supervisory authorities have not issued standardized criteria for classifying assets. Under the German legislative framework, such classification is left to the institutions' discretion, which hinders the preparation of sensible comparisons across different institutions. The authorities are therefore encouraged to develop specific minimum criteria as the basis for regulatory reporting, while allowing institutions to employ stricter criteria for their internal risk management purposes if they would deem those to better reflect the characteristics of their businesses. Furthermore, there is need to strengthen the granularity of the regulatory reporting framework (also see CP 21).

54. **The assessors deem the framework with regard to large exposure to be compliant with the relevant CP.** The authorities are recommended to review the current provisions on decision-making with regard to large exposures as the possibility of retroactive approval undermines the effectiveness of the otherwise stringent provisions (by restricting the opportunities for refusing the loan or putting restrictions on it).

55. **An important ("materially non compliant") deficiency identified during the 2003 FSAP related to the supervisory framework with regard to exposures to related parties.** At this time, the assessors are of the view that, although the German authorities have made progress in addressing the weaknesses that were identified in the 2003 FSAP and accompanying BCP assessment, the supervisory framework with regard to loans to related parties does not yet fully comply with the relevant CP. The German authorities should take further measures to correct the remaining weaknesses, which mainly relate to (i) the fact that the possibility of retroactive approval undermines the effectiveness of the otherwise stringent provisions on decision-making (by restricting the opportunities for refusing the loan or putting restrictions on it); and (ii) the lack of frequent regulatory reporting requirements (the implementation of which would, coincidentally, allow BaFin to make informed decisions as to when and where targeted inspections with regard to the lending practices for related parties may be opportune).

56. **German institutions are required to incorporate country and transfer risks in their risk management framework.** Provisioning against country and transfer risks is left to

the discretion of individual institutions, subject to oversight of the external auditors. Notwithstanding current reporting requirements contained in the German Country Risk Exposure Regulation (*Landerrisikoverordnung*) (LrV), there is a need to strengthen the granularity of regulatory reporting of country and transfer risks (also see CP 21).

57. **With regard to liquidity risk, BaFin should enhance the reporting requirements to the supervisory authorities with regard to foreign currency position risk, including the results of separate stress testing for major currencies.** Recent events have shown the need to make liquidity available across a broad spectrum and assurance of liquidity access in one market is no guarantee that the same level of access is available in other markets. Since Germany is an export driven economy it would seem particularly relevant for BaFin to review its procedures in this regard and make appropriate changes. As also highlighted in the assessment of CP 7, the German supervisors should proactively increase their own inspection work with regard to, inter alia, liquidity management.

58. **With regard to the supervision of operational risks, the assessors are of the view that the area of IT risks remains underexposed in supervisory practice.** Given the significance of IT risks to financial institutions, the supervisory authorities are strongly recommended to beef up their specialized IT inspection capacity and increase the depth and frequency of targeted IT inspections. Additionally, the authorities may want to implement requirements aimed at periodical reporting of material operational risk incidents to the supervisory authorities, ensuring that they are kept abreast of relevant developments affecting operational risks at banks.

59. **The German supervisory framework with regard to interest rate risk in the banking book complies with the criteria of the relevant CP.** Nonetheless, the assessors support the envisaged change of the framework according to which all institutions (instead of only the 'outliers') will be required to periodically report to BaFin on the impact of a pre-defined (potential) parallel interest rate shift. Through this enhanced approach, BaFin will be better able to assess the effect of interest rate changes on the entire German financial sector.

60. **The report of the 2009 Financial Action Task Force (FATF) Mutual Evaluation of Germany concluded that the anti-money laundering/combating the financing of terrorism (AML/CFT) framework prevailing at the time of the evaluation was not fully in line with the FATF's recommendations.** The assessors understand that the German authorities (together with other relevant stakeholders) are in the process of addressing the weaknesses identified in the evaluation. Taking into account the high risk of Germany's financial markets being misused for purposes of money laundering and terrorist financing, the German authorities are particularly recommended to review their AML/CFT enforcement strategy and capabilities to ensure that AML/CFT violations are identified and sanctioned in a timely manner.

Methods of ongoing banking supervision (CPs 19-21)

61. **The supervisory approach of the German supervisory authorities provides a sound foundation for identifying and dealing with system wide and individual institutional problems.** Supervisory staff is reasonably experienced and make balanced judgments regarding remedial actions needed in individual cases and identifying situations where follow-up is necessary. Ensuring proper balance and proportionality of supervisory actions appears on the surface to be a matter that is reconciled at senior management level or informally through discussions between lead supervisors. BaFin may wish to consider the development of a formalized "ladder" of actions, ensuring that timely and appropriate supervisory actions are taken, commensurate with the nature and seriousness of the identified issues (also see CP 23). Moreover, as also highlighted above, the use of rigorous stress tests as forward-looking tools, aimed at identifying vulnerabilities of individual institutions, needs to be more strongly embedded in supervisory practices.

62. **Assessors identified multiple instances where the granularity of the information obtained via formal regulatory reporting was insufficient.** To a certain extent, BaFin has alleviated this weakness by requesting (on the basis of Section 44 KWG) the systemically relevant institutions to report more detailed information on a more frequent basis. Although this additional information flow is helpful, assessors are of the opinion that BaFin should replace this reporting stream with a standardized, comprehensive framework that ensures timely reporting of all material risks on a sufficiently granular basis. The German authorities are aware of the need of improvements and were at the time of the mission already working on substantial amendments to the regulatory reporting framework, with parts already expected to become effective during the course of 2011.

Accounting and disclosure (CP22)

63. **Although the accounting and disclosure practices in Germany largely comply with the relevant CP, there is a risk that diverging valuation practices inhibit consistency and distort comparisons among the peer groups.** The supervisory authorities may want to encourage a further standardization of valuation practices. At the time of the mission, the new regulatory power to demand a change of the responsible auditor, which was granted to BaFin at the end of December 2010, had not yet been tested in practice.

Corrective and remedial powers of supervisors (CP 23)

64. **BaFin's suite of remedial and corrective powers is comprehensive.** However, it should be noted that, BaFin to a large extent, seems to rely on informal pressure exerted by the banking supervisors through ongoing contacts with the supervised institutions. While the assessors recognize the effectiveness of moral suasion and informal pressure that exist, they are also cognizant of the inherent limitations of such instruments.

65. **The authorities need to stand ready to demand progressively stronger remedial action as the situation of a particular institution becomes more precarious, to which end it would be useful to have a more formalized "ladder" of actions, ensuring that timely and appropriate supervisory actions are taken, commensurate with the nature and seriousness of the identified issues.** Such a ladder, even if it does not rely on simple quantitative criteria, would help resist pressure from special interest groups, promote appropriate consistency in the treatment of different banks, and contribute to public confidence in the ability of the authorities to preempt emerging strains in the financial system.

Consolidated supervision and cross-border banking supervision (CPs 24-25)

66. **Arrangements are in place for effective consolidated supervision of conglomerates.** Nonetheless, authorities need to remain vigilant to cross-institutional spill-overs, and the possibility that conglomerates adopt legal forms that hinder effective supervision and resolution.

67. **The supervisory authorities have established multiple supervisory colleges as per CRD requirements, and are continuously strengthening supervisory relationships with relevant competent authorities, both from European Economic Area (EEA) and non–EEA countries.** Appropriate memoranda of understanding (MoUs) and written agreements, reflecting EBA and BCBS guidance and best practice, have been agreed with a significant number of supervisory authorities, allowing for information sharing on a cross-border basis. Supervisory cooperation has been improved through, inter alia, supervisory colleges and regular bilateral contacts.

68. **Important next steps for Germany will be to extend and deepen the cross-border cooperation with relevant competent authorities, ensuring that supervisory overlap is prevented and relevant information is shared effectively and swiftly among supervisors.** Additionally, BaFin should develop and implement (whether unilaterally or through CEBS/EBA) a formalized, detailed framework for assessing the supervision regime of non–EEA competent authorities, allowing it to reach comprehensive conclusions as to the level of reliance that can be placed on such authorities. The assessors have no doubt as to the willingness and ability of the German supervisory authorities to continue developing effective relationships with other competent supervisors and thus improve cross-border cooperation.

69. **Table 1 provides a principle-by-principle summary of the assessment's results.** Table 2 summarizes recommendations, which in some cases go beyond the minimum standards.

Table 1. Summary of Compliance with the Basel Core Principles

Core Principle	Grading	Comments
1. Objectives, Autonomy, Powers, and Resources	Compliant	See below
1.1 Responsibilities and Objectives	Compliant	The mandates of both BaFin and the Bundesbank are clear and publicly disclosed. Arrangements for the ongoing cooperation have been laid down in a MoU as well as in an accompanying guideline. BaFin and the Bundesbank have not agreed on a formalized mechanism for the settlement of potential disputes, but the ongoing communication between the two authorities allows for ample opportunities to discuss diverging opinions; the final decision-making powers of BaFin are undisputed. At the time of the mission, previous plans to merge BaFin into the Bundesbank had been abandoned, due to constitutional constraints.
1.2 Independence, Accountability, Transparency	Largely compliant	The assessors are of the opinion that the design of the German supervisory framework contains important safeguards against government and/or political interference in the day-to-day practices of the authorities. Nonetheless, there remains room for further improvement, in particular with regard to the elaborate reporting requirements of BaFin vis-à-vis the BMF, and the position of BaFin's President and Executive Directors, who can be dismissed without disclosure of the reasons for doing so, and/or transferred to other branches of the Federal government.
1.3 Legal framework	Compliant	The German legal framework includes clear provisions relating to authorization of banking establishments and broad information gathering powers. The BMF has delegated the authority to draft detailed prudential regulation to BaFin, which ensures that proper consultation takes place before new rules are issued. The approach complies with this CP.
1.4 Legal powers	Compliant	While BaFin's suite of remedial and corrective powers is comprehensive, it lacks a formalized "ladder" of actions to ensure that appropriate and timely supervisory actions are taken, commensurate with the nature and seriousness of the identified issues. Also see CP 23.
1.5 Legal protection	Largely compliant	In general, the legal protection for banking supervisors being civil servants is sufficiently safeguarded. There remains some legal uncertainty as to the legal protection of BaFin staff members that are not classified as civil

Core Principle	Grading	Comments
		servants, as their current liability protection does not stem from any formal legislation, but from the Collective Agreement for the Public Service. Additionally, the authorities should be provided with explicit protection for their official actions as an institution, except in cases of gross negligence or willful misconduct.
1.6 Cooperation	Compliant	Appropriate arrangements for information sharing between supervisors and protecting the confidentiality of such information are in place.
2. Permissible Activities	Compliant	The assessors note that the definition for credit institutions used in German legislation goes above and beyond the definition used in the CRD, facilitating banking supervision.
3. Licensing Criteria	Compliant	Appropriate provisions for the licensing of banks are in place.
4. Transfer of Significant Ownership	Compliant	BaFin has the power to review and reject any proposals to transfer significant ownership or controlling interests directly or indirectly held in existing banks to other parties.
5. Major Acquisitions	Materially non-compliant	German legislation does not provide for the authority to *ex ante* review and (dis)approve such participations.
6. Capital Adequacy	Materially noncompliant	BaFin's legal powers to impose higher capital requirements on individual banks that are commensurate with their specific risk profiles of individual institutions have been expanded and specified in August 2009. However, operational guidelines for effective use of these new powers have only recently become available and have not yet been extensively tested in practice. Moreover, the use of stress tests as instruments to closely scrutinize the capital adequacy of individual institutions needs to be enhanced. Prior to the (very recent) national transposition of the CRD II package, relevant provisions defining the components of capital did not fully ensure that proper emphasis was given to the loss absorbing character of regulatory Tier 1 capital, as German legislation lacked detailed provisions, including strict limits, for hybrid Tier 1 instruments. The importance of strong supervision in this area is underscored by the relatively weak capital position of a number of institutions and the prospective challenge of meeting Basel III standards.
7. Risk Management Process	Largely compliant	The MaRisk provide the German supervisory authorities with a sound foundation for the supervision of risk management practices. Yet, more work remains to be done to strengthen

Core Principle	Grading	Comments
		German institutions' risk management practices and the day-to-day supervision of such practices by the supervisory authorities, incorporating lessons drawn from the financial crisis. The German supervisory authorities are particularly encouraged to proactively increase the scope and frequency of their own inspection work, focusing on areas that seemingly have remained underexposed in the past and/or where the financial crisis has revealed significant shortcomings, *inter alia* liquidity risk management, senior management's risk oversight, stress testing capabilities and the IT infrastructure supporting the risk management process. Moreover, the analytical assessments of institutions' risk-bearing capacity need to be enhanced, particularly by more firmly embedding stress testing in the supervisory practices.
8. Credit Risk	Compliant	The comprehensive and extensive work performed by institutions' external auditors on assessing credit risks and credit risk management capabilities, together with the inspections commissioned by BaFin and typically performed by the Bundesbank, offers a sound basis for the supervision of credit risks, even though the reliance placed on external auditors brings about certain inherent vulnerabilities. In addition, diverging practices on the review of asset classifications and provisioning for example, may hamper consistent comparisons by the supervisory authorities across German institutions. The relatively swift recovery of the German economy has, in general, contributed to a relative decrease of the overall credit risk profile of German banks.
9. Problem Assets, Provisions and Reserves	Largely compliant	The lack of standardized criteria for, for example, classifying assets as impaired hampers the preparation of sensible comparisons across different institutions. Although the German authorities have various possibilities to obtain detailed information on problem assets, provisions, and reserves throughout the year, there is no comprehensive framework to ensure timely and comprehensive reporting of such information on a frequent basis. This observation has been incorporated in the assessment of CP 21.
10.Large Exposure Limits	Compliant	The possibility to retroactively approve large exposures undermines the effectiveness of the supervisory framework, as it restricts possibilities to reject the relevant loan, or to

Core Principle	Grading	Comments
		attach conditions to it.
11. Exposures to Related Parties	Largely compliant	The German supervisory framework lacks requirements on the aggregate reporting of loans to related parties. It is noted that the possibility to retroactively approve such loans undermines the effectiveness of the supervisory framework, as it restricts the possibilities to reject the relevant loan, or to attach conditions to it.
12. Country and Transfer Risks	Compliant	The German supervisory framework country and transfer risks complies with this CP, even though it relies heavily on the general obligations placed on supervised institutions to establish appropriate processes for identifying, assessing, treating, monitoring, and communicating all relevant risks, and to identify, monitor, and manage all risk concentrations.
13. Market Risks	Compliant	While the legislative framework lacks a specific requirement to have exercisable contingency plans for dealing with market risk in place, the main elements of such a plan are addressed through various MaRisk requirements.
14. Liquidity Risk	Largely compliant	The framework for liquidity risk supervision should be improved, by incorporating, inter alia, reporting requirements for other currencies than euros. Supervisory inspections of liquidity risk management should be increased, using the recent enhancement of the MaRisk requirements as a catalyst.
15. Operational Risk	Largely compliant	Although the German supervisory framework with regard to operational risk largely meets the requirements of this CP, the area of IT risk has remained underexposed in supervisory practice.
16. Interest Rate Risk in the Banking Book	Compliant	The current approach to interest rate in the banking book complies with the relevant CP. Nevertheless, the envisaged change of the current supervisory framework—requiring all institutions (instead of only the 'outliers') to periodically report on the impact of a pre-defined parallel interest rate shift—is deemed to be a welcome enhancement.
17. Internal Control and Audit	Compliant	The German supervisory framework with regard to internal control and audit meets the requirements of this CP.
18. Abuse of Financial Services	Largely compliant	At the time of the FSAP mission, Germany was in the process of implementing enhancements to the AML/CFT legislation, addressing some of the deficiencies previously raised by the FATF. Given the high risk of Germany's financial markets being misused for purposes of money

Core Principle	Grading	Comments
		laundering and terrorist financing, the German authorities should furthermore review their enforcement strategy and capabilities with regard to AML/CFT, ensuring that AML/CFT violations are identified and sanctioned in a timely manner.
19. Supervisory Approach	Compliant	The German supervisory approach provides a sound foundation for identifying and dealing with system wide and individual institutional problems. Supervisory staff is reasonably experienced and make balanced judgments regarding remedial actions needed in individual cases and identifying situations where follow-up is necessary. Ensuring proper balance and proportionality of supervisory actions appears on the surface to be a matter that is reconciled at senior management level or informally through discussions between lead supervisors. The use of rigorous stress tests as forward-looking tools, aimed at identifying vulnerabilities of individual institutions, needs to be more strongly embedded in supervisory practices. Also see CP 7.
20. Supervisory Techniques	Compliant	BaFin and the Bundesbank rely on external auditors to perform, on an annual basis, detailed checks of compliance with reporting and supervisory requirements and conformance with MaRisk guidelines. These detailed assessments are supplemented by supervisory inspections, typically performed by the Bundesbank staff at the request of BaFin. Additionally, the various risk committees in BaFin and the Bundesbank are capable of identifying broader threats to the system and adjust supervisory initiatives to deal with these threats.
21. Supervisory Reporting	Largely compliant	Assessors have identified multiple instances where the granularity of the information obtained via formal reporting was insufficient. There is a need to enhance the current reporting framework and implement a standardized, comprehensive approach that ensures timely reporting of all material risks on a sufficiently granular basis. At the time of the mission, the German authorities were already in the process of preparing a major reform of the reporting framework, increasing both the granularity of the data that is to be submitted, as well as the frequency of certain submissions. Parts of the new standardized framework are expected to

Core Principle	Grading	Comments
		become effective during the course of 2011.
22. Accounting and Disclosure	Compliant	Although the accounting and disclosure provisions comply with this CP, the accounting rules allow for a menu approach to valuing assets, which may inhibit consistency and can distort comparisons among the peer groups.
23. Corrective & Remedial Powers of Supervisors	Largely compliant	BaFin's suite of remedial and corrective powers is comprehensive, and has recently been further expanded via the Restructuring Act that came into effect on January 1, 2011, providing mechanisms for the orderly restructuring or resolution of troubled institutions. However, BaFin lacks a formalized "ladder" of actions, ensuring that timely and appropriate supervisory actions are taken, commensurate with the nature and seriousness of the identified issues.
24. Consolidated Supervision	Compliant	Consolidated supervision in Germany generally complies with the requirements of this CP.
25. Home-Host Relationships	Largely compliant	The German authorities have faithfully implemented all relevant EU legislation, as well as the relevant international standards from EBA and the BCBS and have agreed MoUs and written agreements with a significant number of supervisory authorities, allowing for information sharing on a cross-border basis. Supervisory cooperation and information sharing, inter alia, conducted through supervisory colleges and regular bilateral contacts, is generally viewed as positive, but can be further strengthened.

Compliant (18); largely compliant (11); materially noncompliant (2); noncompliant (0); and not applicable (0).

F. Recommended Action Plan and Authorities' Response

Table 2. Recommended Action Plan to Improve the Effectiveness of Banking Supervision

Reference Principle	Recommended Action
Objectives, Independence, Powers, Transparency and Cooperation (CP1)	Reevaluate the elaborate reporting requirements of BaFin vis-à-vis the BMF with a view to alleviating the reporting burden for both authorities. Amend the relevant legislation to ensure BaFin's President and Executive Directors are protected against arbitrary and/or obligatory transfers to other functions within the Federal Public Service. Amend the relevant legislation to ensure there is public disclosure of the reasons for dismissal of BaFin's President and Executive Directors. Develop a consistent and well documented ladder of supervisory actions (also see CP 23). Clarify the liability protection for BaFin's staff members that are not designated as civil servants. Review the legal position of the supervisory authorities themselves and provide them with explicit protection for their official actions as an institution, except in cases of gross negligence or willful misconduct.
Major Acquisitions (CP 5)	Amend the KWG to facilitate prior approval of acquisitions that may have a material impact on the risk profile of an institution. For completeness' sake, the assessors note that a comparable recommendation was made as part of the 2003 FSAP and the accompanying CP assessment.
Capital adequacy (CP6)	Firmly embed the use of the new powers to impose higher capital charges, commensurate with institutions' risk profiles, in supervisory processes. Enhance the use of rigorous stress tests as instruments to closely scrutinize the capital adequacy of individual institutions. Continue to closely monitor the efforts of institutions to strengthen their capital base in anticipation of Basel III and intervene strongly if, in individual cases, progress seems to be lacking.

Reference Principle	Recommended Action
Risk management Process (CP 7)	Pursue a further strengthening of risk management practices at German institutions, inter alia, by proactively increasing the scope and frequency of supervisory inspections. Enhance quantitative analyses of capital adequacy in relation to individual institutions' risk profile, inter alia, by embedding more firmly the use of rigorous stress tests to identify weaknesses and ensure a strengthening of institutions' regulatory capital commensurate with their risk profile.
Credit risk (CP8)	Investigate possibilities to improve consistency in practices on the review of for example asset classifications and provisioning across audit firms, allowing for better comparisons across individual institutions. Evaluate supervisory capabilities with regard to the supervision of credit risks and continue to improve the depth and frequency of its credit risk related inspections.
Problem assets, Provisions and Reserves (CP 9)	Develop and publish standardized criteria for classifying assets as impaired, allowing for the preparation of sensible comparisons across different institutions.
Large Exposure Limits (CP10)	Restrict opportunities for retroactive approval of large exposures, by limiting the opportunities for refusal of a loan or putting restrictions on it, as this undermines the effectiveness of the otherwise stringent provisions on decision-making.
Exposures to Related Parties (CP 11)	Restrict opportunities for retroactive approval of exposures to related parties, by limiting the opportunities for refusal of a loan or putting restrictions on it, as this undermines the effectiveness of the otherwise stringent provisions on decision-making.
Liquidity Risk (CP 14)	Enhance reporting requirements for foreign currency position risk. Increase supervisory inspections focused on liquidity risk management.
Operational Risk (CP 15)	Beef up specialized IT inspection capacity and increase the depth and frequency of targeted IT inspections. Develop requirements aimed at periodical reporting of material operational risk incidents to the supervisory authorities.
Abuse of Financial Services (CP18)	Remediate the weaknesses identified through the FATF Mutual Evaluation as quickly as reasonably possible. Review BaFin's enforcement strategy and capabilities with regard to AML/CFT.

Reference Principle	Recommended Action
Supervisory Approach (CP 19)	BaFin may wish to consider providing more guidance through a menu approach, setting out consistent parameters for required actions and suitable measures for remedial requirements based on the institutions placement in the risk matrix (also see CP 23). The use of rigorous stress tests as forward-looking tools, aimed at identifying vulnerabilities of individual institutions, needs to be more strongly embedded in supervisory practices (also see CP 7).
Supervisory Reporting (CP 21)	Extend reporting requirements and develop a standardized, comprehensive framework that ensures timely reporting of a sufficiently granular nature on all material risks.
Accounting and Disclosure (CP 22)	Encourage standardization of valuation practices, allowing for more meaningful comparisons across institutions.
Supervisors' Corrective and Remedial Powers (CP 23)	Develop a consistent and well documented ladder of supervisory actions.
Consolidated Supervision (CP 24)	Grant BaFin the authority to close foreign offices of German institutions or impose conditions on their activities if the oversight by the host supervisor is inadequate or if it cannot gain access to information that may be necessary for the performance of consolidated supervision.
Home-Host relationships (CP 25)	a) Continue to enhance cooperation and information sharing on a cross-border basis. (b) Develop a formalized, detailed framework for assessing the supervision regime of non-EEA competent authorities, allowing BaFin to reach comprehensive conclusions as to the level of reliance that can be placed on such authorities.

Authorities response to the assessment

70. **The German authorities wish to express their appreciation to the IMF and its assessment teams for this assessment.** The German authorities strongly support the FSAP, which promotes the soundness of financial systems in IMF member countries and contributes to improving supervisory practices around the world.

71. **The German authorities appreciate the assessment.** They will use it to critically reflect their current practices and make changes and adjustments where appropriate.

72. **In two areas, improvements were already underway prior to the FSAP:**

- On CP 15, BaFin and the Bundesbank agree with the FSAP evaluation. The process to create within BaFin a separate unit for IT risk regulation and auditing with sufficient staff was started in 2010. It is assumed that during 2011 this unit will finally be established.

- On CP 21 regarding reporting requirements, the German authorities are currently implementing new reporting requirements, which will improve, inter alia, the granularity of the information obtained.

73. The German authorities would like to provide the following overarching comments:

- Issues in the regulatory framework that led to an assessment of (partial) noncompliance with the BCPs with regard to capital adequacy (CP 6), risk management (CP 7) and liquidity management (CP 14) will be dealt with in preparations for, and the implementation of Basel III/ CRD IV.

- The German authorities understand that some clearly unsatisfactory ratings were given where the assessors felt that commendable recent regulatory and supervisory initiatives had not been sufficiently tested and applied in reality. The German authorities consider this as an encouragement for their work and will continue to improve regulatory and supervisory practice. The German authorities are not convinced that the assessors' focus on the execution of supervisory measures is warranted. The German authorities prefer a focus on supervisory outcomes.

74. **Furthermore, there are a small number of recommendations where the German authorities believe that the current regime effectively fulfils the IMF's requirements.** These are set out below:

- On CP 5 regarding major acquisitions, the authorities are convinced that although "German legislation does not provide for the authority to ex ante review and (dis)approve such participations" the qualification as materially non-compliant is not justified. Firstly, Section 12 of the KWG in its current form is fully in line with the respective EU requirements. Secondly, in our view the acquisition of participating interests outside the financial sector is strictly a business decision in which the supervisor should not intervene. The potential risks stemming from an institutions' acquisition and investment policies are sufficiently limited by quantitative limits and by the fact that the institutions' managers are responsible and accountable for the handling and monitoring of the institutions' risks which includes acquisitions and investments. The managers' performance in turn is subject to review by auditors and supervisory interventions should the requirements be breached.

- On CP 6 and CP 7 regarding the use of stress tests, Deutsche Bundesbank carries out a broad variety of different bottom-up and top-down stress test exercises. These stress tests cover solvency risk, macroprudential issues, liquidity risk, as well as systemic stability issues. Communication of stress test results is done in the course of supervisory meetings. That is, the results from the stress tests are part of the overall assessment of banks' soundness, i.e., these results supplement information derived from bank reports and on-site inspections. Stress test results (aggregated and for individual banks) are regularly presented at the meetings of the Heads of Banking Supervision of Bundesbank and BaFin and at the risk committee meetings of Bundesbank and BaFin. Furthermore, results and methodological aspects of top-down stress tests are discussed with selected institutions in the course of supervisory assessment meetings and in a response to special requests by banks. In 2010, for example, there have been several meetings with institutions in order to discuss methodologies and results of supervisory top-down stress tests, and to challenge banks' internal exercises with these results. It should be pointed out that those meetings are in addition to supervisory talks which take place on a regular basis and contain, amongst other topics, also discussions on banks' internal stress tests.[24]

- On CP 9 regarding problem assets, provisions and reserves, external auditors in the context of the annual audits report on so-called "noteworthy loans" on a single-loan basis. For this purpose, these loans have to be classified by risk categories and listed in an overall register pursuant to Section 25 para 1 of the annual report regulation ("PrüfbV"). According to Section 25 para. 2 of the PrüfbV noteworthy loans also include such loans that are expected to be at risk to become "nonperforming" (or "impaired") in major parts. The explanatory notes to the PrüfbV (Section 25) set out indicators for loans that should be regarded as "nonperforming" for reporting purposes in the context of the annual audits:

  - The institution considers it unlikely that the borrower complies with his contractual payment obligations to the institution, its parent company or its subsidiaries in full (without making use of collateral); or
  - A material liability of the borrower to the institution, its parent company or its subsidiaries is past due for 90 days or more.

  With these indicators in hand BaFin and the Bundesbank are of the opinion that the information reported by annual auditors is comparable and does not hamper comparisons across institutions.

- On CP 10, the IMF recommends reviewing the current provisions on decision-making in order to restrict the possibility of retroactive approval which is considered to undermine the effectiveness of the otherwise stringent provisions. The German authorities pointed out that as a general rule the decision of the senior managers to unanimously grant a loan exceeding 10 percent of the institutions own funds has to be taken prior to the incurrence of a large exposure (Section 13 subsection 2, sentence 2 KWG). There are only two exceptional cases in which the senior managers may take

[24] (See also Deutsche Bundesbank Methodological Note, "Stress Tests at the Bundesbank—Overview," February 9, 2011).

this unanimous decision after having incurred a large exposure: in case of urgency of the transaction (sentence 3) or if an already existing exposure becomes a large exposure due to reduction of own funds (sentence 6). The authorities believe that the possibilities for retroactive approval are sufficiently restricted. In fact, to dispose of the exceptions would be disproportionate and—for the second exception—simply impractical.

- On CP 11, regarding exposures to related parties the IMF states that "the German supervisory framework lacks requirements on the aggregate reporting of loans to related parties." This statement is correct, but falsely implies that German supervisors never obtain information on loans to related parties. According to Section 25 (2) No. 1 of the PrüfbV, stricter (single-loan-based) reporting requirements apply where particular loans to related parties must be regarded as noteworthy because of their size or the way they are structured.

- On CP 18, BaFin would like to emphasize that it has already made efforts to strengthen its enforcement strategy and capabilities with regard to AML/CFT in order to ensure that AML/CFT violations are identified and sanctioned effectively. This aims to reflect adequately the recommendations made by the FATF in its MER in this regard. However, the FATF has not criticized BaFin for failing to identify and sanction AML/CFT violations in a timely manner.

- On CP 22, German Accounting and disclosure rules are in line with European directives and European law, especially regarding the adoption of IFRS. Discretion with regard to valuation of consolidated banking groups therefore has to be considered against the current IFRS rules. This is not a country specific criticism but a criticism to the underlying accounting framework. A practical consequence of the application of the IFRS-accounting framework results in different valuations until IAS 39 will be revised. The same applies with regard to European countries which apply national GAAP which are consistent with European accounting directives.

II. Detailed Assessment

75. The assessment of compliance of each principle has been made based on the following four-grade scale: compliant, largely compliant, materially noncompliant, and noncompliant.

- Compliant—A country will be considered compliant with a Principle when all essential criteria applicable for this country are met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the Principle has been achieved by other means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle, and therefore other measures may also be needed in order for the aspect of banking supervision addressed by the Principle to be considered effective.

- Largely compliant—A country will be considered largely compliant with a Principle whenever only minor shortcomings are observed, which do not raise any concerns about the authority's ability and clear intent to achieve full compliance with the Principle within a prescribed period of time. The assessment "largely compliant" can be used when the system does not meet all essential criteria, but the overall effectiveness is sufficiently good, and no material risks are left unaddressed.

- Materially noncompliant—A country will be considered materially non-compliant with a Principle whenever there are severe shortcomings—despite the existence of formal rules, regulations and procedures—and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance. It is acknowledged that the "gap" between "largely compliant" and "materially noncompliant" is wide, and that the choice may be difficult. On the other hand, the intention has been to force the assessors to make a clear statement.

- Noncompliant—A country will be considered non-compliant with a Principle whenever there has been no substantive implementation of the Principle, several essential criteria are not complied with or supervision is manifestly ineffective.

76. **A Principle will be considered not applicable when, in the view of the assessor, the Principle does not apply given the structural, legal and institutional features of a country.** In the case of Germany, this category has not been used in the assessment.

Table 3. Detailed Assessment of Compliance with the Basel Core Principles

Principle 1.	Objectives, autonomy, powers, and resources. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	See below.
Assessment	Compliant
Comments	See below.
Principle 1(1).	Responsibilities and objectives. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.

Description	EC1 The KWG clearly states the tasks and responsibilities of BaFin: *"BaFin shall counteract undesirable developments in the banking and financial services sector which may endanger the safety of the assets entrusted to institutions, impair the proper conduct of banking business or provision of financial services or lead to serious disadvantages for the economy as a whole. BaFin may, as part of its statutory mandate, issue orders to institutions and their senior managers that are appropriate and necessary to stop or prevent violations of regulatory provisions or to prevent or overcome undesirable developments at an institution which could endanger the safety of the assets entrusted to the institution or impair the proper conduct of its banking business or provision of financial services. (…)"* Moreover, the FinDAG notes that BaFin takes over the supervisory tasks formerly allocated to the separate supervisory authorities for the banking, insurance, and securities sectors. During the process that ultimately led to the establishment of BaFin, the German Parliament ordained the continued involvement of the Bundesbank in banking supervision, as the Bundesbank's supervisory activities dated back to before the creation of BaFin. The Bundesbank's mandate for banking supervision follows from a mandate to safeguard financial stability, as laid down in the Act concerning the Deutsche Bundesbank (*Gesetz über die Deutsche Bundesbank*), as well as from the KWG, that highlights the Bundesbank's responsibilities for the ongoing monitoring of German institutions. As explained on the Bundesbank's website, *"owing to its business relationships with credit institutions, its local presence and its general proximity to the market, the Bundesbank has deep insights into the financial sector and knowledgeable staff qualified to deal with issues relating to the financial market and its stability."*[25] The Bundesbank and BaFin have spelled out the details of their respective roles in day-to-day supervision, as laid down by Parliament, in a MoU, as well as in a "Guideline on carrying out and ensuring the quality of the ongoing monitoring of credit and financial services institutions by the Bundesbank." Under these documents, the Bundesbank is assigned most of the operational tasks in banking supervision, whereas decision-making powers (for example on supervisory measures to be imposed on the basis of the output of the Bundesbank's ongoing monitoring and accompanying financial analysis) have been allocated to BaFin. BaFin and the Bundesbank have not agreed on a formalized mechanism for the settlement of potential disputes. However, the ongoing communication between the two authorities allows for ample opportunities to discuss diverging opinions, and the final decision-making powers of BaFin are undisputed. For completeness' sake, it should be noted that consumer protection, in the sense of protecting the rights of individual consumers, is not part of the mandate of BaFin, nor that of the Bundesbank. The supervisory authorities would only become involved in the case of (material indications of) systemic misconduct, e.g., in case of 'massive miss-selling' that may jeopardize the confidence in individual institutions or the financial system as a whole. Protection of individual consumers' rights is mandated to the

[25] http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_bafin.en.php.

	Federal Ministry of Food, Agriculture and Consumer Protection (*Das Bundesministerium für Ernährung, Landwirtschaft und Verbraucherschutz*, BMELV). Finally, it is noted that, at the time of the mission, previous plans to merge BaFin into Bundesbank had been abandoned, due to constitutional constraints. The so-called "ten point plan" that was put forward by the current coalition parties proposes a more incremental reform agenda, consisting of, inter alia, an expansion of the Bundesbank's macro-prudential supervision mandate, an overhaul of BaFin's internal organization structure to better enable fast intervention, and a further elaboration of the functions and composition of BaFin's Administrative Council. EC2—Minimum prudential standards are in place, inter alia, through SolvV, LiqV, and MaRisk, reflecting the provisions of the CRD (and thus the Basel II framework), as well as CEBS/EBA and BCBS guidance. EC3—The German banking law and accompanying regulations are regularly updated and takes into account new standards and guidelines that are being developed by the relevant international standard Committees (e.g., BCBC, CEBS/EBA). The MaRisk, for example, are in the process of being updated; the consultation process for these amendments began in July 2010. The new so-called CRD II package[26] has been implemented in Germany as per December 31,2010. EC4—Information on the financial strength and performance of the German banking industry is published on an aggregated basis by the Bundesbank. AC1—Supervision by the German authorities is performed on a risk-oriented basis, with more resources being allocated to higher risk institutions. At end-2010, 325 full time equivalents (FTE) were working in the BaFin's Banking Supervision Directorate, supported by specialists operating out of the cross-sectoral departments. At the time of the mission, BaFin was in the process of enlarging its organization and was seeking a significant increase of its specialist areas for example, lending business, capital adequacy, and risk management. Decisions on staff allocation are driven by the risk profiles, prepared by the Bundesbank for each institution on at least an annual basis.
Assessment	Compliant
Comments	The mandates of both BaFin and the Bundesbank are clear and publically disclosed. Arrangements for the ongoing cooperation have been laid down in a MoU as well as an accompanying guideline that places the responsibility for the ongoing monitoring of institutions, residing with the Bundesbank, while decision-making powers in the supervisory context have been entrusted to BaFin. BaFin and the Bundesbank have not agreed a formalized mechanism for the settlement of potential disputes, but the ongoing communication between the two authorities allows for ample opportunities to discuss diverging opinions; the final decision-making powers of BaFin are undisputed. At the time of the mission, previous plans to merge BaFin into the Bundesbank had been abandoned, due to constitutional constraints.

[26] Directive 2009/111/EC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF.

Principle 1(2).	Independence, accountability and transparency. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Description	EC1—BaFin's governance structure and organization are detailed in multiple documents, the FinDAG being the most important one. Since BaFin has been entrusted with exercising public duties and wielding the accompanying powers, it is—as per the German Constitution—subject to the legal and technical supervision by the BMF, which bears the political responsibility of BaFin's activities. Also see FinDAG's Section 2*"[BaFin] is under the legal and technical supervision of the BMF."* This legal and technical supervision of BaFin by the BMF is further elaborated in the Principles governing the exercise of legal and technical supervision of BaFin by the BMF (*Grundsatze fur die Ausabung der Rechts- und Fachaufsicht des BMF uber die BaFin*). The guidelines describe that *"the subject of the legal and technical supervision is the legality and fitness for purpose of BaFin's administrative actions."* In exercising its supervisory duty, the BMF relies on information that is in the public domain, as well as on reports from BaFin on *"internal organizational matters, significant events occurring in the exercise of financial services supervision and important topics in connection with activities at an international level."* More specifically, BaFin is to report to the BMF on (i) supervisory measures intended and introduced *"that are of material importance in the exercise of supervision;"*[27] (ii) contacts with foreign supervisory authorities and on the conclusion of cooperation agreements with foreign supervisory authorities; (iii) its advisory activities in connection with the development and support of supervisory systems outside Germany; and on (iv) topics discussed in and results of meetings of relevant European supervisory bodies and other international groups in which BaFin is represented. Furthermore, BaFin is to notify the BMF without delay *"if it becomes aware of possible threats to systemically important credit institutions, financial services institutions, investment funds or insurance undertakings under its supervision, of impeding disruptions on regulated stock exchanges and securities markets or other financial difficulties looming in the financial services field."* Also, BaFin is to inform the BMF without delay of audits by and request for information from the Federal Court of Audit (*Bundesrechnungshof*). In addition to the written reports, the guidelines provide for technical discussions on various topics, as well of the exchange of specialized knowledge. Regulations issued by BaFin on the basis of the KWG are to be submitted to the BMF prior to publication, and the BMF needs to be informed prior to publication about any BaFin announcement and/or notice with regard to *"their regulatory content and their impact on the institutions and undertakings under supervision,"* as well as on BaFin's annual report, press briefings, interviews, and other publications.

[27] The guidelines outlines the term *"matters of material importance"* as *"noteworthy events occurring at systemically important institutions and noteworthy developments on the major financial markets"* as well as *"extreme events occurring at smaller institutions."*

	It should be noted that neither the KWG, nor the FinDAG or the guidelines provide for any direct instruction rights for the BMF vis-à-vis BaFin; the guidelines do not provide for an *ex ante* involvement in individual supervisory decisions and/or actions, nor for *ex post* powers to rescind decisions taken by BaFin. In practice, there is no evidence of the BMF influencing the day-to-day supervisory decisions of BaFin. Also, there is no evidence of government or industry interference in BaFin's supervisory tasks. The President and the Executive Directors of BaFin are, according to Section 9 of FinDAG, appointed for life by the President of the Federal Republic of Germany on proposal of the German Government. Since the President and Executive Directors are civil servants, their removal or dismissal is subject to the provisions of the German Civil Service Act (*Bundesbeamtengesetz*, BBG), which offers sufficient protection against improper dismissal. Public disclosure of reasons for dismissal, however, is not required. Furthermore, there are no legal barriers to transferring the BaFin's President and Executive Board members to other branches of the Federal government.[28] In the context of the latter, the German supervisory authorities point out that there is a *de facto* obstacle for involuntary transfers, as the German Federal Public Service offers only a few functions that correspond to the pay grade and office of the BaFin's senior management (a civil servant's consent is necessary for transfers to functions below their current pay grade and office). The BMF monitors the management of BaFin through its representatives (including the Chairman and the Deputy Chairman) on BaFin's Administrative Council[29] consisting of 21 members. The Administrative Council has been charged by the German legislator with, *inter alia*, reviewing and subsequently adopting the annual budget of BaFin. The Bundesbank Act confirms that *"in exercising the powers conferred on it by this Act, the Deutsche Bundesbank shall be independent of and not subject to instructions from the Federal Government."* Just as in the case of BaFin, members of the governing body of the Bundesbank (*Vorstand*) are appointed by the President of the Federal Republic of Germany. The President, the Vice-President, and one other member shall be nominated by the Federal Government; the other three members shall be nominated by the *Bundesrat* in agreement with the Federal Government. Members shall be appointed for eight years or in exceptional cases for a shorter term of office, but not for less than five years. The Bundesbank employs civil servants (*Beamte*), other salaried staff (*Angestellte*), and wage earners (*Arbeiter*). The Bundesbank and its staff enjoy the same privileges as those granted to the Federal Government and its staff.

[28] Notwithstanding, there seem to be practical impediments to doing so arbitrarily, as the only transfers that can be effected without consent of the relevant civil servant are transfers to a comparable function (also in terms of pay grade) in the German Federal Public Service; the fact that such functions are scarce acts as a *de facto* obstacle.

[29] According to Section 7 of the FinDAG, the Administrative Council *"monitors the management of [BaFin] and supports it in the performance of its functions."*

	EC2—BaFin's objectives are clearly marked in the KWG and are legally binding. Its mission statement (available on its website[30]) clarifies that its regulatory approach is based on (i) a risk-based resource allocation; (ii) proportionality; (iii) fulfilling its European responsibilities; (iv) maintaining an ongoing dialogue with the financial sector; (v) objectivity and transparency; and (vi) cost consciousness. EC3—BaFin currently employs approx 1700 staff members, in large parts consisting of lawyers, economists, and mathematicians. Conversations with supervised institutions have confirmed that BaFin staff is deemed to have credibility and professionalism. The same applies to staff employed by the Bundesbank. EC4—BaFin is entirely financed by levies and fees paid by the supervised institutions. Reference is made of "Section 13 (1) FinDAG: *"[BaFin] shall cover its costs, including the costs charged to [it] by the Bundesbank (...)"* in combination with Section 14 (1) that allows BaFin to charge fees up to EUR 500,000, for each official act performed. As per the Ordinance on the Imposition of Fees and Allocation of Costs pursuant to the FinDAG (*Verordnung über die Erhebung von Gebuhren und die Umlegung von Kosten nach dem [BaFin]*, FinDAGKostV), levies are collected on the basis of certain pre-set parameters (e.g., balance sheet total), whereas fees are charged for example, inspections, approvals, and applications on the basis of actual hours spent on the relevant assignment. Insofar as the annual costs are not fully covered by the proceeds of the aforementioned levies and fees, the remaining costs are allocated *ex post* on a *pro rata* basis to the supervised institutions. There is no evidence of undue sector influence on supervisory processes as a result of the cost allocation/reimbursement. The annual budget of BaFin is drawn up by the Executive Board and presented to the Administrative Council without delay; the budget is adopted by said Council. BaFin's Executive Board prepares accounts on the revenues and expenditures at the end of the financial year and the Administrative Council grants discharge to the Executive Council, subject to approval of the BMF. During the past years, BaFin has gradually increased the resources allocated to banking supervision, as the table below illustrates.

30 http://www.bafin.de/cln_171/nn_721300/EN/BaFin/Legalbasis/Missionstatement/missionstatement__node.html?__nnn=true.

	<table><tr><th>Staff as at</th><th>1-05-'02</th><th>31-12-'04</th><th>31-12-'06</th><th>31-12-'08</th><th>31-12-'10</th></tr><tr><td>BA (Banking Supervision)</td><td>187</td><td>255</td><td>269</td><td>288</td><td>325</td></tr><tr><td>Q 1 (Risk and financial markets analysis)</td><td></td><td>34</td><td>24</td><td>27</td><td>29</td></tr><tr><td>Q 3 (Integrity of the financial system)</td><td>42</td><td>57</td><td>49</td><td>52</td><td>62</td></tr><tr><td>Q RM (Cross-sectoral risk modeling)</td><td></td><td>26</td><td>29</td><td>34</td><td>35</td></tr><tr><td>GW (Prevention of money laundering)</td><td></td><td></td><td>67</td><td>64</td><td>87</td></tr></table> The supervisory staff at BaFin and the Bundesbank is generally experienced, and strong efforts have been made to increase staffing levels and expertise. However, salaries are relatively low, and it is reportedly difficult to retain staff, especially those with highly technical skills and during periods when the financial sector is booming. There seems to be little inflow of mid-level staff and limited-term experts, who might be more familiar with the latest financial market trends and techniques, although BaFin is, in principle, allowed to offer such experts comparative salaries that go beyond the regular civil servant grades. The assessors understand that this power is selectively used to strengthen the supervisory capacities of BaFin AC1 BaFin's Executive Board members are nominated by the President of the Federal Republic of Germany at the proposal of the Federal Government. The Board members are civil servants and are appointed for life.
Assessment	Largely compliant
Comments	In general, the assessors note that the structure of the German system, with a relatively large proportion of German banks being (partly) owned risk by public bodies (regional government and municipalities), inherently encompasses the risk of regulatory forbearance, as supervisors may be inclined to be less stringent vis-à-vis banks (partly) owned by public bodies. In practice, however, the assessors are of the opinion that the design of the German supervisory framework offers important safeguards to the authorities against government and/or political interference in their day-to-day practices. For example, the independent character of BaFin is clearly anchored in the legislative framework, BaFin is clearly mandated to decide in individual cases without having to consult the BMF or other government bodies, Executive Board members are adequate protected against arbitrary dismissal, and BaFin is not reliant on government funding. Also, in practice there are no indications of any interference in the supervisory processes and/or decision making. The civil servant status of most BaFin and Bundesbank staff reduces the scope for regulatory capture. This applies in particular to the President and Executive Directors of BaFin, who are appointed for life. Notwithstanding the aforementioned, the assessors note that the reporting requirements currently laid down in the guidelines for the control of BaFin by the Federal Ministry of Finance place a large burden both on BaFin, as well as on the BMF, whose staff has to review the reports. The German authorities may wish to re-assess whether the reporting requirements can be reduced without hampering the

	BMF in overseeing the legality and fitness for purpose of BaFin's administrative actions. The assessors note that there are no provisions in the German legislation offering protection against arbitrary and/or obligatory transfers of BaFin's President and Executive Directors to other functions within the Federal Public Service, nor on public disclosure of the reasons for dismissal of the President and/or Executive Directors of BaFin. The assessors recommend that German legislation is amended in such a way that arbitrary and/or obligatory transfer of the BaFin's President and Executive Directors can be prevented and that full disclosure of the reasons for such a transfer or dismissal becomes mandatory. It should be noted that a comparable recommendation was already included in the BCP assessment conducted as part of the 2003 FSAP.
Principle 1(3).	Legal framework. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	EC1—The KWG allocates the role to grant banking licensing exclusively to BaFin. BaFin is, however, obliged to consult the Bundesbank as well as the guarantee scheme appropriate for the applying institution prior to granting such license. Also see CP 3. EC2—Various provisions of the KWG allow for the issuance of detailed regulations that provide further elaboration of prudential standards for banking supervision. Although the KWG allocates such secondary rule making powers to the BMF, the KWG typically also allows the BMF to delegate such rule making power to BaFin. In accordance with the recommendation from the 2003 FSAP to extend BaFin's mandate to issue secondary regulations, the BMF has issued the so-called Regulation regarding the delegation of the authority to issue statutory orders to BaFin (*Verordnung zur Übertragung von Befugnissen zum Erlass von Rechtsverordnungen auf die Bundesanstalt für Finanzdienstleistungsaufsicht,* BaFinBefugV), granting BaFin rule making authorization in a number of areas. On the basis of such delegation, BaFin has issued various secondary regulations, inter alia, the Monthly Returns Regulation (*Monatsausweisverordnung*, MonAwV) and the Regulation Governing the Auditing of the Annual Accounts of Credit Institutions and Financial Services Institutions (*Prüfungsberichtsverordnung*) (PrüfbV). Furthermore, BaFin issues guidelines, guidance papers and circulars that provide practical guidance for the implementation of certain provisions or elaborate further on BaFin's interpretation on legal requirements; since such documents have no binding legal power, there are no legal impediments to BaFin issuing these. All publications issued by BaFin are consulted with the Bundesbank and well as with relevant stakeholders before they are issued. The time and form of the consultations depend for example on the type of publication, its complexity, urgency, and relevant importance. EC3 Section 44 *set seq* of the KWG requires supervised institutions, financial holding companies, and enterprises included in the supervision on a consolidated basis, to provide BaFin and the Bundesbank, upon request, with information on all business activities. BaFin may perform inspections at licensed institutions with or without a special reason and may (and in practice, typically does) entrust such an inspection to the Bundesbank. In practice, BaFin announces via letters information on inspections to the relevant institution a few weeks before their planned commencement. The letters,

	elaborate on the scope and timing of the inspection. In the case that BaFin entrusts the inspection to the Bundesbank, such a letter also serve as a letter of engagement, providing the Bundesbank with 'instructions' regarding the desired scope of the inspections. Although German legislation allows institutions to formally raise objections against inspections, doing so does not have suspensory effort and thus cannot prevent commencement of the inspection. Therefore, in practice such objections are not raised. The inspection rights include enterprises to which an institution has outsourced activities (the KWG specifies that an outsourcing arrangement must not prevent BaFin from performing its duties and that the supervisor's right to monitor, audit and/or request information must be ensured by means of suitable arrangements with the service provider).
Assessment	Compliant
Comments	The German legal framework includes clear provisions relating to authorization of banking establishments (also see CP 3) and broad information gathering powers. The BMF has delegated the authority to draft detailed prudential regulation to BaFin, which ensures that proper consultation takes place before new rules are issued. The approach complies with this CP.
Principle 1(4).	Legal powers. A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	EC1—The KWG allows BaFin to employ a broad range of instruments, aimed at ensuring compliance with relevant laws, as well as safety and soundness concerns. Its instruments range from temporary measures to orders aimed at establishing/restoring a situation to one that complies with the relevant laws and other (more radical) instruments like the dismissal of managers and the revocation of institutions' licenses. Moreover, the enactment of the RStruktG provided for a strengthening of BaFin's powers in the event of risks to the stability of the financial system. These new powers, contained in Division 4a of the KWG, allow BaFin to order that an institution's assets and liabilities are transferred to an existing ('transferee legal entity') or newly created ('spin-off') legal entity. BaFin can revoke the institution's license upon completion of the transfer order, if said institution is unable to maintain its operations in conformity with the KWG. It should be noted, however, that the power to impose a transfer order is linked to financial stability risks, which is defined as a *"concern that the credit institution's ongoing-concern risk could have a significantly negative impact on other financial sector enterprises, on the financial markets or on the general confidence of depositors and other market participants in the proper functioning of the financial system"*. A final determination as to the existence of systemic risk is to be made by BaFin, after consulting with the Bundesbank; interconnectedness is one of the elements that needs to be considered. As the provisions of the *RStruktG* only entered into force at the end of December 2010, these provisions had not been tested in practice at the time of the FSAP mission. EC2—There are no legal or practical impediments for BaFin and/or the Bundesbank from accessing a bank's board, (middle) management, staff and records. The KWG provides BaFin with comprehensive access rights, including the possibility to perform

	on-site inspections or instruct the Bundesbank and/or the external auditor to perform such inspections. In every case, inspections can be performed in reaction to a specific event, or on a routine basis without a particular cause. EC3—If an institution violates the legal requirements, or if the business of the institution is not conducted properly, BaFin can deploy a series of measures aimed either at the institutions or at their senior management. Since the enactment of the FMVAStärkG in August 2009, BaFin is authorized to already impose measures if there is a substantial risk that an institution will not comply with funding and liquidity requirements in the near future. Although the KWG allows BaFin to impose administrative fines, it is notable that this power largely relates to (i) a breach of either reporting and/or notification requirements or (ii) a demonstrated contravention of a prior enforceable order. Fines can be imposed on individuals, as well as institutions themselves - the German Administrative Offences Act (*Gesetz über Ordinungswirdrigkeiten*) (OWiG) provides a legal basis for the sanctioning of financial institutions. The penalty payments provided for by the KWG, however, are relatively low.
Assessment	Compliant
Comments	BaFin's suite of powers is comprehensive. Nonetheless, BaFin seems to largely rely on 'moral suasion' and informal (albeit, if necessary, strong) pressure being exerted by the banking supervisors through ongoing contacts with the supervised institutions. Furthermore, BaFin does not have a formalized "ladder" of actions in place, facilitating timely and appropriate supervisory actions which are commensurate with the nature and seriousness of the identified issues. BaFin is recommended to develop such a framework, which would help resist pressure from special interest groups, promote appropriate consistency in the treatment of different banks, and contribute to public confidence in the ability of the authorities to preempt emerging strains in the financial system. Also see CP 23.
Principle 1(5).	Legal protection. A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	EC1—Neither the KWG, nor the FinDAG provides any specific legal protection to BaFin and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. However, it should be noted that even though BaFin itself has no legal protection, most employees of BaFin are designated as civil servants[31] as per the German Constitution (*Grundgesetz*), i.e., are persons to which the exercise of state authority has been entrusted. Although civil servants can, in principle, be held liable, the legal threshold for doing so is high; under the German Civil Code (*Burgerliches Gesetzbuch*, BGB) liability can only be presumed if they *"willfully or negligently commit a breach of official duty incumbent upon him against a third party."* The same applies to supervisory staff of the Bundesbank, the larger part of whom are also designated as civil servants.

[31] BaFin's Annual Report over 2009 refers to 1.191 staff member designated as civil servants as per the end of 2009 and 638 additional non civil servant employees.
http://www.bafin.de/cln_161/nn_720486/SharedDocs/Downloads/EN/Service/Jahresberichte/2009/annualreport__09__complete,templateId=raw,property=publicationFile.pdf/annualreport_09_complete.pdf,

	This provision, however, must be read in conjunction with Article 34 of the Constitution that allocates liability of any person that is exercising a public office entrusted by him, if such would be deemed to exist, to the employing authority. *"If any person, in the exercise of a public office entrusted to him, violates his official duty to a third party, liability shall rest principally with the state or public body that employs him. In the event of intentional wrongdoings or gross negligence, the right of recourse of the individual shall be preserved. The ordinary courts shall not be closed to claims of compensation or indemnity."* As such, any liability is attached to BaFin instead of individual supervisors. EC2—Since civil servants exercising a public office cannot individually be held liable, protection against the costs of defending their actions is in principle superfluous in the German context. Nonetheless, should an action be brought anyway, civil servants are entitled to care and protection from their employers. It is noted that while the German legal framework allows the authorities to take recourse on individual public officials, such recourse would require an intentional or grossly negligent breach of official duties on the part of that individual. In practice, there have been no cases where BaFin has made use of its right of resource.
Assessment	Largely compliant
Comments	The supervisory authorities are of the opinion that staff is afforded adequate protection against liability through the German legal framework that applies to civil servants. Although the assessors are comfortable that this framework offers sufficient safeguards for civil servants, there remains some legal uncertainty as to the legal protection of BaFin staff members that are not classified as civil servants (approx one/third of total staff of BaFin), as their legal protection does not stem from formal legislation, but from the Collective Agreement for the Public Service. The German legislator may want to clarify this through amending the FinDAG. While the assessors recognize that the legal environment in Germany, unlike that in some other jurisdictions, is not strongly litigious, it is recommended that the authorities review the legal position of the supervisory authorities themselves and that they be provided with explicit protection for their official actions as an institution, except in cases of gross negligence or willful misconduct, in line with the practice in other jurisdictions.
Principle 1(6).	Cooperation. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	EC1—The cooperation between BaFin and the Bundesbank is governed by the KWG, as well as by a MoU and a "Guideline on carrying out and ensuring the quality of the ongoing monitoring of credit and financial services institutions by the Bundesbank" (see Principle 1(1)). EC2/EC3—With regard to cooperation with foreign supervisory authorities, BaFin is allowed to exchange information, notwithstanding the confidentiality requirements laid down in the Section 9 of the KWG, with foreign authorities, insofar that these authorities require the information for the performance of their functions and that they are subject to confidentiality requirements that are at least equal to those laid down in the KWG.

	Throughout the past years, BaFin has entered into MoU, aimed at, inter alia, information sharing, with multiple foreign authorities. BaFin's Annual Report over 2009 describes the efforts of BaFin with regard to technical cooperation, i.e. advising and supporting foreign authorities (China, Ukraine, South Korea, and Russia are mentioned) in their efforts to set up or improve supervisory systems. EC4 Section 9 of the KWG provides for a broad confidentiality requirement, covering any and all *"facts which have come to their notice in the course of their activities and which should be kept secret in the interest of the institution or a third party, even after they have left such employment or their activities have ended."* The KWG contains a limited number of grounds under which information sharing would not violate a breach of this broad confidentially agreement, inter alia, vis-à-vis criminal prosecution authorities or courts having jurisdiction in criminal cases or authorities deadline with an institution's liquidation or insolvency proceedings. BaFin is able to deny any demand for confidential information in its possession in any situation that goes beyond the limitative nature of the relevant provision.
Assessment	Compliant
Comments	Also see the detailed assessment of CP 25 for comments on cross border co-operation
Principle 2.	Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.
Description	EC1, 2—The term "credit institution" (bank) is clearly defined in the KWG, its definition echoing the definition contained in relevant EU Directives. According to Section 1(1) sentence 1 of the KWG, credit institutions are enterprises which conduct banking business commercially or on a scale which requires a commercially organized business undertaking, whereas "banking business" comprises, inter alia, the acceptance of funds from others as deposits or of other unconditionally repayable funds from the public, lending business, discount business, principal broking services, safe custody business, guarantee business, underwriting business or e-money business. A licensed credit institution may in principle engage in all, several or single categories of banking business. In addition to the legal definition of banking business as listed above, Section 1(1a) of the KWG defines the financial services which provide the basis for qualifying as a financial services institution. Financial services comprise investment and contract broking, investment advice, operation of multilateral trading facilities, placement business, portfolio management, own-account trading, non-EEA deposit broking, foreign currency dealing, factoring, finance lease and asset management. Here, too, the KWG gives a definitive list of those activities that require a license. Rules concerning payment services are laid down in the Payment Services Oversight Act (*Zahlungsdiensteaufsichtsgesetz*, ZAG) through which the supervisory part of the Payment Services Directive was transposed into national legislation. Section 1(2) of the ZAG provides a definitive list of those activities that require a license. In the course of transposing the so-called E-Money Directive (2009/110/EC) into national legislation by April 30, 2011, rules concerning e-money business will be transferred from the KWG into the ZAG. Conducting e-money business will no longer require a license as a credit institution, but as a payment service provider.

	In order to conduct one or more of these types of businesses, an enterprise requires a license under Section 32 of the KWG and/or Section 5 of the ZAG and will thus become subject to supervision. Exceptions from the licensing requirement under Section 32 of the KWG are only permissible under specific conditions set forth in the KWG. EC3—Rules concerning the protection of the use of terminology are laid down in Sections 39 et seq. of the KWG. Under Section 39(1) of the KWG, except where the law provides otherwise, the use of the term "bank" or "banker" or an expression that includes the word "bank" or "banker" in a firm name or as an addition thereto or to describe the object of the business or for advertising purposes is restricted to (i) credit institutions that are in possession of a license under Section 32 KWG or branches of enterprises within the meaning of Section 53b(1) sentence 1 or Section 53b(7) of the KWG; or (ii) other enterprises which, on entry into force of the KWG, were using such a term legally under the existing regulations. Section 39(3) KWG grants BaFin the power to actively determine that enterprises may not use the terms specified in Section 39(1) of the KWG if the nature and scope of the activities do not justify their use. Within BaFin, a separate unit has been entrusted with the task to detect unlawful banking activities and/or unlawful usage of the term "bank" or "banker" and with enforcing the aforementioned prohibitions. EC4—Deposit business, i.e., the acceptance of funds from others as deposits or of other repayable funds from the public, irrespective of whether or not interest is paid, is banking business according to Section 1(1) sentence 2 no. 1 of the KWG. According to Section 32(1) sentence 1 of the KWG, banking business and hence also deposit business may only be conducted by a credit institution which is in possession of a written license from BaFin. Upon receipt of a license, such institutions are henceforth subject to supervision by BaFin. Complementing these official licensing requirements—as a condition for the conduct of deposits and all other categories of banking and financial services business—is a robust regulatory and legal framework within which infringements of the licensing requirements can be effectively punished. BaFin's powers to intervene in the event of banking businesses being conducted or financial services provided without due authorization are governed by the provisions of Sections 37 and 44c of the KWG, relating to the power to order unlawful institutions to cease business operations and conduct special inspections aimed at determining the nature and volume of the unlawful activities. EC5—BaFin maintains on its websites a full database of licensed banks, branch offices, and branches of foreign institutions.
Assessment	Compliant
Comments	The assessors note that the definition for credit institutions used in the German legislation goes above and beyond the definition used in the CRD. Where the CRD describes a credit institution as an undertaking whose business is to receive deposits or other repayable funds from the public and to simultaneously grant credits for its own account, the German authorities have taken up a definition that is more stringent as the definition for credit institution under the KWG is an undertaking in which activities comprises, in short, of receiving deposits *or* alternatively the granting credits for its own account.

Principle 3.	Licensing criteria. The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
Description	EC1—Under German law, BaFin is both the banking supervisor and the licensing authority (Section 32 of the KWG: "*Anyone wishing to conduct banking business or to provide financial services in Germany commercially or on a scale which requires commercially organized business undertaking needs written authorization from BaFin*)." Since BaFin does not have a dedicated licensing department, new licenses (or extensions to existing licenses) are granted by the frontline supervisor that will be responsible for the relevant institution. Further information on the license application process can be found in a notice published by the Bundesbank in August 2002.[32] EC2—BaFin is allowed under the KWG to limit banking license to specific types of banking business or financial services. Section 32(2) of the KWG allows BaFin to make the granting of authorization subject to conditions, as long as these are "*consistent with the objective pursued by the KWG.*" It is the assessors' understanding that BaFin typically uses this power to oblige "new" institutions to comply with a higher minimum capital requirement of 12 percent during the first three years after commencement of its business activities. EC3—The criteria that have to be met in order to be licensed must be met at any time. The KWG provides for the revocation of banking licenses if BaFin becomes aware of facts that would, if they would have been known at the time the license was granted, have warranted refusal of the license application in the first place. Hence, the licensing criteria are consistent with those applied in ongoing supervision. EC4—The KWG distinguishes between mandatory refusal of a license application and discretionary refusal for other reasons. According to Section 33(1) sentence 1 of the KWG, BaFin *must* refuse the license if, in short (i) sufficient initial capital is not available; (ii) the applicant or its (proposed) senior managers are not deemed to be trustworthy and/or qualified; (iii) the holder of a major participating interest[33] in the institution is not trustworthy or fails to satisfy the requirements set in the interests of the sound and prudent management of the institution; (iv) the institution will not have at least two (proposed) senior managers; (v) the institution has its head office outside Germany; (vi) the institution is not prepared or in a position to put in place the

[32] http://www.bafin.de/cln_161/SharedDocs/Downloads/EN/Service/Merkbl_C3_A4tter/mb__020801__zulassung__fdi,templateId=raw,property=publicationFile.pdf/mb_020801_zulassung_fdi.pdf.

[33] Defined in Section 1 KWG as *"at least 10 percent of the capital of, or the voting rights in, a third party enterprise, held directly or indirectly through one or more subsidiaries or a similar relationship or though collaboration with other persons or enterprises, in the holder's own interest or in the interests of a third party, or if a significant influence can be exercised on the management of another enterprise."*

	organizational arrangements necessary for the proper conduct of business; and (vii) the applicant is a subsidiary of a foreign credit institution and the foreign supervisory authority of that institution has not given permission for the establishment of the subsidiary. Furthermore, it follows from Section 33(3) KWG that BaFin *may* refuse a license application if facts are known which warrant the assumption that effective supervision of the institution would be impaired. In particular, this would be the case if (i) the institution is associated with other individuals or enterprises in a corporate network or is closely linked to such a network which impairs effective supervision of the institution owing to the structure of the cross-shareholdings or to inadequate commercial transparency; (ii) effective supervision of the institution is impaired by the legal or administrative provisions of a non-EEA country applicable to such individuals or enterprises; or (iii) the institution is a subsidiary of an institution domiciled in a non-EEA country that is not effectively supervised in its home country or whose competent authority is not prepared to cooperate satisfactorily with BaFin. Moreover, an application may be refused if the applicant fails to provide sufficient information during the course of the license application review by BaFin. In this context, it is important to note that the KWG provides for a 'closed' legal framework, in the sense that authorization may not be refused for reasons others than those specified in German law. EC5—An application may be refused if facts are known which warrant the assumption that effective supervision of the institution would be impaired. Additionally, the KWG does not allow credit institutions requiring authorization to operate in the legal form of a sole proprietorship, a requirement meant to ensure that there is at all times a clear distinction between the institution's capital and the personal assets of the proprietor. EC6—The KWG contains extensive rules governing the transparency of the ownership structure and the permissibility of participating interests in institutions; anyone holding a qualified participating interest in an institution that has applied for a banking license, is to be identified as part of the licensing process and is subjected to a trustworthiness test. As mentioned above, an application for authorization shall be refused if the holder of a major participating interest in the institution is not trustworthy or fails to satisfy the requirements set in the interests of the sound and prudent management of the institution. The KWG requires prospective holders of a major participating interests (defined as a holding of at least 10 per cent of the capital of, or the voting rights in a credit institution) seek prior approval from BaFin before obtaining said interest. BaFin can prohibit such intended participation (or increase to above the afore-mentioned threshold) if, inter alia, facts are known which warrant the assumption that the prospective holder of such participation is not trustworthy or for any other reason does not satisfy the requirements set in the interests of the sound and prudent management of the institution. EC7—As explained above, it follows from the KWG that an application for authorization shall be refused if sufficient initial capital (as specified in German law) is not available. In the case of deposit taking institutions, for example, the initial capital

	should be at least EUR 5 million. EC8—13 As explained above, it follows from the KWG that an application for authorization shall be refused if the applicant or its (proposed) senior managers are not deemed to be trustworthy and/or qualified. The KWG defines 'senior managers' as "*those natural persons who are appointed according to the law, articles of association, articles of incorporation or a partnership agreement to manage the business of and represent an institution organized in the form of a legal person or a commercial partnership,*" but also allows BaFin, in exceptional cases, to revocably designate as senior manager another person entrusted with the management of an institution's business and empowered to represent it (as long as that person is trustworthy and has the necessary qualifications). Persons to be screened by BaFin are to submit a curriculum vitae and a criminal record certificate (*Führungszeugnis*), allowing BaFin to review their trustworthiness and expertise. As part of the review process, BaFin consults the Federal Central Register (*Bundeszentralregister*) for criminal offences and the Central Commercial Register (*Gewerbezentralregister*) for business offences in order to verify whether candidates are "proper" (i.e., reliable) persons. A prerequisite of the professional qualifications for managing an institution is that they have "*adequate theoretical and practical knowledge of the business concerned, as well as managerial experience,*" whereas "*a person shall normally be assumed to have the professional qualifications if he can demonstrate three years' managerial experience at an institution of comparable size and type of business.*" In principle, every member of the management board must be fully qualified to manage the respective institution. Exceptions may only be acceptable for specialists in areas like IT, provided they are part of a large enough board to ensure that the system of checks and balances still works and all other board members are sufficiently qualified. For completeness' sake, is should be noted that the FMVAStärkG introduced new provisions relating to the monitoring of members of supervisory and administrative bodies. It was decided by the German authorities that *"in view of the financial industry's importance for the real economy, the members of administrative and supervisory bodies"* are required to be trustworthy and *"qualified to understand the transactions performed by the institution or financial holding company, to assess their risks and where necessary to enforce changes in the management of the company's business."* A Guidance Note issued by BaFin in February 2010 offers institutions clarifications on what the new requirements, in the view of BaFin, entail.[34] In 2009, BaFin took 10 formal actions against senior managers that resulted in their dismissal.[35] In the majority of cases, senior managers will give up their positions

[34] http://www.bafin.de/cln_161/nn_721228/SharedDocs/Veroeffentlichungen/EN/Service/Guidance/mb__100222__Verwaltungs__und__Aufsichtsorgane.html?__nnn=true.

[35] BaFin's annual report 2009 BaFin, http://www.bafin.de/cln_161/nn_992932/SharedDocs/Downloads/EN/Service/Jahresberichte/2009/annualreport__09__complete.html. Over 2008, three comparable actions were taken, http://www.bafin.de/cln_161/nn_992932/SharedDocs/Downloads/EN/Service/Jahresberichte/2008/annualreport__08__complete.html.

	voluntarily either upon receipt of an invitation for a formal hearing or after it has become apparent through discussions with the supervisory authorities at a 'problem bank' that supervisory action against senior management is likely. Reliable data on the number of cases were a manager stepped down and was replaced without the supervisory authorities having to revert to formal instruments is, however, not available. EC9, 10—The KWG requires that an application for authorization includes a viable business plan, which should include details of the nature of the institution's proposed business, its organizational structure, risk management and internal control procedures, as well as (as per the *Anzeigenverordnung,* AnzV) projected balance sheets and profit and loss accounts for the first three years following commencement of operations. The requirement that authorized institutions have in place a proper business organization is further elaborated in Section 25a of the KWG, listing various elements that have to be in place, e.g. internal control mechanisms with an internal control system and an internal audit function, sufficient staffing levels and technical and organizational resources, an adequate (IT) contingency plan, arrangements by means of which the institution's financial situation can be continuously gauged with sufficient accuracy and complete documentation of business operations. Also, the KWG contains specific requirements for outsourcing arrangements, including audit rights for BaFin, and internal safeguards aimed at preventing money laundering and terrorist financing. The KWG requires that when developing and implementing a risk management structure, the institution takes into account the type, scope, complexity and risk content of the business operations performed. As a matter of principle, BaFin does require evidence that the necessary initial capital is available, but has set no explicit requirements with regard to the financial strength of principal shareholders. As part of the assessment of such shareholders, it does, however, obtain financial information on their financial strength as part of the review process. EC11—Section 33(1) sentence 1 no. 8 of the KWG stipulates that a license must be refused if the applicant is a subsidiary of a foreign credit institution and the foreign supervisory authority responsible for this credit institution has not given its consent to the establishment of the subsidiary. According to Section 53d of the KWG, BaFin has to assess the appropriateness of supervision on a consolidated basis of a foreign supervisory authority from a non-EEA country if an institution from that country wishes to establish a subsidiary or a branch in Germany. Through this assessment, BaFin can determine whether additional measures are necessary to ensure supervision on a consolidated basis according to the German standards. EC12—BaFin may revoke authorization if it becomes aware of facts which, if they would have been known at the time the authorization was originally granted, would have warranted refusal of such authorization. Thus, revocation is possible if false or incomplete information has been provided as part of the original application. AC1 and EC 10—Although the legal framework does not contain explicit requirements for shareholders of credit institutions to demonstrate their capacity to provide additional

	financial support, if and when necessary, the financial condition of a prospective shareholder of a credit institution is one of the decisive factors when assessing whether the envisaged investment can be authorized by BaFin. Thus, BaFin aims to ensure that significant shareholders will be able to support the credit institution, if and when necessary. BaFin, however, has no legal power to force the shareholder to make additional capital contributions. AC2—The German supervisory framework has no special monitoring mechanism in place for the ongoing supervision of newly licensed institutions; such banks are monitored as per the regular cycle of external audit reporting and annual meetings with BaFin and Bundesbank. The assessors understand that in practice, however, new institutions are subject to move stringent requirements in order to prevent their operations from expanding too rapidly. Typically, BaFin requires of new institutions that they comply with a higher (i.e., 12.5 percent) minimum capital requirement (but final determination of this is always made on a case-by-case basis by the relevant supervisor).
Assessment	Compliant
Comments	Although the German supervisory framework does not fully comply with the additional requirements, the assessors are comfortable that all of the essential criteria are materially complied with. Full compliance with the AC's would require that the German authorities obtain an explicit mandate to review the financial strength of (potential) principal shareholders, as per AC 1.
Principle 4.	Transfer of significant ownership. The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Description	EC1—The KWG contains clear definitions of significant ownership and controlling interest. According to Section 1(9) sentence 1 of the KWG, a qualified participating interest is deemed to exist if at least 10 percent of the capital of, or the voting rights in, a third enterprise is held directly or indirectly through one or more subsidiaries or a similar relationship, or through collaboration with other persons or enterprises, in their own interest or in the interests of a third party, or if a significant influence can be exercised on the management of another enterprise. EC2—Section 2c of the KWG and the Holder Control Regulation (*Inhaberkontroll-verordnung*) (InhKontrollV) regulate the assessment and approval of a proposed acquisition or an increase of a qualified participating interest. Section 2c of the KWG was changed in 2009 to transpose Directive 2007/44/EG and the accompanying 3L3 Guidelines regarding procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector into national legislation; the Guidelines were transposed in the InhKontrollV. According to Section 2c(1) sentence 1 of the KWG, any natural or legal person who intends to acquire a qualified participating interest in a German institution has to report this intention without delay in writing to BaFin and Deutsche Bundesbank. In this report, the proposed acquirer has to state the size of the intended acquisition and all relevant information to enable BaFin an assessment as defined in the InhKontrollV. After having received a complete set of information, BaFin has 60 working days to

	assess the acquisition and to determine whether or not there is a need to prohibit the envisaged acquisition. If BaFin needs to request further information, the expiry of this assessment period is impeded until the information is submitted. The assessment period may, however, even in these cases not exceed a total of 80 or, under certain circumstances (e.g. the proposed acquirer is situated or regulated outside the EEA), 90 working days. While BaFin is reviewing the reported (envisaged) acquisition, it may not be completed; failure to do so may lead to BaFin seeking a transfer of the exercise of voting rights attached to the relevant shares to a trustee and/or instruction to sell the shares. The KWG allows BaFin to impose an administrative fine of up to EUR 500,000. EC3—According to Section 2c(1b) of the KWG, BaFin may prohibit the intended acquisition of, or increase in, the qualified participating interest if facts are known which warrant the assumption that, in short, (i) the acquirer does not meet the demands required in the interest of ensuring a sound and prudent management of the institution; (ii) the institution will not be able to comply or continue to comply with prudential requirements; (iii) effective supervision of the institution would be hampered by the acquisition; (v) the prospective managers of the institution are not trustworthy or lack the necessary professional skills; (vi) the acquirer has been committed for money laundering or terrorist financing; or (vi) if the financial soundness of the proposed acquirer is not insufficient. The acquisition can be prohibited when the information remains incomplete, is not correct or does not fulfill the specific criteria laid down in the InhKontrollV (Section 2c(1b) sentence 2 of the KWG). . EC4—The KWG requires an institution to report to BaFin and the Bundesbank every acquisition or disposal of a qualified participating interest in its own institution, if it reaches, exceeds, or falls below the thresholds for participating interests of 20 percent, 30 percent, and 50 percent of the voting rights or capital, as well as the fact that the institution becomes or ceases to be the subsidiary of another enterprise, as soon as such a change in these participatory relationships comes to its attention. Institutions have to report on an annual basis the name and address of any holder of a qualified participating interest in the reporting institution and in subordinated enterprises. EC5—BaFin can request the court having jurisdiction at the institution's domicile to transfer voting rights obtained without prior approval to a trustee according to Section 2c (2) of the KWG. Please refer to the answer to Essential Criterion 3.
Assessment	Compliant
Comments	Recital 6 of Directive 2007/44/EC explicitly confirms that the thresholds for notifying a proposed acquisition or a disposal of a qualifying holding, the assessment procedure, the list of assessment criteria and other provisions to be applied to the prudential assessment of proposed acquisitions are subject to maximum harmonization. The German authorities are therefore not in a position to deviate from the EU framework regarding 'change in control' situations.
Principle 5.	Major acquisitions. The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	EC1—According to Section 12(1) sentence 1 of the KWG, a deposit-taking institution

	is not allowed to hold a qualified participating interest in a "non financial enterprise" if the amount of the share in the nominal capital would exceed 15 percent of the deposit-taking institution's regulatory capital. Its aggregated qualifying participating interests in such enterprises may not, taken together, exceed 60 percent of the deposit-taking institution's liable capital. Each excess above these limits requires permission from BaFin, and BaFin may only give its consent if the institution holds additional capital for the part of the participating interest which exceeds the limit by liable capital. Additionally, institutions are required under the KWG to inform BaFin and the Bundesbank about the establishment, modification or discontinuation of a participating interest or of corporate ties. This applies, however, only to acquisitions and ties with companies whose head office is located abroad and which become subordinated enterprises and hence part of the consolidated banking group. EC 2—Although the KWG provides for criteria by which to judge (envisaged) transfers of economic ownership of German credit institutions (see CP 4), the KWG does not contain a general rule requiring a German credit institution to obtain BaFin's prior approval before acquiring a participating interest in or establishing corporate ties with an entity not being a credit institution licensed in Germany. Hence, the KWG does not provide criteria by which to judge individual proposals. EC3—Although the KWG allows BaFin to prohibit the acquisition of German credit institutions if such acquisitions would create intransparent structures and thus impedes effective supervision, it does not provide for prior approval by BaFin of any other acquisitions. EC4—Although the KWG contains rules to ensure risks taken on by institutions are covered by sufficient capital, there are no specific provisions on financial and organizational resources in the context of (envisaged) acquisitions of participating interests. EC5—Aside from the specific reporting requirement mentioned above under EC1, the KWG does not require a prior notification of acquisitions or investments. As such, German legislation does not differentiate between the size of the participating interest, the importance of the enterprise in which the institution invests, or other aspects. EC6—Although BaFin is of the view that its powers provide indirect means to mitigate risks stemming from nonbanking activities (it argues that it could, for example, request information on the integration of the acquisition in its risk management systems and if such information would remain forthcoming, construe that this qualifies as an organizational deficiency on the basis of which a formal order could be issued (the assessors, however, deem the legal tenability of such interpretation to be uncertain), it has no direct legal power to prohibit the acquisition of participating interests in nonbanking enterprises. AC1—Although BaFin may be informed about an (envisaged) acquisition of a participating interest in a financial institution in another country, it is not entitled to prohibit such an acquisition in the first place. Given the lack of a formal approval process in Germany, the quality of supervision in the country where the target enterprise is domiciled and its own ability to exercise supervision on a consolidated

	basis is not something that BaFin can formally take into consideration.
Assessment	Materially non compliant
Comments	The German authorities point out that their approach to participating interests is in line with Article 120 of Directive 2006/48/EC, which does not provide for an approval procedure. Whereas the "neutral" (i.e., without being stricter or more lenient) implementation of the EC Directive into national German legislation is acknowledged by the assessors, they hold the view that this approach nonetheless falls short of satisfying this CP. The authorities note that banking supervisors can influence management decisions on envisaged acquisitions through regular contacts that form part of ongoing supervision. While this may sometimes be effective, such informal influence assumes that (i) BaFin receives word of the envisaged transaction at the moment that closing of the transaction can, if necessary, still be avoided by the relevant institution without incurring significant legal risks or costs (which may not always be the case); and (ii) that institution's management is always susceptible to an informal challenge from the banking supervisors (which also is not necessarily the case). Given the inherent risks that such participating interests may entail, the assessors deem a larger and more direct role for BaFin to be advisable; the authorities are therefore recommended to amend the KWG in such way that at least acquisitions that may have a material impact on the risk profile of an institution are made subject to prior approval. For completeness' sake, the assessors note that comparable comments were made as part of the 2003 FSAP and the accompanying BCP assessment.
Principle 6.	Capital adequacy. Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
Description	EC1, 2—The German rules on capital adequacy and the definition of capital are laid down in Section 10 KWG and in the subsequent Solvency Regulation (*Solvabilitätsverordnung*) (SolvV). These rules are based on the Directives 2006/48/EC and 2006/49/EC (CRD), which translated the Basel II-Framework into EU legislation. According to the provisions of the SolvV, institutions have to quantify their credit/counterparty risks, their operational risks and their market price risks and must back them with own funds. The institutions are required to hold at least an overall capital ratio of 8 percent. These provisions apply to the consolidated, sub-consolidated and solo levels. The eligible components of an institution's or a group's own funds (including positions to be deducted) are listed in Section 10 KWG. The eligibility criteria in Germany are those of the CRD, comprising of "original own funds" (Tier 1), "additional own funds" (Tier 2) and "ancillary own funds" (Tier 3), with the proviso that Tier 2 capital is only eligible up to the level of Tier 1 capital. For years, the KWG has contained provisions relating to the so-called silent partnerships (*Stille Gesellschaft*) that could, under certain conditions, be recognized as Tier 1 capital. The use of such instruments by German institutions was never limited since these instruments are deemed to close

	resemble 'traditional' equity instruments, and there have been no cases where the loss sharing character of these instruments has been questioned.[36] It was within the responsibility of individual institutions to ensure that the silent partnerships complied with the provisions of the KWG, with the external auditors reporting concerns they may have on the eligibility of specific instruments as part of the annual audit cycle. Prior to the recent transposition of the so-called CRD II package, relevant provisions defining the components of capital did not fully ensure that proper emphasis was given to the loss absorbing character of regulatory (Tier 1) capital, as German legislation lacked detailed provisions on the eligibility of hybrid Tier 1 capital instruments, nor did it provide for limits of said instruments aimed at ensuring a sufficient quality of capital. It was only through the transposition of the CRD II package that the German legislator introduced a more general framework for hybrid Tier 1 instruments, including specific limits. The German authorities, however, point out that certain specific publications from the BCBS, for example on the treatment of particular capital components like hybrid Tier 1 capital instruments[37] found factual entrance into the supervisory practices through a gentlemen's agreement (which expired in 2007 with the transposition of the Basel II standards in the SolvV) signed by the German internationally active credit institutions (as well as three instituions who signed up voluntarily), whereby they undertook to continuously meet all of the requirements regarding the adequacy of own funds laid down in all relevant Basel standards, including those laid down in the afore-mentioned press release. Compliance with the requirements regarding the adequacy of own funds is monitored on an ongoing basis via the institutions' quarterly returns submitted to BaFin and Deutsche Bundesbank. Moreover, the annual account auditors are required to assess whether the calculation in order to comply with the requirements regarding the adequacy of own funds is appropriate. Contrary to the approach taken by some supervisory authorities from other countries, the German supervisory authorities are not, aside from the minimum requirements laid down in the KWG and SolvV, voicing any target capitalization levels (pre and post stress) for German institutions. The assessors, however, understand that appropriate minimum capital levels are discussed on a bilateral basis between the supervisors and institutions' senior management. EC3—At the moment, the supervisory authorities have adequate legal power to impose a specific capital charge and/or limits on all material risk exposures. Through the enactment of the FMVAStärkG in August 2009, the legal powers to impose higher capital requirements have been expanded and specified, allowing BaFin to now impose such requirements.

[36] The assessors were provided with a memo providing an overview of the legal framework regarding silent partnerships. The memo discusses a number of cases where silent partnerships and participation rights (*Genussscheine*, cumulative upper Tier 2 instruments according to the German Banking Act) absorbed losses on an ongoing basis in the same way as common equity.

[37] Press release of October 1998, http://www.bis.org/press/p981027.htm.

	(i) for risks that are not fully covered by the SolvV; (ii) if the institution's risk-baring capacity is not assured; (iii) to build up additional capital cushions which can be used in periods of economic downturn; and (iv) to make allowance for special business situations of the institution. Historically however, as also acknowledged in BaFin's 2009Annual Report, it lacked strong legal powers to impose higher capital requirements.[38] The main provision, the 'old' Section 10(1b) of the KWG, allowed BaFin to only do this in the case of *"institutions which, by the virtue of their asset or business profile, have a risk structure, which compares unfavorably with that of most other institutions engaged in similar business"* whereas Section 45b allowed for imposing higher requirements only if it could be determined that an institution did not have a proper business organization within the meaning of the KWG, and it had failed to remedy the deficiencies on the basis of a formal order within an appropriate period set by BaFin. While acknowledging the improved legal framework, the assessors note that BaFin has to date only made limited use of its powers to impose higher capital requirements that are commensurate with the risk profiles of individual institutions.[39] The lack of such a track record may stem from the fact that concrete guidance for the supervisors on how to make effective use of these new powers has only very recently become available, and has not yet been extensively tested in practice.[40] It will thus take time before effective use of the new powers can be ascertained. EC4—When determining the capital ratio, institutions have to consider their individual risk profile, either through the Credit Risk Standardized Approach (*Kreditrisikostandardansatz*) or the IRB Approach. The effect of certain credit risk mitigation techniques and netting agreements is recognized under the 5 SolvV.Operational risks and market price risks need to be taken into account when calculating the capital ratio.

[38] *"Thus far, raising capital requirements was only possible if the Supervisory Authority could prove that the risk profile of a specific institution was worse than that of the vast majority of other institutions. This was difficult to prove in practice,"* page 110 of the 2009 Annual Report, http://www.bafin.de/cln_161/nn_722758/SharedDocs/Downloads/DE/Service/Jahresberichte/2009/jb__2009__gesamt,templateId=raw,property=publicationFile.pdf/jb_2009_gesamt.pdf.

[39] Assessors have, for example, observed instances where BaFin mandated increases of risk factors in quantitative models, and thus requiring higher capital requirements for relevant positions/portfolios.

[40] In 2010: Q4, BaFin and Bundesbank issued a document elaborating on the use of additional capital requirements in response to material organizational deficiencies. During the mission, BaFin and Bundesbank reached agreement on a second document, dealing with additional capital requirements for institutions facing material interest rate risks. Assessors understand that BaFin is planning to impose additional capital charges on a number of institutions where interest rate risks are deemed to be excessively high in comparison to their existing capital base.

	Both on- and off-balance sheets risks are included. According to Sections 9 to 14 of the SolvV, credit risk exposures which have to be taken into account when determining the institution's capital adequacy comprise balance sheet exposures (Section 10 SolvV), derivative exposures (Section 11 SolvV), off-balance sheet exposures (Section 13 SolvV), as well as free delivery exposures (Section 14 SolvV). Market risk positions in respect of foreign currency positions (Section 295 SolvV) and commodities positions (Section 296 SolvV) include both on-balance and off-balance sheet positions. The same applies to interest rate and equity price related risks of trading book risk positions (Section 298 SolvV). As mentioned above, BaFin has to date only made limited use of its powers to impose higher capital requirements that are commensurate with the risk profiles of individual institutions. At the same time, however, the stability analysis carried out as part of the FSAP Update, as well as analysis from market participants, suggests that the capital position of a number of institutions remains relatively weak in comparison to international peers in terms of the quality of regulatory capital, in particular because heavy reliance on hybrid instruments continues to be a significant vulnerability. Hence, the assessors conclude that there are *prima facie* cases where required capital ratios do not fully reflect the risk profile of individual banks. EC5—BaFin's new powers under FMVAStärkGF allow for taking the economic conditions under which institutions operate, into account, in the sense that BaFin can now impose higher capital ratios to build up additional capital cushions to be used in periods of economic downturn. In general, capital adequacy requirements take into account the conditions under which the banking system as a whole operates. Those conditions in Germany and most of German banks' main markets are relatively favorable in terms, for example, of macro-economic stability and the legal and political frameworks. EC6—According to Section 7(1) SolvV, BaFin and the Bundesbank have to be immediately notified if an institution falls below the minimum capital requirements. In this case, BaFin is authorized, pursuant to Section 45KWG, to take formal measures—i.e., to prohibit withdrawals by proprietors or shareholders as well as the distribution of profits, to prohibit or limit lending, and to require specific risk-reducing measures—if the institution fails to restore the minimum capital ratio within an appropriate period. If failure to observe the minimum capital ratio appears to threaten the discharge of an institution's obligations to its creditors, BaFin is authorized, pursuant to Section 46 of the KWG, to issue instructions to the institution's management, to prohibit deposit-taking or lending, to prohibit proprietors or managers from carrying out their activities or to appoint a supervising person. In severe cases, falling below the minimum capital requirements may, as a last resort, even give grounds for revoking the institution's license, or in the case of risks to the financial stability of the financial system, impose a transfer order on the basis of Section 48a of the KWG. Although the assessors were provided with some documentation illustrating the use of the powers under Sections 45 and 46 of the KWG, they could not determine the existence of a consistent and long lasting track record for invoking these. EC7—BaFin permits institutions to use internal assessments of risk as inputs to the calculation of regulatory capital for credit/counterparty, operational, and market price

	risks. Institutions that want to calculate their risk-weighted exposure amounts for credit risk by using risk parameters derived from internal rating systems have to comply with the requirements laid out in Sections 56 to 70 of the SolvV. The use of the IRBA is subject to approval by BaFin pursuant to Sections 58 of the SolvV. Prior to deciding on an IRBA application, the German authorities conduct IRBA examinations, typically encompassing a review of the implementation plan, the monitoring of the plan during the entire implementation period and suitability examinations of all rating systems prior to their use for calculating regulatory capital requirements. In the implementation plan, the institution has to describe the implementation dates of all rating systems for which it is seeking approval to use the IRBA. Such plans must plausibly demonstrate that the institution will achieve the supervisory reference point within two and a half years of reaching the entry threshold and full implementation of the IRBA within five years at the latest. The suitability examinations of the rating systems are ordered by BaFin pursuant to Section 44 (1) sentence 2of the KWG in order to verify the compliance with the requirements on internal rating systems; typically, such examinations are performed by specialized staff from the Bundesbank, joined by BaFin experts. SolvV allows BaFin to revoke, in whole or in part, approval that has already been granted, if it determines that the institution no longer satisfies the conditions for using IRBA. BaFin can waive revocation of the IRBA approval if the institution can submit a plausible plan showing how it will achieve a timely return to compliance or if it can demonstrate that the effects of non-compliance are immaterial. It follows from SolvV that the principle that an institution may use, upon prior approval from BaFin, internal models also applies to market risk and operational risk. Also in these situations, BaFin may revoke its approval when it is of the opinion that an institution ceases to satisfy the requirements. The assessors were provided with materials illustrating BaFin's approach to increasing risk factors in quantitative models used by institutions, amounting to higher capital requirements for the relevant positions/portfolios. Such interventions are often triggered by outliers in backtesting reports provided to BaFin. AC1, 2—The KWG and its subsequent regulations apply to all institutions domiciled in Germany and do not differentiate between internationally active and non-internationally active banks. AC3—The supervisory authorities have formal power to require banks to adopt a forward-looking approach to capital management and to set capital levels in anticipation of possible events and changes. The MaRisk obliges institutions to implement stress tests of their main risks in their risk management framework, taking into account all relevant risk factors, risk concentrations and diversifications as well as to perform reverse stress tests (since the 2010 amendment, published on December 15, 2010).[41] Under the IRBA, an institution has to use stress tests in the assessment of its capital adequacy. According to Section 123 SolvV *"stress testing shall involve*

[41] http://www.bafin.de/cln_171/nn_724266/SharedDocs/Veroeffentlichungen/DE/Service/Rundschreiben/2010/rs__1011__ba__marisk.html. At the time of the mission, an English translation of the updated MaRisk was not yet available.

	identifying possible events or future changes in economic conditions that could have unfavorable effects on an institution´s credit risk exposures and assessment of the institution´s ability to withstand such changes." Since the enactment of the FMVAStärkG, BaFin may set higher minimum capital requirements for institutions in order to consider risks which are not covered completely by the SolvV, or to build up additional capital buffers for periods of economic downturn. However, as discussed elsewhere in this assessment, at the time of the mission, specific guidance for supervisors on how to make effective use of the new powers has only very recently become available, and has not yet been extensively tested in practice. AC4—The requirements of actual own funds applies to both individual institutions and groups of institutions or financial holding companies (Section 10(1) of the KWG). Generally speaking, every individual institution has to meet the capital requirements at all times, even if it is part of a group; however, under strict conditions, institutions domiciled in Germany can refrain from applying the minimum capital requirements on the solo level. In such a situation, the relevant institution is obliged to notify BaFin and Bundesbank that and to what extent it will make use of this exception, while simultaneously furnishing BaFin and the Bundesbank with suitable documentation to prove compliance with the relevant conditions. German legislation does not provide for reporting on the distribution of capital across groups. AC5—The 2009 enactment of the FMVAStärkG has strengthened legal powers to require an individual bank or banking group to maintain capital above the minimum. The authorities reportedly exert moral suasion on some banks to do so. However, it will take time before effective use of the new formal powers can be ascertained.
Assessment	Materially noncompliant
Comments	This CP requires supervisors to set prudent and appropriate minimum capital adequacy requirements for banks, reflecting the risks that the institutions undertake. In general, rules and requirements with regard to the components of capital, as well as the effective use to set higher capital charges, commensurate with the risk profile of individual institutions, form important cornerstones of an effective supervisory framework on capital adequacy. A proactive approach to capital requirements is warranted by the situation of the German banking system as it recovers from the crisis and prepares for Basel III. In general, although the capitalization of the German banking system has been strengthened, in part through exceptional government measures, the capital position of a number of institutions remains relatively weak in comparison to international peers in terms of the quality of regulatory capital, as heavy reliance on hybrid instruments continues to be a significant vulnerability. Furthermore, past events have shown that various institutions were only marginally capitalized prior to the financial crisis, with supervisory action aimed at raising their capital base and/or improving the loss absorbing capacity of their regulatory capital having been insufficiently effective. Also, relevant provisions defining the components of capital did not fully ensure that proper emphasis was given to the loss absorbing character of regulatory Tier 1 capital. Through the enactment of the FMVAStärkG in August 2009, the legal powers to impose higher capital requirements have been expanded and specified, allowing BaFin

	to intervene more effectively. Although the assessors were provided with some documentation illustrating the use of the relevant powers under the KWG, the assessors conclude on the basis of conversations with staff and such documents that BaFin has to date only made limited use of its powers to impose higher capital requirements that are commensurate with the risk profiles of individual institutions. The lack of such experience may stem from the fact that concrete guidance for the supervisors as toon how to make effective use of these new powers, has only very recently become available and has not yet been extensively tested in practice. While acknowledging the improved legal framework, it will take time before effective use of the new powers can be ascertained. BaFin is strongly recommended to continue its efforts in developing guidance on the relevant provisions of the KWG, allowing it to avoid forbearance, and simultaneously to ensure a consistent application of the relevant legal powers across all institutions. As part of the assessment, the assessors received general information on stress tests used by the Bundesbank to detect vulnerabilities of financial institutions and of the financial system as a whole. The assessors understand that the results of such stress tests are made available to BaFin and line supervisors, and that the results and methodological aspects of such top-down stress tests are discussed with supervised institutions in the course of the ongoing supervisory programme. The assessors are, however, of the view that the use by the German supervisory authorities of stress tests as instruments to closely scrutinize the capital adequacy of individual institutions needs to be enhanced, with attention to be given to both the rigor and frequency of such stress tests, as well as the incorporation of the results in ongoing supervisory practices and the accompanying decision-making process for supervisory interventions. Institutions themselves are subject to stringent MaRisk requirements for stress testing, recently updated as part of the 2010 amendment of the MaRisk, but such general rules cannot replace comprehensive and consistent assessments of the authorities themselves, aimed at independently identifying (future) vulnerabilities and making sure the institutions' capital position remain commensurate with these risks. The assessors understand that BaFin is currently engaging in discussions with the German banks on their long term capital planning. As elsewhere, the considerably stricter rules on capital adequacy to be imposed under Basel III regarding the levels of capitalization and its quality will challenge a significant share of German banks. The results of the capital impact assessment conducted for 15 major German banks in November 2010, as well as the outcomes of the initial BCBS quantitative impact study with 68 German institutions participating, are used as input for discussions on banks' capital planning. It is imperative that the German supervisory authorities continue to closely monitor the recapitalization efforts and intervene strongly if, in individual cases, progress appears to be too slow.
Principle 7.	Risk management process. Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.
Description	EC1—According to Section 25a of the KWG, institutions must have in place a proper business organization which encompasses, as per the KWG, appropriate and effective risk management on the basis of which an institution must continuously safeguard its

	resilience. The KWG further elaborates on what appropriate and effective risk management entails, i.e., *"the definition of strategies as well as the establishment of internal control mechanisms with an internal control system and an internal auditing function, whereby the internal control system comprises, in particular structural and operational arrangements with a clear definition of the areas of responsibility and processes for identifying, assessing, treating, monitoring and communication risks) and an internal audit function."* The requirements of Section 25a are specified in the MaRisk which were originally published by BaFin in 2005 and have subsequently been revised in, 2007, 2009 and recently in 2010.[42] It codifies requirements formerly laid down in separate circulars dealing with credit business, trading activities and the internal audit function, supplemented by requirements for the management of interest rate risk, liquidity risk and operational risk. As per its holistic approach, the MaRisk are aimed at ensuring proper risk management of all material risks of an institution. The circular has a modular structure, with a general part (AT module) providing basic principles for risk management, as well as various specialized parts, elaborating on, respectively, (i) the internal control system including requirements for specific risk categories, and (ii) the internal audit function. The requirements apply *mutatis mutandis* to groups of institutions, financial holding companies and financial holding companies. Additionally, the MaRisk contain specific requirements for group risk management, requiring that all risks are properly aggregated across entities, business units and material activities of the relevant group. With the MaRisk, German banking supervisors have provided a qualitative framework that addresses those risks which can be generally regarded as 'material' for almost all institutions. According to the principle of proportionality, the MaRisk allow for a tailor-made implementation, taking into account the size of the institution and the nature, scale, complexity and risk content of their business activities, thus ensuring that the risk management framework of institutions remains commensurate to the risks and complexities of individual institutions. All elements of the risk management of an institution are subject to the annual audits performed conducted by external audits. More specifically, the PrüfbV requires the auditors to *"assess the adequacy of the risk management structure pursuant to Section 25a KWG as well as the further requirements regarding a proper business organization (…), taking due regard of the complexity and scope of the risks incurred by the institution. Particular attention shall be paid to counterparty credit risk, market price risk including interest rate risk in the banking book, and liquidity and operational risks".* In addition to this general requirement, the KWG allows the supervisory authorities to designate focus areas for the annual audits. Throughout the crisis years, BaFin has made active use of this power, requiring the external auditors to focus on, *inter alia*, valuation practices with regard to structured products and more recently on the effectiveness of supervisory boards.

[42] Circular of BaFin dated 15 December 2010, not yet available in English at the time of the mission. The assessors understand that the 2010 amendments related to, inter alia, liquidity management (incorporating guidelines published by CEBS/EBA), stress testing and concentrations of risks.

	The provisions of Section 25a KWG can be subject to on-site inspections commissioned by BaFin and typically performed by the Bundesbank ('special audits' pursuant to Section 44 KWG). The assessors have been provided with documentation illustrating that BaFin typically commissions such audits whenever the results of the annual audit cycle give rise to concerns. During the period 2007-10, BaFin commissioned well over 200 special audits per year. Information provided to the assessors on the scope of the work performed suggests that the larger part of these special audits were focused on, respectively, MaRisk's basic principles for risk management (the afore-mentioned AT module), as well as institution's risk management practices with regard to credit, market, and counterparty risks; practices with regard to liquidity, operational, and interest rate risks, however, seem to have been relatively underexposed, just as the requirements on internal audit functions. The adequacy of institutions' risk management capabilities are assessed on (at least) an annual basis as part of the generation of institution specific risk profiles. As part of this exercise, supervisors of the Bundesbank (who compile the profiles) are asked to assess the risk situation and the quality of the accompanying controls across a number of risk factors. Individual ratings ('A' being the best and 'D' being the worst) are subsequently aggregated in an overall risk matrix, highlighting the strengths and weaknesses of an individual institution. The profiles are subsequently shared with BaFin for finalization and decision-making on supervisory actions, if any. A guideline for the preparation of the risk profiles, issued by the supervisory authorities in June 2008, has been provided to the assessors (*Leitfaden zur Erstellung von Risikoprofilen für systemrelevante und nicht-systemrelevante Institute*). The assessors understand that a further guideline[43] (with a focus on the quantitative assessment of capital adequacy) has been prepared and *de facto* forms the basis of ICAAP assessments since June 2010; while this document is still labeled as draft, the main contents were already presented to banks and Bundesbank is using it as preliminary guidance. In cases when the risk management of an institution is not appropriate and/or effective, BaFin can issue an official order to an institution to address the shortcomings identified; the assessors have seen evidence of such orders being imposed. If the institution does not remedy the shortcomings within the specified period, Section 45b allows BaFin to, inter alia, impose additional capital charges; (ii) order the institution to take measures to reduce the risks; (iii) restrict the opening of branches; and (iv) restrict of the institution's business activities, in particular the acceptance of deposits and lending activities. EC2—The MaRisk requires institutions' executive boards (*Geschäftsleitung*) to define sustainable business - and consistent risk strategies. The risk strategy has to take into account the objectives and plans of the institution's material business activities as set forth in the business strategy, as well as the risks of material outsourcings. Responsibility for the determination of these strategies cannot be delegated; the executive board itself is required to ensure the implementation of the strategies. The MaRisk requires executive boards to review the strategies at least once a year

[43] "Vorläufiger Leitfaden - Beurteilung bankinterner Verfahren zur Sicherstellung der Risikotragfähigkeit im Rahmen des Supervisory Review and Evaluation Process (SREP)," undated.

	and adjust them as appropriate. The supervisory board of the institution has to be notified of all strategies and given an opportunity to discuss them. The MaRisk also require senior management to submit an appropriate written report on the institution's risk situation to the supervisory body on a quarterly basis. The report, as per the MaRisk, *"has to be written in a form that is comprehensible and meaningful and has to contain both a presentation and an evaluation of the risk situation. The report has to deal separately with special risks for business performance and the measures planned by senior management."* While assessors understand these quarterly reports are provided to the supervisory authorities if a bank is systemically-relevant or if there is a necessity because of special reasons; in those cases, their contents are ultimately fed into the risk profiles. In addition to determining suitable business and risk strategies, institutions are required under the MaRisk to establish an internal process to ensure its risk-bearing capacity. This means that, on the basis of its overall risk profile, the institution has to ensure that the material risks are covered by the risk-taking potential at all times, and that the institution is therefore able to bear its material risks. The MaRisk require institutions to develop and implement processes for identifying, assessing, treating, monitoring, and communicating risks (including stress testing and risk reporting) in order to safeguard the institution's risk-bearing capacity. As mentioned under EC1 above, specialized parts of the MaRisk set specific requirements for the most material risk factors, i.e., credit, market, (including interest rate risk), liquidity, and operational risks. Compliance with these requirements is monitored through the annual audit work conducted by external auditors, as well as dedicated inspections commissioned by BaFin on the basis of Section 44 of the KWG. The fact that every German institution is required to regularly review the appropriateness and effectiveness of its risk management structure has also been clearly anchored in the KWG. EC3—The MaRisk prescribe that the content of the risk strategy as well as any amendments, together with the business strategy where appropriate, have to be properly documented and communicated in a suitable manner within the institution. In addition, processes as well as the related tasks, competencies, responsibilities, controls, and communication channels have to be clearly defined and attuned to one another. This also applies to the interface between the institution and service providers to whom activities have been outsourced. The MaRisk discuss specific elements that have to be included in the guidelines, i.e., (i) rules regarding the structural and operational arrangements, as well as the assignment of tasks, the decision-making hierarchy and the various responsibilities; (ii) rules on the processes for identifying, assessing, treating, monitoring and communicating risks; (iii) rules regarding the internal auditing function; (iv) rules which ensure compliance with statutory provisions and other requirements (e.g., data protection, compliance); (v) rules regarding procedures for material outsourcings; and (vi) principles for compensation schemes. While the structural and organizational arrangements should also cover controls embedded in the processes, institutions' internal audit functions should independently verify the effectiveness and appropriateness of risk management in general, and the internal control system in particular, as well as the orderliness of all activities and processes, regardless of whether these are outsourced or not. Institutions are required to implement internal risk reporting capabilities through which

	relevant developments are reported to senior management at regular intervals, but at least on a quarterly basis. Instances where limits were exceeded to a substantial degree have to be included in these risk reports, including an explanation for such breaches. The expectation is that senior management subsequently takes action to ensure positions are brought within the limits again and, to the extent applicable, actions are taken to prevent such breaches from reoccurring. Additionally, important risk information has to be communicated immediately to senior management, the responsible members of staff and, where appropriate, the internal auditing function, so that appropriate measures and/or audits can be initiated at an early stage Institutions have to insure suitable procedures allowing for such reports are in place. EC4—According to Section 25a of the KWG, all executive board members are responsible for the orderliness of the business organization, including appropriate and effective risk management practices. AT 3 MaRisk stipulates that the executive board members only comply with this responsibility when they are able to assess the risks and continuously take the necessary measures to mitigate them. The assessors have seen evidence of BaFin initiating action against individual board members on the basis of severe deficiencies in risk management capabilities. In order to ensure an appropriate information flow to the executive board members (which enables them to fulfill their duties), the MaRisk require submission of risk reports on the risk situation and the results of the stress tests at appropriate intervals to the executive board. The specialized parts of MaRisk provide for additional details on the risk reports for specific risk categories. As mentioned above, executive boards are required to submit an appropriate written report on the institution's risk situation to the supervisory board on a quarterly basis. EC5 Under the second pillar of the Basel II framework (the Supervisory Review Process, SRP), banking supervisors are tasked with assessing the quality of banks' internal governance, risk management and internal control processes, taking due regard to each institution's specific circumstances. In accordance with this, the supervisory framework in Germany obliges licensed institutions to establish an internal process (Internal Capital Adequacy Assessment Process, ICAAP) in order to identify all material risks and to ensure these risks are sufficiently covered by its 'risk-bearing capacity', i.e. its capacities to identify, assess, mitigate, monitor and communicate these risks. This analysis and the accompanying risk-bearing capacity is reviewed by the supervisory authorities; in Germany, this SRP is incorporated in the process through which the risk profile are generated. Both the KWG and the MaRisk require German institutions are obligated to take into consideration all relevant risks, including any risk concentrations, and ensure they use suitable methods and procedures for determining their risk-bearing capacity, whereas the methods and procedures used have to reflect the size of the institution and the nature, scale, complexity and risk content of the activities conducted.[44] As mentioned under EC1, a guideline for the preparation of the risk profiles is available, with finalization of a recent supplement pending.

[44] Further information on the implementation of Pillar 2 in Germany can be found at http://ww2.bafin.de/sdtf/xls/srp.doc.

	At the end of 2010, BaFin and the Bundesbank finalized an internal “range of practice paper for ICAAP”, compiled on the basis of the supervisors’ assessments performed in 2010 of the ICAAPs of 150 institutions. The internal paper, shared with the assessors, contains aggregated conclusions on the risk-bearing capacity of German institutions.. EC6 German institutions are allowed to use their own risk models for the calculation or minimum capital requirements for credit -, market - and operational risk, with the *proviso* that these models have been accepted by BaFin. Detailed provisions for the use of internal models are laid down in the SolvV. These provisions include requirements aimed at insuring that appropriate procedures for independent validations (i.e. validations conducted by other staff members than those who participated in the design and development) of such models are in place. Institutions making use of internal models should be able to demonstrate to BaFin that its internal validation processes enable it to assess the performance of such models in a consistent and meaningful manner. Although annual supervisory schedules evidence that the supervisory authorities are examining the use and performance of relevant models, the assessors were not in a position to establish the depth and intrusiveness of these reviews. The assessors have, however, identified instances where the supervisory authorities have increased risk factors in quantitative models used by institutions on the basis of significant outliers in backtesting reports. EC7—According to the MaRisk, senior management of an institution should receive regular reporting on the risk situation of licensed institutions. Such risk reports should be *“comprehensible and meaningful”* and have to contain both a description and an assessment of the risk situation. Also see the comments under EC2. To enable the timely and proper preparation of such reporting, institutions should implement *“technical facilities and related processes have to be based, in particular, on the institution’s operational needs, business activities and risk situation.”* (Section AT 7.2 MaRisk). The assessment of institutions’ reporting capabilities are incorporated in on-site inspections, focusing on the quality of information in the report and the process of bottom-up data aggregation, including data quality. The German supervisors recognize that IT complexity, especially in large banks, has steadily increased throughout the past years, not only due to increasing information requirements but also due to mergers and acquisitions and the need to adequately capture data that may be dispersed over several ‘legacy’ IT systems, that may not always be easily reconcilable. The financial crisis, as evidenced in various reports,[45] highlighted the inadequacy of many institutions’ IT infrastructures in supporting the broad management of financial risks. A newly established IT working group has worked on a new concept for assessing institutions’ IT systems, which has been delivered in December 2010. While the assessors view this as a positive step, they also note, as highlighted in CP15, that the area of IT has been relatively underexposed in German supervisory practice.

[45] For example, the October 2009 report from the Senior Supervisors Group on “Risk Management Lessons from the Global Banking Crisis of 2008”, an international forum in which representatives from BaFin participate, highlights a number of areas of weakness that require further work by the firms to address, including inadequate and often fragmented technological infrastructures that hindered effective risk identification and measurement.

	EC8—The MaRisk contain specific rules on the development of new products. According to these provisions, institutions have to have a concrete business plan prior to commencing business activities that relate to new products or markets (including new distribution channels). Such a plan is to be based on the result of a risk analysis performed for these new business activities and has to describe the main consequences of the new activities on risk management. The decision as to whether or not to undertake activities involving a new product or market has to be made in conjunction with a unit independent of front office. The business plan and the start of new business activities have to be approved by the responsible members of the executive board, in cooperation with the board members responsible for monitoring the activities in question. The approval processes can be delegated, provided that clear guidelines are in place and that the executive board is informed of the decisions as soon as possible. As far as trading activities are concerned, a test phase has to be implemented before continuous trading in the new product or on the new market commences. During the test phase, trading has to be limited to a manageable scale. Continuous trading shall only begin once the test phase has been completed successfully and appropriate processes for identifying, assessing, treating, monitoring and communicating risks are in place. For lending transactions, the business plan may also be drafted on the basis of a test phase if warranted by the complexity of the new product or business. The observance of the aforementioned requirements is included in the annual audit cycle of the external auditors as well as, to the extent that the supervisors become aware of new activities, in special audits commissioned on the basis of Section 44 of the KWG. The supervisory authorities are, however, not yet conducting dedicated inspections of the effectiveness of product approval processes at German institutions. The assessors deem this to be an area where the supervisory program of the German authorities can be enhanced, taking into account the fact that the financial crisis revealed that the inherent risks embedded in complex products were often not understood by institutions' senior management. EC9—The main rules for the segregation of functions can be found in Section BTO 2.1 of the MaRisk, one of its specialized chapters, elaborating on the general AT module. It stipulates that those functions responsible for monitoring and communicating risk control have to be segregated up to and including executive board level from those functions that initiate lending transactions and from the trading units respectively. Risk reports have to be written by the risk control function, whose reporting line should lead directly to the members of the executive board. The observance of these requirements is incorporated in the annual audit cycle of the external auditors, as well as in special audits commissioned by BaFin on the basis of Section 44 of the KWG. EC10—In addition to basic principles for risk management, the MaRisk also contains specific requirements with regard to the organization of the lending and trading businesses, as well as requirements for the identification, assessment, management, monitoring, and communication of all relevant other risks. At the time of the mission, amendments of the supervisory framework for liquidity risks had just been incorporated in the MaRisk (version of December 15, 2010), thus ensuring ongoing compliance with

	the CEBS guidelines on liquidity buffers and survival periods that were published in December 2009.[46] AC1—The MaRisk requires the establishment of an independent risk control function that has to be segregated from the institution's front office. The assessors note that the MaRisk requires a tailoring of the risk control framework of licensed institutions to their size, activities, and risk profile. The MaRisk requires that the effectiveness and appropriateness of the institution's risk management framework is periodically examined and assessed by the internal audit function. AC2—As part of the process of identifying, assessing, mitigating, monitoring, and communicating all relevant risks, institutions are required to perform appropriate stress tests of the relevant MaRisk Section at regular intervals. The term "stress test" is used as a generic term for the different methods applied by institutions' to monitor their susceptibility to losses under exceptional, but plausible possible events. This also includes sensitivity or scenario analyses. The MaRisk requirements on stress testing have been enhanced through the 2010 amendments, published by BaFin on December 15, 2010. The updated provisions explicitly require institutions to take into account risk concentrations and stress their diversification assumptions, as well as to perform reverse stress tests. These updated provisions reflected the revised stress testing guidelines published by CEBS/EBA on August 26, 2010.[47] Institutions are required to perform stress tests for all the identified main risk drivers and have to take into account risk concentrations and risks from off-balance sheet items. They have to incorporate the institution's strategic direction and its economic environment. The results of the stress testing exercises have to be taken into consideration when evaluating the risk-baring capacity of an individual institution. The aforementioned draft detailed guideline on all material aspects for assessing the risk-bearing capacity, as well as the underlying procedures and processes to facilitate the supervisory judgment concerning this risk-bearing capacity offers further clarifications on the use of stress testing capabilities. The assessors understand that as highlighted in the assessment of CP6, in the course of the ongoing supervisory programme, the (i) Bundesbank performs its own stress tests across different institutions; (ii) results of such stress tests are made available to BaFin; and (iii) results and methodological aspects of such top-down stress tests are discussed with supervised institutions. Although the guideline for the preparation of the risk profiles, issued by the supervisory authorities in June 2008, highlights that the assessment of an institution's risk bearing capacity should consider *"whether that institution's ICAAP is forward-looking as well as whether it takes sufficient account of the effects of potential future developments (e.g. economic downturn, changes in the*

[46] http://www.eba.europa.eu/documents/Publications/Standards--Guidelines/2009/Liquidity-Buffers/Guidelines-on-Liquidity-Buffers.aspx. At the time that the guidelines were released, CEBS/EBA expected its members to apply the guidelines by the end of June 2010 at the latest.

[47] http://www.eba.europa.eu/News--Communications/Archive/2010/CEBS-today-publishes-its-revised-Guidelines-on-str.aspx. At the time the revised guidelines were released, the expectation of CEBS/EBA was that CEBS will ask its members to apply the guidelines by December 31, 2010.

	institution's own market position, impact of the implementation of the institution's own strategies, stress scenarios)", the assessors are of the opinion on the basis of conversations with staff and documents reviewed that the supervisory practices with regard to such forward-looking assessments should be enhanced. AC3—The MaRisk are aimed at the identification, assessment, mitigation, monitoring and communication of all relevant risks at individual institutions. The general AT module of the MaRisk lists those risks that are deemed material in general, but this overview is not meant to be limitative (*"in principle, at least the following risks are to be deemed material"*). The accompanying annotation clarifies that, depending on the institution's own risk profile, other risks (such as, for example, reputational risks or placement risks) may also have to be classified as material. The aforementioned guideline for the preparation of the risk profiles allows for the incorporation of such other risks in the assessment.
Assessment	Largely compliant
Comments	When it comes to the supervision of institutions' risk management practices and procedures, the MaRisk provides the German supervisory authorities with a sound foundation that, on the face of it, is comprehensive, with provisions relating to all relevant aspects that one would expect to find in a sound risk management framework. The fact that the external auditors are required to opine as part of the annual audit cycle on the adequacy of risk management structures in place, provides the supervisory authorities with a sound understanding of where deficiencies may exist and where further work may need to be done through special audits commissioned on the basis of Section 44 KWG observance of all aspects of the MaRisk. Nonetheless, it is indisputable that the financial crisis has revealed severe shortcomings in the risk management practices at banks globally. Various studies have shown that such shortcomings typically related to, inter alia, risk aggregation within firms and ineffective procedures aimed at ensuring an enterprise-wide view of risks, lacking or ineffective articulation, understanding and implementation of a sound risk appetite by firms' senior management, inadequate stress testing capabilities and/or incorporation of the results from such stress tests in the managing the institutions' risk profile, ineffective liquidity management and valuation practices and deficiencies in many institutions' IT infrastructures in supporting the broad management of financial risks.[48] While these areas are typically addressed in the MaRisk requirements, the German supervisory approach has not always been succesful in proactively identifying, monitoring, and mitigating these issues in a timely manner. To some extent, this can seemingly be traced back to the significant reliance on third parties and the time lags between issues arising and supervisory action that inherently follow from the annual audit cycle. Although the assessors are encouraged by various initiatives, such as the (i) designation of relevant focus areas for the annual audits; (ii) updated guidance for the preparation of the risk profiles; and (iii) recently enhanced requirements on liquidity

[48] Reference is made of the aforementioned report from the Senior Supervisors Group on "Risk Management Lessons from the Global Banking Crisis of 2008.

	management and stress testing imposed on institutions, more work remains to be done to strengthen German institutions' risk management practices and the day-to-day supervision of such practices by the supervisory authorities. In particular, the German supervisory authorities are encouraged to proactively increase their own inspection work, focusing on areas that seemingly have remained underexposed in the past and/or where the financial crisis has revealed significant shortcomings, in particular in the areas of liquidity risk management, senior management's risk oversight (including product approval procedures), stress testing capabilities, and the IT infrastructure supporting the risk management process. By conducting more frequent inspections, the supervisory authorities will be in a better position to respond in a timely and decisive way to risk management deficiencies that may exist in German institutions and urge them to continuously improve their risk management frameworks. A key element of a sound supervisory framework with regard to risk management practices relates to the assessment of institutions' capital adequacy in relation to their risk profiles. While the relevant guidance clearly requires the supervisors to determine whether the available financial resources are sufficient to cover an institution's main risks, including the incorporating of a forward looking perspective in the assessment, the assessors are of the opinion that the analytical assessments in this area need to be enhanced, inter alia, by more firmly embedding stress testing in the supervisory practices. While it is understood that institutions are subject to stringent requirements for stress testing, imposing general rules on institutions cannot replace comprehensive, consistent and independent assessments of the authorities, aimed at independently identifying future vulnerabilities and making sure the institutions' capital position remain commensurate with these risks. Partly based on comments received from industry players in Germany on the depth of on-site inspections conducted by the supervisory authorities since the financial crisis, assessors have no doubt as to the German supervisory authorities' ability and willingness to vigorously seek improvements in the risk management capabilities of German banks as well as to their desire to enhance their own capabilities in supervising these practices and ensure that any weaknesses identified are resolutely addressed by the institutions' senior management. At the time of the mission, however, this process was still ongoing and sustainable effectiveness could thus not yet be determined.
Principle 8.	Credit risk. Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Description	EC 1—According to AT 4.2 item 1 MaRisk, an institution's executive board has to define a sustainable business strategy and a consistent risk strategy, and is required to ensure the implementation of such strategies. The risk strategy has to contain the objectives of risk management with regard to the institution's material business activities. It may be divided into sub-strategies where appropriate (e.g., a strategy for credit risks) and must take risk concentrations into account. In addition to a risk strategy for credit risk, institutions' credit risk management policies and procedures have to contain structural and operational arrangements for lending

	businesses (BTO 1 MaRisk) and processes for identifying, assessing, treating, monitoring, and communicating credit risk (BTR 1 MaRisk). According to AT 4.3.1 item 2 MaRisk, processes as well as the related tasks, competencies, responsibilities, controls, and communication channels have to be clearly defined and attuned to one another. Organizational guidelines for the lending business (including the above mentioned arrangements and processes) have to be written down and communicated to the staff members concerned (AT 5 item 2 MaRisk). The external auditors are required, pursuant to Section 23(2) of the PrüfbV, to assess the material structural features and risks of an institution's lending business, taking into account specific risks stemming from large exposures and related party lending; material observations are to be included in the annual audit report. Moreover, BaFin can (and in practice, periodically does) commission special audits of institutions' lending practices and the accompanying risk management framework. Although the assessors were only able to sample a limited number of annual audit reports, they seem to be comprehensive and extensive. However, the significant time lag between the end of a calendar year and receipt of the annual audited report, the finalization of the review of the audited reports by the Bundesbank, together with the reliance on interpretations of work performed by others instead of on first-hand evidence, remain inherent vulnerabilities of the German supervisory approach. Additionally, diverging practices of audit firms on the review of asset classifications and provisioning for example, may hamper consistent comparisons by the supervisory authorities across German institutions. Annual supervisory schedules shared with the assessors support the conclusion that the authorities are, in addition to the aforementioned annual audit cycle, also periodically perform their own inspections. Such inspections typically relate to qualitative and organizational aspects of sounds credit risk management, as well as quantitative elements (i.e., model reviews) and usually consist of multiple weeks of on-site work; information provided to assessors shows that more than half of the 200+ inspections commissioned by BaFin annually relate to the provisions of MaRisk, with the detailed requirements for lending activities included in the scope of the larger part of such inspections. Through these inspections, BaFin can to a large extent mitigate the aforementioned inherent vulnerabilities. They are typically performed by staff from the Bundesbank, supported by one or more credit risk specialists from BaFin, and the fieldwork can last up to a number of weeks.[49] EC 2—Requirements for structural and operational arrangements for the lending businesses are laid down in AT 4.3.2 item 1 and 2 and in BTO 1 MaRisk. The structural and operational arrangements can be divided in two broad categories (i) requirements for segregation of functions and voting (BTO 1.1 MaRisk), requiring a clear structural separation of the front and back offices up to and including the executive board level; and (ii) requirements for lending business processes (BTO 1.2 to 1.4 MaRisk), with detailed requirements that address the granting of loans, further processing of loans, monitoring of loans, intensified loan management, treatment of

[49] Section BA52 of BaFin's 'basis issues department' consists of approx ten experts in the field of credit risk management; contrary to the frontline supervisors, who have an institutin-specific focus, these experts have a horizontal perspective on credit risk management practices at German banks.

	problem assets, risk provisioning, procedures for the early detection of risk, and the risk classification procedure. In accordance with the concept of proportionality, the MaRisk allow for a simplified implementation, tailored to the size of the institutions, its business focus, and its risk situation. The provisions of the MaRisk are broadly compliant with the requirements of this EC. EC3—The requirements for segregation of functions and voting mentioned above are also aimed at preventing conflicts of interests. Thus, the MaRisk contributes to ensuring that credit decisions are made as objectively as reasonably possible. Various provisions of the MaRisk elaborate on the general requirement for the segregation of functions and altogether provide a more granular perspective on duties that have to be separated from an institution's front office. For example, (i) The assessment of certain types of security and decisions regarding risk provisioning for significant exposures. (ii) The responsibility for the development and quality of loan processing, the monitoring of loan processing, intensified loan management, the processing of problem loans and risk provisioning. (iii) The responsibility for the development and quality as well as the regular review of the criteria which govern the classification of exposures requiring intensified loan management. (iv) The responsibility for the development and quality as well as the regular review of the criteria which govern whether or not an exposure has to be passed on for restructuring or winding up, as well as lead responsibility for the restructuring or winding-up process and the monitoring thereof. (v) The responsibility for the development, quality and monitoring of the use of risk classification procedures. The effectiveness of the framework for segregation of duties implemented in accordance with the aforementioned provisions is reviewed by the supervisory authorities as part of regular inspections performed on the basis of Section 44 of the KWG, as well as by the external auditors as part of the external audit cycle. EC4—Although BaFin and the Bundesbank frequently receive comprehensive internal management information from the systematically important institutions on credit portfolios and credit risk management, the formal, minimum regulatory reporting requirements that apply to all individual institutions are less granular and do not for example, provide insight in loan classification, provisioning, sectoral, and geographic concentrations. Whenever necessary, BaFin can demand further information at all times according to Section 44(1) of the KWG, including but not limited to internal risk reports and reports of the internal audit function of an institution. German banking supervisors hold conversations with the members of the executive board once a year, during which risk management topics are generally discussed. AC1—According to Section 13(2) of the KWG, loans to single borrowers or counter-parties that exceed 10 percent of the institution's own funds (large exposures) have to be granted on the basis of a unanimous decision of all members of the executive board, prior to the granting of the loan. Having said this, the assessors note that the

	possibility under the KWG of having loans that are urgent approved retroactively undermines the effectiveness of the prescribed decision-making practices, as such retroactive approval limits the possibilities to reject the relevant loans, or attach specific conditions to it. In addition to the approach for large exposures described above, institutions are required to define a clear and consistent decision-making hierarchy for lending decisions, thus ensuring that decisions on more material and/or risky exposures are exclusively taken by senior management. The consistency and effectiveness of the decision-making hierarchy is reviewed by the supervisory authorities as part of regular inspections performed on the basis of Section 44 of the KWG, as well as by the external auditors as part of the external audit cycle. AC2—Since trading transactions (irrespective of their classification to the trading or the banking book) are also categorized as credit transactions (Section 19(1) of the KWG and AT 2.3 item 1 MaRisk), the same requirements concerning the structural and operational arrangements for lending business and the processes for identification, assessment, treatment, monitoring, and communication of credit risk generally apply counterparty credit risk exposures. Just like for "ordinary" lending transactions, the use of external credit ratings does not release the institution from its obligation to form its own judgment of the counterparty risk and to incorporate its own findings and information in the lending decision. Trading transactions may only be executed with contractual partners for whom counterparty limits apply (BTR 1 item 3 MaRisk). All transactions concluded with a particular counterparty are to be counted toward that counterparty's individual limit. Issuer limits generally also have to be set up for trades. AC3—In the context of the MaRisk, any extending of credit is counted as a "granting decision" (AT 2.3 item 2 MaRisk) with the effect that the same requirements apply as for originating credits. This comprises, inter alia, the voting rules, the requirements for granting of loans and the further loan processing (among others). The MaRisk state that transactions are to be counted toward the borrower-related limits immediately and that compliance with the relevant limits has to be strictly monitored (BTR 1 item 5 MaRisk). The rules for large exposures imply that an institution has to monitor the total indebtedness in order to ensure continuously comply with the existing legal requirements.
Assessment	Compliant
Comments	While recognizing the inherent vulnerabilities of the strong reliance on the work performed by external auditors—such as the time lag between the end of the accounting year and the delivery of the annual audit reportsrespective, the review of these reports by the Bundesbank, as well as the fact that the supervisory authorities are inherently basing their work on third party interpretations instead of on their own observations—the assessors are of the opinion that the credit risk management framework laid down in the MaRisk provides for a comprehensive and extensive basis for the supervision of credit risks. Notwithstanding, diverging practices of audit firms on the review of asset classifications and provisioning for example, may hamper consistent comparisons by the supervisory authorities across German institutions. The assessors note that although the German authorities have various possibilities to

	obtain information on the credit risk positions of German institutions—they frequently receive internal management information on credit portfolios and credit risk management from at least the systemically important institutions—detailed information on credit risk exposures is currently only available through the quarterly reporting of large loans (*Millionenkredite*) to the Bundesbank's credit register. At the time of the mission, the German supervisory authorities were contemplating reducing the reporting threshold in order to obtain a more complete overview of credit risk exposures from medium-sized and smaller institutions. The need to strengthen the granularity and frequency of the regulatory reporting framework has been incorporated in the assessment of CP 21. Annual supervisory schedules shared with the assessors support the conclusion that the authorities are, also periodically performing their own inspections. Such inspections typically relate to qualitative and organizational aspects of sounds credit risk management, as well as quantitative elements, i.e., model reviews and usually consist of multiple weeks of on-site work. To a large extent, such inspections can effectively mitigate the inherent vulnerabilities mentioned above. As far as the "credit risk environment" in Germany is concerned, the relatively swift recovery of the German economy has, in general, contributed to a relative decrease of the overall credit risk profile of German banks. While the overall nonperforming loan (NPL) ratio (taking into account provisions) increased slightly after the crisis, it has consistently declined and is currently lower than in 2003, the last stress period for German institutions, and in line with international peers. On the basis of the aforementioned, the assessors deem it justifiable to rate the observance of this CP as 'compliant', albeit with some recommendations aimed at further strengthening the supervision of credit risks at German banks. (i) The German supervisory authorities should investigate possibilities to improve consistency in practices on the review of asset classifications and provisioning for example across audit firms, allowing for better comparisons across individual institutions; and (ii) The German authorities should evaluate their capabilities with regard to the supervision of credit risks and continue to improve the depth and frequency of their own credit risk related inspections.
Principle 9.	Problem assets, provisions and reserves. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
Description	EC1—In general, BTO 1.4 of the MaRisk requires institutions to set up meaningful risk classification procedures for the initial, regular or ad hoc assessment of credit risks. Criteria have to be defined to ensure that risks are assigned to a risk class in a comprehensible manner for the purpose of their assessment. Institutions have to set forth criteria which are to form the basis for valuation allowances, write-downs, and loan loss provisions (including country risk provisioning), taking due account of the accounting standards in use (e.g., an internal valuation procedure for loans). The calculations of necessary risk provisions are to be kept up to date. In the event that substantial risk provisioning is required, senior management has to be notified immediately.

	Furthermore, institutions have to set forth criteria to determine when an exposure requires special observation (intensified loan management). Those exposures are to be reviewed at regularly scheduled intervals in order to determine what sort of further handling they require. The institution determines at its own discretion what criteria to use and how much discretionary power is desirable when using such criteria. Additionally, the institution has to set forth criteria governing the transfer of an exposure to the staff or units specialized in restructuring and winding up. Aside from the aforementioned regulatory requirements, institutions have to comply with the provisions of the HGB. According to Section 252 of the HGB *et seq*, all loans must, in principle, be valued annually on an individual basis (although a group valuation on a portfolio basis is allowed for homogenous loans). As soon as full repayment of the loan by the borrower appears doubtful, provisions have to be made (as a minimum for that part not secured by collateral). In the event of a total default, loans must be written off immediately. EC2—The classification and provisioning policies and processes are subject to special audits commissioned by BaFin on the basis of Section 44 of the KWG. The PrüfbV requires the external auditors to incorporate a review of these policies and processes in their annual audits, including an assessment of the likely recoverability of the loans and the appropriateness and sufficiency of the provisioning. If the assessment of the recoverability depends on the quality of collateral, the realizable value of collateral shall needs to be incorporated in the assessment. EC3—Pursuant to Section 19(1) of the KWG The term 'credit' refers to *"asset items, derivatives as well as guarantees assumed in respect thereof, and other off-balance sheet items."* This definition therefore encompasses all positions and transactions containing credit risk (including counterparty risk) regardless of their on-balance or off-balance status. Therefore, the assessment of auditors concerning the risk classification and provisioning needs to include off-balance sheet positions, if applicable, as well. Prudential regulations (e.g. MaRisk and PrüfbV) have a comparable scope. EC4—The MaRisk contain requirements for (i) the classification of loans; (ii) the procedures concerning the early detection of risks; (iii) the processes for intensified loan management; (iv) the treatment of problem loans; (v) as well as requirements concerning the risk provisioning. According to the HGB, an individual valuation of all exposures has to be carried out once a year for accounting purposes. In practice, the basis for assessing the value of loans is determined by the likelihood of the loan being repaid, i.e. the borrower's ability to repay. For loans exceeding EUR 750,000 (or 10 percent of the own funds, whatever threshold is reached first), the disclosure of relevant documents by borrowers to institutions is obligatory (Section 18 of the KWG). The classification and provisioning policies and processes are subject to special audits commissioned by BaFin on the basis of Section 44 of the KWG. The PrüfbV requires

	the external auditors to incorporate a review of these policies and processes in their annual audits, including an assessment of the likely recoverability of the loans. If the assessment of the recoverability depends on the quality of collateral, the realizable value of collateral shall needs to be incorporated in the assessment. As such, the external audit reports allow the supervisor to determine that institutions have proper policies and adequate risk provisioning in place. EC5—According to BTO 1.2.4 and 1.2.5 MaRisk, institutions have to establish appropriate processes for intensified loan management and for the treatment of problem loans. As mentioned above, institutions have to set-up meaningful risk classification procedures for the initial, regular or ad hoc assessment of problem loans. Under German rules and requirements, institutions determine at their own discretion whether or not the criteria for intensified loan management trigger an automatic procedure, or whether they instead provide indicators which form the basis for an assessment; either way, the overarching objective is to identify problem exposures quickly so that appropriate measures can be taken at an early stage. Additionally, institutions also have to set forth criteria governing the transfer of an exposure to the staff or units specialized in restructuring and winding up. Policies are processes for the treatment of problem loans are subject to special audits commissioned by BaFin on the basis of Section 44 of the KWG, as well as the annual audit work performed by external auditors as part of the regular audit cycle. EC6—According to the MonAwV, institutions have to file quarterly regulatory reports with the Bundesbank. These reports are intended to give the supervisory authorities an ongoing insight into the business performance and to enable them to identify arising difficulties in a timely manner. Although the monthly returns do not contain detailed loan classifications and risk provisioning for example, such information is provided to the supervisory authorities as part of the annual audit reports, as well as through the large exposure reports for loans of EUR 1.5 million or more. There are, no legal impediments for the supervisory authorities to obtain relevant information throughout the year by requesting internal risk reports of institutions (the assessors have discussed examples of this with the authorities), as well as by commissioning special audits focusing on the risk classification and provisioning. EC7—If the processes and procedures for risk classification, intensified loan management, treatment of problem loans and risk provisioning—as well as for all other parts of risk management—are deemed to be inappropriate, BaFin can issue an official order pursuant to Section 25a (1) sentence 8 of the KWG to an institution to remove any shortcomings in this area. If the institution does not remove the shortcomings within the timeframe specified, BaFin has several tools at its disposal; it can, inter alia, impose additional capital charges, order risk reducing measures and impose restrictions on the institution's deposit and credit business. Although BaFin lacks the power to demand an increase of provisioning levels, the aforementioned powers effectively allow it to *"increase the overall financial strength"* of an institution (as required under this CP), or seek a risk deduction that is commensurate with the perceived provisioning shortfall. EC8—Risk classification and provisioning form part of the annual audit cycle. As per Section 23 and 26 of the PrüfbV, the recoverability of the loans and the adequateness of provisions have to be assessed by the external auditors. If doubt would arise on the

	accurate valuation or certain assets (even if they have been approved by the external auditor), BaFin is authorized under Section 10 (3b) of the KWG to adjust the institution's own funds. The assessors have been provided with supervisory materials illustrating the use of this supervisory power in practice. EC9—According to BTO 1.2.1 items 2 and 3 MaRisk, the value and legal validity of the security has to be assessed prior to the granting of the loan. Existing security values may be used if there are no indications of changes in value. If the value of the security is dependent to a substantial degree on the financial situation of a third party (e.g., guarantees), the counterparty risk of the third party has to be reviewed as well. Furthermore, within the framework of further loan processing, the value and legal validity of the security has to be assessed at suitable intervals if a threshold to be set by the institution, and depending on the type of security, is exceeded. The MaRisk require institutions to perform *ad hoc* reviews of exposures, including the underlying security, whenever the institution obtains knowledge that would indicate a substantial negative change in the risk assessment of the exposure or the security. In the context of the annual audits, the auditor is required to describe 'noteworthy loans' (including loans for which sizable risk provisions are necessary or were necessary in the concluded financial year), classified by risk category, and assess the viability of the collateral as far as relevant for the valuation of positions. If possible the prospective realizable (net-) value of collateral has to be indicated as well (Section 26(2) PrüfbV). EC10—There are no special provisions laid down in the KWG or in the HGB that establish standardized criteria for assets to be classified as impaired; under the German legislative framework. Such classification is left to the institutions' discretion. Although the annual reports from the external auditors are to provide insight into the risk classification of an institution's entire exposure volume (Section 23(4) PrüfbV), preparing sensible comparisons of such information across different institutions is hampered by the lack of standardized criteria. EC11—As a general rule of the MaRisk, risk reports containing both a description and an assessment of the risk situation have to be submitted to an institution's executive board in a comprehensive and meaningful form. Senior management is required to submit *"an appropriate written report on the institution's risk situation to the supervisory body"* on a quarterly basis. Reports have to contain both a presentation and an evaluation of the risk situation and have to address all material risks, including (but not limited to) credit, market and operational risks. Details on internal risk reporting concerning credit risk are laid down in BTR 1 of the MaRisk. For example, risk reporting of credit risk (which has to be carried out at least quarterly) has to address the following aspects: (i) The performance of the lending portfolio, e.g., by sector, country, risk class and size, or security category, taking special account of risk concentrations. (ii) The extent of limits granted and external lines; moreover, large exposures and other noteworthy exposures (e.g., material problem loans) have to be listed and commented on. (iii) Where appropriate, a separate analysis of country risks. (iv) The development of the institution's risk provisioning.

	Internal risk reporting will typically be included in special audits commissioned by BaFin on the basis of Section 44(2) of the KWG. EC12—According to the HGB, valuation and provisioning generally has to be conducted on an individual item basis (although exceptions from this principle are allowed for standardized retail loans, e.g., homogenous consumer loans) and external auditors are required to opine in their annual reports information on notable loans on an individual basis (structured by risk classification). At least the following exposures have to be regarded as 'notable': (i) Loans to members of the board (executive and supervisory boards, including connected persons). (ii) Loans for which provisions are or will be necessary in a significant amount. (iii) NPLs (if material related to the total volume of loans). (iv) Loans with exceptional collateral. According to Section 23(3) of the PrüfbV, the auditor has to describe the selection procedure for loans to be audited. This also encompasses large exposures defined by Section 13 of the KWG, but is not limited to those exposures. Those exposures also have to be reviewed on an individual item basis. AC1—In Germany, there is no requirement for institutions to classify loans on the basis of the length of time that payments are overdue, although in practice this is often used by financial institutions as one of the major criteria for classifying loans as "nonperformed" or "impaired." The risk classification system prescribed in BTO 1.4 of the MaRisk for determining credit risk has to be based not only on quantitative criteria, but wherever possible, also on qualitative criteria. In particular, account has to be taken of the borrower's ability to generate income in the future in order to repay the loan. Institutions have to monitor whether or not the borrower complies with the terms of the contract (BTO 1.2.2 item 1 MaRisk). Ad hoc reviews of exposures, including security, have to be conducted annually and whenever the institution obtains information, either from internal or external sources that would indicate a substantial negative change in the risk assessment of the exposures or the security. The risk classification system is also subject of audits performed by the German banking supervisors and the annual auditors as well. Effecting an improved classification of loans which would otherwise fall in arrears without refinancing is deemed to be inappropriate by the supervisory authorities.
Assessment	Largely compliant
Comments	Although the design of the supervisory framework with regard to problem assets, provisions and reserves is comprehensive, the assessors note that the German supervisory authorities have not issued standardized criteria for classifying assets as impaired; under the German legislative framework, such classification is left to the institutions' discretion. Although the assessors acknowledge that individual circumstances may (also) be relevant when classifying assets, the lack of standardization hampers the preparation of sensible comparisons across different institutions. The authorities are therefore encouraged to develop specific (minimum)

	criteria as basis for regulatory reporting, whilst allowing institutions to employ stricter criteria for their internal risk management purposes if they would deem those to better reflect the characteristics of their business. Any material differences between the (minimum) regulatory criteria and institutions' internal criteria should be reconciled in the annual reports prepared by the external auditors. Although the German authorities have various possibilities to obtain detailed information on problem assets, provisions and reserves throughout the year, there is no comprehensive framework to ensure timely and comprehensive reporting of such information. This observation has been incorporated in the assessment of CP 21.
Principle 10.	Large exposure limits. Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
Description	EC1—Historically, Section 19(2) of the KWG is defined in a limitative form when, owing to legal or economic connections, independent borrowers have to be treated as a single borrower unit. According to this definition, two or more natural or legal persons or partnerships are regarded as a single borrower unit if (i) one of them can exercise a direct or indirect dominant influence over the other or others; or (ii) if, even without any such dominant influence, their dependencies make it appear likely that, if one of these borrowers encounters financial problems, this will also lead to payment difficulties on the part of the others. Section 19(2) of the KWG mentions a number of instances where the existence of a single borrower unit is to be assumed. At the time of the mission, the provisions of the KWG on connected counterparties had just been revised. The revised version of the definition makes clear that unilateral contagion (i.e., a situation where financial problems of one of the parties trigger financial difficulties for the other without the same being true for the opposite situation) is sufficient to define two or more natural or legal persons or partnership as a single borrower unit. The revised provisions stipulate the possibility for an institution to disprove the existence of direct or indirect dominant influence on an individual basis, even where one of the explicitly mentioned cases of assumed dominant influence is given. In cases of doubt, ad hoc decisions are taken by the supervisory authorities, exercising their discretionary powers. The external auditors are required, pursuant to Section 23 (2) of the PrüfbV, to assess if institutions have processes which ensure the generation of appropriate single borrower units according to Section 19 (2) of the KWG. Any modifications of the processes have to be noted separately. EC2—The German rules on large exposures can be found in Sections 13 and 13b of the KWG, and are further elaborated in the Large Exposure Reporting Obligation (*Grosskredit- und Millionenkreditverordnung*, GroMiKV). In addition to defining large exposures, the provisions also cover the decision-making requirements relating to the granting of large exposures, the definition of limits for individual large exposures and aggregated large exposures, and procedures for limits in breaches and reporting obligations to the German supervisory authorities. In its definition of a large exposure, the KWG distinguishes between nontrading book and trading book institutions. For nontrading book institutions, Section 13 (1) sentence

	1 of the KWG defines large exposures as exposures to an individual borrower or a single borrower uni, which amount to or exceed at least 10 percent of the liable capital. For trading-book institutions, Section 13a of the KWG distinguishes between large exposures from banking and from overall business. According to Section 13a (1) sentence 3 of the KWG, large exposures from overall businesses are defined as exposures to an individual borrower or a single borrower unit, which amount to or exceed 10 percent of the own funds, whereas large exposures from banking businesses are defined as exposures to an individual borrower or a single borrower unit excluding the individual total position from trading book business which amount to or exceed 10 percent of the liable capital. According to Section 13b of the KWG, the rules on large exposure limits apply to both a solo and a consolidated basis. The key provision is the limitation of a single large exposure to 25 percent of the liable capital for the banking book and 25 percent of the own funds for the overall business of trading-book institutions (individual large exposure limit). As part of a recent revision of the KWG, the former requirement that an institution may not incur large exposures which in total exceed eight times its liable capital for the banking book and eight times its own funds for the overall business of trading book institutions (aggregate large exposure limit), has been removed in line with the simplification of the EU approach to large exposures (as per the CRD II package) and no longer forms part of regulatory reporting. The assessors understand that supervisory practice has shown that this aggregate large exposure limit was, in reality, never breached. If an institution would exceed the individual large exposure limit, the responsible manager must be notified immediately and the supervisory authority must be notified of the breach. Moreover, the amount by which the lending exceeds the large exposure limit must be backed by liable capital or own funds. Although BaFin may, temporarily or otherwise, exempt an institution from the requirement to provide capital backing, it usually makes such consent subject to a time limit and to the reservation that it may be revoked at any time. Assessors understand that BaFin regularly attaches other conditions to the granting of such consent, especially an obligation to report immediately as soon as the solvency ratio reaches or falls below certain thresholds. According to Section 56(2) no. 6 of the KWG, breaches of the large exposure limits, which have not been approved, may, in the event of negligence or deliberate intent, constitute a breach of administrative regulations and entail the imposition of an administrative fine. Institutions are required to report to the Bundesbank their large exposures for the preceding quarter each January, April, July, and October. Such reports must include the amount of notifiable large exposures on the reference date, the amount that counts for the individual large exposure limit, taking into account the exemptions provided for by Sections 9 to 11 of the GroMiKV, and the risk-weighted amount of notifiable large exposures. As the provisions on large exposures apply mutatis mutandis to groups of institutions and financial holding groups, the superior institution of groups is also required to produce quarterly reports by the last calendar date of the following month in the same way as individual institutions. As mentioned above, the definition of exposure for determining the amount of large exposures follows from Section 19(1) of the KWG and includes on balance sheet assets, derivatives, and other off-balance-sheet transactions. Section 20(1) to (5) of

	the KWG lays down rules on exceptional cases of exposures which need not to be considered as utilization of large exposure limits. Institutions' senior management has to inform itself about the state of all large exposures at the dates for submission of the quarterly large exposures reports. Also, the annual account auditors are required, pursuant to Sections 23(1) PrüfbV, to verify and assess institutions' compliance with the large exposure rules. EC3—According to AT 4.3 and AT 4.3.2 of the MaRisk, institutions have to establish appropriate processes for identifying, assessing, treating, monitoring, and communicating risks, including associated risk concentrations, depending on the nature, scale, complexity, and risk content of its business activities. These processes have to ensure that material risks can be identified at an early stage, are captured completely, and can be presented in an appropriate manner (please refer to Section 25a(1) no. 1 of the KWG). Specific requirements for counterparty risk as one of the material risks are determined in BTR 1 of the MaRisk. According to the MaRisk, no lending transaction may be entered without a borrower-related limit (borrower limits or borrower unit limits) and trades may only be executed within the confines of counterparty and issuer limits. The relevant limits have to be closely monitored and any instances in which limits are exceeded, as well as any measures taken as a result, have to be recorded and, if necessary, escalated to senior management. According to Section 23(1) of the PrüfbV, the audit of the annual accounts conducted by the external auditors must cover compliance with the large exposure rules at the level of the individual institution. According to Section 36(2) of the PrüfbV, the auditors have to report on precautionary measures made to comply with the requirements for large exposure on a consolidated basis (please refer to Section 13b of the KWG) including the compliance with the disclosure requirements. In addition to the regular valuation conducted by the external auditors, banks' compliance with the large exposures rules is also examined in the course of special audits ordered by BaFin pursuant to Section 44 of the KWG. EC4—AT 2.2 of the MaRisk requires institutions to carefully manage their material risks, as well as risk concentrations associated with these risks. In order to manage these risks, AT 4.1 item 1 of the MaRisk requires that, on the basis of the overall risk profile, the institutions have to ensure that the material risks are covered by the risk taking potential at all times, taking into account any risk concentrations that may exist. In order to assess such concentrations, qualitative and, if possible, quantitative techniques should be used. Additionally, risk concentrations have to be treated and monitored by appropriate procedures (e.g., limits, "traffic light systems" or using other precautions). Detailed provisions on decision-making in the case of large exposures can be found in the KWG. In essence, such exposures require a unanimous decision from senior management prior to legally incurring the exposure. In individual, urgent cases, the KWG allows for decisions to be taken promptly after incurring the exposure; if such retroactive decision has not been taken within one month of the exposure having been incurred, the institution has to notify BaFin and the Bundesbank of this fact.

	BTR 1 item 7 of the MaRisk requires the preparation of a risk report for the management board on at least a quarterly basis, which has to include the main structural features of the lending business. Among others, the report has to contain information about the performance of the lending portfolio (e.g., by sector, country, risk class, and size) and the extent of limits granted, external lines, large exposures and other noteworthy exposure. The internal auditors are required to assess the management of risk concentrations as part of their annual audit cycle (Section 23(5) PrüfbV). Banks' appropriate consideration of risk concentrations is, in addition to the annual review conducted by the external auditors, also examined in the course of special audits ordered by BaFin pursuant to Section 44 of the KWG. On these occasions, an assessment is also typically carried out of the institutions' systems for monitoring risk concentration in the form of sectoral and regional loan concentrations. EC5—The current supervisory legislation in Germany only partly provides for supervisory monitoring of risk concentration, such as country and transfer risks.[50] To a certain extent, however, this is compensated by the fact that reports filed with the Bundesbank's Central Credit Register (*Evidenzzcentrale*)[51] on loans of EUR 1.5 million or more to individual borrowers or a single borrower unit, have to incorporate sectoral and geographical information on the borrowers. The information derived from the Credit Register is periodically analyzed by the Bundesbank in order to identify potential risks to the stability of the overall financial system, or developments that may pose risks to the financial solidity of individual firms. AC1—The definition of large exposures which is given in Sections 13 et seq. of the KWG is in accordance with the definitions of AC1.
Assessment	Compliant
Comments	Although the assessors are of the view that the German approach to large exposures is in line with the relevant BPC, the authorities are recommended to review the current provisions on retroactive decisions, as the possibility of retroactive approval undermines the effectiveness of the otherwise stringent provisions (by restricting the opportunities for refusing the loan or putting restrictions on it).
Principle 11.	Exposures to related parties. In order to prevent abuses arising from exposures (both on- and off-balance sheets) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related

[50] Where country and transfer risks on an individual non-EEA country exceed a total of EUR 10 million, institutions are required to notify BaFin and the Bundesbank on a quarterly basis of their country risk exposures, broken down by individual countries.

[51] In Germany, a reporting requirement for large loans has been in existence since the midthirties. The reporting requirement was introduced at that time because it became apparent in connection with the Great Depression that banks often had insufficient information on the overall indebtedness of their major borrowers and frequently encountered grave difficulties when such enterprises collapsed. The information contained in the Credit Registerr allows credit institutions to obtain information on the aggregatated exposures of reported borrowers and thus to improve their credit risk management of their own exposures. Moreover, it allows the supervisors to gain a better insight into credit concentrations of individual credit institutions.

	companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.
Description	EC1—Sections 15 and 17 of the KWG contain rules governing the granting of loans to related parties (*Organkredite*). Although the KWG does not provide for an explicit power of BaFin to designate someone as a related party, the law itself provides for a comprehensive definition, encompassing, inter alia, senior managers of the institution, members of a governing body, proxy holders (*Prokuristen*) and spouses, civil partners, and minors of persons designated as a related party. EC2—Section 15 of the KWG confirms that loans to related parties may be granted only by virtue of a unanimous decision by all of the institution's members. Loans to related parties—other than as part of staff programmes—may only be made on markets terms and only with the explicit approval of the Supervisory Board. Furthermore, Section 15 allows BaFin to order that loans which are, for whatever reason, not granted on market terms, should be fully backed with liable capital. EC3—In general, loans to related parties may only be granted, as mentioned above, on the basis of a unanimous decision by all senior managers of the institution and only with the explicit consent of the supervisory body; although there is no legal requirement to do so, in practice, board members with conflicts of interest are excluded from the approval process. Although the KWG provides for exemptions, these are solely meant to take account of the principle of proportionality and practicality and do not materially invalidate the principle rule laid down in the KWG. Having said this, the assessors note that the possibility under the KWG of having urgent loans approved retroactively undermines the effectiveness of the supervisory framework on loans to related parties, as such retroactive approval limits the possibilities to reject the relevant loans, or attach specific conditions to it. Section 15(4) of the KWG sets out more detailed decision-making provisions. It stipulates that the decisions of the senior managers and the Supervisory Board must be taken prior to the loan being granted. The decisions must explicitly include provisions on the interest payable on, and repayment of, the loan, and must be clearly documented. EC4—While German legislation does not contain specific provisions for dealing with potential conflicts of interests that may arise in the context of loans being granted to related parties,[52] the assessors are of the opinion that such provisions would be superfluous in light of the requirements that decisions on granting loans to related parties have to be taken on a unanimous basis anyway. In this context, it should be noted that one of the guiding principles of the MaRisk is the separation between front office (initiating the loan) and back office (voting on and subsequent managing of the loan). In the case of related parties, the unanimous decision by the senior managers and supervisory board allows for an independent assessment of the loan proposal and the aforementioned separation of duties ensures that ongoing conflicts of interest cannot influence the ongoing management/monitoring of the relevant loan.

[52] The assessors, however, understand that in practice, BaFin does impose such a requirement, ensuring that senior managers or supervisory board members benefiting from the loan are excluded from the approval process.

	EC5—Section 15(2) of the KWG allows BaFin to impose limits for the granting of loans to related parties (as comprehensively defined in the KWG). Any loans that would breach such limits would either have to be reduced to the stipulated limits upon a further order of BaFin; in the meantime, they would have to be backed with liable capital. In this context, however, the assessors note that BaFin has no practical experience with imposing such limits on the granting of loans to related parties. As per BaFin's comments, the imposition of such limits is seen as a deep encroachment into institutions' fundamental lending freedom. EC6—The KWG does not contain specific requirements on risk management practices for loans to related parties, but does require in general that institutions have in place a proper business organization that should include processes for identifying, assessing, managing, as well as monitoring and reporting all material risks. Under Section 23(1) of the PrüfbV, the external auditors are required to report on observance of the institution's internal rules governing loans to related parties, as well as Section 15 of the KWG. On the basis of these assessments, the supervisor is able to determine whether banks have effective policies and procedures in place to monitor and control related party lending. EC7—There are no rules in Germany for the reporting of aggregated exposures to related parties to BaFin. Although such provisions existed in Germany prior to 1998, they were abolished because, as per the explanation of BaFin, *"they did not provide any important insights for banking supervision, and the EU didn't stipulate them in Directives."* To a certain extent, the lack of reporting requirements is an obligation for external auditors PrüfbV to comment in their annual audit report on *"noteworthy loans"*, which include *"loans to managers which are exceptionally significant in view of their magnitude or particular features."*
Assessment	Largely compliant
Comments	The assessors are of the view that although the German authorities have made progress in addressing the weaknesses that were identified in the 2003 FSAP and accompanying BCP assessment, the supervisory framework with regard to loans to related parties does not yet fully comply with this CP. The German authorities should take further measures to correct the remaining weaknesses, which mainly relate to (i) the fact that the possibility of retroactive approval undermines the effectiveness of the otherwise stringent provisions on decision-making (by restricting the opportunities for refusing the loan or putting restrictions on it); and (i) the lack of reporting requirements (the implementation of which would, coincidentally, allow BaFin to make informed decisions as to when and where targeted inspections with regard to the lending practices for related parties may be opportune).
Principle 12.	Country and transfer risks. Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring, and controlling country and transfer risks in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Description	EC1, 2 Section 25a(1) sentence 3 of the KWG requires German institutions to establish a proper business organization that incorporates the need to ensure appropriate and effective risk management practices are in place, covering all relevant risk areas. Although the MaRisk does not contain specific provisions on the management of country and transfer risks, its general requirement that institutions must establish appropriate processes for identifying, assessing, treating, monitoring, and communicating all relevant risks they are faced with, encompasses the need to give due regard to the identification, measurement, monitoring and control of country and transfer risks.

	More specifically, BTR 1 item 6 of the MaRisk requires institutions to identify risk concentrations by using qualitative and, to the extent possible quantitative procedures. According to the afore-mentioned provision, *“risk concentrations have to be managed and monitored through suitable procedures, e.g., limits, traffic lights systems or on the basis of other precautionary measures.”* As part of the annual audit cycle, the external auditors are required to asses *“the total extent of the country risk-related exposures incurred by the institution, as well as the method used to manage and monitor them.”* In particular, the auditors are required to opine on whether the estimation of country-related exposures is based on appropriate analysis by the institution (Section 24 PrüfbV). EC3—As far as provisions are concerned, the German supervisory authorities do not decide on appropriate minimum provisioning amounts of bandwidths per country or geographic region. The MaRisk require institutions to set forth criteria forming the basis for loan loss provisions (including country risk provisioning), taking due account of the accounting standards in use. The calculations of necessary risk provisions are to be kept up to date and are subject to review by the external auditor as part of the annual audit cycle (Section 26 and 31 PrüfbV). EC4—BaFin requires institutions on the basis of the Country Risk Exposure Regulation (*Landerrisikoverordnung*, LrV) to report any lending to borrowers outside the EEA if their aggregated exposure to a specific country at the end of any quarter exceeds EUR 10 million. If this reporting requirement applies, details must be provided of the transactions with those countries in which the loans amount to at least EUR 1 million, including collateral positions and provisions made to cover for credit and country risks. Information on country risks can also be distilled from the reports filed with the Credit Register of the Bundesbank, covering those borrowers whose credit volume amounts to EUR 1.5 million or more, pursuant to Section 14 of the KWG. The KWG allow the supervisory authorities to request information from licensed institutions on all business activities. The assessors understand that the authorities have used this provision during the financial crisis to periodically request information from various German credit institutions on, inter alia, their exposures to Greece.
Assessment	Compliant
Comments	Assessors note that the German supervisory approach with regard to country and transfer risks relies heavily on the overarching obligations placed on supervised institutions to establish appropriate processes for identifying, assessing, treating, monitoring, and communicating all relevant risks, and to identify and effectively monitor and manage risk concentrations. In the view of assessors, this approach fits within the framework of this CP that explicitly recognizes there are different international practices for providing effective oversight of country and transfer risks, including the setting of appropriate provisions.
Principle 13.	Market risk. Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Description	EC1—Institutions are required under Section 25(a) of the KWG to establish and maintain an appropriate and effective risk management system commensurate with the size and scope of their business model. BTR2 of the MaRisk sets specific requirements for the management of market risks, encompassing, inter alia, a threshold system in order to limit market risks and appropriate valuation of positions and risk reporting. An effective internal control framework is included in the requirements. Management oversight is part of the requirement and checked through the internal and external exercise and, if part of the scope, checked through Bundesbank on-site exercises. EC2—The use of limits is an active ingredient in the German requirements for exercising an effective risk management system. Limit exceptions are required to be reported daily to senior management and a risk report, including limit deficiencies, is required to be furnished to senior management at reasonable intervals as size and scope of operations would warrant. EC3—The market risk requirements mandate that trading book positions be valued on daily and overall risk positions consolidated at least once a day with resulting P&L, limit exceptions, and overall position reported to senior management in control of risk management promptly. Valuations and oversight requirements are scaled to the size and nature of the trading book with valuation and communication of risks internally required daily, weekly or monthly in line with the institution's needs. With respect to the utilization of proper pricing methods, institutions should have in place a proper framework that embraces methods for dealing with valuation during times of unusual market stress and for dealing with situations where market prices are stable, unavailable, or distorted. EC4—Stress tests are required to be carried out at regular intervals as reasonably dictated by the nature and size of the bank's trading activities. The stress testing must be broad enough to include off-balance sheet risk and concentrations and must be robust enough to demonstrate that the institution is accounting for events that are both plausible and exceptional taking into consideration the historical, strategic, and economic environment. There is no specific requirement for an institution to develop a contingency plan covering material market risk shocks. The MaRisk, however, do contain a general requirement for banks to have contingency plans in place for time-critical activities and processes, as well as special requirements for contingency plans aimed at coping with liquidity squeezes. Institutions are required to regularly review procedures used to assess market price risks and should be able to employ alternative valuation methods in the event of longer periods during which market prices are unavailable, outdated or distorted. Supervisory materials illustrating the use of business contingency management by German banks and the incorporation of this topic in supervisory activities performed, has been provided to the assessors. Institutions are also required to initiate a risk report to senior management at regular intervals, but at least quarterly. AC1—A basic tenant of the market risk requirements is the clear structural separation between the trading unit, the risk control unit, and the settlement or back office function. The marks used in pricing are required to be developed outside the trading unit and subject to oversight that the prices are in line with market conditions.
Assessment	Compliant
Comments	While the legislative framework lacks a specific requirement to have exercisable contingency plans for dealing with market risk in place, the main elements of such a plan are addressed through general MaRisk requirements.

Principle 14.	Liquidity risk. Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.
Description	EC1 Section 25(a) of the KWG imposes a general obligation requiring institutions to have suitable arrangements for managing, monitoring, and controlling risk. Supplementary requirements are contained in the MaRisk for addressing more rigid standards regarding market, credit, and liquidity risks. The MaRisk requirements are principle based and institutions must address all forms of material risk including liquidity risk. In addressing liquidity risk institutions should take account of all areas including off-balance sheet and special-purpose type vehicles. There are specific quantitative requirements in the LiqV that requires a one-to-one relationship between liquid assets and callable liabilities in the first maturity band including relevant off-balance sheet items and taking account of liquidity facilities or lending commitments. Systemically relevant institutions are encouraged to use their own internal liquidity risk measurement procedures and risk model subject to authorization after an in depth examination of the model by the Bundesbank. In addressing minimum requirements for use of such model the Bundesbank takes into account whether there is a satisfactory governance structure and limit system in place in the institution. Introduction of CEBS guidelines on liquidity buffers and supervisory requirements and incorporation of BCBS' requirements on liquidity risk measurement has been completed in December 2010. EC2—An institution's executive board in Germany has specific responsibility for ensuring policies, practices, procedures, and processes are in place to limit and control risks, including liquidity risk. The executive board must also ensure that management is correctly implementing its policies and processes. The executive board should ensure that its risk strategy is aligned with its business model and strategy. Proper documentation of the process must be evident. The existence of suitable risk management over liquidity and other risks is confirmed by the annual accounts auditor and through Section 44 of the KWG audits conducted by the Bundesbank. Actual practice by banks in Germany varies considerably and ranges from simple rudimentary procedures carried out manually to highly sophisticated risk management controls and models utilized by the larger institutions. EC3—Under practices and procedures required by the MaRisk guidelines, institutions' senior management must be adequately involved in establishing policies, process, and controls that effectively monitor, control, measure, and limit liquidity risk. The implementation of the institutions framework and its adequacy is monitored by the annual external audit exercise and through examination requested by BaFin and carried out by the Bundesbank. EC4—Institutions in Germany must take a holistic view of risk and take into account how credit, operational, market, and other risks affect liquidity and vice versa. The sophistication and oversight of risk varies, of course, depending on the size and nature of the institution's business. The vast number of financial institutions in Germany consists of small local savings banks and cooperative banks that are rigidly constrained geographically and service middle market commercial and industrial firms. The major risk threatening this class of institutions is an economic decline either locally

	or throughout Germany or the EU. The large and complex banking group have in place more sophisticated methods, and, depending on the business model, a higher requirement to have a system in place that incorporates the full array of possible risks the institution may face and appropriate controls to measure, monitor, and control these risks. Stress testing is part of the expected tools to be in place to measure the possible adverse effects on the bank as a result of unexpected but plausible events. Larger macro type factors that may be part of a system wide or institutional stress test are being considered by the appropriate unit in the Bundesbank. EC5—There is not a routine surveillance mechanism with respect to foreign currency liquidity and position risk although oversight is conducted by BaFin on a selected institution basis on any issues or concerns identified during the annual accounts audit or the institution has a particularly large exposure identified through the annual risk profile exercise or other means. BaFin relies on its authority under Section 44 of the KWG to collect information, which ranges from internal management reports, special stress testing results or scenario analysis and contingency funding plans if warranted. EC6—Institutions are required to develop detailed contingency plans to handle unusual liquidity demands and also a proper reporting channel up to and including the bank supervisors. Such plans are reviewed during the annual review of accounts by the auditors. AC1—There is no explicit requirement for banks to conduct separate foreign currency stress tests. The rule of proportionality would apply where a bank must conduct stress tests on a single currency basis if the bank thinks it has a material funding risk in external currencies. BaFin can, of course, use its powers to require special reports or effect corrective action should the situation warrant. AC2—Any such confirmation would take place during the annual review of accounts by the auditor or through special examinations conducted by the Bundesbank.
Assessment	Largely compliant
Comments	BaFin should consider strengthening and tightening the reporting requirements for other currencies than euros. Recent events have shown the need to make liquidity available across a broad spectrum and assurance of liquidity access in one market is no guarantee that the same level of access is available in other markets. Since Germany is an export driven economy it would seem particularly relevant for BaFin to review its procedures in this regard and make appropriate changes. Documentation provided to the assessors suggests that the area of liquidity risk management has been relatively underexposed in the supervisory approach of the German authorities. Given the significant deficiencies with regard to liquidity risks that have been revealed in the crisis period, the German supervisors should proactively increase their own inspection work with regard to liquidity management, being a relatively underexposed area in the supervisory efforts of the German authorities. In particular, the observance of the enhanced MaRisk requirements on liquidity risk management should be thoroughly tested by the authorities, with decisive action to be taken in the case of deficiencies.
Principle 15.	Operational risk. Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size

	and complexity of the bank.
Description	EC1 Institutions are required under Section 25a(1) KWG to establish an appropriate and effective risk management structure in line with its risk bearing capacity with proper controls in place and appropriate management reporting. MaRisk deems operational risk a material risk and therefore subject to the described minimum requirements. MaRisk guidelines incorporate a feature requiring the bank to institute a review with an eye toward assessing whether existing controls are adequate when, and if, any material changes occur in the financial, business, or economic situation. The nature of the controls over operational risk depends very much on the size and complexity of the institution. EC2—Requirements under the MaRisk guidelines are that senior management is responsible for defining an appropriate business strategy surrounded by reasonable and adequate risk controls. Responsibility to properly carry out these requirements cannot be delegated. The supervisory board must be informed and given the opportunity to discuss the framework or make changes to it. EC3—The MaRisk clearly prescribe that senior management is responsible for implementation. Annual oversight is exercised by the external auditors as part of the annual review cycle. EC4—MaRisk points out the need to outline a plan for business continuity in the event of a major disruption aimed at reducing the impact any external event may have on the institution. The effectiveness and suitability of the plan should be reviewed on a regular basis. In the event certain activities are outsourced the institution must assess the contingency plans of the service provider are comprehensive and satisfactory. The supervisory authorities, however, do not independently review the plans for completeness, thoroughness, or reasonableness on a routine basis. EC5—The MaRisk guidelines require symmetry between the scope and quality of data and technology platforms and the institutions need, business line, and risk situation. Further, the guidelines require IT systems to incorporate appropriate safeguards to protect data integrity, availability, and authenticity. To accommodate this latter requirement IT systems must be based on established standards. The suitability of the IT systems must be reviewed periodically by qualified staff from the institution, who must be familiar with the technical and professional aspects of the processes and the IT system. EC6—MaRisk requirements are clear that senior management must file a quarterly report regarding the institution's risk situation including pertinent information evaluating the risk and plans on how management will institute policies and procedures to address the concern. Important issues regarding risk or any other threat must be immediately forwarded to regulatory authorities along with accompanying information and documents and senior management, in conjunction with the supervisory board, must institute procedures to carry this out. Section 26(1) of the KWG requires institutions to file their annual accounts and management reports with BaFin and the Bundesbank. Under requirements in the HGB, this report has to provide for a clear and realistic picture of the company accompanied by an analysis of business results.

	To ensure that the supervisors are kept abreast of relevant developments affecting operational risks at banks, the authorities may want to implement requirements aimed at periodical reporting of material operational risk incidents to the supervisory authorities. EC7—Under MaRisk guidelines legal risk is included as a material risk subject to the disciplines outlined above. EC8—Under MaRisk requirements, material outsourcing contracts must include (i) specifications and description of the services to be performed; (ii) audit rights for internal and external auditors ensuring BaFin's information and examination rights; (iii) proper procedures to ensure compliance with data protection requirements; (iv) right to give notice of termination; (v) procedures designed to ensure continuing compliance with bank supervisory requirement; and (vi) commitments from the service provider to inform the bank of any incident likely to threaten continued performance. The institution is responsible for identifying which outsourced activity is material relative to the bank's particular risk profile. The MaRisk, however, do not provide for a form of pre-clearance by the supervisor of envisaged outsourcing arrangements. AC1—Under Section 25(1)a of the KWG the same elements of risk management addressed on an individual institution basis must apply to the group as well and be implemented at the group level. The specific requirements for group risk management are laid out in the MaRisk document and are very much in line with institutional specific requirements. The scope of risk management at the group level must cover all material risks regardless of whether the risks are housed in a non-consolidated entity. MaRisk procedures state that the requirements set forth on material risk should be judged through an overview of the institution's risk conducted at regular intervals and on an event driven basis. Any additional risk carried by operationally intense business is required to be considered in the risk assessment overview.
Assessment	Compliant
Comments	Although the German supervisory framework with regard to operational risks largely meets the requirements of this CP, the assessors are of the view that the area of IT risk remains underexposed in German supervisory practice. Given the significance of IT risk to financial institutions and the significant impact that IT disruptions may have on individual institutions or, in case of material outages of systemically relevant architecture (e.g., payment systems), on the financial system as a whole, the supervisory authorities are strongly recommended to strengthen their specialized IT inspection capacity and increase the depth and frequency of targeted IT inspections, focusing, inter alia, on IT security and the prevention of cyber crime, IT controls and contingency procedures, and tests. Also, the authorities may want to implement requirements aimed at periodical reporting of material operational risk incidents to the supervisory authorities, ensuring that they are kept abreast of relevant developments affecting operational risks at banks. Also, the authorities may want to elaborate their minimum requirements on operational risk

	management, taking into account the recent BCBS' Consultative Document on Sound Practices for the Management and Supervision of Operational Risk.[53]
Principle 16.	Interest rate risk in the banking book. Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor, and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
Description	EC1—Under practices previously described, interest rate risk is considered a material risk under Section 25a(1) of the KWG and the MaRisk requirements. As such, banks must have in place adequate control systems, monitoring and measuring procedures, and a proper oversight framework designed to channel exceptions to policy or other burning issues to risk management and senior management. Senior management is required to define a sustainable business strategy and design appropriate risk management processes to accompany the execution of that strategy. This responsibility to formulate both a business and a risk management strategy may not be delegated. EC2—Interest rate risk is embraced in the overall requirements to monitor and control effectively market price risk in the banking book. The procedures used to address market pricing risks must be reviewed on a regular basis and incorporate the possibility of a major market disruption in testing scenarios and improving procedures. Overall responsibility for compliance rests with senior management. Review of implementation is carried out by external auditors are part of the annual accounts review exercise or though Section 44 audits commissioned by BaFin and typically conducted by the Bundesbank. EC3—According to AT 4.3.2 of the MaRisk, appropriate stress testing has to be carried out at regular intervals. Where stress tests are used, they must be robust and carried out at regular intervals, and concentrations and off-balance sheet factors are included. In particular, the supervisory authorities require institutions to undertake a test institutions' vulnerability to interest rate shocks via a stress test consisting of a +/-200 bps sudden shift of the yield curve. (This is the standard supervisory stress test outlines in current guidance for supervisors from the BCBS[54] and CEBS/EBA[55].) Institutions must report the outcome of the stress test to BaFin and the Bundesbank if it shows a decline of the economic value of the institution by more than 20 percent of own funds. AC1—The MaRisk allows discretion to choose whether interest rate risks results are run through the P&L or through the present value of the positions. Under a banking circular, BaFin asked institutions to calculate the impact of a sudden and unexpected

[53] Published on December 10, 2010, http://www.bis.org/publ/bcbs183.htm.

[54] Reference is made of the standardized interest rate shock described in Annex 3 of the BCBS' Principles for the management and supervision of interest rate risk, issued in July 2004. http://www.bis.org/publ/bcbs108.htm.

[55] Technical aspects of the management of interest rate risk arising from nontrading activities under the supervisory review process, published in October 2006. http://www.eba.europa.eu/getdoc/e3201f46-1650-4433-997c-12e4e11369be/guidelines_IRRBB_000.aspx.

	interest rate shock on a regular basis. If the economic value of the institution declines by more than 20 percent of own funds this case must be reported to BaFin and the Bundesbank. A relatively small number (130) of institutions reported a decline of the magnitude set out by BaFin. At the time of the mission, BaFin was in the process of imposing high capital charges on some (12) of these institutions, taking into account that the reported decline of own funds was especially material given the existing capital base. AC2—The MaRisk guidelines require internal capital measurement systems for those banks where it is relevant to include interest rate risk in the banking book. AC3—Stress tests should reflect the results of an exceptional but plausible event scenario consistent with the institutions strategic business plan and economic environment. Senior management is required to report the risk factors and the results of the stress testing at appropriate intervals. Suggested methods are to reduce the risk are also included in the risk report. AC4—The MaRisk requires a bank to have a clear structural separation between the trading unit, the risk control function, and the settlement and control function up to and including senior management level. An institution may not have to employ the separation rules if the trading activity is immaterial to the institution's risk parameters as a whole.
Assessment	Compliant
Comments	The assessors understand that BaFin is considering adapting the aforementioned approach to the interest rate shock, requiring all institutions (instead of only the institutions that breach the predefined threshold of 20 percent of their own funds and thus are considered to be 'outliers') to report on the impact of a predefined parallel interest rate shift on income. Under this approach, BaFin would be better able to assess the effect of interest rate changes on the entire German financial sector. Notwithstanding this contemplated change, the German supervisory framework with regard to interest rate risk in the banking book complies with this CP.
Principle 17.	Internal control and audit. Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Description	EC1—There is a complete and encompassing legal framework that adequately covers responsibilities of board and denior management with respect to corporate governance in all banking and credit institutions. Testing for compliance is a regular feature of BaFin's and the Bundesbank's oversight. EC2—Section 25a of the KWG requires appropriate and adequate risk management in credit and financial institutions. In addition BaFin instituted the MaRisk framework that sets out executive board responsibility for establishing and maintaining an adequate control environment in accordance with the nature, depth, and breadth of the

	institutions business activity. Continuing refinement and testing is noted through the external audit. EC3—Adequate legal backing is noted that places full responsibility for oversight of proper control procedures firmly in the hands of the board and senior management. BaFin and the Bundesbank have established an ongoing program of testing and assessing competency of board members and eventually this will lead to establishing guidelines to assist external auditors and authorities in ensuring only competent and qualified individuals are in place in governing boards. EC4—BaFin has adequate powers to remove or force the dismissal of members of the executive board for cause. The 2009 Annual Report of BaFin lists 10 measures against managers, as opposed to 3 in 2008; the assessors have received supervisory materials showing effective use of measures taken against board members. Reportedly, managers tend to give up their post voluntarily upon receipt of a letter indicating that it is contemplating initiating formal action, or when it becomes apparent after discussions with supervised institutions that perceived problems are of such a nature that action against management will likely follow.[56] EC5—The MaRisk framework requires both qualitative and quantitative requirements that ensure adequate staffing and skill sets relative to back office operations as well as remuneration in line with market requirements to ensure the appropriate level and skill sets needed to effectively run the organization. EC6—The internal audit function reports to the executive board but is required to have a high degree of independence. This function serves as a compliance monitor and staff members must concentrate their efforts on auditing and are not allowed to have responsibilities not directly related to this task. Institutions that perform investment banking services are required to have adequate separation of duties and a formal compliance structure in line with MaRisk standards. EC7—Section 25a of the KWG and MaRisk standards clearly set out the requirement that credit institutions must have in place an adequate and functioning internal audit unit. The internal audit function has broad responsibilities to examine and assess risk management, business strategy connected with risk oversight, internal control functions and adherence to regulatory and supervisory guidelines. EC8—To comply with the MaRisk standards the credit institution must align its staffing needs, both qualitatively and quantitatively, in conformance with the operational, business line, and risk management requirements of the institution. This applies to the internal audit function as well. The internal audit function appears to be independent, adequately staffed, competent, and operating under suitable and comprehensive audit plans that are updated yearly or more frequently, if necessary. Serious deficiencies noted must be reported immediately including offenses related to mismanagement or misconduct by executive board members.

[56] The number of cases where managers resigned prior to formal action being taken is not being tracked by BaFin.

	AC1 N/A AC2—No explicit rule exists, but built in safeguards would suggest compliance in spirit. Serious issues arising from malfeasance of executive board members must be reported immediately to the chairman of the executive board and BaFin. Also, while there is not an audit committee per se, nonetheless, the actual workings of the audit function and the reporting chain provides a close equivalency. AC 3 N/A. AC 4—Serious situations require immediate notification to the chairman of the supervisory board and BaFin.
Assessment	Compliant
Comments	The German supervisory framework with regard to internal control and audit complies with this CP.
Principle 18.	Abuse of financial services. Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Description	EC1—In Germany, the legal framework for AML/CFT for banks is composed of different laws and regulations. The Anti Money Laundering Act (*Geldwäschegesetz*, GwG) is relevant for all addressees in the financial market and includes general provisions in particular regarding customer due diligence (CDD) and internal safeguard measures. The KWG adds certain specific rules for the banking sector only and the Regulation (EC) No. 1781/2006 on information on the payer accompanying transfers of funds defines the requirements that have to be obeyed when performing payments. Finally, the PrüfbV defines the obligations for auditors when carrying out the annual AML/CFT audits or targeted audits on behalf of BaFin. Whilst, in addition to the work performed by the external auditors, specialized staff from BaFin would typically also perform their own investigations of institutions' anti money laundering (ML) capabilities, the assessors understand that, also due to resource constraints, in practice only a limited amount of such inspections is performed throughout the year. These laws and regulations include not only provisions to combat ML and terrorist financing (TF), but also for the prevention of other criminal activities than AML/CFT, which could lead to an exposure to assets. In particular, the obligations comprise both the requirements for banks regarding the implementation of preventive measures as well as the legal tools for BaFin to conduct proper supervision. EC2—Section 25a(1) of the KWG constitutes the general requirement for banks regarding the implementation of a proper business organization. Accordingly, an institution must have a proper business organization, which ensures compliance with the legal provisions to be adhered to by the institution and encompasses in particular a proper risk management. The latter should include, in any case, an appropriate strategy and appropriate internal control procedures, which consist of an internal control system and an internal audit function; the internal control system should include in particular suitable rules for the monitoring and controlling of risks. Additionally, according to Section 25c(1) of the KWG, banks are obliged to develop and update internal principles, appropriate business and customer related safeguards,

	and controls targeted to prevent ML and TF. Complementary and without prejudice to the requirements listed in Section 25a (1) of the KWG, German institutions are required to—in the framework of their orderly business organization and appropriate risk management—develop and update internal principles, appropriate business and customer related safeguards and controls and perform inspections to prevent other criminal activity than AML/CFT, which could lead to an exposure to assets. In Germany, all banking businesses are subject to a licensing regime. Whenever a new business applies for a license, it must go through a thorough licensing procedure including background checks of the natural persons involved in that business undertaking. There are also regulatory measures to prevent criminals or their associates from gaining access to existing institutions or companies after they have been granted their license. The Mutual Evaluation Report, prepared by the IMF on the basis of fieldwork conducted in 2009,[57] offers a detailed analysis of (the statutory provisions relating to) transaction monitoring and suspicious transaction reporting (STR). The evaluation concludes that *"the statutory provisions relating to the monitoring of transactions, including transactions with persons in countries that do not or insufficiently apply the FATF standard are generally weak, but specific guidance has been provided to institutions in the form of the BaFin circulars, which highlight weaknesses in the AML/CFT regimes of other countries, typically (but not exclusively) in line with the public statements made by the FATF"* and that *"STR reporting is well established, but the reporting obligation fails to meet the FATF standard in several key areas."* EC3—MaRisk embeds requirements with regard to a proper business organization, including principles, appropriate business and customer related safeguards and controls aimed at preventing other criminal activities than AML/CFT, which could lead to an exposure to assets. Hence, the quarterly 'MaRisk' reports, submitted to BaFin as per AT 4.3.2 MaRisk, are the proper 'channel' to inform BaFin about suspicious activities that are material to the safety, soundness and reputation of an institution. Additionally, institutions' management boards are expected to notify BaFin immediately of all information that is vital from the point of view of risks for BaFin; such information may relate to suspicious activities and/or other criminal activities than AML/CFT, which could lead to an exposure to assets. Institutions are to report suspicious activities involving cases of potential ML and TF financing to the law enforcement authorities of the German *Lander*, who—under the German Constitution—are responsible for policing and law enforcement, as well as to the German Financial Intelligence Unit (FIU). EC4—The German legislative framework provides for various provisions on CDD and internal safeguard requirements. When establishing a business relationship, banks are required to fulfill certain obligations with regard to the customer and the business relationship itself. According to the GwG, institutions have to (i) adequately identify the contracting party; (ii) take appropriate risk-based measures to determine whether the contracting party is a natural person based outside the country, who is or has been

[57] http://www.fatf-gafi.org/document/11/0,3343,en_32250379_32236963_44650635_1_1_1_1,00.html.

	entrusted with prominent public functions (PEPs); and (iii) clarify whether the contracting party is acting on behalf of a beneficial owner and, if so, to identify the beneficial owner. Furthermore, institutions are required to seek and obtain information on the purpose and the intended nature of the business relationship. These provisions are complemented with the overarching provision that if a bank is unable to fulfill the CDD requirements, it may not establish or continue a business relationship or carry out any transactions, regardless of any legal or contractual provisions. Although the aforementioned Mutual Evaluation Report concluded the framework of preventive measures in the context of CDD and record keeping is *"generally adequately,"* the report deemed the structure of the measures to be *"problematic"* in specific areas. These include the very broad CDD exemptions granted with respect to specified low-risk customers; the treatment of all EEA member states and jurisdictions on the EU's third country equivalence list as a single-risk category when determining certain low-risk scenarios; the treatment of the EU/EEA as a single domestic market in terms of correspondent banking obligations; and the concept of what constitutes senior management in relation to the approvals processes PEPs and correspondent banking relationships. However, Germany has meanwhile achieved substantial improvements for the financial sector by enacting the Law for the Implementation of the Second EU E-money Directive on March 9, 2011; at this time, however, it is too early to opine on the practical effectiveness of these legislative changes. The main issue that remains outstanding, that is, the treatment of all EU/EEA member states as a single risk category, is to be solved at an EU level. EC5—According to Section 25f(1) of the KWG, credit institutions must apply enhanced due diligence measures in their business relationships with correspondent institutions based in third countries. Although the FATF assessment found a high awareness of the risks associated with correspondent banking relationship over an extended period of time and had no indication that institutions are not applying appropriate measures within the confines of the KWG, it also noted that the aforementioned approach with regard to intra-EU relationships *"falls significantly short of the FATF standard."* Germany has meanwhile addressed this through the implementation of the Second EU E-money Directive on March 9, 2011. EC6—The external auditors of financial institutions supervised by BaFin and the *Länder* play a pivotal role in the approach to supervising financial institutions for compliance with AML/CFT requirements. First, they produce annual AML/CFT audit reports for all supervised institutions under a specific statutory authority and provide these reports to BaFin. Second, they can carry out specific on-site AML/CFT inspections at the behest of BaFin. More specifically, under Section 29(2) of the KWG, the external auditors of credit institutions and financial services institutions are required to examine whether institutions have complied with their anti-money laundering (AML) obligations under the GwG, the KWG, and EC Regulation 1781/2006 (relating to wire transfers). Under Section 21 of the PrüfbV, the auditors must address a broad range of AML/CFT and related requirements. The law implementing the Second EU E-money Directive and the accompanying revised version of the PrüfbV oblige the auditors to address a

	broad range of AML/CFT and related requirements. EC7—BaFin is the designated competent AML/CFT supervisory authority with the powers to apply sanctions for noncompliance with the GwG and sector specific laws. The statutory sanctions available vary according to the laws on which they are based. The GwG specifically provides for a number of administrative fines (*Zwangsgeld*) for failure to comply with preventive measures set out in the GwG. Failure to comply with AML/CFT measures that are contained in sector- specific legislation, such as the KWG, may be sanctioned on the basis of the powers granted to BaFin under such laws. Between 2001 and the Mutual Evaluation in 2009, BaFin showed a very limited track record in sanctioning AML/CFT failures. During that period, it imposed one administrative fine for an AML/CFT failure (under the authority of the predecessor legislation to the GwG), but has never applied any fines or dismissed any managers for AML/CFT failures under the authority of the sector-specific regulatory laws (although on two occasions the BaFin threatened dismissal action). Five money service remitters' licenses were revoked for AML/CFT reasons. No other sanctions have been applied beyond written warnings. Equally, there have been no other sanctions for failures to comply with AML/CFT obligations. EC8—As mentioned above, the broad German requirements for proper risk management and internal control, laid down in the KWG, encompass the need for independent evaluations of the risk management policies, processes and controls; the supervisors have full access to relevant reports from internal auditors. The GwG requires financial institutions to take appropriate internal measures to ensure that they cannot be misused for the purpose of ML and TF; in particular, institutions are required to designate a ML compliance officer directly subordinate to the management and to provide the officer with the means and procedures necessary to carry out his or her responsibilities properly and effectively. There are, however, no explicit provisions in the GwG, nor in other laws or regulations which explicitly oblige financial institutions to ensure high standards when hiring employees. Based on the FATF Evaluation, the assessors understand that when checking employee reliability, financial institutions may exercise a great deal of discretion with regard to the frequency of checks and the instruments used. It is also up to the company to decide the process for performing checks on existing employees, with regular checks of employee reliability during employment only being required in exceptional, justified cases. Finally, Section 9(3) of the GwG requires institutions to ensure that employees involved in carrying out transactions and for initiating and establishing business relationships are aware of methods of ML and TF and of the requirements of the GwG. EC9—Credit institutions must draw up organizational instructions to ensure that written reports on all internal cases of suspicion (including financial transactions which were requested but refused and all transactions which are unusual on ML and TF criteria) are submitted to the compliance officer in writing for further examination and decision-making and are also documented there. The internal auditing department of each institution must examine the institution's compliance with all applicable duties under the GwG. Examination reports must be

	drawn up and submitted at least once a year to the management board of the bank. The reports must contain, inter alia, a description of the internal reporting system for suspicious transactions as well as detailed information on the type, number and local occurrence of STRs filed with the competent law enforcement authorities in accordance with Section 11 of the GwG and on the termination of business relationships. In addition, ad hoc information of the management board is necessary with regard to single cases that could have a deep impact on the reputation of the institution. In particular, the reports must contain an assessment of whether the measures adopted by the bank to prevent ML, TF, and other criminal activities than AML/CFT, which could lead to an exposure on assets, are adequate and sufficient and whether the compliance officers has fulfilled the tasks assigned to them. The institution's compliance officer is obliged to annual reporting to the board of management. EC10—The information contained in an STR may be used only for (i) criminal proceedings specified in Section 15(1) and 15(2) of the GwG; (ii) criminal proceedings related to a criminal offense liable to maximum punishment of more than three years imprisonment; (iii) taxation proceedings; (iv) the supervisory tasks of competent authorities pursuant to Section 16(2) of the GwG; and for (v) the purpose of threat prevention (Section 11(6) of the GwG). The names and personal details of persons who make an STR are granted special protection by the law enforcement agencies. As an additional measure, BaFin requires financial institutions to file STRs only through the ML compliance officer without disclosing the officer's name or the names of any members of staff of the financial institution involved in the respective case. EC11—BaFin, as a competent authority according to Section 16(2) of the GwG, is obliged by law to inform the competent law enforcement agency, with a copy to the FIU, where it has reason to believe that an offence pursuant to Section 261 of the Criminal Code (*Strafgesetzbuch*) or that terrorist financing has been or will be committed or attempted (Section 14(1) of the GwG). EC12—The KWG regulates the possibility for BaFin to cooperate with foreign authorities in the supervision of banks, financial services institutions, and insurance companies. BaFin may cooperate on banking supervision of groups of institutions, or financial holding groups. Cooperation on banking prudential supervisory issues with counterparts from other states of the EEA is based on Section 8 of the KWG. Cooperation on AML/CFT issues can be provided on the basis of Section 9(1) of the KWG, regardless of whether or not the foreign counterpart is from an EU or EAA state. BaFin also frequently cooperates with the supervisory authorities and FIUs in other countries if it wants to issue licenses for the conducting of money remittance services to persons resident in another country. In such cases, it makes enquiries with the authorities in another country whether any information is held there to be said against the issue of a license. In several cases, the BaFin has concluded MoUs with supervisory authorities of foreign states concerning their cooperation in the field of financial supervision which allow them, inter alia, to inspect German branches and subsidiaries of financial institutions domiciled in their states on site in their capacity as home-country authority.

	Since 1999, these MoUs also contain a special paragraph with regard to financial crimes, i.e., ML, if the foreign authority also has responsibility with regard to AML/CFT. AC1—BaFin as a supervisory authority has no specific expertise for addressing criminal activities. However, BaFin cooperates closely with the FIU, which has such expertise and shares it with BaFin in order to strengthen the supervisory quality.
Assessment	Largely compliant
Comments	Although the FAFT Mutual Evalution performed in 2009 acknowledged that Germany has introduced a number of measures in recent years to strengthen its AML/CFT capabilities, it also concluded that the AML/CFT framework prevailing at the time of the evaluation was not fully in line with the FATF's recommendations. The identified weaknesses with regard to CDD and record-keeping, as well as sanctioning of AML/CFT violations and enforcement are especially pertinent to this CP; full compliance would require both changes to the regulatory framework as well as a more pervasive supervisory approach. Particularly, given the high risk of Germany's financial markets being misused for purposes of ML and TF, BaFin is strongly recommended to review its enforcement strategy and capabilities with regard to AML/CFT as, at the time of the 2009 Mutual Evaluation, BaFin showed a very limited track record in sanctioning AML/CFT violations. At the time of the mission, the German supervisory authorities were (together with other relevant stakeholders) in the process of addressing the weaknesses identified in the evaluation. In this context, the assessors note that the new law for the Implementation of the Second Electronic Money Directive that has been enacted in March 2011 addresses a number of concerns highlighted in the evaluation. The BMF has developed a draft Act to Optimise the Prevention of Money Laundering (*Gesetz zur Optimierung der Geldwäscheprävention*) which, among other things, strengthens the role of the FIU in analyzing STRs, extends and solidifies the catalogue of due diligence duties for non-financial institutions, and strengthens the supervisory remits of the competent authorities in the Länder. The draft Act is currently being discussed among the relevant ministries. The German authorities are strongly urged to ensure that the identified weaknesses are addressed as quickly as reasonably possible, resulting in a sound and effective AML/CFT framework.
Principle 19.	Supervisory approach. An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.
Description	EC1—Responsibilities for risk assessment, risk profiling, and risk evaluation are jointly undertaken by BaFin and the Bundesbank in line with the framework contained in the guideline for the preparation of the risk profiles, issued by the supervisory authorities in June 2008; the assessors understand that a further guideline has been prepared and *de facto* forms the basis of ICAAP assessments since June 2010. The Bundesbank initiates the ongoing risk assessment process by preparing a bank-by-bank analysis on the basis of the annual audit, status of ongoing monitoring issues, and results of any on-site inspections; this document is referred to as a "risk profile." The Bundesbank subsequently provides this document to BaFin for consideration, as BaFin has the final

	decision on the adequacy of the document and the supervisory matters arising from the individual and collective profiles. In line with relevant CEBS guidelines,[58] the supervisory review and evaluation process is conducted in four layers: scope and classification; individual risk assessment; review and evaluation of ICAAP; and, supervisory measures. While the normal process is based on an annual review cycle evolving issues can prioritize both the review and oversight adjusting for risk in the system or in individual institutions. Every institution is subject to supervisory attention but the degree and frequency is adjusted according to the level of risk to financial stability as a whole. Depending on the results of the bank-by-bank analysis each institution is placed into a risk matrix system that comprises four risk or quality categories and three levels of systemic relevance. The resulting determination of where the institution fits in the risk matrix will then form the basis for future supervisory oversight, remedial actions that may be required and identifying issues that are emerging as concerns where additional information may be needed, areas that need immediate attention, or selecting themes for prioritization of audit requirements in the upcoming cycle. Supervisory materials provided to the assessors show that the risk profiles, and particularly those for the larger and/or more complex banks, are comprehensive. With regard to risk assessing individual institutions, the assessors note that the BVR and the DSGV have also instituted their own frameworks for risk-rating the associated cooperative, respectively savings banks. These risk ratings are linked to the protection schemes for all member banks, whereby institutions with a relatively weak rating are charged higher contribution payments and *vice versa*. These ratings that are periodically discussed with the supervisory authorities, thus provide individual institutions with a monetary incentive to improve their internal control and risk management practices. EC2—The monitoring and assessment of risks to the financial system is the task of dedicated structures within BaFin and the Bundesbank. BaFin has set up a dedicated unit, Directorate Q1 with the creation of the authority in 2002. This directorate currently has sections devoted to financial stability, risk analysis, financial instruments, and risks from the real economy. Most recently in 2010, a unit devoted to cross-institutional analysis was set up in BaFin's policy department. In 2009, the Bundesbank established a Financial Stability Department that has been tasked with the bottom-up analysis of potential contagion effects (including international as well as cross-sectoral aspects). In an effort to further improve the monitoring and analytical framework, BaFin and the Bundesbank have established a risk committee in 2009 that is designed to integrate the micro and macro elements of financial system oversight. The deliberations of the risk committee are typically based on analyses prepared by the structures described above, or on work of the risk committee's secretariat. Risks under consideration are added to a continuously updated list that also specifies for what institutions the relevant risk may be relevant, actions already undertaken and further actions to be taken; ultimately, this list informs the annual supervisory strategy of the German

[58] Guidelines on the Application of the Supervisory Review Process, issued on January 25, 2006, http://eba.europa.eu/getdoc/00ec6db3-bb41-467c-acb9-8e271f617675/GL03.aspx.

	banking supervisors. The assessors received materials explaining the mandate and mechanics of the risk committee have been provided. EC3—See description in EC1. EC4—The regulations governing the audit of annual accounts are quite clear on the responsibility of the external auditor to perform a detailed and through check on compliance with prudential standards and regulations. If any doubt remains the Bundesbank may perform its own inspection or BaFin may require a Section 44 of the KWG review conducted by an external party. EC5—Institutions are legally obligated to report substantive changes or material issues effecting its health or stability. EC6—Financial institutions file annual and monthly prudential information that form the foundation for an early alert system based on peer group comparisons. Ratios relating to market, credit, liquidity, earnings, asset growth, and other areas are compared to the peer groups defined by the Bundesbank. Quarterly returns containing balance sheet data are reviewed to determine unusual activity and any identified issues are forwarded to the line supervisor for follow-up and resolution. Experience has shown that the highly homogeneous savings bank and cooperative banks sector are particularly well suited to a statistically based analysis framework and form a viable part of supervisory oversight. In the case of regional banks and branches of foreign banks a statistical based identification system is less useful but still an important part of identifying potential soft spots. As a purely statistical process does not produce sufficiently useful insights in the case of the largest institutions—the institutions are to heterogeneous and the pool of data is too small—quantitative and qualitative assessment of the supervisor remain crucial. AC—Institutions are required to achieve and maintain an adequate risk management system in line with the nature and size of their business model. Oversight is conducted by BaFin and the Bundesbank and any blemishes contained in the risk management system itself or the institutions compliance with its own internal process can warrant an additional capital charge or lesser supervisory action depending on the nature, seriousness, or frequency of the fault. Capital add-ons must be tied to a fault in the risk management system and it would be difficult, if not impossible, to require additional capital charges for emerging risks that are not fully recognized and pose a clear and present danger. This said, the German banking system faces serious challenges with respect to the introduction of Basel III requirements and Basel liquidity rules as well as transitioning its Landesbank sector to a different business model or changes in the geographical limitations. While it is considered outside the remit of BaFin or the Bundesbank to deal with these issues alone, nevertheless, the potential for a spill-over to broader banking stability cannot be dismissed.
Assessment	Compliant
Comments	The supervisory approach provides a sound foundation for identifying and dealing with system wide and individual institutional problems. Supervisory staff is reasonably experienced and make balanced judgments regarding remedial actions needed in individual cases and identifying situations where follow-up is necessary.

	A guideline for the preparation of the risk profiles, issued by the supervisory authorities in June 2008, has been provided to the assessors (*Leitfaden zur Erstellung von Risikoprofilen für systemrelevante und nicht-systemrelevante Institute*). The assessors understand that an updated a further guideline (with a focus on the quantitative assessment of capital adequacy) has been prepared and de facto already forms the basis of ICAAP assessments since June 2010. Also, the supervisors have recognized that the resilience of business models should feature prominently in their risk assessments, and have incorporated this area in their supervisory strategy for 2011; in particular, the authorities intend to focus on, inter alia, the lack of profitability of certain banking businesses as well as increased risk-taking in investment banking Ensuring proper balance and proportionality of supervisory actions appears on the surface to be a matter that is reconciled at the Executive Director level or informally through discussions between lead supervisors. BaFin may wish to consider the development of a formalized "ladder" of actions, ensuring that timely and appropriate supervisory actions are taken, which are commensurate with the nature and seriousness of the identified issues (also see CP 23). Moreover, the use of rigorous stress tests as forward-looking tools, aimed at identifying vulnerabilities of individual institutions, needs to be more strongly embedded in supervisory practices (also see CP 7).
Principle 20.	Supervisory techniques. An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Description	EC1—The development of a yearly supervisory strategy and individual supervision plans for each institution embraces both on-site and off-site factors as well as input from the risk committee and macro-economic factors. Supervisory cooperation between BaFin and the Bundesbank is contained in the Prudential Supervisory Guidelines of 2008. The responsibility to carry out on-site visits to financial institutions by the Bundesbank is authorized in Section 7(1) of the KWG. There is a constitutional provision that requires proportionality in carrying out supervision of companies that applies to credit institutions as well. The consequence is a careful balancing act to ensure that oversight takes into account the institutions specific risk profile and its systemic place in the banking hierarchy. Powers to institute corrective measures are adequate. EC2—Each year at the end of October the Bundesbank outlines a schedule for the on-site inspections taking account of the risk profiles, the inherent stability risk to the system of each institution and the degree of urgency that any specific issue would need to be dealt with. This supervisory schedule includes the analysis of the audit performed by the external auditors on an annual cycle, supervisory discussions with individual institutions, and results of any special audits conducted under Section 44 of the KWG. After discussions with BaFin the schedule is finalized but may be amended as warranted and required. EC3—Supervisory work routinely requires a verification of the institutions implementation of the MaRisk requirements which relate to risk management controls and process. The yearly audits require verification of the accuracy of prudential returns. BaFin has power under Section 44 of the banking act to require special inspections where warranted and justified to gather additional information relating to

	general or specific risks both in individual banks or in a class of banks that are affected by the same issue. The supervisory authorities require strict follow-up of any supervisory measure imposed on an institution including hard guidelines for resolution and timing of remedial actions. EC4—The overarching monitoring of the financial system is conducted through a variety of measures including any documents, reports, and annual accounts submitted by the institution and thorough review of audit reports and results of routine and special supervisory exercises. The results of these reviews are carried through to the supervisory strategy for each institution where priorities are set and the scope of the inspection is determined. EC5—The Bundesbank, through its regional offices, meets at least annually with the senior management of every institution to discuss their comprehensive reports prepared by their annual auditors, as well as the risk profiles drawn up by the authorities who conducts many of the annual prudential discussions that are required. In consultation with BaFin, the Bundesbank representative may discuss actions that may be required if the deficiency does not rise to the level where a formal action is necessary; in the case of the latter, the final assessment would be made by BaFin, taking into account the Bundesbank's recommendations. BaFin can join the prudential discussions in those situations where it believes its presence is necessary and useful. In addition to the annual prudential discussion either BaFin or the Bundesbank may institute prudential discussions at any time. With respect to large and complex institutions dialogue between the banks and prudential supervisors is more frequent (if not continuous in the case of the largest and most complex institutions) and take place at many levels of the organization. This was confirmed in discussions with some of the institutions. EC6—Section 33 of the KWG affirms that BaFin is required to assess the professional qualifications and trustworthiness of managers of financial institutions during the licensing process. The quality of management is assessed on an ongoing basis through review of their annual audit reports. BaFin may require a Section 44 of the KWG audit if any doubt rises about a manager's qualifications. Under Sections 35 and 36 of the KWG BaFin may remove management for cause including willful or reckless violations of the banking act or disregard for safety and soundness through violation of rules or orders issued by BaFin. In February 2010, BaFin issued a guidance note pertaining to the fit and proper criteria as well as expertise testing of supervisory board members to implement the FMVAStärkG, which was enacted in August 2009. Supervisory boards are to be trustworthy and qualified to understand the risks engaged in by the institution to a level where they are in a position to require adjustments in risk monitoring, measurement, or oversight. Implementation is a work in process. EC7—BaFin places strong emphasis on institutions implementing adequate internal auditing policies and procedures in line with the risks inherent in each institution's business model. Compliance with Section 25a of the banking act and the requirements under the MaRisk guidelines are an area where external auditors of the annual financial statements are required to delve deeply to uncover any transgression of orderly internal oversight. Any deficiencies uncovered need to be reported immediately to the chairman of the supervisory board and BaFin. Results of the review of internal

	audit is incorporated in the risk profile and flagged as an area where the Bundesbank may wish to take a closer look at the next scheduled on-site visit or conduct a special audit. EC8—The Bundesbank conducts the annual prudential discussions with the managing board which includes elaboration on the individual banks risk profile, areas where improvements are expected, and the supervisors' view of strengths and weaknesses. BaFin may, of course, join in these annual meetings to convey or underscore any particular areas of interest where attention needs to be paid. AC1—According to Section 44 (4) of the KWG, BaFin can send and sends representatives to meetings of the supervisory boards of banks and their sub-committees; the Bundesbank has no legal right to participate, but employees of the Bundesbank can be deployed by BaFin. The German banking supervisors participated in about 700 meetings of supervisory and control bodies and their sub-committees between 2005 and 2010. Statistics provided to the assessors show that the supervisors' attendance was especially high at supervisory board members of institutions that required intensified supervision during the financial crisis. Attendance at the meetings of supervisory boards and their committees is an important information tool for the German banking supervisors. This tool is used selectively according to the risk situation and in order to complete information for upcoming prudential interventions.
Assessment	Compliant
Comments	BaFin and the Bundesbank rely on the external auditors to perform, on an annual basis, detailed checks of compliance with reporting and supervisory requirements and conformance with MaRisk guidelines. While this system can produce unhealthy time lags in identifying emerging supervisory concerns in a class of institutions, the regional offices of the Bundesbank, who are typically commissioned by BaFin to perform supervisory inspections on the basis of Section 44 of the KWG as well as BaFin, are competently staffed and intimately familiar with the institutions they supervise, permitting the early identification of any emerging threat to the collective or individual institutions they oversee. Additionally, the various risk committees in BaFin and the Bundesbank are capable of identifying broader threats to the system and adjust supervisory initiatives to deal with these threats.
Principle 21.	Supervisory reporting. Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
Description	EC1—Section 26(1) of the KWG requires institutions to submit the annual accounts along with a certification from the auditor, and the annual management report. Under Section 26(3) of the KWG these requirements are also operative at the consolidated bank level. The auditors must also submit specified data relating to detailed information on asset quality and loan loss provisioning. A monthly return is also filed with the Bundesbank containing information on the balance sheet and the P&L. Reporting on the adequacy of own funds is submitted quarterly but any capital shortfall would be required to be reported immediately. Separate monthly reports are filed with respect to adequacy of funds to meet payment and settlement obligations. *Ad hoc* reports are required when an institution meets or exceed the 10 percent limit on

	loans to a single borrower and loans that exceed EUR 1.5 million. The described reports are filed with the Bundesbank and are available electronically to staff of BaFin on an as needed basis or passed to BaFin if anomalies exist and are flagged by the Bundesbank. EC2—The financial reports submitted to the Bundesbank follow rules set out in the HGB and applicable to all companies. A regulation governing the financial statements of credit and financial services institutions is also relevant and was designed by BaFin and approved by the Ministry of Justice pursuant to EC rules which require some parent institutions to report under IFRS. Those institutions not required to file under IFRS may elect to do so. If the IFRS consolidated statements are used for prudential purposes it should follow the regulation regarding the procedure for calculation own funds as it contains prudential filters that incorporate CEBS and BCBS recommendations. EC3—The annual accounts are filed in accordance with the Principles of Proper Accounting (*Grundsätze ordnungsgemäßer Buchführung*). The basic principles are codified in the HGB, i.e., the "historical cost principle," the "item-by-item valuation principle," the "realization principle," the "imparity principle" and the "prudence principle." The principles, together with accompanying comprehensive accounting, valuation and provisioning rules, ensure that the annual accounts present a true and fair view of the net worth, financial position, and results of a company. EC4—The standard package of weekly, monthly, quarterly, and yearly reports filed with the Bundesbank are in line with the nature, size, and unique risk profiles of individual banks. Besides the customary reporting requirements that follow out of the COREP and FINREP frameworks[59] that harmonize reporting standards across Europe, the supervisory authorities have, in response to the financial crisis, imposed additional reporting requirements on credit institutions with systemic risks. Altogether, the additional reporting that is currently set[60] consists of (i) detailed liquidity reports accompanied by liquidity calls with the supervised institutions; (ii) monthly reports on the development of income, risk-weighted assets (credit, market, and operational risks), own funds and solvency ratio (tier 1-capital ratio and total capital ratio) both on a solo and consolidated basis and compared with figures for the respective period of last year; (iii) monthly reports on profit and loss from trading activities; (iv) monthly updates on institutions' capital and funding plans; (v) monthly reports on rating migration within the credit portfolio; (vi) quarterly MaRisk reports,

[59] COREP provides common reporting standards directed at institutions licensed in European member states covering, capital and solvency, credit, market, and operational risks (http://www.eba.europa.eu/Supervisory-Reporting/COREP.aspx), whereas FINREP deals with financial reporting (http://www.eba.europa.eu/Publications/Standards-Guidelines/CEBS-Revised-Guidelines-on-Financial-Reporting.aspx).

[60] At the outset of the crisis, reports had to be submitted on a more frequent basis. As conditions improved and institutions were able to put effective risk mitigants in place, the reporting frequency was somewhat relaxed.

	submitted by senior management to the institution's supervisory board members; (vii) quarterly reports on planned and concluded internal audits (once a year the major findings of all concluded internal audits of the FY); and (viii) all minutes of supervisory board meetings and, in advance, important papers prepared for these meetings Additional reporting requirements have been established for credit institutions that were heavily exposed to severe market and credit risks through structured finance products (for example, RMBS, CMBS, CDS, and CDO). The abovementioned additional supervisory reports are compiled, evaluated, and assessed by the regional offices of the Bundesbank and by the responsible supervisors at BaFin. The Bundesbank may propose to BaFin to take on supervisory measures in case these reports might hint to an evolving crisis at the institution or to severe violations of regulatory requirements for the proper management of credit, market, liquidity and/or operational risks set out in the MaRisk; the final decision on any supervisory actions/measures, though, solely rests with BaFin. EC5—Reporting requirements are standardized as to reporting periods, but comparability may be limited as a result of different valuation techniques. In important areas the supervisory agencies can ask for additional information on a standardized basis and often do so. There is also manual manipulation of data in some cases to attempt to harmonize reported figures to a more consistent format. EC6—There is no question that BaFin has the power under the KWG to request information from the company, members of the governing board, employees and associated enterprises relating to supervisory matters, which is broadly defined. BaFin may also request a special audit under Section 44 of the KWG to be carried out by an external party of the Bundesbank. BaFin's information gathering and inspection powers encompass external service providers, holding companies and enterprises included in the supervision on a consolidated basis. EC7—Section 44 of the KWG *et seq* provides BaFin with sufficient and adequate powers to gain access to all bank records. EC8—BaFin has adequate authority to enforce compliance with respect to content and timeliness in reporting of supervisory returns. The KWG offers various options for dealing with reporting deficiencies, depending on their nature and seriousness, ranging from the imposition of fines to measures against senior managers and the revocation of the banking license. BaFin may require institutions to correct inaccurate information. The German supervisory authorities are prone to act in situations where breaches of reporting requirements are frequent otherwise a reminder or a written warning will result in curative action. EC9—The integrity and reliability of information filed in prudential returns is to be checked as part of the annual audit, as per the PrüfbV. Auditors use the standard practice of determining materiality and employing the technique of random sampling. Any deviations noted with respect to completeness, timeliness, or accuracy must be noted in the auditor's report. In general the returns are scrutinized by the regional offices of the Bundesbank and any questionable returns may warrant referral to BaFin where a special audit can be ordered if warranted.

	EC10—Where audits are not carried out by BaFin or the Bundesbank staff supervisory authorities may use outside auditors or outside audit companies. Auditors must meet high professional standards, pass proper vetting procedures, and exercise their duties professionally, competently, and independently. The use of special audits is authorized under Section 44 of the KWG. Furthermore, Section 30 of the KWG allows BaFin to instruct the auditor of the annual accounts to focus on certain issues. Where BaFin commissions external auditors or staff of the Bundesbank to perform supervisory inspections, BaFin determines the exact scope of the work; if evidence arises during the course of an inspection that suggests that the scope should be amended, BaFin can direct the external auditors and or Bundesbank staff to do so. EC11—Section 29(3) of the KWG requires the auditor to inform the German supervisory authorities of any occasion where an audit will be qualified or an audit certificate withheld. External auditors are required to notify the authorities immediately if they becomes aware of facts which might (i) jeopardize the institutions existence or materially impair its development; (ii) constitute a major infringement of the provisions relating to the institutions' approval criteria or the pursuit of business under the KWG; or (iii) indicate that the senior managers have seriously infringed the lawarticles of association, articles of incorporation or partnership agreement. BaFin and the Bundesbank also have the right to request the auditor to explain their report and bring attention to any matter that would point to the institution not conducting its business properly.
Assessment	Largely compliant
Comments	Although the German framework for regulatory reporting largely meets the letter of this CP requirement, assessors identified multiple instances where the granularity of the information obtained via formal regulatory reporting was insufficient. To a large extent, BaFin has alleviated this weakness by requesting the systemically relevant institutions to report more detailed information on a more frequent basis. Reporting received in this fashion, often on the basis of institutions' internal management information, relates to, inter alia, liquidity positions (twice a week), trading P&L (monthly), funding plan updates (monthly), capital plan updates (monthly), MaRisk report, credit and market risks information (quarterly), planned and concluded audits (quarterly), and structured products (monthly). Although this additional information flow is helpful, assessors are of the opinion that BaFin should replace this reporting stream with a standardized, comprehensive framework that ensures timely reporting of a sufficiently granular nature on all material risks. In this context, it is noted that the German authorities are already in the process of preparing a major reform of the reporting framework, increasing both the granularity of the data that is to be submitted, as well as the frequency of certain submissions. Parts of the new standardized framework are expected to already become effective during the course of 2011.
Principle 22.	Accounting and disclosure. Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Description	EC1—Section 25(a) of the KWG requires institutions to have an adequate framework

	of financial control that is suitable and accurate; it is explicitly stated in the KWG that board members of institutions are responsible for the institution's proper business organization, including financial controls. The guidance on accounting and recordkeeping are contained in the HGB and the principles of proper accounting. If an institution fails to comply with the legal requirements BaFin may issue an order requiring appropriate remedial action. If the institution violates such an enforceable order it is a breach of administrative regulations that are punishable by a fine. BaFin can also take appropriate measure against the responsible individuals ranging from a warning to dismissal. EC 2—Under Section 242 of the HGB, board members are responsible for the content, adequacy, and accuracy of the annual accounting reports. Furthermore, financial institutions are required under Section 26 of the KWG to draw up their annual accounts for the previous year in the first three months of the current financial year, and submit their annual accounts, as approved, and the accompanying management report to BaFin and the Bundesbank. The accounts must be audited and certified by a competent external auditor and the audit certificate (or a note accounting for the withholding of such a certificate) has to be submitted to BaFin and the Bundesbank. Disclosure requirements are set out in the HGB. Failure to comply with timely filing of annual accounts or otherwise not fulfilling expected requirements is a breach of the administrative regulations and a fine may be levied by BaFin. EC3—The rules relating to valuations that are consistent, realistic, and prudent are in the hands of those responsible for developing and implementing the principles of proper accounting, which apply to all companies and by extension all banks. There is no evidence to conclude that BaFin or the Bundesbank have any method for influencing or flagging issues relating to accounting rules. As such, banks have a menu of options to choose in valuing assets including historical cost, item by item valuation, realization principle, imparity principle, or prudence principle. The regulations governing provisioning are likewise imbedded in the HGB and the accounting principles. Under EU directives institutions must show trading assets at fair value. Following guidance provided by the EU only distributable profits, net of provisioning, may be disclosed. EC4—Routine audit requirements relevant to scope are contained in Section 29 of the KWG with added detail in the regulations governing the annual audits of credit institutions. Power to instruct the auditor on specific items that BaFin may wish to be covered more deeply, are derived from Section 30 of the KWG: *"Notwithstanding the special duties of the auditor pursuant to Section 29, BaFin can also issue requirements vis-à-vis the institution regarding the contents of the audit, which the auditor must take into consideration when auditing the annual accounts. In particular, BaFin can determine focal points of the audits."* During the past years, BaFin has ordered the audits to focus on, inter alia, structured products, securitization exposures, valuation procedures, and the functioning of supervisory boards. EC5—The PrüfbV requires external auditors to assess and describe, inter alia , the institutions' approach to managing large exposures and loans to related parties (as laid down in Sections 13, 13a and 15 of the KWG); country related exposures and the method to monitor and manage these; noteworthy loans (including loans for which sizeable risk provisions are necessary); the underlying value of loans and the

	suitability of risk provisions; the quality of the underlying collateral and its likely realisability; and institutions' net asset position, including the nature and extent of off-balance sheets items and the nature and scope of hidden reserves and hidden losses. The PrüfbV contains no specific reference to asset valuations, trading positions or securitizations. Such items would, however, implicitly be included in the auditors' assessment of the adequacy of the risk management framework of credit institutions. EC 6—In line with Section 28(1) of the KWG institutions must immediately notify BaFin and the Bundesbank of the auditor selected to conduct the annual reviews. BaFin has a window of 30 days to reject the auditor and require the appointment of another if sufficient concrete and transparent grounds exist. Auditors may also be rejected under the HGB on grounds of conflicts or impartiality. As of December 31, 2010, BaFin can require changes in the auditor in charge if he or she did not adequately fulfill the role expected within one of the prior two years. At the time of the mission, this new power had not yet been tested in practice. EC 7—The accounting principles and rules are not within the purview of bank supervisors. The HGB contains detailed requirements for the presentation of annual accounts for corporations as well an added layer for credit and financial services institutions. A Regulation Governing the Financial Statements of Credit Institutions and Financial Services Institutions which was drafted by BaFin and approved by the Federal Ministry of Justice provides additional requirements pertaining to accepted accounting standards and practices for banks. Pursuant to EC regulations, a parent institution may be required to draw up its annual accounts in accordance with IFRS rules. If the parent institution is not required to file under IFRS rules it may, nevertheless, chose to do so. If the consolidated accounts are set up in accordance with IFRS principles then procedures for surrounding the annual accounts are applied only within the scope of the appropriate section of the HGB. The financial statements are subject to rigid audits performed by a German public auditor that must apply Institute of German Certified Public Accountants standards, which are in line with international standards. EC 8—Disclosure rules, similar to accounting rules, are the prerogative of the stock exchanges and the HGB. The requirements under Section 26(a) of the KWG are in line with EC directives that require qualitative and quantitative disclosure of own funds, capital adequacy and risk management procedures. By law, BaFin can issue specific guidance to correct deficiencies in disclosure practices. EC 9—Disclosure requirements for credit institutions are contained in the HGB and detailed accounting principles—because of their close connection with institutions' actual own funds—in the SolvV. The latter requires institutions to disclose for example, (i) the high level strategy and processes for each risk category; (ii) the structure and organization of risk management; (iii) the scope and nature of risk reporting; (iv) the hedging policies; (v) the structure of own funds; as well as (vi) certain quantitative and qualitative information on derivative and netting positions; credit, market, interest rate, operational, securitizations, and credit risks; and mitigation techniques. These requirements come on top of the disclosure requirements of the HGB relating to the consolidated annual accounts and management reports. BaFin is required to take into account the principle of proportionality and required information and disclosure is commensurate with the size and complexity of the institution.

	EC10—The Bundesbank monitors compliance with disclosure standards in particular those required under Section 5 of the SolvV. If compliance is lacking the Bundesbank will report the matter to BaFin for corrective measures. The auditor of the annual accounts must also verify that compliance with the Section 5 requirements is achieved by the institution. EC11—BaFin's annual report satisfies this criterion. AC1—Meetings with the banking committee of the German Institute of Certified Public Accountants are held annually along with members of the regional associations for savings and cooperative banks whom also act as statutory auditors for affiliated institutions. AC2—Section 29 of the KWG requires the auditor to report on a number of situations that could have serious detrimental effects on the institution or reflect questionable business practices. The auditor is held harmless for any inaccuracies of fact contained in a report filed in good faith. AC3—An external auditor may be excluded from an audit of a publicly traded company if he or she was responsible for the annual audit for seven consecutive years. AC4—In compliance with Section 26(a) 1 of the banking act every institution must have a formal disclosure policy. AC5—Supervisory authorities have no legal access to work products of the external auditor but in discussing issues which require elaboration the discussions may entail limited disclosure of work product information.
Assessment	Compliant
Comments	The supervisory authorities meet on a yearly basis with the Banking Committee of the German Institute of Certified Public Accountants (*Institut der Wirtschaftsprüfer in Deutschland e.V*), as well as – in the case of the savings – and cooperative banks – with the representatives of the Associations that also act as the statutory auditors of their affiliated institutions). Although there is limited ongoing oversight of the auditors by the supervisory authorities, BaFin has been granted (as of the end of December 2010) the authority to demand, under certain circumstances, the replacement of the auditor in charge. At the time of the mission, this new power had not yet been tested in practice. Also, it would seem that this new power has been demarcated rather strictly, as BaFin would have to demonstrate that *"the preceding audit, including the audit report, did not achieve the object of the audit".* Accounting rules do not fall under the purview of the supervisory authorities. The accounting rules allow for a menu approach to valuing assets. While this is not deemed to be a significant issue by the authorities, in part because of special reporting requirements for systemically relevant institutions and manual adjustments that permit more meaningful analysis, diverging valuation practices may inhibit consistency and can distort comparisons among the peer groups. BaFin and the Bundesbank may want to consider a more active role in encouraging a further standardization of accounting - and valuation practices, as they will have a significant bearing on regulatory capital and reserving requirements.

Principle 23.	Corrective and remedial powers of supervisors. Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Description	EC1—The ongoing framework of the supervisory process includes regular meetings with the management board and its chairman. The purpose of such meetings is to keep the managing board apprised of any relevant issues concerning the banking sector and the situation surrounding the condition of the institution. It is a basic principle under German law that administrative orders must be in writing. Follow-up of remedial actions is intense. EC2—An institution that incurs a loss of more than 25 percent of own funds, a fall in capital or liquidity below required minima, an acquisition of a qualified participating interest in an institution, the intention to merge with another institution, or an intention to terminate business is required to report these occurrences to BaFin and the Bundesbank in order to allow sufficient time to consider alternatives to effect an orderly resolution of a problem bank. A firm that is overextended or insolvent must immediately report to BaFin, who is the only one that may file an insolvency petition. EC3—BaFin has an arsenal of supervisory tools available to use in situations that require supervisory intervention. These measures range from simple administrative actions to the issuance of orders and ultimately the removal of managers for intentional or willful acts that violate orders or provisions of the banking act. *In extremis*, BaFin may revoke a license. BaFin may impose fines up to euro 500,000 for intentional breeches of the banking act. Some violations of the banking act may be considered criminal offences under Section 54 of the act. Punitive or corrective measures are subject to the principle of proportionality and each case must stand on its own merit with extenuating circumstances taken into account. While BaFin has an adequate array of supervisory tools at its disposal, the assessors note that the actual use of these formal powers in practice remains limited. According to the 2009 Annual Report of BaFin there were 141 cases of serious incidents, but only one fine was issued and only 10 formal actions were taken against managing directors, suggesting a very light touch in the enforcement area. BaFin has pointed out that the published statistics only refer to formal measures imposed and that, since BaFin is required under the German Constitution to avail itself of the mildest of all comparable measures, it often does not reach the stage where formal actions are taken. EC4—As mentioned above, BaFin has a broad range of powers to address various scenarios. Under the KWG, it can, inter alia, restrict business activities in cases of material organizational deficiencies, restrict or suspend the distribution of profits, issue instructions to managers, prohibit or restrict the acceptance of deposits and the granting of loans, and remove management and/or supervisory board members or transfer their powers to special commissioners. More recently, on August 1, 2009, the FMVAStärkG was enacted. Through this Act the early intervention powers of BaFin were strengthened. Other major legislative developments in Germany relate to the establishment of the German Federal Agency for Financial Market Stabilization and the accompanying Financial Market Stabilization Fund to support financial institutions that experience financial difficulties stemming from the financial crisis, and the

	RStruktG that introduced, inter alia, mechanisms for the orderly restructuring or resolution of troubled institutions. As a consequence of the enactment of the Restructuring Act, the KWG was amended, allowing BaFin—under certain circumstances—to order an institution to sell all assets or systemically critical business segments to another institution or a government owned bridge bank; it also allows BaFin to temporarily order the transfer of assets. EC5—BaFin has various powers to deal with the situation described. According to Section 45 of the KWG, BaFin may restrict or suspend withdrawals by the proprietors or partners, the distribution of profits, the amortization of reserves for showing a profit, or the granting of loans if an institution does not meet the requirements concerning own funds or liquidity or if there are facts, which warrant the assumption that the institution will fall below the minimum requirements in the foreseeable future. Prior to August 2009 BaFin was *de facto* not able to impose higher requirements concerning own funds or liquidity of an institution, in order, inter alia, to take account of risks not provided for in the SolvV or if there are extraordinary risks that threaten the institution's risk bearing capacity. The 2009 amendment of the KWG via the FMVAStärkG has greatly enhanced this power. EC6—Based on Section 36 of the KWG, BaFin can request the dismissal of managers and members of the supervisory board or prohibit them from carrying out activities. Section 56 of the KWG provides for the option of imposing fines of up to a maximum of EUR 500,000 on the institution itself or on its managers responsible for intentional or reckless breaches of the provisions of the KWG listed, or of orders issued by BaFin. AC1—Banking supervisory measures, with which the banking supervisors react to deficiencies at institutions, generally represent incriminating administrative acts. Unlike favorable administrative acts, against which proceedings for failure to act can be initiated three months after application if necessary, there are neither banking supervisory regulations nor general administrative law regulations applying to incriminating administrative acts. Instead, the intervention standards set out in the KWG generally grant BaFin a margin of discretion. In this context, authorities, unless obliged to act *ex officio*, can decide whether and when to implement administrative procedures after a due assessment of circumstances. However, limitations on the periods, in which BaFin may intervene, may arise from general legal principles or from the principle of proportionality. The law only establishes specific periods during which BaFin may take action in individual cases. For example, in accordance with Section 2c(1b) sentence 1 of the KWG, BaFin may prohibit the acquisition of a qualified participating interest only during a maximum period of 90 working days after submission of the full report if the conditions listed have been met. AC2—Section 46 of the KWG enables BaFin to take temporary measures in order to counteract dangers for the security of assets entrusted to the institution. BaFin may take any measure appropriate in the individual case to counteract the undesirable development. The non-exhaustive list in Section 46(1) sentence 2 no. 1-4 of the KWG sets out measures such as issuing concrete instructions to managers, prohibiting or restricting the acceptance of deposits and the granting of loans, prohibiting proprietors and managers from carrying out their activities, or limiting such activities, and appointing supervisors. BaFin may also prohibit or restrict payments to affiliated companies if these payments adversely affect the financial situation of the institution.

	In cases where there is a danger of insolvency, possible temporary measures in accordance with Section 46a(1) sentence 1 no. 1-3 of the KWG include a ban on sales and payments, closure of the institution for business with customers and a prohibition on accepting payments not intended for the discharge of debts to the institution. AC3—Due to BaFin being an integrated supervisory authority for all financial sectors, remedial actions in relation to a bank are internally communicated to and coordinated with every relevant department and Section that supervises an entity or a market that could be affected by these measures.
Assessment	Largely compliant
Comments	BaFin's suite of remedial and corrective powers is comprehensive. Nonetheless, BaFin seems to largely rely on informal (albeit, if necessary, strong) pressure being exerted by the banking supervisors through ongoing contacts with the supervised institutions. Although the assessors recognize the effectiveness of moral suasion and informal pressure being brought to bear, they are also cognizant of the inherent limitations of such instruments. Furthermore, the authorities need to stand ready to demand progressively stronger remedial action as the situation of a particular institution becomes more precarious, to which end it would be useful to have a more formalized "ladder" of actions. Such a ladder, even if it does not rely on simple quantitative criteria, would help resist pressure from special interest groups, promote appropriate consistency in the treatment of different banks, and contribute to public confidence in the ability of the authorities to preempt emerging strains in the financial system. Through the consistent and timely application of such a ladder, the supervisory authorities can ensure that timely and appropriate supervisory actions are taken, commensurate with the nature and seriousness of the identified issues.
Principle 24.	Consolidated supervision. An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Description	EC 1—The KWG covers a large number of reporting and submission requirements that allow BaFin and the Bundesbank to judge the structure of an organization as a whole at the group level. Documentation at the application stages for a banking license contains very granular information about participating parties and close associations. BaFin can refuse the license if the structure is opaque or it impairs effective supervision. Also, ongoing reporting requirements help the German supervisory authorities maintain current information on the structure of the group. Ad hoc notifications relating to an institution's participating interests must be filed (i) when an acquisition or termination takes place when participating interests reach 20 percent, 30 percent, and 50 percent of voting rights or capital; (ii) when an institution ceases to be or becomes a subsidiary of another enterprise; (iii) in the case of existence of, changes in or termination of a close association to a natural person or enterprise; (iv) in the case of acquisition, changes, or termination of a qualified participating interest in another enterprise; intention to merge; or (v) in case of establishment, relocation or closure of a branch in a non-EEA state or the commencement or termination of the provision of cross-border services without a branch. Annual notifications also capture an institutions close association to a natural person or enterprise, the institutions participating interest in other enterprises, and number of domestic branches. Under Section 24(3a) of the KWG, financial holding companies must annually submit an aggregated report of subordinated institutions, financial enterprises and ancillary

	services undertakings. BaFin must transmit a list of such holdings to competent authorities in other EEA states and to the EC. Lastly, institutions face regulatory reporting requirements on a consolidated level in relation to solvency, large exposure, adequacy of risk management, and outsourcing. For systemically relevant institutions the reporting requirements are expanded (albeit while a standardized, comprehensive framework that ensures timely reporting of data that is of a sufficiently granular nature is lacking) to earnings and other areas. EC2—BaFin has the power to request information and conduct audits on subordinate enterprises both domestically and cross-border as well as financial holding companies at the head of a financial group and members of the governing body of such groups. These powers are limited to monitoring the accuracy of regulatory reporting or verification of data that is necessary to effect supervision on a consolidated basis. BaFin cooperates with other competent authorities within the EEA including exchange of information necessary to carry out effective supervision. The identification and monitoring of group structures is essential to orderly supervision and the financial soundness of the institutions. BaFin tracks EEA supervisory requirements aligning supervisory power along structural lines. EC3—As previously explained, the KWG requires a viable and effective risk management framework on both a solo and consolidated basis and must take into account all material risks and covers the whole of the organization including entities that may not be subject to supervisory consolidation. EC4—Section 10a of the KWG sets out the scope of supervisory consolidation. Depending on the structure of the group there is a differentiation between groups of institutions and financial holding groups. The requirement of adequate own funds is directed at both individual banks and banking groups and compliance is monitored through the quarterly returns required. As regard to large exposures the standards and limits apply to individual institutions and exposures with a group of institutions or a financial holding group. EC5—BaFin and the Bundesbank cooperate fully with respect to meeting the objectives of Section 7 of the KWG. Details of the cooperative arrangements are contained in the Prudential Supervisory Guidelines. On the international front, Section 8 of the KWG sets out requirements for cooperation with relative authorities across the EEA and is consistent with the EU provisions set out in the CRD. BaFin also has numerous MoUs guiding cooperation with various overseas supervisory authorities. Supervisory colleges are in place for the major German banking groups. EC6—The range of activities groups of institutions or financial holding groups may conduct depends on the type of license the individual group entities hold. As long as the entities do not violate respective supervisory or prudential rules BaFin has no explicit powers to limit the group's activities or the locations in which they can operate. BaFin will, however, flag concerns if the business unit abroad encumbers supervision on a consolidated basis or if an institution cannot demonstrate a proper business organization. BaFin has the authority to give specific instructions to institutions that are appropriate and necessary for ensuring a proper business organization. In principle, such instructions could also entail the temporary termination of activities or businesses that are not properly managed.

	EC7—The banking act requires appropriate risk management controls on both a solo and consolidated basis. The requirement for sound risk management also pertains to cross-border activities. German banking supervisory authorities regularly review the adequacy and effectiveness of institution's and group's risk management through both on-site and on-site methods. If a case arises where risk management is less than satisfactory BaFin has adequate tools to effect corrective action. EC8—As previously stated, banking organizations must set in place a risk management system that is comprehensive and includes the full constellation of risks that the organization faces. Management and financial controls are extended enterprise wide and include units domiciled abroad. An institution's risk positions in overseas entities are included in the monthly returns. MaRisk requirements include provisions that management must ensure that risks arising from the group's activities are adequately communicated throughout the organization. Compliance is documented through the report on the audit of the annual accounts. The auditor must specifically state that the foreign branches are included in the risk management structure of the organization. BaFin has adequate supervisory tools to deal with issues of non-compliance. EC 9—BaFin lacks the authority to order the closure of a foreign office unless there is a serious breach of the institution's risk management and control environment. BaFin can require an institution to upgrade its risk management and failure to comply could rise to the level where closure of the office is the most expeditious way forward. If a deposit taking institution or a securities firm domiciled in another EEA member state opens an office in Germany and is not properly observing its obligations under Section 53b(3) of the KWG and the institution or the home supervisor fails to take proper curative measures or those measures fail to correct the deficiency that BaFin may take appropriate measures, up to and including prohibition of new business within Germany. BaFin however is not permitted to require closure of overseas offices or impose limitations on activities solely on the grounds of inadequate supervision by host supervisors. EC10—The enterprise is responsible for ensuring that the group has an adequate level of own funds sufficient to meet regulatory requirements and account for risks in the institution as a whole. AC1—Participating interests in banks by nonbanks are permitted under conditions set out in Section 2(c) of the KWG. Under Section 44 of the KWG the holder of the qualified participating interest is subject to the same obligation to provide information and documents to the supervisor as the institution itself. BaFin can prohibit the acquisition if (i) the buyer is not trustworthy or does not fill the requirements of a solid and prudent business man; (ii) the institution is not able to fill the supervisory requirements; (iii) the institution will be integrated into an enterprise group whose structure detracts from effective supervision; or (iv) the institution would be a subsidiary of a country where supervision is not effective. In cases where an acquisition takes place despite the objection of BaFin for the reasons stated above, BaFin can prohibit the holder of the participating interest from exercising voting rights or could transfer the voting rights to a trustee. With regards to fit and proper standards regardless of the ownership all institutions must have at least two fully qualified

	managers. AC2—Bank supervisory rules across the EEA are largely based on the CRD. The quality control aspects are in the hands of the EC and peer reviews conducted by CEBS. The supervisory regimes of the EEA countries are in principle consistent with German banking law. In other cases BaFin would assess the equivalence of the host supervisor. AC3—German supervisory authorities' on-site assessments are planned on a yearly basis and are mindful of the time gaps between visits. For internationally active banks the assessment plans are risk-based and the scope would include relevant overseas operations. The assessors understand that supervisors of the German big internationally active banks spend approx 30 percent of their time abroad, often in the United Kingdom, the United States, and Asia.
Assessment	Compliant
Comments	Consolidated supervision in Germany generally complies with this CP, with a notable exception. BaFin lacks the ability to require institutions to close an office in a jurisdiction that lacks adequate supervision or where secrecy provisions unduly hamper effective transmission of information to the home supervisor. Large German banks operate globally and have branches or subsidiaries in a number of places where information flows are not as robust as desirable and individual depositor information is rigidly protected. BaFin has entered into a number of supervisory arrangements intended to open gateways for information exchange but such arrangements usually permit only a general flow of broad information and it may still be difficult to gain timely insights into the institution's depositor relationships and safeguards that may be required in jurisdictions where money laundering may be an issue. The authorities may want to amend the German legislation in such a way that BaFin can require an institution to close foreign offices or impose conditions on their activities if oversight by the host supervisor is inadequate or if it cannot gain access to information that may be necessary for the performance of consolidated supervision. The authorities will need to remain vigilant to cross-institutional spill-overs, and the possibility that conglomerates adopt legal forms that hinder effective supervision and resolution.
Principle 25.	Home-host relationships. Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
Description	EC1—According to Section 8(3) of the KWG, the German supervisory authorities have to share "*all relevant and essential information required for the performance of supervision"* with competent authorities in the EEA when supervising cross-border institutions. The Section elaborates that "all information which may affect the assessment of an institution's financial situation in the EEA state in question shall be deemed to be essential information in this respect." In particular, this includes (i) information on the group structure, including all major institutions; (ii) procedures for the collection of information and the verification of that information; (iii) adverse developments in institutions or in other group entities which could seriously affect these institutions; and (iv) major sanctions or exceptional supervisory measures. The mandatory establishment of supervisory colleges has been anchored in German legislation through an amendment of the KWG that entered into force as of January 1,

	2011 (reference is made of the new Section 8e of the KWG). Moreover the new Section 9(1) of the KWG sentence 4 no 9 allows for information exchange with competent authorities and third countries in the context of colleges established according to the new Section 8e of the KWG. The German supervisory authorities recognize the importance of cross-border supervision and are actively involved in establishing supervisory colleges. At the time of the mission, the German supervisory authorities had established colleges for 18 institutions according to CRD requirements[61] and participated as host authorities in 25 European colleges chaired by other supervisory authorities. Guidelines from CEBS/EBA, relating to, inter alia, the effective functioning of colleges,[62] are carefully observed. EC2—BaFin, in cooperation with the Bundesbank, has to coordinate and distribute relevant information to the competent authorities in those cases where it is responsible for the supervision of a cross-border institution with an EU head office. The materials compiled by the authorities in the context of the mission illustrate the regular and *ad hoc* information exchange with regard to German institutions. The German supervisory authorities have signed MoUs to facilitate cooperation (including information sharing) with approximately 40 countries, including most of the EEA authorities. In the case of 'formal' colleges, written agreements (as per the CEBS/EBS template[63]) about the functioning of the college are in place. In practice, written agreements and MoUs entered into with foreign supervisory authorities are in practice communicated to the supervised institutions as a matter of faithful cooperation. There are, however, no legal provisions stipulating that this is necessary. Relevant MoUs are published on BaFin's website.[64] A particular issue that is surfacing in Germany, but is of broader relevance within the EEA member states, relates to the assessment of the equivalence of third countries' confidentiality provisions. The German authorities are currently awaiting decisions by CEBS/EBA as to the equivalence of certain countries, to be determined on the basis of the methodology published on June 15, 2010.[65] As per the methodology, participation of competent authorities from non-EEA member states is not possible at long as the equivalence of confidentiality provisions of a non EEA country has not been agreed between all college members. CEBS/EBA is currently investigating possibilities to establish secure, web based portals that could be used within supervisory colleges to greatly enhance information

[61] The German authorities have established colleges for each banking group headquartered in Germany which has at least one subsidiary or two relevant/significant branches in another EEA country.

[62] http://www.eba.europa.eu/Supervisory-Colleges/Publications.aspx.

[63] http://www.eba.europa.eu/Supervisory-Colleges/Publications/CEBS-today-received-a-call-for-technical-advice--s.aspx.

[64] http://www.bafin.de/cln_179/nn_721404/EN/BaFin/International/MemorandaofUnderstanding/memorandaofunderstanding__node.html?__nnn=true.

[65] http://www.eba.europa.eu/Supervisory-Colleges/Publications/CEBS's-methodology-for-the-assessment-of-the-equiv.aspx.

	sharing on a 'real time' basis. While this work is ongoing, the German supervisory authorities have been pursuing a strengthening of their own IT capacities in this area; given the current status of the work, is may be possible to start testing the new secure web platforms for three colleges in the first half of 2011. EC3—In accordance with Section 8(3) of the KWG, the following information should be shared with other competent EEA authorities (i) information on the group structure as well as the framework of supervision in which the group operatesl (ii) significant developments in certain institutions or other group entities which could seriously affect these institutions; and (iii) extraordinary or severe supervisory measures that BaFin has taken according to the rules of the KWG. In terms of information provided as home supervisor to host supervisors, the relationship with EEA supervisors is determined by the CRD requirements and the new requirement to agree a joint risk assessment and capital adequacy decision with other EEA supervisors annually from 2011.[66] In the case of one systemically relevant German banking group, the supervisory authorities have 'field-tested' the so-called "joint risk assessment and decision" process[67] during the course of 2010; the result of this field-test have been incorporated in the final JRAD guidelines that were published in December 2010.[68] Through this process, consensus was reached with host country supervisors as to the sufficiency of the institution's current capital position. From 2011 onward, all colleges for which the German authorities are home supervisors will conduct the JRAD process according to the current guidelines. EC4—In terms of the information provided as host supervisor to home supervisors, the relationship with EEA supervisors is, again, determined by the CRD requirements and the new requirement to agree a joint risk assessment and capital adequacy decision with other EEA supervisors annually from 2011. In 2009 BaFin was host supervisor for 167 cross-border institutions. The competencies of BaFin as host supervisor are stipulated in Sections 53, 53a and 53b of the KWG. Section 53b(4) of the KWG establishes a cooperative procedure between BaFin and the home supervisor. In the case of material problems or deficiencies, particularly regarding liquidity, BaFin shall *"request the institution to rectify the shortcomings within a specified period."* If the institution fails to comply with this request, BaFin notifies the home supervisor. If the home supervisor fails to take any measures or if its measures

[66] Relevant guidelines on this so-called JRAD process were published by CEBS/EBA on December 22, 2011. http://www.eba.europa.eu/News--Communications/Latest-news/CEBS-s-Guidelines-for-the-joint-assessment-and-joi.aspx.

[67] Article 129 (3) of the CRD, as amended, requires that the consolidating supervisor and supervisors of subsidiaries involved in the supervision of an EEA cross-border banking group do everything within their power to reach a joint decision on the application of the Pillar 2 provisions related to the ICAAP and to the Supervisory Review and Evaluation Process. The joint decision should cover the adequacy of the consolidated level of own funds held by the group with respect to its financial situation and risk profile, as well as the required level of own funds above the regulatory minimum, applied to each entity within the group. These tasks should be carried out within each college of supervisors established in accordance with the CRD and operating under the framework developed by CEBS/EBA. Formal guidelines for this so-called JRAD process were published on 22 December 2010, following a consultative document issued in April 2010. http://eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/JRAD/Guidelines.pdf

[68] http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/JRAD/Guidelines.pdf

	prove insufficient, BaFin can take the necessary measures. In this case, BaFin can ultimately prohibit the conduct of new business in Germany. In 2009, 80 branches of EEA banking groups were registered in Germany. For branches and subsidiaries of EEA headquartered banks, the supervisory competencies of BaFin are stipulated in Section 53b of the KWG which refers to numerous other provisions of the KWG. In the latter case, BaFin can exercise nearly the same regulatory powers as for German branches and subsidiaries. In addition to ongoing information exchange on a bilateral basis between BaFin as host supervisor and the home supervisor, some extended multilateral home-host cooperation is established by the new provision of Section 8e of the KWG which formalizes the cooperation between host and home supervisors in supervisory colleges. EC5 German branches and subsidiaries of foreign institutions are subject to similar prudential supervision as national institutions. The applicable legal provisions for subsidiaries of foreign banks are Sections 53, 53a and 53b of the KWG. In accordance with Section 53b of the KWG (implementing article 40 (1) of Directive 2006/48/EC), the principle of home state supervision applies to branches of institutions based in EEA member states, whereby BaFin and the Bundesbank retain several competencies, inter alia, regarding liquidity, reporting requirements, rights of access to data, and suitable arrangements for managing, monitoring and controlling risks. EC6—The provisions of the KWG on licensing (in particular Section 33(1) sentence 1 no. 8 of the KWG) state that a license shall be refused if the applicant is a subsidiary of a foreign credit institution and the competent supervisory authority for this credit institution has not given its consent to the establishment of the subsidiary. Section 33b of the KWG stipulates cases where the competent home state authority within the EEA is to be consulted before granting a license. BaFin can refuse granting a banking license in accordance with Section 33(3) of the KWG if effective supervision of the institution is impaired due to the legal or administrative regulations of a third state or if no effective supervision is exercised in the state in which the institution's head office is domiciled or if the foreign supervisory authority is not prepared to cooperate satisfactorily. EC7—The supervisory authorities of a foreign institution's home country are regularly granted the right to audit branches and subsidiaries of foreign institutions in Germany on the basis of existing MoUs, to the extent that the granting of reciprocal audit rights is ensured and that the matter is discussed with the BaFin in advance. Section 53b(6) of the KWG expressly grants foreign supervisory authorities in the EEA member states an audit opportunity after prior notification of BaFin. Additionally, Section 44a(2) of the KWG allows BaFin to permit banking supervisory authorities from other EEA-states—and if reciprocity is granted also non-EEA states—to check the accuracy of data transmitted by a German enterprise to certain enterprises abroad, if the transmission of data is necessary to comply with the prudential provisions applicable to the enterprise domiciled abroad. Although, as highlighted above, BaFin will seek the views of the home supervisor of an institution wishing to establish a licensed subsidiary in Germany, the assessors have - in the case of institutions from non EEA member states, not seen evidence of formalized, detailed assessments of the supervisory regime (including banking secrecy provisions), its supervisory practices and the quality, and quantity of its supervisory resources, prepared to determine the degree to which the German authorities can 'rely' on their work. In the case of an institution incorporated in another EEA member

	state, an assessment of the effectiveness of the global consolidated supervision of the home state supervisor is of less relevance because of the overriding assumption that the home state's supervisory regime is based on the same EU legislation, and thus comparable with that of Germany. EC8—The BaFin does not permit the establishment of shell banks within Germany. The FATF report on the Mutual Evaluation of Germany explains that while there is no statutory prohibition on such entities, the possibility of creating a shell operation is precluded through the licensing and supervisory processes, which require that licensed institutions have, among other things, an appropriate organizational and management structure. The FATF assessment team has found no evidence to suggest that the BaFin's licensing regime has failed to prevent the creation of shell banks within the jurisdiction. EC9—According to Section 8(8) of the KWG, BaFin informs other competent authorities about supervisory actions it intends to take relating to an incident about which it was informed by the other authority. If BaFin takes unusual or significant supervisory actions, it generally—even if there is no legal requirement to do so—consults with the competent authority or authorities in the EEA. Furthermore, in the case of an emergency situation, which potentially jeopardizes the stability of the financial system in any EEA member state in which an institution supervised by BaFin is domiciled, BaFin is required under Section 8(7) of the KWG to promptly inform the Bundesbank and the BMF. AC1—According to the new Section 8e(3) of the KWG, BaFin has to inform all members of a college on an ongoing basis about the relevant measures of its supervisory activities. The communication between home and host supervisor in colleges is developed according to a written agreement which also entails provisions about the communication strategy between host and home supervisor. The strategy of the college takes the scope and nature of the cross-border operations of the bank or banking group into consideration.
Assessment	Largely compliant
Comments	Effective cooperation between competent supervisors of both EEA and non EEA member states is an important precondition for the supervision of banking groups that are active on a cross border basis. The relevant practices and guidelines for such cooperation are evolving rapidly and the German supervisory authorities are doing their utmost to incorporate the relevant practices in their supervisory approach; the assessors note that the German authorities have faithfully implemented all relevant EU legislation, as well as the relevant international standards from EBA and BCBS and have continuously increased the home-host relationships with numerous countries, as reflected in a sizeable amount of MoUs signed and a rising number of joint inspections/assessments. Important next steps for Germany will be to extend and deepen the cross-border cooperation with relevant competent authorities for the various colleges that have been established, to establish efficient and secure channels for information sharing ensuring a swift information 'delivery' to all relevant authorities, to further increase the joint work performed with other home- and/or host supervisors and to prepare and agree joint recovery and resolution plans for the German global systemically important financial institutions. Based on conversations with market participants, the assessors understand that while participants are generally positive when it comes to the cross-border cooperation between supervisors, there remains room for improvement, particularly with regard to

	preventing supervisory overlap and ensuring that relevant information is shared effectively and swiftly amongst supervisors, thus limiting ad hoc requests from individual supervisory agencies. The assessors, however, have no doubt as to the willingness and ability of the German supervisory authorities to continue developing effective relationships with other competent supervisors. More in detail, the German authorities are recommended to create a formalized, detailed framework for assessing the supervisory regime of competent authorities from non EEA member states, allowing them to reach comprehensive conclusions as to the level of reliance that can be placed on such authorities.

Appendix 1—Recommended Action Plan of the BCP Assessment from the 2003 FSAP

Materially noncompliant and no action underway to achieve compliance

77. **CP 5 Investment criteria.** The authorities should set criteria for both pre-notification and information-after-the-event for significant acquisitions and investments conducted by credit institutions. The criteria should take into account the character, size, organization, and capabilities of the acquiring institution as well as the type, riskiness, and size of the acquired asset. The "test" conducted by BaFin should only imply that the acquiring institution has the necessary resources, skills, and organizational capacity to handle the acquisition without undue risk.

78. **CP 10. Connected lending.** The authorities should implement stronger rules on connected lending to minimize the risk of a related party abusing a credit institution. This includes procedures to ensure that loans are granted without any undue influence from interested parties; that the endorsement procedures at the managing and supervisory boards are tightened; that the management, monitoring, and reporting—to the management and supervisory boards—of the loans and transactions with connected parties is conducted in a separate dedicated unit; and that reporting to the supervisory authority is more detailed and frequent than at present.

Largely compliant, and measures underway to achieve compliance

79. **CP 11 Country risk.** Introduce more frequent and more detailed reporting of country and transfer risks. This is planned to be introduced in the prudential reporting statements of September 2003.

80. **CP 16 On-site and Off-site supervision.** Strengthen the resources and skills of BaFin and the Bundesbank in order to increase their role in onsite supervision. Implement various measures to enhance proactive supervision. BaFin and the Bundesbank have recently hired some 400 additional staff and 600 more staff is earmarked for hiring as the banking supervisory authorities bolster their resources in view of its responsibilities and prepare for Basle II implementation. An ambitious training program for new staff is already underway.

81. **CP 18 Offsite supervision.** Implement a structured framework for peer review, early warning indicators or similar process for a systemic evaluation of banks' performance. The banking authorities have started to develop a structured automated system that may address this weakness, however, there is no current timetable for implementation.

Largely compliant, but no measures underway to achieve compliance

82. **CP 1(2) Independence.** Clarify in law, or otherwise, the scope of the right of the Ministry of Finance (MoF) to issue instructions to BaFin. Terminate the right of the MoF to be involved in decisions regarding internal procedures of the BaFin. Clarify the status of the

President of BaFin in relation to the rules for high civil servants when it comes to dismissal. Amend the law so that the reasons (those given in the Civil Service Act) for the dismissal of the President of BaFin must be publicly disclosed.

83. **CP 13 Other risks.** Issue guidance papers (or use some other method to achieve similar results) in order to establish risk management practices and standards that are commensurate with a bank's size, complexity, and risk profile. This applies, inter alia, to liquidity, overall interest rate, and operational risks. Strengthen the role and responsibilities, and thus the competencies, of the supervisory boards.

84. **CP 20 Consolidated supervision.** Group-wide supervision should also include the supervision of nonfinancial entities, including a holding company, to the extent they may pose risks to the banking group.

85. **CP 22 Remedial action.** Set explicit standards to mitigate against the risk of supervisory forbearance. These could be concrete, such as a requirement to act within a specified time limit if the capital adequacy ratio falls below the statutory minimum level. They could also be indirect, such as a legal provision to the effect that the Head of the BaFin must ensure that action in all cases are taken promptly, taking into account the specific situation.

86. **CP 24 Home country supervision.** Implement a rule to the effect that branches of foreign banks cannot be licensed in Germany in cases where the German supervisors are not assured that they will receive all information, which is necessary for supervisory purposes, even if it is classified as confidential in the home country. It should also be possible to refuse to grant a license in the cases where the home supervisory authority does not guarantee full cooperation, or when the German authority deems the home authority not capable of conducting adequate supervision on a consolidated basis.

Table 4. Recommended Action Plan to Improve Compliance of the Basel Core Principles, 2003

Reference Principle	Recommended Action
CP 1(2) Independence	Clarify scope of political powers in relation to BaFin
CP 5 Investment criteria	Strengthen rules for prenotification of acquisitions
CP 10 Connected and related lending	Strengthen rules to grant and to monitor loans to related parties
CP 13 Other risks	Issue guidance rules for “sound practices”, e.g., for liquidity, interest rate, and operational risks.
CP 16 On-Site and Off-Site supervision	Implement measures to ensure proactive identification and treatment of weaknesses in institutions.
CP 18 Off-Site supervision	Establish a structured framework for systemized analysis.
CP 20 Consolidated supervision	Include nonfinancial entities in group-wide supervision
CP 22 Remedial measures	Introduce explicit rules to ensure prompt corrective action, in particular in severe cases.
CP 24 Host country supervision	Amend legislation so that BaFin may refuse licensing branches when home country supervisory cooperation cannot be guaranteed.