

Germany: Report on the Observance of Standards and Codes (ROSC)

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GERMANY

Report on Observance of Standards and Codes

Prepared by the Monetary and Capital Markets and European Departments

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This report presents the Report on Observance of Standards and Codes (ROSC) for the financial sector prepared in connection with the IMF Financial Sector Assessment Program (FSAP) Update mission, which visited Germany in January–February 2011. The authorities have commented on these reports and the underlying detailed assessments, and their reactions are included. The FSAP team who worked on preparing these assessments comprised Messrs. Brockmeijer (Head), Bologna, Hardy, Kazarian, Kiff, and Verkoren, and Ms. Sylvester (all MCM), Mr. Parente (Italian Insurance Supervisory Authority), Mr. Rodgers (former Executive Director and Acting Commissioner of the Australian Securities and Investments Commission), and Mr. Ryback (former Special Advisor 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). The mission appreciates the cooperation received from the authorities.

The ROSC covers the Basel Core Principles for Effective Banking Supervision (BCP); the International Association of Insurance Supervisors (IAIS) principles for insurance regulation; the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation; and the Committee on Payment and Settle Systems (CPSS) and IOSCO Recommendations for Central Counterparties (CCPs).

In general, the level of observance of these standards is very high, and most of the enhancements suggested in the 2003 assessment have been put in place. The authorities are aware that the size and sophistication of the German financial system demand that the supervision go beyond the standards, and they are working to make further improvements, especially those needed to implement the regulatory and financial policy initiatives that have been occasioned by the global crisis. The crisis showed that more timely information, additional on-site supervision, and follow up through forward-looking supervisory action are needed.

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BaFin	German Federal Financial Supervisory Authority <i>(Bundesanstalt für Finanzdienstleistungsaufsicht)</i>
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles
BCM	Business continuity management
BMF	Federal Ministry of Finance
CP	Core Principles
CCP	Central Counterparty
CIS	Collective investment schemes
CPSS	Committee on Payment and Settle Systems
CRA	Credit rating agency
CRD	Capital Requirements Directive
CSD	Central securities depository
DVP	Delivery versus payment
EBA	European Banking Authority
ECC	European Commodity Clearing
EEA	European Economic Area
ESA	Exchange Supervisory Authorities
ESMA	European Securities Market Authority
EUR	euro
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
IAIS	International Association of Insurance Supervisors
IAS	International Auditing Standard
ICP	Insurance Core Principles
ICSD	International central security depository
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commission
MAD	Market Abuse Directive
MiFID	Markets in Financial Instruments Directive
MOU	Memorandum of Understanding
MMOU	Multilateral Memorandum of Understanding
MTF	Multilateral trading facilities
OTC	Over the counter
RCCP	Recommendations for Central Counterparties
ROSC	Report on Observance of Standards and Codes
SRO	Self regulatory organization
TSO	Trading surveillance office
USD	United States dollar
VAG	Insurance Supervision Act

I. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. Summary

1. **In general, the level of observance of the BCP is high, even though specific weaknesses remain.** The authorities are aware that the size and sophistication of the German financial system demand that the supervision goes beyond the minimum standards, and they are working to make further improvements, reflecting regulatory and financial policy initiatives occasioned by the global crisis. The detailed assessment shows, *inter alia*, that microprudential supervision needs greater emphasis—also on a forward-looking basis—on capital adequacy, and highlights a need for more pro-active on-site supervision and improved data gathering. Further, the authorities need to stand ready to demand progressively stronger remedial action as the situation of a particular institution becomes more precarious; to this end it would be useful to implement a more formalized “ladder” of supervisory actions.

B. Information and Methodology Used for the Assessment¹

2. **This assessment was performed on the basis a study of the legal and regulatory framework, a self-assessment prepared by the German authorities, and detailed discussions with key stakeholders.** Discussions were held with government representatives, the German Federal Financial Supervisory Authority (BaFin), the Bundesbank, the Association of German Banks (*Bundesverband Deutscher Banken*), the German Savings Banks Association (*Deutscher Sparkassen- und Giroverband*), the National Association of German Cooperative Banks (*Bundesverband der Deutschen Volksbanken und Raiffeisenbanken*), and private sector participants in the banking and financial markets. 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 commented on a draft version of this assessment, which are reflected in the final version.

3. **The assessment has been conducted in accordance with the Core Principles (CP) Methodology published in October 2006 by the Basel Committee on Banking Supervision (BCBS) and involved a qualitative assessment of each CP.** It assessed compliance with both the “essential” and the “additional” criteria, but assigned ratings solely on the basis of compliance with the “essential” criteria. The assessment has been prepared on the factual situation at the time of the mission, but the assessors have taken notice of regulatory initiatives that were in train but had yet to be completed or implemented.

¹ The assessors were William Ryback (external expert) and Constant Verkoren (IMF, Monetary & Capital Markets Department).

C. Institutional and Macroprudential Setting and Market Structure

4. **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. 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.

5. **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 when 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 this sector remains outstanding.

6. **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. At the time of the mission, the health of the financial sector had stabilized via strong policy support, channeled through exceptional measures. Financial stresses have meanwhile abated but pockets of vulnerability remain and the restructuring process for the weaker institutions is yet to be completed.

D. Preconditions for Effective Banking Supervision

7. **Germany has a solid institutional framework supporting the conduct of sound macroeconomic policies.** Monetary policy is conducted within the European System of Central Banks framework. Budgetary policy is conducted within a fiscal framework based on predefined rules and within the requirements of the European Stability Pact.

8. **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 Capital Requirements Directive).

9. **The structure of financial institutions in Germany is governed by company law; i.e., the German Commercial Code (*Handelsgesetzbuch*) and various other laws.** Furthermore, corporate governance requirements have been laid down in the German Corporate Governance Code (*Deutschen Corporate Governance Kodex*), adopted in February 2002.

10. **German-listed companies have been required to apply International Financial Reporting Standards (IFRS) since 2005.** There is a full range of high-quality accounting, legal, and ancillary financial services available in the jurisdiction. The German legislative framework contains various safeguards with regard to disclosure and transparency. As part of its responsibilities for securities market supervision, BaFin is to maintain fair and transparent conditions in markets.

11. **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, consisting of schemes that are mandatory for all banks, as well as voluntary schemes to provide additional arrangements and guarantees for its members. Furthermore, on January 1, 2011 the Restructuring Act (*Restrukturierungsgesetz*) came into effect, providing mechanisms for the orderly restructuring or resolution of troubled institutions. As a consequence of the enactment of the Restructuring Act, BaFin is currently allowed—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.

E. Main Findings

12. **The current assessment confirms a high degree of compliance with the BCP, but highlights a number of weaknesses that need to be addressed.** The German authorities have enhanced their supervisory framework since the 2003 FSAP, acting on recommendations made at that time and initiating improvements 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. Although weaknesses remain, the supervisory authorities are in a number of cases already in the process of addressing them.

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

13. **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.** The independent character of BaFin is clearly anchored in the legislative framework; BaFin is clearly mandated to decide on individual cases without having to consult the Federal Ministry of Finance (BMF) or other government

bodies; and BaFin is not reliant on government funding. There is, however, room for improvement with regard to the protection of the position of the President and Executive Directors of BaFin. Furthermore, additional steps are necessary to safeguard the legal protection of the authorities as well as staff that are not designated as civil servants (whose protection solely stems from the Collective Agreement for the Public Service, and is not anchored in formal legislation).

Licensing and Structure (CPs 2–5)

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

Prudential Regulation and Requirements (CPs 6–18)

15. **While it is acknowledged that the capitalization of the German banking sector has seen an upward trend during the past years, the assessment highlights weaknesses in the supervision of capital adequacy.** BaFin’s legal powers to impose higher capital requirements has been expanded and specified through the enactment of new legislation 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. Moreover, the use of stress tests as instruments to closely scrutinize the capital adequacy of individual institutions needs to be further enhanced and efforts to improve the quality of capital need to be intensified. 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.

16. **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 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 profile.

Methods of Ongoing Banking Supervision (CPs 19–21)

17. **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 systemically relevant institutions to report more detailed information on a more frequent basis. Although this additional information flow is helpful, this reporting stream should be replaced 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 (CP 22)

18. **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. Furthermore, the new regulatory power to demand a change of the responsible auditor, granted to BaFin at the end of December 2010, had at the time of the mission not yet been tested in practice.

Corrective and Remedial Powers of Supervisors (CP 23)

19. **Although BaFin’s suite of remedial and corrective powers is comprehensive, it needs to stand ready to demand progressively stronger remedial action as the situation of a particular institution becomes more precarious.** Therefore, it would be useful to implement 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)

20. **The supervisory authorities have established multiple supervisory colleges as per Capital Requirements Directive (CRD) requirements, and are continuously strengthening supervisory relationships with relevant competent authorities, both from the EU and European Economic Area (EEA) and non-EEA countries.**

Appropriate Memoranda of Understanding (MoUs) and written agreements, reflecting European Banking Authority (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. Moreover, supervisory cooperation has been improved through—inter alia—supervisory colleges and regular bilateral contacts. 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 amongst supervisors.

Table 1. Summary of Compliance with the Basel Core Principles

Core Principle	Comments
1. Objectives, Autonomy, Powers, and Resources	See below
1.1 Responsibilities and Objectives	<p>The mandates of both BaFin and the Bundesbank are clear and publically disclosed. Arrangements for the ongoing cooperation have been laid down in an 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.</p> <p>At the time of the mission, previous plans to merge BaFin into the Bundesbank had been abandoned, due to constitutional constraints.</p>
1.2 Independence, Accountability, Transparency	<p>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.</p>
1.3 Legal framework	<p>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 proper consultation takes place before new rules are issued. The approach complies with this CP.</p>
1.4 Legal powers	<p>BaFin’s suite of remedial and corrective powers is comprehensive. However, BaFin lacks a formalized “ladder” of actions, ensuring that appropriate and timely supervisory actions are taken, commensurate with the nature and seriousness of the identified issues. Also see CP 23.</p>
1.5 Legal protection	<p>In general, the legal protection for banking supervisors being civil servants is sufficiently safeguarded. There remains some</p>

Core Principle	Comments
	legal uncertainty as to the legal protection of staff members that are not classified as civil servants, as their current liability protection is not stemming from formal legislation but from the Collective Agreement for the Public Service. Additionally, the authorities themselves 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	Appropriate arrangements for information sharing between supervisors and protecting the confidentiality of such information are in place.
2. Permissible Activities	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	Appropriate provisions for the licensing of banks are in place.
4. Transfer of Significant Ownership	BaFin 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.
5. Major Acquisitions	German legislation does not provide for the authority to review and (dis)approve such participations ex ante.
6. Capital Adequacy	<p>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. Yet, 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 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.</p> <p>The importance of strong supervision in this area is underscored by the relatively weak capital position of a number of institutions, as well as the prospective challenge of meeting Basel III standards.</p>
7. Risk Management Process	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 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

Core Principle	Comments
	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	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 asset classifications, provisioning et cetera may hamper consistent comparisons by the supervisory authorities across German institutions.
9. Problem Assets, Provisions and Reserves	For example, the lack of standardized criteria for 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	The possibility to retroactively approve large exposures undermines the effectiveness of the supervisory framework, as it restricts to possibilities to reject the relevant loan, or to attach conditions to it.
11. Exposures to Related Parties	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 possibility to reject the relevant loan, or to attach conditions to it.
12. Country and Transfer Risks	The German supervisory framework for 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 and effectively monitor and manage all risk concentrations.
13. Market Risks	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 on contingency planning.
14. Liquidity Risk	The framework for liquidity risk supervision should be improved, incorporating, inter alia, reporting requirements for other currencies than euros. Supervisory inspections of liquidity risk

Core Principle	Comments
	management should be increased, using the recent enhancement of the MaRisk requirements as a catalyst.
15. Operational Risk	Although the German supervisory framework with regard to operational risks largely meets the requirements of this CP, the area of IT risks has remained underexposed in supervisory practice.
16. Interest Rate Risk in the Banking Book	The current approach to interest rate in the banking book complies with the relevant BCP. 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 predefined parallel interest rate shift—is deemed to be a welcome enhancement.
17. Internal Control and Audit	The German supervisory framework with regard to internal control and audit meets the requirements of this CP.
18. Abuse of Financial Services	At the time of the FSAP mission, Germany was in the process of implementing enhancements to the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) legislation, addressing the deficiencies previously raised by the Financial Action Task Force (FATF). Moreover, given the high risk of Germany’s financial markets being misused for purposes of money laundering and terrorist financing, the German authorities should 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	<p>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.</p> <p>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.</p>
20. Supervisory Techniques	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. These detailed assessments are supplemented by supervisory inspections, typically performed by 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	Assessors have identified multiple instances where the granularity of the information obtained via formal reporting was

Core Principle	Comments
	<p>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.</p> <p>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 already become effective during the course of 2011.</p>
22. Accounting and Disclosure	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	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. BaFin lacks, however, 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	Consolidated supervision in Germany generally complies with the requirements of this CP.
25. Home-Host Relationships	The German authorities have sought to implement all relevant EU legislation, as well as the relevant international standards from the EBA and the BCBS. 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. Important next steps for Germany will be to extend and deepen the cross-border cooperation with relevant competent authorities; to establish efficient and secure channels for information sharing, ensuring a swift information "delivery" to all relevant authorities; to further increase joint work performed with other supervisory authorities; and to prepare and agree joint recovery and resolution plans for the German global systemically important financial institutions.

F. Recommended Action Plan and Authorities' Response

21. The following recommendations aim to suggest measures to further improve the banking supervision and regulation.

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

Reference Principle	Recommended Action
Objectives, Independence, Powers, Transparency and Cooperation (CP1)	<p>(a) Reevaluate elaborate reporting requirements of BaFin vis-à-vis the BMF with a view to alleviating the reporting burden.</p> <p>(b) Amend 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.</p> <p>(c) Amend relevant legislation to ensure there is public disclosure of the reasons for dismissal of BaFin's President and Executive Directors.</p> <p>(d) Develop a consistent and well documented ladder of supervisory actions (also see CP 23).</p> <p>(e) Clarify liability protection of BaFin's staff members that are not designated as civil servants.</p> <p>(f) 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.</p>
Major Acquisitions (CP 5)	<p>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.</p> <p>For completeness' sake, the assessors note that a comparable recommendation was made as part of the 2003 FSAP and the accompanying BCP assessment.</p>
Capital adequacy (CP6)	<p>(a) Firmly embed the use of the new powers to impose higher capital charges, commensurate with institutions' risk profiles, in supervisory processes.</p> <p>(b) Enhance the use of rigorous stress tests as instruments to closely scrutinize the capital adequacy of individual institutions.</p> <p>(c) 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.</p>
Risk management Process (CP 7)	<p>(a) Pursue a further strengthening of risk management practices at German institutions, inter alia, by proactively increasing the scope and frequency of supervisory inspections.</p> <p>(b) 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.</p>

Reference Principle	Recommended Action
Credit Risk (CP8)	(a) Investigate possibilities to improve consistency in practices on asset classifications, provisioning et cetera across audit firms, allowing for better comparisons across individual institutions. (b) Evaluate supervisory capabilities with regard credit risks and continue to improve the depth and frequency of 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.
Exposures to Related Parties (CP 11)	Restrict opportunities for retroactive approval of exposures to related parties.
Liquidity Risk (CP 14)	(a) Enhance reporting requirements for foreign currency position risk. (b) Increase supervisory inspections focused on liquidity risk management.
Operational Risk (CP 15)	(a) Beef up specialized IT inspection capacity and increase the depth and frequency of targeted IT inspections. (b) Develop requirements for the reporting of material operational risk incidents to the supervisory authorities.
Abuse of Financial Services (CP18)	(a) Remediate the weaknesses identified through the FATF Mutual Evaluation as quickly as reasonably possible. (b) Review BaFin's enforcement strategy and capabilities with regard to AML/CFT.
Supervisory Approach (CP 19)	Enhance the use of rigorous stress tests as forward-looking tools, aimed at identifying vulnerabilities of individual institutions (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

22. **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.

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

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

- On CP 15, BaFin and 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.

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

26. **Issues in the regulatory framework 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 Basle III/ CRD IV.**

27. **The German authorities understand that in some areas, 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.

28. **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 the German situation is in line with the requirements of the principle. 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.²
 - 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:

² (See also Deutsche Bundesbank Methodological Note, "Stress Tests at the Bundesbank—Overview," 9 February 2011).

- 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 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 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 PrüfV, 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 Mutual Evaluation Report 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 that apply national Generally Accepted Accounting Principles, which are consistent with European accounting directives.

II. INSURANCE CORE PRINCIPLES³

A. Summary

29. **Insurance regulation and supervision is generally of a high standard, and most of the enhancements suggested in the 2003 assessment have been put in place.** Further enhancements will need to be undertaken, particularly in the context of the forthcoming introduction of Solvency II requirements, in such areas as to the frequency of on-site inspections, the enhancement of resources devoted to group-wide supervision, and stability analysis, for example, through sophisticated stress testing for larger insurers and improved group-wide stability analysis.

B. Introduction

30. **This assessment of Germany's observance of the IAIS Insurance Core Principles (ICPs) was carried out as part of the 2011 FSAP Update.** The main mission took place in January–February 2011. The assessor was Fausto Parente of the ISVAP.

C. Information and Methodology Used for the Assessment

31. **The assessment was based on a review of the relevant laws and regulations in force at the time; discussions with the supervisors, other government bodies, and market participants; and additional material provided by the authorities.** Because of strong legal restrictions on the sharing of institution-specific information, access to on-site inspection reports and similar documents was limited. The authorities and market participants were uniformly cooperative.

D. Institutional and Market Structure—Overview

32. **The German Federal Financial Supervisory Authority (BaFin) is the insurance supervisor.** The Federal Ministry of Finance (BMF) has legal and supervisory control over BaFin.

³ The assessment was conducted by Mr. Fausto Parente of the Italian Insurance Supervisory Authority (ISVAP).

33. **The supervision of insurance companies in Germany is based on the Insurance Supervision Act (VAG).** Furthermore, insurers have to comply with other acts, codes, ordinances and circulars.

34. **The insurance sector consisted of 621 companies at end-2010, comprising 98 life insurers, 265 nonlife insurers (including 48 health insurers), 152 *Pensionskassen*, 36 reinsurers, others including 40 death benefit funds and 30 *Pensionsfonds*.** The sector includes many small companies but also several of the world's largest primary insurers and reinsurers. Of the sectors' roughly €1.4 trillion in total assets, €804 billion was held in life insurers at end-2009. The *Pensionskassen* and *Pensionsfonds* held roughly €133 billion in total assets at end-2009. Despite the global financial crisis and the current low interest rate environment, soundness indicators have remained generally healthy across the insurance sector.

35. **The auditing and accounting rules applicable to financial institutions generally comply with international standards.** Since 2005, German-listed companies apply as required the IFRS. The judicial system, including that for bankruptcy and the enforcement of property rights, is well developed. The payment and settlement system is reliable and efficient.

36. **Germany has a solid institutional framework supporting the conduct of sound macroeconomic policies.** Germany was hit hard by the global crisis, mainly because of the economy's international connections, but at the time of the assessment a strong recovery was under way. Nonetheless, trend growth in potential output is relatively slow, and currently interest rates are unusually low.

E. Main Findings

37. **The level of observance of these standards is very high.** The authorities are aware that the size and sophistication of the German financial system demand that the supervision go beyond the standards, and they are working to make further improvements, especially those needed to implement the regulatory and financial policy initiatives that have been occasioned by the global crisis.

38. **Insurance regulation and supervision is generally of a high standard, and most of the enhancements suggested in the 2003 assessment have been put in place.** For example, new rules have been issued to improve qualitative requirements posed on all the insurance undertakings in the area of corporate governance, risk management, and internal control. Reinsurance companies are now subject to more extensive regulation and supervision, which, however, allow for the differences between them and primary insurers. The new regulations aim at anticipating some of the Pillar 2 requirements that will be implemented with Solvency II, paving the way for a smooth transition to the new risk-based solvency regime starting in 2013. A new risk-based system to select the

priorities for the supervision as well as the efficient allocation of supervisory resources has been implemented.

39. **The authorities acknowledge the need to continue to develop supervisory capacity.** The incoming prudential regime under Solvency II will require enhancement of BaFin supervisory resources (both in terms of quantity and quality). To these ends, the frequency of on-site inspections should be increased especially for insurers that are deemed to have a medium-sized market impact (current practice is to have an on-site inspection at least every eight years). Given the presence of large, cross-border insurance groups, group-wide supervision needs to be enhanced, as should the level of supervisory cooperation. In many of these areas, the further refinement of stress testing techniques would be helpful. The implementation of the EU directive on insurance intermediaries is a major step towards ensuring adequate supervision of market conduct issues. However, the split of competences between BaFin and the local Chambers of Industry and Commerce should be reviewed to ensure against an effective market conduct supervision and consumer protection.

40. **Most of the requirements and supervisory tools, which are in use for the supervision of primary insurers, are also applied to the reinsures.** The most relevant exception is the investment activity, which is regulated on the basis of the “prudent person principle” to take into account the specific features of the reinsurance activity. This approach may have merit, but experience elsewhere suggests that vigilance is required in its application.

Table 3. Summary of Observance of the IAIS Insurance Supervisory Principles

ICP	Comments
1. Conditions for effective insurance supervision.	Insurance supervision in Germany is facilitated by sound and progressive financial sector policy framework and financial market infrastructure.
2. Supervisory objectives.	The objectives fixed under the law are mainly focused on the protection of the policyholders.
3. Supervisory authority.	BaFin is operationally independent and subject to clear accountability mechanisms; its staff is experienced and qualified. Public disclosure of the reasons for dismissal of board members should be required, although it is recognized that in practice reasons would be given.
4. Supervisory process.	BaFin is moving toward a more risk-based supervisory approach, which will be fully in place once Solvency II is implemented. For the time being, a risk model to select and prioritize the supervisory analysis has been made operational.
5. Supervisory cooperation and information sharing.	BaFin is empowered to, and does regularly exchange information with other supervisors, both within and beyond the EU. It's a

ICP	Comments
	signatory to the EU/ EEA Protocols on supervisory cooperation and the IAIS multilateral MoU as well as of a number of bilateral MoUs.
6. Licensing.	The licensing regime, based on EU directives, is clear and transparent.
7. Suitability of persons.	BaFin performs robust due diligence on any proposed significant owner, board members, trustees, and appointed actuaries prior to licensing and after by also monitoring subsequent changes.
8. Changes in control and portfolio transfers.	The conditions under which a qualified holding in an insurance undertaking can be assumed are clear and in line with the relevant EU directives. Portfolio transfers must be approved by BaFin.
9. Corporate governance.	BaFin has recently introduced new requirements for insurers, which strengthened the robustness of its assessment of insurers' corporate governance. Those measures can be seen as an anticipation of the Pillar 2 requirements, which will come into force under Solvency II.
10. Internal controls.	BaFin has articulated clearly its supervisory expectation of insurers in implementing appropriate internal controls tailored to the nature, scale, and complexity of their operations. As for other areas of the supervision, measures were introduced to enhance the insurers' internal controls systems in view of the incoming implementation of Solvency II.
11. Market analysis.	BaFin performs market analysis and stress tests to identify, assess, and mitigate risks to the insurance sector. Quantitative analysis will need to be enhanced and kept up to date, for example, through more comprehensive stress testing for large insurers.
12. Reporting to supervisors.	BaFin has a systematic process to review regulatory returns and information provided by insurers as part of its off-site surveillance. The supervisory returns take advantage of the auditor assessment performed on the financial statement.
13. On-site inspection.	BaFin conducts on-site inspections, which are prioritized based on an analysis of insurers' risk profiles and its market impact. It also has recently conducted joint on-site inspections with other supervisors to address specific issues. However, the frequency of regular on-site inspection for the medium and low-impact insurers should be increased. While resources allocation should be prioritized according to assessed risks, the chance of detecting emerging difficulties would be importantly increased if at least brief inspection visits were conducted every three or four years for medium-sized insurers.
14. Preventive and corrective measures.	In line with EU directives, BaFin is empowered to take a range of preventative measures, which allows a progressive escalation

ICP	Comments
	of supervisory actions to respond to emerging concerns. The implementation of Solvency II will imply further increase of flexibility in the possible supervisory actions by introducing a more specific intervention ladder based on the solvency ratios.
15. Enforcement or sanction.	BaFin takes a proportionate approach in exercising its enforcement powers under the VAG. The use of administrative fines is considered to be rarely necessary due to the fact that insurers always comply even with initial informal requests from the authorities.
16. Winding-up or exit from the market.	Legislation provides for orderly exits of insurers and a high degree of protection for policyholders in the event of insolvency.
17. Group-wide supervision.	The German regulatory frameworks for insurance groups and financial conglomerates are broadly in line with EU directives. The impending implementation of Solvency II will strengthen BaFin's supervision of insurance groups, subject to the adequacy of regulatory resources.
18. Risk assessment and management.	The VAG has established high-level requirements relating to insurers' risk management, supplemented by BaFin circular and supervisory expectation. The effectiveness of insurers' risk management system is regularly assessed by BaFin. The risk management requirements can be seen as an anticipation of Solvency II.
19. Insurance activity.	BaFin directly reviews premium pricing for some classes of business and monitors insurance risks through its assessment of insurers' risk management system and technical provisions.
20. Liabilities.	There are clear, legal principles and regulatory guidelines for insurers to estimate their insurance liabilities. In addition, the audit reports of external auditors as well as appointed actuaries for certain line of businesses can also be used. BaFin monitors insurers' technical provisions by off-site examinations as well as on on-site inspections, and has the power to require insurers to remedy any shortfall.
21. Investments.	Regulatory requirements are in place for insurers to manage their investment risks in a manner proportionate to the nature, scale, and complexity of their operations. In addition, a number of specific quantitative limits are applicable on the investment activity of the primary insurer in order to ensure an adequate spread of the risks. For the reinsurance activity, the regulation follows the "prudent person principle."
22. Derivatives and similar commitments.	The regulatory policy and requirements for the use of derivatives by primary insurers are aligned with international best practice. Quarterly reporting is also defined. However, the provisions for reinsurance activity are more

ICP	Comments
	general, and the reporting requirements are less stringent.
23. Capital adequacy and solvency.	The capital adequacy regime is based on EU directives (Solvency I). The implementation of Solvency II with effect from January 2013 will result in a more risk-sensitive regime that will enhance risk-based supervision.
24. Intermediaries.	BaFin is not responsible for the direct supervision of the intermediaries. The implementation of the relevant EU directive has been a major step in enhancing the supervision of intermediaries, but it is difficult to assess the effectiveness of market conduct control performed by the competent supervisors. It is advisable to carry out such an analysis and take appropriate actions to continue improving the protection of policyholders at the point of sale.
25. Consumer Protection.	There are various tools which enable the consumers to solve possible issues ranging from the complaints to BaFin, the help of consumers' associations, and the ombudsman.
26. Information, disclosure and transparency towards markets.	BaFin publishes market data and analysis, although often with considerable time lags.
27. Fraud.	The core requirements are in place.
28. Anti-money-laundering, combating the financing of terrorism (AML/CFT).	While BaFin is in the process of addressing the weaknesses identified in the FATF, especially when dealing with the increased control of the insurers' activity, there is no evidence that remedial actions are systematically taken by the Länder with regard to insurance intermediaries that they supervise.

F. Recommended Action Plan and Authorities' Response

Recommended Action Plan

41. **The following recommendations aim to suggest measures to further improve insurance regulation and supervision.** In many areas they go beyond the essential criteria of the ICPs.

Table 4. Germany: Recommendations to Improve Observance of ICPs

ICP	Recommendation
2. Supervisory objectives.	Consideration could be given to explicitly mention systemic stability.
3. Supervisory authority.	There is scope for strengthening regulatory resources, particularly for supervision of internationally active insurance groups and implementation of Solvency II. Public disclosure of the reasons for removal of board members should be envisaged.
4. Supervisory process.	It is recommended that BaFin continue to develop a risk-based supervisory approach, by further enlarging the risk model, which has been put in place to also take into account the group-wide supervision. As stress testing and other quantitative supervisory techniques are developed, they should strongly influence prioritization in the supervisory process.
5. Supervisory cooperation and information sharing.	It is recommended that the concrete application of the confidentiality rules be monitored in order to avoid that it can become an obstacle for full information sharing among supervisors.
7. Suitability of persons.	Consideration should be given to having the power to extend similar requirements, as needed, to other high-level managers who determine day-to-day policies. Moreover, it is recommended that insurers be required to report to BaFin as they become aware of circumstances that may be relevant for the fitness and propriety of key functionaries.
9. Corporate governance.	It will be important to continue to check that mutual insurers do in fact follow procedures equivalent to the corporate governance code (from which they are exempt), and adapt those procedures as needed as Solvency II is introduced.
11. Market analysis.	BaFin should continue to develop stress testing capacity, especially regarding larger insurers and financial groups, and longer-term effects.
12. Reporting to supervisors.	It is advisable to introduce an explicit obligation for the <i>prompt</i> notification of supervisors by insurers and auditors of any material changes which affect the current or foreseeable financial condition of an institution. Care should continue to be taken to keep reporting requirements up to date, while containing regulatory burden; for example, by harmonizing and centralizing to the extent possible reporting requirements imposed by authorities in different jurisdictions or for different purposes.
13. On-site inspection.	It is recommended that, without sacrificing the principles of risk-based supervision, the frequency of regular on-site inspection for the medium and the low impact insurers be increased to bring it closer to international best practice.
14. Preventive and corrective measures.	The level of sanctions will need to be kept under review to ensure that they remain effective as deterrents.
17. Group-wide supervision.	It is advisable to consider:

ICP	Recommendation
	<ul style="list-style-type: none"> • Increasing the adequacy of resources, particularly for the effective supervision of international active groups and financial conglomerates. • Developing the risk classification tool (see ICP 4) to include the group-wide supervision. • Harmonizing the supervisory approach in the area of group capital adequacy calculation by issuing more detailed rules on, inter alia, the treatment of participation in credit institutions, the valuation criteria to be used. • Regularly addressing group-wide effects in stress tests.
20. Liabilities.	<p>It is recommended that, in view of the increasing complexity of the valuation criteria to be used under Solvency II as well as their differences with the current ones, BaFin should increase the number of its staff equipped with actuarial expertise and related quantitative skills. Its advisory function in this field could be enhanced.</p> <p>Stress tests for liability-side risks should be refined and conducted more frequently to assess the sensitivity of results to variations in actuarial assumptions and discount rates.</p>
21. Investments.	<p>In view of the increasing complexity of the valuation criteria to be used under Solvency II, it is advisable to keep the supervisory reporting requirement under review, and to continue developing BaFin's internal assessment and monitoring.</p>
22. Derivatives and similar commitments.	<p>It is recommended that the prudent person principle approach which forms the basis for the supervision of reinsurers' investment activity and use of derivatives be complemented by reinforced off-site and on-site monitoring of such activities.</p>
24. Intermediaries.	<p>It is advisable to carry out an analysis of the impact of the relevant EU directive, and take appropriate actions to continue improving the protection of policyholders at the point of sale.</p>
26. Information, disclosure and transparency towards markets.	<p>Time lags in the publication of aggregate insurance data should be shortened. The availability of preliminary data—perhaps when over 90 percent of input data have been compiled—on a more timely basis would be valuable. Moreover, in view of the incoming Solvency II regime, consideration should be given to the enhancement of the disclosure requirements applied to the insurers.</p>
28. AML/CFT.	<p>The authorities should continue to address the weaknesses identified through the FATF Mutual Evaluation as quickly as reasonably possible.</p>

Authorities' Response to the Assessment

42. **The authorities broadly agree with the assessment.**

III. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION⁴

A. Summary

43. **The overall level of compliance with the IOSCO Principles is very high.** Two main factors influence the ability of the system to meet the highest standards required by the IOSCO Principles:

- the continued existence of “grey market” activity outside the fully regulated market means that functionally similar financial market products and activities are not subject to the same standard of regulation (this issue is of concern mainly regarding certain closed-end funds and retail-oriented products with embedded options, where regulations on potential mis-selling and services to retail investors are relatively light). The authorities are working on proposals to deal with this issue, and that initiative is to be encouraged; and
- in its supervision activities, BaFin relies heavily on the analysis of incoming reports and other data, including annual compliance reports on regulated entities prepared by external auditors. It makes comparatively little use of on-site compliance inspections, whether on a routine basis or as part of a program that identifies potential emerging compliance risks resulting from changes in market conditions or behavior. In addition, post trade transparency for trading on equities markets—while fully compliant with standards required under the European regime—applies only at the level of the individual market and does not result in an overall level of transparency because of the absence of standards for consolidating and disseminating post trade data. The authorities should work towards achieving a more “whole of market” transparency regime.

B. Introduction

44. **This assessment was carried out as part of the FSAP Update mission to Germany that took place between January 19 and February 4, 2011.** A previous assessment was undertaken in 2003. Since then, there have been continuous developments in the legislative framework both at the European level and the German national level since the original assessment in 2003.⁵

⁴ The assessment was undertaken by Mr. Malcolm Rodgers (former Executive Director and Acting Commissioner of the Australian Securities and Investments Commission).

⁵ For example, the Transparency and the Markets in Financial Instruments Directive (MiFID) directives—among others—have come into effect since 2003. At the national level there have been numerous developments, including legislation—for example—legislation restricting and imposing a transparency regime for short selling.

C. Information and Methodology Used for the Assessment

45. **The assessor relied on a number of sources in carrying out this assessment, including:** a review of the relevant legislation; the self-assessment prepared by the staff of BaFin; other material published by BaFin; detailed discussions with the staff of BaFin and other regulatory authorities and ministries; and discussions with a range of market participants and representative bodies. The assessor extends his thanks to the staff of the authorities for their cooperative participation in the process and for their comprehensive self assessment.

46. **The assessment was conducted based on the IOSCO Objectives and Principles of Securities Regulation and the associated methodology adopted in 2003, as updated in 2008.**⁶ An assessment of the securities settlement systems under the CPSS/IOSCO Recommendations was conducted separately, so Principle 30 is not considered here.

47. **During the assessment, the new principles adopted by IOSCO and published in June 2010 were also discussed.** These new principles are not yet the subject of a formal methodology and discussions about them were informal and not part of the assessment. Nonetheless, this report reflects those discussions.

48. **The conclusions set out below are based on information and findings as of January of 2011.** As noted, the assessment takes place against a background of continuing change in the legislative framework and the regulatory environment for securities regulation.

Institutional structure—overview

49. **At the Federal level, BaFin is responsible for administering and enforcing the large body of different laws that govern capital and financial services market activity.** Other Federal legislation not administered by BaFin—such as company legislation, legislation on public auditors and competition legislation—has an impact on the regulatory environment for securities market activity. The State-based Exchange Supervisory Authorities (ESAs) supervise exchanges. In addition, the new European body for securities markets, the European Securities Market Authority (ESMA), commenced operations on January 1, 2011.

50. **BaFin’s rule-making function focuses on the making of detailed, technical rules pursuant to primary or secondary legislation.** The European regulatory

⁶ The IOSCO methodology was amended in 2008 to update footnotes to reflect recent IOSCO publications. Currently IOSCO is expanding the methodology to cover the new principles adopted in mid-2010.

framework plays a very significant role in the German national regulatory framework. The reform agenda at the European level is significant, and includes reviews of some fundamental aspects of the regulation of market activity, such as the MiFID. There is also a separate German domestic reform agenda; for example, the recent legislation on short selling and proposals to deal with mis-selling in currently unregulated or lightly regulated markets.

51. **It is worth noting that the industry is concerned about the implementation costs resulting from a rapidly changing legislative framework, both in Europe as a whole and in Germany.** In particular, concerns focus on differences in the timing of implementation between Germany and other States in Europe; and on material differences between the standards set in some German legislation and those required by European directives.

Market structure and activity

52. **The German financial sector is dominated by banking institutions.** Moreover, at end-2010, there were 717 nonbank financial institutions licensed to provide investment services; 908 issuers admitted to trade on regulated markets; and 73 authorized asset management companies. A very large number of financial products are traded on German markets.

53. **There are currently seven securities exchanges, one derivatives exchange (Eurex Deutschland in Frankfurt), and one energy exchange.** There are two approved multilateral trading facilities (MTFs). The Frankfurt exchange dominates trading in equities, with well in excess of 90 percent of trading taking place on that exchange. The Stuttgart Stock Exchange has created a strong market in retail level trading of nonshare instruments.

Recent developments

54. **The financial crisis and its aftermath have affected activity in the securities sector as well as other parts of the financial sector and the real economy.** There has been considerable pressure on retail open-ended real estate funds. The investor compensation fund established under the Deposit Guarantee and Investor Compensation Act came under funding pressure because of a single incident.

Preconditions for effective securities regulation

55. **The general preconditions necessary for the regulation of securities markets appear to be in place in Germany.** There is a stable macroeconomic environment. There are no significant barriers to entry and exit for market participants. The legal and accounting framework is sound. Commercial law has been kept modern and corporate governance standards have been recently reviewed.

D. Main Findings

56. **BaFin’s overall approach to supervision relies very heavily on the flow of information coming to it from the regulated population and mandatory reports such as auditors’ reports on regulated entities’ financial condition and compliance with legislative obligations.** It has recently adopted a risk scoring methodology for the regulated population, but this is in its early stages and does not seem to have yet resulted in active monitoring programs calibrated on a risk basis. A new cross-divisional system of examining more systemic risks is in the process of being established.

57. **Principles for the regulator (Principles 1-5):** Regulators at both Federal and State levels work with a clear legal framework and clearly defined powers and responsibilities. However, there remains significant “grey market” activity, where financial products (such as closed-end funds, or participation rights) and services relating to them (especially marketing and advice) are subject to regulation at a lower standard that would be required under the IOSCO Principles.⁷ In practice, BaFin and the ESAs appear to be operationally independent, although at the State level, ESAs are within the State Ministries so formal preconditions of independence are not met. BaFin has a high level of accountability to the BMF. Powers available to the regulators are sufficient. BaFin’s funding arrangements and level of resources enable it to carry out regulatory mandate for securities markets. BaFin has adopted integrity policies that support their general obligations to maintain high standards of professional conduct.

58. **Principles for enforcement (Principles 8-10):** BaFin (and where relevant, State-regulated Trading Supervisory Offices and ESAs) has extensive powers and regulated entities have extensive reporting obligations. BaFin (and the State authorities) have power to take enforcement actions and sanction regulated entities (and other persons). BaFin takes a systematic approach to ongoing supervision. It relies heavily on annual reports from external auditors, and makes limited use of on-site inspections. It appears to have effective working arrangements with the prosecution authorities, and there is a track record of enforcement action, including criminal action.

59. **Principles for cooperation (Principles 11-13):** BaFin has obligations to share information and cooperate with other domestic regulators, and for ensuring cooperation with foreign regulators; these arrangements appear to work effectively in practice. BaFin is a signatory of the IOSCO Multilateral MoU, and many bilateral MoUs. There is good evidence of BaFin’s practical cooperation with foreign regulators.

⁷ Examples include ship investment funds, real estate funds, and private equity funds. Data on the overall size of activity in grey markets are not readily available. Proposals to integrate the supervision of these products into the general scheme were published in April 2011.

60. **Principles for issuers (Principles 14-16):** A prospectus approved by BaFin is required for securities offered to the public or admitted to trading on a regulated market. Material event reporting also applies for issuers of securities traded on a regulated market. Financial statements must be prepared in accordance with International Financial Reporting Standards. Substantial shareholder disclosure and specific takeover legislation, including mandatory bid requirements, provide an effective framework for change of control transactions.

61. **Principles for collective investment schemes (Principles 17-20):** Operators of collective investment schemes (CISs) must hold a license issued by BaFin. CIS operators (both asset management companies and investment stock corporations) must keep fund assets segregated. Operators must prepare and publish annual and semiannual reports for each fund, and each CIS requires a prospectus, the content of which must accord with IOSCO Principles. Asset valuation methodology is detailed in the legislation. BaFin uses annual audit reports extensively in its supervision, and undertakes a small number of on-site inspections.

62. **Principles for intermediaries (Principles 21-24):** A license issued by BaFin is required to carry on a business of providing financial services. Ongoing risk-based capital requirements, mainly reflecting the institution's credit and market risk, and other prudential requirements apply.

63. **Principles for secondary markets (Principles 25-30):** Exchanges and MTFs require authorization by the relevant ESA or by BaFin (for MTFs). Exchange markets are subject to continuous supervision by the trading surveillance offices (TSOs) and ESAs, with BaFin responsible for investigating and taking action on market abuse. Transparency obligations in place for exchange markets and MTFs and apply to trading in shares and certificates representing shares, but not other instruments traded on regulated markets.

Table 5. Summary Implementation of the IOSCO Principles

Principle	Findings
Principle 1. The responsibilities of the regulator should be clearly and objectively stated	The responsibilities of BaFin and the State-based ESAs are clearly established by law. Market participants understand the role played by BaFin, and exchange markets understand the role of the ESAs and exchange TSOs. Legislation requires cooperation and information sharing between the main regulators and other authorities with a regulatory role impacting on securities markets. However, at the time of the assessment, advice on, selling, and marketing of certain investment products (such as closed-end funds) are not regulated as fully as are other investment services, although the approval process for prospectuses has been unified.
Principle 2. The regulator should be operationally	BaFin is operationally independent. It has a strong line of accountability and detailed obligations to provide information

Principle	Findings
independent and accountable in the exercise of its functions and powers	<p>to the BMF about its activities. BMF approval is not required for its operational decisions as a regulator. Security of tenure of its most senior management is not formally provided for but is de facto well-entrenched.</p> <p>The ESAs are separate units within the relevant State Ministry (for example Frankfurt stock exchange, and Eurex are supervised by an ESA located within the Hessian Ministry of Economic Affairs, Transportation and Regional Development). This structure does not meet the formal standards for independence required by the IOSCO principles. Although in practice ESAs do not appear to be subject to political interference, the institutional structure of exchange market supervision remains open to the potential for political direction.</p>
Principle 3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers	<p>BaFin has extensive powers, including licensing and ongoing supervisory and enforcement powers. The fact that BaFin can only make enforceable rules in relation to specific matters expressly provided for by the Parliament may limit its ability to react quickly in a crisis. Resources appear adequate. BaFin staff members are largely career civil servants, but where needed, BaFin can employ expertise outside the civil service framework.</p> <p>The State-based ESAs (and under them exchange TSOs) have the powers needed to carry out their functions.</p>
Principle 4. The regulator should adopt clear and consistent regulatory processes	<p>As public authorities, BaFin and the ESAs (and the TSOs) are subject to a comprehensive administrative law regime that requires consistency and fairness. There is no formal requirement for BaFin to take compliance costs into account when formulating policy, but BaFin plays a very limited role in policy formation, which occurs at the BMF level.</p>
Principle 5. The staff of the regulator should observe the highest professional standards	<p>Staff of BaFin are bound by extensive obligations—including confidentiality obligations that apply to the civil service generally, and in addition, BaFin has adopted internal policies (for example in relation to disclosure of trading by staff) to supplement these broad obligations.</p>
Principle 6 The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets	<p>Not applicable. The regulatory role played by exchanges and especially the TSOs that each exchange has are dealt with under the Principles for secondary markets. Under German law, exchanges and their TSOs are public law entities subject to the general framework for public authorities, not private law entities under delegated authority.</p>
Principle 7. SROs should be	Not applicable.

Principle	Findings
subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities	
Principle 8. The regulator should have comprehensive inspection, investigation and surveillance powers	The regulators have broad supervisory, investigative, and enforcement powers over regulated entities and extensive information-gathering, and, in appropriate cases, enforcement powers not confined to regulated entities.
Principle 9. The regulator should have comprehensive enforcement powers	<p>BaFin has extensive powers to requisition information, inspect documents, and enter premises. It can compel individuals to give it oral evidence (but not so as to involve self-incrimination). It can take a range of enforcement action directly, including by imposing substantial administrative fines. Criminal investigation and prosecution is the responsibility of the public prosecutor.</p> <p>ESAs appear to have powers adequate to enable them to be credible regulators of exchange markets under the Exchange Act.</p>
Principle 10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.	<p>In broad terms, BaFin has a credible and effective monitoring and enforcement program. But its monitoring programs are heavily based on analysis of material reported to it, including annual audit reports on compliance by regulated entities, and it makes limited use of its on-site inspection powers. For regulation of market intermediaries and CIS operators, this approach may not detect concerns in a timely manner, especially relating to conduct of business as market conditions and market participant behaviors change.</p> <p>The role played by ESAs seems appropriate to their function.</p>
Principle 11 The regulator should have the authority to share both public and non-public information with domestic and foreign counterparts	BaFin and other regulators involved in the regulation of securities markets are obliged to cooperate and support one another's functions, and have extensive information sharing powers. There are no materially significant limits on BaFin's ability to share information with other regulators in the EU, and with foreign regulators, or preconditions to it doing so.
Principle 12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts	BaFin participates fully in European information-sharing arrangements, is a signatory to the IOSCO MMOU, and has entered many unilateral MOUs with foreign regulators. There is good evidence that these arrangements are working in practice and result in a considerable flow of information between regulators, both domestically and internationally.
Principle 13. The regulatory system should allow for	BaFin has no power to directly represent foreign regulators formally, for example in court proceedings. But it can and does

Principle	Findings
assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers	assist foreign regulators to gather information and evidence, and provide other forms of practical assistance.
Principle 14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions	To offer securities to the public or have them admitted to trading on a regulated market, issuers must have a prospectus approved by BaFin, the content of which is in line with IOSCO standards. Issuers must also publish annual and half-yearly reports, and (for issuers of shares) interim management statements or quarterly reports. They must disclose material price sensitive information without delay. BaFin has published extensive guidance to assist issuers with their obligations, and its supervision of compliance with these obligations is effective.
Principle 15. Holders of securities in a company should be treated in a fair and equitable manner	German company legislation provides the basic framework for shareholders rights. Assertion of these rights is a private law matter. Separate law deals with company insolvency. The securities legislation has a transparency regime for substantial shareholdings. Comprehensive takeover legislation is administered by BaFin, and includes a mandatory bid requirement when a person reaches a 30 percent holding, and disclosure rules. There is good evidence of BaFin's use of its powers to ensure compliance with disclosure requirements for substantial shareholdings and obligations under takeovers legislation.
Principle 16. Accounting and auditing standards should be of a high and internationally acceptable quality	Issuers of traded securities must prepare and have audited consolidated financial statements that comply with the IFRS; other issuers must prepare accounts in accordance with German accounting standards. German national accounting standards are generally in line with international standards. Auditors must apply auditing standards which are analogous to the international audit standards (IASs). Accounting standards are provided for in legislation supplemented by elaboration and guidelines set by a private body under an agreement with German Ministry of Justice. Audit standards are set by a private body. Issuers' compliance with financial reporting standards is monitored by the Financial Reporting Enforcement Panel, and by BaFin (which is responsible for enforcement action). Compliance with auditors' obligations (including independence obligations) and compliance with audit standards is monitored by the Chamber of Auditors, which is itself supervised by the Auditor Oversight Commission.
Principle 17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or	CIS operators can operate as asset management companies or investment companies, and must be licensed by BaFin and meet eligibility criteria including integrity requirements for managers and significant owners, minimum capital, and

Principle	Findings
operate a collective investment scheme	<p>internal controls and risk management systems. The content of advertising is regulated by the investment legislation. Marketing of CISs can be undertaken without requiring a license issued by BaFin (provided no other BaFin regulated activity is involved), but is then regulated by licensing arrangements under the general commercial code.</p> <p>In its monitoring of compliance by CIS operators, BaFin is heavily reliant on analysis of audit reports, and does not have an intensive on-site inspection program. Such heavy reliance on audit reports increases the chance that undesirable conduct is not detected in a timely fashion, thereby increasing risks to market performance, investor protection, and BaFin's reputation. Although all CIS operators and funds are subject to external audits, ongoing monitoring involves insufficient performance of on-site BaFin inspections of entities involved in operating CIS, given the material importance of the sector.</p>
Principle 18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets	<p>The legislation and fund rules approved by BaFin govern the legal form of CIS and the rights of investors. Fund assets must be kept separate from those of the operator, and be held by a licensed custodian bank approved by BaFin. Individual fund rules must be approved by BaFin.</p>
Principle 19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme	<p>For retail funds CIS, the CIS operator must issue a full prospectus and a simplified prospectus (to be replaced by the Key Information Document by mid 2011) and lodge a copy of the prospectus with BaFin. Both full and simplified prospectuses must contain information necessary for investors to make an informed judgment, including about risks. The simplified prospectus regime will be replaced by a requirement for a Key Investor Information document as part of the German implementation of UCITS IV.</p> <p>Operators must also publish annual and half-yearly reports for each fund containing financial and other information about fund activities.</p>
Principle 20. Regulation should ensure that there is a proper and disclosed basis for assets valuation and the pricing and the redemption of units in a collective investment scheme	<p>The Investment Act and related legislation contains detailed provisions for the valuation of CIS assets that apply to all retail funds, covering rules for valuation, the timing of valuations and the process for valuation, and the pricing of units on issue and redemption. Compliance with these rules must be monitored by internal audit and is subject to annual external audit. The legislation also covers procedures for the pricing of units both on issue and on redemption.</p>
Principle 21. Regulation should provide for minimum entry	<p>A person must hold an authorization issued by BaFin to carry on a business of providing financial services, a term that</p>

Principle	Findings
standards for market intermediaries	includes all forms of financial market activity, including proprietary trading and providing customer-specific advice about financial instruments, and operating an MTF. Eligibility standards include the integrity of managers and owners of significant shareholdings, managers' competence, resource requirements including capital, and the adequacy of internal controls, risk management, and supervisory systems operational requirements. Authorized institutions have extensive reporting obligations, and BaFin carries out extensive reviews of these reports and external audit reports, and some on-site inspections. See comments under Principle 10.
Principle 22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake	Authorized institutions (under the German legislation this includes both credit institutions and financial services institutions) are subject to minimum capital requirements. Nonbank intermediaries are not permitted to hold client assets or funds, and as a consequence are not subject to detailed ongoing risk-based capital requirements. Banks conducting securities business are subject to ongoing, risk-based solvency and liquidity requirements monitored by BaFin's Banking Directorate in collaboration with the Bundesbank. Authorized institutions must provide monthly returns which are reviewed both by the Bundesbank and BaFin. BaFin conducts extensive reviews of reports including annual compliance audit reports.
Principle 23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters	Licensees must have risk management, compliance and internal control functions. Compliance with these requirements is subject to specific review in the annual audit process, reviewed by BaFin.
Principle 24. There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk	There are no specific ex ante procedures for dealing with the consequences of the failure of an intermediary. For the nonbank sector, BaFin would deal with such a failure on an ad hoc basis, with a focus on ensuring orderly winding up (through a Court-ordered insolvency process) and ensuring clients of the firm are fully informed. For banks involved in securities business, the Banking Department would be responsible.
Principle 25. The establishment of trading systems including securities exchanges should be subject to regulatory	Exchange markets require approval by the ESA of the relevant State (Land) under the Stock Exchange Act; MTFs must hold a license issued by BaFin under the Banking Act. In each case, similar preconditions must be met before approval is

Principle	Findings
authorization and oversight	granted. Exchange markets are monitored by exchange TSOs under the supervision of ESAs. BaFin is responsible for supervision of the two licensed MTFs.
Principle 26. There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants	TSOs conduct real-time monitoring and supervision of exchange markets, under the supervision of the relevant ESA. ESAs monitor and respond to the work of TSOs, and conduct periodic reviews of overall exchange compliance. Currently two MTFs are licensed by BaFin as investment services enterprises under the Banking Act, subject to additional MTF-specific obligations under the Securities Trading Act. BaFin monitoring activity is that applying to generally to market intermediaries.
Principle 27. Regulation should promote transparency of trading	The regulatory framework provides for pre and post trade transparency in equities, in line with MiFID requirements for exchange markets, MTFs, and systematic internalizers, and permitted exceptions are in line with market norms in other jurisdictions. However, dispersal of trading across multiple venues highlights the absence of an integrated overview of activity.
Principle 28. Regulation should be designed to detect and deter manipulation and other unfair trading practices	Insider trading, market manipulation (and front running) are both criminal and administrative offences. The definitions for insider trading and market manipulation are appropriately broad, and apply to derivatives market activity as well as securities markets. BaFin has an active program to detect misconduct and enforce compliance, supported by the ESAs and TSOs. BaFin reviews daily trading reports from all market participants and other information to assist it to detect market abuse and insider trading. The enforcement record indicates this activity is working well.
Principle 29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption	Derivatives trading platforms monitor large positions and can set position limits. Large counterparty exposures for banks subject to prudential requirements are monitored as part of the prudential supervision process.
Principle 30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk	Assessed as part of assessment of CPSS-IOSCO standards.

E. Recommended Action Plan and Authorities' Response

64. **The following recommendations aim to suggest measures to further improve the securities regulation framework and supervision.**

Table 6. Recommended Action Plan to Improve Compliance with the IOSCO Objectives and Principles for Securities Regulation

Reference Principle	Recommended Action
Responsibilities of the regulator (Principle 1)	The authorities should, as a matter of urgency, continue with steps to ensure that uniform regulatory standards apply across functionally similar financial market products and services, especially with regard to standards for advice on, selling, and marketing of products, as was recommended in 2003. ⁸
Independence of the regulator (Principle 2)	The authorities should give consideration to: <ul style="list-style-type: none"> a. mechanisms to strengthen the formal independence of the State ESAs; b. reviewing the reporting obligations of BaFin to the BMF with a view to streamlining them; and c. mechanisms, such as fixed term contracts, to ensure the position of the president and senior management of BaFin is secure and not open to potential arbitrary decisions based on political or other nonperformance-related considerations.
Regulatory compliance programs (Principles 10, 17 and 21)	BaFin should continue to develop and refine its risk assessment system, and make more intensive use of on-site inspections by BaFin staff as part of its monitoring activities. This will require additional resources. It is understood that BaFin is moving in this direction.
Market transparency (Principle 27)	The authorities should work toward achieving a more complete transparency regime in the context of the current European-wide review of aspects of the MiFID regime. At a minimum such a regime should include standards for data interoperability, and it should result in an effective mechanism to produce consolidated post-trade reporting for the equities market.

Authorities' response

65. **The authorities broadly agree with the assessment.**

66. **A proposal of the government on “grey capital market products” was published in April 2011.** The law is scheduled to be published early 2012. According to the draft law, grey capital market products will be financial instruments in the terms of

⁸ Proposals were published in April 2011 to treat “grey market” products as other financial instruments and to provide full BaFin supervision over investment services in grey capital market products performed by investment firms under BaFin’s supervision.

Securities Trading Act (Wertpapierhandelsgesetz, WpHG). The new definition of financial instruments will cover all grey market products, which are currently subject to the non-securities investment prospectus regime: this includes registered bonds, shares in civil-law partnerships, general partnerships or limited partnerships, silent partnerships, participation rights, trust units and units in other closed-end funds. According to the draft, the new regulation provides full BaFin supervision over investment services in grey capital market products performed by investment firms under BaFin's supervision. This means that the whole obligations of the WpHG are applicable.

67. **The authorities note that not only the use of their enforcement powers is robust but also the supervisory system in which such powers are exercised.** BaFin has implemented a coherent supervisory system with respect to CIS and Intermediaries. External auditors' services on the one hand - and risk assessments, market contacts and on-site inspections made use of by BaFin staff, as well as e.g. mandates for focused audits and audit regulations specifying audits and auditor reports on the other hand, complement each other and build a consistent supervisory system.

F. New IOSCO Principles

68. **In June 2010, IOSCO reviewed its Principles; nine new Principles were added and one Principle removed (Principle 6).** Until the methodology is in place, the new Principles are not assessed. However, a short discussion on the new Principles was held.

Table 7. Summary Implementation of the New IOSCO Principles

Principle	Findings
Systemic risk monitoring and perimeter of regulation: New Principle 6: The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate New Principle 7: The Regulator should have or contribute to a process to review the perimeter of regulation, appropriate to regularly.	Existing structures and practices in BaFin support a focus on systemic risk. Within the Directorate responsible for cross-sector issues, there is a risk and financial markets analysis department. Two years ago, BaFin established an organization-wide risk committee with representatives from all sectors, including insurance and supervision. In addition, a new risk committee was formed in late 2010 to focus on the nonbank components of the securities industry, such as hedge funds.

<p>Securitization: New Principle 8: The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.</p>	<p>The regulation of securitization will be done on an EU-wide basis, and include conflicts of interest provisions the major investor groups. Meanwhile, detailed conflict rules for licensed market intermediaries are in force (see under Principle 23 and the material referred to there).</p> <p>In January 2011, a new legislative framework for securitization came into effect in Germany. This framework introduced, for new securitizations after January 1, 2011:</p> <ul style="list-style-type: none"> a. a 5 percent retention rule (which is at a later stage planned to be increased to 10 percent); b. disclosure rules for sponsor and originators of securitizations; and c. a requirement that issuing institutions (banks) randomly select assets to be included in a securitization from a pool of assets selected for the securitization. <p>Assessment of measures to prevent conflicts of interest and misalignment of incentives are part of ongoing supervision of regulated entities. BaFin has published a related circular detailing the implementation of related legislation.</p>
<p>Auditor oversight: New Principle 19: Auditors should be subject to adequate levels of oversight New Principle 20: Auditors should be independent of the issuing entity that they audit. New Principle 21: Audit standards should be of a high and internationally acceptable quality</p>	<p>Auditors are subject to a system of public oversight by requiring auditors to be subject supervision by the Chamber of Auditors. Independence standards are specified in the Commercial Code. They include a requirement for auditor rotation after 7 years. The Commercial Code provides that audit standards adopted by the European Commission apply to statutory audits. Audit standards are largely in line with IASs.</p>
<p>Credit rating agencies: New Principle 22: Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision</p>	<p>Regulation of credit rating agencies (CRAs) is set at the EU. The relevant European Regulation (EC 1060/2009) provides a comprehensive set of rules regarding conflicts of interest, procedures, internal organization, transparency and the presentation of ratings. This framework reflects the IOSCO code of conduct for CRAs. Current oversight of the CRAs is based on an integrated oversight model involving supervisory colleges. From mid-2011, ESMA will assume responsibility for CRA regulation. Main elements relate to independence and avoidance of conflicts of interest; disclosure; and confidential information.</p>

<p>Analysts: Principle 23: Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.</p>	<p>For licensed firms, research activities from part of the regulated activities supervised by BaFin. These activities are subject the relevant requirements of MiFID and the Market Abuse Directive (MAD). The independent analysts are not required to be licensed but they are subject to regulations such as MAD.</p>
<p>Hedge Funds: Principle 28: Regulation should ensure that hedge funds and/or hedge fund managers/advisers are subject to appropriate oversight.</p>	<p>Hedge funds are already subject to regulation in Germany under the regulation applying to collective investment schemes, and to additional rules that apply specifically to them. The European Directive on Alternative Investment Funds Managers was formally approved in late 2010, and is expected to be transposed into national law and applied by Member States by 2013.</p>

IV. EUREX CLEARING AG OBSERVANCE OF THE CPSS-IOSCO RECOMMENDATIONS FOR CENTRAL COUNTERPARTIES

A. Summary

69. **Eurex Clearing AG (Eurex) observes the CPSS- IOSCO Recommendations for Central Counterparties (RCCPs).** Eurex has a sound, transparent, and enforceable legal basis to address the legal risks related to its activities. It has developed a comprehensive and adequate risk management framework to address financial and operational risks. The default rules and procedures are clearly stated in its rules, which are available to its participants. Participants' assets as well as collaterals are safely kept in regulated national and international depositories, although there is legal uncertainty for client's assets portability which is addressed by legislative proposals. Eurex uses central bank money for the cash settlement of most of its transactions. Eurex governance arrangements and composition of management, boards, and committees are clear and made publicly available.

70. **Eurex is regulated and supervised as a bank, and all regulatory requirements are related to banking activities.** BaFin does not fully observe the recommendation on regulation and oversight, as it has not defined any specific regulatory regime that covers Eurex CCP business. Furthermore, the Bundesbank does not have the legal basis to oversee Eurex as a financial market infrastructure.

71. **The authorities provisionally evaluated the impacts of the draft CPSS/IOSCO Principles (still to be finalized by the end of 2011) on Eurex activities, and it was concluded that the impact of the new principles on Eurex Clearing depends on the outcome of the current discussion.** Nevertheless, it was expected that

the new principles would not have a significant impact on Eurex, and it will be able to adjust to the new requirements as far as needed.

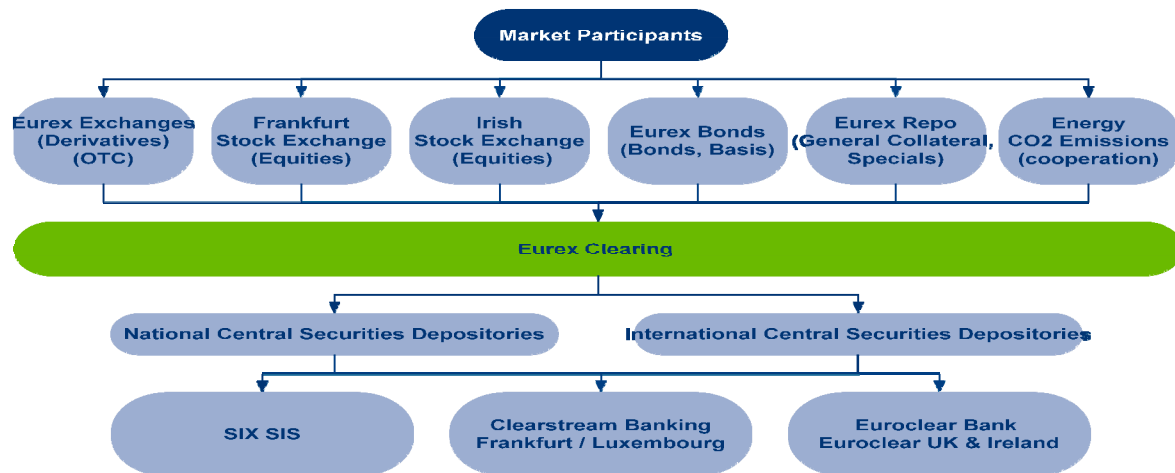
B. Information and Methodology Used for Assessment

72. **The assessment of Eurex against the CPSS/IOSCO RCCP was undertaken in the context of the IMF’s FSAP Update for Germany, which occurred from January 17–February 3, 2011.**⁹ Prior to the mission, Eurex conducted a comprehensive and clear self-assessment following the methodology of the RCCPs published in 2004. The assessor also benefited from discussions with *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin), Deutsche Bundesbank, as well as Eurex senior management and staff, and some major participants in the system. The German authorities were fully cooperative and all relevant documentation to fulfill the assessment was made readily available. Relevant authorities and the operator of the system have been very cooperative in providing supplemental information and organizing additional meetings, when required.

C. Institutional and Market Structure—Overview

73. **Eurex provides central counterparty services for several stock exchanges and over-the-counter (OTC) transactions.** It offers fully automated, electronic, and straight-through post trade services for both cash instruments and derivatives such as equities, bonds, repo, and energy products. The structure is illustrated by the following diagram:

Figure 1. Market Participants



⁹ The assessment was undertaken by Mr. Elias Kazarian (IMF, Monetary & Capital Markets Department).

Eurex was established in 1990 offering clearing services to Eurex predecessor, Deutsche Termin Börse. It is a wholly-owned subsidiary of Eurex Frankfurt AG, which in turn is jointly owned by Deutsche Börse AG and SIX Swiss Exchange.

Table 8. Key Statistics of Eurex, 2007-10

	2006	2007	2008	2009	2010
1. Number of transactions (millions)					
1.1 Equities	73.48	109.98	129.15	94.23	96.45
1.2 Debt instruments	0.009	0.089	0.115	0.085	0.097
1.3 Derivatives	1,526.75	1,899.80	2,165.04	1,687.16	1,896.92
TOTAL	1,600.24	2,009.87	2,294.31	1,781.48	1,993.47
2. Value of transactions (EUR billions)	108,039.4	127,156.4	116,757.3	80,525.9	99,838.9
3. Average daily value of transactions (EUR billions)	423.7	504.6	459.7	317.0	390.0
4. Peak value of transactions (EUR billions)	945.2	1,287.1	1,110.3	802.3	841.1
5. Number of clearing members of which:	119	118	109	117	128
5.1 Foreign clearing members	66	66	60	65	75
6. Clearing fund (EUR millions)	752	895	1,392	1,259	912

Source: Eurex.

74. **Eurex is licensed as a credit institution and is regulated and supervised by BaFin.** In conducting its oversight responsibilities, BaFin applies the RCCPs. Eurex is also subject to the Bundesbank's oversight. BaFin and the Bundesbank's statutory mandate to regulate and oversee Eurex is based on their banking supervisory capacity (German Banking Act). Both BaFin and Bundesbank have formal and extensive cooperation to monitor Eurex activities.

D. Main Findings

Legal Framework (Rec. 1)

75. **Eurex clearing activities are governed by a consistent and solid set of laws, regulations, rules, and instructions.** In particular, this legal framework supports the enforcement of transactions, netting procedures, protection of customer assets, and delivery versus payment (DVP) with finality. There are adequate rules for addressing the event of a participant default, including the effective use of collateral, and these rules can legally be enforced. The implementation of both the settlement finality and collateral directives provide a solid protection both in Germany and other EEA countries.

Participation requirements (Rec. 2)

76. **Eurex access and exit criteria are well defined and publicly disclosed.** Eurex requirements for participants' financial resources and operational reliability are defined according to membership category and the types of services selected by the participants. All members must be regulated entities and must have a minimum capital requirement. Eurex also reviews the external credit ratings of the applicants before approval and assesses participants' operational capability.

Financial risk management (Rec. 3-6)

77. **Eurex has a comprehensive risk management framework composed of objectives, measures, and tools defined at the level of Eurex and that of the DBG.** Eurex monitors its participants' exposure on a real-time basis, and conducts intra-day calls for margins. Eurex employs different tools to limit its exposures to potential losses from defaulting participants. Major measures include a high level of required capital, margin requirements, and contributions to the clearing fund. The levels of margins are verified via back testing and stress testing calculations. Eurex can also require additional financial resources/margins from participants in situations when unusual trading activity is detected. The stress testing policies, assumptions, and scenarios are discussed with market participants and the regulating authority, and mitigating actions are available on Eurex website. Eurex default procedures are clearly stated in the system's rules and published on its website.

Custody and investment risks (Rec. 7)

78. **Eurex securities and cash associated with its clearing activities are held in national and international central securities depositories.** Cash collateral is placed according to Eurex Treasury and Credit Policy, which describe standards for approving market counterparts and treasury limits. Some private banks are used for the deposit of non-Euro currencies, generally in form of repos. Eurex investments in United States dollars (USD) are carried out through repo transactions and the Bank of New York Mellon and JP Morgan Chase act as triparty agents.

Operational risk (Rec. 8)

79. **Eurex business continuity arrangements are developed at the level of the holding company, DBG, and covers all sites, networks control centers and business sites.** At the DBG level, there is a group risk management that defines the overall objectives and monitors the overall risk profile of DBG, including a comprehensive business continuity management (BCM) policy. The BCM policy ensures that the risk framework is implemented group-wise so that all risks are identified, centrally recorded, and systemically assessed. Contingency plans and back-up facilities are regularly tested

with market participants and relevant parties, and maintained to ensure the resilience of Eurex.

Money settlements (Rec. 9)

80. **Eurex uses both central bank money and private settlement bank for cash processing (margin and settlement).** The central bank money is used for cash payments of euros (EUR) and Swiss francs, and for settlement in the Euro area and Swiss markets. For cash payments of British pound and USD, as well as for global Eurobond settlement, private settlement banks, including the two international central securities depositories (ICSDs), Clearstream Banking and Euroclear Bank, are used.

Physical deliveries (Rec. 10)

81. **Eurex deliveries of securities are carried out in book-entry form (immobilized or dematerialized), and delivery obligations are fulfilled via book transfer.** Eurex Clearing Conditions clearly define the responsibilities to deliver and receive securities from participants. The Eurex delivery process is supported by a DVP and a receive versus payment settlement eliminating principal risk. A simultaneous booking is always given due to the functionality of the chosen settlement system of the CSD, which operates on DVP.

Risks in links between central counterparties (Rec. 11)

82. **Eurex has one link with the European Commodity Clearing AG (ECC), which is located in Germany.** The contractual relation is simultaneously extended by Eurex as a counterpart of the ECC and the clearing member. Eurex has specific rules and risk methodology for linked CCPs, aimed at minimizing the risk that all obligations cannot be performed in a timely manner. Both Eurex and the ECC are regulated and supervised by BaFin and designated payment systems, which provides legal protection to finality.

Efficiency (Rec. 12)

83. **Eurex reviews its pricing and service levels, as well as capacity level on a regular basis.** It performs periodic benchmarking studies with comparable CCPs in other European countries to assess its costs and fees. Eurex applies higher prices to clear OTC transactions compared to exchange-traded transactions. Although such a policy has the merit that it encourages moving trade to exchanges, it is possible that the clearing fees for nontraded transactions are subsidizing the cost of clearing traded transactions.

Governance (Rec. 13)

84. **Eurex is a wholly-owned subsidiary of Eurex Frankfurt, which is owned by Eurex Zurich, and the latter is jointly owned by Deutsche Börse and SIX Swiss Exchange.** Eurex governance arrangements and composition of the boards are clear and publicly available via the Eurex website. At its supervisory board, Eurex has representative from Deutsche Börse, market participants, and regulators (only as observers).

Transparency (Rec. 14)

85. **Eurex discloses to its clearing members and other market participants its rules, procedures, and policy on its website.** These rules cover, among other things, governance issues, the rights and obligations of participants, procedures for handling risks, and fees for using its services. Also important notices and information are posted on the website. Eurex has completed a comprehensive self-assessment following the RCCPs assessment methodology.

Regulation and oversight (Rec. 15)

86. **Eurex is regulated and supervised by several authorities.** In Germany, the main regulator is BaFin, which cooperates with Deutsche Bundesbank. As a global CCP, Eurex is also regulated and overseen by the Swiss Financial Market Supervisory Authority/Swiss National Bank, as a recognized overseas clearinghouse by the United Kingdom Financial Service Authority, and as a Multilateral Clearing Organization by the United States Commodities Futures Trading Commission as well as by the United States Securities and Exchange Commission. Licensed as a credit institution and subject to the banking act, Eurex does not have a specific regime for its CCP activities, although BaFin has been using the overall risk management provision to require Eurex to meet the CPSS/IOSCO recommendations.

Table 9. Summary of Detailed Assessment of the Observance of Eurex Clearing AG (Eurex) of the CPSS-IOSCO Recommendations for Central Counterparties

Responsibility	Comments
Legal risk	
1. Central counterparties should have a well-founded, clear and transparent legal basis in the relevant jurisdiction.	Eurex is regulated as a credit institution with a single purpose to provide clearing activity. The banking law and other legislations provide a sound, transparent, and enforceable legal basis for each aspect of its activities. Eurex can change its clearing conditions without prior consultation or approval by the relevant regulator and overseer, although Eurex does so in practice. It is recommended that the relevant authorities should require Eurex to consult the authorities prior to deciding on any material changes of its clearing conditions.
Participation requirement	
2. A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met in an on-going basis. A CCP's participation requirements should be objectives, publicly disclosed, and permit fair and open access.	Eurex has adequate financial and technical requirements for participants, which are based on the types of membership and the products and services that the member will use. In particular, a full member must be regulated by the relevant authorities, meet adequate minimum capital, contribute to the clearing fund, have qualified staff and meet the minimum level of technical capability including network communication, and establish appropriate settlement arrangement.
Measurement and management of credit exposures	
3. A CCP should measure its credit exposure to its participants at least once a day. Through margin requirements, other risk control mechanisms or a combination of both, a CCP should limit its exposure to potential losses from defaults of its participants in normal market conditions so that the operation of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.	Eurex has a comprehensive and adequate risk management framework composed of objectives, measures, and tools defined and implemented at the level of Eurex entity and the DBG. This framework is reviewed and assessed on a regular basis. Eurex employs different tools to limit its exposures to potential losses from defaulting participants, including capital requirement, margin requirement, contribution to clearing fund, and employs other risk control mechanisms. In addition, intra-day risk controls are in place to safeguard and strengthen the lines of defense of Eurex and thus ensuring its continuous integrity for the markets cleared by Eurex.

Responsibility	Comments
Margin requirements	
<p>4. If a CCP relies on margin requirements to limit its credit exposures to participants, these requirements should be sufficient to cover potential exposures in normal market conditions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.</p>	<p>Eurex relies on initial and variation margin requirements to limit its credit exposures to participants. The margin requirements are met through cash and eligible securities deposited in regulated entities. Eurex tests regularly the risk-based model on which the margin requirements calculation is based. The margin model and its parameters are regularly validated internally and by the authorities.</p>
Financial resources	
<p>5. A CCP should maintain sufficient financial resources to withstand, at a minimum, the default of a participant to which it has the largest exposure in extreme but plausible market conditions.</p>	<p>By using a comprehensive risk management framework, Eurex has defined its financial resources needed to withstand the default of three participants with the largest exposures in extreme, but plausible market conditions. Eurex performs daily stress testing with extreme, but plausible market conditions, which can also be run on intraday basis when needed. As a CCP Eurex has access to an intraday credit facility of the Eurosystem in line with the TARGET2 Guideline.</p>
Default procedures	
<p>6. A CCP default procedures should be clearly stated, and should ensure that the CCP can take timely action to contain losses and liquidity pressure and to continue meeting its obligations. Key aspects of the default procedures should be publicly available.</p>	<p>Eurex default rules and procedures are clearly stated in its clearing conditions, which allow Eurex to transfer customers' positions to another clearing member, close out, and settle the defaulting member's open positions. Eurex also has the right to assign the remaining positions pro rata to the nondefaulting clearing members.</p> <p>Although customer's securities and collateralized assets have a strong legal protection, German insolvency law does currently not fully support the portability of customer positions and collateral. Insolvency law as it currently stands provides for close-out netting of customer positions in the event of a clearing member's default. In parliament, an amendment to the existing insolvency law is currently discussed that would allow the CCP to transfer customer positions and collateral to another clearing member in the event of the original clearing member's default.</p>

Responsibility	Comments
Custody and investment risk	
<p>7. A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimised. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.</p>	<p>Securities pledged to Eurex by its participants are only deposited with CSDs and ICSDs, which are supervised by national authorities. These securities can be withdrawn only with the consent of Eurex clearing AG.</p> <p>Eurex has in place processes and specialized staff to monitor the custodian banks, including daily monitoring and periodical review of the custodians. Eurex assesses these custodians against recommendation 12 with regard to accounting practices and safekeeping/internal control procedures, regulated, and strong financial position.</p>
Operational risk	
<p>8. A CCP should identify sources of operational risk and minimise them through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfillment of a CCP's obligations.</p>	<p>The Eurex risk management framework is governed by policies and procedures defined both at the level of Eurex and of the DBG, which has developed and implemented a comprehensive BCM policy. This policy defines the organizational roles and responsibilities, and the guiding principles to ensure operational resilience.</p> <p>To ensure business continuity, there are two geographically separated IT processing sites. The systems are clustered between the two data centers and load balanced in normal operation mode with continuous full data synchronization (real-time data mirroring). Eurex carries out testing of its contingency plan, IT infrastructure, and communication network with the majority of its participants on an annual basis.</p>
Money settlements	
<p>9. A CCP should employ money settlement arrangements that should eliminate or strictly limit its settlement bank risks, that is, its credit and liquidity risk from the use of banks to effect money settlements with its participants. Funds transfers to a CCP should be final when effected.</p>	<p>Eurex relies on a few banks for the settlement of foreign exchange denominated transactions, which exposures it to settlement risk. Access to central bank account would enhance the integrity of the settlement process. To this end, in 2008, Eurex applied for an account with the Federal Reserve Bank of New York but no positive access decision has been taken since then.</p> <p>Eurex uses central bank money for a broad range of products; e.g., the collections of margins, the settlement of German equities, and the settlement of bonds and repos. Nevertheless, as most banks hold their fixed income portfolios in the ICSDs (i.e., Clearstream Luxembourg and Euroclear Bank Brussels), contracts based on these fixed income securities are settled in commercial bank money in those ICSDs. This applies to bond and repo transactions carried out on the trading platforms Eurex Bonds and Eurex Repo.</p> <p>To further reduce settlement risk, Eurex may consider to settling in central bank money and/or increasing the number of settlement agent banks for foreign exchange currencies.</p>

Responsibility	Comments
Physical deliveries	
10. A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.	Eurex deliveries of securities are carried out in book-entry form (immobilized or dematerialized) and delivery obligations are fulfilled via book transfer. Eurex rules clearly define the responsibilities to deliver and receive securities from participants. Eurex settles on a DVP basis, which takes place in the CSD or ICSD. All risks affecting deliveries are assessed by risk management in real-time.
Risks in links between CCPs	
11. CCPs that establish links either cross-border or domestically to clear trades should evaluate the potential sources of risks that can arise, and ensure that the risks are managed prudently on an ongoing basis. There should be a framework for cooperation and coordination among the relevant regulators and overseers.	Eurex has currently one link with the ECC. There is a clearing link agreement between Eurex and ECC that define the rights and obligations between Eurex and ECC. Eurex has specific rules and procedures for a linked CCP. Before entering into a link, risks are evaluated (including due diligence or other analysis/measures as seen fit) according to a specific link methodology. Once a link is implemented and is operational, the risks associated with the link are evaluated daily.
Efficiency	
12. While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants.	Eurex has in place procedures to control its operational costs. Eurex performs periodic benchmarking studies with comparable CCPs in other European countries to assess its costs and fees. Eurex applies higher prices to clear OTC transactions compared to exchange-traded transactions. Eurex's argument for this policy is to promote the move of OTC transactions to the exchange. Although such a policy has merits, it is possible that there is a preferential treatment to clear traded transactions compared to the clearing of OTC transactions.
Governance	
13. Governance arrangements for a CCP should be clear and transparent to fulfill public interest requirements and to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures.	<p>Eurex governance arrangements are clear and transparent, and publicly available via the Eurex website. These arrangements also reflect the public interest requirements and support the objectives of owners and participants.</p> <p>Eurex should increase the number of independent board members taking into account the interests of small and medium-sized clearing members.</p> <p>Due to the crucial role of Eurex in the German financial market, BaFin may explore the possibility to define explicit public interest objective to Eurex such as to facilitate prompt, efficient, and sound clearing of securities transactions.</p>

Responsibility	Comments
Transparency	
14. A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the costs and risks associated with using its services.	Eurex discloses to its clearing members and other market participants its rules, procedures, and policies on its website. These rules cover, among other things, governance issues, procedures for handling risks, the rights and obligations of participants, and the costs of using its services.
Regulation and oversight	
15. A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and an international context, central banks and securities regulators should cooperate with each other and with other relevant authorities.	<p>Eurex is regulated and supervised as a bank, and all regulatory requirements are related to banking activities. There is no special regulatory regime that covers Eurex' CCP business. Both BaFin's and the Bundesbank's mandates to regulate, supervise and oversee Eurex is based on its banking status. Furthermore, the Bundesbank does not have the legal basis to oversee Eurex as financial market infrastructure.</p> <p>The Bundesbank should be provided with the legal mandate to oversee Eurex as a CCP. Further, the Bundesbank's staff should participate in the onsite inspection of Eurex as a complementary to BaFin's regulatory responsibility.</p> <p>Given the intensive involvement of BaFin and Bundesbank in domestic and international committees, working groups and fora on clearing and settlement, the current staff is not entirely sufficient to effectively carry out regulation and oversight of clearing activities. To this end, BaFin and the Bundesbank should recruit additional staff to regulate and oversee clearing activities.</p> <p>For the full compliance with this recommendation:</p> <ol style="list-style-type: none"> a. BaFin should define and disclose its objectives and policies with regard to CCPs activities. b. BaFin should either issue a new regulatory regime dedicated to CCP activities, or further develop, in the Banking Law, special rules and requirements for CCP activities. c. BaFin should request Eurex to consult BaFin for any material changes of its clearing conditions.

E. Recommended Action Plan and Authorities' Response

Table 10. Actions to Improve Compliance with CPSS-IOSCO Recommendations

Reference Recommendation	Recommended Action
Recommendation 1: Legal risk	It is recommended that the relevant authorities should require Eurex to consult the authorities in advance for any material changes of its clearing conditions. This procedure would achieve a higher degree of legal safety, better ensure that the public interest is taken into account, and increase impartiality vis-à-vis its participants.
Recommendation 15: Regulation and oversight	<p>BaFin should clearly define and disclose its objectives and policies with regard to CCP activities.</p> <p>BaFin should either issue a new regulatory regime dedicated to CCPs activities, or further develop, in the Banking Law, specific rules and requirements for CCPs activities.</p> <p>BaFin should request Eurex to consult BaFin for any material changes of its clearing conditions.</p> <p>The Bundesbank should be provided with the legal mandate to oversee Eurex as a CCP. Further, the Bundesbank's staff should participate in the onsite inspection of Eurex as a complementary function to BaFin's regulatory responsibility</p> <p>BaFin and the Bundesbank should recruit additional staff to carry out the regulation and oversight of clearing activities more effectively.</p>

Table 11. Further Recommended Actions

Reference Recommendation	Recommended Action
Recommendation 6: Default procedures	At present, the legal basis to ensure portability of a customer's collaterals is not entirely robust from a legal viewpoint. In the case of default, there is a potential risk that the customer's holdings cannot be ported to another clearing member. However, an amendment of Article 104a of the insolvency law to eliminate this potential risk is currently under discussion in Bundestag.
Recommendation 9: Money settlements	To further reduce settlement risk, Eurex may consider to settling in central bank money and/or increasing the number of settlement agent banks for FX currencies.
Recommendation 12: Efficiency	Eurex should make public its differentiated price policy with regard to clearing nontraded transactions as a part of the general policy to encourage movement of these transactions to the exchange.

Reference Recommendation	Recommended Action
Recommendation 13: Governance	<p>Eurex should increase the number of independent board members taking into account the interests of small and medium-size clearing members.</p> <p>Due to the crucial role of Eurex in the German financial market, BaFin should explore the possibility of defining an explicit public interest objective to Eurex, such as facilitating prompt, efficient, and sound clearing of securities transactions.</p>

Authorities' response to the assessment

87. **In Recommendation 13, the IMF suggests to increase the number of independent board members taking into account the interests of small and medium-sized members.** However, Eurex has to take into account that in Germany, the members of the supervisory board are elected by the shareholders only and Eurex cannot influence their decision.