Peer Review of Germany

Review Report

9 April 2014

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Foreword

Financial Stability Board (FSB) member jurisdictions have committed, under the FSB Charter and in the *FSB Framework for Strengthening Adherence to International Standards*[1], to undergo periodic peer reviews. To fulfil this responsibility, the FSB has established a regular programme of country and thematic peer reviews of its member jurisdictions.

Country reviews focus on the implementation and effectiveness of regulatory, supervisory or other financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving desired outcomes. They examine the steps taken or planned by national authorities to address International Monetary Fund (IMF)–World Bank Financial Sector Assessment Program (FSAP) and Report on the Observance of Standards and Codes (ROSC) recommendations on financial regulation and supervision as well as on institutional and market infrastructure that are deemed most important and relevant to the FSB's core mandate of promoting financial stability. Country reviews can also focus on regulatory, supervisory or other financial sector policy issues not covered in the FSAP that are timely and topical for the jurisdiction itself and for the broader FSB membership. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, or its compliance with international financial standards.

FSB jurisdictions have committed to undergo an FSAP assessment every 5 years; peer reviews taking place 2-3 years following an FSAP will complement that cycle. As part of this commitment, Germany volunteered to undergo a peer review in 2013.

This report describes the findings and conclusions of the Germany peer review, including the key elements of the discussion in the FSB's Standing Committee on Standards Implementation (SCSI) on 10 March 2014. It is the eleventh country peer review conducted by the FSB and the fifth using the revised objectives and guidelines for the conduct of peer reviews set forth in the December 2011 *Handbook for FSB Peer Reviews.*[2]

The analysis and conclusions of this peer review are based on the German financial authorities' responses to a questionnaire and reflect information on the progress of relevant reforms as of December 2013. The review has also benefited from dialogue with the German authorities as well as discussion in the FSB SCSI.

The draft report for discussion was prepared by a team chaired by Arthur Yuen (Hong Kong Monetary Authority) and comprising Dimple Bhandia (Reserve Bank of India), Jean Boissinot (French Treasury), Remy Jansen (Dutch Central Bank) and Lau Lee Chin (Monetary Authority of Singapore). Jason George and Costas Stephanou (both FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

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1 See http://www.financialstabilityboard.org/publications/r_100109a.pdf.

2 See http://www.financialstabilityboard.org/publications/r_120201.pdf.

Abbreviations

AIF	Alternative Investment Fund
AIFMD	Alternative Investment Fund Managers Directive
BaFin	Federal Financial Supervisory Authority
BCBS	Basel Committee on Banking Supervision
BMF	German Federal Ministry of Finance
CAR	Capital adequacy ratio
CCP	Central counterparty
CPSS	Committee on Payment and Settlement Systems
CRD	Capital Requirements Directive (EU)
CRR	Capital Requirements Regulation (EU)
CSD	Central Securities Depository
DGS	Deposit guarantee schemes
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EUR	Euro
FMIs	Financial market infrastructures
FMSA	Federal Agency for Financial Market Stabilisation
FSA	Act on Monitoring Financial Stability
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee (*Ausschuss für Finanzstabilität*)
FSR	Financial Stability Report
GDP	Gross Domestic Product
G-SII	Global systemically important insurer
IAIS	International Association of Insurance Supervisors
ICAAP	Internal Capital Adequacy Assessment Process
ICPs	Insurance Core Principles
IMF	International Monetary Fund
IORPs	Institutions for occupational retirement provision
IOSCO	International Organisation of Securities Commissions
IRB	Internal Ratings Based approach
IT	Information Technology
JST	Joint Supervisory Team (SSM)
MoU	Memorandum of Understanding
OTC	Over-the-counter
ROSC	Reports on the Observance of Standards and Codes
SCSI	Standing Committee on Standards Implementation
SIB	Systemically important bank
SIFI	Systemically important financial institution
SoFFin	Financial Market Stabilisation Fund
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism
UCITS	Undertakings for Collective Investment in Transferable Securities

Executive summary

Background and objectives

The main purpose of this peer review is to examine two topics that are relevant for financial stability and important for Germany: the macroprudential policy framework and microprudential supervision. Both topics were included in the key FSAP recommendations and are topical for the broader FSB membership. The peer review focuses on the steps taken to date by the German authorities to implement reforms in these areas, including by following up on relevant FSAP recommendations.

Main findings

Good overall progress has been made in addressing the FSAP recommendations in both areas, although several elements of the reforms are ongoing. Going forward, the authorities need to expeditiously develop and implement a comprehensive macroprudential strategy, and to further strengthen the banking and insurance supervisory frameworks in order to enhance risk identification and allow for timely intervention in financial institutions. An important driver of developments in this context has been, and will continue to be, EU initiatives.

Macroprudential policy framework

The reforms in institutional and organisational arrangements introduced by the Financial Stability Act (FSA) broadly address the FSAP recommendations on the macroprudential policy framework. In particular, the law delineates statutory responsibilities for financial stability in Germany; establishes the Financial Stability Committee (FSC), and mandates the Bundesbank to provide it with substantial analytical support, including the identification of systemic risks and the formulation of recommendations to mitigate them; specifies arrangements for cooperation and information exchange between the Bundesbank and the Federal Financial Supervisory Authority (BaFin); and provides for backstop powers to collect additional information from financial institutions.

The FSC brings together key officials with a wide range of expertise, perspectives and responsibilities. The organisational design attempts to strike a balance between the responsibilities of the institutions represented in the FSC – the Federal Ministry of Finance (BMF), Bundesbank, BaFin and, as a non-voting member, the federal agency for financial market stabilisation (FMSA) – and their respective individual mandates.

The FSC is already functional but, with just about a year of existence, it is too early to evaluate effectiveness in attaining its mandated objectives. The authorities emphasise that the FSC has already played an instrumental role in strengthening cooperation between its members as well as deepening and formalising the information sharing arrangements between the Bundesbank, BaFin, and the FMSA. In that context, the main benefit of the FSC has been to act as an overlay to the existing institutional structure by enhancing coordination and information exchange among senior policymakers across different authorities.

The framework underpinning the FSC will need to be clarified and fine-tuned as processes crystallise and as more experience is gathered. The FSC will also need to promptly develop a macroprudential strategy and operationalise it. It is important for this strategy to be comprehensive and to address aspects of the FSC's institutional design that remain unclear:

- *Scope of coverage:* The FSC's focus is not on regulation per se but rather on systemic risks and how to address them, including through regulation. However, the extent of its involvement in the development or implementation of regulations with systemic implications is not fully clear. This also applies for crisis management and resolution of a failing systemically important financial institution, particularly since several FSC members may be involved in those decisions within their institutions. The authorities indicate that some of these issues are discussed in the FSC (e.g. the calibration of the macroprudential tools set forth in the EU's Capital Requirements Directive (CRD) IV/Capital Requirements Regulation (CRR)), but that the FSC is not necessarily steering the debate and that each member institution has the mandate and authority to act if the need arises. However, there could be instances in the future whereby disagreements could arise among member institutions as to whether an issue should be discussed by the FSC or not. It may therefore be preferable – both for transparency and accountability – if there was greater clarity on the types of issues that are within the scope of the FSC for discussion and/or for decision-making purposes.

- *Deliberations and decision-making:* The German authorities are of the view that FSC members participate in the deliberations primarily as official representatives of their respective institutions, but also in a personal capacity. Such an arrangement may foster more open and frank discussions within the FSC, but it may also lead to confusion if the members are called upon to reach a decision (e.g. for the issuance of a warning or recommendation) that potentially binds their institutions without providing an opportunity for prior consultation within their respective institutions. Moreover, decision-making by the FSC, particularly on key issues, is supposed to be based on consensus. Failure to reach consensus does not mean that a majority decision cannot be taken (recognising that the Bundesbank retains a veto with respect to key decisions) or that the member institutions cannot act unilaterally based on their own statutory powers. A consensus-driven approach has strong merits in terms of reaching a common understanding of systemic risks and facilitating the coordinated implementation of measures to address them, but there are also possible downsides. One such example is the risk of inaction arising from the efforts by any one member institution to reach consensus within the FSC (to avoid being seen as proceeding unilaterally). Conversely, the potential market signal and implications for the FSC's functioning if member institutions were to take independent action on issues that fall within the scope of the FSC may need to be examined. It would therefore be important for the German authorities to develop protocols and procedures for reconciling diversity of views in decision-making.

- *Warnings and recommendations:* The primary policy instrument at the disposal of the FSC is its ability to issue warnings or 'comply or explain' recommendations to public sector authorities. The authorities emphasise that there should be no mechanistic threshold or predetermined criteria to trigger such actions. Given the nature and diversity of factors that could impinge on financial stability, a certain amount of flexibility and discretion in this area is desirable. At the same time, however, the FSC should be able to form a consistent view on the conditions that would prompt the issuance of a warning or a recommendation. This would necessitate the development of an analytical framework setting out the relevant considerations to determine the potential need for specific warnings and recommendations before a decision is made. Moreover, while the FSC has not yet issued any warnings or recommendations, it would be useful to develop the framework underpinning the 'comply or explain' mechanism, such as the parameters and criteria that will be used to determine that a warning or recommendation has been complied with or that an explanation about non-compliance is acceptable (and on how to proceed if it is not), and to assess the impact of the policy measure and whether it has been effective.

- *Macroprudential tools:* The FSA does not equip the FSC with specific macroprudential tools. The tools that are currently available, and that are within the remit of BaFin, are those specified in CRD IV/CRR. Experience from other countries indicates that such tools may not be sufficient to address certain systemic risks and that other tools may also be needed. However, the legislative process necessary to deploy a new tool may last longer than desirable, especially during times of stress when prompt action is needed. In addition, this process may itself generate undesirable market behaviour. As a result, it is desirable to define ex ante (to the extent possible) a macroprudential toolkit instead of waiting for specific risks to emerge before proposing and adopting new tools.
- *Communication:* Thus far, there has been little use of public communication by the FSC, with one press release having been issued following its inaugural meeting. The authorities have expressed a preference for the FSC to only engage in public communication when necessary (e.g. to announce a warning or a recommendation) in order to maximise its impact. The authorities are also of the view that the FSC's main communication tool is its annual report to the Bundestag. While useful for enhancing accountability, it is not clear this tool is sufficient or targeted enough to ensure effective communication to stakeholders. Drawing on examples from other countries, the authorities may find it useful to reflect on the current approach to ensure that opportunities for effective communication to various target audiences are not missed. It would also be helpful if there was greater clarity on whether members of the FSC can and should speak on behalf of the FSC as opposed to their own institution.

Microprudential supervision

Overall, good progress has been made in response to the FSAP recommendations to enhance the microprudential supervisory framework for banks and insurers, including by incorporating some of the latest regulatory developments and international guidance. In particular, the stress testing framework and coverage for banks and insurance companies has been enhanced, the regulatory reporting framework for both sectors has improved, and the intensity of on-site supervision for larger banks has increased. Regulatory initiatives at both global and European level have shaped the direction and pace of German reforms in this area.

An important development impacting banking supervision in Germany will be the commencement of the Single Supervisory Mechanism (SSM) on 4 November 2014. On this date, primary responsibility for the supervision of the largest banks in the Euro area, including an expected 24 German banks, will be transferred to the European Central Bank (ECB). National authorities will remain involved in the supervision of those banks, as it is expected that they will assist the ECB in the performance of its new supervisory tasks. For smaller banks, national competent authorities will retain responsibility with ECB oversight. These changes will have a significant impact on the roles, responsibilities and tasks of both BaFin and Bundesbank as well as on current supervisory practices.

While these changes pose uncertainties and challenges, the German authorities are encouraged to continue their efforts to enhance supervisory frameworks and processes. In particular, the transition to the SSM does not lessen the need by the authorities and/or the ECB to implement measures to further enhance: (i) prompt and comprehensive risk identification; and (ii) timely and effective supervisory intervention.

Prompt and Comprehensive Risk Identification

The authorities need to continue to strengthen their supervisory practices to enable the early and comprehensive identification and assessment of risks within each institution, including:

- *Business model and risk culture:* The authorities acknowledge the significant impact of business models on banks' and insurance companies' forward-looking risk profile and have undertaken some work in this area, particularly on insurance supervision. At the same time, the authorities point out that the choice of business model remains the responsibility of the institution; the supervisory response in the first instance is to ensure that the institution's Board and senior management have considered the inherent risks stemming from their business models and that there exist appropriate controls and buffers to mitigate them. Building on existing experience and instruments as well as forthcoming European Banking Authority (EBA) and ECB guidance, BaFin and the Bundesbank should adopt a comprehensive approach for assessing banks' and insurance companies' business models. This will allow supervisors to identify the inherent risks associated with different business models independently from the institutions and help them challenge assumptions made by those institutions on the level of risk and the required controls and buffers. Moreover, since major acquisitions (and qualifying holdings) can have a significant impact on banks' risk profile, the authorities should consider adapting their practices to ensure that, at a minimum, they are always informed of such activities at an early stage. This would enable supervisors to identify and assess the potential risk implications for the institution and to take steps to mitigate or avoid these risks. Finally, drawing on international guidance on corporate governance and risk culture, the authorities are encouraged to continue to increase their expertise and efforts to ensure appropriate coverage of these qualitative aspects through on-site inspections and off-site analysis.
- *Credit risk oversight:* Even though the Bundesbank regularly performs credit inspections of banks' internal ratings based approach (IRB), much reliance is placed on external auditors to assess non-IRB aspects of credit risks, such as asset quality and the adequacy of loan loss provisioning. The authorities rarely conduct on-site inspections of these areas, with BaFin typically commissioning external auditors to perform such reviews. Since credit risk is the primary inherent risk for the large majority of banks, it is imperative that the German authorities have sufficient in-house expertise to identify and supervise all aspects of credit risks, including non-IRB elements. In addition, and as recommended by the Basel Committee and the FSB, supervisors must be able to assess whether the output from third parties such as

external auditors can be relied upon to the degree intended. BaFin and the Bundesbank should evaluate, as part of their ongoing review of resources, the need for strengthening their internal credit risk supervision expertise to enable them to increase the depth and frequency of inspections in this area and enhance their quality assurance of third party assessments of asset quality and credit provisioning processes.

- *Stress testing liquidity risks:* The Bundesbank has made commendable efforts to enhance the rigor and institutional coverage of stress testing for banks, but has yet to incorporate liquidity risks within its framework. Banking supervisors regularly review banks' internal stress test framework/models and obtain internal liquidity stress test results from selected banks to evaluate their forward-looking liquidity positions. However, these results are less independent, comparable and consistent than those derived from the authorities' own tests. The authorities are encouraged to incorporate liquidity scenarios in their stress testing framework and to perform their own liquidity stress tests. In addition, the authorities could further embed liquidity and other stress tests in their supervisory practices and make greater use of stress test results.
- *Insurance on-site inspections:* Due to Solvency II preparations, BaFin has been unable to increase the number of on-site inspections of insurance companies. While this has been compensated for to some extent by other activities, such as meetings with board members and short visits to institutions, BaFin is encouraged to follow through with its plans to double the number of on-site inspections. The Solvency II preparations have also resulted in most on-site inspections focusing primarily on the readiness of insurance companies' internal models, including risk management requirements. Although understandable, this has meant that various other key risk areas of insurance companies – such as those related to information technology, new investments, products and activities – have received relatively less attention. BaFin should identify the key risk areas of insurers based on its new risk classification approach and use them to determine its on-site inspection programme.

Timely and Effective Intervention

Timely and effective supervisory intervention that is commensurate with the nature and severity of identified issues ensures that the institution takes appropriate corrective actions. An important tool in this respect is a "ladder of supervisory actions":

- *Ladder of actions for banking supervision:* BaFin adopted in December 2013 a formal "ladder of actions" for banking supervision that sets out a series of supervisory actions and measures when deficiencies are identified in organisational matters, capital adequacy or liquidity. Although the ladder includes some forward-looking elements, its effectiveness could be further enhanced by placing greater emphasis on forward-looking elements (e.g. risks to the long-term viability of a bank's business model or potential weaknesses stemming from its risk appetite and culture) as well as by expanding quantitative and qualitative triggers beyond those found in the German Banking Act and existing guidelines. These triggers should not be set as "hard" or mechanical thresholds mandating actions to be taken once they are breached. Rather, they should serve as internal guidance points to prompt further analysis/escalation by supervisors. They would reduce the degree of subjectivity when implementing the ladder and, bearing in mind the diversity of institutions, enable greater consistency of actions across teams or when the need arises to escalate issues. The introduction of such triggers may in some cases also help to reduce delays in supervisory responses to bring about corrective action for banks and increase the willingness to act.

- *Ladder of actions for insurance supervision:* The Insurance Act provides BaFin with a wide range of measures for insurance supervision, from the prudential and consumer protection perspectives. These measures, however, have not been translated into a formal "ladder of actions" to guide interventions for different types of identified problems. BaFin should consider adopting such a ladder for insurance supervision, taking into account the specific nature of insurance supervision as well as the diversity of insurance entities in Germany and hence the range of issues that may arise.

Recommendations

In response to the aforementioned findings and issues, the peer review has identified the following recommendations for consideration by the German authorities:

Macroprudential policy framework

- The FSC should consider further specifying its role on financial stability issues – such as in the development and implementation of prudential regulations and involvement in crisis management and resolution – to ensure clarity vis-à-vis its member institutions and to enhance accountability.
- The FSC should put in place an analytical framework setting out the: (a) conditions for triggering warnings and recommendations; (b) functioning of the 'comply or explain' mechanism; and (c) approach to assessing the impact of the policy action.
- The FSC should develop a comprehensive macroprudential toolkit on an ex ante basis to ensure the timely application of relevant tools if the need arises.
- The FSC should develop a comprehensive strategy to maximise the effectiveness of its communication and avoid duplication with its member institutions. This strategy should include the identification of target audiences and the calibration of the range and content of communication tools accordingly.

Microprudential supervision

- BaFin and the Bundesbank should continue to strengthen their supervisory practices to ensure the early and comprehensive identification of risks within each institution. This includes *inter alia* enhancing business model and risk culture analysis; ensuring that supervisors are aware of major acquisitions by supervised banks and are able to take necessary actions at an early stage in response to their impact on banks' risk profile; increasing credit risk expertise to enhance the oversight of non-IRB aspects of credit risk; incorporating liquidity risk scenarios in their stress testing framework; and increasing the number and scope of on-site inspections for insurance companies.
- To enhance the timeliness, consistency and effectiveness of supervisory interventions, BaFin should expand the use of forward-looking elements and of objective quantitative and qualitative triggers in the banking supervision "ladder of actions"; and introduce a separate "ladder of actions" for insurance supervision.

1. Introduction

Germany underwent an FSAP update in 2011[3] that included assessments[4] of the Basel Committee on Banking Supervision's (BCBS) *Core Principles for Effective Banking Supervision*, the International Association of Insurance Supervisors (IAIS) *Insurance Core Principles*, the International Organisation of Securities Commissions (IOSCO) *Principles and Objectives of Securities Regulation*, and the Committee on Payment and Settlement Systems (CPSS)-IOSCO *Recommendations for Central Counterparties*.

The FSAP concluded that the German financial system had stabilised and was recovering after parts of it were hit hard during the global financial crisis. While banks were found to be robust against many shocks, important vulnerabilities remained – such as balance sheet weaknesses in some banks (e.g. concentration risks, wholesale funding exposures) and widespread low profitability that made it more challenging to build up stronger capital buffers. The FSAP commended the high standard of financial sector regulation and supervision, but it also identified areas of specific weakness in the crisis and it stressed that structural reforms (particularly for Landesbanken)[5] were overdue. Finally, the FSAP noted that the framework to manage financial crises had been enhanced significantly, particularly with the introduction of a new bank resolution regime, but that deposit protection schemes needed to be rationalised and that specific strategies for exiting from government support to banks should be finalised.

The main purpose of the peer review report is to examine two topics that are relevant for financial stability and important for Germany: its macroprudential policy framework and microprudential supervision. Both topics were included in the key FSAP recommendations and are topical for the broader FSB membership. The peer review focuses on the steps taken to date by the German authorities to implement reforms in these areas, including by following up on relevant FSAP recommendations. In particular, the review evaluates progress with the reforms in order to draw conclusions and policy implications as well as identify remaining impediments and lessons that could be of benefit to Germany and its FSB peers.

The report has two main sections, corresponding to the two topics being reviewed. Section 2 focuses on the macroprudential policy framework, while Section 3 analyses the steps taken by the authorities to strengthen the prudential supervision of banks and insurance companies. In addition to these sections, Annex 1 provides background information on the structure of

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[3] See "Germany: Financial Sector Stability Assessment" (IMF Country Report No. 11/169, July 2011, available at http://www.imf.org/external/pubs/ft/scr/2011/cr11169.pdf).

[4] See "Germany: Report on Observance of Standards and Codes (ROSC)" (IMF Country Report No. 11/170, July 2011, available at http://www.imf.org/external/pubs/ft/scr/2011/cr11170.pdf). All ROSC assessments and technical notes have been published (http://www.imf.org/external/np/fsap/fsap.aspx).

[5] See "Germany: Technical Note on Banking Sector Structure" (December 2011, IMF Country Report No. 11/370, http://www.imf.org/external/pubs/ft/scr/2011/cr11370.pdf) for a description of Germany's three-pillar system (i.e. private commercial banks, public sector savings banks and their associated Landesbanken, and cooperative banks).

the German financial system and on recent regulatory developments, while Annex 2 presents the follow-up actions reported by the German authorities to other key FSAP recommendations; these actions have not been analysed as part of the FSB peer review and are presented solely for purposes of transparency and completeness.

2. Macroprudential policy framework

Background

Prior to the establishment of the Financial Stability Committee (*Ausschuss für Finanzstabilität*, FSC) in 2013, there was no explicit authority in charge of macroprudential oversight. Financial stability was an important, albeit somewhat implicit, part of the mandates of the institutions now represented on the FSC (see below). A Standing Committee on Financial Market Stability (*Ständiger Ausschuss für Finanzmarktstabilität*), consisting of delegates from the BMF, the Bundesbank and BaFin, discussed financial stability issues but had no explicit legal mandate or powers.

The FSAP noted the need for the Bundesbank's macroprudential responsibilities and powers to be clearly defined and to include not only identifying systemic risks but also formulating recommendations for action to mitigate these risks, including through structural reforms. It recognised that the Bundesbank will not necessarily have decision-making power over most relevant instruments and suggested that consideration be given to the introduction of an "act or explain" requirement if public argumentation is insufficient to elicit action by other relevant authorities. The FSAP also noted the need for the authorities to operationalise their plans to strengthen macroprudential supervision and, to support the new macroprudential function, it recommended the frequent and open exchange of information between macro and microprudential supervisors.

At around the same time as the FSAP, the institutional framework for macroprudential policy was beginning to take shape in the EU, leading to the establishment of the European Systemic Risk Board (ESRB) in 2010. In December 2011, the ESRB issued a recommendation calling on all EU member states to designate a macroprudential authority – either a single institution or a board – and to establish the necessary institutional arrangements to support its functioning.[6] The ESRB issued a follow-up recommendation to national macroprudential authorities in April 2013, requiring them by the end of 2014 to define their intermediate objectives and to assess the macro-prudential instruments available to them, and by the end of 2015 to develop a policy strategy.[7] The recently-approved Single Supervisory Mechanism (SSM) also includes provisions for the conduct of macroprudential policy in the EU countries participating in the SSM and coordination between national macroprudential authorities and the European Central Bank (ECB; see Box 1).

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[6] See http://www.esrb.europa.eu/pub/pdf/recommendations/2011/ESRB_2011_3.en.pdf.

[7] See http://www.esrb.europa.eu/pub/pdf/recommendations/2013/ESRB_2013_1.en.pdf.

Box 1: The EU/Eurozone framework for macroprudential policy

Macroprudential framework within the EU

In 2009, the Report on Financial Supervision in the EU (de Larosière report) considered how EU supervisory arrangements could be strengthened following the financial crisis. It recommended *inter alia* that the existing arrangements be complemented by an EU-level macroprudential body with a mandate to oversee risk in the financial system as a whole. Building on the report, the European Commission (EC) proposed the establishment of the ESRB, which was created in December 2010. In addition, the EU member states have adopted macroprudential arrangements at the national level.

Within the EU, responsibility for adopting measures necessary to maintain financial stability is primarily vested with national authorities, which have the responsibility to take the initiative in this regard and to act in response to ESRB recommendations and warnings. The main reason for entrusting macroprudential policy primarily at national level is that, notwithstanding EU financial integration, the financial and macroeconomic cycles as well as the structural characteristics of financial systems still differ substantially among EU and even euro area countries. It is therefore considered appropriate for different countries to operate somewhat distinct macroprudential policies to control (for example) the timing of aggregate credit expansion and contraction within their borders.

The ESRB is playing a key coordination role with respect to macroprudential policy within the EU. It is helping to shape the overall framework through a recommendation to member states to establish national macroprudential authorities (December 2011), a follow-up recommendation on objectives and instruments (April 2013), and a Handbook (March 2014) to assist macroprudential authorities to operationalise these instruments. Over the longer term, it will help coordinate interventions: the ESRB is to be notified prior to the use of macroprudential instruments defined in EU legislation and provide "opinions" or "recommendations" regarding the proper use of proposed measures.[8]

Macroprudential instruments

In addition to macroprudential surveillance, the ESRB relies on 'soft' (i.e. communication) and 'intermediate' (i.e. formal warnings or recommendations) macroprudential interventions. As discussed above, the responsibility for 'hard' instruments lies primarily at the national level.

Some of these 'hard' instruments have an EU legal basis. This is notably the case for the banking sector: the EU's fourth Capital Requirements Directive (CRD IV) and accompanying regulation (CRR) provide the legal basis for developing the macroprudential toolkit sketched out by Basel III. In particular, the CRD IV/CRR includes provisions for a countercyclical capital buffer; a systemic risk buffer; higher sector-specific risk weights; and various institution-specific capital buffers. The ESRB is working to provide guidelines for the implementation of these tools and CRD IV/CRR give the ESRB a coordination role among national authorities regarding the use of these tools.

Other macroprudential instruments or powers (e.g. loan-to-income or debt-to-income ratio limits etc.) can be defined through national legislation provided they remain within general EU parameters and constraints (e.g. provision prohibiting the loosening of microprudential ratios).

Macroprudential policy in the SSM context

In addition to microprudential supervision, the SSM devolves some macroprudential responsibility, albeit limited to the banking sector, to the ECB. The ECB will play a role analogous to what national authorities are required to by CRD IV/CRR with respect to the macroprudential capital buffers. In particular, while macroprudential intervention remains the responsibility of Euro area national authorities, they are required to inform the ECB in advance of the introduction of any measures and the ECB retains the authority to make them stricter (for example, if a national authority's response fails to address potential spillovers within the euro area).

8 See http://www.esrb.europa.eu/pub/pdf/other/140303_flagship_report.pdf for details.

Steps taken and actions planned

Institutional arrangements: In October 2012, the German Parliament passed the Act on Monitoring Financial Stability (Financial Stability Act, FSA),[9] which formally established a committee in charge of macroprudential oversight starting on 1 January 2013. The FSC, which replaced the Standing Committee on Financial Market Stability, is tasked with:

- strengthening cooperation between the institutions represented on the FSC in the event of a financial crisis;
- discussing the factors that are key to financial stability;
- issuing warnings and recommendations;
- advising on the handling of warnings and recommendations issued by the ESRB; and
- reporting annually to the lower house of Parliament (Bundestag).

The FSC consists of three voting members from each of the BMF, Bundesbank and BaFin. The chair of the Federal Agency for Financial Market Stabilisation (FMSA) attends FSC meetings as a non-voting member, while third parties may be invited by the FSC chair to attend meetings as appropriate. All FSC members are part of the senior management of their respective organisations and have relevant experience and competence in financial stability matters.[10] The chair and deputy chair of the FSC was given to the BMF to reflect its ultimate responsibility for safeguarding financial stability, particularly in the case of macroprudential measures involving fiscal outlays or requiring the introduction of new legislation. The Minister of Finance and/or the Governor of the Bundesbank can attend the meetings of the FSC. They can also participate in the voting, if needed, by replacing one of the regular members from their respective institutions.

The FSA stipulates that FSC decisions generally require a simple majority, although decisions on warnings and recommendations as well as on the submission of the FSC's annual report should be taken unanimously;[11] the law also confers veto power to Bundesbank representatives with regard to these decisions. The German authorities strive for consensus so that any decision of the FSC reflects the collective view of the member agencies.

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[9] See http://www.bundesbank.de/Redaktion/EN/Downloads/Bundesbank/Tasks_and_organisation/bundesbank_act_monitoring_financial_stability.pdf and http://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2013/2013_04_macroprudential_oversight.pdf.

[10] The BMF representatives (approved by the Minister) are the State Secretary overseeing the Directorates-General responsible for financial market policy and economic and fiscal policy strategy, and the respective heads of these Directorates-General. The Bundesbank representatives (approved by its Executive Board) are the Deputy President, another member of the Board, and the head of the Financial Stability Department. The BaFin representatives (approved by its Executive Board) are the President and two other members of the Board (currently the heads of banking and insurance supervision). The FMSA is represented by the Chairman of the Management Committee. Every FSC member also has a designated alternate.

[11] This does not mean that reaching consensus on warnings, recommendations and the annual report is mandatory, but there is an expectation that consensus will be sought before any majority decisions are taken.

Logistical and secretariat support for the FSC is provided by the BMF, with corresponding coordination units at Bundesbank and BaFin. Unlike macroprudential bodies in some other countries,[12] there are no standing committees of deputies or technical staff from member agencies to discuss issues in advance of FSC meetings. This is because the analytical support for the FSC's activities is provided predominantly by the Bundesbank (see below). According to the German authorities, inter-agency coordination on both the FSC and other matters takes place on an ongoing basis.

The FSC is required by statute to meet on a quarterly basis – although any member may request that a meeting be convened at short notice – and thus far has met on four occasions. In addition to discussing risks to financial stability, the FSC has considered the need for and development of macroprudential tools, including those established under CRD IV/CRR. The FSC has not yet, however, published any warnings or recommendations or issued any other public communication except for a press release on the occasion of its first meeting.

Tools: Although the FSC itself does not 'own' any prudential instruments to support its mandate, the institutions represented in it have comprehensive regulatory and supervisory powers that can be deployed, taking due account of discussions within the FSC. Certain types of non-prudential tools (e.g. tax policies) may also be used if needed, although the authorities point out that it would be difficult to apply them in practice as both the relevant considerations and their effects are more complex.

The issuance and publication of warnings and recommendations constitute the core tools available to the FSC in implementing macroprudential policies. Warnings and recommendations can be addressed to the Federal Government, BaFin or other public bodies (e.g. state authorities) in Germany. The purpose of issuing warnings is generally to draw attention to risks which might impair financial stability, while recommendations identify measures that the FSC considers necessary to implement in order to avert risks to financial stability. As previously mentioned, the FSA confers a veto power to the Bundesbank on such decisions. The warnings and recommendations may be published, although the FSC may choose not to publish them if it perceives that threats to financial stability can arise from their publication. The authorities have, however, indicated that they consider non-publication to be an exception rather than the rule.

The FSC also does not have the power to direct the addressees of its recommendations; instead, the FSA contains a "comply or explain" framework whereby the addressee of a recommendation is required to notify the FSC within a reasonable period of time about its progress in implementing the recommendation or explain in detail the reasons for non-compliance. The FSA assigns the responsibility for monitoring of this follow-up procedure to the Bundesbank. The detailed process by which the FSC develops, issues and follows up on recommendations remains work in progress.

Currently, one of the main areas of focus for the FSC is operationalising the macroprudential tools provided under CRD IV/CRR and embedding them in a comprehensive macroprudential strategy. While these tools will be deployed by BaFin, the FSC is playing a

[12] See the FSB peer reviews of the UK (http://www.financialstabilityboard.org/publications/r_130910.pdf) and the US (http://www.financialstabilityboard.org/publications/r_130827.pdf).

role in their calibration and could make recommendations to BaFin about their deployment. The FSC intends to extend the range of available macroprudential instruments if financial stability concerns make this necessary, consistent with the 2013 ESRB recommendation.

Analytical framework: Analytical support for the FSC is provided predominantly by the Bundesbank. The FSA specifically tasks the Bundesbank with analysing factors that are important to financial stability and identifying risks which may impair financial stability. The Bundesbank is also responsible for making proposals to the FSC regarding the issuance of warnings and recommendations, presenting evaluations of the implementation measures to the FSC, and preparing the FSC's annual report. Importantly, as stipulated by the FSA, the Bundesbank performs these tasks in a fully independent role.

The discharge of these responsibilities has been assigned to the Bundesbank's Financial Stability Department, established in May 2009 and currently comprising around 150 employees. The Financial Stability Department includes three divisions charged with macroprudential tasks: Surveillance, Analysis, and Policy. In order to coordinate on financial stability matters (including the preparation of the surveillance note for the FSC) with all relevant departments and business units within the Bundesbank, an internal "coordination committee for financial stability" (KAF) has also been established.

The FSC agenda includes, as a standing item, a discussion of the Bundesbank's surveillance note with an assessment of systemic risks, complemented by background papers analysing specific risks, as needed. Systemic risk analysis in the surveillance note comprises a mix of quantitative (involving a variety of indicators and models) and qualitative factors (typically involving expert judgment). The note includes a list of risks that are ordered in three categories given their probability of occurrence and systemic relevance.[13] This list is supplemented by an "open" list of potentially systemically important topics to monitor ("watch list") that have either not been analysed in depth or are initially considered as not important enough for inclusion in the other three categories. The note also includes a comprehensive set of standardised financial market indicators ('dashboard'). The ensuing discussion by FSC members may lead to a call for more in-depth information and analyses (e.g. in the form of a subsequent background paper) on any identified risk.

Both the surveillance note and the background papers contain suggestions for further action. These suggestions are classified into three categories depending on priority; these are "further proceedings" (for information only), "issues for discussion" (FSC members to exchange views without necessarily taking explicit action), and "option for decision" (FSC members to take an explicit decision). The latter category includes, but is not limited to, suggestions to issue warnings or recommendations on systemic risk or to enhance data requirements.

BaFin contributes to the work of the FSC in areas that fall within its core competences. It does this by preparing (sometimes jointly with the Bundesbank) in-depth analyses on specific

[13] The three categories are: significant systemic risks, characterized by having a relatively high probability of occurring in the near to medium term and/or having a high impact on the financial system/real economy; systemic risks that have a lower probability of occurrence and/or have a smaller impact compared to significant systemic risks; and low systemic risks that are either not likely to materialise in the near future (but would have systemic effects) or are likely to materialise (but would have limited consequences).

topics based on its cross-sectoral expertise. Internally, BaFin has also stepped up its sector-wide surveillance. In January 2013, BaFin established a cross-sectoral Risk Committee that meets quarterly and reports to its Board. The Risk Committee includes representatives from all directorates, as well as observers from the Bundesbank's Banking Supervision and Financial Stability Departments. The objective of the Risk Committee is to combine the macro and micro perspectives, to assess relevant risks, and to take them into account in supervisory activities. Through the Bundesbank's attendance, the Risk Committee also informally feeds in the Bundesbank's macroprudential surveillance to the FSC.

The FSC's mandate is solely macroprudential in nature; unlike similar bodies in some other countries, it does not have a secondary objective to promote economic development. The FSC monitors and analyses the macroprudential effects of measures in other policy areas as part of its ongoing financial stability surveillance, while assessing the effects of its actions on other policies is expected to form an integral element of the process of issuing recommendations. According to the authorities, the FSC's composition helps to address conflicts that could arise between macroprudential and broader economic policy objectives.

Information exchange: The FSAP recommended frequent and open exchange of information between macro and microprudential supervisors. The FSA enshrines this principle in statute and provides for the Bundesbank and BaFin to share the necessary information ("observations, findings and assessments") required by BaFin for the purposes of performing its supervisory functions and by the Bundesbank for the purposes of discharging its responsibility to safeguard financial stability.[14] The FSA also provides backstop powers to allow the Bundesbank to collect such information if relevant data cannot be obtained from BaFin. These include, if necessary, an authorisation for the BMF to issue statutory orders defining the specific economic and commercial data (not already obtained by BaFin) that the Bundesbank can collect from financial corporations. While the FSC itself does not generally review institution-specific information, it does receive system-wide risk surveillance and other reports on special topics that may include such information.

Information exchange also takes place between the FMSA and the FSC. Through its attendance of FSC meetings, the FMSA can provide input on issues relevant to its stabilisation and resolution experience. Conversely, the chair of the FMSA reports on financial stability issues and any FSC decisions to the governmental Steering Committee established by the Financial Market Stabilisation Act.[15]

The FSA requires the FSC to work closely and exchange information with the ESRB and other authorities charged with safeguarding financial stability in the EU (both national authorities and the ECB as part of the SSM). In this context, the Bundesbank represents the German authorities (together with BaFin) in the ESRB and informs the other FSC members about ESRB matters (unless classified). It is also responsible, on behalf of the FSC, to pre-

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[14] A Memorandum of Understanding signed between Bundesbank and BaFin specifies data exchange, confidentiality arrangements, and information technology requirements that are relevant for his purpose.

[15] The Steering Committee takes decisions, based on proposals by the management committee of the FMSA, regarding stabilisation measures (e.g. recapitalisations, liquidity guarantees and asset transfers), policy issues, and matters of particular importance or conditions for financial corporations regarding measures of the Financial Market Stabilisation Fund (SoFFin).

notify the ESRB about FSC recommendations that the Committee considers to present a risk of material negative cross-border spillovers.[16] The Bundesbank and BaFin also contribute to the analytical and coordination work of the ESRB via the participation of their staff in working groups, expert teams and work streams.

Communication: The deliberations of the FSC and the minutes of its meetings are considered confidential. However, the FSC could decide to publish its warnings and recommendations, and it perceives their publication as the default option. The FSC could also communicate with stakeholders through press releases providing information on the meeting (as it has done once, on the occasion of its inaugural meeting) but the authorities have indicated that they intend such communication to be ad hoc and need-based rather than taking place on a regular basis. Moreover, the FSC is expected to report annually to the Bundestag on its activities as well as on developments in financial stability. It is expected that the first annual report will be delivered in mid-2014. While the format of the report is still work in progress, the authorities expect that the report will present an update of the risks to financial stability set out in the Bundesbank's annual Financial Stability Review (FSR)[17] along with a report of the activities and macroprudential strategy of the FSC.

Lessons learned and issues to be addressed

The reforms in institutional and organisational arrangements introduced by the FSA broadly address the FSAP recommendations on the macroprudential policy framework. In particular, the law delineates statutory responsibilities for financial stability in Germany; establishes the FSC, and mandates the Bundesbank to provide the FSC with substantial analytical support, including the identification of systemic risks and the formulation of recommendations to mitigate them; specifies arrangements for cooperation and information exchange between the Bundesbank and BaFin; and provides for backstop powers to collect additional information from financial institutions. These reforms have taken place against a backdrop of comprehensive changes to the arrangements for financial stability in the EU.

The FSC also heeds the December 2011 ESRB recommendation on the macroprudential mandate of national authorities. In responding to that recommendation, Germany has opted for a board structure. The design of macroprudential oversight appears to be both pragmatic and reflective of the pre-existing institutional arrangements. The FSC brings together a sufficiently large number of key officials with a wide range of expertise, perspectives and responsibilities. The organisational design attempts to strike a balance between the responsibilities of the institutions represented in the FSC – BMF, Bundesbank, BaFin and, as

[16] As noted in Box 1, the ESRB is to be notified prior to the use of macroprudential instruments defined in EU legislation and provide "opinions" or "recommendations" regarding the proper use of proposed measures. Pre-notification is not required when using other (national) macroprudential instruments, although a number of authorities have indicated their intention to notify the ESRB if their use has cross-border implications.

[17] The Bundesbank has published a FSR on the German financial system in November of every year since 2003 (with the exception of 2008). The analyses and assessments contained therein are intended to contribute to the public debate on financial stability and are the starting point for relevant recommendations to market participants and policymakers alike. For a list of risks presented in the latest FSR, see http://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Financial_Stability_Review/2013_financial_stability_review.html. BaFin has also issued an annual report since its foundation in May 2002.

a non-voting member, the FMSA – and their respective individual mandates. The FSC is designed to be operationally independent in order to foster effective coordination, while the FSA acknowledges the Bundesbank's independence as set in statute.

The FSC is already functional but, with just about a year of existence, it is too early to evaluate effectiveness in attaining its mandated objectives. Its operational and strategic framework – which is partly dependent on broader EU/euro area macroprudential policy developments – has not yet been fully developed. Nevertheless, the authorities emphasise that the FSC has already played an instrumental role in strengthening cooperation between its members as well as deepening and formalising the information sharing arrangements between the Bundesbank, BaFin, and the FMSA. In that context, the main benefit of the FSC has been to act as an overlay to the existing institutional structure (without seeking to usurp or duplicate mandates and powers) by enhancing coordination and information exchange among senior policymakers across different authorities.

The framework underpinning the FSC will need to be clarified and fine-tuned as processes and procedures crystallise and as more experience is gathered. The FSC will need to promptly develop a macroprudential strategy (as called for by the ESRB's April 2013 recommendation) and operationalise it. Work by the FSC on the strategy is already underway, covering issues such as intermediate objectives, relevant tools, when to issue a warning rather than a recommendation (or vice versa), whether to publish it, and the extent to which decision-making on macroprudential policies should be rules-based. It is important for this strategy to be comprehensive and to provide a roadmap that addresses aspects of the FSC's institutional design that remain unclear. These aspects, which are described below, relate to the scope of coverage; deliberations and decision-making; warnings and recommendations; macroprudential tools; and communication.

***Scope of coverage**:* The FSA sets out the overall role and objectives of the FSC. As the framework of the FSC is further defined, however, it will be important for certain boundary and scope issues to be clarified. In particular, the FSC is not directly responsible for the regulation and supervision of systemically important financial institutions (SIFIs), and its focus is not on regulation *per se* but rather on systemic risks and how to address them, including through regulation. However, the extent of its involvement in the identification of SIFIs or the development of regulations with systemic – cyclical or structural – implications (e.g. capital buffers for SIFIs, or margin requirements for over-the-counter (OTC) derivatives) or their implementation is not fully clear. This is also the case for crisis management and resolution of a failing institution with potential systemic consequences, particularly since several FSC members may be involved in those decisions within their respective institutions.[18] In both instances, the FSC's involvement may need to be more clearly defined in order to avoid overlaps, gaps and possible confusion vis-à-vis the responsibilities of its member institutions and to enhance accountability.

[18] Section 2(2) of the FSA notes that the FSC's tasks include "discussing the factors that are key to financial stability [and]… strengthening cooperation between the institutions represented on the Financial Stability Committee in the event of a crisis".

The authorities indicate that some of these issues are discussed in the FSC as needed (e.g. the calibration of the macroprudential tools set forth in CRD IV/CRR), but that the FSC is not necessarily steering the debate and that each member institution has the mandate and authority to act if the need arises. The current division of responsibilities within the FSC is based on each member's respective competencies, but there could be instances in the future whereby disagreements could arise as to whether an issue should be discussed by the FSC or not. It may therefore be preferable – both for transparency and accountability purposes – if there was greater clarity on the types of issues that are within the scope of the FSC for discussion and for decision-making purposes.

- ***Recommendation 1: The FSC should consider further specifying its role on financial stability issues – such as in the development and implementation of prudential regulations and involvement in crisis management and resolution – to ensure clarity vis-à-vis its member institutions and to enhance accountability.***

Deliberations and decision-making: The German authorities are of the view that FSC members participate in the deliberations primarily as official representatives of their respective institutions, but also in a personal capacity. Such an arrangement may foster more open and frank discussions within the FSC, but it may also lead to confusion if the members are called upon to reach a decision (e.g. for the issuance of a warning or recommendation) that potentially binds their institutions without providing an opportunity for prior consultation within their respective institutions.

Decision-making by the FSC, particularly on key issues, is supposed to be based on consensus. Member institutions strive to achieve consensus in pre-meeting preparations and during the deliberations of the FSC. The authorities note that, while discussions in the Committee to date have been robust, there exists a strong national culture of consensus that facilitates decision-making. Failure to reach consensus does not mean that a majority decision cannot be taken (recognising that the Bundesbank retains a veto with respect to key decisions) or that the member institutions cannot act unilaterally based on their own statutory powers. For example, the Bundesbank could issue warnings outside the FSC through the FSR or other public communication (e.g. speeches), while BaFin can deploy any of the macroprudential instruments in CRD IV/CRR without waiting for an FSC recommendation.

A consensus-driven approach has strong merits in terms of reaching a common understanding of systemic risks and facilitating the implementation of measures to address them, but there are also possible downsides. One such example is the risk of inaction arising from the efforts by any one member institution to reach consensus within the FSC (to avoid being seen as proceeding unilaterally), which may lead to delays in taking action. Conversely, the potential market signal and implications for the FSC's functioning if member institutions were to take independent action on issues that fall within the scope of the FSC may need to be examined. It would therefore be important for the German authorities to develop protocols and procedures for reconciling diversity of views in decision-making.

Warnings and recommendations: The primary policy instrument at the disposal of the FSC is its ability to issue warnings or 'comply or explain' recommendations to public sector authorities. The German authorities emphasise that there should be no mechanistic threshold or predetermined criteria to trigger such actions. Given the nature and diversity of factors that could impinge on financial stability, a certain amount of flexibility and discretion in this area is desirable. At the same time, however, the FSC should be able to form a consistent view on the conditions that would prompt the issuance of a warning or a recommendation. This would necessitate the development of an analytical framework setting out the relevant considerations (e.g. materiality, issues to consider for taking action such as the effectiveness and efficiency of the proposed tool, implementation and reporting processes etc.) to determine the potential need for specific warnings and recommendations before a decision is made. Preparatory work is already underway, drawing also on ESRB work on the application of the countercyclical capital buffer in EU member states.

The Bundesbank is responsible for operationalising the 'comply or explain' mechanism. While the FSC has not yet issued any warnings or recommendations, it would be useful to develop the framework underpinning this mechanism, such as the parameters and criteria that will be used to determine that a warning or recommendation has been complied with or that an explanation about non-compliance is acceptable (and on how to proceed if it is not), and to assess the impact of the policy measure and whether it has been effective.

- ***Recommendation 2**: The FSC should put in place an analytical framework setting out the: (a) conditions for triggering warnings and recommendations; (b) functioning of the 'comply or explain' mechanism; and (c) approach to assessing the impact of the policy action.*

Macroprudential tools: The FSA does not equip the FSC with specific macroprudential tools (these are currently within the remit of BaFin). As a result, the FSC will need to engage with its member institutions to ensure that any such tools are applied effectively. The need for dialogue and communication will arise both initially (at the time of developing the tools) and at a later stage (when their mobilisation may be necessary). This dialogue will be critical to foster a common understanding on the use of the instruments, their impact, as well as on their effectiveness and potential unintended consequences.

As previously noted, the macroprudential tools that are currently available to the German authorities are those specified in CRD IV/CRR. Experience from other countries indicates that such tools may not be sufficient to address certain types of systemic risks and that other tools may also be needed.[19] In Germany, however, the legislative process necessary to deploy a new macroprudential tool may last longer than desirable, especially during times of stress when prompt action is needed. In addition, this legislative process may itself generate undesirable market behaviour, such as an acceleration of risky practices before the FSC recommendation for the tool is adopted. As a result, it is desirable to define ex ante (to the extent possible) a macroprudential toolkit instead of waiting for specific risks to emerge before proposing and adopting new tools.

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[19] See "Macroprudential Policy Tools and Frameworks – Progress Report to the G20" by the FSB, IMF and BIS (October 2011, http://www.financialstabilityboard.org/publications/r_111027b.pdf); "Macroprudential Policy: An Organizing Framework" (March 2011, http://www.imf.org/external/np/pp/eng/2011/031411.pdf) and "Key aspects of macroprudential policy" (June 2013, http://www.imf.org/external/np/pp/eng/2013/061013b.pdf) by IMF staff; and "Macroprudential instruments and frameworks: A stocktaking of issues and experiences" (May 2010, http://www.bis.org/publ/cgfs38.pdf) and "Operationalising the selection and application of macroprudential instruments" (December 2012, http://www.bis.org/publ/cgfs48.pdf) by the CGFS.

- ***<u>Recommendation 3</u>: The FSC should develop a comprehensive macroprudential toolkit on an ex ante basis to ensure the timely application of relevant tools if the need arises.***

Communication: Public communication, as a form of 'soft' intervention, is a critical part of the FSC's toolkit and is especially important during times of crisis – hence the need for building market awareness through a well-designed strategy. Thus far, there has been little use of this tool by the FSC, with one press release having been issued following its inaugural meeting. The authorities have expressed a preference for the FSC to only engage in public communication when necessary (e.g. to announce a warning or a recommendation) in order to maximise its impact, rather than to issue periodic "no action" press releases that may not provide new information and therefore attract little market attention.

The authorities are also of the view that the FSC's main communication tool is its annual report to the Bundestag. While useful for enhancing accountability, it is not clear this tool is sufficient or targeted enough to ensure effective communication to relevant stakeholders. There are examples of communication through multiple outlets (speeches, articles, press releases etc.) by macroprudential authorities in other countries that can provide more focused and timely messages to their intended audiences. Drawing on those examples, the German authorities may find it useful to reflect on the pros and cons of the current approach to ensure that opportunities for effective communication to various target audiences are not missed.

The first annual report of the FSC is due in mid-2014. As previously noted, the systemic risk analysis section of the report will be largely based on Bundesbank's work. The authorities see the annual FSC report as a means of updating the risks identified in the November FSR, even though the latter is prepared solely by the Bundesbank and reflects its own views. The risks of conflicting messages from this process will need to be carefully managed. It would also be helpful if there was greater clarity on whether members of the FSC can and should speak on behalf of the FSC as opposed to their own institution.[20]

- ***<u>Recommendation 4</u>: The FSC should develop a comprehensive strategy to maximise the effectiveness of its communication and avoid duplication with its member institutions. This strategy should include the identification of target audiences and the calibration of the range and content of communication tools accordingly.***

3. Microprudential supervision

Background

The FSAP noted that the standard of financial sector regulation and supervision of banks and insurance companies was generally high, but that certain weaknesses identified as a result of the financial crisis should be addressed. This section reviews progress made by the German authorities to implement the FSAP recommendations in the area of microprudential

[20] Section 2(10) of the FSA specifies that the "The Financial Stability Committee shall be represented by the chair or, in his/her absence, by the deputy chair".

supervision, and is divided in two parts covering the banking and insurance sectors respectively. The review bases its analysis on existing international guidance[21] and on EU legislative developments, such as the upcoming implementation of Solvency II, the CRR/CRD IV and the SSM.

Steps taken and actions planned: Banking supervision

Background

Banking supervisory responsibilities and tasks are divided between BaFin and the Bundesbank with the details of their cooperation having been formalised through a Memorandum of Understanding (MoU) and an accompanying Supervision Guideline.[22] According to these documents, the Bundesbank is primarily responsible for the ongoing monitoring and analysis of regulatory returns/financial statements and on-site inspections of banks. The Bundesbank then communicates the results of its analysis and inspections to BaFin, which will make the final assessment and is the competent authority with decision making powers on all banking supervisory measures and questions of interpretation.

The FSAP made five main recommendations to strengthen banking supervision:

- Analytical, forward looking assessments of institutions need to be enhanced by firmly embedding the use of rigorous stress testing in supervisory practices/capital adequacy assessments (BCPs 6,7 and 19);
- Increase the scope and frequency of the German authorities' own inspection work, focusing on areas such as liquidity risk management, stress testing capabilities and information technology (IT) infrastructure (BCP 7);
- Amend the German Banking Act to facilitate prior approval of acquisitions that may have a material impact on the risk profile of an institution (BCP 5);
- Firmly embed the use of new powers to impose higher capital requirements in supervisory practices and closely monitor the efforts of institutions to strengthen their capital base in anticipation of Basel III (BCP 6);
- Extend reporting requirements and develop a standardised, comprehensive framework that ensures timely and granular reporting of all material risks (BCP 21).

Forward-looking supervision: BaFin and the Bundesbank have taken some steps to make banking supervision more forward-looking while at the same time intensifying the supervision of SIFIs. With respect to more forward looking supervision, resources have increased in specific risk areas, particularly for qualitative horizontal reviews and IT supervision; BaFin and the Bundesbank are paying more attention to banks' business models, primary business functions and associated risks; and supervisors are increasing the attention devoted to the risk management function in banks. The authorities acknowledge that

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[21] This includes the BCBS and IAIS Core Principles as well as FSB work on supervisory intensity and effectiveness (see http://www.financialstabilityboard.org/list/fsb_publications/tid_147/index.htm).

[22] See http://www.bafin.de/EN/Homepage/homepage_node.html and http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Richtlinie/rl_130521_aufsichtsrichtlinie_en_ba.html.

additional supervisory efforts need to be directed at assessing the effectiveness of boards and the risk culture at (large) banks, given their importance as indicators for the risk taken by those institutions. Both BaFin and the Bundesbank indicate that they will incorporate criteria set out in forthcoming guidance from the EBA and ECB on the assessment of business models[23] into their own supervisory review activities. Concerning the supervision of SIFIs, the identification of domestic systemically important banks is underway, with first drafts of recovery plans currently being assessed by BaFin and the Bundesbank for 21 banks.

Stress testing: The Bundesbank regularly conducts stress tests to evaluate financial system stability and the solvency of individual institutions under various scenarios, including the resilience of banks to macroeconomic shocks. In order to enhance the rigor of stress testing, the Bundesbank has recently made improvements to its framework, including the expansion of the macroeconomic portfolio stress tests to cover 1,500 small and medium-sized banks (in addition to the larger banks) and the development of a new stress test on interest rate risk. The Bundesbank is also examining the possibility of including all universal banks in Germany in the contagion stress tests versus only the 12 largest banks as is currently the case.

The Bundesbank's stress test results at the individual bank level are also made available to banking supervisors at BaFin. Supervisors then engage with the banks as part of their regular supervisory meetings on areas of concern flagged in the stress tests. Stress tests results are also used as inputs when updating the risk profile of an institution.

Through the minimum risk management requirements – as specified in the so-called MaRisk document – supervisors have also taken steps to formalise supervisory expectations surrounding bank stress tests, as well as the requirement for banks to be more forward-looking in their capital planning process.[24] The German authorities also expect to use the upcoming EU-wide Stress Tests and Comprehensive Assessment to obtain a forward looking assessment of the vulnerabilities of the German banks.

On-site supervision: BaFin and the Bundesbank have taken important steps to enhance on-site supervision of banks by: (1) improving the level of technical expertise and "know-how" among staff; and (2) increasing the number of supervisory staff in both institutions.

The supervision of IT risks and interest rate risk in the banking book are two areas in particular where the aforementioned measures have been implemented. IT risks for institutions, especially the larger banks, have grown in significance given the need for more granular and specialised information, rise in the number of mergers and acquisitions, and

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[23] The EBA is currently developing a Business Model Analysis module as part of the Single Supervisory Handbook. The ECB is also expected to provide guidance in this area as part of the SSM Risk Assessment System. Both initiatives involve a qualitative analysis of the business and risk strategies of the institutions as well as an in-depth analysis of financial statements including the main sources of earnings, corresponding inherent risks, and estimated capital, risk and earnings projections (also under stressed scenarios).

[24] For example, the MaRisk document now requires banks to develop a capital plan that covers a time horizon of at least two to three years beyond its regular risk quantification process and to include a material downturn scenario. Banks are also required to conduct stress tests to analyse the impact of potential events that may not be adequately reflected in their probability-based risk quantification methods. See "Supervisory Assessment of Bank-Internal Capital Adequacy Concepts" (December 2011, available at http://www.bundesbank.de/Redaktion/EN/Downloads/Core_business_areas/Banking_supervision/Marisk/2011_12_07_supervisory_assessment_bank_internal_capital_adequacy_concepts.pdf).

resultant increase in IT system complexity. To address these risks, BaFin has established a new IT section staffed by officers with specific expertise in this area and, in cooperation with the Bundesbank, developed supervisory guidelines for the supervision of IT risks (especially IT security). In addition, interest rate risk in the banking book, including the analysis of institutions' internal risk management measures and methodologies to calculate the impact of prescribed interest rate shocks, has now become a key element of on-site inspections.[25]

The authorities have also enhanced the intensity of on-site supervision of banks through an increase in the number of inspections (from 283 in 2011 to 330 in 2013). While most inspections last between two and six weeks, the duration varies depending mainly on the size and complexity of the institution, its business activities, as well as on the scope of the inspection. In terms of scope, the number of non-capital related areas, such as remuneration, liquidity risk management, assessment of complex products, commodities business etc. covered in the examinations, particularly of larger banks, has increased over the past 2 years.

Notwithstanding the increase in number of on-site inspections, there continues to be a significant reliance on third parties, particularly external auditors, to conduct on-site reviews of areas such as asset quality and anti-money laundering processes. External auditors are also required to perform annual assessments of institutions' compliance with MaRisk requirements.

Major acquisitions: No steps have been taken in response to the FSAP recommendation in this area. The German authorities believe that they would overstep their role as supervisors if they formally vet and give prior approval for major acquisitions proposed by banks; therefore, no changes to the German Banking Act have been made to address this issue. In light of CRD IV, the authorities do expect to continue to review compliance with legal thresholds for qualifying holdings and acquisitions[26] made by banks.

German supervisors do not use a formal prior approval process for major acquisitions. However, the authorities note that institutions are expected to prepare a strategic plan (prior to the acquisition of, or merger with, any other enterprise) setting out the objectives, the main implications for risk management, and the material impact on the overall risk profile of the institution or group.[27] The authorities also point out that supervisors are in close contact with supervised (especially larger) banks, so they are normally aware in good time about material events such as a major acquisition. On the other hand, however, there is no formal requirement for banks to share their strategic plans with the authorities or indeed to seek the authorities' views on these plans. As a result, there remains a risk that supervisors will be

[25] All German banks are required to report the impact of an overnight 200 basis point increase and decrease in the yield curve as part of their interest rate risk quarterly reporting. This type of risk is especially relevant for small- and medium-sized banks since they derive the bulk of their income from term transformation in the banking book.

[26] This is already in place in the German Banking Act (section 12) and will be replaced by similar requirements in the European CRR (Articles 89-91).

[27] Such a requirement is set out in MaRisk, module AT 8.3. The plan is expected to include: the planned medium-term development of the financial position and financial performance; the prospective level of the risk positions; the necessary adjustments to the risk management, risk control processes and IT systems; and an outline of any material legal implications (accounting law, tax law etc.).

informed too late about a major acquisition or will not be prompted to assess its impact on the risk profile of the bank and take any necessary action at a sufficiently early stage.

Capital adequacy and supervisory intervention: In preparation for the implementation of CRD IV/CRR, German banks have taken steps to enhance their capital adequacy. The authorities have concluded that fewer than 10% of banks, comprising mainly smaller institutions such as savings and cooperative banks, will face problems in meeting the new risk-based capital requirements.[28] The authorities are actively monitoring the banks' progress in meeting these requirements (see Box 2) and are confident that they will meet them by the agreed commencement date.

The FSAP recommended that BaFin further develop its supervisory guidance with respect to imposing capital add-ons so as to avoid forbearance and ensure consistent application of its legal powers to impose higher capital requirements. At the time of the FSAP, BaFin had developed two internal guidelines regarding the application of higher capital requirements for addressing interest rate risks in the banking book and organisational deficiencies. Although no further guidelines were developed subsequently, the transposition of the CRD IV in the German Banking Act (effective 1 January 2014) includes a list of circumstances that would require capital add-ons and thereby restrict supervisory discretion in the decision to impose higher capital requirements;[29] in most cases the only discretion left to BaFin is the decision on the amount/rate of the capital add-on. BaFin has stated that it intends to develop further guidance for supervisors on how to determine the appropriate amount/rate of capital add-on under different circumstances set out in the Banking Act and taking into consideration the severity of the problem.

Formal measures to impose capital add-ons are rarely used, and the German authorities have generally applied moral suasion to incentivise a bank to increase its capital levels. Nevertheless, the authorities have taken other steps to facilitate timely and consistent supervisory intervention to address capital inadequacies in banks. In particular, a new enhanced approach has been developed (see Box 2) to assess an institution's internal capital adequacy assessment process (ICAAP). In addition, BaFin in December 2013 implemented a "ladder of actions" that identifies possible supervisory actions and measures that could be taken with regard to capital inadequacies,[30] as well as liquidity problems and organisational deficiencies (e.g. control weaknesses and risk management issues).

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[28] According to the authorities' monitoring system, the fully phased-in CRD IV capital shortfall of the 42 largest German banks has been reduced from EUR 32 billion in mid-2012 to EUR 14 billion by mid-2013. The IMF also highlighted in the August 2013 Article IV report for Germany (IMF Country Report No. 13/255, available at http://www.imf.org/external/pubs/ft/scr/2013/cr13255.pdf) that the large German banks have raised capital faster than their international peers. The Landesbanks have also improved their Tier 1 capital ratios following extensive deleveraging.

[29] See Section 10 Para 3 of the German Banking Act.

[30] The list of possible supervisory measures is structured in several steps, beginning with routine actions and gradually moving into more severe supervisory interventions as the situation deteriorates. Qualitative guidance would be provided on choosing the appropriate measure and the use of supervisory discretion. A "ladder of actions" has also been developed for two other common supervisory concerns, namely organisational deficiencies and liquidity issues.

Reporting requirements: To supplement the EBA's reporting requirements, the German supervisors have strengthened national reporting requirements and will implement several new regulatory reports during 2014 and 2015. In particular, the granularity and timeliness of certain types of financial information will be enhanced, especially those relating to profit and loss items such as trading results, fees and commissions. Banks will be expected to report their forecasts for these key items, and will be required to provide additional data on specific risk areas such as credit quality.

Box 2: Capital adequacy

Basel III/CRR Monitoring System and Processes

The authorities actively monitor banks' progress in meeting the new Basel III/CRR risk-based capital requirements. A monitoring system has been installed for large and systemically relevant banks, under which 42 of the largest banks are required to submit semi-annual information about their capital position assuming fully phased-in Basel III risk-based capital requirements. For the remaining, less significant institutions, monitoring is conducted via a separate Basel III screening process.

Overview of the Proposed Supervisory Review and Evaluation Process (SREP)

Background and methodology
BaFin and the Bundesbank established an SREP quantification working group in 2012, which has developed a new approach for assessing an institution's ICAAP. This approach integrates quantitative and qualitative methods to better assess the reliability and appropriateness of an institution's ICAAP. Under the new SREP approach, the assessment would take place on a risk-by-risk basis (including also organisational shortcomings). The sum of the adjusted risk amounts (without any inter-risk diversification effects) is compared to the adjusted risk bearing capacity. If the risk bearing capacity is lower than the sum of the risk amounts, this is considered as a capital deficit and will lead to corresponding supervisory actions and, if necessary, additional pillar 1 capital add-ons.

Field test results
In October 2013 the working group validated the draft approach in a field test with a peer group of five banks engaged in retail business. The five banks have very similar business models and risk profile, which is a requirement for peer comparisons under the proposed approach. The field test showed that the proposed SREP approach developed by the working group is in general suitable to ensure a systematic and comprehensive SREP quantification. In most cases reviewed in the field test, capital requirements were higher than what was reflected in the bank's own ICAAP results. As the new SREP approach is still in draft, there is currently no plan to impose capital add-ons for institutions with capital shortfalls in the field test. However, gaps and deficits identified may be addressed as part of the ongoing supervision of institutions (via meetings etc.).

On the whole, the German authorities concluded that, while the computed risk and capital figures are very important inputs to its capital assessment process, the process of challenging these figures, as well as the ability to incorporate supervisor's deep knowledge of a bank's specific characteristics in the assessment would be equally, if not more, important. Thus, a structured panel discussion leading to an expert judgment that is based on figures but includes qualitative aspects is perceived to bring up the most reliable results in terms of the capital requirement's assessment. The authorities are working to streamline this new proposed SREP approach so that the assessment can be completed within a shorter timeframe and using fewer resources.

Beginning in 2015, the reporting threshold for large credit exposures will be lowered, resulting in detailed loan information to be reported for a greater population of credit exposures. In addition, BaFin and the Bundesbank are developing a new formal reporting system for the ICAAP used by banks. With effect from 2014 and 2015, the current liquidity reporting requirements will be replaced by reporting of the Liquidity Coverage Ratio and the Net Stable Funding Ratio requirements of Basel III respectively. Unlike the existing liquidity regulatory reports, which only included figures at the individual entity level, the new liquidity reporting requirements will also capture consolidated group-wide liquidity exposures.

Steps taken and actions planned: Insurance supervision

Background

BaFin supervises private insurance undertakings operating in Germany that are of material economic and financial significance as well as public insurance undertakings engaging in open competition that operate across the borders of any federal state. The supervisory authorities of the federal states are mainly responsible for supervising public insurers whose activities are restricted to the particular state and those private insurance undertakings that are of lesser economic and financial significance. At present, roughly 600 insurance undertakings and 30 pension funds are supervised by BaFin.[31]

The FSAP highlighted the following areas for improvement in insurance supervision:

- Further development of a risk-based supervisory approach, including the expansion of group-wide supervision an supervision of re-insurers' investments (Insurance Core Principles (ICPs) 4, 17 and 22);
- Development of stress-testing capacity and analysis of longer-term effects (ICP 11);
- Increase in the frequency and number of on-site inspections (ICP 13);
- Increase in the number of staff with actuarial expertise and related quantitative skills (ICP 20); and
- Enhancement of reporting requirements for (re-)insurers as well as the shortening the time lags in the publication of aggregate insurance data (ICPs 12 and 26).

An important driver for change has been the Solvency II Directive. Solvency II aims to harmonise EU regulations for insurance companies and introduce a more risk-based and forward-looking approach to supervision. Although the application date of Solvency II has been postponed to 1 January 2016,[32] preparations for its introduction by many EU member states, including Germany, began some years ago.

***Risk-based supervision*:** Guided by the European Insurance and Occupational Pensions Authority (EIOPA) and BaFin, German insurance companies have participated on a voluntary

[31] See http://www.bafin.de/EN/Supervision/InsuranceUndertakingsPensionFunds/insuranceundertakingspensionfunds_node.html.

[32] See http://ec.europa.eu/internal_market/insurance/docs/solvency/131002_draft-directive_en.pdf.

basis in multiple quantitative impact studies[33] in preparation for the implementation of Solvency II. BaFin has used the results of these studies to monitor the progress of insurers in meeting the financial requirements of Solvency II. In addition, BaFin has allocated considerable resources to the pre-application process for the use of internal models under Solvency II. Following the recently published EIOPA Preparatory Guidelines,[34] BaFin expects to continue focusing its attention and resources on preparations for Solvency II, including the implementation of the insurers' Forward Looking Assessment of Own Risks and the enhancement of scenario analysis and stress testing practices.

In 2013, BaFin began its "Strengthening prospective supervision" initiative, with the aim of refining its supervision of insurers, including completing improvements to IT software to support the revised risk assessment/classification approach. This initiative is still underway, but the first set of results was received at the end of 2013.

Stress testing: BaFin has supplemented its current Solvency I supervisory regime for insurance companies with stress testing requirements.[35] Although this does not lead to explicit capital requirements for asset risks, asset cover stress tests are submitted by approximately 320 direct insurance undertakings (life, health and property & casualty insurers) for analysis. The asset cover tests assess the coverage of available assets to meet liabilities under four scenarios over a one-year time horizon.[36] For 2014, BaFin is planning to enhance its stress tests to have a more market value-based focus and to refine the systematic and market-wide analysis of stress tests. Furthermore, BaFin uses scenario analysis on an annual or semi-annual basis as a quantitative instrument to review an insurer's resilience in adverse market scenarios. Recently, the scenario analysis instrument has been expanded to include a multi-year survey (four years ahead) for expected business results and solvency prognoses of insurers.

On-site inspections: Despite being a recommendation in the FSAP, BaFin has not increased the frequency or number of on-site inspections of insurance companies in recent years. This is largely due to the significant volume of resources needed for internal model-related inspections[37] in the pre-application phase of Solvency II. In total, 100 insurers, of which six

[33] The German Insurance Association initiated an additional quantitative impact study in 2013.

[34] See https://eiopa.europa.eu/en/consultations/consultation-papers/2013-closed-consultations/march-2013/guidelines-on-preparing-for-solvency-ii/index.html.

[35] The solvency margin is the amount of regulatory capital an insurance undertaking is obliged to hold against unforeseen events. The minimum solvency margin requirements have been in place in the EU since the 1970s and, following their review, a limited reform of the rules was agreed by the European Parliament and the Council in 2002. This reform is known as Solvency I.

[36] The four scenarios are: 1) bond price reduction of 10% due to a 200 basis point interest rate rise for a duration of 5 years; 2) an equity price reduction based on the year-end index value; 3) an equity price reduction based on the year-end index value in combination with an interest rate rise of 100 basis points; and 4) a property price reduction of 10% combined with an equity price reduction depending on the year-end index value. According to the most recent stress test in 2013, only five insurance companies, all of which were property & casualty insurers, had negative results.

[37] Of the 88 on-site inspections and shorter on-site visits conducted at the largest insurance groups in 2012, only three of them did not focus on the internal models. In 2013 the total number of inspections and visits to these groups dropped to 41, but the range of on-site inspections was more diversified, covering topics such as governance, Pillar I and II requirements, investments and operational risk.

are deemed to have a high market impact, have not received an on-site inspection during the past ten years. BaFin has compensated for the lack of on-site inspections by planning shorter on-site visits, interviews or unplanned event-driven inspections. In 2014, BaFin will reprioritise its work and expects to be able to double the number of on-site inspections.

Group-wide supervision: Although BaFin's supervision of insurance entities is – in the first instance – focused on the solo entities in insurance groups, some enhancements have been made to the supervision of large insurers at a group-level, including:

- For international groups, including one global systemically important insurer (G-SII)[38] for which BaFin is the home supervisor, BaFin has taken measures to enhance the organisation and/or attendance of meetings of colleges of supervisors. Moreover, amendments to the German Insurance Supervision Act are being proposed to address legal constraints that prevent BaFin from sharing information with other supervisors, especially concerning internal models.
- Expansion of the risk classification approach to include a high-level risk assessment at group-level on an annual basis from 2011 (first pilot) onwards. Group solvency assessment is already an important part of the Solvency I group risk classification.
- Increase of actuarial expertise (by 19 full-time equivalents) in 2011 and 2012, as well as continuous efforts to increase actuarial qualifications among existing staff, thereby strengthening the supervision of complex liability structures.
- BaFin actively participates in the preparation of the 2014 EIOPA stress test where the major component ("core stress test") is performed at a group-wide level. BaFin will implement this framework once it is approved at the EU level. In any case, more stringent requirements for group-wide supervision will come into place with the introduction of Solvency II.

Reporting requirements: Since the FSAP, BaFin has made some improvements to the reporting requirements for insurers, both on a permanent and an ad hoc basis. On a permanent basis, the investment reporting has been extended to include more data on insurers' investments. On an ad hoc basis, BaFin has requested additional investment data from a sample group of 30 insurers (including the largest entities) on 24 occasions between 2011 and 2013. Robust controls appear to be in place to validate the quality of data.

The amendments to the German Insurance Supervision Act, which are expected to become effective in 2014, will strengthen regular reporting requirements for insurers and their external auditors. In spite of this, BaFin does not exclude the possibility of extending the requirements further in 2014 and 2015 in light of the EU AIFMD and Solvency II.

Lessons learned and issues to be addressed

Overall, good progress has been made in response to the FSAP recommendations to enhance the microprudential supervisory framework for banks and insurers, including by incorporating some of the latest regulatory developments and international guidance.

[38] The identification by BaFin of other German insurance companies as being systemically important has been postponed until international guidance on this topic becomes available.

Although the German authorities did not initiate a comprehensive review of supervisory practices to identify the key supervisory lessons from the financial crisis, various individual elements of microprudential supervision have been evaluated and strengthened in recent years. In particular, the stress testing framework and coverage for banks and insurance companies has been enhanced, the regulatory reporting framework for both sectors has improved, and the intensity of on-site supervision for larger banks has increased. It is important, in this context, to recognise the role that regulatory initiatives at both global and European level have played in shaping the direction and pace of reforms in Germany.

An important development impacting banking supervision in Germany will be the commencement of the SSM on 4 November 2014. On this date, primary responsibility for the supervision of the largest banks in the Euro area, including an expected 24 German banks, will be transferred to the ECB. National authorities will remain involved in the supervision of those banks, as it is expected that they will assist the ECB in the performance of its new supervisory tasks. Ongoing supervision of these banks will be conducted by Joint Supervisory Teams (JSTs) coordinated by the ECB (also with staff from national competent authorities), whilst teams of supervisors independent from the JSTs (drawn from both from national authorities and the ECB) will be formed to conduct on-site inspections. For smaller banks, national competent authorities will retain responsibility with oversight provided by the ECB. These impending changes will have a significant impact on the roles, responsibilities and tasks of both BaFin and Bundesbank as well as on current supervisory practices. Both institutions are currently assessing the impact of the SSM in terms of resources, processes and governance during the transition period[39] as well as the ongoing support that will be provided to the SSM.

While these changes pose uncertainties and challenges, the German authorities are encouraged to continue their efforts to enhance supervisory frameworks and processes, as these will play a pivotal role in the microprudential supervision of German banks and insurance companies. In particular, the transition to the SSM does not lessen the need by the German authorities and/or the ECB to implement measures, described below, to further enhance: (i) prompt and comprehensive risk identification; and (ii) timely and effective supervisory intervention.

Prompt and Comprehensive Risk Identification: Early identification of institutions' inherent or emerging risk exposures is a key element of effective forward looking supervision and is a necessary complement to supervisory efforts to address and rectify risk management and control gaps noted in institutions. The authorities will need to continue to strengthen their supervisory practices to enable the early and comprehensive identification of risks within each institution, including the assessment of important risk drivers relating to an institution's business model and risk culture, stress testing, credit risk oversight, and on-site inspection of insurance companies, as further elaborated below.

Business model and risk culture

[39] This includes resources required for the execution of a comprehensive assessment of banks' assets and a subsequent stress test by the ECB/EBA, as well as a parallel run of the national and ECB supervisory risk assessments of banks.

The German authorities acknowledge the significant impact of business models on banks' and insurance companies' forward-looking risk profile and have undertaken some (financial) analysis for a few individual banks in this area. At the same time, the authorities point out that the choice of business model remains the responsibility of the institution; the supervisory response in the first instance is to ensure that the institution's Board and senior management have considered the inherent risks stemming from their business models and that there exist appropriate controls and buffers to mitigate them. Regarding insurance supervision, BaFin has already introduced useful new instruments, such as scenario analysis of financial statements and the use of multiyear prognosis of business results. These instruments contain key elements for a more structured assessment methodology of insurers' business models (both of solo and group-level entities) enabling BaFin to have a better understanding of the embedded risks. Building on existing experience and instruments as well as forthcoming EBA and ECB guidance, BaFin and the Bundesbank should adopt a comprehensive approach for assessing banks' and insurance companies' business models. This will allow supervisors to identify the inherent risks associated with different business models independently from the institutions and help them challenge assumptions made by those institutions on the level of risk and the required controls and buffers.

The German authorities have decided not to change their approach (or relevant laws) with regard to major acquisitions made by banks. This means that, in contrast to the FSAP recommendation, such acquisitions are not formally vetted or approved in advance. While EU law does not oblige national authorities to vet or approve major acquisitions or qualifying holdings made by banks, some EU member states (e.g. Netherlands) have adopted such provisions in national regulation in response to the lessons from the financial crisis. Since major acquisitions (and qualifying holdings) can have a significant impact on the risk profile of financial institutions, the authorities should consider adapting their practices to ensure that, at a minimum, they are always informed of any such activities at an early stage. This would enable supervisors to identify and assess the potential risk implications for the institution and, if necessary, to take steps to mitigate or avoid these risks.

A focus on more qualitative aspects of institutions – such as corporate governance, risk appetite and risk culture – also provides supervisors with important indicators of Board effectiveness and the way that risks are taken and managed by an institution. While these are relatively new areas of attention for the prudential supervision of banks and insurers and are difficult to measure, both BaFin and Bundesbank have already taken promising steps to include them in their supervisory processes, including through regular attendance of Board meetings, review of institutions' risk reports, and interviews with board members. Drawing on international guidance in this area,[40] the authorities are encouraged to continue to increase their expertise and efforts to ensure appropriate coverage of these qualitative aspects through on-site inspections and off-site analysis.

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[40] See, for example, the November 2013 FSB *Principles for an Effective Risk Appetite Framework* (http://www.financialstabilityboard.org/publications/r_131118.pdf) and the consultative document entitled *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* (http://www.financialstabilityboard.org/publications/c_131118.pdf).

Credit risk oversight

Even though the Bundesbank regularly performs credit inspections of banks' internal ratings based approach (IRB), much reliance is placed on external auditors to assess non-IRB aspects of credit risks, such as asset quality and the adequacy of loan loss provisioning. The authorities rarely conduct on-site inspections of these areas, with BaFin typically commissioning external auditors to perform such reviews.

Since credit risk is the primary inherent risk for the large majority of banks, it is imperative that the German authorities have sufficient in-house expertise to identify and supervise all aspects of credit risks, including non-IRB elements. In addition, and as recommended by the BCBS and the FSB,[41] supervisors must be able to assess whether the output from third parties such as external auditors can be relied upon to the degree intended. BaFin and the Bundesbank should therefore evaluate, as part of their ongoing review of resources, the need for strengthening their internal credit risk supervision expertise to enable them to increase the depth and frequency of inspections in this area and enhance their quality assurance of third party assessments of asset quality and credit provisioning processes.

Stress testing liquidity risks

Timely and comprehensive stress tests covering all relevant risk factors allow for the prompt identification of key risk drivers in each institution, thereby enabling early intervention to prevent identified weaknesses from developing into a larger threat to safety and soundness. The Bundesbank has made commendable efforts to enhance the rigor and institutional coverage of stress testing for banks, but has yet to incorporate liquidity risks within its stress testing framework.

Banks' internal stress test framework and models are currently subjected to regular supervisory review to ascertain their robustness. The banking supervisors also obtain internal liquidity stress test results from selected banks to evaluate their forward-looking liquidity positions. However, these results are less independent, comparable and consistent than those derived from the authorities' own stress tests. In line with ongoing EBA work in this area,[42] the German authorities are encouraged to incorporate liquidity scenarios in their stress testing framework and to perform their own liquidity stress tests. With the implementation of the new liquidity reporting requirements in 2014, more granular data would be available to facilitate the conduct of such tests.

In general, stress tests are useful in flagging key risk factors. But their effectiveness as a forward-looking supervisory tool depends largely upon how well they are embedded in supervisory practices. The German supervisory authorities are already engaging banks on areas of concern identified in stress tests and incorporate stress test results in their risk profile assessments. In addition, the authorities could further embed liquidity stress tests, as well as

[41] See Principle 9, Essential Criterion 11 of the September 2012 BCBS *Core Principles for Effective Banking Supervision* (http://www.bis.org/publ/bcbs230.pdf), and the November 2010 FSB report on *"Intensity and Effectiveness of SIFI Supervision, Recommendations for Enhanced Supervision"* (http://www.financialstabilityboard.org/publications/r_101101.htm).

[42] See http://www.eba.europa.eu/-/eba-launches-discussion-on-the-methodology-for-the-assessment-of-liquidity-and-funding-risk-under-supervisory-review.

other stress tests, in their supervisory practices and make greater use of stress test results. For instance, to ensure that supervisory interventions are taken in a timely manner, results from stress tests could be one of the factors (or triggers) considered in the "ladder of actions".

Insurance on-site inspections

Due to Solvency II preparations, BaFin has been unable to increase the number of on-site inspections of insurance companies. While this has been compensated for to some extent by other activities, such as meetings with board members and short visits to institutions, BaFin is encouraged to follow through with its plans to double the number of on-site inspections. The Solvency II preparations have also resulted in most on-site inspections focusing primarily on the readiness of insurance companies' internal models, which include a strong focus on risk management requirements. Although understandable, this has meant that various other key risk areas of insurance companies – such as those related to IT, new investments, products and activities – have received relatively less attention. Going forward, BaFin should identify the key risk areas of insurers based on its new risk classification approach and use them to determine its on-site inspection programme.

- ***Recommendation 5*: BaFin and the Bundesbank should continue to strengthen their supervisory practices to ensure the early and comprehensive identification of risks within each institution. This includes inter alia enhancing business model and risk culture analysis; ensuring that supervisors are aware of major acquisitions by supervised banks and are able to take necessary actions at an early stage in response to their impact on banks' risk profile; increasing credit risk expertise to enhance the oversight of non-IRB aspects of credit risk; incorporating liquidity risk scenarios in their stress testing framework; and increasing the number and scope of on-site inspections for insurance companies.**

Timely and Effective Intervention*:* Once key risks within institutions have been identified, timely and effective supervisory intervention that is commensurate with the nature and severity of the identified issues is critical to ensure that the institution takes appropriate corrective actions. An important tool in this respect is a "ladder of supervisory actions".

Ladder of Actions for banking supervision

BaFin has access to various supervisory tools and powers, both formal and informal (i.e. moral suasion), to intervene in an institution when necessary. As previously noted and in response to the FSAP recommendations, BaFin adopted in December 2013 a formal "ladder of actions" for banking supervision. The "ladder of actions" sets out a series of supervisory actions and measures, including capital add-ons, which can be taken when deficiencies in any of three areas are identified: organisational matters (related to risk management practices and operational controls), capital adequacy or liquidity.

The ladder already includes some forward-looking elements derived from minimum risk management requirements (under the German Banking Act) regarding a bank's business and risk strategy. However, the ladder's effectiveness could be further enhanced by placing greater emphasis on forward-looking elements (e.g. risks to the long-term viability of a bank's business model or potential weaknesses stemming from its risk appetite and culture) as well as by expanding quantitative and qualitative triggers. In particular, the authorities should build on the triggers found in the German Banking Act and existing guidelines to facilitate analysis by supervisors on a more forward-looking basis. Such triggers would reduce the degree of subjectivity when implementing the ladder, and enable greater consistency of actions across teams or when the need arises to escalate issues. Given the wide diversity in the nature of institutions and the types of issues and concerns, these triggers should not be set as "hard" or mechanical thresholds mandating actions to be taken once they are breached. Rather, they should serve as internal guidance points to prompt further analysis/escalation by supervisors on a timely basis. The introduction of such triggers may in some cases also help to reduce any delays in supervisory responses to bring about corrective action for banks and increase the willingness to act. Such objective triggers would also be useful to support less experienced supervisors.

Ladder of Actions for insurance supervision

The Insurance Act (which will be further refined based on the upcoming Solvency II requirements) provides BaFin with a wide range of measures from both the prudential and consumer protection perspectives. These measures, however, have not been translated into an agreed formal "ladder of actions" to guide interventions for different types of identified problems. For the same reasons as the ones mentioned above for banking, BaFin should consider adopting such a ladder for insurance supervision as well. The banking ladder could serve as a starting point, but it is important to tailor the insurance ladder to the specific nature of insurance supervision and regulations, as well as to the diversity of insurance entities operating in Germany and hence the range of issues that may arise.

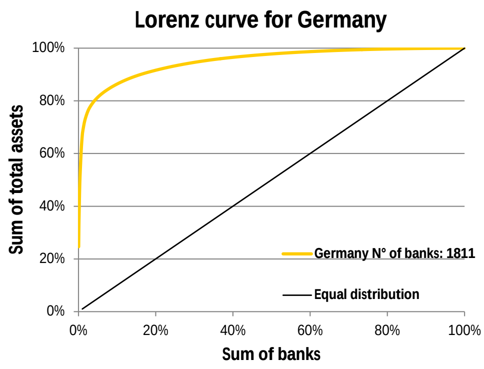
- ***<u>Recommendation 6</u>: To enhance the timeliness, consistency and effectiveness of supervisory interventions, BaFin should expand the use of forward-looking elements and of objective quantitative and qualitative triggers in the banking supervision "ladder of actions"; and introduce a separate "ladder of actions" for insurance supervision.***

Annex 1: Structure of the financial system and recent developments

Financial system structure

Banking

As of 31 December 2012, the banking sector in Germany comprised 2,053 banks, a decline since the time of the FSAP when, at year-end 2010, there were 2,093 banks. A salient feature of the German banking system is its three-pillar structure:



- The commercial banking sector consists of 275 institutions, accounting for a market share (with regard to local business) of 41%. The sector includes four major internationally active banks, 163 regional banks and credit institutions and 108 branches of foreign banks (market share according to total local assets of 3.7%).
- Savings banks represent the second pillar of the system and consist of 432 institutions with a market share of 30%. Savings banks conduct regional business based on the regional, non-competitive principle. In addition, eight Landesbanken – which carry out their own business, primarily for small and medium-sized enterprises – support the regional institutions with a comprehensive range of services. The winding-up of West LB is one of the major changes occurring within this sector in recent years.
- The third pillar is represented by 1,002 cooperative banks, together accounting for a market share of about 13%. Two cooperative central banks complete this sector.

In addition to the universal banks described above, there are several specialised institutions: 18 mortgage banks, 15 business development banks and 22 building and loan associations. There are also 1,559 financial services institutions and 32 securities trading banks.

Pre-tax earnings at the end of 2012 stood at an aggregate EUR 30.2 billion for the 1,754 reporting institutions. This was virtually unchanged from 2011, but much higher than in previous years. Earnings were supported by historically low loan loss provisioning due to a favourable macroeconomic environment in Germany.

The results of the Basel III quantitative impact study showed that, on average, the 42 German banks participating in the exercise complied with Basel III common equity tier one capital requirements of 7% as of year-end 2012. The sum of individual capital shortfalls for the seven large and internationally active banks remains at about EUR 14 billion; it is worth noting, however, that this figure has decreased by EUR 16 billion in the six months since June 2012. Preliminary results for June 2013 indicate a further reduction. This improvement is attributable to increases in regulatory capital as well as a reduction in risk-weighted assets.

Insurance

At the end of 2012, a total of 568 primary insurance companies (including burial funds) and reinsurance companies were subject to federal supervision in Germany. Property and casualty insurance companies, which provide insurance for business and household assets as well as liability coverage, represent the largest share of the total with 210 institutions. Total gross written premiums for the primary insurance sector were EUR 192.5 as of year-end 2012. Gross written premiums in Germany's large reinsurance sector amounted to more than EUR 46.7 billion in 2011.

The investment portfolio of Germany's primary insurance sector[43] amounted to EUR 1.12 trillion in 2012, up by 4.5% from the previous year. The investment portfolio of the reinsurance sector amounted to EUR 236.6 billion. A breakdown of the combined portfolios by investment category shows that investments in bonds, loans and other fixed income products account for 80.9% of the total, investment holdings for 10.6%, real estate for 3.1%, equities for 2.9% and other investments for 2.5%.

The largest domestic insurance company is Allianz SE – designated a G-SII by the FSB – with total group-level financial assets of EUR 400 billion at the end of 2012. Munich Re is another globally active domestic insurance company, with group-level capital investments valued at EUR 225 billion.

At the beginning of 2012, the BMF responded to the persistent low-interest rate environment by lowering the maximum technical interest rate for new contracts, from 2.25% to 1.75%. In addition, in order to ensure that insurance companies remain able to finance future obligations under life insurance and annuity contracts, the BMF introduced an "additional interest provision" to the premium reserve.

Investment companies and funds

The fund sector in Germany is small when compared to jurisdictions such as Ireland or Luxembourg. At the end of 2012, approximately 6,000 domestic investment funds were managing about EUR 1.3 trillion worth of assets. Specialised funds, which are reserved for institutional investors such as banks and insurance companies, were the largest group of domestic investment funds, responsible for EUR 970 billion in financial assets. Funds open to the general public managed assets with a value of EUR 330 billion. The majority of assets managed by funds open to the general public and specialised funds were in the form of funds with a mixed mandate (about 43%), followed by bond funds (29%), equity funds (13%), real estate funds (9%), funds of funds (5%) and money market funds (0.6%).

Broker-dealers

In line with the definitions stipulated by the Eurosystem, the Other Financial Institutions subgroup dealing with security and derivatives dealers is used for the broker-dealers segment. Standing at roughly EUR 840 million at the end of 2012, this line of activity is very small. In fact, in Germany, broker-dealer business is typically carried out by banks.

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[43] Excluding Institutions for Occupational Retirement Provision, deposit receivables from the insurance business assumed as reinsurance cover, and investments where the investment risk is borne by the policyholder (particularly in the case of unit-linked life insurance).

In general the overall structure of the non-bank sector has not changed since the FSAP. The persistent low-interest rate environment remains one of the main challenges for the sector, putting particular pressure on life insurance companies. The proposed changes to the legislation on money market funds will alter the structure of that sector but, because of its limited size, the overall composition of the non-bank sector is unlikely to change.

Other major regulatory reforms

Banking

The establishment of the SSM for the Euro area is likely to have a significant impact on the way that BaFin and the Bundesbank perform their banking supervision tasks. Commencing in late 2014, the ECB will be responsible for the direct supervision of around 24 German banking groups. BaFin and the Bundesbank will however, continue to be involved in the supervision of these institutions as their staff members will be part of the “joint supervisory teams” that the ECB is preparing to establish. BaFin and Bundesbank will retain their responsibilities with regard to the remaining approximately 1,800 banks, but will have to supervise these in compliance with guidelines and general instructions set out by the ECB.

The German parliament has adopted the Act on Ringfencing and Recovery and Resolution Planning for Credit Institutions and Financial Groups (*Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen),* which covers recovery and resolution planning for financial institutions as well as resolvability assessments. Together with the Bank Restructuring Act, it serves as the key framework for managing crises and restructuring financial institutions. Accordingly, Germany has already implemented several major elements of the proposed EU Banking Recovery and Resolution Directive, whereby potentially systemically important institutions are called upon to develop and submit recovery plans to the national supervisory authorities.

Detailed requirements for the content of recovery plans will be published by BaFin as Minimum Requirements for the Design of Recovery Plans (*Mindestanforderungen an die Ausgestaltung von Sanierungsplänen* - MaSan). Key aspects are a strategic analysis of the institution, internal and external interconnectedness and, most importantly, recovery options and recovery indicators which are evaluated in a set of stress scenarios. Beyond recovery plans written by the institutions themselves, BaFin will develop resolution plans which will be discussed with the FMSA and the Bundesbank. In addition, BaFin will examine the resolvability of institutions. If, after consultation with the Bundesbank and the FMSA, the assessment indicates obstacles to the resolution of a particular institution, BaFin will first address this matter with the institution itself and then, if an adequate response is not taken or proposed, will take steps to eliminate the impediments. In the event of a failure of a potential systemically important institution, BaFin has the power to transfer the assets and liabilities of the institution (e.g. to a bridge bank) to avoid a systemic crisis caused by an immediate interruption of financial services. Such a transfer requires the concurrence of the FMSA’s Steering Committee if it entails or could necessitate financial assistance from the Restructuring Fund (SoFFin). BaFin shall, after consultation with the Bundesbank, assess whether any going-concern risk and/or systemic risk with regard to the failing institutions is evident. According to restructuring law, a restructuring fund is managed by the FMSA, established to provide funding for bridge banks where this is needed. All German credit institutions pursuant to section 1 (1) of the German Banking Act, with a few minor exceptions pursuant to section 2 of the Restructuring Fund Act (Restrukturierungsfondsgesetz – RstrukFG), are obliged to contribute to this fund.

In addition, BaFin and the Bundesbank jointly developed a method to identify potential systemically important institutions. The approach is based upon recommendations from the BCBS on this issue and the German Banking Act.

In order to increase the solvency and resolvability of credit institutions and to contribute to the stabilisation of financial markets, the Act on Ringfencing and Recovery and Resolution Planning for Credit Institutions and Financial Groups requires – if certain thresholds are exceeded – deposit-taking credit institutions to separate proprietary trading and other highly risky capital market activities from deposit-related activities by spinning these risky activities off into a legally, economically and organisationally independent company. The Bill has entered into force in January 2014; spin-off activity will be implemented by mid-2016.

Insurance

On 2 January 2014, section 64a (7) of the German Insurance Supervision Act (*Versicherungsaufsichtsgesetz* or VAG) entered into force, amending existing legislation. It defines in more detail certain requirements which senior managers of insurers and reinsurers are required to meet in light of their general responsibility to ensure that a company has a proper business organisation. The new Sections 64a (7) and section 142 of the aforementioned Act introduce the possibility of imposing criminal sanctions on managing board members if they fail to fulfil their duty to establish a proper business organisation, including effective risk management, if this jeopardizes the stability of the undertaking.

Going forward, the authorities plan to amend the Insurance Supervision Act to accommodate a number of international and European requirements. In particular, it will be amended to implement the preparatory guidelines introduced by EIOPA on 25 September 2013 (these guidelines will also be implemented through the modification of existing circulars, issuance of new circulars, rulings or interpretive decisions) and the Solvency II Directive (although this is dependent upon the time necessary to translate it into national law).

Other planned reforms include modifying domestic supervisory standards to implement the FSB’s requirements as they relate to the supervision of G-SIIs, implementation of the Directive on credit agreements relating to residential property, amending the Act on the Supervision of Financial Conglomerates to reflect the requirements of the SSM Regulation and facilitate cooperation between BaFin and the ECB, changing domestic guidance and legislation to reflect the requirements of the European Regulation on Credit Rating Agencies and finally, adapting legal provisions for long-term guarantees by life and health insurers to protect them from the effects of the persistent low interest rate environment.

Securities

European Market Infrastructure Regulation (EMIR)

Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 (EMIR) on OTC derivatives, central counterparties (CCPs) and trade repositories entered into force on 16 August 2012. The German EMIR Implementation Act (*EMIR-*

Ausführungsgesetz) entered into force on 16 February 2013 and brings the German legal framework in line with the EMIR.

The main obligations arising from EMIR are: central clearing for certain classes of OTC derivatives; application of risk mitigation techniques for non-centrally cleared OTC derivatives; reporting to trade repositories on derivatives; application of organisational, conduct of business and prudential requirements for CCPs; application of requirements for trade repositories, including the duty to make certain data available to the public and the relevant authorities.

Technical standards issued by the European Securities and Markets Authority (ESMA) and by the EBA, or joint technical, standards issued by all European Supervisory Authorities clarify the regulation in greater detail – a precondition for its application to a large extent.

As regards the risk mitigation techniques for non-centrally cleared OTC derivatives, the relevant draft technical standards relating to the exchange of collateral and adequate capital are in the process of being developed.

These developments are under close observation and legislation will be adapted as and when a final text is agreed upon.

Regulation on credit rating agencies

Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies.

The EU Regulation on credit rating agencies has been in force since December 2010. In November 2011, the Commission put forward proposals to reinforce the regulatory framework on credit rating agencies. The new rules came into force on 20 June 2013 (Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies). The Regulation is intended to reduce conflicts of interest and reliance on credit ratings. Moreover, it enhances transparency and tends to improve the quality of credit ratings. Credit rating agencies are supervised by ESMA.

Directive on Alternative Investment Fund Managers (AIFMD)

The AIFMD 2011/61/EC entered into force in July 2011, subsequent to which Germany had a transition period of two years in order to translate the Directive into German law. The relevant law implementing the AIFMD (AIFM-Umsetzungsgesetz) took force on July 22, 2013. By virtue of the Act Implementing the AIFMD, the Investment Act was repealed and replaced by the Investment Code (*Kapitalanlagegesetzbuch* – KAGB).

The Investment Code introduces a regulatory framework which specifically covers all kinds of investment funds, Undertakings for Collective Investment in Transferable Securities (UCITS) as well as Alternative Investment Funds (AIFs) and their managers. As such, the Investment Code is more comprehensive than the AIFMD which primarily targets the managers of non-UCITS. Thus, the Investment Code encompasses rules on open-ended as well as closed-ended investment funds and their respective managers. By introducing a material definition of what constitutes an investment fund, the Investment Code captures the former “grey” capital market for investment funds. In addition to the requirements of the AIFMD designed for the managers of funds distributed to professional investors, the

Investment Code contains appropriate national rules for funds offered to retail investors, their management companies and depositaries. A transitional period applies to most AIFs and their managers and compliance with the new rules is to be achieved by July 2014.

MiFID review

On 20 October 2011, the European Commission published its proposal to review Directive 2004/39/EC of 21 April 2004 on markets in financial instruments. The final proposal, which is still under discussion, is designed to deliver on the G20 commitment to trade standardised derivatives on exchanges or electronic platforms. Furthermore, it will enhance trade transparency and investor protection and introduce a new trading category (organised trading facility) with a view to regulating those trading venues that are not captured by the current regulation as well as provisions regarding high frequency trading and commodity derivatives trading.

CSD Regulation

The EU-Regulation on Central Securities Depositaries (CSDR) is currently under negotiation in the "trilogue" between the Council of the EU (Council), the European Parliament (EP) and the European Commission. The CSDR aims at increasing the safety and efficiency of post-trading services and at harmonising the supervisory rules for CSDs throughout the EU.

Recovery and resolution frameworks for financial market infrastructures (FMIs)

In late 2012, the European Commission held a consultation on a possible recovery and resolution framework for financial institutions other than banks. On the basis of the respective work that is currently underway at the international level (CPSS-IOSCO with regard to the recovery of FMIs and the FSB with regard to the resolution of FMIs), the Commission intends to present suitable proposals for such frameworks in 2014.

Transparency Directive (review)

The EU Transparency Directive lays down requirements concerning the periodic reporting and disclosure of major holdings with a focus on listed companies. A review of the existing Transparency Directive was carried out between October 2011 and May 2013. The revised Transparency Directive dated 22 October 2013 (Directive 2013/50/EU amending the Directive 2004/109/EG) came into force on 26 November 2013. Member States will then have two years to achieve implementation. In order to reduce the administrative burden and discourage short-termism on financial markets, listed companies are no longer obliged to publish quarterly financial information. Moreover, new rules have been introduced to prevent investors from secretly building up a controlling stake in a listed company ("hidden ownership") as investors are now requested to report all financial instruments that have the same economic effect as holdings of shares.

Market Abuse Regulation

In October 2011, the European Commission published its proposal for a new Market Abuse Regulation. This regulation, which has not yet been finalised, is intended to update and strengthen the existing framework to prohibit insider trading and market manipulation under the current Market Abuse Directive by including all financial instruments which are traded on organised platforms and OTC, and adapting rules to new technology. The manipulation of benchmarks such as LIBOR will be explicitly outlawed, market abuse occurring across both commodity and related derivative markets will be prohibited, and cooperation between financial and commodity regulators is to be reinforced.

Benchmark Regulation

In September 2013, the European Commission adopted a proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts in order to improve the functioning and governance of benchmarks and to ensure that benchmarks produced and used in the EU are robust, reliable, representative and fit for purpose and that they are not subject to manipulation. Discussions of this proposal among member states have been initiated.

Annex 2: Follow-up of other key FSAP recommendations

This Annex presents the follow-up actions reported by the German authorities to key FSAP recommendations that are not covered in sections 2 and 3. The actions mentioned below have not been evaluated as part of the peer review and are presented solely for purposes of transparency and completeness.

Recommendations	***Steps taken to date and actions planned (including timeframes)***
Structural issues	
Develop a comprehensive strategy aimed at improving the efficiency and stability of the banking system, which includes the following: (a) urgently establishing viable business models for the Landesbanken; (b) loosening the regional constraints under which local banks operate; (c) opening up the public banks to private participation; and (d) strengthening these banks' governance to reduce non-commercial influences.	German supervisory authorities have taken steps to analyse banks' business models in more depth. The reform of the Landesbanken continues to proceed at a gradual pace. In 2012, the restructuring of a large Landesbank was completed. Most Landesbanken have adapted their business model and significantly strengthened their capital position. Changes in their governance have also taken place. As Landesbanken and Sparkassen operate under laws enacted at state (i.e. regional) level, no responsibilities apply at Federal Government level, nor is there any scope for specific sector-targeted supervisory measures.
Crisis management and bank resolution	
Ensure the financial strength of the new bank restructuring fund, and clarify the interaction between the restructuring fund and the various deposit guarantee schemes (DGS) and mutual protection schemes.	The German Bank Restructuring Fund rests on three strong pillars. From 2011 to 2013, approximately EUR 1.8bn were collected from the banks via an annual levy. This primary pillar will increase in volume over time. Should the banks achieve a higher profitability in the future, the annual bank levy will increase, as the caps would no longer constrain the levy. As a second (temporary) pillar, up to EUR 20bn are available to the Fund immediately as a federal loan in cases where the sum of the collected fees is insufficient at the time of utilisation of the Fund. This pillar also consists of liquidity guarantees of up to EUR 100bn. These measures have been available from day one of the setting up of the Fund in order to guarantee its credibility and authority. The federal loan is only meant as a backstop to ensure the Funds functioning until such a loan would be repaid by the banks, if necessary through special levy (third pillar), which may increase the annual levy in any particular year by up to 300%. The system of levies ensures that even if the state had to step in, the ultimate bill would be presented to and borne by the banks. In fact the purpose of the law, to place the burden firmly with the industry is arguably already achieved at the present stage.

	There is no formal interaction between the Fund and the DGS/mutual protection schemes. Whereas the Fund provides own capital and guarantees to ensure restructuring of assets and liabilities relevant for the stability of financial system the DGS/mutual protection schemes act as safeguard for protected deposits within the respective framework, i.e. at least EUR 100.000 per eligible customer per bank. As in the past, individual DGS schemes will be asked to contribute to costs of future rescue measures in proportion to the savings they achieve by avoiding the failure of a bank. This will continue to be a matter of bargaining until the EU Bank Recovery and Resolution Directive is implemented.
Reform the DGS regime by instituting a harmonized and legally binding deposit guarantee of EUR 100,000, backed by adequate prefunding.	Reform completed (amendment to the Act on Deposit Guarantee and Investor Compensation, which entered into force in June 2009). Deposits are guaranteed up to an amount of EUR 100,000 per eligible customer per bank. Current national deposit insurance arrangements are compliant with the agreed set of international 18 Core Principles by IADI/BCBS. The revision of the European DGS Directive (expected finalization Mid 2014) mainly deals with a further harmonisation of protected deposits, a faster pay-out, and an improved financing of schemes.
Finalize specific strategies for exiting from the government support to banks, and require the affected banks to formulate strategic plans.	<u>Portigon (former WestLB)</u> In February 2008 the owners of WestLB, the state of Northrhine-Westphalia and the savings banks of the state of Northrhine-Westphalia agreed on a 5bn EUR guarantee to cover extraordinary risks arising in WestLB. During the second half of 2009 the situation deteriorated and the FMSA developed an interim solution. By the end of 2009, WestLB became the first German bank to transfer parts of its portfolio into a wind-down-agency called "Erste Abwicklungsanstalt" or EAA. In November 2011 EU-COM voiced serious concerns about the sustainability of WestLB's business model, which the German government agreed to push for. Following an agreement between the respective parties on 30th June 2012, WestLB ceased all new business. The bank transferred its savings bank business (volume about EUR 40bn) to Helaba (Hessische Landesbank) and moved its remaining portfolio (volume about EUR 100bn) to the EAA (wind-down-agency) with the objective of winding down this portfolio. This wind-down process will take place under guarantee by the former owners (the state of Northrhine-Westphalia and the savings banks of the state of Northrhine-Westphalia). The servicing business of the remaining entity (Portigon) is transferred into a separate company and must be privatised by the end of 2016 (EU-COM).

	HRE In September 2008, HRE Group encountered some severe financial difficulty. Subsequently a number of steps were taken in order to completely take over the bank under existing commercial law, culminating in a squeeze-out, not an expropriation, of all remaining shareholders on the 13th October 2009. About EUR 176bn of HRE Group's assets were transferred into a wind-down-agency called "FMS Wertmanagement" or FMS-WM in 2010 with the objective of completely winding-down these assets over time. A European Commission ruling is mandating a privatisation of HRE Group: DEPFA by the end of 2014 (under certain conditions) and pbb (Deutsche Pfandbriefbank) by the end of 2015. HRE is currently seeking to sell its Irish subsidiary DEPFA in a non-discriminatory process. Commerzbank In 2008 and 2009, SoFFin helped rescue ailing Commerzbank with a silent participation of EUR 16.4bn. In addition, through SoFFin the government acquired a stake of 25% plus one share in the bank at a cost of EUR 1.8bn. On 31 May 2013, Commerzbank acted on its strategic goals – by returning the last remaining tranche of SoFFin's silent participation, thereby terminating the last tranche of state-aid other than the direct shareholding in the bank. Due to the issuance of new capital and the fall in the bank's share price the original shareholders of Commerzbank lost most of their previous investment. The timing of the disposal of the remaining direct shareholding (17.2%) is under continuous assessment and will occur once conditions are judged suitable and a corresponding decision has been taken. Since this decision lies not in the hands of the bank, it is not subject of the bank's strategic plan. Aareal In 2009, Aareal Bank received a Silent Participation of EUR 525mn and a guarantee facility of up to EUR 4bn. In 2012, Aareal redeemed the last SoFFin-guaranteed bond issue. In 2010 and 2011, Aareal repaid EUR 150mn and EUR 75mn of the Silent Participation. The bank always paid the coupon of 9% on the Silent Participation. It is the stated goal of the bank to substitute the government's silent participation by issuing CRR/CRD IV-compliant Additional Tier I instruments, once the respective compliance criteria have been finalised.