

Draft Act for the Strengthening of Financial Markets and Insurance Supervision

On 3 April 2009, the German Federal Government (*Bundesregierung*) published the first draft of an Act for the Strengthening of the Financial Markets and Insurance Supervision (*Gesetz zur Stärkung der Finanzmarkt- und der Versicherungsaufsicht*) ("**Draft Act**") which is currently being discussed in the German Parliament.

According to the German Federal Government, the purpose of the Draft Act is to strengthen the preventive powers of the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht - "BaFin"*) and to improve its powers of intervention in times of crisis. At the same time, new reporting requirements for institutions and insurance companies shall extend the information basis of the BaFin so as to be in a better position to identify potential future risks. The Draft Act also attempts to expand the supervisory powers of the BaFin with respect to groups of institutions or insurance companies and financial holding groups, and to introduce quality requirements for members of the supervisory boards of institutions.

Currently, the Draft Act is discussed very controversially both in Parliament as well as in public. Therefore, it is quite unclear whether the Draft Act, in its current or amended form, will pass Parliament before the next General Election later this year.

1. Overview

The main proposals comprised in the Draft Act are:

Higher capital requirements in the case of specific business risks: The powers of the BaFin to impose higher individual capital requirements on a institution or a group of institutions shall be extended, in particular in cases where a "sustainable adequacy" of an institution's own funds is no longer ensured or if the "risk-bearing capacity" of the institution diminishes. In respect of insurance companies, the BaFin shall be authorised to set individual adjustment items (*Korrekturposten*) to be deducted from the insurance company's amount of own funds.

Ban of intragroup payments: The BaFin shall be given the power to impose a ban on payments owed by an institution or an insurance company to its intragroup creditors. The purpose of such a ban is to prevent that a German institution or insurance company is deprived of liquidity by its (non-German) parent company or affiliates ("ring-fencing").

Higher professional requirements for members of supervisory boards: The BaFin shall be authorised to dismiss members of the supervisory board of institutions and insurance companies if they are not adequately qualified or not trustworthy, or if they act negligently in the exercise of their control functions. In addition, the maximum number of seats in the supervisory board available to former managing directors of the institution or insurance company and to members of the supervisory board of other BaFin supervised entities shall be limited.

Contents

1. Overview

2. Background and Criticism

3. The Changes in Particular

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Higher individual liquidity requirements: In the German Federal Government view, the liquidity of many institutions has shown to be inadequate in light of the current crisis. Hence, the BaFin shall in the future be authorised to impose individual higher liquidity standards as considered appropriate to safeguard an institution or a group of institutions.

Prohibition to distribute profits: A prohibition to distribute profits can currently only be imposed on an institution if the supervisory ratios in respect of the institution's own funds or liquidity are no longer met. In the future, such prohibition shall already be possible if there is a danger of the institution falling below the relevant ratios. Moreover, the BaFin shall be authorised to prohibit the repayment and distribution of profits in regard of all subordinated capital instruments that form part of an institution's own funds (hybrid capital instruments).

New reporting requirements: Institutions and groups of institutions will, *inter alia*, be required to report regularly on their "leverage ratio" (i.e. the ratio of their own funds to the sum of their balance sheet total plus liabilities deriving from off-balance sheet transactions), especially in order to monitor risks deriving from off-balance sheet securitisation transactions.

2. Background and Criticism

The Draft Act is intended to form part of the German Federal Government's measures to stabilise the financial markets that have been agreed upon in October 2008. Its proposals are highly topical in light of today's discussion on the reform of regulation since they draw on the ideas published in various reports such as the Turner-Review and the Larosière-Report. However, the proposed amendments contained in the Draft Act have been heavily criticised in the first parliamentary hearings, by the Parliament's expert committees as well as in an expert hearing in late May since they anticipate a number of measures that are still being discussed or about to be implemented on European and international level, especially with regard to the proposed amendments to the Basel II framework. The main points of criticism are that a German solo attempt to tighten regulatory capital requirements might result in a competitive disadvantage for German institutions and trigger the need for substantial revision once the respective measures have been adopted on an international level.

Moreover, the suitability of some of the proposed measures to stabilise the financial market is at least doubtful. The prospect of vaguely formulated but material limitations on investors' and creditors' rights (the application of which lies within the discretion of the BaFin) creates a legal uncertainty that might even worsen the ability of institutions to improve their capital basis.

Hence, in a statement on the Draft Act dated 15 May 2009, the Second Chamber of the German Parliament (*Bundesrat*) requested the German Federal Govern-

ment to demonstrate the need for adopting a national legislation without taking into account the forthcoming implementation of international conventions and European Directives in this area, all the more since an immediate entering into force of the Draft Act without transitional grace periods would not be possible, and since some parts of the Draft Act should not be implemented for the time being because of their detrimental pro-cyclical effects.

Moreover, the *Bundesrat* argues that the causes of the financial crisis (namely, non-transparent risks) must be fought. These risks would have to be identified and curtailed by virtue of an EU-wide, general legislation and not by decisions of the supervisory authority in the single case, as currently provided for by the Draft Act.

It remains to be seen which impact these arguments will have on the further discussion, and whether the legislative process in respect of the Draft Act will be continued at all, particularly as later this year there will be a General Election in Germany the outcome of which is quite open. In any event, substantial changes to the current version of the Draft Act are very likely.

3. The Changes in Particular

The Draft Act introduces a number of amendments to the German Banking Act (*Kreditwesengesetz* – "**KWG**") as well as the German Insurance Supervision Act (*Versicherungsaufsichtsgesetz* – "**VAG**"). While a few amendments relate either to banking or insurance supervision, the majority of the proposed changes to the KWG and the VAG concern financial institutions as well as insurance companies.

3.1 Higher capital requirements in the case of specific business risks

The Draft Act extends the (already existing) authority of the BaFin to impose individual higher capital requirements on institutions, groups of institutions and financial holding groups in certain specific cases.

Currently, such a measure requires that the institution, with a view to the composition of its assets or its business activities, shows an extraordinary risk structure that makes it distinct from the "vast majority" of other institutions which are active in comparable areas of business. The German Federal Government holds the view that this requirement has shown to be too inflexible to enable the BaFin to adequately react to the individual risk profile of an institution.

According to the Draft Act, the BaFin shall be authorised to impose higher capital requirements than those required under the KWG and the Solvency Regulation (*Solvabilitätsverordnung* – "**SolvV**") (i) in order to account for such risks that are not or not entirely subject to the SolvV, (ii) if the "risk-bearing capacity" of the institution is not guaranteed, (iii) in order to ensure the creation of an additional "equity capital buffer" for times of an economic downturn, and

also (iv) to account for "specific business circumstances", for example, the starting of business activities of a newly established institution.

Moreover, in the case of shortcomings to the internal business organisation of an institution, the Draft Act would change the powers of the BaFin to impose higher capital requirements from an *ultima ratio* to a pre-emptive approach the measures of which could be taken even before the respective adjustments to the institution's internal business organisation have been identified and ordered.

In order to meet higher regulatory capital requirements ordered by the BaFin, the institution would have to acquire additional equity capital or reduce its credit risk positions. As the Draft Act does not set particular thresholds for such discretionary interventions, it would largely be up to BaFin to determine the suitability and appropriateness of such steps. Criticism by banking industry associations of the Draft Act points out that imposing higher capital requirements on institutions in times of crisis might even aggravate financial instability. Hence, such measures would only make sense if taken far in advance of an imminent misbalance. At the same time, the BaFin's authority to require an institution to create an additional capital buffer might result in a distortion of competition if not applied strictly on the basis of equal treatment.

The proposed extension of the powers of the BaFin to impose higher capital requirements on insurance companies are less drastic. By the individual determination of adjustment items (*Korrekturposten*) which have to be deducted from the insurance company's own funds, the BaFin could indirectly increase the amount of own funds that the insurance company is required to hold. In this respect, the Draft Act introduces an instrument to the area of insurance supervision that is already available in the area of banking supervision under the KWG. According to the legislative reasoning to the Draft Act, the setting of such adjustment items is primarily intended to account for future variations of an insurance company's amount of own funds that are not yet reflected on its balance sheet. However, the wording of the Draft Act would, in principle, also allow to use this supervisory instrument in the context of other situations.

3.2 Ban of intragroup payments ("ring-fencing")

The Draft Act introduces so-called "ring-fencing" to the BaFin's repertoire of supervisory measures both in respect of the supervision of financial institutions and insurance companies.

According to this proposed amendment, the BaFin may prohibit or limit payments to affiliated companies (or may render such payments subject to certain requirements) if it concludes that these transactions would be detrimental to the relevant financial institution or insurance company. However, these measures may only be ordered in cases of danger, i.e. if the BaFin concludes that the discharge of the institution's or insurance company's obligations vis-à-vis its creditors

and especially the safety of the assets entrusted to it is at risk, or that an effective supervision is not guaranteed.

According to the legislative reasoning to the Draft Act, said instrument aims to prevent a German institution or insurance company from being deprived of liquidity by foreign group companies (which themselves are in need of liquidity) in a situation of crisis (a situation recently experienced in the Lehman failure). With regard to groups of companies located within the EU, however, it is doubtful whether such measures would be compatible with the European law principle of freedom of payments.

3.3 Higher professional requirements for members of supervisory boards

One measure that has already attracted significant attention in the German press is the proposed extension of the existing requirements with respect to managing directors regarding their trustworthiness (*Zuverlässigkeit*) and professional qualification (*fachliche Eignung*) to members of supervisory boards of financial institutions and insurance companies.

Financial institutions and insurance companies would have to submit to the BaFin the information necessary to assess the trustworthiness and professional qualification of any member of their supervisory board, both when applying for a banking or an insurance licence and in relation to any subsequent appointments.

If facts justify the assumption that a member of the supervisory board does not meet these criteria, the BaFin could refuse the granting of the banking or insurance licence, or, as an instrument of its ongoing supervision, demand the dismissal of such member, prohibit the further exercise of his/her mandate, or assign specified functions of the supervisory board to an appointed special representative.

Furthermore, in respect of financial institutions, the BaFin could demand the dismissal or prohibit the further exercise of the mandate of a member of the supervisory board if such member has failed to detect substantial violations of the principles of proper business management by the institution due to the negligent exercise of his/her control functions, or if he/she fails to do everything necessary to rectify existing violations despite a respective warning of the BaFin.

It is important to note that this proposed amendment is in fact more rigorous than the existing BaFin powers regarding the dismissal of managing directors of financial institutions (as well as the proposed changes in relation to insurance companies) as these persons can or could only be dismissed if they have "deliberately or frivolously" violated regulatory provisions and continue to do so despite a warning of the BaFin.

Significant changes to this part of the Draft Act are likely because there is currently no exemption from the requirement of professional qualification in relation to employee representatives on the supervisory board.

Moreover, the Draft Act's requirements for the members of the supervisory board do not distinguish between private institutions and savings banks or other public banks, where positions are often filled according to other practical considerations.

Most importantly, the requirement of "professional qualification" (*fachliche Eignung*) is a statutorily defined term which presupposes that the relevant person has "sufficient theoretical and practical knowledge in the business areas concerned as well as managerial experience (*Leitungserfahrung*)". As a rule, sufficient theoretical and practical knowledge is assumed if at least three years of recent managerial experience at an institution of comparable size and business can be demonstrated. It is unrealistic to assume that all members of the supervisory board, especially with regard to smaller institutions, fulfil these requirements.

Hence, the Parliament's expert committees have recommended in a statement on the Draft Act to relax this requirement and to clarify that the required qualification of the members of the supervisory board must be determined on the basis of the scope and complexity of the institution's main business. In addition, it should be clarified that not every single member of the supervisory board must have expertise in all relevant areas of business as long as the supervisory board as a whole is able to adequately fulfil its duties.

The Draft Act would also establish quantitative restrictions on supervisory mandates in the banking and insurance sector. Not more than two former managing directors of a particular financial institution or insurance company would be allowed to sit on the supervisory board of the same entity. In addition, supervisory board members could not assume more than five mandates in entities subject to supervision by the BaFin. The Draft Act also stipulates that managing directors of insurance companies may not have more than two supervisory mandates in other insurance companies, including mandates in insurance special purpose entities. Only where all such mandates are exercised within the same group of insurance companies, the number of mandates could be increased up to five.

3.4 Higher individual liquidity requirements

Corresponding to the proposed powers of the BaFin to impose increased regulatory capital requirements on an institution, the Draft Act enhances BaFin's ability to require an institution to hold liquidity beyond the level already required under the KWG and the Liquidity Regulation (*Liquiditätsverordnung* - "LiqV"). As such intervention shall be restricted to cases "where the sustainable liquidity of the institution can otherwise not be guaranteed", the discretion of the BaFin to impose additional liquidity requirements is narrower than in the case of ordering increased regulatory capital requirements.

3.5 Prohibition to distribute profits

Probably the most controversial amendment to the KWG is the extension of the authority of the BaFin to prohibit an institution from distributing profits to its

shareholders and holders of subordinated (hybrid) capital instruments.

Currently, the BaFin may only prohibit or limit withdrawals by the institution's shareholders and the distribution of profits to them if the institution does not have adequate own funds within the meaning of the regulatory capital requirements or fails to satisfy the requirements on liquidity. The issuance of such an order is in each case subject to the expiry of a grace period, that means, the institution must have failed to remedy the respective deficiency within a period of time set by the BaFin.

The Draft Act now provides that the BaFin may resort to these measures as soon as the institution's asset position, earning position or financial standing justifies the assumption that it will not be able to permanently fulfil these requirements (including any previously imposed individual regulatory capital or liquidity requirements). Hence, the Draft Act justifies severe limitations of shareholders' rights based on a mere forecast of an institution's ability to fulfil supervisory requirements.

In addition, the Draft Act extends the scope of said prohibition to holders of subordinated capital instruments that can be allocated to an institution's own funds: In the case that an institution effectively is in breach of regulatory capital or liquidity requirements, the BaFin would be authorised to ban or limit "disbursements of any kind of profits on equity instruments that are not entirely covered by an annual net profit". The Draft Act also stipulates that conflicting contractual rights of holders of equity instruments are not enforceable.

The legislative reasoning to the Draft Act justifies this substantial limitation by concluding that there can be no protection of reliance for holders of subordinated capital instruments in this respect since returns on such instruments would by their nature anyway be linked to the generation of annual net profits.

Presumably even more encroaching is that the BaFin shall be able to prohibit or restrict "accounting measures that serve to outbalance an annual net loss or to disclose an annual net profit". There is no clarification on the measures that might possibly be covered by this authorisation, except a statement in the legislative reasoning to the Draft Act that it "can be appropriate, in regard of institutions with tense financial standing, to already contravene the compensation of an annual deficit that would be to the detriment of the institution's reserves".

All of the above measures would also be applicable to superordinate companies of financial holdings or a group of institutions. Moreover, whenever prompt action is justified by a "sudden aggravation of an institution's equity capital or liquidity", all of the above measures could be taken without the prior setting of a grace period.

3.6 New reporting requirements

The Draft Act introduces new disclosure requirements that are intended to enable the BaFin to better identify risk concentrations within groups of institutions and insurance companies.

The amendments to the KWG envisage that the parent company of a group of institutions is obliged to disclose to the BaFin certain intragroup transactions, in particular loans, investments, guarantees, off-balance sheet transactions and transactions involving equity capital that exceed a certain volume. In particular, all transactions that individually or collectively (that is, with regard to one particular counterparty) reach or exceed 5% of the amount of own funds required at group level would have to be reported to the BaFin once a year. In addition, ad-hoc reporting is required with respect to any transaction that might endanger the adequacy of the superordinate company's own funds. So far, comparable reporting requirements for intragroup transactions with respect to groups of institutions only exist pursuant to sections 13 et seq. of the KWG in connection with the Large Exposure and Million Loan Regulation (*Groß- und Millionenkreditverordnung – "GroMiKV"*).

Similar reporting requirements for significant intragroup transactions already exist under the VAG at the level of insurance companies. However, the Draft Act stipulates a further reporting requirement concerning insurance groups or holdings. Pursuant thereto, the parent company of an insurance group or holding would have to report to BaFin on a quarterly basis any "significant risk concentrations" at group level. Significant risk concentrations are defined in the Draft Act as a credit or investment volume vis-à-vis one particular counterparty which, separately or with respect to the accumulated credit or investment volume of the group, exceeds 10% of the solvency margin of the group.

Moreover, the Draft Act introduces a new reporting requirement for institutions that is based on the so-called "leverage ratio" (*modifizierte bilanzielle Eigenkapitalquote*). Said leverage ratio depicts the ratio of an institution's own funds (*bilanzielles Eigenkapital*) to the sum of its total assets (*Bilanzsumme*), its off-balance sheet liabilities (*außerbilanzielle Verpflichtungen*), and the assumed costs of transforming its off-balance sheet claims into balance sheet assets (*Wiedereindeckungsaufwand für Ansprüche aus außerbilanziellen Geschäften*).

The changes in an institution's leverage ratio would

have to be reported to the BaFin annually as well as on an ad-hoc basis at the end of a quarter, in the latter case provided that the variation is greater than 5% compared to the annual financial accounts, based on the institution's most recent monthly reporting (*Monatsausweis*). This new reporting requirement is meant to help detecting additional on- or off-balance sheet risk potentials of institutions.

3.7 Further measures relating to insurance supervision

The Draft Act also contains a number of amendments that pertain exclusively to the supervision of insurance companies.

While an existing provision in the VAG on permissible transactions of insurance companies merely requires that such business is "directly associated" with insurance business, the Draft Act would introduce an amendment clarifying that transactions cannot qualify as associated business if they entail additional financial risks. More importantly, the amendment specifies that borrowings do generally not qualify as transactions directly associated with insurance business. The explanatory statement to the Draft Act states, however, that the amendment would still leave room to account for exceptional circumstances in which short term liquidity or a short term overdraft is needed.

The Draft Act introduces a new reporting requirement in respect of the direct or indirect transfer of insurance risks via insurance special purpose vehicles (securitisation). The reporting shall include the relevant prospectus and all underlying contractual agreements of the securitisation as well as a list of all identified risks for the respective insurance company in connection with the securitisation. In addition, the Draft Act clarifies that the effects of a securitisation via an insurance special purpose vehicle located in a country outside the EU/EEA may only be recognised if the insurance SPV is subject to a standard of supervision that is equivalent to that under the VAG.

Further provisions particularly intend to enhance supervision over insurance holding companies. These, too, would in the future need to have a proper internal business organisation comparable to that of insurance companies. This requirement is complemented by another six new reporting requirements, including the disclosure of the information necessary to assess the trustworthiness and professional qualification of the managing directors of the holding.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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