

German provisions for the strengthening of financial regulation come into force

On 1 August 2009 the German Act for the Strengthening of the Financial Markets and Insurance Supervision (*Gesetz zur Stärkung der Finanzmarkt- und der Versicherungsaufsicht*) ("**New Act**") came into force. The New Act mainly introduces a number of amendments to the German Banking Act (*Kreditwesengesetz* – "**KWG**") as well as the German Insurance Supervision Act (*Versicherungsaufsichtsgesetz* – "**VAG**") governing the supervision of credit institutions, financial services institutions (together referred to in the following as institutions), insurance companies and insurance holding companies.

According to the official legal reasoning, the purpose of the New Act is to strengthen the preventive powers of the German Federal Financial 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, insurance companies and insurance holding companies shall extend the information basis of BaFin so as to be in a better position to identify potential future risks. The New Act also introduces a duty of groups of institutions or insurance companies as well as financial holding groups to notify BaFin of risk concentrations and it provides for proof of qualification requirements for members of the supervisory boards of companies of the financial sector.

The New Act was discussed very controversially both in Parliament and in public. It has, however, been adopted largely unchanged.

1. Overview

The main provisions of the New Act are:

Higher capital requirements in the case of specific business risks: The powers of BaFin to impose higher individual capital requirements on an institution or a group of institutions are extended, in particular in cases where a "sustainable appropriateness" of an institution's own funds is no longer ensured or if the "risk-bearing capacity" of the institution diminishes.

Ban of intragroup payments: In a crisis situation, BaFin now has the power to impose a ban on payments 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"). Should it take such measures, BaFin has to inform the competent home state supervisory authorities of the group companies of the relevant institution.

Higher requirements for proof of qualification for members of supervisory boards: BaFin is authorised under the New Act to request the dismissal of 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 the number of mandates in supervisory boards of companies of the financial sector is limited.

Contents

1. Overview	1
2. Background	2
3. New provisions	2
3.1 Higher capital requirements in the case of specific business risks	2
3.2 Ban of intragroup payments ("ring-fencing")	2
3.3 Fit and proper requirements for members of supervisory boards	3
3.4 Limitation on the number of mandates	3
3.5 Higher individual liquidity requirements	4
3.6 Prohibition to distribute profits	4
3.7 New reporting requirements	4
3.8 Further measures relating to insurance supervision	5

This publication 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. If you would like to know more about the subjects covered in this publication or our services, please contact:

[Corinna Baltzer](#) +49 69 7199 1556

[Dr. Marc Benzler](#) +49 69 7199 3304

[Rainer Gallei](#) +49 69 7199 3142

[Peter Scherer](#) +49 69 7199 1294

[Daniela Weber-Rey](#) +49 69 7199 1551

[Dr. Sven Zeller](#) +49 69 7199 1280

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance, Mainzer Landstraße 46,
60325 Frankfurt am Main, Germany
www.cliffordchance.com

Higher individual liquidity requirements: According to the official legal reasoning the liquidity of many institutions has shown to be inadequate in light of the current crisis. Hence, BaFin is now 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 could so far only be imposed on an institution if the supervisory ratios in respect of the institution's own funds or liquidity were no longer met. Under the New Act, such prohibition will be possible if there is a danger of the institution falling below the relevant ratios. Moreover, BaFin is 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

The New Act forms part of the German Federal Government's measures to stabilise the financial markets that have been agreed upon in October 2008. Its content is highly topical in light of the current discussion on an adequate reform of regulation on a national as well as international level since it draws on the ideas published in various reports such as the Turner-Review and the De Larosière-Report. However, the amendments contained in the New 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 an European and international level, especially with regard to the proposed amendments to the Basel II framework.

There have been certain amendments which might alleviate some of these concerns. However, the provisions of the New Act have remained largely unchanged in comparison to the first draft presented.

3. New provisions

While a few amendments under the New Act relate either to banking or insurance supervision, the majority of the changes to the KWG and the VAG concern institutions as well as insurance companies.

3.1 Higher capital requirements in the case of specific business risks

The New Act extends the (already existing) authority of 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 shows an extraordinary risk structure in respect of the composition of its assets or its business activities that makes it distinct from the "vast majority" of other institutions which are active in comparable areas of business. According to the official legal reasoning, this requirement has shown to be too inflexible to enable BaFin to adequately react to the individual risk profile of an institution.

According to the New Act, BaFin is authorised to impose higher capital requirements than those required under the KWG and the German Solvability 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 New Act changes the powers of BaFin to impose higher capital requirements from an *ultima ratio* to a pre-emptive approach the measures of which can 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 BaFin, the institution has to acquire additional equity capital or reduce its credit risk positions. As the New Act does not set particular thresholds for such discretionary interventions, BaFin has to determine the suitability and appropriateness of such steps in its discretion.

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

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

According to this amendment, 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 institution or insurance company. However, these measures may only be ordered in cases of danger, i.e. if 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 safeguarded.

The official legal reasoning to the New Act explains that 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).

3.3 Fit and proper requirements for members of supervisory boards

One measure that has attracted significant attention in the German press is the proposed extension of the existing requirements with respect to executive directors of institutions, financial holding companies, insurance companies and insurance holding companies regarding their integrity (*Zuverlässigkeit*) and professional experience. While the draft Act referred to professional qualification (*fachliche Eignung*), the term used also with respect to the managers of regulated companies, the New Act refers to the supervisory board members' expertise (*Sachkunde*) to clarify the difference between the requirements on managers and supervisory board members. Under the New Act, the expertise of supervisory board members needs to be adequate to enable them to fulfil their control function and to assess and supervise the business of the relevant enterprise. The size and complexity of the business of the relevant company needs to be taken into account. No distinction is made between shareholder and employee representatives in supervisory boards.

Under German case law a different concept has been developed which is also expressed in the German Corporate Governance Code that applies to all exchange traded companies. Thereafter, the supervisory board as a whole should have members who possess the knowledge, capabilities and professional experience to properly execute the function of the supervisory board. This approach recognises that not every single member of a supervisory board needs to have special knowledge on all relevant subjects but that the qualifications may supplement each other provided that all members of the board together cover all relevant issues. The German legislator has not explicitly adopted this approach for the regulated financial sector. However, in its reasoning to the provision, the Financial Committee of the German Parliament (*Bundestag*) concedes that the requirements on expertise depend on the function performed in the supervisory board. In practice, the regulator therefore will have to consider to what extent the composition of a supervisory board as a whole and a division of responsibilities needs to be taken into account when evaluating the fit and properness of a member of such board.

Under the New Act, institutions and insurance companies have to submit to BaFin the information necessary to assess the integrity and expertise of any member of their supervisory board, both when applying for a banking or an insurance licence and in relation to any subsequent appointments. The same applies to insurance holding companies and financial holding

companies in the case of appointments of members of their supervisory board.

If facts justify the assumption that a member of the supervisory board of an insurance company does not meet the fit and proper criteria, BaFin shall refuse the granting of an insurance licence – inconsistently, the New Act does not provide for a similar provision with regard to institutions.

As an instrument of ongoing supervision, if a member of a supervisory board does not meet the fit and proper requirements or if he/she has failed to detect substantial violations of the principles of proper business management 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 BaFin, BaFin may demand his/her dismissal, prohibit the further exercise of his/her mandate, or assign specified functions of the supervisory board to an appointed special representative.

Finally, in the case of insurance holding companies and mixed financial holding companies, BaFin may prohibit the exercise of voting rights in subsidiaries if it follows from given facts that one member of the supervisory board does not meet the fit and proper requirements.

3.4 Limitation on the number of mandates

The New Act establishes quantitative restrictions on supervisory mandates in the banking and insurance sector. The New Act requires that not more than two former managing directors of an institution or insurance company may sit on the supervisory board of the entity. In addition, supervisory board members may not assume more than five mandates in entities subject to supervision by BaFin. Whereas in the banking sector enterprises which are members of the same institution related guarantee scheme are not counted in this regard, in the insurance sector the limitation does not apply to supervisory mandates in enterprises which are members of the same group of (insurance) companies.

By comparison, the German Corporate Governance Code prohibits the appointment of former managers of exchange traded companies only for the first two years following the termination of their management function and it limits the recommended number of supervisory mandates to three as far as external exchange traded companies are concerned. Whereas the limitations on the number of mandates are only recommendations under the Corporate Governance Code, these limitations are mandatory provisions under the New Act.

Mandates as a legal or statutory representative of insurance companies, pension funds, insurance holding companies or insurance special purpose vehicles are limited to two. The regulator may allow for more mandates within one (insurance) group. Where this limitation was not met on 1 August 2009, it will need to be met as of 31 December 2010. Although the New Act does not contain a similar limitation for management mandates in institutions, it is the practice of BaFin to

limit the number of such mandates depending on the time that should be duly invested in their performance.

3.5 Higher individual liquidity requirements

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

3.6 Prohibition to distribute profits

Probably the most controversial amendment to the KWG is the extension of the authority of BaFin to prohibit an institution from distributing profits to its shareholders and holders of subordinated (hybrid) capital instruments.

So far, BaFin could only prohibit or limit withdrawals by an institution's shareholders and the distribution of profits to them if the institution did not have adequate own funds within the meaning of the regulatory capital requirements or failed to meet the requirements on liquidity. The issuance of such an order was in each case subject to the expiry of a grace period, i.e., the institution could remedy the respective deficiency within a period of time set by BaFin.

The New Act now provides that BaFin may resort to these measures as soon as an institution's asset position, earnings position or financial standing justifies the assumption that it will not be able to permanently fulfil the regulatory capital or liquidity requirements (including any previously imposed individual regulatory capital or liquidity requirements). No grace period applies. Hence, the New Act allows for severe limitations of shareholders' rights based on a mere forecast of an institution's ability to fulfil supervisory requirements.

In addition, the New Act extends the scope of said prohibition to holders of subordinated capital instruments that may be allocated to an institution's own funds: In the case that an institution effectively is in breach of regulatory capital or liquidity requirements, BaFin is now 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 New Act stipulates that conflicting contractual rights of holders of equity instruments are not enforceable.

The official legal reasoning to the New 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 BaFin is 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 for a statement in the official legal reasoning to the New Act that it "may be necessary, in the case of institutions with tense financial standing, to avoid the compensation of an annual deficit by accounting measures which diminish the institution's reserves".

All of the above measures also apply to superordinate companies (*übergeordnete Unternehmen*, usually the parent company) of financial holding groups and of groups of institutions. Moreover, whenever prompt action is justified by a "sudden aggravation of an institution's equity ratio or liquidity", all of the above measures can be taken without the prior setting of a grace period.

3.7 New reporting requirements

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

The superordinate entity of a group of institutions is obliged to disclose to 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 have to be reported to 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. Comparable reporting requirements for intragroup transactions with respect to groups of institutions previously only existed pursuant to sections 13 et seq. of the KWG in connection with the German Large Exposure and Million Loan Regulation (*Groß- und Millionenkreditverordnung*).

Similar reporting requirements for significant intragroup transactions already exist under the VAG at the level of insurance companies which are part of an insurance group. The New Act stipulates a further reporting requirement of superordinate entities of insurance groups. Pursuant thereto, the superordinate entity of an insurance group has to report to BaFin on a quarterly basis any "significant risk concentrations" at group level. Significant risk concentrations are defined in the New 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, reaches or exceeds 10% of the adjusted solvency margin of the group.

Moreover, the New Act introduces new reporting requirements for institutions which are based on the so-called "leverage ratio" (*modifizierte bilanzielle Eigen-*

kapitalquote). Said leverage ratio is 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*).

Institutions have to report their leverage ratio to BaFin annually. In addition, where the leverage ratio calculated on the basis of an institution's so-called monthly reporting (*Monatsausweis*) – which has to be prepared quarterly – deviates from the leverage ratio calculated on the basis of the latest annual accounts (or, if an institution is required to prepare interim financial statements, on the basis of the latest interim financial statement) for at least 5%, such deviation needs to be reported, too. These new reporting requirements are meant to help detecting additional on- or off-balance sheet risk potentials of institutions.

3.8 Further measures relating to insurance supervision

Although the insurance industry neither caused nor aggravated the financial crisis, the New Act contains several amendments that pertain exclusively to the supervision of insurance companies.

Under the VAG, in accordance with the underlying EU insurance directives, insurance companies must limit their business to insurance business and any transactions directly associated to this business. The New Act introduces an amendment to this provision clarifying that transactions cannot qualify as associated business if they entail additional financial risks. More importantly, the amendment specifies that borrowings as a rule do not qualify as permissible business. The official legal reasoning to the New Act states that the amendment still leaves room to account for exceptional circumstances in which short term liquidity or a short term overdraft is needed. However, this amendment limits the possibility of borrowings even further than the current position of BaFin which in addition to short-time borrowings allows for financial dispositions to prepare or secure investments to the extent they are based on a reasonable financial planning and appropriate in the framework of the business. This limitation was introduced despite concerns of the German insurance industry and the Second Chamber of the German Parliament (*Bundesrat*) that it may inappropriately impair the business of insurance companies.

In the case of life insurance companies, the New Act strengthens the position of the responsible actuary and

introduces a duty of the managing directors of life insurance companies to inform BaFin about the proposal of the actuary on the surplus participation of policyholders and, where applicable, about its intention to deviate from such proposal in advance, giving the reasons for such deviation. To safeguard the independence of the responsible actuary, any dismissal or amicable termination of his/her employment agreement needs to be reported to BaFin, providing the reasons for such dismissal or termination.

The New Act introduces a number of provisions regarding the issuance of insurance linked securities ("ILS"). To ensure that BaFin is informed about all ILS transactions of German insurers, the New Act provides for a new notice requirement in respect of the direct or indirect transfer of insurance risks via insurance special purpose vehicles (securitisation). The notice has to include the relevant prospectus and all contractual agreements underlying the securitisation as well as a list of all identified risks borne by the insurance company in connection with the securitisation. In addition, the term of the ILS may not be shorter than the term of the reinsurance agreement between the insurance company and the insurance special purpose vehicle ("ISPV"). Furthermore, the New Act clarifies that the effects of a securitisation on the capital requirements of an insurance company as well as on the calculation of its restricted assets (*gebundenes Vermögen*) required to cover its technical provisions may, in the case of an ISPV domiciled in a country outside the EU/EEA, only be recognised where such ISPV is subject to a standard of supervision that is equivalent to the supervision of ISPVs under the VAG. Finally, the regulation of German ISPVs is strengthened by application of the provisions on holders of significant participations in insurance companies to ISPVs and by an authorisation of the German Federal Ministry of Finance (*Bundesfinanzministerium*) to introduce requirements on the internal administrative procedures in a regulation to ensure the effectiveness of the agreements of the ISPV.

Further provisions intend to enhance supervision over German insurance holding companies. The New Act removes an exemption from regulation - which had been introduced only recently - for insurance holding companies which verifiably do not execute control over the companies in which they hold participations. In addition, the New Act extends the requirement of a proper internal business organisation including an appropriate risk management to insurance holding companies, introduces additional notice requirements and applies the new requirements on members of the supervisory board also to insurance holding companies.

This publication 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.

www.cliffordchance.com

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Prague ■ Riyadh* ■ Rome ■ São Paulo ■ Shanghai ■ Singapore ■ Tokyo ■ Warsaw ■ Washington, D.C.

* Clifford Chance has a co-operation agreement with Al-Jadaan & Partners Law Firm