



## **Munich Financial Center Initiative**

### **Position Paper**

on the occasion of the members' trip to Berlin on February 25, 2010



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## Financing for SMEs

### A. Core statements

The purposeful measures undertaken by Germany's federal government have lessened the impact of the financial crisis upon the financing available to the business community, thus precluding a credit crunch in the process. An upswing is manifesting itself in 2010. This will strengthen companies' needs for credit. Unless further support measures are undertaken, the specter of this need going unmet remains. Causes of this prospective lack of lending capacities could be the lowering of credit ratings expected to ensue from the issuing of annual accounts for 2009 and, in a related trend, the greater demands for capital backing imposed by Basel II. This ramifies the effects of the lack of such equity faced by a number of banks coping with the financial crisis.

The persistence of market-caused problems in securing corporate financing should be addressed by extending the term of existence of Germany's Economic Fund (Wirtschaftsfonds Deutschland) to 2011. This, in turn, necessitates promulgating the measures satisfying the EU's legal codes.

The procedures governing the dispensing of credit by KfW's Special-Purpose Program (Sonderprogramm) should be further simplified. New offers have to be developed. Another measure should be KfW's retaining a portion of the risks associated with its global credit facilities. The employment of the likelihood of delinquency as a criterion in the evaluation of applications for funds going to corporate operations should be eased. The conditions governing the indemnification clauses in agreements disbursing funds to corporate operations and the financing of sureties should be adapted to conform to those regulating the supporting of investments. A further step should be the improvement of the refinancing instruments provided by KfW to leasing companies not forming part of corporate groups.

Germany's legislators have promulgated a number of measures improving the insurance of loans. However, the need to closely monitor markets remains.



Urgently requiring solutions are the problems associated with the securing of financing following up mezzanine loans. This solving requires joint efforts by Germany's federal government and by KfW.

A further objective has to be the revival of securitization markets, and the accompanying enactment of measures securing a high level of quality.

Capable of consideration would be policies enabling SMEs (small and medium-sized enterprises) that made large-sized investments during the last few years to extend the terms of depreciation carried in their commercial balance sheets. This measure would strengthen the balance sheets of such companies, which are, as a rule, basically healthy operations, in this time of economic difficulties. This measure would thus help ease the securing of financing by corporations.



## **B. Elucidations**

### **I. Basel II's cyclicality**

In contrast to Basel I's "flat rate" requirement of capital adequacy, Basel II has managed to achieve a greater sensitivity to risk in setting the amounts of capital backing required to be provided by banks. This determination of need for capital and backing takes into consideration the level of risk contained in each bank's portfolio. Entailed in this is the employment by the financial institutions of in-house ratings and of legally-mandated rules of calculation in weighting the risks associated with assets and in calibrating expected and associated losses. Rating systems are primarily comprised of probabilities of delinquency (PD), of loss given default (LGD) rates and of estimates of the volumes of loans affected by delinquencies. These key parameters are subject to a one-year timeframe. Several procedures of compiling estimates do contain elements--"through the cycle PDS" and (if necessary) "downturn LGDs"--eliminating the effects of economic cycles. The track record manifesting itself since the promulgation of Basel II has shown, however, that times of economic difficulties can cause both parameters—with this encompassing robust rating procedures—to experience an extension of timeframe to the next year. The converse also holds true: an upswing tends to reduce this term of perception. This occurs on a time-lag basis, as ratings of customers are updated at intervals imposed by scheduling.

### **II. The EU's temporary framework**

Corporate financing will continue to be encumbered in the post-2010 period by the problems being experienced by financial markets. This mandates the extending to 2011 of the terms of operation of both Germany's Economic Fund and of KfW's Special-Purpose Program. The German government's ability to deploy this fund is circumscribed by the newly-created Temporary State Aid Framework enacted by the EU to overcome the crisis. This framework applies, however, only to the end of 2010.

Requisite to achieving the extending of this framework to 2011 is the no-delay entering into of negotiations by Germany's federal government with the European Commission.



## III. KfW's Special-Purpose Program

Germany's Economic Fund has a total lending capacity of €40 billion. It is administered by KfW. Of this amount, €16.2 billion had been applied for, but only €5.7 billion had been approved (as of January 8, 2010). To improve the deployment of the credit supplied by the Economic Fund, alterations in terms, tied interest rates, years of postponements of repayments, flexibility and financing of corporate operations were instituted in December 2009. In further moves, the attractiveness of the program is to be enhanced by taking the following approaches:

- simplifying the formulation of the requirements imposed by KfW on applications for loans by banks
- speeding up the processing of such applications
- increasing the attractiveness of the global-purpose loans supplied by KfW to companies' main banks through KfW's assumption of a portion of the associated risks, thus augmenting the banks' capital backing and abilities to provide loans
- easing the requirements arising from using the probability of delinquency as a criterion in determining the acceptance of an application for funds for corporate operations. The current ceiling on the probability during the year of delinquency is 6.67%. Raising this ceiling will provide companies that are basically economically viable and thus have good prospects with access to KfW's Special-purpose Program.
- Adjusting the conditions written into indemnification clauses governing the dispensing of funds for corporate operations to match those applying to loans fostering investments; and treating the financing of sureties in the same way as that of commissions. The upswing will impart a greater importance to these instruments. KfW's current offer (of taking a greater than 50% stake in the financing supplied by consortia) has not been accepted by financial markets.



## **IV. Leasing markets**

Leasing is an important component of economic activities. Support for this market, which is currently in the doldrums, was supposed to come from the provision to leasing companies not affiliated with banks or manufacturers of access to KfW's Special-Purpose Program. The exclusion of follow-up financing, rigidly-set terms and high rates of interest caused, however, the hoped-for effects to not materialize. To retain the diversity of non-affiliated and small and medium-sized leasing companies extant in Germany, the refinancing channeled via KfW has to be improved.

## **V. Credit insurance**

Credit insurance and corporate liquidity are highly intermeshed. The lack of coverage impairs corporate liquidity by giving rise to the need for the securing of further loans. The top-up cover is a supplement to the coverage commitments provided by private insurers of credits. This cover has joined state assumption of risks in improving the ways in which companies are able to secure protection against non-payments of receivables. Excluded, however, from this are companies which not been accorded any coverage at all by private suppliers.

Requisite is the close monitoring of market developments and the formulation of solutions furthering the resolution of this problem.



## VI. Mezzanine financing

Mezzanine financing constitutes an alternative to loan-based financing. On today's markets, there is a scarcity of supply of the former. Many tranches of standard and other mezzanine products will expire in 2011, further capping their provision to the sectors in which such products had been in strong demand. Financing following up mezzanine products is not currently available, with banks limiting their supplying of loans to the terms remaining of mezzanine products. The banks have accordingly reduced their loan approvals by a corresponding amount. Needed today is an offer serving as a replacement for equity capital. Affected by this problem are a large number of large-sized SMEs (and thus the employees working for them) in Bavaria. KfW has offered to replace expiring mezzanines with loans issuing from the Special-Purpose Program. This would not solve the problem. Equity capital is a key component of corporate creditworthiness. Needed is to find solutions helping companies. The chairman of Deutsche Bank announced in December 2009 the creation of a fund for the country's SMEs. Now in existence, the fund has palliated but not completely remediated the above-mentioned problems.

Working with the banks that provided standard mezzanine financing during the past few years, Germany's federal government should facilitate the provision of follow-up financing, with this support to be channeled, if necessary, via KfW.



## **VII. Securitization markets**

A lack of trust in markets has precluded the revival of securitization operations. These, in turn, had been a main wellspring of the liquidity required by banks and investors to refinance and manage their portfolios and risks. These important instruments thus remain unavailable to banks.

To ensue from the enhancing of the transparency of such products, attained by an improvement of the legal framework in which they are offered, a jump-starting of securitization markets is requisite, as it would lessen the equity encumbrances faced by banks, thus augmenting their abilities to provide loans. Such a jumpstart would enable even large-sized companies to avail themselves once more of this form of financing.

The assuring of high levels of transparency and quality would strengthen investors' trust in these products.

One way of instituting this jumpstart would be KfW's assumption--via purchases or provisions of guarantees--of a temporary basis of a portion of risks arising from securitizations undertaken by SMEs. A portion of these risks has to be retained by the original suppliers of loans.

## **VIII. Reality-compatible depreciation of investments in commercial balance sheets**

A number of companies are basically healthy. They have invested heavily during the last few years in production operations, but are now experiencing a sharp drop in orders. The assets held by such companies are, however, not properly depicted in commercial balance sheets, since the recession and its accompanying low rates of utilization of productive capacities will extend their terms of utility.

Companies facing this situation could be provided with the option of extending the term of depreciation carried in the balance sheets in a way according to the lives of business and technical use of the capital goods. Such measures would improve the company's key balance sheet indicators, possibly easing the supplying of credit in the process. Requisite would be, however, the exclusion of ramifications upon tax balance sheets.



## Regulatory equity

### A. Core statements

#### I. Improving the quality, composition and transparency of capital bases

FPMI basically approves of the stiffening of the rules applying to regulatory equity. The increasing of the amount of core capital enables it to fulfill its purpose of serving as a bolster against risk, thus enhancing the overall stability of financial markets in the process. This, in turn, mandates the retention and extension of the ways in which banks secure core capital. A failure to do such would give rise to the peril of a credit crunch. This has to be avoided at all costs.

Regardless of the legal form taken by banks, silent contributions to capital should retain their classification of being components of core capital. There are no practical reasons for treating such silent contributions as those possessed by Landesbanken (state-level public sector banks) owned by public sector trusts in ways differing from those consigned to such banks which have become joint stock companies (AGs). The determinant should be the nature of the capital instrument and not of the legal form of the issuer.

To be rejected is the proposal that the consolidation of group regulatory equity is to include the “asymmetric” elimination of the shares held by minority interests in corporate subsidiaries’ core capital, in cases in which the subsidiaries’ risk-related items are continued to be carried on a 100% basis.

The Basel Committee has yet to reveal its position on grandfather clauses and periods of transition. Their deliberations should be guided by the EU’s regulations on hybrid capital, which will take effect at the beginning of 2011. These provide complete protection during the first ten years to legacy issues not satisfying the new requirements. This protection will then be reduced on a step-by-step basis in the period concluding in 2040.



## **II. Introduction of a leverage ratio**

With its introduction now being considered, a leverage ratio can serve at best as a flashing light to legally-mandated bank supervisors. Turning it into a hard ceiling in conjunction with Pillar 1 of Basel II (quantitative minimum requirements) is not the way to get a grip on risks, as the USA's track record has shown. The divergences existing among international-level accounting standards would cause the introduction of a leverage ratio's leading to considerable distortions of competition.

Acting unilaterally, Germany's legislators promulgated an act designed to strengthen the supervision of financial markets and of insurers. Comprised in this is the requirement to report the so-called "modified equity ratio" carried in balance sheets, in accordance with § 24 paragraph 1 Nr. 16 as well as § 24 paragraph 1a Nr. 5 KWG (Kreditwesengesetz = "Banking Act"). In view of the work being undertaken by the Basel Committee on the establishment of an internationally-applicable leverage ratio, this should be suspended.

## **III. Improvement of the coverage of risk of debtor default**

To avoid the creation of disincentives, the IRB and standard approaches to the planned equity supplement on receivables forthcoming from banks whose balance sheet sum exceeds \$25 billion and from non-regulated financial companies should be introduced simultaneously.



## **B. Elucidations**

### **Background**

On December 17, 2009, the Basel Committee for Banking Supervision published “Strengthening of the resilience of banking sector”. This consultation paper took a look at the measures undertaken in response to the crises on financial markets and designed to augment the resilience of the banking sector. The proposals as to how to revise Basel II contained in the paper develop the catalogue of measures resolved upon on September 25, 2009, by the G20 countries at the summit in Pittsburgh. The proposals depict the current state of the discussion on how best to define “regulatory equity”. Consultations with the banking industry are to be concluded by April 16, 2010.

### **Key features of the individual points**

#### **I. Improving the quality, composition and transparency of capital bases**

G20 set a goal of improving the quality of regulatory equity. The Basel Committee has redefined the components of equity. Core capital (tier 1) serves to secure the existence of the company (going concern). Supplementary capital (tier 2), on the hand, has to be available for use in cases in which the company is going to be dissolved (gone concern). Tier 3 capital is no longer going to exist.

Core capital is going to be reclassified as having two components: common equity and additional going concern capital.

The former is comprised of “hard” core capital. In joint stock companies, this capital is to largely consist of ordinary shares and retained earnings reserves. These will have to satisfy a catalogue comprised of 14 classifications. These also include: most subordinated, perpetual, classified as equity under the relevant accounting standards, directly issued and paid up. The paper does not take a conclusive position on whether or not “predominant” means in this context 51 % or more. Experts have been envisioning stakes ranging up to 85 %.



Companies that are not joint stock in nature are also subject to the 14 criteria governing hard core capital. For such companies, the criteria are, however, open to interpretation, with this ensuing from the need to adapt them. This could lead to disparities of treatment between the two classes of companies, with this also being capable of affecting the sector comprised by Germany's Landesbanken.

Fourteen classifications have also been constituted for the supplementary core capital, with these including subordinated to depositors, general creditors and subordinated debt of the bank. These classifications are not quite as rigid as those applying to hard core capital. The Basel proposals foresee innovative hybrid capital's losing its ability to be recognized as hard core capital.

To be recognized as supplementary (tier 2) capital, funds will have to accord to one of nine categorizations, with these including subordinated to depositors and general creditors of the bank. The taking into account of divestiture has caused the rescinding of the previous ceiling of 100 % of core capital. Fully-recognizable are, however, only those instruments whose original and remaining term of at least five years.

Beefed up have also been the requirements governing items deductible from capital, with this including certain kinds of participations or losses resulting from value write downs. The current rule foresees the deductible's being equally split between core and supplementary capital. In the future, this will exclusively occur in the hard core capital. Such current components of equity as deferred tax assets or capitalized goodwill will no longer be recognized as such.

Other changes involve the relationships between corporate parents and subsidiaries. Remaining the same will be the parent's completely taking into account the risk-related items carried in the subsidiaries' accounts when calculating consolidated capital ratios. The change will be that the core capital arising from minority interests' holdings in subsidiaries will no longer be allowed to be classified as being part of the hard core capital. This reversal of this longstanding procedure is impossible to understand and is inconsistent.

A final move is the rescinding of the universally-applicable solvency coefficient (overall ratio). Taking its place will be three capital ratios, with their depicting the relationships between risk-related items and hard core, core and total capital respectively.



The deliberations of the Basel Committee have not yet covered periods of transition and grandfather clauses, and this despite the fact that their development will largely determine the scope of the banking industry's ability to provide loans. An abrupt switch to the new capital norms poses the peril of a credit crunch. This would hamper economic growth.



## **II. Introduction of a leverage ratio**

The Basel Committee has proposed the introduction of a so-called “leverage ratio”. It reports and delimits the relationship between regulatory equity and the sum of transactions (including those carried on balance sheets and off balance sheet items). The ramifications of the divergences existing among international accounting standards have to be reconciled.

The current consensus foresees the leverage ratio’s being first introduced as a supplementary parameter of reporting in Pillar 2 of Basel II. Once a period of transition has been completed, the leverage ratio is to become a hard, limiting (of business) index incorporated into Pillar 1 of Basel II.

The Basel Committee is currently limiting itself to describing the concept informing the ratio. It has yet to indicate what the index’s maximum amount could be. This has been accompanied by Germany’s Central Credit Committee’s calling for the conducting of thorough and international-level consultations on this key parameter.

## **III. Improvement of coverage against the risk of debtor default**

The Basel Committee’s plans to improve the coverage against the risk of default by banks whose balance sheet sums exceed \$25 billion and by non-regulated financial corporations involve the imposing of a supplement on regulatory capital backing amounting to some 40%, as compared to the status quo. As of this writing, this requirement is only to apply to institutes using the IRB approach. The objective is to raise the costs of doing business with large-sized banks, and to thus bring about a diversification of risk throughout the entire system.

The Basel Committee has also voiced criticisms of banks’ tendency to over-depend upon external ratings. In Pillar 2 of Basel II, the Committee has imposed the requirement that banks have to carry out proprietary rating processes, their use of external ones notwithstanding.



## Lessening Basel II's cyclicality

### A. Core statements

Basel II determines the amount of equity to be retained by banks. In comparison to Basel I, its capital adequacy requirements show a much greater sensitivity to risk. Financial institutions that have chosen the IRB approach employ internal ratings and legally-mandated calculation processes to weight the risks associated with their assets and to determine losses expected to ensue from them. These operations, in turn, form the basis of equity requirements. The ratings are comprised of probabilities of delinquency (PD), of losses given default (LGD) and of an estimate of the volume of credit affected by such defaults.

Times of economic difficulties cause these probabilities and loss ratios to increase. This, in turn, causes the capital requirements to which banks are subject to rise precisely in such times. Conversely, the requirements fall in times of economic flourishing. It is for this reason this reason that Basel II is described as being pro-cyclical.

This effect and the rise in capital backing requirements it causes lead in turn, to banks' having correspondingly less capital to provide in times of crisis, and to their thus being less able to fulfill their economic responsibilities. The result of this lack of financial resources could well be a credit crunch, in which banks are incapable of providing companies with the capital required by the latter for their investments.

A number of the measures being contemplated to counter this cyclicality would undermine the risk-sensitivity forming a basic thrust of Basel II. Needed thus are measures capable of achieving both goals in a compatible way.

One option would be “dynamic provisioning“, in which capital reserves are accumulated in times of economic prosperity—and drawn upon during downturns. The calculation of risk and exposure to such are not substantially affected by this procedure.

Another option would be to replace “point-in-time” rating procedures, which take into account the current economic situation when determining the creditworthiness of a debtor, with “through-the-cycle” ones, which tend to be long-term in scope.



## **B. Elucidations**

### **I. Basel II's cyclicality**

By eschewing Basel I's flat rate approach to capital adequacy, Basel II has managed to add risk-sensitivity to the process of setting the level of capital to be retained by banks. This is achieved by configuring the banks' need for capital and reserves according to the amount of risk evinced in their portfolios. Financial institutions that have chosen the IRB approach employ internal ratings and legally-mandated calculation processes to weight the risks associated with their assets and to determine losses expected to ensue from them. Rating systems are primarily comprised of probabilities of delinquency (PD), of losses given default (LGD) rates and of estimates of the volumes of loans affected by delinquencies. The forecasts of these key parameters are subject to one-year timeframes. Several procedures of compiling estimates do contain elements-- "through the cycle PDS" and (if necessary) "downturn LGDs"--eliminating the effects of economic cycles. The track record manifesting itself since the introduction of Basel II has shown, however, that times of economic difficulties can cause both parameters—with this also encompassing robust rating procedures—to experience an extension of timeframes to the next year. The converse also holds true: an upswing tends to reduce this term of perception. This occurs on a time-lag basis, as ratings of customers are updated at intervals imposed by scheduling.

This situation leads to the rises in the probability of delinquency and in loss ratio ensuing in times of economic difficulties' causing corresponding increases in the capital backing required to be maintained by banks. The converse holds true for times of economic prosperity. That's why Basel II is regarded as being pro-cyclical. Basel II's use of tools adequately measuring risk augments the transparency and accuracy of the reporting of the risks faced by a bank. This use has, however, triggered a lively discussion in the pre-promulgation phase as to how these cyclical effects can be best countered.



## II. Ramifications of cyclicality

Basel II's cyclicality and the higher need for capital backing associated with it lead to banks' having less capital to provide in times of economic difficulty, and to their not being able to fulfill their economic responsibilities of providing companies with an amount of capital adequate to enable the companies to make investments. This process was observed in the American banking sectors in the 90s, in which it was noticed that the amount of capital possessed by a bank was inversely related to its capital banking requirements and directly related to the performance of the economy as a whole. During downturns, these relationships led to restrictions in banks' abilities to provide loans. This impairment caused (and causes) the strengthening of recessions and the sapping of upturns.

Agreements countering this cyclicality and the fluctuations in capital requirements that it causes have to be reached. The ensuing measures would help prepare financial institutes to overcome times of crisis, or to even preclude ones of the extent of today's upheavals coming into being. The risk-attunement gained through Basel II has to be retained, as this enables assessments of situations adequately depicting risks.



### III. Measures lessening the impact of or permitting a proper response to cyclical effects

The following remarks elucidate the most popular measures undertaken to deal with cyclicity.

#### - Downturn PD

Downturn PD and PD scaling employ the greatest probable rate of delinquency experienced during the last economic cycle (for instance: the last seven years) to calculate the capital requirements of a client or of a portfolio. This method yields capital requirements that are potentially higher in times of prosperity than those calculated using current methods, thus ensuring to an extent the compilation of capital reserves capable of being depleted, on a step-by-step basis, in downturns. These procedures do have a serious downside. They do not permit assessments of current risks. Case-in-point: a factoring institute whose business is exclusively short-term in nature. An assessment of its level of risk would be incorrect in most of the years constituting an economic cycle. This proposal is not contained in the official consultation papers released on the adaptation of capital adequacy directives (Basel II – EU).

#### - Through-the-cycle rating procedures

Through-the-cycle rating procedures take into account as few economic influences as possible. They deliver therefore an averaging of probabilities of delinquency over time. This leads naturally to a calibration of risk featuring lower peaks and troughs and thus less pronounced cycles. These procedures share the problem with the Downturn PD approach of less accurately reporting the risk contained in current situations.

#### - Dynamic provisioning

Dynamic provisioning was presented in the supplementary consultation package Nr. IV on the capital adequacy directive. It constitutes a proven way of countering cyclical effects. This method employs supplemental value adjustments to accumulate capital reserves in times of prosperity. These are then available for drawing upon in downturns. A formula issued by supervisory authorities ensures to the greatest possible extent that no competitive advantages arise among banks from the procedure's use. This method does not impair risk-sensitivity, and enables clear-cut and dual control.



## IV. Sidebar on measures involving accounting procedures

The financial crisis has caused several accounting measures to be considered. One of them has been the object of official consultations: the leverage ratio. It is presented below.

### - Leverage ratio

Also comprised in the supplementary consultation package Nr. IV was the demand for the incorporation of a generally-applicable equity indicator in balance sheets. In complete contrast to Basel II, this determinant of credit volume is not calibrated using risk. As a matter of course, this leaves only the amount (currently higher) of risk-bearing assets (Basel II) and the leverage ratio to be the trigger used as the tool of bank management. The above proposal does not satisfy the requirements imposed by Basel II as to risk-attuned management. Another reason why the above proposal is very controversial is the distortion of competition it would cause. This would ensue from the variety of accounting approaches in use. The proposal's ineffectiveness has been revealed in the USA's current financial market crisis. All of the operations of the country's major banks (including Citigroup and Lehman Brothers) were monitored by a leverage ratio. Despite this, the banks had demonstrably not accumulated enough capital to master risks turning into realities.



## Introduction of a tax on financial markets or on transactions; a tax on stock exchange turnover

### A. Core statements

A tax on financial markets or transactions or on stock market turnover has to be promulgated on a worldwide scale, and has to achieve identical effects in each market. Achieving such is the only way of precluding evasion and the attendant distortions of competition. It seems, however, unrealistic.

The tax is designed to enable banks to bear their share of the costs ensuing to governments from the carrying out of measures of support. This tax will be difficult to get enacted. Affected by it would not be the banks, but rather the public sector and the economy.

An alteration of the speculative practices undertaken by certain market participants cannot be achieved by enacting this tax.

The tax would constitute an encumbrance to private pension plans (products offered by insurers, by investment funds and by old age care facilities) by reducing their yields.

A tax on transactions involving shares would cause a further reduction in investors' willingness to take on the risks associated with investing in stock. Viewed from the taxation point of view, such investments have become relatively unattractive.

The tax would have not helped avoid the current crisis.

The reintroduction of a tax on stock exchange turnover and the introduction of a tax on financial markets or transactions would be counterproductive for Germany.



## **B. Elucidations**

### **I. Current situation**

The IMF is preparing a study on the financial sector for consideration by the G20 countries at their summit in April 2010. The study looks at the subjects of financial market and transaction taxes and of stock exchange turnover taxes (as a rule: 0.5% - 15% of the stock quote). The following should be noted:

A financial market tax has been discussed repeatedly over the last 30 years. Each discussion came to the conclusion that a precondition for its realization would be its enactment by all of the world's financial centers. This global-level of introduction is required to preclude evasion and the ensuing distortions of competition. The failure of all financial centers to enact this law would lead to transactions and staff members' being located in the centers not levying the tax. But this objective of achieving a global-level regulation is unrealistic.

That's why the EU has refrained from pursuing it, preferring to strive to improve the pan-European market by doing away with tax-related encumbrances of financial transactions. To this end, the Union has prohibited the introduction of taxes on IPOs. Only 8 of the 17 long-time EU members levy on a tax on stock exchange turnover, and thus on transactions involving securities. This tax is not prohibited by the EU.

Unilateral enactments by nations of such taxes can paralyze their financial markets, of which the one in Bavaria is a major source of local value added. Case in point is Sweden, which introduced such a stock exchange turnover tax in 1984, only to rescind it in 1991. The announcement in 1986 that the rate of this tax would be doubled resulted in 60% of the volume of trading in the 11 most widely-traded stocks on the local exchange—accounting for 50% of its total trading volume—being relocated to London.

Germany rescinded its stock exchange turnover tax on January 1, 1991, doing such to foster the development of its financial market, and following the suit of Luxembourg (1987), Spain (1988) and the Netherlands (1990). Germany's example was emulated by Denmark (1999), Austria (2001), France (2008) and Italy (2008).



## II. Financial market tax: an instrument preventing crises?

It is a mistake to believe that such a tax would lead to banks' bearing part of the costs ensuing to the public sector for measures supporting the financial sector. This tax would not affect the banks, but rather the public sector and the business community by increasing the costs of the state's procurement of capital. This, in turn, would increase the public sector's expenditures, limit its financial room to maneuver and impair economic growth. Also to be taken into account is the fact that three quarters of the revenues expected to ensue from the tax would accrue to London, New York, Zurich, Singapore and Hong Kong. The increase in tax revenues would not suffice to offset the state's further expenditures. Such a tax would make Germany a loser among financial markets. It would also give rise to new costs of administration.

Also to be taken into consideration is the fact that the state is already, via SoFFin and through obligations to pay interest and commission, being recompensed for its efforts.

Such a tax would also not change the patterns of speculations evinced by certain market players. It would, rather, cause other objects and places of speculation to achieve greater volumes of transaction. The tax would also have a detrimental affect on risk management, as it would lead players to look for ways to evade it. One option would be to relocate transactions from securities to non-regulated exchanges, with an accompanying loss of the transparency whose necessity has been so eloquently emphasized by the financial crisis. Trading on securities exchanges is the easiest to monitor and accordingly to tax. The ramifications of these measures would, however, be less desirable.

These taxes would not have helped preclude the current financial crisis, whose cause was neither speculation nor market volatility, but rather valuation regulations and incorrect ratings of structured financial products. These primarily included mortgage credits-based structured paper, which were purchased along with the related insurance. This led to the mistaken assumption that the insurance would protect purchasers against defaults and drops in value.



### III. Negative ramifications of a tax on financial transactions

Companies securing financing from capital markets would experience a rise in such costs. This, in turn, would lessen earnings and the taxes levied on them. Many such companies would resort to procuring financing via loans, thus obviating the need to pay such a tax on financial transactions.

The objective subscribed to by all participants is the augmenting of companies' capital resources. Rather than achieving this objective, the tax would have the opposite effect.

The interest borne by fixed-interest securities would increase, thanks to the tax's lessening of the flow of funds into the market. Main parties affected by this would be Germany's federal and its state governments. Their costs of procuring financing would rise. The exclusion of governmental securities from taxation would result in rises in the costs of companies' refinancing operations.

Investment funds would experience double taxation (taxes levied on fund components and on the funds' transactions themselves).

The possibility cannot be excluded that the tax on financial transactions would cause the quotes of securities to plunge. This would have detrimental effects on insurers, investment funds and old age care financial plans. That, in turn, would reduce the funds available for the average citizen's old age care. Demographic trends make such capital-based old age plans highly desirable. The costs associated with these provisions would rise.

Banks are merely intermediaries that pass on each increase in costs to their customers. This means that the costs incurring from such a tax would accrue to either suppliers or those demanding their products. Affected therefore would be companies and private investors. Neither of them was, however, responsible for the crisis.

The tax would cause a lessening of financial markets' liquidity. Fluctuations would inevitably become greater on markets. This increase in volatility would result from the capability of small-sized swings in demand to cause changes in stock quotes and prices. The overall effect would be an impairing of the markets' ability to function.



Summing it up, the tax on financial markets would result in a lessening of economic growth. The increase in revenue accruing to the public sector would stem from the private sector. This would cause a worsening of the conditions governing financial transactions. Viewed as a whole, financing would become more unattractive and hedging against fluctuations in rates of exchange would get more expensive. The reintroduction of the stock exchange turnover tax and the introduction of a tax on either financial markets or their transactions would therefore be counterproductive for Germany.



## Revamping Germany's system of financial market supervision

### **A. Core statements**

#### **I. Commissioning the Deutsche Bundesbank with the entire responsibility for the supervision of banks**

- The sharing of the responsibility by BaFin and by the Bundesbank has made such supervision too unwieldy.
- Making the Bundesbank solely responsible would increase efficiency.
- The Bundesbank's independence has to be maintained.

#### **II. Financing of the supervision of financial markets**

- Reintroduction of a percentual participation (in the form of taxation) is a must.
- The 100% charging on currently in force leads to conflicts, which are built into the system.

#### **III. Retaining Germany's deposit insurance systems**

- No ad-hoc alterations of these systems.
- Germany's deposit insurance systems have proven their mettle.
- Giving them a single structure would necessitate extensive investigations.



## **B. Elucidations**

### **I. Assigning the Deutsche Bundesbank with the sole responsibility for the supervision of banks**

Munich Financial Center Initiative views the developments on financial markets as necessitating the assigning of the entire responsibility for the supervision of banks to Deutsche Bundesbank. This has to be accompanied by a maintaining of the Bundesbank's independence of operation.

The sharing of the responsibility for the supervision between BaFin and the Deutsche Bundesbank proved its inefficiency during the financial crisis. A lean and flexible system would have been capable of recognizing at an earlier stage the problems faced by several banks. Such a system would have been capable of taking effective measures, and of doing such more rapidly.

The assigning of the responsibility to the Bundesbank could eliminate redundancies of operations and problems arising from consultations undertaken by the two agencies. All told, it would constitute a major step towards giving Germany a highly efficient system of banking supervision. Via its main offices, the Deutsche Bundesbank is on-site throughout Germany. It is thus capable of supervising an industry that is highly decentralized in nature.

Special attention has to be paid to ensuring the independence of the Deutsche Bundesbank. The enactment of administrative decisions without having to resort to a ministerial empowerment to intervene exists in such other areas of public life as universities.

Of decisive importance is the Deutsche Bundesbank's continuing to be able to maintain the stability of the financial system by monitoring and evaluating its macroeconomic performance and other aspects of its operations. The Bundesbank carries out this brief by being represented on the ECB's Council and by becoming part of the European Council for Systemic Risks.



## II. Financing financial market supervision

The sole sources of income for BaFin (The Germany Federal Agency for the Supervision of Financial Services) are fees, reimbursements and, primarily, apportionments. These have been rising, and now pose a major encumbrance for the banking industry.

It is not primarily these costs but rather questions about the constitutionality of these 100% apportionments which have led Munich Financial Center Initiative to call ever since the founding of BaFin and since the taking effect of the country's Act on the Supervision of Financial Services for the revamping of the regulations on costs. The current system has a built-in contradiction. Banks bearing the excessive costs resulting from BaFin's operations have no way of enforcing their objections to such by taking part in an indirect controlling of these. Another factor is BaFin's being also responsible for areas not having anything to do with supervision, with these including the preventing of money laundering. Such responsibilities should be financed by the state.

For these reasons, Munich Financial Center Initiative is strongly calling for a reintroduction of the practice of having a percentage of BaFin's costs defrayed by tax revenues. This would enable the state to bear the costs of the operations for which it is responsible and which are not germane to banking supervision, with these including those arising from the assumption of liability for breaches of official duties.

Held in 2007, the conferences of the ministers of economic affairs and of finance of the country's states voiced their support for tax revenues' being used to cover the costs ensuing from breaches of official duties and from operations not forming part of banking supervision.



### III. Maintaining Germany's deposit insurance system

Munich Financial Center Initiative (known by its German abbreviation of “fpmi”) rejects an (another) ad hoc alteration in the country's system of insuring deposits and securing banks through the institution of European-level regulations.

In response to the financial crisis, the European Union's overhauling of markets has begun with the promulgation of such legislation as the alteration of the directive governing deposit insurance. FPMI strongly hailed the revamping of the Act on Deposit Insurance and Investor Indemnification, which caused the raising of the maximum level of protection to €50,000/€100,00 and the rescinding of the rule mandting a 10% participation in losses.

In mid-2009, the European Commission commenced another process of consultation. It is intended to yield a further sweeping revamping of the directive governing deposit insurance. FPMI's positive view of this consultation stems from its triggering a broad-ranging discussion on this important subject. The reformulation of the directive has, however, to be subjected to a painstaking process of consideration. This is because Germany's system of deposit insurance, setting forth decades of successful consumer protection, once more proved its mettle in the financial market crisis. Any attempts to reform this system have to maintain the balance between providing the requisite level of customer protection and assuring the financial industry of not having to bear excessive costs and risks.

The protection accorded to financial institutions forming part of Germany's credit unions and savings banks sector joins the deposit insurance practices adhered to by the country's private banks (these place in effect no ceilings on such insurance) in providing the highest level of protection to consumers. This system showed its intrinsic value in the financial market crisis. Germany did not experience any runs on banks. FPMI does not see any need to undertake any revamping of the directive on deposit insurance that would encompass the systems featuring voluntary and bank-securing schemes. Of decisive importance is the continuing to permit banks to maintain systems providing higher (than mandated elsewhere) levels of consumer and bank protection.



FPMI views proposals calling for the creation of such a European-level system of deposit insurance as not being advisable at this time. This is because such a creation has to be preceded by the binding resolution of a large number of highly-complex issues. This, in turn, requires the pursuing of a wide-ranging discussion. To be determined is especially whether or not such a pan-European system would be more effective than the national ones. There seems to be no justification for transferring the authority to operate deposit insurance systems from the national to the supranational level. Subsidiarity mandates that the decision as to how to employ the funds stemming from deposit insurance systems and as to how to pursue payments of indemnification should be retained by the EU's member countries and by banking groups.

Obligations to pay into the system are only acceptable to members of a deposit insurance system in cases in which, at the very least, they have an indirect say, via the bodies controlling the system, as to how it handles its professional and political responsibilities (via the launching of audits and other measures). It is not clear how this influence could be brought to bear in a European-level system of deposit insurance.

Another factor requiring consideration is the divergences of standards of supervision still existing in Europe. This mandates the postponing of such measures until this matter has been resolved.

FPMI views the first step as being the careful analysis of the practical ramifications of the revamped directive that took effect in March 2009. Deposit insurance forms an important and highly sensitive component of the relationship of trust existing between a bank and its customers. This mandates showing the utmost in painstaking care when weighing the pros and cons of an extensive harmonization of existing systems.



## The European system of financial supervision

### A. Core statements

FPMI welcomes the new structure imparted to the system supervising financial markets.

The structure does not, however, adequately ensure the incorporation of expertise on insurance matters into the deliberations and decisions of the European Systemic Risk Board.

The Council has resolved to equip EU-level agencies (EIOPA, EBA, ESA) with rights of intervention. These should not be subject to further limitation.

The creation of new pan-European agencies should lead to the greatest possible uniformity and application of Europe-wide codes of supervision.

### B. Elucidations

In its meetings on October 20<sup>th</sup> and December 2<sup>nd</sup>, 2009, ECOFIN's Board resolved to create a new pan-European structure for financial supervision. At the summit held on December 10-11, 2009, the leaders of the EU's member countries confirmed these resolutions. The European Parliament will consult on this matter during the first quarter of 2010. This will be followed by negotiations between the Parliament and the Board.

Europe's new structure of financial supervision is to have the following components:

**Macro-supervision** This will be carried out by the ESRB (European Systemic Risk Board). This board's brief is the improving of the incorporation of macroprudential findings into the EU's system of financial supervision by handling the responsibility for detecting risks to the stability of the system. It exercises this responsibility by issuing alerts to such risks and recommendations on how to eliminate them.

**Micro-supervision** The transformation has been undertaken of CEIOPS, CEBS and CESR into EU agencies equipped with greater **effective** powers and forming part of the European System of Financial Supervision (ESFS).



FPMI has a positive view of the new structure of financial supervision. The great breadth and depth of the financial crisis and of the economic upheaval it unleashed revealed gaps in the regulation of financial markets. Alleviating these requires a revamping of the system of financial supervision.

FPMI sees the make-up of the ESRB, which is responsible for the macro-supervision, as posing a problem. The sole representative of the insurance sector on the ESRB's General Board is the president of the EIOPA (European Insurance and Occupational Pensions Authority). Responsible for formulating the decisions of the ESRB, the General Board is composed of 34 voting members. Of them, 27 are the presidents of national banks. These 27 are entitled to be accompanied by supervisors of national-level insurance industries when so dictated by the matter at hand. This, however, does not suffice to secure an adequate incorporation of insurance expertise into the ESRB's decision-making processes.

The Council of the European Union has substantially curtailed the decision-making and interventionary powers that the EU Commission had proposed for the **system of microprudential supervision**. Foreseen is the agencies' having a right of intervention that is confined to breaches of European codes of supervision by the financial institutions' being supervised. The European agencies (EIOPA, EBA, ESA) are to no longer have any power of intervention in cases of crises or in disputes between national-level bodies of supervision. FPMI believes the rights of intervention resolved upon by the Council should not be subjected to further restrictions.

Requisite to impel the development of Europe's market for financial services is the greatest possible uniformity of formulation and application of a European code of supervision. The best way to achieve this is by empowering the new European agencies mentioned above. A further factor is the shortcomings in the working relationships among national-level bodies of supervision revealed by the financial crisis. These shortcomings could be alleviated by the commissioning of the European agencies.



## Solvency II

### A. Core statements

FPMI has a positive view of the Solvency II directive. The directive does, however, have problems requiring resolution. They stem from CEIOPS' proposals on measures of implementation. They are too restrictive.

Open to criticism are especially CEIOPS' recommendations on the

- classification and quality of equity
- risk-adequate calibration of the standard approach
- recognition of (partially) internal models
- requirements and scope of the reporting and publication obligations arising from “Solvency and Financial Condition Reports” and “Reports to Supervisors”.

### B. Elucidations

#### I. Endorsement of the Solvency II directive

FPMI has supported from the very outset the Solvency II directive, as it contains an approach melding economic considerations, fundamental principles and incorporations of risk. Notwithstanding its lack of consideration of all essential elements encompassed in the economic and risk-adequate calibration of the risk profiles of insurance groups (missing is group support), the directive is to be regarded, on the whole, as being a success. It will give rise to a higher level of consumer protection, to a modern system of supervision, to a greater degree of integration of markets, and to—provided that the measures of implementation are properly formulated—a greater ability to compete on the part of Europe's insurance industry.



## II. Measures of implementation posing problems

**Problems** are, however, posed by a variety of the **measures of implementation** (Level 2) proposed by CEIOPS and submitted to the EU Commission, from which they will be relayed to EIOPS for promulgation. CEIOPS has recommended taking a highly restrictive interpretation of the Solvency II framework directive. Viewed as a whole, this recommendation could lead to a substantial increase in capital requirements, and to a questioning of the directive's approach of employing principles informing economic considerations. The insurance industry has been a pillar of stability during the financial crisis. This role makes this recommendation unnecessary. The recommendation also raises questions as to how the European insurance industry's ability to compete is to be maintained.

The following recommendations by CEIOPS appear to be especially problematical:

### - Classification and quality of equity

To be rejected are CEIOPS' proposals to rigidly restrict the recognition of hybrid capital instruments as so-called tier 1 capital. Even those hybrid instruments previously recognized as being tier 1 capital are to be stripped of these categorizations (lack of grandfather clauses).

A decisive flaw is the lack of taking into account of reserves constituted for deferred tax assets and for fluctuations, and of earnings expected to be realized.

Open for criticism is also CEIOPS' proposal to create a deduction for standalone equity when determining the amount of equity arising from holding companies' participations in insurance companies. This proposal is not encompassed in the Solvency II directive.



## - Risk-adequate calibration of the standard approach

FPMI has been calling for Solvency II's featuring an appropriate and realistic SCR (Solvency Capital Requirement). To be rejected are both a lump sum and an excessive increase of capital requirements (as a consequence of the financial market crisis) applying to the classes of risk to be taken into account--and an underestimation of such requirements. A further increasing of capital intensities and a beefing up of the stress tests applied to risks arising from insurance procedures should be refrained from, since their current levels can be viewed as being conservative in nature. No causal relationship has been established between the financial market crisis and insurance procedures that would justify a stiffening of calibration methods. CEIOPS has proposed the greater taking into account of the risks arising from capital investments. We view this as being acceptable, as the currently-applied calibration takes an approach that is at the lower end of the range of prudence.

- Without supplying adequate justification for doing such, CEIOPS has raised—in a number of cases, substantially—the parameters of correlation used in taking into account the co-dependencies existing between indicators of classes of risk. In a contradiction of the requirement of the Solvency II directive, the correlations between the modules of main risks are to be increased.

## - Recognition of (partially) internal models

The bar for the recognition of internal capital models should not be placed too high. The requirements have to be realistic and capable of being fulfilled. The same conditions have to apply to the recognition of partial models. These are not to be regarded as temporary solutions to be employed during the period of transition to internal models, but rather as permanent, valuable entities. Supervisory authorities should, however, make sure that companies do not apply partial models to categories of risk already adequately depicted by standard formulas. FPMI rejects this kind of “cherry picking”, as it is linked with low levels of SCR. In cases in which the standard formula is not capable of modeling one or more categories of risk, the companies have to be required to employ partial or completely internal models in their determination of the amount of risk-related capital required.



- Requirements and scope of reporting and publication obligations arising from SFCR (Solvency and Financial Condition Reports) and from RTS (Report to Supervisors)

Criteria of materiality and proportionality determine the scope of requirements to report imposed by regulatory and public bodies. Another criterion is that this information has to be required to properly supervise the reporting company and to keep the public informed. Information of interest to competitors is not to form part of this obligation to report. Reasons of efficiency mandate the refraining from compiling discrete sets of documents for supervisory bodies and for the general public. Such documentation should also contain references and links to other pertinent documents, such as annual reports.



## Product information sheets / reporting on brokerage commissions

### A. Core statements

Each investment product requires a dedicated sheet providing potential investors in a concise and clear way with all requisite information on the product.

The introduction on January 1, 2010 of the transcript of consultation (§ 34 of Germany's Act on Securities Trading (WpHG) and the Act's requirements in § 31 WpHG on the information required to be supplied on securities services join to obviate the need to enact another regulation on the contents of product information sheets, as already stipulated for the insurance industry by § 4 of Germany's Ordinance on the Information Requirements of Insurance Contracts (VVG-InfoV).

Pending on the European level is the introduction of a Key Investor Document (KID). To provide investors with key information in standardized form, the KID obviates the need for stand-alone solutions on the national level.

§ 4 paragraph 4 of the VVG-InfoV requires the reporting of the costs of contractual settlement and of distribution. A discrete disclosing of commission actually paid to brokers makes no sense in the area of insurance, as this would not bring about a greater degree of transparency for customers. According to §31d of WpHG, disbursements to third parties made for securities-related services, as defined by Germany's Act on the Trading in Securities, have to be disclosed to customers.

The Act's stipulations on informing investors do not apply to investments made on non-regulated markets. The protection of investor interests and of fair competition mandates the urgent creation of a level playing field, in which such products would be subject to the same requirements. This would further the process of creating a single code of capital investment.



## **B. Elucidations**

### **I. Product information sheets**

Such concise sheets are already being created and utilized for a large number of financial instruments, with these including especially those involving stakes in investment funds and structured products. The current discussion has caused the banking industry to check to see if these documents can be designed to be made easier to understand and more standardized. A thrust is increasing the comparability of products belonging to the same groups.

#### **- Increasing the transparency of investment consulting through the introduction on January 1, 2010 of transcripts of consultation**

Taking effect on January 1, 2010, the revamping of the requirement to compile transcripts of consultations on financial instruments (§ 34 WpHG) imparts a greater transparency to such services. In accordance with legal requirements, to be documented are the occasion and length of the consultation. Also to be listed is the investor's objectives, with these to include his or her propensity for risk. The obligation to generate documentation extends to the consultant's recommendations and the main reasons for such. Documented is thus the elucidations provided to the customer of the essential characteristics, opportunities and risks of and arising from the financial products that have been recommended. SOP (standard operating procedure) is to incorporate into the transcript of consultation any rebates accruing (payments made by the issuing party to the bank of distribution).



## **- Deployment of product information sheets appended to transcripts of consultation**

The investor is provided prior to the conclusion of the transaction with product information sheets. Thus constituting an object of the consultation, these take the form of appendixes to the transcript of consultation. With this depending on the characteristics and risks of and associated with the individual products, the sheets feature a variety of contents and thrusts. It is precisely this individualization, which takes into account the features of the product, which makes the customer appropriately aware of the purposes of the financial instruments. A legal regulation can do no more than lay down abstract criteria to which the product information sheets have to adhere. Taking into account the features of the individual product is beyond the scope of such a regulation, which would lead to a schematization of the contents and the depictions of the product information sheets. Instead of enhancing the transparency and impact of the product information sheet, doing such would, rather, give rise to the semblance of a comparability that actually, due to entirely different ways of functioning and risks, does not exist.

## **- Existing legal requirements applying to product information sheets**

Companies providing securities-related services have to observe § 31 paragraph 2 of WpHG and § 4 of Germany's Ordinance on Securities Services Practices and Organization (WpDVerOV) when designing their product information sheets. These detailed requirements' objective is to produce items that are fair, high-clarity and not misleading. The degree to which this objective has been achieved is one object of the examination conducted by auditors of securities and deposit-related services.

Pending on the European level is the introduction of a Key Investor Document (KID). It will provide key information to investors in a standardized form. This introduction obviates the need for national-level stand-alone solutions, which would give rise to costs.

The enactment of any further regulations, whose formulation would arise from the additional requirements placed on product information sheets, would make sense, under conditions now prevailing, only for investments made on non-regulated capital markets.



## II. Reporting of brokerage commissions in product information sheets

### - Position at the outset and background situation

The revamping of the VVG includes a clause (§ 4 para. 4) introducing a reporting of the costs, in euros, of the contractual settlement and of distribution factored into life and health insurance products. The customer receives this information along with the product information sheet prior to his or her submission of his or her application. Legislators have chosen this method of reporting instead of one detailing the brokerage commission.

Instituted at the same time, and forming part of the implementation of the Markets in Financial Instruments Directive (MiFID) in the area of consulting services provided for investment funds and other objects, was the stipulation that brokers have to inform potential clients as to the costs associated with investment products, and as to the fact that these costs partially ensue from the remuneration paid for distribution (§ 31d para. 1 WpHG). In a further move, verdicts issued by Germany's Federal Court of Justice have impelled the development of the obligation to disclose any rebates. The ensuing set of requirements imposed by supervisory bodies and civil courts has decisively influenced the provision of consulting services. This set obviates the need for further regulation.

### - Insurers' position

The reporting of the costs calculated into an insurance contract constitutes valuable information for customers, as these costs are comprised of all those arising from the settlement of the contract and from distribution. This, in turn, creates comparability among competitors.

The reporting of the commission actually paid to brokers does not enable the customer to get any more information or insights from his or her contract. This is because this reporting does not increase transparency. Quite the opposite. Thanks to the wide variety of systems of remuneration in existence, it promotes an intransparency of competition. Points of differentiation among such systems are the treatment accorded to each kind of broker—employee, self-employed representative of a single company, agent for two or more companies, and broker. Each channel of distribution also features a variety of components of remuneration. Conditions can



arise in which these are not attributable to individual contracts (new business allowances, fixed salary components, cross-selling commissions) or are not determinable as of the time of contractual conclusion, but rather subsequent to the end of the financial year.

The insurance industry expressly welcomes initiatives striving to improve product transparency and the quality of consulting. The instruments deployed to achieve these objectives have, however, to be suitable and effective. Providing customers with transparency as to the commissions paid to brokers does not improve the quality of consulting. Rather, it could lead to customers' demanding a share of the commissions, and to their entering into an insurance contract for the purposes of getting such a stake. Current legislation forbids brokers' disbursement of commissions.

The only way of improving the quality of consulting provided in the insurance industry is to optimize the standard of quality of service shown by brokers and to enlist the insurers' and brokers' interest in maintaining long-term relationships with customers. These objectives have long been supported by the insurance industry.

The business model utilized by life insurance policies is based upon such relationships, which yield the private pensions so urgently needed by the German economy.



## Consulting on a fee-based basis

### A. Core statements

Capable of coexistence are the various systems of fee-based and commission-based consulting. Real world consumer protection mandates the customer's getting to decide whether he or she wishes fee-based consulting on investment products, or wishes to have a free-of-charge session possibly leading to the commission-based brokerage of products. For consumers, the thing to know is which basis the broker is working under: commissions or fees.

Today's system of insurance consulting offers highly-qualified counsel on insurance products at a fair price. It meets the needs of consumers having medium or low levels of income. With this especially holding true of the life insurance area, the provisions paid for contract settlement compensate brokers for the great amount of time that they spend in providing initial briefings and for consultations not leading to entering into contracts. Such provisions are thus indispensable for such brokers. The sustainability of the counsel is assured by the five-year terms of liability accorded to commission paid in the area of life insurance and by the follow-up commissions paid in non-life and accident insurance.

Fee-based consulting can be of interest--as an extension of today's offerings--for the affluent and for corporate customers. A number of these customers are prepared to pay fees for counsel on financial investment and on insurance—and to pay brokers also for their arranging of a financial investment or for the conclusion of a contract of insurance coverage, with the latter involving liaison services in cases of damage.

The state should refrain from directly or indirectly intervening on behalf of a model, as this would represent an unnecessary tampering with a system already achieving a high degree of transparency. This would cause a distortion of competition.

Fee-based consulting is not immune from consultants' making use of their room to maneuver in order to optimize their fee-based income—at the cost of the quality of objectivity of counsel provided.



## **B. Elucidations**

### **I. Current situation**

The financial market crisis has shown that customers often feel inadequately informed--or even misinformed--about financial products.

The legal requirements placed on consulting and documentation in the insurance sector differ fundamentally those applicable to the securities sector. Insurance companies already largely fulfill, via their adherence to legal requirements, the demands placed by Germany's consumer protection ministry for consultations meeting the needs of consumers.

Already promulgated and implemented in and by the insurance industry are:

- The achieving of transparency at the time of first contact with customers as to the status of brokers (in acc. with § 11 of Germany's Ordinance on Insurance Brokerage--VersVermV )
- Non-affiliated examination of professional expertise by Chambers of Industry and Commerce (§ 34 d para. 2 Nr. 4 of Germany's Trade Law--GewO and §§ 1 ff. VersVermV)
- Liability for incorrect consulting services (§§ 63, 68, 6 para. 5 VVG) with an obligation on the part of the broker to render indemnification
- Product information sheets providing concise and comprehensive summaries of the risks for which insurance coverage has been provided and of the product chosen (§ 4 VVG).

Germany has enacted legislation also placing strict requirements on the consulting services provided in the securities area. This legislation decrees the provision of comprehensive information to consumers. In a further move (one similar to the situation existing in the insurance area) and as of January 1, 2010, it is now required to compile a transcript of the consultation.



Embedded in Germany's intermeshed banking community, the commission-based brokerage of products ensures a country-wide provision of investment consulting services. To be taken into account is that funds and other issuers of products supply the services, with these particularly involving staff member training and the formulation of product information, largely producing the high quality of consulting services extant in the country. Fulfilling the legal requirements imposed by § 31d WpHG, the customers are informed about such matters. The degree of success of efforts to adhere to these requirements forms an object of the audits conducted of securities and deposit-related services.

Shortcomings are therefore still to be found only in the services involving the products traded on non-regulated markets.

## **II. Background information**

The calls for a fostering of fee-based consulting is a consequence of the financial market crisis and of an expert audit commissioned by Germany's consumer protection ministry. The term "financial consulting" covers the widest possible variety of kinds of products, including those traded on non-regulated markets. Lumping them together disregards their differences of objectives (including the maximizing of capital and the organizing of old age pensions featuring a securing against risk), of legally-mandated operating conditions, and of distribution structures.

Fee-based consulting is deemed to be a process featuring a consultant whose income comes from the provision of consulting services, and who has no products or services to sell, or who does so on a not-for-profit basis. Not covered by this term is the kind of fee-based consulting in which a consumer is provided with an abstract depiction of which kind of provisions for old age and other situations best meets his or her needs (type-related recommendation).

The model of providing consulting services on a fee-paying basis has long been practiced in the industry. The profession of "insurance consultants"—per se ones not affiliated with insurers—has been in existence for several decades. Official certification can be secured for it. As of this writing, some 175 persons are exercising this profession.



## Requirements placed on financial brokers and consultants

### A. Core statements

In contrast to those applying to insurance brokers (§ 34 d of Germany's Trading law--GewO), no particular legal requirements exist as to the professional qualifications of investment consultants and brokers working on the basis of §34c GewO and providing financial investments traded on non-regulated markets. These persons should be subjected to the preconditions for registration adhered to by insurance brokers, with these including the provision of proof of professional expertise and of professional liability insurance coverage.

Not viewed as being requisite, on the other hand, is the enacting of further regulations applying to brokers of financial investments (banks, financial services corporations) already encompassed in Germany's Banking Act (KWG). Strict requirements as to professional expertise and amounts of equity are already in force in this area.

### B. Elucidations

Comprised in the crisis of confidence gripping the financial market is also the one for private investment. The brokering of products traded on non-regulated markets had caused investors to experience substantial losses in the pre-crisis era. These losses joined with the outbreak of the crisis in exacerbating the mistrust with which financial investments and their distributors are regarded. This situation has caused fpmi to call for the enactment of a law leading to a raising of the qualifications possessed by investment consultants and brokerages now only required to have a commercial permit issued in accordance with § 34c of Germany's GewO. This does not impose any requirements as to professional expertise and as to the securing of professional liability insurance coverage. Emulating the example of the process of being admitted to the profession in force for insurance brokers, the responsibility for operating these procedures of approval and registration should be assigned to a single body—also for purposes of efficiency. The positive experiences arising from the implementation of the directive on insurance brokers joins the comparability of the issues to be regulated in making a self-administering body a suitable and cost-effective option.

Preconditions for being admitted to this profession have to be the reliability (already stipulated), an orderly financial situation, the securing of professional liability insurance evincing the minimum amount of coverage, and the displaying of proof of professional expertise.



The object of the requirement to secure admission to the profession has to be the person (either a single-person company or a legal person) exercising the profession. The proof of professional expertise requisite for the admission to the profession is interpersonal in nature, and can thus only be furnished by natural persons. In cases in which legal persons intend to secure this certification, the expertise has to be, therefore, supplied by persons authorized to represent the company. As is the case with the requirements placed upon insurance brokers, this proof can be furnished in financial services companies featuring large-sized structures by their having an adequate number of employees possessing this expertise. This certification has to be conferred upon the supervisor directly responsible for the persons undertaking the financial brokerage or consulting. Requisite to be brought about is that the person handling the supervision is capable of ensuring that all people directly entrusted with the consulting/brokerage have the qualifications required to exercise their professions. An adequately high quality of consulting can be assured through there being a suitable ratio of supervisors and supervisees.

Similar to the situation created by the Act on Insurance Brokerage, recommended for the provision of the proof of professional expertise required for the securing of the admission to the profession is the setting up of an examination of professional expertise administered by a public sector body. The test itself can use the components of examinations leading to the securing of such qualifications as investment funds specialist, consultant on financial services, and specialist for financial consulting. Once more emulating the Act on Insurance Brokerage, other kinds of professional qualification, in addition to the above examination, should be accepted as being of the same utility.

Customers/consumers have to be able to verify the fact that consultants and brokers have been admitted to their professions. In addition to securing such an authorization, this, in turn, entails the registration of the brokers in a central register. This would be maintained in the Internet. Doing such would provide unrestricted and easy access to the register. Investment brokers often offer both insurance and capital investment products (for instance: mutual funds). This fact mandates the creation of a single register. It could be an adaptation of the existing register of insurance brokers ([www.vermittlerregister.info](http://www.vermittlerregister.info)).

An alternative to this could be an amendment to the KWG's commissioning BaFin or the Deutsche Bundesbank with the conferring of the admissions to the profession (with this entailing the examination of professional expertise and registration). The need to secure professional liability insurance coverage could be replaced by becoming part of a deposit insurance scheme.



## Regulations applying to non-regulated capital markets

### A. Core statements

The protection of consumer interests mandates the ensuring of the supervision of all financial market products and players--as foreseen in the commitments made by the G20 countries at their summits in Washington and London.

To be undertaken at the national level should be the creation of the legal framework leading to the same conditions prevailing on non-regulated markets as on those in which financial products are distributed whose regulation is assured by Germany's KWG and WpHG. This would give rise to a "holistic code of capital investment".

To be required of dealers of products traded on non-regulated markets are primarily an adequate level of professional expertise and of professional liability insurance.

### B. Elucidations

Non-regulated capital markets are characterized by having large varieties of products and of legal frameworks for such, of suppliers, and of channels of distribution to investors. The only items subject to some form of regulation are closed-end participation products distributed to investors, which this occurring via Germany's Act on Sales Brochures. The lack of state supervision causes shady suppliers to operate on the market. These persons often lack adequate qualifications. Consumers investing on these non-regulated markets have to contend with shortcomings involving the practices and transparency regulated and mandated by the WpHG.

The interests of consumer protection thus mandate that the requirements involving products traded on non-regulated markets should be as strict as those imposed by the KWG and by the WpHG on financial instruments and their distribution. These efforts should, however, preclude excessive regulation—and have to take into account the characteristics particular to the products traded on non-regulated markets and the nature of the distribution channels used there.



Especially inadequate are the conditions imposed by commercial law upon self-employed financial consultants and brokers. In cases in which a bank has incorrectly informed an investor about a participation in a closed-end investment, the consumer generally has a solvent (meaning that it forms party to an investment securing system) party to which he or she can address a claim. Preventing the effective enforcement of claims for indemnification by self-employed financial brokers is often that they are often not members of such systems and, in cases of insolvency, lack professional liability insurance.

Measures of implementation suited to handle the problems of the lack of adequate qualifications by self-employed brokers and consultants due to inadequate coverage in commercial law could be the establishment of content-related requirements, the demanding of professional liability insurance, and the assigning these persons to an investment security scheme. Worthy of consideration would be a revamping of the code of commercial law emulating the one applying to insurance brokers, or encompassing the markets under the supervision stipulated

by the KWG.