Amendments to the new EU Capital Requirements Directive and the Minimum Requirements for Risk Management

Just over two years after the transposition of the Basel II rules contained in European Union Directives 2006/48/EC and 2006/49/EC into national legislation, these directives have once again been amended. These amendments include not only corrections to passages that had been found in practice to be unclear but also direct responses to lessons learnt from the financial crisis. The focal point of the rules is large exposures, the recognition of hybrid capital components, supervisory cooperation and crisis management. In addition, however, extensive technical changes were made, especially in the areas of securitisations and liquidity risk. These rules have to be transposed into national legislation by 31 October 2010; institutions are required to start applying these new rules with effect from 31 December 2010.

In addition, the Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement,* hereinafter referred to as MaRisk) were modified in response to flaws detected in risk management. Some of these modifications, involving the treatment of risk concentrations, requirements to be fulfilled by stress tests and liquidity management, and the rules governing compensation systems, are also a response to lessons learnt from the financial crisis. The new MaRisk rules have to be implemented, in principle, by the end of this year.

Amendments to the recast Capital Requirements Directive of the EU

Capital Requirements Directive revised ...

In April 2008, the European Commission presented a consultation document outlining proposals for further amendments to the Capital Requirements Directive (CRD).[1] These were aimed at correcting grey areas that had been detected even after only one year of practical implementation in the member states – the Commission's work had therefore not been motivated initially by the financial crisis. Still, as the consultations went on, initial lessons from the turmoil in the financial market were incorporated into the work on the amended directive. The European Parliament ratified the new directive on 6 May 2009, and the Council followed suit on 27 July 2009. However, the new directive has not yet been published in the Official Journal of the European Union.

... in several areas

The main focus of the new directive is on large exposures, the recognition of hybrid capital components, supervisory cooperation and crisis management. However, a raft of other technical changes were made, especially with regard to securitisations and liquidity risk. In some cases, this could lead to an increase in capital requirements for securitisations.

Major material amendments to the directives

Revision of the large exposures rules

Functioning of large exposures rules reviewed

The large exposures rules were only selectively amended in the Banking Directive and the Capital Adequacy Directive. However, both directives required the Commission to present, by 31 December 2007, a report to the European Parliament and the Council assessing the functioning of the large exposures rules and outlining any appropriate proposals to amend these rules. To prepare the report, the Commission sent several "Calls for Advice" to the Committee of European Banking Supervisors (CEBS), which in March 2008 published the second part of its advice on the review of the large exposures rules. This formed the basis for the revision of the large exposures provisions by the directive amending the Capital Requirements Directive.

Focus on idiosyncratic risks

The aim of the review was to simplify the large exposures rules while also giving more prominence to their core objective: that the solvency of a bank should not be threatened by the default of a counterparty or group of connected counterparties. The aim is to mitigate this idiosyncratic risk by means of legal regulations while monitoring other types of risk concentrations, such as sectoral or regional risk concentrations, under the Supervisory Review Process which constitutes Pillar 2 of the Basel II framework.

Loans to credit institutions no longer privileged

The most radical change in the large exposures regime is that all claims of an institution on other credit institutions and financial services institutions count towards the upper large exposures limit of 25% of own funds. However, institutions are exempted from this

1 This term is actually used as a "working title" to denote two separate instruments, 2006/48/EC (referred to in this article as the "Banking Directive") and 2006/49/EC (referred to in this article as the "Capital Adequacy Directive").

rule up to an absolute amount of €150 million. Nonetheless, the exposure is not permitted to exceed the institution's own funds under any circumstances. The Bundesbank opposed tightening large exposures rules for interbank lending since the effects on the money market, which had been hit by the financial crisis, are unforeseeable – and the money market is of key importance for carrying out monetary policy operations effectively. Moreover, part of the other capital relief was abolished, such as for participations in insurance companies or liquidity netting in networks of institutions.

Exception for payment settlement

However, in order to maintain the efficiency of payment and securities settlement for customers and of correspondent banking, on which the former is based, exceptions have been made. Overnight loans from this type of business, or loans granted in correspondent banking business up until the close of business, do not count towards the large exposures limit. For national groups of institutions or associations, moreover, the new rules exempt intra-group or intra-association transactions from counting against the large exposures limit.

Large exposures regime simplified

The large exposures regime was also simplified. The most prominent simplification was to abolish the overall upper large exposures limit of 800% of own funds for the sum total of all large exposures and the reduced individual large exposures limit of 20% for intra-group lending. The former limit was virtually irrelevant in practice and also insufficiently granular for proper diversification of the credit portfolio – which is why Pillar 2 is the better place for the supervisory monitoring of the diversification of the credit portfolio. With regard to intra-group lending, special internal procedures such as the decision-making requirements for loans to management pursuant to section 15 of the German Banking Act (*Kreditwesengesetz*) are regarded as being better suited to mitigating contagion risk from intra-group loans.

Recognition of collateral further aligned with own funds requirements

Lawmakers sought to align the recognition of collateral even more closely to the methodology used to calculate capital requirements. Owing to the protection purposes of the large exposures regime, only financial collateral is generally recognised, in the light of its highly liquid nature. Institutions can choose from among three procedures to recognise the collateralisation effects, with methods II and III already being applied (see section 29 of the Large Exposures Regulation (*Großkredit- und Millionenkreditverordnung*)). (I) A substitution approach in which, in the case of guarantees, the institution recognises the protection seller or, for securities pledged as collateral, the issuer of the securities as the borrower instead of the original borrower. (II) The comprehensive collateral approach which uses "haircuts" and in which the value of collateral (which reduces the amount of the claim and thus mitigates credit risk) is reduced in line with the characteristics of the collateral. Institutions may use this approach if they also use it in the context of their capital requirements. (III) Estimating the financial impact of financial collateral on LGD for institutions that use the advanced internal models approach for credit risk.

Rules for groups of connected clients tightened

Another lesson drawn from the crisis was to specify more clearly the rules governing the formation of groups of connected clients. The definition of a group of connected clients clarifies that refinancing-related risks also need to be recognised when calculating risk units. This means that firms dependent on a single source of refinancing, as was the case for acquiring entities in ABCP programmes, have to be organised into groups of connected clients. Moreover, the Commission made it clear that unilateral dependency is already sufficient grounds to require the formation of a group of connected clients. German administrative practice, which required mutual dependency based on the grounds given for the Fifth Act Amending the German Banking Act, accordingly needs to be abandoned. However, when examining economic dependency, sectoral or regional dependency do not need to be taken into account since sector and regional concentration risks are not to be covered by the large exposures rules but by Pillar 2 of Basel II.

Harmonisation of reporting formats

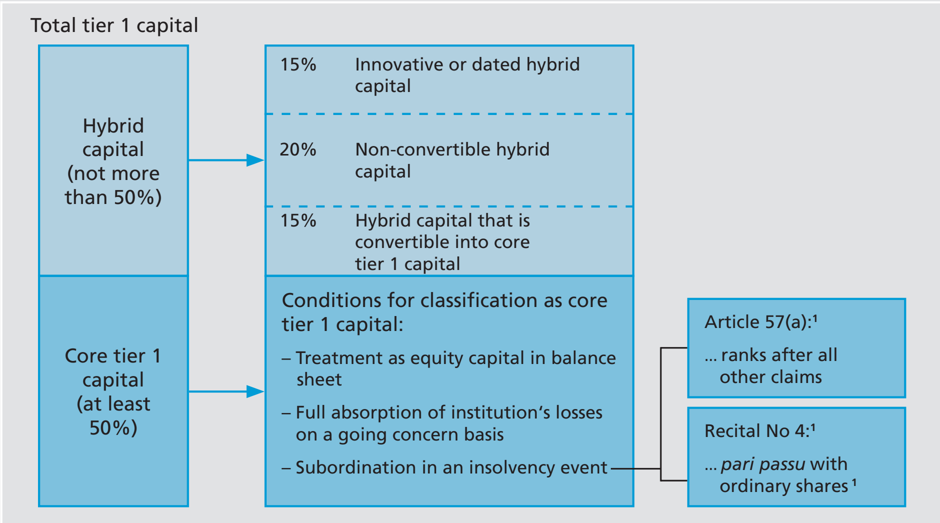
Lastly, the new directive requires authorities to use a uniform reporting format for large exposures reports from 2013. The directive stipulates that the credit institution is to identify the client or group of connected clients – irrespective of whether or not they are exempt from being counted towards the large exposures limit – for every large exposure and to give the type and amount of collateral posted as well as of credit risk mitigation. In addition, banks using an Internal Ratings-Based (IRB) Approach to calculate capital requirements for credit risk are to report their 20 largest exposures to their competent authorities. Germany already meets this requirement through its reports of loans of €1.5 million or more to its credit register.

Inclusion of hybrid capital instruments

Implementation of the Sydney Agreement of the Basel Committee on Banking Supervision

The new Article 63a represents the transposition into European legislation of the "Sydney Agreement" issued by the Basel Committee on Banking Supervision in 1998 on the inclusion of hybrid financial instruments – ie those capital components that combine features of equity and debt capital – in tier 1 capital. The provisions in Article 57(a) and recital number 4 of the new directive are designed to draw a clear distinction between hybrid capital and the components of "core" tier 1 capital. If a component of capital is equivalent to ordinary shares during liquidation and fully absorbs losses on a going concern basis, it can be fully included in tier 1 capital. The Bundesbank believes that the new directive's "*pari passu* with ordinary shares" requirement for inclusion in core tier 1 capital would not have been necessary since a proper subordination agreement is already enough to ensure that preferred creditors are protected by the bank's tier 1 capital. Permanence, loss absorbency and ability of the issuer to cancel interest payments are the key conditions for recognition of hybrid capital, which can now only be included to a limited degree in tier 1 capital. CEBS was requested to elaborate more detailed guidelines on these criteria for inclusion, thereby ensuring maximum convergence of supervisory practice in this area. The draft implementation guidelines were published on 22 June 2009; the consultation period ends on 23 September 2009.

Rules for recognising hybrid capital instruments*



* Hybrid capital instruments are a hybrid of equity and debt capital and contain both key features of equity (eg the investor's losses are absorbed) as well as of debt capital (eg investor's fixed claim on interest). Innovative capital instruments are hybrid tier 1 capital instruments which have not only a pure call option but also some other feature which might lead to them being redeemed (usually an interest step-up clause). — **1** Directive 2009/.../EC of the European Parliament and of the Council amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC ... (unpublished).

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Key criteria for recognition: permanence, ...

The provision of hybrid capital instruments is regarded as permanent if they are undated or have a maturity of at least 30 years. Although the issuer may have a call option, the instruments may not be redeemable for at least five years after the date of issue. Such a call option may be combined with an incentive for the institution to redeem (usually an interest rate step-up) only after ten years at the earliest. The competent supervisor may forbid the redemption of dated instruments at the date of maturity. Hybrid capital instruments can be called or redeemed only with the prior consent of supervisors; such calls or redemptions are not permitted to have any material impact on the institution's solvency. The responsible authorities, moreover, may require the institution to replace the capital with equal or higher-quality capital.

... loss absorbency ...

The nominal amount and undistributed interest or dividends must be available to the institution to absorb losses. To create flexibility here and allow room for differences in national practice, the text of the directive does not go into specifics. The CEBS implementation guidelines, which are currently under consultation, describe various ways of absorbing losses (eg by writing down the principal to the nominal value, or converting it into higher forms of capital); however, it is ultimately up to the competent supervisor to decide whether it regards the envisaged legal or contractual provisions for absorbing losses on a hybrid instrument as being sufficient. Moreover, by subordinating investors' repayment claims, the claims of depositors and other senior creditors are protected if the issuing institution becomes insolvent.

... and the flexibility to cancel coupons/ dividend payments

In order to preserve a bank's cash under duress, the rules governing hybrid financial instruments must give the credit institution the opportunity to cancel coupons or dividend payments non-cumulatively and indefinitely, which means that such payments are non-recoverable. The cancellation of these payments is mandatory if the institution fails to meet prudential supervisory requirements. Instead of paying the coupons or dividends in cash, however, the institution can issue new equity capital shares, the value of which can then be used to settle outstanding payments. The CEBS guidelines under consultation contain further guidance on this procedure.

Limits for counting instruments against tier 1 capital

Depending on their structures, hybrid financial instruments may be included up to a maximum of 50% of tier 1 capital. Dated instruments or instruments containing an incentive to redeem may make up a maximum of 15% of tier 1 capital; undated instruments with a pure call option can be included up to 35% of tier 1 capital. Those capital instruments which, at the behest of the bank, can be converted into elements of paid-up capital pursuant to Article 57(a) of the directive may constitute up to 50% of tier 1 capital. These buckets are not additive and cover each respective lower limit.

Grandfathering of old transactions

To avoid disrupting the capital markets, Article 154 of the amending directive contains a grandfather clause protecting capital instruments already issued at the time the provisions take effect at the national level. It permits the inclusion of these instruments up until the year 2040. Such old transactions may be included in tier 1 capital in full for the first ten years after 31 December 2010; in the 20 years thereafter, the bucket for inclusion will be gradually reduced to 20% and then to 10% of tier 1 capital.

Major technical changes to the directives

Securitisation rules

Retention of risk by originator is precondition for assuming securitisation

One of the key changes in the new Capital Requirements Directive was the insertion of a new Article 122a which stipulates that a credit institution, acting as an investor, may assume an exposure to securitisation risk only if the originator (or sponsor or original lender) has confirmed that it will retain at least 5% of the risk. The quantitative risk is supplemented by qualitative requirements, especially with respect to the risk analysis to be conducted by investor institutions. To enable such analyses, originators and sponsors are required to disclose comprehensive information to investors about the retained risk and the data relevant to the securitised portfolio. In addition, originators and sponsors have to subject their securitised positions to the same lending standards and procedures as unsecuritised loans, otherwise the originator's risk transfer will be disallowed.

Penalty for violating qualitative requirements

Supervisors can punish violations of the provisions of Article 122a by imposing a higher risk weight up to a maximum of 1,250% on the affected securitised positions. In addition to these changes, the conversion factors for qualified securitised liquidity facilities in the Standardised Approach for credit risk have now been uniformly set at 50% and the special treatment of market disruption facilities has been abolished.

Use of life insurance as credit collateral

Improvement in recognition of life insurance as credit collateral

The opportunities for recognising life insurance as credit collateral in the Standardised Approach have been improved. Under the old regime, life insurance policies could only be recognised as risk mitigants if the insurer had an external rating of at least A-. In future, the recognition of life insurance will no longer be based mainly on the credit rating of the insurer but instead on the quality of the cover fund for life insurance claims. This means that, under certain conditions, it is now possible to recognise life insurance provided by firms that are either unrated or have a poorer external rating, thereby considerably increasing the range of eligible life insurance. Even though the risk weights for claims collateralised by life insurance have been reduced in part, the Bundesbank believes that the recognition of life insurance as credit collateral is still relatively rigid.

Primary criterion: quality of cover fund

Treatment of mutual fund shares/units in the IRB Approach

Modified capital charge for mutual fund shares/units

The treatment of mutual fund shares/units in the Internal Ratings-Based (IRB) Approach has likewise been changed. When determining the risk weights for mutual fund shares/units in a look-through approach, assets that are not assigned to the exposure class "equity claims" will be recognised in future at a modified weighting rate. If a mutual fund invests mainly in high-quality debt securities, this could lead to considerable relief compared with the previous regime.

Treatment of liquidity risk

Implementation of the Basel Committee's new liquidity principles

In response to the vulnerability of many institutions in terms of refinancing exposed by the financial crisis, the hitherto more cursory liquidity rules have been made more specific in Annexes V and XI of the Banking Directive. This represents the transposition into European law of the key elements of the Basel Committee's "Principles for Sound Liquidity Risk Management and Supervision", which had already been revised in September 2008. The new liquidity rules explain banks' internal liquidity management tasks and tools and emphasise their particular systemic relevance. In contrast to solvency supervision, the underlying approach is based less on probabilities and more on the potential impact of stress. Accordingly, the simulation of severe liquidity shocks and the subsequent contingency planning and quantitative liquidity provisioning will play a key role. As before, liquidity supervision, including that of cross-border institutions, will remain largely in the hands of national supervisors; in liquidity supervision there is no "consolidating supervisor" similar to that in capital supervision. Liquidity supervision within Europe thus remains an area of supervisory law with little convergence.

Supervisory cooperation

Expanding European supervisory cooperation by…

The proposed amendments to the Banking Directive are also intended to expand cooperation among banking supervisors under normal circumstances and in times of crisis.

The competent national supervisors are being expressly called upon for the first time to duly

... introducing a "Community dimension", ...

consider the potential effect of their decisions on the stability of the financial system in all other EU member states concerned when exercising their general duties and especially in emergency situations (Article 40 (3)). However, the introduction of such a "Community dimension" is not to be understood as binding supervisors to specific actions or specific results but rather as a broad and general objective.

... including explicit rules governing "supervisory colleges" ...

The inclusion of rules governing the establishment of "supervisory colleges" represents the entry into the Banking Directive of a further key element of international cooperation. These colleges are designed for cross-border groups of institutions in the EU; some are already in existence while others have yet to be established. All host country supervisors hold a meeting headed by the home supervisor or "consolidating supervisor" in what is known as a "general college". There are currently three such colleges in Germany under German management. The home supervisor may also limit the number of participants to the supervisors of countries of particular relevance ("core college"). Supervisory colleges are intended to enhance the effectiveness of cooperation between national supervisory authorities in the supervision of cross-border credit institutions (Article 131a). To this end, participating supervisors are to exchange relevant information from the various EU member states in which the group of institutions is active, aggregate it into a joint risk assessment and determine supervisory examination programmes based on the risk assessment of the group. In addition, duplication of supervisory requirements is to be eliminated and consistent application of the supervisory requirements by colleges ensured. Moreover, the participating supervisors may also agree on the voluntary delegation of tasks and responsibilities in order to enhance the efficiency of their work.

... strengthening the role of CEBS, ...

The details concerning the establishment and functioning of supervisory colleges are regulated by written coordination and cooperation agreements formulated by the "consolidating supervisor" after consulting all competent supervisory authorities (Article 131a (2)). To avoid inconsistency and regulatory arbitrage, CEBS has been asked to develop guidelines for the practical functioning of the operations of supervisory colleges (Article 131a (2)). Moreover, in a dispute between members of a supervisory college, CEBS can be consulted as a neutral and independent conflict-resolving mediator (Article 129 (3)). The newly added Article 42b also strengthens the role of CEBS; this article stipulates that the competent national supervisory authorities should contribute to the convergence of supervisory instruments and procedures in the EU when fulfilling their tasks. For this purpose, the CEBS guidelines, recommendations, standards and other measures should be followed, and reasons stated if they are not followed (the "comply or explain" procedure pursuant to Article 42b (1) b).

... enhancing the role of the "consolidating supervisor" ...

The new Banking Directive has strengthened the role of the "consolidating supervisor" by giving it the authority, in the areas of Articles 123 and 124 (capital adequacy) and Article 136 (2) (additional capital charges) to make the final decision on a consolidated basis if the competent supervisors are unable to reach a joint decision within four months (Article 129 (3)).

... and improving the exchange of information between the responsible authorities

Lastly, the amending directive places the exchange of information between the competent national supervisors on a broader basis. Now, in cases of a crisis with implications for the stability of the financial system, central banks and finance ministries are explicitly involved in an exchange of information (Articles 49 and 50). In addition, the new directive fundamentally strengthens the right of host country supervisors to obtain information on "significant" (ie systemically relevant) branches (Article 42a). The home and host supervisors are to jointly decide within two months whether a branch is significant. If no agreement can be reached, the decision is taken by the branch's host supervisor. This involvement of host country supervisors of legally dependent units is very far-reaching and, in and of itself, is not consistent with the principle of home country supervision of foreign branches currently valid in the EU.

On the whole, the strengthening of the position of the consolidating supervisor as the head of the supervisory colleges is an important step towards more stringent supervision which at the same time relieves the burden on institutions. The establishment of supervisory colleges takes due account of the specific circumstances of the European banking and financial market. The use of supervisory colleges as instruments of ongoing supervision and crisis prevention and also as a supporting measure in crisis management is to be viewed positively and regarded as a key step towards improving the European supervisory framework.

Further changes with regard to supervisory cooperation are in the pipeline for the coming year: the Council of Heads of State or Government came to an agreement in June 2009 to establish a "European System of Financial Supervisors" by the end of 2010.

Outlook

Further changes in the European framework for prudential supervision are currently being planned for the foreseeable future (CRD 3 and CRD 4). Key elements of CRD 3 include a revision of the rules on securitisation and the trading book. The new CRD also addresses compensation policies. It is currently being negotiated by the Council of Ministers. Transposition into national legislation (together with the current amended version of the Capital Requirements Directive) is scheduled for completion by end-2010.

In CRD 4, which is currently undergoing consultation with market participants, the European Commission is proposing additional capital requirements for residential property loans denominated in foreign currency. In addition, national options for mortgage lending (in domestic currency) will be tightened. Other contents of this amendment include through-the-cycle expected loss provisioning and the introduction of a leverage ratio. There is no definite date yet as to when the Commission will submit a concrete proposal for a draft directive. However, it is already clear now that national implementation by the end of 2010 will be neither possible nor reasonable. Moreover, the Basel Committee intends to conduct quantitative impact studies on these capital issues in 2010.

Adjustments to MaRisk

Deficiencies in risk management ...

Banking supervisors reacted to deficiencies in credit institutions' risk management revealed by the financial crisis by making adjustments to the Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement*, hereinafter MaRisk). For example, institutions had not taken adequate account of all major risks, especially such risks that had been shifted to off-balance-sheet special-purpose vehicles (SPVs). Blindly focusing on external rating results drew attention away from the actual risks; the backward-looking orientation of risk measurement led to the understatement of risk; and compensation systems were excessively oriented to short-term success. In some cases, the processes for managing risk concentrations and liquidity risk were inadequate as well. Supervisors, learning from these weaknesses and following international standards set by Basel, the EU and the G20, defined certain elements of the MaRisk more clearly and made extensions to these rules. Other changes to MaRisk were made on the basis of experience obtained from ongoing supervisory practice and from incidents of fraud in some banks' trading business.

... necessitated adjustments to MaRisk

Capital adequacy assessment

Capital adequacy assessment: emphasis on the process character

The MaRisk now emphasise more clearly that institutions are required to establish a process to ensure capital adequacy on an ongoing basis. Elements of such a process include regular analysis of the risk profile, stress testing, updating the available risk-taking potential, regularly updated capital planning, the internal limit system, the establishment and pursuit of strategies and the internal reporting system. Supervisors are well aware that not all institutions already have the requisite sound mathematical processes or sufficient time series to quantify all material risks. Instead of therefore excluding these risks from the capital adequacy assessment altogether, a qualified expert assessment is necessary in order to obtain a meaningful assessment of the respective risks which can be verified by supervisors.

Quantification of all material risks

Risk concentrations

Importance of risk concentrations

In giving greater emphasis to proper management of risk concentrations, the MaRisk were adapted in the light of the insight that hidden – and therefore beyond the reach of risk management – risk concentrations can be a key cause of banks' difficulties. Logically, the MaRisk now clearly state that management needs to inform itself not just of the material risks to the institution but also about the concomitant risk concentrations. As for the risk concentrations associated with credit risk, the MaRisk now state clearly that not only qualitative procedures but also – where possible – quantitative procedures are necessary. These must cover counterparty and sector concentrations, regional concentrations and other concentrations which can lead to considerable losses relative to the risk-taking potential.

Stress tests

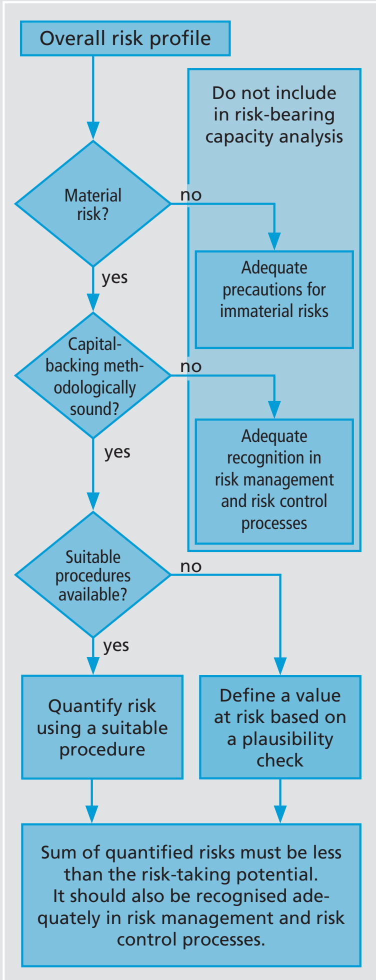
Stress test as a central risk management instrument

Stress tests are necessary to detect an institution's vulnerability to losses even under extreme circumstances. They are an important complement to risk analysis using mathematical and statistical models since these only enable a limited reflection of reality and also are often based on historically observed assumptions and interdependencies. The reliability of these models for predicting the future is fundamentally limited, all the more so in times of dynamic change such as in a financial crisis. Institutions are required to develop meaningful stress tests in order to increase their sensitivity to situations that to them could be critical and, in this manner, to obtain the necessary risk management stimuli. The Bundesbank's prudential on-site inspections have revealed that some institutions have not attached enough importance to their stress tests in terms of risk management. That was another reason why it made sense to specify in more detail the requirements with regard to adequate stress testing.

Institutions' practices not satisfactory

Stress tests comprise sensitivity analyses in which only one risk factor is varied and scenario analyses in which several or even all risk factors are varied simultaneously in order to simulate the impacts of predefined events. It is necessary to use not only historical events but also hypothetical events so that stress tests can also simulate exceptional but plausible events – so much the more if historical data do not represent a sufficiently broad variety of material risk factors across an adequate time horizon, which would mean that previously unobserved yet possible events could not be derived from the time series alone. Looking only at historical developments, moreover, especially after long periods of stability, can make the observer unaware of their abrupt end or of a trend reversal. For

Inclusion of key risks in the risk-bearing capacity analysis



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management to be able to put the results of the stress test into the proper perspective, the risk report needs to present not only the potential impact of the assumed scenarios on the risk situation but the material assumptions underlying the stress tests in a verifiable and meaningful manner.

Institutions define appropriate stress tests

Given the highly heterogeneous nature of the institutions, it does not make sense for supervisors to impose one-size-fits-all stress tests. The MaRisk have therefore deliberately rejected standardised stress tests, instead leaving it up to each individual institution to design tests that take due account of their individual situations. The requirement that the results of the stress test also be incorporated into the assessment of capital adequacy was newly added to the MaRisk. However, even the previous version of MaRisk had required that it be possible for the institution's material risks to be covered on an ongoing basis by the institution's risk-taking potential. It is therefore only logical to call on institutions to review regularly whether or not and to what extent they can bear risk even under stress.

Inclusion in capital adequacy assessment

Liquidity risk

Proactive liquidity management as a factor in survival

The financial crisis has made clear just how important it is for credit institutions to properly manage their liquidity risk. With this in mind, the liquidity management requirements in the MaRisk were more clearly defined and complemented to incorporate the changes to the liquidity requirements in the Banking Directive. In particular, the success of liquidity risk management even in a difficult situation hinges on institutions being properly prepared for a deterioration in the liquidity situation, which is why the relevant requirements in the MaRisk were expanded. Institutions are now required to recognise an impending liquidity bottleneck at an early stage while also taking into account the impact of other risks, such as reputational risk, on the liquidity situation.

Appropriate liquidity risk stress tests

The MaRisk now place particular emphasis on the importance of institutions' individual stress tests to detect potential liquidity difficulties. Institutions are required to regularly perform adequate stress tests over varying time horizons so that they are prepared for unforeseen developments which could be caused by either endogenous or market-wide factors.

Contingency plan and liquidity reserves

Each institution, taking the results of its own stress tests into account, is required to draft a contingency plan for liquidity shortfalls and review the planned measures regularly for feasibility. Continuous and permanent access to the relevant sources of refinance also needs to be reviewed. For short-term liquidity gaps, an institution has to hold a sufficient supply of sustainable liquidity reserves, such as highly liquid, unencumbered assets. The institution must also establish the extent to which any remaining restrictions exist on the transfer of liquid funds and assets within a group.

Extended liquidity risk reporting requirements

Contingency planning aspects were added to the liquidity risk reporting requirements. Now, not only the liquidity situation but also the results of the stress tests and key changes in the contingency plan for liquidity shortages have to be reported to senior management. Special attention is to be given to liquidity risk from off-balance-sheet business.

Interest rate risk in the banking book

Equity capital not included when assessing interest rate risk

The part of the MaRisk explanatory notes covering interest rate risk in the trading book was amended so that now undated equity capital components may not be included in the present-value calculation of interest rate risk. This makes it clear that the function of equity capital as an unlimited risk-taking potential is incompatible with the assumption of a maturity when determining the interest rate risk position.

Group-level risk management

Scope of requirements at group level expanded

In order to enhance the stature of group-level risk management and to specify what requirements superordinated enterprises pursuant to section 25a (1a) of the German Banking Act (*Kreditwesengesetz*) have to meet, the existing group risk management requirements were supplemented and transferred to a module of their own. Each superordinated enterprise, in coordination with its subordinated enterprises, is required to ensure compliance with the rules governing strategies, capital adequacy, risk management and control processes, organisation of operations and internal audit within the group. The decision on which risks to include in risk control hinges on their economic materiality rather than whether or not they are part of the supervisory consolidation definition. Consequently, special-purpose vehicles which do not fall within the consolidation definition must, for instance, also be included in consolidated group-wide risk management depending on their riskiness.

Compensation practices

Compensation practices as a cause of the crisis

The compensation schemes at some institutions offered their staff, in the past, an incentive to take excessive risk, thus contributing decisively to the current crisis. With this in mind, new rules governing incentive and compensation practices were added to the MaRisk which go far beyond the previous demand that incentive and compensation schemes be consistent with strategic aims.

Long-run success as basis for variable compensation

The new requirements are based on the respective principles for sound compensation practices issued by the Financial Stability Board (FSB) and CEBS. Compensation schemes have to avoid incentives to incur excessive risk. Variable compensation for senior management and staff members that are in a position to enter large risk positions should take into account not only their individual contribution to profit but also the contribution made by the organisational unit and the overall profitability of the institution. Moreover, a time horizon for assessing and paying out variable compensation should be chosen which is large enough to ensure that future negative developments are also properly taken into account.

Structural compensation principles that can be implemented flexibly

The new requirements are not intended to serve as detailed prescriptions which regiment compensation policy or even set absolute figures for compensation in banks. Instead, they are conceived as fundamental

Overview of selected amendments to the MaRisk

Area	What has changed?
Risk-bearing capacity	– Stronger emphasis on process character – Inclusion of all material risks in risk-bearing capacity analysis, using qualified expert assessments if necessary
Risk concentrations	– Stronger emphasis on proper management – Clear statement that all risk concentrations associated with material risks have to be duly taken into account – Assessment of risk concentrations associated with counterparty credit risk is to be based – where possible – on quantitative procedures, too
Stress tests	– Term will be used in future according to international conventions – Hypothetical events will be used alongside historical events to represent exceptional but plausible events in stress tests – Clarification: stress test results are also to be given due consideration when assessing the risk-bearing capacity
Liquidity risk	– Regular performance of adequate stress tests over time horizons of varying length – Development of contingency plans and regular review of underlying contingency measures – Extended liquidity risk reporting requirements
Interest rate risks in the banking book	– Ban on inclusion of undated own funds components in the present-value calculation of interest rate risk
Consolidated group-level risk management	– Existing consolidated group risk management requirements amended to clearly define the requirements to be met by superordinated enterprises pursuant to section 25a (1a) of the German Banking Act and transferred to a module of their own
Compensation systems	– Variable compensation for staff members in risk-relevant positions should take due account of the risk taken – The level of variable compensation should also properly reflect future negative business trends
Technology and organisation	– When issuing IT authorisations, care should be taken that members of staff only have those rights actually needed for their activity
Organisational and operational structure of lending business	– Processing principles need to be formulated individually for transactions with hedge funds and private equity firms, too – The exclusive use of external credit assessments is no longer an adequate basis for lending decisions
Organisational and operational structure of trading business	– Requirements for processes in trading business amended to include clause stipulating that intra-group transactions, too, can only be conducted on the basis of clear rules – Verification of foreign business

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principles that can be implemented flexibly in order to bring the incentive impacts of banks' compensation structures much more in line with their sustainable development.

Technology and organisational measures

Restricted IT authorisations

A new requirement for assigning IT authorisations was inserted into the MaRisk in response to cases of fraudulent activity at some institutions' trading desks. Now, staff may, as a general rule, only be assigned the rights they actually need for their activities (principle of minimum authorisation).

Organisational and operational structure of lending business

Business with hedge funds and private equity firms

The part of the MaRisk explanatory notes covering process-related principles was amended to stipulate that such principles also be formulated for business with hedge funds and private equity firms. Institutions are thus required to develop processes for these types of business covering, in particular, the provision of financial and other information, an analysis of the purpose and structure of the transaction to be financed, the quality and availability of collateral and an analysis of repayment capability.

External rating classification by itself not sufficient

The MaRisk previously allowed institutions to rely solely on external sources when assessing counterparty credit risk (CCR). The current version of the MaRisk, by contrast, makes a point of stating that the exclusive use of external credit ratings is no longer a sufficient basis for a lending decision.

Organisational and operational structure of trading business

New requirements for internal trading business

The requirements for processes in trading business were amended to include a rule stating that also internal transactions, such as trading business between branches or organisational units within the same firm, can only be conducted on the basis of clear rules. A definition of internal transactions was added, as well as a note that, in principle, only standard form contracts be used. Other amendments cover trade settlement and review, which is now to be performed electronically as a rule, using existing settlement systems.

Monitoring of existing trading business

In those cases in which no counter-confirmation can be obtained for overseas business, the institution must find another suitable way to confirm the existence of the transaction. In the confirmation and coordination procedure, the institution should pay particular attention to a preponderance of cancellations or corrections affecting certain staff members or certain transactions. Institutions have to be in a position to verify the existence and the content of trading business in order to detect and prevent fraud early on.

Entry into force

Implementation of the amended CRD by the end of next year ...

The amended EU directive will be transposed into German legislation by adapting the provisions of the German Banking Act and the more concrete rules in the Solvency Regulation and the Large Exposures Regulation. The EU directive requires the amended national legal regulations to enter into force by 31 October 2010 and to be applied by institutions beginning on 31 December 2010. Given the relatively tight timeframe, work on implementation has already begun; in a time-tested procedure, the banking industry (in the form of specific expert panels) and the banking supervision working group have already been brought on board at an early stage.

... including already planned amendments to the directive

The implementation process is also scheduled to include additional planned changes to the Banking and Capital Adequacy Directives which will likewise take effect on 31 December 2010. These include, above all, improvements in market risk rules for the trading book, higher capital requirements for re-securitisations and new principles for compensation. The European Commission already presented a draft directive containing these amendments in July 2009. In a further step, new rules for additional risk provisioning to mitigate procyclicality are to be prescribed, and the number of national options and discretions reduced as much as possible. The Commission has announced that it will present a draft directive in October 2009.

Implementation of the MaRisk by end of year

In principle, the new MaRisk have to be implemented by 31 December 2009. However, if the implementation of the requirements leads to difficulties that are not the fault of the institutions, supervisors will refrain from taking prudential supervisory actions until 31 December 2010. It is, not least, the current financial crisis which has encouraged supervisors, in the supervisory process, to pay particular attention to ensuring that institutions independently and responsibly implement the revised Minimum Requirements for Risk Management.