

The Act Modernising Accounting Law from a banking supervision perspective

The latest financial crisis, which is not over yet, has made clear that corporate information available to bank supervisors and the market is crucial to preventing crises. Against this background, balance sheet reporting by banks not only provides supervisors with an important source of information and a basis for analysis, but is also the starting point in measuring regulatory capital and prudential capital requirements. Appropriate accounting rules are key in this context. For this reason, the Deutsche Bundesbank was closely involved from the outset in modernising accounting practices that are based on the German Commercial Code (*Handelsgesetzbuch* – HGB) through the Act Modernising Accounting Law (*Bilanzrechtsmodernisierungsgesetz*).

The aim of the Act Modernising Accounting Law was to modify HGB accounting rules by moderately harmonising them with international accounting rules, the International Financial Reporting Standards (IFRS) as drawn up by the International Accounting Standards Board (IASB). On the one hand, rules were relaxed for small and medium-sized enterprises (SMEs) in particular. On the other, while maintaining the principle of prudence in accounting practice, internationally oriented accounting and valuation practices that were already being applied are now anchored in law. However, harmonisation hit its limits in connection with preventing unwanted fluctuations in the statement of income. This may be seen in the fair value accounting of the trading portfolio, which is now permitted for credit institutions, under which valuation gains cannot be fully recognised as income. This is achieved by applying a supervisory haircut to the fair value, as well as by setting up a compulsory (and countercyclical) risk reserve. By modifying fair value accounting in this way, the timeliness of the information in the financial statements is improved without the need – in contrast to the IFRS – to dispense with the proven HGB principle of prudence.

The changes to the German Commercial Code as a result of the Act Modernising Accounting Law have led to a modern German accounting legislation that can be actively advocated at an international level, too, as an alternative to the IFRS. In addition, it offers an appropriate basis for a risk-oriented banking supervision of all credit institutions.

Objective of the Act Modernising Accounting Law

Act Modernising Accounting Law ends years of debate

Following the publication of the Act Modernising Accounting Law on 28 May 2009, the first financial statements to be prepared completely in accordance with new accounting law will be presented as at 31 December 2010. The Act Modernising Accounting Law marks the end of years of debate on the development of German accounting law.

Keywords to sum up the Act Modernising Accounting Law are ...

The keywords that might sum up the Act Modernising Accounting Law are internationalisation, harmonisation, deregulation, and preservation of the principle of prudence.

... internationalisation, ...

With regard to internationalisation, German legislators sought to align HGB accounting rules with international accounting standards in order to make the HGB rules an internationally recognised and cost-efficient alternative accounting procedure for enterprises which do not report directly under the IFRS. In addition, several accounting methods were codified in the German Commercial Code which had already been commonly used by some reporting entities based on an interpretation of the Generally Accepted German Accounting Principles (*Grundsätze ordnungsmäßiger Buchführung* – GoB). Moreover, a number of European harmonisation provisions were implemented.

... harmonisation, ...

... deregulation and ...

Another declared objective of German legislators was to scale back accounting requirements in order to simplify accounting procedures for SMEs in particular.

Despite the aims of internationalisation and deregulation, however, the proven principles of German accounting law such as the principle of prudence, the purpose of which is creditor protection, were to be upheld. In future, too, the HGB annual accounts will serve as the basis for setting the level of dividend payments and for taxation purposes.

... preservation of the principle of prudence

This article looks in more detail at selected new rules that are especially relevant to the banking industry, the regulatory framework and bank supervisory practices.

Credit institutions' accounting of financial instruments assigned to the trading portfolio (section 340e (3) of the German Commercial Code)

In future, credit institutions' trading portfolios will be valued at fair value. In this important segment for the banking industry, the amortised cost principle has been formally revoked. For some time now, a number of big banks have interpreted the GoB such that the financial instruments assigned to their trading portfolios are stated at fair value. However, under the Act Modernising Accounting Law, the market price is not simply taken as the fair value. Instead, the Act provides for a double safeguard to uphold the principle of prudence by requiring a haircut and a block on dividend payments.

Valuation of trading portfolio codified in German Commercial Code

Definition of the trading portfolio

In the light of the financial crisis and of growing reservations with regard to fair value ac-

Limited to trading by credit institutions

counting in financial statements, under the Act Modernising Accounting Law, fair value accounting was introduced for credit and financial services institutions only; this is contrary to the original intention of the government bill. It was felt that no such rule was needed for companies of the real economy.

German Banking Act definition of trading

For credit and financial services institutions, the new subsection 3 of section 340e of the German Commercial Code stipulates that financial instruments assigned to the trading portfolio are to be valued at fair value minus a risk haircut. No definition of financial instruments is given, however, in light of the variety and continuous innovation in this area. Nor is an individual definition of the trading portfolio offered; instead, the explanatory memorandum to the act refers to the trading portfolio definition set forth in the German Banking Act (*Kreditwesengesetz*). As a result, all derivatives acquired for trading purposes must also be reported at their positive or negative fair values in the trading portfolio. The trading book is more broadly defined in the German Banking Act and contains, in particular, holdings of commodities. Under the German Commercial Code, financial instruments assigned to the trading portfolio are ultimately those that credit and financial services institutions include neither in the liquidity reserve or current assets on the one hand, nor in fixed assets on the other. For banks, this gives rise to a further asset category in addition to current assets and fixed assets.

Balance sheet reporting of derivatives to be welcomed

In particular, supervisors welcome the stipulated balance sheet reporting and fair value accounting of derivatives in the trading port-

folio. Thus, this category of financial instruments – which is of substantial importance to banks' risk situation – is now properly reflected in the balance sheet.

However, the recognition of fair value gains as income in the HGB profit and loss account raises the supervisory issue of the recognition of these unrealised gains and losses in regulatory capital. Where the regulatory measurement of capital is based on financial statements drawn up according to the IFRS, such unrealised trading gains are recognised under the Basel recommendations¹ and European guidelines.² The same applies under the German Transitional Regulation Governing Consolidated Financial Statements (*Konzernabschlussüberleitungsverordnung*),³ which does not stipulate a prudential correction for trading gains. The reason given for accepting unrealised trading gains as tier 1 capital is that the holdings are constantly changing hands and short-term gains are constantly being realised in the trading book. Moreover, legislators have taken into account the risks associated with abandoning the realisation principle by requiring a haircut on the fair values.

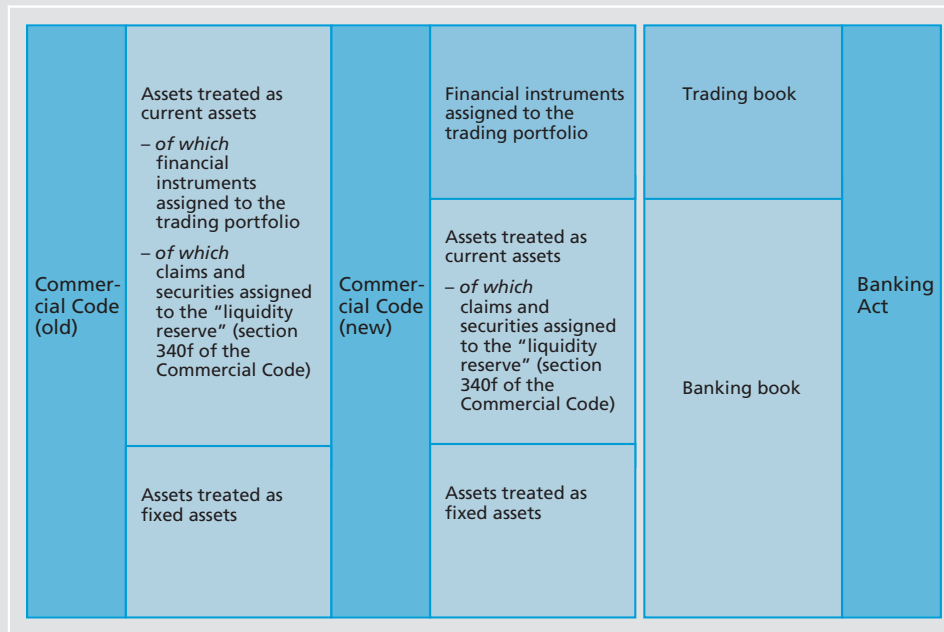
Supervisors recognise fair value gains of the trading portfolio

¹ See relevant press releases of the Basel Committee on Banking Supervision of 8 June 2004 (<http://www.bis.org/press/p040608.htm>), 20 July 2004 (<http://www.bis.org/press/p040720.htm>) and 15 December 2004 (<http://www.bis.org/press/p041215.htm>).

² See CEBS (Committee of European Banking Supervisors) Guidelines on Prudential Filters for Regulatory Capital of 21 December 2004: <http://www.c-ebis.org/Publications/Standards-Guidelines.aspx>.

³ Regulation on Determining the Adequacy of the Own Funds of Groups of Institutions and Financial Holding Groups When Using Consolidated and Interim Financial Statements at Group Level (*Konzernabschlussüberleitungsverordnung*) of 12 February 2007, Federal Law Gazette, 2007, part I No 5, 23 February 2007, pp 150 ff.

Categorisation of financial instruments in accordance with the German Commercial Code and the German Banking Act



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*Creation of
separate
balance sheet
items for
trading
portfolio*

The special valuation rules for the trading portfolio have been taken into account in that the balance sheet form in accordance with the Credit Institution Accounting Regulation⁴ now contains separate balance sheet items (asset item 6a and liability item 3a)⁵ for the trading portfolio, showing the gross value. In order to report income and expenditure from the trading portfolio, the former net income/loss on financial transactions has been changed to net income/loss from the trading portfolio.

*Corresponding
net income/loss
in the P&L
account*

*Reclassification
restrictions for
trading
portfolio*

On top of that, as an accompanying measure to rule out abuse of law, reclassification restrictions apply to the trading portfolio. According to section 340e (3) sentences 2 to 4 of the German Commercial Code, financial instruments may not be reclassified to the

trading portfolio retroactively. Reclassifying financial instruments out of the trading portfolio is permitted only if exceptional circumstances lead to the intent to trade being abandoned. The act explicitly refers to severe constraints on the tradability of financial instruments. Thus, legislators have responded to the massive market disruptions triggered by the financial crisis. However, a slump in prices in itself does not justify reclassification. In addition, reclassification out of the trading portfolio is possible if the financial instruments in question are included retrospectively

⁴ Credit Institution Accounting Regulation (Kreditinstituts-Rechnungslegungsverordnung) in the wording of the announcement of 11 December 1998, Federal Law Gazette, 1998, part I, pp 3658 ff, as last amended by the law of 18 December 2009, Federal Law Gazette, 2009, part I, pp 3934.

⁵ Section 35 (1) No 1a of the Credit Institution Accounting Regulation.

in hedging relationships in accordance with the German Commercial Code. In this way, HGB rules governing reclassification differ from the rules which the German Banking Act envisages for banks' trading books, according to which financial instruments are to be reclassified if the conditions for assignment to the trading book or the banking book no longer apply.⁶ In this context, banks' internally defined, verifiable criteria play a major role. Although they allow some harmonisation of the trading portfolio and the trading book, deviations are justifiable for operational reasons since, when defining the trading book, greater importance can be attributed to the bank's strategic intention. By contrast, greater objectivity is called for when defining the trading portfolio in order to prevent abuse of law. When financial instruments are reclassified under HGB provisions, the last known fair value represents the new amortised cost for the following cost evaluation. This renders intentional profit shaping largely impossible.

Risk haircut

Haircut to preserve the principle of prudence

In order to counter the risk of recognising unrealised gains from financial instruments assigned to the trading portfolio as income, legislators have opted for a modified market valuation method. Thus, a risk haircut on the actual market values of financial instruments acquired for trading purposes is required.

Haircut to take account of probability of default

Section 340e (3) sentence 1 of the German Commercial Code stipulates that credit and financial services institutions must value financial instruments in the trading portfolio

at fair value minus a risk haircut. This haircut is intended to take account of the probability of default of the unrealised gains. The act contains no regulations on how the haircut is to be determined. Instead, the explanatory memorandum to the act calls for an adequate calculation method and refers to the banks' internal risk management according to regulatory requirements. Legislators therefore assume that banking supervisors will monitor the suitability of the calculation method and the calculation parameters. The principal option is to apply a value-at-risk-based haircut⁷ using financial mathematics, although the legislative materials pertaining to the Act Modernising Accounting Law do not expressly state whether banks which calculate a VaR according to the Solvency Regulation⁸ for prudential purposes are also required to use it to determine the HGB haircut; certainly, it is appropriate if the institutions create convergence in this respect.⁹ For banks which do not calculate a VaR based on the Solvency Regulation, legislators do not address the question whether in such cases a VaR is to be

Use of prudential procedures

VaR-based haircut possible, but not compulsory

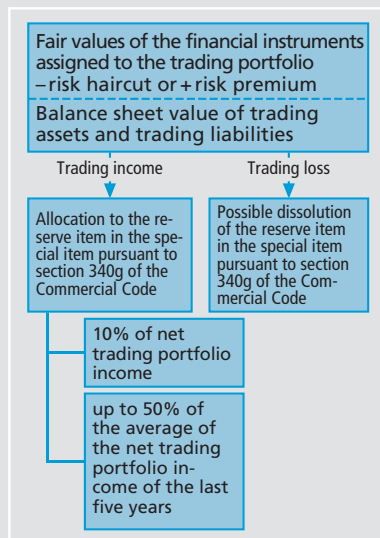
⁶ Section 1a (4) sentences 3 and 4 of the German Banking Act.

⁷ The value-at-risk (VaR) is the estimated, maximum expected loss which, with a given probability and under normal market conditions, will not be exceeded within a specified period of time.

⁸ Regulation governing the capital adequacy of institutions, groups of institutions and financial holding groups (or Solvency Regulation – Solvabilitätsverordnung); Deutsche Bundesbank, Solvency Regulation (Solvabilitätsverordnung) and Liquidity Regulation (Liquiditätsverordnung) – Banking Regulations 2a, February 2008.

⁹ See IDW Stellungnahme zur Rechnungslegung: Bilanzierung von Finanzinstrumenten des Handelsbestands bei Kreditinstituten (Institut der Wirtschaftsprüfer in Deutschland e.V. (Institute of Public Auditors in Germany)), (comment on accounting practices: Reporting of financial instruments acquired for trading purposes by credit institutions) (IDW RS BFA 2)), IDW-Fachnachrichten, no 4/2010, pp 154-166, paragraph 50; IDW RS BFA 2, paragraph 53 assumes an obligation to use the VaR-based haircut.

Valuation and balance sheet reporting of the trading portfolio in accordance with section 340e (3) and (4) of the German Commercial Code



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calculated solely for the purpose of determining the HGB haircut. Instead, reference is made to the institution's appropriate internal risk management in accordance with the German Banking Act and the Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement*).

Where institutions' internal risk management models are used to measure regulatory capital, they are accepted by the Deutsche Bundesbank and the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin*). Additionally, however, other calculation procedures are already used in banking. A risk-sensitive haircut may be applied which, based on the minimum requirements, reduces the market value by potential trading portfolio losses. Moreover,

Compliance with risk management procedures

using established and prudentially recognised procedures creates synergies, produces an appropriate harmonisation of the institution's internal risk management and the balance sheet valuation, and ensures the comparability of the risk haircuts applied.

Although the act explicitly mentions only a risk haircut, trading liabilities will probably have to be valued with a risk premium on the fair value that satisfies the principle of prudence in the same way.¹⁰

Risk premium for trading liabilities

Risk reserve in section 340g of the German Commercial Code

As the second means of preserving the HGB principle of prudence alongside the fair value haircut, section 340e (4) of the German Commercial Code requires the accumulation of a risk reserve.

Risk reserve with function of block on dividend payments

Under this provision, 10% of net income from the trading portfolio must be allocated to the special item for general banking risks pursuant to section 340g of the German Commercial Code each financial year. These allocations must be continued until 50% of the average net annual income from the trading portfolio over the last five years has been reached. This is based on the net income from the trading portfolio after deducting the risk haircut. The risk reserve is to be shown separately, if necessary as an of which sub-item, in the fund for general banking risks. The accumulation of the risk reserve is compulsory, and is therefore not at the discretion

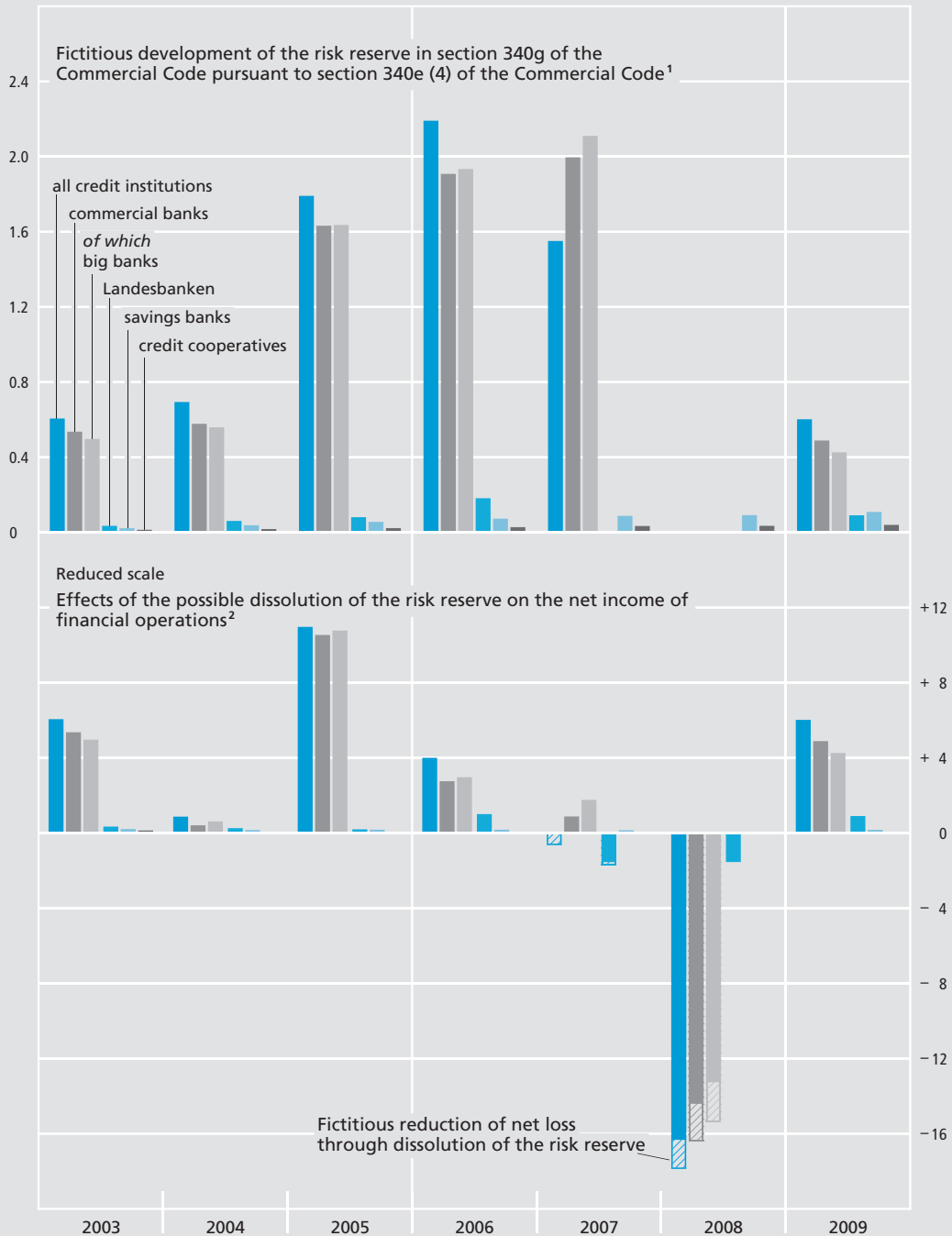
10% of net income allocated to fund for general banking risks

50% of the average as de facto upper limit

¹⁰ See also IDW RS BFA 2, paragraph 59.

Simulation of the risk reserve from the trading income of credit institutions

€ billion



¹ This chart shows how the risk reserve would have developed if the rules governing the formation of the risk reserve introduced through the Act Modernising Accounting Law had applied since 2003. The simulation is based on the net income of financial operations, which is replaced under the Act Modernising Accounting Law by net income from the trading portfolio. — ² The whole pillar represents the net income of financial operations based on the individual accounts pursuant to the Commercial Code; the hatched area represents the fictitious reduction of the net loss from financial operations through dissolution of the risk reserve pursuant to section 340e (4) of the Commercial Code.

of the bank's management. In this way, it ultimately acts as a block on dividend payments using unrealised fair value gains, although valuation gains are not the sole basis of the calculation. In this respect, the restriction to 50% of the average net income appears justified and acceptable. Moreover, the risk reserve, like other amounts included in the fund for general banking risks, counts as tier 1 capital within the meaning of section 10 (2a) number 7 of the German Banking Act.

Dissolution of risk reserve possible in event of loss

As a general principle, the risk reserve may only be dissolved to offset a net loss on the trading portfolio. Furthermore, dissolution is possible if the risk reserve exceeds 50% of the average net annual income from the trading portfolio over the last five years. According to the wording of the law, when calculating this average, only financial years in which a net income was generated are to be taken into consideration.

Countercyclical impact of formation and dissolution of the risk reserve

Besides safeguarding against imponderables resulting from the recognition of unrealised valuation gains in trading in the income statement, the risk reserve also has a countercyclical impact. The interaction of its being formed from trading gains and its dissolution to cover trading losses tends to level institutions' net trading income. The risk reserve's relatively low upper limit serves to curtail its countercyclical effect, however.

The valuation hierarchy of fair values

With the new subsection 4 of section 255 of the German Commercial Code, legislators

have, in terms of the valuation criteria, created a fair value measurement hierarchy. This step became necessary when fair value accounting of institutions' trading portfolios was introduced, and in light of experiences made with the financial crisis. Although the act itself contains no legal definition of the fair value, following international definitions, the fair value according to section 255 (4) of the German Commercial Code may be understood to mean the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.¹¹ The fair value is, as a general principle, equivalent to the market price in an active market. If there is no active market, the fair value is to be determined using generally accepted valuation models (such as, for example, option pricing models and discounted cash flow models). As a fall-back in this fair value measurement hierarchy, the act stipulates the amortised cost valuation methodology. In this context, the fair value that was last determined is deemed to be the amortised cost within the meaning of section 253 (4) of the Commercial Code.

In the financial crisis it proved difficult to establish whether a price for a financial instrument qualified as a market price in an active market. This became especially evident when markets previously considered undoubtedly active became illiquid in just a short space of time. In particular, migration in the hierarchy of valuation methodologies proved difficult when isolated market activities could still be observed. Thus, clear cri-

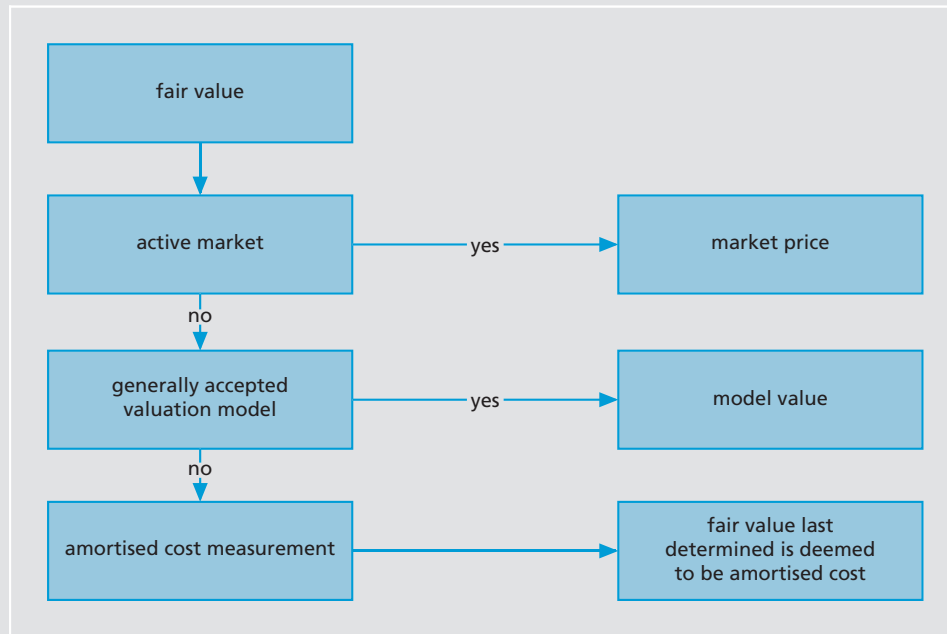
Hierarchy of fair value determination from market to model value

No explicit fair value definition

Migration in the valuation hierarchy remains critical

¹¹ See IDW RS BFA 2, paragraph 33.

Valuation hierarchy pursuant to section 255 (4)
of the German Commercial Code



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teria are needed which spell out under what circumstances a market qualifies as active and when a valuation needs to be carried out at the second hierarchy level using valuation models. The act contains no criteria for distinguishing an active from an illiquid market. According to the explanatory memorandum, a market price can be deemed to have been determined in an active market if, for example, it is readily and regularly available on a stock exchange and it is based on current and regular market transactions between independent third parties.

The migration within the fair value valuation hierarchy, notably in tense market settings, and the assessment of the valuation models – particularly where complex structured financial instruments are concerned – are likely to

remain two of the most difficult issues in the fair value valuation of trading portfolios for the reporting banks and their auditors, as well as for prudential assessment purposes.

Recognising hedging relationships

The purpose of a valuation unit is to report a hedging relationship in the balance sheet. Without special rules on the accounting treatment of hedging relationships, economically sensible and, where applicable, completely matched positions would not be adequately reported in the balance sheet and the profit and loss account by the one-sided recognition of changes in value. The use of valuation units is not unknown in German accounting law. However, in accounting practice it was

Codification of valuation units in the German Commercial Code led to appropriate reporting of hedging relationships

initially based solely on a practice-oriented interpretation of the GoB. The application of compensatory valuation, which was developed through practice, enabled banks to circumvent the problems that arose in connection with the balance sheet treatment of the strict application of the imparity principle and the principle of individual evaluation.

Restriction of traditional HGB principles

This practical application is anchored in the new section 254 of the German Commercial Code in uniform, principles-oriented rules. Where there is a valuation unit, use of the principle of individual evaluation, the realisation principle, the imparity principle and the amortised cost principle is restricted. For prudential purposes, where a documented hedge transaction has been conducted as part of the bank's internal risk management operations, a valuation unit must be recognised in the balance sheet in order, among other things, to ensure an appropriate balance sheet treatment of the derivatives vis-à-vis the banking book. Thus, unrealised losses are not shown in the balance sheet if opposite changes in value or cash flows from the same risks actually offset each other.

Hedgeable risks

Recognising compensating changes in value

With the help of section 254 of the German Commercial Code, economic hedging strategies against on-balance-sheet risks are to be documented in the annual accounts. On-balance-sheet risks are based on changes to the fair value which lead, in the case of individual evaluation, to an allowance or a write-off, whereas the compensating change in value has no effect on income. For this rea-

son, it is necessary to set up valuation units to achieve an accurate and appropriate reflection of the bank's net asset position and profitability.

A valuation unit whose purpose is to hedge against a change in the fair value is a fair value hedge. A cash flow hedge, on the other hand, hedges the exposure to the variability of the cash flow. Fluctuations can result from a variety of risks such as price risk, interest rate risk, equity risk and credit risk.

Hedges against risk of both fair value and cash flow changes can be recognised

Hedgeable items

According to section 254 of the German Commercial Code, assets, debt as well as firm commitments and highly probably transactions are eligible as hedgeable items.

Broad definition of hedgeable items

The possibility to include expected transactions in valuation units, and therefore to include anticipatory hedging relationships in the balance sheet, is an innovation. However, it is only given if, first, the transaction has a very high likelihood of materialising; second, similar transactions have been realised in the past; and third, adequate documentation has been submitted and evidences the company's hedging strategy.

Anticipated transactions as hedgeable item an innovation

Reporting entities have relative freedom in how they set up valuation units. In the case of a micro hedge, a valuation unit is used to hedge only one individual item against a given risk. A portfolio hedge means that several items can be included in one valuation unit. With a macro hedge, all items subject to

Micro, portfolio and macro hedges possible

a particular risk can be combined to form one valuation unit.

Hedging instruments

Hedges can be both derivative ...

According to section 254 sentence 1 of the German Commercial Code, financial instruments serve as hedges, although they are not defined there either. However, one can refer to section 1a (3) of the German Banking Act for this purpose, which defines financial instruments as all contracts which create a financial asset for one of the parties involved and a financial liability or a capital instrument for the other. Original financial instruments as well as derivatives whose underlying is a financial instrument may serve as a hedging instrument. Under section 254 sentence 2 of the German Commercial Code, the same applies to derivatives whose underlying are commodities, and which are used to hedge against price risks.

... and non-derivative financial instruments

Hedged items and hedging instruments may be used to create a valuation unit only if they are exposed to the same risk, yet respond to that risk in opposite ways. Proof that this criterion is met must be provided, and the intention to hedge has to be documented. If a valuation unit is liquidated prematurely, a plausible reason must be given. Part-time hedges are possible if the hedge period is set in advance.

Opposite responses to same risks

Checking the effectiveness of valuation units

Proof must be provided that a valuation unit is suitable as a means of offsetting the risk in

question. Thus, it is necessary to measure the extent to which opposite changes in value or opposite cash flows which were based on the same risk led to the offset. If this offset was incomplete or if there were mismatches in time, a distinction has to be made between the effective and the ineffective part of the hedging relationship. The amortised cost principle and the imparity principle must still be observed with regard to the ineffective part.

Effectiveness must be measured

Changes divided into effective and ineffective parts

When checking the effectiveness, offsetting effects may be considered in terms of the aggregate fair value or of only a change in value owing to the hedged risk.

Different ways to measure effectiveness

Reporting valuation units in balance sheet and P/L account

A valuation unit can be reported in the balance sheet using either the freezing method (*Einfrierungsmethode*) or the booking through method (*Durchbuchungsmethode*). The former makes it unnecessary, where a hedging relationship is effective, to adjust the instruments included and to explicitly recognise the hedging relationship in the balance sheet. Where the hedge covers only part of the risk, the imparity principle must be applied for the unhedged part.

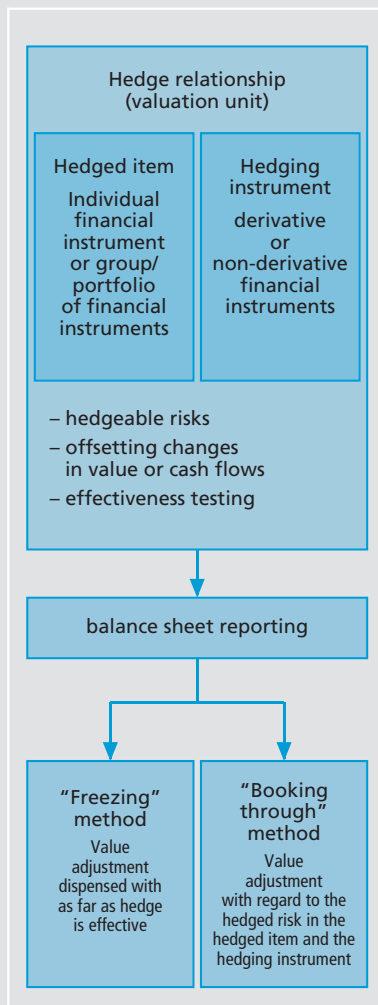
Options for reporting: ...

... freezing method disregards changes, ...

Booking through as prescribed by IAS 39 leads to all changes in value being recognised. In the profit and loss account the entries pertaining to changes in the value of effective hedging relationships balance each other out. Thus, the valuation units and the

... booking through method covers both changes

Hedge accounting pursuant to section 254 of the German Commercial Code



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balancing of risks resulting from them are identifiable.

Need for change in recognition of valuation units in practice

Although strictly retaining the procedure which institutions were already using was considered, the rule introduced through the Act Modernising Accounting Law leads to a

Freezing method differs from the previous fixed valuation

need for change in the accounting of valuation units. Particularly significant in this respect are the method for reporting, and measuring the effectiveness of, a hedging relationship. Previously, a fixed valuation was carried out along the lines of freezing, which assumes the effectiveness – once it has been determined – of a hedging relationship to be given; as a result, the valuation unit is not reassessed. Under the new legal provisions, the effectiveness of a hedging relationship has to be reviewed constantly, and any ineffectiveness taken into account. It remains to be seen what methods will be used in practice in future.

Any ineffectiveness must be reported

Ultimately, therefore, it is particularly important when assessing an institution's risk based on the appropriate recognition of valuation units that adequate and comparable procedures are developed in practice.

Need to develop best practices

It should be said at this point that under the Act Modernising Accounting Law, too, not all derivatives are reported in the balance sheet. Trading portfolio derivatives and hedge derivatives in valuation units, in the case of which the booking through method is used, are recognised. Where the freezing method is applied, hedge derivatives are not shown in the balance sheet; nor are the other derivatives, notably interest rate derivatives to hedge the banking book against general interest rate risk. Suitable, objective solutions for a loss-free valuation of the banking book need to be developed in practice which guarantee that the changes in the values of all the instruments included in the assessment are appropriately reported in the balance sheet

As in the past, certain derivatives are not recognised

and the profit and loss account. Until then, care should be taken to ensure the required transparency of the information regarding the fair value of financial derivatives in the notes to the financial statement pursuant to section 285 number 19 of the German Commercial Code.

Consolidated accounting – consolidation requirement

Current HGB consolidation rules easily dodged

In the financial crisis, the consolidation regulations proved to be a major weakness of existing accounting regulations. Section 290 of the German Commercial Code was based on two complementary concepts for determining whether a potential subsidiary had to be included in the consolidated accounts of a parent company. The so-called single management concept lacked specifics and could be easily dodged. The supplementary control concept was based on the control actually exerted over a subsidiary by way of formal corporate ties, and could be circumvented with relative ease. The distribution of economic opportunities and risks was secondary. In the wake of the financial crisis, it became evident that institutions had transferred – sometimes large volumes of – risky assets to special purpose entities (SPEs) which, because the legal definition of control did not apply to them, could be excluded from consolidation. Ultimately, however, the institutions in question had to assume the risks arising from assets transferred to SPEs because of, for example, existing liquidity facilities.

SPEs and associated risks often not consolidated

Unlike the provisions of the German Commercial Code, the IFRS consolidation rules are based on an economic assessment of the distribution of opportunities and risks. Although the actual consolidation standard IAS 27¹² is likewise based on formal indicators of control, the special regulation for SPEs set forth in SIC 12¹³ proceeds from an economic perspective. Whenever the majority of the opportunities or risks resulting from an SPE rests with the potential parent company, the SPE must be included in the parent's consolidated accounts.

IFRS rules (IAS 27/SIC 12) as a model

Revised version of the HGB consolidation concept

On its own, the elimination, envisaged in the government's bill on the Act Modernising Accounting Law, of the participation criterion would probably not have achieved the objective of a more extensive HGB consolidation that includes SPEs. An originator will often shy away from a participating interest in an SPE precisely in order to evade the consolidation requirement. For this reason, legislators opted for a complete overhaul of the HGB consolidation rules. Today, under the new subsection 1 of section 290 of the German Commercial Code, a potential subsidiary must be included in the consolidated accounts, even if control is merely possible – whether or not a participating interest is held. The criteria that define control are now set forth in subsection 2, although these include,

Concept of potential control ...

... based on extended control approach

¹² IAS 27: Consolidated and Separate Financial Statements.

¹³ SIC 12: Consolidation – special purpose entities.

for the time being, the indicators of control that have applied to date.

Consolidation of special purpose entities

Economic view of distribution of risks and opportunities ...

A new feature has been introduced through section 290 (2) number 4 of the German Commercial Code, which contains a special interpretation of control which is aimed purely at companies which are set up to achieve a closely and clearly defined objective of the parent company. These SPEs are deemed to be potentially controlled by the parent if, from an economic perspective, the parent bears the majority of the risks and opportunities. The explanatory memorandum refers explicitly to the rules of SIC 12 of the IFRS, and mentions also the indicators for control which are listed there. In this connection, the act deliberately defines what constitutes a company in very broad terms in order to offer, from the beginning, as little scope as possible to circumvent the rule. However, special funds within the meaning of section 2 (3) of the Investment Act (*Investmentgesetz*) have been deliberately excluded to prevent a consolidation requirement on the basis solely of an investment in such a fund, all the more as, in this case, the fund shares are already reported on the balance sheet.

... special interpretation of control over SPEs

Practical application of decisive importance

Although the consolidation principles of IFRS, through IAS 27 and SIC 12, have not always proven sufficiently robust in practice, the alignment of the HGB consolidation requirement with the internationally accepted standards is to be welcomed. When preparing IFRS consolidated accounts, too, the requirement to consolidate an SPE has occasionally been

negated on the basis of SIC 12 in a normal scenario; yet taking an economic perspective of the distribution of potential opportunities and risks is the only way to thwart deliberate evasive strategies – hence the need for reporting entities, auditors and supervisors to work together to achieve an appropriate practical application of the new consolidation rules contained in the German Commercial Code.

Impact on the supervisory consolidation of groups of institutions

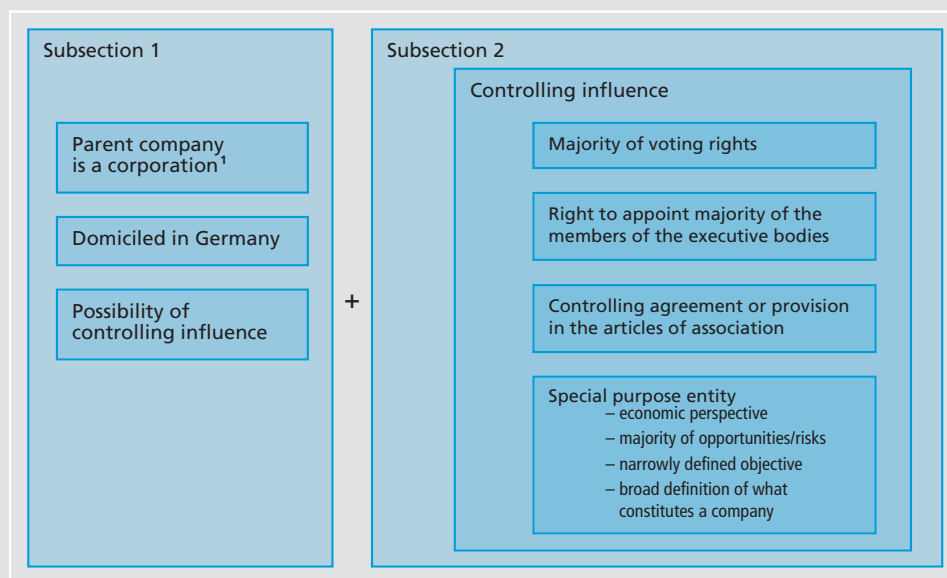
The supervisory consolidation of the own funds of groups of institutions and financial holding groups pursuant to section 10a of the German Banking Act follows HGB consolidation according to the supervisory consolidation group pursuant to section 10a (1) to (5) of the German Banking Act. The definition of the subordinated company in accordance with section 10a (1) sentence 2 in conjunction with section 1 (7) of the German Banking Act takes as its starting point the definition of the subsidiary company set forth in section 290 of the German Commercial Code, and thus the revised HGB consolidation requirement.

Supervisory consolidation follows HGB consolidation ...

The aim is to ensure that the supervisory consolidation of own funds does not lag behind HGB consolidation requirements. As a general principle, therefore, the consolidation requirement which has been extended under the German Commercial Code through the Act Modernising Accounting Law ought also to apply to SPEs launched, for example, in connection with credit institutions' securitisa-

... unless risks are already covered by prudential requirements

Consolidation requirement pursuant to section 290 of the German Commercial Code



¹ Pursuant to sections 340i and 341i of the Commercial Code, credit institutions and insurers are required to draw up consolidated accounts irrespective of their legal form.

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tion activities. Where risks arise for banking groups as a result of such SPEs, and these risks have already been adequately covered elsewhere through prudential requirements, prudential consolidation could under certain circumstances be dispensed with. Discussions with the banking industry on this topic are ongoing.

Effects on the formation of single borrower units pursuant to section 19 (2) of the German Banking Act with regard to large exposures and loans of €1.5 million or more

The expansion of the HGB consolidation requirements has a knock-on effect on the formation of single borrower units pursuant to section 19 (2) of the German Banking Act.

Although the criteria as to what constitutes a group is based primarily on the definition set forth in the German Stock Corporation Act (*Aktiengesetz*), section 290 (2) number 4 of the German Commercial Code also contains an irrefutable presumption with regard to controlling influence, which in turn meets the criteria of what constitutes a group pursuant to section 18 (1) sentence 1 in conjunction with section 17 (1) of the German Stock Corporation Act. Hence it follows that enterprises which are consolidated in accordance with the German Commercial Code by their parent company must also be included in the single borrower unit of that parent.

First experiences made with credit reporting show that institutions are highly adept in using the criteria – to which section 290 (2)

Formation of single borrower units follows HGB consolidation

Calculating the discount rates for provisions in accordance with the Regulation on the Discounting of Provisions (*Rückstellungsabzinsungsverordnung*), issued on the basis of the Act Modernising Accounting Law (*Bilanzrechtsmodernisierungsgesetz*), pursuant to section 253 (2) sentences 4 and 5 of the German Commercial Code (*Handelsgesetzbuch*)

The Deutsche Bundesbank calculates the discount rates for provisions in accordance with section 253 (2) of the German Commercial Code and with the criteria relating to the maturity matching, averaging and gearing of interest rate levels to the yield on high quality euro-denominated corporate bonds specified in the Act Modernising Accounting Law and in the Regulation on the Discounting of Provisions.¹

Maturity matching

In theory, provisions can have any given maturity. In this context, those for post-employment benefit obligations, in particular, may span several decades. Hence, in order to ensure that discount rates are maturity matched, a yield curve, which plots the relationship between the interest rate and the time to maturity, is needed which extends into the desired maturity period of the provision. For the purpose of calculating yield curves with a long maturity, it is advisable to choose underlying financial instruments which have a similarly long maturity. Moreover, since a yield curve depicts merely one relationship between a given maturity and a given interest rate, the financial instruments used should also be as homogeneous as possible with regard to their credit quality and other features. Debt securities with a low quality or a high annual coupon generate a different market yield to safe paper or instruments whose interest is not paid out until the end of their life (zero-coupon bonds). Ultimately, the method of calculation has to be transparent and reproducible, provide a good fit with observed market yields and deliver “smooth” curves without any kinks or breaks. The last of these criteria is designed to ensure that any deviations or distortions in the yield of individual securities do not impact significantly on neighbouring maturities.

Averaging

The use of market interest rates when discounting provisions enables a more realistic representation of the actual obligations that exist; however, this approach also leads to fluctuations in the profit and loss account owing to interest

rate changes. Simulations using the Deutsche Bundesbank’s Financial Statements Data Pool have demonstrated that fluctuations in performance, based upon changes to company pension reserves, can be kept in check by applying a market interest rate that is calculated as the average of the preceding seven years. This is attributable to the fact that, in relation to the central bank interest rate, the length of each of the last six interest rate cycles since 1960 has averaged just under seven years. Since longer-term yields generally follow these interest rate patterns as well, a “smoothing” over a seven-year period is significantly more effective than over five years as initially envisaged.

Yield level

When discounting, it is primarily the level, that is to say the absolute level, of the discount rates which determines the present value of the provisions. According to international accounting standards (eg IAS 19.78) this should be geared to the market yields of “high quality corporate bonds”. Such pegging to corporate bonds with a rating of AA (Aa), which can be achieved without much ado in, say, the USA and the UK with their large share of capital market financing, is impeded in Germany’s bank-based financial system by a paucity of this kind of bond. Even if, as an expedient, corporate bonds from all of the EEA member states were to be referred to in aggregate this would not, at present, facilitate a reliable estimation of yield curves in the long-term maturity segment. In practice, therefore, corporate bond yields are not, as a rule, used for estimating one’s own yield curve but for calculating a mark-up on a yield curve derived from Federal securities (Bunds) or from swaps. To this end, the yield indices of private data providers are often used in place of individual bonds.² Inclusion in the index is a guarantee that certain minimum requirements in terms of the features, rating, residual maturity and volume outstanding of the bonds concerned have been fulfilled.³ The mark-ups derived from such indices may be calculated on the basis of an individual bond yield, such as that with the longest maturity, or of a specific maturity band⁴ or of the average of all bonds taken

¹ See also J Stapf and D Elgg (2009), The discounting of provisions pursuant to the Act Modernising Accounting Law: the calculation and announcement of discount rates by the Bundesbank, *Betriebs-Berater* online magazine, Vol 64, pp 2134-2138 (in German only). — ² This type of procedure is used by consultancies and auditing firms. Indices broken down by rating category and maturity band are offered by Markit Group Ltd and Merrill Lynch International, among others. — ³ For an

explanation of the criteria applying to index composition please refer to, for example, Markit iBoxx EUR Benchmark Index Guide, 2008, at www.markit.com/assets/en/docs/products/data/indices/bond-indices/Markit_iBoxx_EURBenchmark_Guide.pdf. — ⁴ As a general rule, these include all bonds with maturities of 1-3 years, 3-5 years, 5-7 years, 7-10 years and 10+ years. — ⁵ For example, an average of 13 bonds are featured in the 10+ years maturity band of Markit iBoxx, and the overall

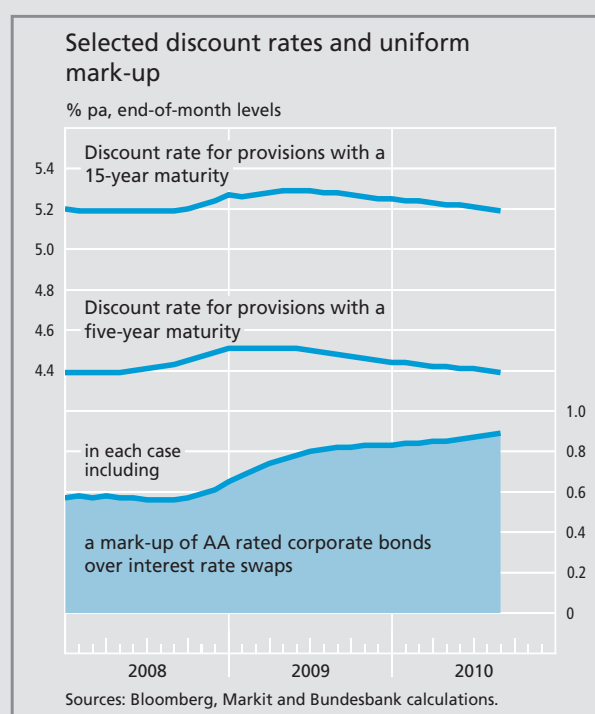
together. The discount rates determined by the Bundesbank include the mark-up as the difference between the maturity matched seven-year averages of all corporate bond yields and the seven-year mean value of the swap curve. This mark-up is then uniformly added to the swap curve across the entire maturity, with the result that it is also extrapolated beyond the longest maturity of the corporate bonds. Said procedure is extrapolated forwards over subsequent months, in other words the seven-year window is moved along by one month, thereby allowing the simple, transparent calculation of a "smooth-flowing" curve path. For stability reasons, it is inadvisable to create mark-ups on the basis of maturity bands or to extrapolate the yield of the last maturity band or the yield of the bond with the longest maturity. The longest bond method takes 100% account of any yield changes experienced by individual bonds, while the last maturity band approach considers 8%. By comparison, if the average yield of all bonds is extrapolated, this figure stands at a mere 0.4%.⁵ Despite the limited duration⁶ of the average across all bonds, the position of the resulting mark-up is just a few basis points below that of a mark-up calculated, say, solely on the basis of the yield of the last maturity band. This is a consequence of the way in which the maturities of the individual bonds are distributed as well as of the dispersion of their average yields. Over 50% of the bonds fall into the bottom two maturity bands (up to five years). The average maturities in the bands have a dispersion of two to eleven years, while the corresponding average yields lie within a much narrower range of 2½% to 5¼% per annum. Given this fact, the high number of bonds with shorter maturities is inclined to reduce the maturity rather than lower the yield.

Discount rates

In line with these principles, the Bundesbank calculates a zero-coupon interest rate swap curve using euro-denominated plain vanilla swaps. Under a plain vanilla swap, the counterparties exchange fixed, as a rule annual interest payments for a floating interest rate, usually the six-month EURIBOR, quoting full-year maturities up to and around

index contains 287. — 6 Duration refers to a maturity period adjusted for any payments (coupon payments) which occur during the maturity period. In the case of the zero-coupon swap curve, the maturity and the duration coincide as payments become due exclusively at the end of the maturity period. — 7 For more specific information on the raw data, conversion, interpolation and calculation of the mark-up, see the Regulation on the Discounting of Provisions, Federal Law Gazette I of

the 50-year mark. As interest payments are exchanged throughout the entire duration of the transaction – in most cases once a year – the fixed interest rates for such swaps are converted into zero-coupon swap rates.⁷ Missing or illiquid and therefore unused maturities are interpolated, on the assumption that forward interest rates will remain constant. This makes it possible, particularly in the long-term maturity segment where trading is concentrated on "round" maturities, to deliver a smooth-flowing curve. The rates used for the discounting of provisions are ultimately generated by imposing a uniform mark-up. The discount rates and the uniform mark-up applied across the entire swap curve clearly demonstrate the smoothing effect that is achieved through averaging (see chart below). The relevant rates are published every month on the Bundesbank's website.⁸



25 November 2009, pp 3790-3791, and refer to the Federal Ministry of Justice website at www.bmj.bund.de. — 8 See online documentation under Areas of interest, Statistics > Interest rates, yields at www.bundesbank.de/statistik/statistik_zinsen.en.php.#abzinsung. The interest rates listed there can also be downloaded as an excel file or as a time series.

Intragroup lending may be relevant for large exposure purposes

number 4 of the German Commercial Code has been added – as to what constitutes control with regard to the formation of single borrower units. However, in individual cases, institutions and auditors seem to take different views on the need to consolidate SPEs in accordance with the German Commercial Code. This is probably due primarily to the legal implications that HGB consolidation has in terms of limiting large exposures to SPEs. For this reason, the legality of the impact of section 290 (2) number 4 of the German Commercial Code on the formation of single borrower units on the basis of the new criteria on what constitutes a group is being questioned by sections of the banking industry. Yet the very objective was that credit institutions should not be able to circumvent prudential ratios by transferring assets to SPEs, ie that they do not, for example, undermine upper large exposure limits by setting up more and more SPEs. However, German bank supervisors have yet to adopt a final stance in this question and define the scope of application. Their task will be to ensure that the aim behind the expansion of the HGB consolidation rules, namely to prevent the circumvention of consolidation requirements, is taken into account in connection with the large exposure limits, too.

Information in the notes (section 285 of the German Commercial Code)

Information in the notes adjusted to comply with new rules ...

With the Act Modernising Accounting Law, the information to be given in the notes pursuant to section 285 of the German Commercial Code has also been adjusted.

The changes reflect experiences made in the financial crisis and seek to improve transparency in the areas in which measures to internationalise the German Commercial Code have tended to water down the principle of prudence.

The most important changes concern the extended or added compulsory information about off-balance-sheet transactions as well as about (derivative) financial instruments and valuation units.

The revised section 285 number 3 of the German Commercial Code requires that information be given concerning the type and purpose, as well as the risks and rewards of transactions not shown in the balance sheet, if this information is necessary for assessing the financial situation of the company in question. In particular, the experiences made in the financial crisis, which revealed that risks had been masked by transferring them to off-balance-sheet SPEs, led to the inclusion of this provision, under which information must be provided on transactions which might be linked, above all, to SPEs or offshore transactions, except where they are already consolidated anyway.

... in terms of off-balance-sheet transactions, ...

Under the revised number 19, information now has to be provided on derivative financial instruments that are not stated at fair value. By contrast, the notes are not required to contain information about the derivative financial instruments assigned to the trading portfolio (section 340e (3) of the German Commercial Code).

... derivative financial instruments not stated at fair value, ...

... financial instruments in the trading portfolio and ...

Related to the above, under number 20, information on financial instruments assigned to the trading portfolio is compulsory. In particular, details have to be provided on the basic assumptions made when determining fair value using generally accepted valuation methods.

Regulation. Moreover, information also has to be given on, for example, the method used to determine the risk haircut, the reasons for any reclassifications, the amount of the reclassified financial instruments as well as the effect of the reclassification on the annual result. Information must, moreover, be provided on the extent to which the institutions' internal criteria for the inclusion of financial instruments in the trading portfolio have changed during the financial year, and on the impact this has had on the annual result.

... explanation of risk haircut, reclassifications and change of definition

... valuation units

Number 23 stipulates that the valuation units in accordance with section 254 of the German Commercial Code be broken down by hedged risk; additionally, a differentiation is to be made between the types of valuation units formed, with anticipatory valuation units to be shown separately. Moreover, information on the effectiveness of each valuation unit has to be included. And finally, the notes must show how this ties in with the company's risk management.

The pro-rata amount of the net income from the trading portfolio to be allocated to the fund for general banking risks in accordance with section 340e (4) of the German Commercial Code must be reported separately.

Risk reserve from trading income

Changes to the Credit Institution Accounting Regulation

Alignment of Credit Institution Accounting Regulation

The changes made to the Act Modernising Accounting Law also have implications for the Credit Institution Accounting Regulation.

The new forms 1 (balance sheet), 2 and 3 (profit and loss account – account form and staggered form) of the Credit Institution Accounting Regulation as a result of the revised version of the German Commercial Code following the Act Modernising Accounting Law are available in the internet.¹⁴

Forms adjusted

Breakdown of the trading portfolio, ...

In addition to the introduction of the trading portfolio as a balance sheet item, the requirement for the notes to contain a breakdown of the asset-side trading portfolio into derivative financial instruments, claims, debt securities and other fixed-income securities, shares and other variable-yield securities as well as other assets, and of the liabilities-side trading portfolio into derivative financial instruments and liabilities, has been anchored in section 35 (1) of the Credit Institution Accounting

Accounting rules will always be subject to change. International accounting in particular having lost some of its credibility in the wake of the financial crisis, it is vital to rebuild confidence. German legislators have made a valuable contribution to re-establishing the credibility of financial reporting with the Act Modernising Accounting Law.

Act Modernising Accounting Law key to restoring lost confidence

¹⁴ The forms are available at http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_dokumentation_verordnungen.en.php.