Directive for Implementation and Quality Assurance of the Current Supervision of the Credit and Financial Service Institutions by the Deutsche Bundesbank (*Supervision Directive*)

NON-BINDING TRANSLATION

in its version of the announcement of: 21 February 2008

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As a result of § 7 Paragraph 2 Clause 2 of the German Banking Act (*KWG*) in its version of the announcement of 9 September 1998 (BGBl. I p. 2776), last amended by Article 2 No. 9 of the Law on Integrated Finance Provider Supervision of 22 April 2002 (BGBl. I, p. 1310), the Federal Institute for Financial Services Supervision (*BaFin*) – in consultation with Deutsche Bundesbank – enacts the following directive (*Supervision Directive*):

Preamble

Being responsible administration body pursuant to § 6 Paragraph 1 of the *KWG*, the *BaFin* performs the supervision over the institutions according to the *KWG*. § 7 Paragraph 1 *KWG* rules the cooperation between *BaFin* and Deutsche Bundesbank (in the following: *Bundesbank*) regarding the current supervision of the institutions by the *Bundesbank*.

According to § 7 Paragraph 2 Clause 2 *KWG*, the *BaFin* directives regarding the current supervision are enacted in consultation with the *Bundesbank*. These directives and, thus, the *Supervision Directive*, serve the purpose of uniformity and quality of banking supervision acting as well as of a transparent separation of duties without overlapping. *Bundesbank* and *BaFin* shall comply with these directives in the course performing the current supervision.

The *Supervision Directive* shall also serve the purpose of substantiating the risk-oriented approach of the banking supervision, such approach having been laid out in Article 124 of the Directive 2006/48/EG of the European Parliament and the Council of 14 June 2006 on the commencement and exercise of the activity of the credit institutions (Banking Directive) and the according guidelines of the Committee of the European Banking Supervisory Authorities (CEBS). Article 124 of the Banking Directive implements the Supervisory Review Process (SRP; banking supervising examination process) which comprises the SREP (supervisory review and evaluation process, banking supervision and evaluation process).

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SREP commits the supervision to review the risk management of the institutions at least once per year, thereby assessing present and potential risks and to make allowance for the extent and relevance of the risks for the institution and for the importance of the institution for the financial system.

The relevant instruments for implementation of this risk-oriented approach of the supervision in Germany are – based on an accordingly oriented investigation of the facts – the risk classification, the risk profile and the risk-oriented supervision plan based thereupon.

1. Part: Principles of the Cooperation

1. Sub-part: Duties and Responsibilities

Article 1 Principles of the supervisory review and evaluation process (SREP)

The risk-oriented supervision focuses on the supervisory review and evaluation process (SREP). It comprises:

(i) investigation of the facts
(ii) analysis and assessment of present and potential risks based on the investigated facts
(iii) a summarizing and future-oriented evaluation of all information
(iv) evaluation-based decisions on supervisory measures and their implementation and
(v) risk-oriented supervision planning.

Article 2 Current Supervision by Deutsche *Bundesbank*

(1) The *Bundesbank* shall, within the scope of the SREP, assume the duties of current supervision according to § 7 Paragraph 1 *KWG*. The current supervision comprises, in particular, the investigation of facts, the analysis of the incoming information to be raised and the resulting assessment of present and potential risks.

(2) The results and assessments of the current supervision shall immediately be provided by the *Bundesbank* to *BaFin*, so that the latter can make a final evaluation and decision on the facts. Any discrepancies regarding the documents which have to be submitted regularly shall independently be clarified by the *Bundesbank* with the institutions, as the case may be, within the scope of right of access (§ 44 Paragraph 1 P. 1 *KWG*).

(3) An analysis within the meaning of this Directive means that received information is summarized and processed according to their significance for the duties of the banking supervision. In the following, evaluation means the assessment of the consequences of facts for the respective institution and its significance for the banking

supervision. The information to be analysed and assessed by the *Bundesbank* within the current supervision shall, in particular, be included in the documents submitted by the institutions, in the audit reports according to § 26 *KWG* and the annual financial statements. Furthermore, the information resulting from implementation and analysis of the banking business examinations shall be assessed. The *Bundesbank* summarizes the findings gained from the current supervision and their assessments to a risk profile. The risk profile comprises, in particular, an evaluation of the risks of the institution, its organisation and internal control procedures as well as an estimate of its risk capacity.

Article 3 Supervision by *BaFin*

(1) The *BaFin* shall finally assess in a future-oriented summary,

- whether the risks occurred to the institutions are covered by regulations, strategies, procedures and mechanisms which guarantee a solid risk management and risk coverage and

- whether the institution has ensured that the occurred risks are covered by adequate capital resources.

Relevant basis for the evaluation is the risk profile of the institution. Irrespective of the authorization of the *Bundesbank* for assessment of the examination findings, the *BaFin* possesses the final evaluation- and decision authorization regarding all measures of supervisory law and questions on interpretation. Nevertheless, the *BaFin* is usually supported by the *Bundesbank* in its decision-making processes.

(2) *BaFin* shall make all decisions on supervisory measures on basis of its evaluation. These are, in particular, general decrees and administrative acts including all examination orders. In addition, *BaFin* makes the planning decisions within the supervision planning regulated in Article 10. Previously, and during implementation of severe supervisory measures, a close coordination regarding supervisory activities takes place between *BaFin* and *Bundesbank*.

2. Sub-part: Cooperation

Article 4 Cooperation, in particular regarding certain institutions

The *Bundesbank* shall also be responsible for the current supervision of institutions according to Article 5 to 7.

Article 5 Problem Institutions

(1) In case of problem institutions, it is necessary to intensify the current supervision, in particular by detailed analyses of the risks and their possible consequences on the risk capacity of the institution. These detailed analyses and evaluations shall be presented in the risk profile. Due to the necessary intensification of the supervisory activities with these institutions, a close cooperation between *Bundesbank* and *BaFin* is required.

(2) The *BaFin* closely investigates the findings and assessments made by the *Bundesbank* during the current supervision in order to achieve a final supervisory evaluation and to prepare or implement any supervisory measures. If the present information for a final evaluation does not suffice, the *BaFin* may at any time entrust the *Bundesbank* with the additional clarification of facts and request detailed analyses of the *Bundesbank*.

(3) Problem institutions means institutions whose economic situation gives cause for concern, at which severe supervisory conclusions have been made or supervisory measures are to be prepared or introduced. *BaFin* and *Bundesbank* jointly generate a list of the problem institutions.

Article 6 System-Relevant Institutions

(1) In case of system-relevant institutions, an intensification of the current supervision is required, in particular by incoming analyses of the risks and their possible consequences on the risk capacity of the institution. These detailed analyses and evaluations must be laid down in the risk profile.

(2) Due to the necessary intensification of the supervisory activity with these institutions, a close cooperation between *Bundesbank* and *BaFin* is required. The *BaFin* closely investigates the findings and assessments made by *Bundesbank* in the course of the current supervision in order to achieve a final supervisory evaluation and to prepare or implement any supervisory measures. In case the present information for a final evaluation does not suffice, the *BaFin* may at any time entrust the *Bundesbank* with an additional clarification of the facts and request detailed analyses of the *Bundesbank*.

(3) System-relevant institutions are institutions whose existence endangering would, due to their size, their intensity of inter-bank relationships and their close integration with foreign countries, cause severe negative consequences with other credit institutions and, therefore, would lead to instability of the financial system. The assessment as system-relevant institution takes place amicably between *BaFin* and *Bundesbank*.

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Article 7 Supervision-Intensive Institutions

(1) In case of supervision-intensive institutions, further supervisory information is required from the current supervision, in particular due to significant developments, the summarizing evaluation in the risk profile or definition of a focus in the examination planning. This higher need for information requires a detailed cooperation and communication between *BaFin* and *Bundesbank* in order to timely initiate the necessary supervisory measures in the course of preventive supervision.

(2) In general, supervision-intensive institutions are institutions from whose information available to supervision negative development potentialities can be assumed. An according categorization of an institution is also possible if, due to its significance for the whole market or a relevant part thereof, a special supervisory interest exists or a detailed view for purposes of a comparison is supposed to be achieved. *BaFin* and *Bundesbank* jointly prepare a list of supervision-intensive institutions.

Article 8 Further Principles of the Cooperation

(1) *BaFin* and *Bundesbank* shall timely provide each other with information they need for assumption of their duties. The *BaFin* shall immediately inform the *Bundesbank* about all supervisory decisions made by it. *BaFin* and *Bundesbank* shall submit to each other copies of all letters they create during the current supervision. The filed documentation must allow a processing of the individual facts by *BaFin* and *Bundesbank* at any time.

(2) In order to avoid redundant work, plans and projects of general relevance for the supervision shall be coordinated between *BaFin* and *Bundesbank*. These plans and projects are of general relevance if they serve the purpose of developing the supervisory law and the supervisory instruments.

3. Sub-part: Instruments of the banking supervision- and evaluation process

Article 9 Risk Profile

(1) The risk profile comprises an evaluation of all risks of the institution, its organisation and internal control procedures as well as its risk capacity. The *Bundesbank* shall evaluate in a risk-oriented manner the collected facts under consideration of all risks from the business activity of the institution and its risk management in the risk profile. The generation of the risk profile takes place on basis of the structure and evaluation system developed therefore by *Bundesbank* and *BaFin*. The risk profile shall be generated by the *Bundesbank* at least once per year as of 30 September and submitted to the *BaFin* for adjustment and decision. Furthermore, the *Bundesbank* carries out an intra-year update in case of essential additional information, in particular, if the evaluation of the institution in relevant partial areas or the risk classification would change.

(2) The evaluations and classifications must allow the *BaFin* – on basis of the risk profile of the institutions - to adequately assess the supervisory need for action or further information. The *Bundesbank* shall, if necessary, suggest further supervisory treatment of the institution and shall justify it risk-oriented and under consideration of the financial strain on the institution.

Article 10 Supervisory Planning

In order to guarantee a coordinated and risk-oriented approach of the supervision, the *Bundesbank* shall, on basis of the estimates in the risk profile and the relevance of the institutions, suggest the supervisory planning for the following year until 31 October each year and coordinate it with the *BaFin* which shall submit their final comments until 15 December. In doing so, the *Bundesbank* shall define a focus based on the individual risk profile, the relevance of the institution for the stability of the financial market and the potential importance of the handling of individual cases. The supervisory planning comprises, in particular, the analysis of the examination reports, the supervision discussions, the examinations according to § 44 *KWG* and, as the case may be, the determination of examination focuses according to § 30 *KWG*. Planning decisions in the course of the supervisory planning shall be made by the *BaFin* on basis of a proposal of the *Bundesbank* after discussion on the supervision strategy. Deviations to the supervision planning caused by a certain event can be made upon consultation with the *Bundesbank*.

Article 11 Announcement of Supervisory Decisions

(1) After consultation with the *Bundesbank*, the *BaFin* renders final statements on the compatibility of concrete or abstract facts with the respectively relevant legal norms, announcements, circulars or other supervisory regulations.

(2) The examination findings and evaluations made by the *Bundesbank* in the course of the current supervision shall usually be taken as basis for the supervisory measures by *BaFin*.

(3) *BaFin* shall instruct the institutions to avoid the discovered shortcomings. It is in particular responsible for determination of the contents and the timeframe of avoidance of these shortcomings. This shall apply, irrespective of whether the shortcomings have been discovered during the annual audit, during banking or other examinations according to § 44 *KWG* or by other sources. After approval by *BaFin*, the instruction to avoid the shortcomings may take place by the *Bundesbank*. The supervision of such avoidance takes place in the course of the current supervision.

(4) In case of important, problematic or supervisory-intensive institutions, the announcement and explanation of the final assessment of the institution with the help of the risk profile takes place during event-driven discussions. In other cases, the announcement and explanation of the risk profile agreed upon between *BaFin* and *Bundesbank* may also take place in routine discussions.

2. Part: Instruments of Supervision for Risk Detection

1. Sub-Part: Instruments of Knowledge Gain

Article 12 Supervision Meetings

(1) Supervision meetings are carried out routinely or in relation to a certain event. The frequency, duration and intensity of the discussions shall adequately reflect the importance of such event.

(2) Routinely supervision meetings with individual institutions shall in particular serve the purpose of a regular discussion of the economic development, the risk situation as well as the general business situation of the institutions on basis of the analysed annual financial statement documents. Such meetings may, after consultation with the *BaFin*, also concern the avoidance of shortcomings for which the taking of measures does not seem to be necessary. The meetings are generally carried out by the *Bundesbank* once per year; however, with small institutions whose solvency is guaranteed and which are unremarkable as regards supervision, yearly supervision meetings are not necessary. *BaFin* is entitled to attend such meetings. Routinely meetings shall be planned by the *Bundesbank* in a timely manner so that the *BaFin* is able to attend. If it does not attend, it shall be informed about the results in time.

(3) Subject matter of supervisory meetings relating to a certain event is facts or issues which, due to significant developments at the institutions, require special supervisory attention. Such meetings may be initiated by *Bundesbank* or *BaFin*; they shall respectively be coordinated between *BaFin* and *Bundesbank*. The respectively other institution is entitled to attend. In case it abstains from attending, a timely notification shall be ensured.

Article 13

For discussions with auditors or other third parties on individual institutions, Article 12 (Supervisory Meetings) Paragraph 2 or 3 shall apply.

Article 14 Analysis of the Annual Financial Statements and Audit Reports according to § 26 *KWG*

(1) The *Bundesbank* analyses the annual financial statements and audit reports according to § 26 *KWG*. In order to guarantee a high quality standard, it shall apply analysis criteria jointly developed by *BaFin* and *Bundesbank*. The *BaFin* may, if necessary, determine that certain aspects of the analysis requiring special attention have priority. The results of the analysis shall be part of the risk profile of the institution.

(2) The *Bundesbank* shall prepare an analysis report for each institution in which it explains its findings in reasonable form. In order to guarantee a high quality standard, it shall apply uniform evaluation criteria jointly developed by *BaFin* and *Bundesbank*.

(3) In case of non-problematic institutions, the preparation of a short note instead of an analysis report may – with regard to a risk-oriented supervision – suffice, provided *BaFin* and *Bundesbank* have agreed thereupon.

(4) The analyses by the *Bundesbank* shall take place according to the potential urgency of the cases and depending on the risk situation of the institution as well as the severity of the findings in previous audit reports. Details shall be determined in the supervision planning which might be adjusted during the year.

Article 15 Information Inquiry

In case of information inquiries which concern several institutions, *BaFin* and *Bundesbank* shall consult each other regarding necessity and contents of the information to be raised. In consultation with the *BaFin*, the information shall be raised and analysed by the *Bundesbank* or, in exceptional cases, by the *BaFin*, and shall be made known to each other. The authorization of the *Bundesbank* to require information with regard to its responsibility in the area of finance stability remains unaffected.

Article 16 Order and Analysis of Audits according to § 44 *KWG*; Other Audits

(1) The *BaFin* shall instruct the institutions to carry out audits according to § 44 Paragraph 1 Clause 2 and § 44b Paragraph 2 Clause 1 *KWG* and submits the audit order, provided it is an audit by the *Bundesbank*, to the main office of the *Bundesbank* which shall, via the head office for the institution, notify the institution of the composition of the audit team. The *Bundesbank* shall thereby be in charge of the composition of the audit team.

(2) Provided the audit order is submitted to third parties, the *BaFin* shall, by submission of a copy of the order, inform the *Bundesbank* thereof and shall ensure that a copy of the audit report will also be sent to the *Bundesbank* after its finalization.

(3) *BaFin* and *Bundesbank* shall consult each other upon the implementation and analysis of the audit reports of audits relating to a certain event. All other audit reports including the reports on audits of public and private deposit guarantee institutions shall be analysed by the *Bundesbank*. If decrees of supervisory measures due to severe findings become necessary, the *BaFin* may carry out detailed analyses.

(4) In case of routine audits, the *Bundesbank* shall provide the analysis reports to *BaFin* within two months upon receipt of the audit reports. In case of audits having been carried out by the *Bundesbank*, the latter shall provide the audit report to *BaFin* within two months upon conclusion of the audit. In critical cases, a shorter submission period may be agreed upon with *BaFin*.

Article 17 Banking Business Audits

(1) The audits according to § 44 *KWG* also comprise the banking business audits (§ 7 Paragraph 1 *KWG*) for assessment of the adequate equity capitalization and risk management methods of the institutions. Such audits are the banking business audits according to § 44 *KWG* which take place in the course of the supervisory review and evaluation process (SREP) for compliance with § 25a *KWG*, and are subject to the MaRisk, aiming at the adequacy of risk management, as well as audits regarding supervisory admission and for current control (post-review) of internal risk measurement procedures (at present: IRBA, AMA, market risk, liquidity models). Banking business audits do not mean audits regarding recoverability of liabilities and the collateral granted therefore as well as regarding risk precautions in the credit business, as carried out by the auditors during audits of the annual financial statements or special audits.

(2) The banking business audits, being part of the current supervision of the *Bundesbank* is, according to § 7 Paragraph 1 *KWG*, incumbent upon the *Bundesbank* and shall, in general, be implemented by their head offices. In exceptional cases, the *BaFin* may implement them itself or, upon consultation with the *Bundesbank*, commission third parties with the implementation of banking business audits. In case of audits of the *BaFin*, Paragraph 3 shall apply accordingly.

(3) The *BaFin* may participate in audits by the *Bundesbank*; employees of the *BaFin* may, upon consultation with the *Bundesbank*, carry out audit activities and examine individual audit areas in the scope of the audit order.

(4) Peculiarities which are discovered during the implementation of a banking business audit shall immediately be announced to the *BaFin* and the responsible head office.

2. Sub-part: Regulatory and Information Reporting

Article 18 Supervisory Information and Regulatory Reports pursuant to the *KWG* or Legal Provisions subject thereto

(1) Regulatory reports according to the *KWG* and legal provisions enacted on basis of the *KWG* shall be processed by the *Bundesbank*. If necessary, it investigates the facts further on, evaluates them and presents them to *BaFin* in a timely manner. It shall immediately inform the *BaFin* about any peculiarities and critical developments. In this context, it may render a statement vis-à-vis *BaFin* and make further proposals regarding the next steps. The final supervisory evaluation of and decision on the facts is incumbent upon the *BaFin*.

(2) When processing the different facts of the information report, *BaFin* and *Bundesbank* shall, due to the special urgency of the underlying facts, agree with each other on the further steps (in particular in cases of §§ 2c, 28 Paragraph 1 or 29 Paragraph 3 *KWG*) upon receipt of the notice already. The final supervisory decision is incumbent upon the *BaFin*.

3. Sub-part: Data Processing

Article 19 EDP

(1) The *Bundesbank* enters and analyses any notices, reports as well as contents of the annual financial statements, audit reports and information according to § 25 *KWG* into the EDP. It guarantees the unlimited access of *BaFin* to all data and information collected by the banking supervision; this also includes the information raised in the course of the Monthly Balance Sheet Statistics.

(2) The IT framework shall be agreed upon between *BaFin* and *Bundesbank*. Details shall be decided upon unanimously.

3. Part: Final Provisions

Article 20 General Questions on Application of the Directive

Individual questions of general importance regarding application of this directive are discussed between *BaFin* and *Bundesbank* on a regular basis. Further regulations on the supervisory processes and interfaces between *BaFin* and *Bundesbank* shall be defined by *BaFin* in consultation with the *Bundesbank* in a demand-oriented manner.

Article 21 Effectiveness

This directive becomes effective immediately. It replaces the directive of 10 October 2003.

Bonn and Frankfurt am Main, 21 February 2008

Jochen Sanio