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GESCHÄFTSZEICHEN **I 4 - 62 - 9/2001** (BEI ANTWORT BITTE ANGEBEN)

Exposure draft of proposed amendments to IAS 32 (Financial Instruments: Disclosure and Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement)
Joint statement of Federal Financial Supervisory Authority (BAFin) and Deutsche Bundesbank

Dear Sirs

In June 2002, the International Accounting Standards Board (IASB) issued the above-mentioned exposure draft for comments. We welcome the opportunity to respond to this important contribution to the ongoing project of international harmonisation of accounting standards. This comment letter has been prepared in close cooperation with the Deutsche Bundesbank, which shares the opinion expressed in this letter.

From a banking supervisory point of view, IAS 32 and IAS 39 are important standards because both deal with financial instruments which are key to banking business as well as to the functioning of the financial markets and the financial industry as a whole. Well-defined accounting standards are therefore needed for such instruments. Banking supervisors share an interest in reliable, prudent, comprehensive and clearly developed accounting standards owing to the simple fact that the regulatory capital regime is based on the figures which stem from the financial statements. Additionally, regulators try to promote stable and transparent accounting procedures as a prominent factor in enhancing market discipline and improving bank's risk management techniques.

Ab Freitag, den 31.05.2002, sind die Dienstsitze Bonn **und** Frankfurt/M. der **Bundesanstalt für Finanzdienstleistungsaufsicht (BAFin)**, unter folgenden Telefonnummern zu erreichen: 0228/4108-0 **IVBB:** 01888/436-0, **FAX Bonn:** 0228/4108-1550, **FAX Frankfurt/M.:** 0228/4108-123

Owing to the importance of IAS 39 for the financial sector and bearing in mind the fact that the discussion on it is complex and sometimes marked by diverging opinions, we are confining our comments on this standard to a number of issues which are of particular interest from a supervisory point of view. These issues are hedging, the held for trading or fair-value designation, derecognition and impairment. We shall not respond directly to the questions set out in the invitation to comment on the document.

(a) Hedge accounting

The exposure draft on hand deals with the hedging issue with regard to firm commitments only. We understand that it was not the objective of the proposed amendments to reconsider the fundamental approach to accounting for financial instruments established by IAS 32 and IAS 39. Therefore, this project has not been used to rethink the current hedging rules of IAS 39 as a whole. However, we have doubts as to whether this is the right way to deal with this controversial issue, which has been the subject of intense discussion in terms of the questions and answers of the IAS 39 Implementation Guidance. It is our impression that these discussions do not seem to provide a sufficient answer to the problems of banks in implementing IAS 39 in their internal accounting systems.

There must be a common understanding among banks and external auditors of the application of accounting standards and of what is in accordance with IAS 39 and what is not. As a matter of principle, accounting standards have to ensure a fair presentation of the business of an enterprise. Within this context, it is said that financial information should be provided to the public 'through the eyes of the management'. Accounting standards should not be in contradiction of these guiding principles, and the implementation of standards should not hamper the most advanced and highly sophisticated risk management procedures of banks. This is one of the central concerns of banking regulators with regard to the implementation of IAS 39. Regulators are convinced that it is helpful for reporting and accounting requirements for internal risk management and external use to be comparable or similar to a maximum extent. This will ensure that the banks give to the users of their financial statements a comprehensive picture of the basic figures used for internal risk management procedures as well. Additionally, it is expected that such comparability of internal and external information will improve risk management techniques and provide the users with reliable information for assessing the quality of the management.

The current hedging rules in IAS 39 will lead to a situation where the internal risk management and the internal risk reporting procedures deviate to a significant extent from the reporting for external accounting purposes. The hedging rules allow, as a matter of principle, the designation of derivatives to individual assets and liabilities or specific transactions. That means that, basically, IAS 39 accepts micro hedges only. However, it is no longer the common practice of banks to hedge risk on a so-called micro basis or deal by deal basis. Instead, banks, regularly use more effective risk management techniques which manage and control risk on a portfolio basis or net basis.

As a result, there are clear signals that the IAS 39 hedging requirements do not mirror modern risk management techniques. We are aware of the IASB's concerns that macro-hedges or portfolio-hedges could be used for an active earnings management with the aim of blurring a bank's real economic situation, and it is in the clear interests of the regulators to avoid such a tendency. Therefore, it is necessary to set strict requirements when such hedging procedures are used for accounting purposes, for example, a clear definition of hedges and measurable, effective and sufficiently documented strategies. Within this context, we think that it might be useful to take into account the existence of well-developed and reliable risk management procedures. It is clear that an efficient use of internal information for external purposes has to be based on fundamental principles which assure a fair and unbiased presentation of a bank's economic situation. For these purposes, different rules and organisational frameworks already exist. In particular, there are supervisory requirements for the organisation of risk management. For example, the Basel Committee has issued various documents dealing with this aspect (Framework for the evaluation of internal control systems, January 1998; Risk management guidelines for derivatives, July 1994.). In addition, the German Banking Supervisory Office (a predecessor of BAFin) published a paper in 1995 on "Minimum requirements for the trading activities of credit institutions" (copy attached). These requirements concern *inter alia* the organisation of trading and back office activities and the functioning of a risk management and risk controlling system. The compliance of the bank's organisation with these rules is checked regularly during the annual audit and in the course of special audits by the supervisory authorities or by specially appointed auditors. Furthermore, in Germany a disclosure standard (DRS 5-10) dealing with the risk reporting of banks to the public is published by the German Accounting Standards Committee.

As a result, there is a clear tendency for the existence of commonly accepted rules to improve bank's risk management. This provides a reliable source for a clear documentation of hedge relationships, not only for micro hedges but also for macro and portfolio hedges. At all times, a clear picture should be available on what transactions are within a portfolio, the values of these transactions and the remaining net position subject to a qualified hedging derivative.

When using information derived from internal risk management systems for accounting purposes, the issue of internal contracts is involved, as such risk management systems inevitably work on the basis of internal contracts. Therefore, there has to be further discussion of this topic in the context of hedge accounting. For such a discussion, it would seem helpful that one crucial prerequisite for the recognition of such contracts has to be a strict market orientation of the transaction. This would mean a prohibition of antedating such contracts or generating such contracts by using non-market quotes. This is, of course, already crucial for the banks' own management since breaches of these principles completely destroy the reliability of the whole risk management process. Additionally, it seems possible to design such contracts in a way that is neutral in respect of the income statement. However, such a result would require that all items forming part of the contract have to be measured using the same approach. This implies that the value adjustment of a net position in the banking book because of the hedged risk would be compensated by the value adjustment of the hedging derivative in the banking book, whereas this hedging derivative would appear in the trading book with its reverse value, thus transferring the open position with its earnings impact and volatility from the banking book to the trading book but still leaving it within the bank.

As a result, there are still some approaches which could be developed further on to reconcile external accounting information and internal risk management information as a prerequisite for allowing hedges on a macro or net basis for accounting purposes as well. There seem to be ways of simplifying the hedging rules in the standard since the deviation between fair value hedges and cash flow hedges is an artificial one which allows management discretion and the use of the different effects of these methods on earnings and capital. Further elaboration on the fair value hedge as the only method seems to us to be a promising approach. We have no problems with the IAS 39 approach of showing all derivatives with their fair value on the balance sheet but exploring more possibilities of simplification may be useful, for example, to allow a so-called 'short cut method'. This method allows a value adjustment of the hedged item equal to the fair value adjustment of the hedging derivative, under the condition, of course, that the effectiveness of the hedge is proven with sufficient documentation by the risk management system. Concerning hedges, consistency would appear to be necessary on all value adjustments going to P&L.

In order to develop relevant standards, it would be useful to explore such possible approaches in close cooperation with banking practice. We take the view that it would be valuable for the IASB to consider steps in such a direction

(b) Held for trading or fair value designation

The proposal to permit any financial instrument to be designated as a trading item when initially recognised is sometimes felt to be beneficial, particularly in respect of an easier application of certain hedge transactions. It is our impression that this will not solve the problem because there is a difference between measuring the hedged item at fair value - as proposed with the held for trading designation - and adjusting the value of the hedged item to the extent of the hedged risk, in accordance with the current hedge accounting rules of IAS 39. As a consequence, the proposed simplification of hedges leads to the problems of fair value accounting for items within the banking book which, usually, are not traded on deep and liquid markets and where, therefore, no reliable fair value exists. The held for trading or fair value designation renews the problems associated with an extensive application of fair values. The main problem, as mentioned during the discussion of the Exposure Draft of the Joint Working Group of Standardsetters, is that, for a lot of financial instruments, an active or liquid market does not exist and a method of reliably measuring a fair value is not available. This means that the concerns expressed during the discussion of the Exposure Draft of the Joint Working Group of Standardsetters, ie whether the majority of financial instruments can be measured in a reliable and transparent manner, are still relevant. Furthermore, the problem of recognition of own creditworthiness and the reporting of increased profits in the case of an impairment of own creditworthiness will arise again.

In addition to this, we would have serious concerns about the comparability of annual accounts in general if the fair value option enters IAS 39. One aspect is the creation of a new and artificial category ‘held for trading” not fulfilling the trading definition, which will not enhance transparency. We admit that you are trying to solve this problem with the label ‘financial instruments at fair value’ (IAS ED 39.18A), but this will further increase the complexity of financial information. Therefore, we would prefer to return to a clear definition of (short-term-oriented) trading . Another and, perhaps, more important aspect is the possibility of ‘cherry picking’. Every user of IAS 39 would be able to decide individually whether, and to what extent, financial instruments are measured at fair value or at cost. This can be used to manage the overall earnings of the company.

(c) Derecognition (continuing involvement approach)

In principle, we support any approach assuring the recognition and reliable measurement of all remaining risks in the financial statements. This aspect is extremely relevant in the case of traditional and synthetic securitisation transactions and the accounting for Special Purpose Entities.

The proposed continuing involvement approach may have some theoretical advantages but it seems there is at least a need to elaborate in greater detail the concrete application of this approach. The concept as described in IAS ED 39 is relatively vague and unclear. It works with numerous assumptions which could make a fair presentation difficult. In this context, showing the whole amount of an asset should be avoided if only a minor risk remains at the reporting entity. To comply with this, it would seem more promising to apply a components approach showing a guaranty for parts of a transferred credit risk as a contingent liability. A transfer of an asset should not appear as a loan granted. A guaranty covering parts of transferred credit risk should not appear as a liability but as a contingent liability since there is no unconditional obligation to pay to a third party. If there is a reasonable probability of paying, for example, to the extent of expected losses within a transferred portfolio, the liability item ‘accrued expenses’ would be more appropriate. Additionally, having an asset appearing in a balance sheet of more than one company should be avoided.

We share the view that there is a need for consistent and internationally harmonised rules on derecognition which do not confuse the reader of a financial statement. So far, it seems to be easier to follow a components approach that assures the recognition of only the remaining risk. Therefore, in the case of a partial risk transfer, it is more appropriate as an initial step to derecognise the asset completely and, as a second step, to book some kind of liability for the remaining risk. Such an approach seem to be less complex and more transparent than the proposal of the Exposure Draft.

(d) Impairment

We agree with the proposal that a loan asset or financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment. From a supervisory point of view, such a rule would be a major step in the right direction since it would assure a prudent and timely recognition of risk provisions for large portfolios. Furthermore, it would reflect common accounting practice in many countries.

In respect of the measuring concept, however, we think it would be useful not only to rely on the discounted cash flow approach (which might be helpful for large loans or large portfolios), but also to accept the traditional concept of historic loss rates to provide for the general credit risk. It is unclear whether the discounted cash flow method will generate better results in all cases. It is more likely that the often-used historical method will lead to more or less the same results as the discounted cash flow concept. Therefore, the information gain of allowing only one method is limited. In addition, the estimation of expected cash flows might be difficult for small and medium-sized banks, which us usually assess groups of assets collectively for impairment in a reliable manner by using historical data.

In respect of a practical application of the rule, it would seem useful not to exclude newly originated loans from the concept. Compared with the overall portfolio, the portion of such loans is normally not large but it is common practice not to make a distinction between “new” and “old” loans in the case of a group assessment. Furthermore, it is necessary to assess the value of any loan - irrespective of whether it is “new” or “old” - at the balance sheet date and it therefore makes sense to include any non-impaired loan in the collective evaluation for impairment

Final remark

We hope these remarks will be helpful for the further discussion and development of the standard. We perceive the need for further elaboration of the standard by the IASB in close contact with Bankers and international regulators and would welcome the opportunity to make further contributions to this project. It is a key standard, not only (primarily) for the banking industry, but also for the financial sector as a whole and other companies using financial instruments. Therefore, the standard has to consider all existing methods of dealing with financial instruments and allowing the application and further developments of highly sophisticated risk management procedures.

Yours sincerely

Thomas Schmitz-Lippert

This letter has been mailed electronically; it does not have a signature.

Text der Mindestanforderungen (engl., BBk-Übersetzung)

Statement covering Minimum requirements for the trading activities of credit institutions (BBk-Übersetzung)

Contents

1 Range of application

This Statement contains minimum requirements for the conduct of trading activities which are to be observed by all credit institutions in order to safeguard their solvency and which should be supplemented and fleshed out by means of internal instructions, taking into account the nature and volume of the particular trading activities; this Statement also applies to the branches of German credit institutions abroad. It is published in agreement with the Federal Supervisory Office for Securities Trading and does not affect section 5 of the Securities Trading Act, for which the Federal Supervisory Office for Securities Tra-ding will issue regulations of its own.

For the purpose of these minimum requirements, the term "trading activities" covers all contracts which are based on

- money market transactions

- securities transactions (including trading in borrowers' notes and registered debt secu-rities and stock lending but excluding issuing business)

- foreign exchange transactions

- trading in precious metals

- trading in derivatives

and which are concluded in the bank's own name either on its own behalf or for the ac-count of third parties.

Derivatives trading comprises all transactions whose prices derive from an underlying asset, a reference price, a reference interest rate or a reference index.

Trading activities also include - regardless of the underlying - any form of repurchase ag-reement.

Commission business in securities and derivatives is exempt from the provisions of this Statement with the exception of subsection 6.1 Recording of spot transactions in securi-ties.
Commission business in foreign exchange and precious metals and fixed-price trading in securities (article 9 of the special regulations applying to securities transactions) which are verifiably settled promptly by means of an offsetting transaction with the central insti-tution are exempt from the provisions of section 3 Risk control and risk management with the exception of the provisions of subsection 3.3 Legal risks.

2 General requirements

2.1 Responsibilities of management

All managers (section 1(2) of the Banking Act) are responsible - irrespective of their in-ternal competencies - for ensuring the proper organisation and monitoring of trading activities. They will be able to fulfil these responsibilities only if they can assess the risk content of these activities and if they take the organisational measures necessary to limit the business risks. This entails, in particular, limiting and monitoring the credit and market price risks arising from trading activities within the framework of a risk control and risk management system.

2.2 Definition of operational rules by management

Trading activities may only be conducted in keeping with a set of operational rules de-fined by management. The corresponding management decisions have to be documen-ted.

In particular, the operational rules must cover the following:

a) the business strategies on which trading in the individual product groups is based,

b) the markets in which trading is allowed,

c) the nature, scope, legal framework and documentation of trading activities,

d) a list of the counterparties with whom trade may be conducted,

e) the procedures for measuring, analysing, monitoring and managing the risks,

f) ceilings for risk positions according to the type of business or risk, organisational unit or portfolio,

g) a procedure for reacting to any overshooting of the limits and to extreme market deve-lopments,

h) the functions and responsibilities of individual members of staff and work units,

i) internal accounting and external reporting,

j) staffing and technical equipment,

k) the internal controlling and monitoring system,

l) internal reporting,

m) the maintenance of confidentiality with respect to trades.

The operational rules are to be reviewed periodically and, if necessary, to be revised by management. Organisational guidelines (e.g. work documentation, work-flow procedures, job descriptions, delineation of responsibilities) are to be prepared on the basis of these operational rules and to be implemented by management or an agent authorised by the latter. The guidelines are to be reviewed periodically and, if necessary, they are to be updated. There must be a written record confirming that the members of staff have noted the instructions concerning themselves. The staff members must have instant access to these instructions.

2.3 Trading in new products or new markets

The start of trading (test phase) in new products or new markets must be authorised be-forehand by the manager responsible on the basis of a comprehensive and detailed ope-rational concept; management is to be informed without delay of the start of trading. Du-ring the test phase trading should be limited to a readily manageable scale. The test phase should involve all the organisational units which will later be incorporated into the work, including the auditing department within the scope of its duties. It should be ensu-red that full trading in new products or markets only begins once the test phase has been successfully concluded, management has given its approval and the necessary internal job documentation, suitably qualified staff and appropriate technical equipment are available and risk control systems are in place.

2.4 Qualifications and conduct of staff members

Management must ensure that the staff members involved in risk control and risk mana-gement, trading, back-office processing, accounting, monitoring, auditing and the organi-sation of the trading business, as well as their deputies in their particular field of respon-sibility, have comprehensive knowledge of the products traded as well as of the trading and management techniques used. In order to avoid incentives being created for exces-sive risk-taking the salary scales should be set, within the scope of general business po-licy, in such a way that they do not overly depend on trading performance. The salaries of the risk management and risk control staff and of back-office staff members should be adequate to ensuring that qualified personnel can be found and retained.

Within the scope of their controlling duties the heads of trading offices must keep a close eye on their employees' relations with business associates and brokers as well as on the acceptance and granting of favours and gifts. They should take care to note whether certain traders or brokers are given preference in business relations without good reason.

Information on the securing of business and closing of deals is to be treated as confiden-tial. In keeping with data protection, management must ensure the confidentiality of con-versations in offices in which loudspeakers or intercoms are used.

Traders should do business only with brokers who do not disclose to uninvolved third parties information about the volume and contents of deals. Traders should not enter the premises of business associates and brokers without the respective permission of a ma-nager of the parties involved or of an agent authorised by the latter. In addition traders are not permitted to do business from third-party trader or broker offices.
Management must promptly inform the Federal Banking Supervisory Office and the ap-propriate Land Central Bank about any manipulations by its own staff which have caused the bank significant losses as well as about any corresponding measures planned or al-ready initiated.

2.5 Market-based conditions

Transactions on terms not in line with market conditions - with the exception of the busi-ness listed under subsection 6.2 - are, as a matter of principle, inadmissible. The internal controlling bodies must ensure that deals are closed in accordance with the market con-ditions prevailing on the contract date. Any differences are to be offset by means of veri-fiable payment transactions. The use of separate "points accounts" for this purpose is not permitted.

2.6 Preservation of records

Each transaction must have a proper audit trail. Subject to the existing statutory retention periods, all business, control and monitoring records for the current year and at least for the past year have to be preserved. The tape recordings of telephone conversations mentioned under subsection 3.3 are exempted from this.

3 Risk control and risk management

In order to limit the risks associated with trading activities, a system should be set up for measuring and monitoring risk positions and for analysing the loss potential (risk control) and for managing them (risk management). The risk control functions should be entrusted to persons not accountable to the traders. The limiting of the risk positions is a task for management.

3.1 Requirements of the system

The risk control and risk management system must be designed in accordance with the scale, complexity and risk content of the trading activities conducted or envisaged. The bank's overall business strategy, general trading practices and other market circumstan-ces should be taken into account in designing the system. In particular it must cover and quantify the market price risks associated with the trading activities. It should be incorpo-rated into an overall risk monitoring and management structure covering as far as pos-sible all the bank's areas of business and should facilitate the identification and analysis of comparable risks from non-trading activities. The system must be sufficiently flexible to enable the bank to respond at short notice to changes in the basic market and organisa-tional conditions.

The system's individual components, its methods and computation procedures for risk quantification and the parameters used for this are to be documented in detail, to be re-viewed regularly - at least annually - and to be continuously developed further. In addi-tion, market-related parameters must be adjusted immediately to changes in the market situation. Risk figures derived from risk simulation models must be continuously compa-red with actual trends. In the event of major discrepancies between the model-based figu-res and actual trends the model is to be adjusted.
The trading activities and the associated risk positions are to be regularly examined with regard to the loss risks they entail. For this purpose not only more or less probable events but also "worst-case" scenarios should be taken into account. In particular, ex-traordinary market price changes, disruptions of market liquidity and the failure of major market participants are to be allowed for. Special attention should be given to the inter-connections between different individual markets and to the possibility that disturbances might spill over to other market segments and markets.

Management is to be verifiably notified in an informative fashion of the results of the ex-aminations.

3.2 Risk limitation

Management has to set an upper limit for losses, bearing in mind the credit institution's capital and earnings performance. Based on the results of the risk control analysis and on this upper limit for losses, a system of risk-curbing limits is to be set up related both to credit risks and to market price risks. In the event of changes in the risk assessment the limits are to be adjusted without delay. Overall limits are to be set and approved by ma-nagement for each of these categories of risk. Without the prior consent of management or its authorised agents, no trade may be transacted for which no limit exists or which would lead to the overshooting of a limit. The functions and powers of such agents are to be laid down in writing.

The credit institution must ensure that all trading activities are counted without delay to-wards the corresponding limits and that every trader is informed promptly of the limits relevant to him and of their current level of utilisation.

All the individual positions in the various business areas and categories of risk are to be aggregated into overall risk positions at least once a day at the close of trading and are to be recorded, listing the individual categories of risk, by the start of trading on the next day at the latest.

3.2.1 Credit risks

Trades - except for stock exchange transactions and spot transactions in which the equi-valent amount has been remitted or is to be remitted on a delivery-versus-payment basis, or for which appropriate cover is available - may be concluded only with contracting par-ties for whom counterparty limits have been agreed. The counterparty limits are to be set by a party independent of the traders in line with the rules and procedures for the granting of loans and must take into account any changes in the financial standing of the counterparties. All transactions concluded with a particular counterparty are to be offset against that counterparty's individual limit.

In setting the limits, loss risks arising from uncompleted trades (replacement risk) and performance risks are to be treated separately. Collateral is to be requested whenever this is deemed appropriate in view of the type and circumstances of a transaction.

3.2.2 Market price risks

The limits for delimiting market price risks are to be geared to the loss risks based on cur-rent market prices and possible market price changes. In setting limits for individual pro-ducts or portfolios, the general and product-specific trading experience, the qualifications of the staff members and the sophistication of the data processing equipment are also to be taken into account.

The trading positions are to be marked to market daily.

3.2.3 Liquidity risks

Particular attention is to be paid when setting limits to the risk, in the case of insufficient market liquidity in individual products (especially in off-the-floor markets), of not being able to conclude contracts or not being able to conclude them on the expected terms for the purpose of managing positions.

As part of liquidity management, the credit institution must ensure that payment obligati-ons can be met on settlement dates or in respect of margin calls.

3.3 Legal risks

Trades and all subsidiary agreements are to be concluded on the basis of clear and cor-rectly documented agreements, unless this has already been ensured by corresponding stock exchange terms and conditions.
At the time a trade is transacted the terms must be clear and completely agreed and documented. This applies in particular also to the placing of so-called overnight orders.

Traders' conversations relating to transactions are to be taped; these tape recordings are to be preserved for at least three months.

Prior to the conclusion of agreements in connection with trading activities, especially in the case of basic agreements, netting agreements and the furnishing of collateral, it should be checked whether and, if so, to what extent they are legally enforceable. Any legal risks are to be disclosed to the office responsible for monitoring the transactions.

Special instructions are to be drawn up for forward transactions with persons who are not merchants registered on the commercial register; these should take into account the sta-tutory regulations applying to such transactions.

3.4 Operational risks

The data processing systems used must be adequate to the nature and volume of the trading activities. The plausibility of the market prices, volatilities

etc. stored in the data-bases is to be reviewed regularly. If various databases are used, they need to be reconci-led with one another at regular intervals.
A written contingency plan has to ensure, among other things, that in the event of the breakdown of the technical equipment necessary for trading activities, back-up facilities can be deployed at short notice. In addition, precautions are to be taken to cope with possible software errors and with unforeseen staff absences.

The procedures, documentation requirements, data processing systems and contingency plans in use for the trading activities are to be regularly reviewed.

4 Organisation of trading activities

The supreme principle of operational procedures in the area of trading activities is the clear functional separation of

- trading

- back-office processing and control

- accounting and

- monitoring.

At the very least, trading must be organisationally segregated from the other functions. The functional and organisational separation of trading from the other functions is to be ensured up to and including the management level.

Furthermore, within each function it must be ensured that, in handling business transacti-ons, activities which are mutually incompatible are carried out by different persons.

If functional separation is impossible owing to the size of the enterprise or inappropriate owing to the small volume of trading, the orderly and proper handling of transactions must be ensured by the direct involvement of management (and, in the case of the latter's ab-sence, by their authorised agents).

Where data processing equipment is used, functional separation is to be ensured by ap-propriate procedures and safeguards. Access rules for performing certain functions are to be defined in detail. All technical instructions for the data processing systems used in trading or for risk management are to be entered by parties independent of the trading, back-office processing/controlling, accounting and monitoring staff. Every change must be automatically documented by the system.

4.1 Trading

A record of each transaction showing all the key data (e.g. type of business, volume, terms, maturity, counterparty, date, time, name of the trader, serial number, subsidiary agreements) must be made as soon as it has been conducted and passed without delay to the back office together with all the documents. A different form of documentation is permissible for deals conducted via a stock exchange settlement system or other settle-ment system.

Each deal is to be recorded immediately to determine the respective trading position (portfolio update).

Where data is recorded direct in an EDP system, it must be ensured that a trader can enter transactions solely under his own trader ID. The trading date, time and transaction serial number must be entered automatically by the system and must be impossible for the trader to alter. If the trader deviates from the specified norms when entering tran-saction data, this must be approved in each case by a unit not connected with the trading office. Trades concluded after the back office has closed recording for the day (late trades) are to be marked as such and included in that day's positions (including subsequent recor-ding). A late-trade slip must be passed immediately to a party unconnected with the tra-ders.

Trading outside the business premises is only admissible within the scope of an express ruling by management; the scope for such trades (authorised individuals, purpose, vo-lume, data recording, confirmation, notification of the manager responsible) is to be de-fined in writing and authorised by management. For such trades an immediate telex con-firmation is to be demanded of the counterparty. The trades are to be reported immedia-tely by the trader to his own bank in a suitable form (by telephone, fax, etc.). The trades should be separately identified and brought to the notice of the responsible manager or his authorised agent.

4.2 Back-office processing and control

On the basis of the business documents obtained from the traders, the back office must write the necessary confirmations and contract notes and attend to the other processing formalities (e.g. maturity control, payments).

Transactions are to be subjected to constant checks. In particular, checks must be made to ensure that

a) the business documents are complete and up-to-date

b) the traders' paper work is correct and complete and - where available - matches the data in the brokers' confirmations, print-outs from EDP trading systems or other relevant sources

c) the nature and scale of transactions are within the scope of usual business activities and the defined limits

d) market terms have been agreed

e) any deviations from specified norms (master data, delivery instructions, methods of payment and suchlike) have been agreed.

The checks are to be documented.

Any discrepancies must be clarified at once. If they are not based on obvious errors, a party authorised by management and not connected with the traders has to be notified. Clarification of the discrepancies is to be appropriately documented.

As a matter of principle every trade is to be confirmed immediately in writing or in equiva-lent form. The confirmation must contain all the transaction data, including the date of transaction. If the trade is transacted via a broker, the broker is to be named. The prompt receipt of counter-confirmations is to be monitored, taking care to ensure that the in-coming counter-confirmations do not go to the traders. Complaints about missing or in-complete counter-confirmations must be made immediately unless it is a spot transaction, all parts of which have been executed correctly. Any discrepancies are to be noted and to be clarified without delay.

A different form of confirmation from the one mentioned above is admissible for trades transacted through a stock exchange settlement system or other settlement system.

Trades which are subject to a netting agreement must also be individually documented and recorded by the accounting department. They are to be processed as individual tran-sactions. It is, however, permissible to reconcile the prices and balance of the individual transactions recorded in the bank's books with the counterparty in the form of a summary confirmation. It is likewise admissible for the counterparty to settle only the payment ba-lance.

Furthermore, where direct recording and settlement systems are used there must be controls similar to the above; in particular, by means of automatic documentation functi-ons it must be possible to reconstruct at any time which user carried out which functions and when.
The principles of cross-border remote data processing in bank accounting set out in the Statement of the Federal Banking Supervisory Office - 13 - 362 - 3/82 - dated October 16, 1992 (amended by the circular to the central associations of the German credit instituti-ons of December 28, 1992) apply *mutatis mutandis* to the processing of trading transacti-ons via remote data processing equipment located abroad.

4.3 Accounting

All transactions are to be recorded by the accounting department immediately - regard-less of their finalised bookkeeping. Subsidiary agreements on transactions which are not themselves trades but which create trading positions are likewise to be recorded in the accounting system and included in the respective positions.

Uncompleted transactions are, as a matter of principle, to be recorded in subledgers (e.g. in memorandum accounts) at the time they are contracted; upon completion they are to be booked in the general ledger accounts and individual accounts (value-date recording).

The data pertaining to each trade must be discernible from the accounting records. The records of the accounting department must at all times clearly show the individual un-completed transactions - broken down by type of business, maturity and counterparty. This applies in the case of netting agreements, too. The positions per currency and per type of business and the trading results are to be reconciled regularly with the traders' figures.

Any amendments or cancellations are to be subjected to a check by a party independent of the traders.

Where EDP systems are in use, functional separation is ensured if the account coding principles or the booking systems and the corresponding programs are the responsibility of a party independent of the traders and back-office staff.
In the case of cross-border remote data processing in banks' accounting systems, the regulations contained in the Federal Banking Supervisory Office's letter of October 16, 1982 - I 3-362 - 3/82 - (amended by the circular to the central associations of the German banks dated December 28, 1982) are to be observed.

4.4 Monitoring

The risks arising from trading activities are to be monitored in a timely fashion. A member of management or the latter's authorised agent is to be entrusted with this task; such per-son/persons must not have any direct responsibility for day-to-day trading activities.

The following tasks are not to be delegated:

a) The responsible manager is to be verifiably informed each day of the risk positions and the trading results at the close of business in writing or in some other suitable form. The report, reconciled with the traders, is to be made by a party independent of the tra-ders.

The risk positions are to be presented in a comprehensible form and must show the open position per type of transaction or risk or per organisational unit or portfolio, the limit fixed in each case and its degree of utilisation. At the same time care must be taken to ensure that late trades are included in the positions of the day on which they were concluded.

Overshootings of counterparty limits are to be notified daily in writing to the responsible manager upwards of a limit to be defined by management.

The trading results should show both the daily result and the cumulative monthly/annual figures broken down by trading area.

b) The responsible manager is to be informed at least monthly of all uncompleted for-ward deals (including options and repurchase agreements and transactions not settled promptly) with major counterparties. The transactions should be aggregated per counter-party and compared with the limit set for each counterparty.

c) The responsible manager must inform the other members of management at least once a month of the risk and performance trends in the individual trading areas and comment on the results. He must draw their attention to special risks, significant overshootings of limits, peculiarities in performance as well as any unusual deals in re-spect of counterparties, volumes, terms and conditions etc. and the corresponding com-mercial background; this is to be documented.

d) The responsible manager is to be informed immediately if repeated or serious violati-ons of these requirements or of the internal instructions, terms not in line with market conditions or unusual business practices are noted or if there is a suspicion of incorrect conduct on the part of a market participant.

5 Auditing

Compliance with the minimum requirements is to be checked at irregular, appropriate in-tervals by the internal auditors. The main audit areas should be subjected to a risk-orien-ted audit at least once a year. Each sub-division of the minimum requirements is to be audited at least at three-yearly intervals; the audit rota is to be documented in an audit plan.

The main audit areas are as follows:

· limit system

· determination and reconciliation of positions and results

· changes in the EDP systems

· completeness, correctness and timeliness of the internal reporting system

· functional separation

· degree to which terms are in line with market conditions

· confirmations and counter-confirmations.

A written report is to be prepared on the audit and to be presented to all the members of management. The manager responsible for the audited area must submit written com-ments on the shortcomings and recommendations listed in the audit report. Defects not yet remedied and recommendations not yet implemented are verifiably to be brought to the notice of all the managers at least once a year.

At least once a year all the counterparties are to be sent lists of the uncompleted forward deals for the purpose of reconciliation by the internal auditors. Each transaction is to be listed along with the key transaction data. Even if there were no uncompleted forward trades with business partners on the day of reconciliation, these counterparties are ne-vertheless to be included in the confirmation procedure on an appropriate scale (so-cal-led zero confirmations). It is to be ensured that return confirmations or contradictions are addressed direct to the auditing department. Outstanding return confirmations are to be the subject of reminders at least once.

6 Regulations for special kinds of business

6.1 Recording of spot transactions in securities

Uncompleted spot transactions in securities can be booked prior to completion in the case of commission business or of own-account and fixed-price trading concluded in the domestic market. This facility is not intended to prompt banks which have hitherto used "value-date recording" to change their booking procedures. Own-account and fixed-price transactions processed abroad, however, are to be recorded in the balance sheet without exception only after they have been completed.

6.2 Prolongation of foreign exchange operations

The prolongation of forward foreign exchange or option transactions at the rate or strike price of the original trade is permissible only if

a) the bank's management or the latter's appointed agent has expressly authorised such trades

b) prolongation is effected at the express written request of a customer not having the character of a credit institution

c) prolongation is verifiably based on a transaction in goods or services

d) the customer undertakes to present appropriate documents at the bank's request in support of the criteria mentioned under c)

e) an appropriate provision is set up in the event of a profit ensuing from the spot legs of swap trades contracted at different rates; in the event of a loss a balancing item in the corresponding amount can be shown on the assets side to ensure that the earnings result is not affected

f) prolongation does not exceed a total time to maturity of six months from the original maturity of the forward foreign exchange transaction or foreign exchange option trade. If the transaction is prolonged by more than six months, the customer must explain the un-derlying trade to the bank in detail and prove the need for prolongation. The customer is to be notified of the profit or loss arising from prolongation

g) prolongation is effected exclusively with the original credit institution.

The criteria listed under a) to e) also apply to forward foreign exchange transactions which are completed prematurely on terms not in line with the market.

6.3 "Name-to-follow" deals

Traders should not allow brokers to run their own positions and should not accept "name-to-follow" deals; they must insist that brokers name the counterparty immediately. The sole exceptions to this are own-account or name-to-follow transactions which brokers are allowed to enter into within the scope of the stock exchange regulations.

6.4 Third-party foreign exchange transactions

Credit institutions should not contract trades, either directly or with the involvement of brokers, which enable other banks to conclude transactions for which they are not accep-ted by their partners or which these other banks do not wish to appear under their own name (third-party transactions). Third-party trades may only be transacted in exceptional cases within the scope of a ruling issued by management. Such transactions are to be designated as third-party trades, to be documented separately and to be brought to the notice of management (or of the latter's authorised agent).

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