Risk-oriented banking supervision pursuant to Basel II –
A German perspective on implementing the SRP

Peter Spicka
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Deutsche Bundesbank
Centre for Technical Central Bank Cooperation
Implementing the Supervisory Review Process –

Agenda

- Institutional framework for implementing Basel II
- The supervisory review process (SRP)
- Banking supervision under Pillar II: SREP in Germany
  - Workflow
  - Scope and classification
  - Individual risk assessment
  - Review and evaluation of ICAAP
  - Supervisory measures
- Experiences, challenges, outlook
Implementing the Supervisory Review Process

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- Experiences, challenges, outlook
Institutional framework for implementing Basel II

International standards

Basel I
Basel II

EU-rules

Banking Directive
Capital Adequacy Directive

National rules e.g. Germany

Banking Act
Solvency Regulation

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Institutional framework for implementing Basel II

Basel Committee for Banking Supervision

- Formulating broad supervisory standards and guidelines
- Recommending statements of best practices
- Does not possess any formal supranational supervisory authority
- Conclusions have no legal force.

Standards morally binding and globally accepted
Institutional framework for implementing Basel II

Basel II and the EU

[Diagram showing the institutional framework for implementing Basel II, with labels for different committees and groups such as the Council, European Commission, European Parliament, Economic and Monetary Affairs Committee (ECON), EBC, EFCC, FSC, EFC, and various other committees and working groups.

Legend:
- EBC: European Banking Committee
- EFCC: European Financial Conglomerates Committee
- EFC: Economic and Financial Committee
- FSC: Financial Services Committee
- FST: Financial Stability Table
- Interim Working Committee on Financial Conglomerates

1. Finance ministries (FST also central banks)
2. Supervisors and Central Banks
3. Supervisors]
Institutional framework for implementing Basel II

National implementation: Germany

KWG (Banking Act) - Creation of a legal foundation for additional individual capital requirements (pillar II)

Solvabilitätsverordnung (Solvency Ordinance) - Expansion to a comprehensive set of rules for equity requirements, in particular risk measurement methods and authorisation requirements (pillars I and III).

Minimum requirements for risk management („MaRisk“) - Expansion to a comprehensive set of rules that merges all requirements for (integrated) risk management (pillar II).
Institutional framework for implementing Basel II

National implementation: Germany

Transposing Basel II through the German Banking Act and related prudential regulations


German Banking Act
- General provisions/powers to issue regulations
- Selected details
  - New rules governing the trading book (section 1a of the Banking Act)
  - Partial elimination of single-entity supervision of German institutions (section 2a of the Banking Act)
  - Cooperation between supervisory authorities in the EEA (section 8 et seq of the Banking Act)
  - Consolidated group (section 10a of the Banking Act)
  - Zero weighting of intra-group exposures (section 10c of the Banking Act)

Section 10 of the Banking Act: Capital adequacy

Solvency Regulation: Minimum capital and disclosure requirements

Sections 13 and 14 of the Banking Act: Rules for large exposures and loans of €1.5 million or more

Regulation governing large exposures and loans of €1.5 million or more (Large exposures rules)

Section 25a of the Banking Act: Institutions' organisational obligations

Minimum requirements for risk management (MaRisk)

Qualitative risk management requirements and "Procedures for assessing internal capital adequacy"
Institutional framework for implementing Basel II

National implementation: Germany
Implementing the Supervisory Review Process

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- Experiences, challenges, outlook
The supervisory review process (SRP)

**Importance of supervisory review**

- Ensure banks to have adequate capital to cover all risks
- Encourage banks to improve risk management techniques
- Recognise responsibility of the bank management for internal capital assessment and capital commensurate with risk profile
- Foster active dialogue between banks and supervisors
The supervisory review process (SRP)

Basel II and the SRP

Four key principles of supervisory review

**Requirements for banks**

**Principle 1:** Internal assessment of capital adequacy (CAAP)

**Principle 3:** Capital above the minimum ratios; supervisors can require banks to hold capital in excess

**Requirements for supervisors**

**Principle 2:** Review and evaluation of the CAAP

**Principle 4:** Intervention at an early stage to prevent capital from falling below minimum levels
The supervisory review process (SRP)

**SRP in the EU**

**ICAAP**
Art. 22, 123 CRD
- Identify and assess all material risks
- Hold adequate level of capital in relation to the institute’s risk profile
- Use sound risk management systems and develop them further
- Should be embedded in the institution’s business and organisational processes

**SREP**
Art. 124 CRD
- Identify, review and evaluate all risk factors (Risk Assessment System - RAS)
- Assess, review and evaluate the ICAAP
- Assess, review and evaluate compliance with standards set in the Directive

**Supervisory instruments**

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The supervisory review process (SRP)

SRP in the EU

Committee of European Banking Supervisors (CEBS)

Four categories have emerged as common to all competent authorities in the EU:

- Scope and classification (including proportionality)
- Individual risk assessment
- Review and evaluation of ICAAP
- Overall assessment and supervisory measures
Implementing the Supervisory Review Process

- Institutional framework for implementing Basel II
- The supervisory review process (SRP)
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- Experiences, challenges, outlook
SREP in Germany – Workflow

Risk-oriented supervision approach – supervisory grades

- **Basic supervision**
  
  All institutions, independent of size, systemic relevance and risk situation

- **Intensified supervision**
  
  Institutions relevant for financial stability reasons
  
  Institutions showing signs of increased risks and/or organisational weaknesses in basic supervision
  
  Institutions with supervisory information deficiencies becoming apparent in basic supervision
  
  Preventative random samples of institutes (without any specific reason)
SREP in Germany – Workflow

Basic supervision - instruments

- Evaluation of annual accounts
- Evaluation of auditor’s reports (of the annual accounts)
- Monitoring, analysis and evaluation of regular and event-driven reporting such as
  - Monthly reporting
  - Reporting according to German Solvency Regulation
  - Reporting according to German Liquidity Regulation
  - Reporting according to catalogue of special data
  - Reporting large exposures and loans of 1.5 million euro and more

- Classification of banks
- Prudential discussions on a regular basis
- Risk profile
SREP in Germany – Workflow

Intensified supervision - instruments

Specific collection of off-site information
- Telephone calls/ written inquiries
- Request/processing of documents

Collection of on-site information
- Ad hoc supervisory consultations
- On-site examinations

Updated risk profile
SREP in Germany – Workflow

Design of the SREP in Germany
(including all four required components according to CEBS)

Individual risk assessment (risk profiles), Supervisory planning, Review and evaluation of ICAAP

Scope and risk classification

If necessary

Supervisory measures

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SREP in Germany – Scope and Classification

Objective of risk classification

- Classification of banks in comparison to their peer groups
- At least once a year on basis of evaluation of auditor’s reports
- Early warning system
- Risk indicator
- Tool to systemize the assessment of banks (comparability, transparency)
- No supervisory measures initiated
International comparison

Quite a number of supervisory authorities use comparable instruments, e.g.:

- US (FDIC, Fed and OCC): CAMELS
- UK (FSA): ARROWS (formerly: RATE)
- NL (DNB): RAST
- F (CB): ORAP; SAABA and SIGNAL
SREP in Germany – Scope and Classification

Structure of the risk classification of banks (SRP-Rating)

Off-site data
Quantitative
(Reporting, Auditor’s Report)

Component rating

Off-site data
Qualitative
(Auditor’s Report)

Component rating

On-site data
Qualitative
(On-site inspections)

Component rating

‘Interim’ rating

Supervisory assessment (expert’s opinion)

Final rating
SREP in Germany – Scope and Classification

SRP-Rating variants

- Credit unions
- Commercial banks
- Savings banks
- Large international banks

Decreasing homogeneity and number of institutions

Statistical analysis

Individual analysis

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SREP in Germany – Individual Risk Assessment

Risk profile - Definition

- Concise assessment of the key risk areas of an institution
  - Both verbal …
  - and by a rating (four grades A to D)

- Clarification of those areas of a bank’s business and organisation which require more information
SREP in Germany – Individual Risk Assessment

Risk profile - Objective

- Working tool for supervisors
- For information of supervisory management
- Starting point for supervisory planning
- (Co-ordination between supervisory authority and central bank)
## SREP in Germany – Individual Risk Assessment

<table>
<thead>
<tr>
<th>Drawing up a risk profile - Overview of main components</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Overall assessment</td>
</tr>
<tr>
<td>- Assessment by external parties (Banking associations, Rating agencies)</td>
</tr>
<tr>
<td>- Company profile / group profile</td>
</tr>
<tr>
<td>- Capitalisation</td>
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<tr>
<td>- Profitability and accounting policy</td>
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<tr>
<td>- ICAAP</td>
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<tr>
<td>- Internal governance</td>
</tr>
<tr>
<td>- Material risk areas (both risk level and risk control)</td>
</tr>
<tr>
<td>- Compliance and money laundering</td>
</tr>
</tbody>
</table>
# Drawing up a risk profile
- structural breakdown

## I. Overall assessment

### I.1 Overall judgement (verbal)
(Grade: ...)

### I.2 External grades (e.g. Banking associations)

### I.3 Institute’s strategy

### I.4 Partial judgements

<table>
<thead>
<tr>
<th>Information required</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company profile</td>
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<tr>
<td>Capitalisation</td>
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<td>Profitability</td>
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<td>ICAAP</td>
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<td>Internal Governance</td>
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<tr>
<td>Risk areas</td>
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<tr>
<td>- Credit risk</td>
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<tr>
<td>- Market risk</td>
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<tr>
<td>Compliance</td>
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<tr>
<td>(Securities Trading Act)</td>
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<tr>
<td>Money Laundering</td>
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</tr>
</tbody>
</table>
SREP in Germany – Individual Risk Assessment

Risk profile for large international banks

Auditor’s reports, supervisory reporting data, information from prudential discussions and on-site inspections, internal risk reports

Overall risk assessment of the institution
SREP in Germany – Individual Risk Assessment

Additional step: Assessment of a bank’s impact on systemic relevance

- High
- Medium
- Low
### SREP in Germany – Individual Risk Assessment

**Results of the risk classification 2006**  
*(comparative figures for the previous year)*

<table>
<thead>
<tr>
<th>System relevance</th>
<th>Institutions in %</th>
<th>Quality of the institution*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td><strong>High</strong></td>
<td>0.6% (0.9%)</td>
<td>1.2% (1.0%)</td>
</tr>
<tr>
<td><strong>Medium</strong></td>
<td>2.6% (1.8%)</td>
<td>3.2% (3.3%)</td>
</tr>
<tr>
<td><strong>Low</strong></td>
<td>35.6% (24.1%)</td>
<td>37.2% (41.9%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>38.8% (26.7%)</td>
<td>41.6% (46.2%)</td>
</tr>
</tbody>
</table>

*Source: Federal Financial Supervisory Authority, Annual Report 2006, page 70*
Risk profiling - Summary

SRP-Rating Quantitative
(standardised combination of ratios, high discriminatory power; basis: latest annual account; only for savings banks, credit cooperatives, partly for commercial banks)

SRP-Rating Qualitative
(15 Questions covering organisational and operational issues; basis: auditor’s report; problem: lack of data)

Risk profile (Forward looking approach)

Risk indication

Current data

Publications by the institution

Third party information (publications)

Notifications, reporting, applications

Prudential discussions

Auditors’ Reports

Special examinations (according to Banking Act)
SREP in Germany – Supervisory Planning

Supervisory audit planning

*Principle: supervisory reactions on detected weaknesses and information collection to detect weaknesses*

- Selection of institutes according to risk profiles
- Selection of institutes for preventative reasons
SREP in Germany – Review and Evaluation of ICAAP

Instruments and procedure

- Inquiries
- Prudential discussions
- On-site examinations
Inquiries

- Off-site instrument
- Often by telephone
- Often referring to limited facts
SREP in Germany – Review and Evaluation of ICAAP

Prudential discussions

- Routine supervisory consultations once a year
- Ad hoc supervisory consultations anytime
- Increasing importance
SREP in Germany – Review and Evaluation of ICAAP

Prudential discussions – possible topics

- Business development (year of the auditor’s report)
- Business development (current financial year, prognosis)
- Risk management and control
- Credit risk strategy
- Auditor’s reports notifications
- Risk situation credit business
- Experience MaRisk
## Kind of examinations (§44 Banking Act)

<table>
<thead>
<tr>
<th>Internal models examinations</th>
<th>SRP examinations (Pillar II)</th>
<th>Credit business (value) examinations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approval of applications to use the IRB approach</td>
<td>Examinations on appropriateness of business organisation (§ 25 Banking Act, MaRisk)</td>
<td>Examinations of the (quality of) credit business</td>
</tr>
<tr>
<td>Examinations (IRBA, AMA, MRM, Liquidity Risk Models)</td>
<td>Examinations on continued compliance with Pillar I and III requirements</td>
<td></td>
</tr>
</tbody>
</table>
‘Minimum Requirements for Risk Management’ (MaRisk) cover the qualitative requirements of Pillar II of the Basel framework for banks.

MaRisk stand for a principle based approach and serve to implement the principle of dual proportionality set forth in the SRP.

On the basis of numerous escape clauses the MaRisk can be applied in a simplified manner depending on the credit institutions’ size, business speciality and risk situation.
SREP in Germany – Review and Evaluation of ICAAP

Excursus: ‘Minimum Requirements for Risk Management’

Structure of the Minimum requirements for risk management (MaRisk)

- General part (Allgemeiner Teil, AT)
  - AT 1 Preliminary remarks
  - AT 2 Scope of application
  - AT 3 Overall responsibility of the management
  - AT 4 General requirements for risk management
  - AT 5 Organisational guidelines
  - AT 6 Documentation
  - AT 7 Resources
  - AT 8 Activities in new products or on new markets
  - AT 9 Outsourcing

- Special part (Besonderer Teil, BT)
  - BT 1 Special requirements for the internal control system
    - BT O Requirements for the organisational and operational structure
    - BT R Requirements for risk management and control
  - BT 2 Special requirements for the internal audit

Risk management in MaRisk (based on section 25a (1) of the Banking Act)

- AT 4.1 Risk-bearing capacity
- AT 4.2 Strategies
- AT 4.3 Internal control system
  - AT 4.3.1 Organisational and operational structure
  - AT 4.3.2 Risk management and control
    - Identification, assessment, management, monitoring and communication of material risk
- AT 4.4 Internal audit

Internal control system

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## SREP in Germany – Supervisory measures

### Informal supervisory measures
- Request to heal undesired developments (diversity of forms: letter with non-binding request, supervisory consultations, request threatening further measures)

### Formal supervisory measures

<table>
<thead>
<tr>
<th>Instruction</th>
<th>Legal Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instruction to repair undesired developments in the institution (Basis: SRP specific norm)</td>
<td>§ 25 (1) S.1 Banking Act</td>
</tr>
<tr>
<td>Instruction to repair undesired developments in the institution (Basis: blanket clause)</td>
<td>§ 6 (3) Banking Act</td>
</tr>
<tr>
<td>Instruction of capital surcharges/risk reduction</td>
<td>§ 45b Banking Act</td>
</tr>
<tr>
<td>Sanctions</td>
<td>§§ 35, 36, 56 Banking Act</td>
</tr>
</tbody>
</table>
SREP in Germany – Summary

Organisation of the SREP

Risk classification
(SRP-Rating)

Risk profile
- Verbal
- Component ratings
- Request for information

Classification
(Quality of the institution)

Classification
(Systemic relevance)

Mapping of supervisory actions
- Problem areas
- Information requests

Supervisory planning

SREP activities
- Prudential discussions
- On site inspections
- ...

Supervisory measures
Implementing the Supervisory Review Process

- Institutional framework for implementing Basel II
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  - Scope and classification
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  - Review and evaluation of ICAAP
  - Supervisory measures

**Experiences, challenges, outlook**
Experiences, challenges, outlook

Experience from implementing Basel II in Germany

From a quantitative supervisory modus to a qualitative modus

Manager qualification

§ 10 Banking Act
Capital principle
Liquidity principle
Large exposures

- Minimum Requirements Risk Management (2005)

Qualitative dimension

Quantitative dimension

Past
Future

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Source: Simler (2006)
Experiences, challenges, outlook

Experience from implementing Basel II in Germany

Steps to a more qualitative oriented supervision in Germany

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Implementing the Supervisory Review Process
Experiences, challenges, outlook

*Experience with the use of Basel IRB approaches – Worldwide*

<table>
<thead>
<tr>
<th></th>
<th>Foundation IRB</th>
<th>Advanced IRB</th>
</tr>
</thead>
<tbody>
<tr>
<td>G 10</td>
<td>135</td>
<td>154</td>
</tr>
<tr>
<td>… of that Europe</td>
<td>122</td>
<td>121</td>
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<tr>
<td>… of that Germany</td>
<td>43</td>
<td>21</td>
</tr>
<tr>
<td>Non G 10</td>
<td>20</td>
<td>21</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>155</strong></td>
<td><strong>175</strong></td>
</tr>
</tbody>
</table>
Experiences, challenges, outlook

Experience with the use of Basel IRB approaches – Germany

- More than 60 credit institutions in Germany want to use the new IRB approaches (in comparison worldwide: 330 institutions)
- IRBA banks in Germany are either large banks or very specialised banks
- Currently 51 applications (29 banks for the Foundation IRB, 22 banks for the Advanced IRB)
- 16 banks have received their authorisation to use the IRB on 1 January 2007
- In general application process of the IRBA in banks was so far quite satisfying
IRBA banks will cover more than 2/3 of the total assets of all German banks.

(in % of total assets of all banks)
Experience and feedback from on-site inspections with regard to ‘Minimum Requirements for Risk Management’

- In 2006 more than 100 examinations
- Main focus: credit business
Experiences, challenges, outlook

Experience and feedback from on-site inspection with regard to ‘Minimum Requirements for Risk Management’

Typical notifications during examinations:

- Credit process, in particular processing of problem loans
- Segregation of functions
- Risk-management
- Risk-controlling
- Reporting
- Internal audit
Experiences, challenges, outlook

*Qualification of on-site inspectors*

- Training program
- On-site training
- E-Learning
Experiences, challenges, outlook

Training program

- Foundation courses
- Intermediate course
- Advanced courses
Experiences, challenges, outlook

*Training program*

- Basic concept: modular structure of courses according to the qualification and experience of the staff (in consultation with their supervisors)

- Maximum length of training: 12 ½ weeks of foundation and consolidation, 3 weeks of specialisation
## Experiences, challenges, outlook

### Training program

<table>
<thead>
<tr>
<th>Module</th>
<th>Foundation</th>
<th>Conso'n</th>
<th>Special'n</th>
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<tbody>
<tr>
<td><strong>Q11.1 Banking business, especially lending operations</strong></td>
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<tr>
<td>Q11.11 Basics of banking business</td>
<td>1 week</td>
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<tr>
<td>Q11.12 Basics of lending operations</td>
<td>1 week</td>
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<tr>
<td>Q11.13 Particular features of lending operations</td>
<td>1 week</td>
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<tr>
<td>Q11.14 Selected Legal Risks within credit business</td>
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<tr>
<td><strong>Q11.2 Financial mathematics and statistics</strong></td>
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<tr>
<td>Q11.21 Basics of financial mathematics and statistics</td>
<td>1 week</td>
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<tr>
<td>Q11.22 Evaluation of financial products</td>
<td>1 week</td>
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<tr>
<td>Q11.23 Evaluation of financial products and term structure models</td>
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<tr>
<td><strong>Q11.3 Accounting, audits of accounts and internal audits</strong></td>
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<td>Q11.31 Basics of accounting and audits of accounts</td>
<td>1 week</td>
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<tr>
<td>Q11.32 Particular features of accounting and audits of accounts</td>
<td>1 week</td>
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<tr>
<td>Q11.33 International bank accounting practices</td>
<td></td>
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<tr>
<td>Q11.34 Update of Knowledge and Analysis of bank balance sheets</td>
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<tr>
<td><strong>Q11.4 Risk controlling at credit institutions</strong></td>
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<tr>
<td>Q11.41 Basics of risk controlling at credit institutions</td>
<td>1 week</td>
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<tr>
<td>Q11.42 Market and credit risk models at credit institutions</td>
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<tr>
<td>Q11.43 Basics of operational risk management</td>
<td>2 days</td>
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<tr>
<td>Q11.44 Operational risk models</td>
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<tr>
<td><strong>Q11.5 National and international banking supervision</strong></td>
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<tr>
<td>Q11.51 Basics of supervision</td>
<td>1 week</td>
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<tr>
<td>Q11.52 Minimum requirements for the trading activities of credit institutions and Principles I and II</td>
<td>1 week</td>
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<tr>
<td>Q11.53 Framework Basel II</td>
<td>1 week</td>
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<tr>
<td>Q11.54 Audit of internal procedures (IRB)</td>
<td>1 week</td>
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<tr>
<td>Q11.55 Level of implementation of Basel II at the credit institutions</td>
<td>1 week</td>
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<tr>
<td><strong>Q11.6 Data processing at credit institutions</strong></td>
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<tr>
<td>Q11.61 Data processing at credit institutions and audits of IT systems</td>
<td>1 week</td>
<td></td>
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<tr>
<td>Q11.62 Test procedures and IT security concepts</td>
<td>1 week</td>
<td></td>
<td></td>
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<tr>
<td><strong>Q11.7 Key qualifications for auditors</strong></td>
<td>1 week</td>
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</tbody>
</table>

**Total duration:**
- 8 weeks 2 days
- 8 weeks
- 3 weeks 2 days
Experiences, challenges, outlook

Outlook

- Basel II important step forward with regard to
  - resilience of credit institutions
  - better dealing with risks
  - contribution to the stability of the financial system

- Costs of introduction of new approaches are an investment in the risk management of credit institutions and their ability to survive

- Financing of the economy still possible for reasonable conditions
Experiences, challenges, outlook

Outlook

- Topics in focus:
  - Outreach of Basel II
  - Liquidity risks
  - Definition of regulatory capital

- Not any further meaningful regulation activities in the near future
- Intensified communication among supervisors
Thank you very much for your attention!

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