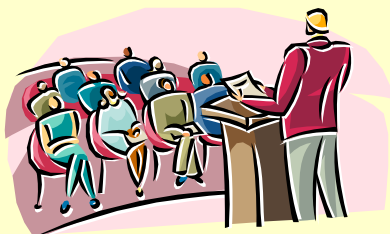


Subject of the talk



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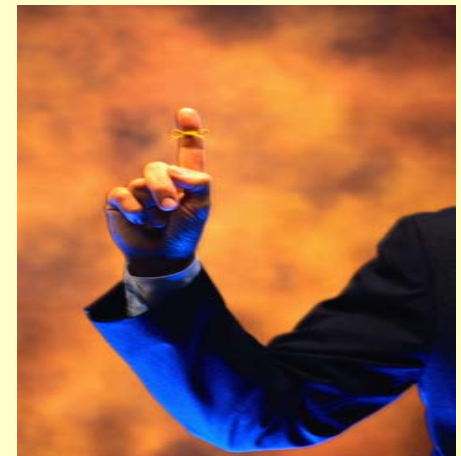
Effects of the financial market crisis –
recommendations of the courts of audit
concerning investment strategies and the use of
derivative financial instruments

President of the German Central Bank Axel Weber



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„We are not in the year one after the crisis, we are in the third year of the crisis.“

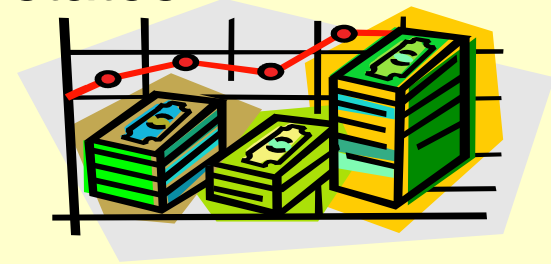


Global effects of the crisis on the public budgets



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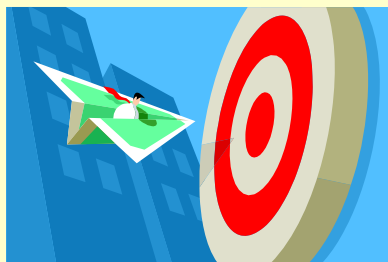
1. Cyclical **deficiency in receipts**
2. **Additional expenditures** in support of economic situation and saving the bank
3. Extreme increase of the debts
 - **more interest spending**
4. Clearly higher risk surcharges of the government bonds of the PIIGS-states
 - **higher interest level**
5. Downgrading of the credit rating of states
 - **higher interest level**





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Goal of the talk



- Picturing the results of the audit of the Court of Audit Saxony-Anhalt and stimulate the exchange of experiences
 - Effects of the financial crisis and the acting of the administration,
 - Demands on the public administration,
 - Conclusions and recommendations of the Court of Audit,
 - Derivation of new challenges for the courts of audit

Subject of the audit of the Court of Audit Saxony-Anhalt in 2009



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Effects of the financial market crisis and the acting of the public administration with a view to these effects

- in total five audit reports,
- Summary of the most important results in the actual annual report, May 2010



Audit areas in context with the effects of the crisis



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Statebudget Saxony-Anhalt

Credit management Debt 31.12.2008: app. 19,9 billion €

Special assets Stock 31.12.2008: app. 1,1 billion. €

➤ **high interest spending require interest optimization
an risk limitation**

Municipal budgets

only selected municipalities, partially high indebtedness
(credit management),

➤ **high interest spending require interest optimization
and risk limitation**





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Subjects of the audit

- Investment guidelines and strategies,
- Comparison of the yield with alternative bonds with similar term and rating of issuers,
- Assessment of the risks involving with business transactions,
- Controlling within the public administration,
- Audit of derivative businesses consulting external expertise (specialist of a audit firm)



Selected important results of the audit



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1. Conclusion of complex derivatives without quantification of the risks
2. Uneconomical use of derivatives
3. Conclusion of derivatives at the prime of financial market crisis
4. Organisational weak points within the public administration



1. Conclusion of complex derivatives without quantification of the risks



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Total portfolio (deadline: 31.12.2008)

- 69 derivatives for optimization, 2,28 billion € total nominal extent,
- 36 of them are complex derivatives, in part very complex structures,

Result

- 21 conclusions of the 36 derivatives have a high complex structure,
 - neither the ministry of finance nor the external expert were able to rate these conclusions,
- available organizational and technical equipment is not sufficient,
 - the ministry of finance is not able to estimate the risks of the derivatives daily,
- there is no suitable organizational and regulatory framework,

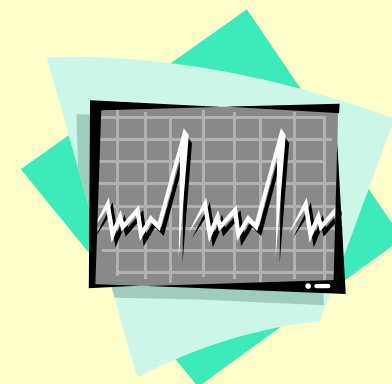
1. Conclusion of complex derivatives without quantification of the risks



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Recommendation of the Court of Audit

- Conclusions only with such derivatives, which total risks can be estimated,
- If it's not able: No trading with such complex derivatives!





2. Uneconomic use of derivatives

Net interest received

- by cameralistic point of view, 2008: net receipts 18,5 million €
- by economic point of view: uneconomic use,

Market value

- 2008 to 2007: fallen by 82,3 million €
- 2009 to 2008: gone up by 21,9 million €
- considerable uncertainty, if there is a positive development,

Life

- some derivatives have a remaining life of 36 years,
- average of derivatives: still 12 years



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2. Uneconomic use of derivatives

Recommendation of the Court of Audit

- at the time of business transactions: Administration has to form its own opinion on the development of markets and interests.
- to view the total life of derivatives: No suspension of payment undertaking into the future!



3. Conclusion of derivatives at the climax of the financial market crisis



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Mid-september till december 2008

- conclusion of complex derivatives,
- 6 trades, total extent 179 million €,
- goal: exploitation of market warp,

High speculative character, high risk potential

- market value of these 6 trades dropped by 8,9 million € in a period between 5 and 12 weeks,

Recommendation

- Forbade speculation!
- Such derivatives are omit in the future.



4. Organizational weak points



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Risks in the organization of structure and procedure in the ministry of finance,

Concerning amongst others:

- the risk-bearing capacity, regulations in service instructions,
- internal control system, analysis of risk processes and control processes,
- personnel and technical-organizational resources,

Assessment of the Court of Audit:

- Immediately need for action:
 - The pictured weak points and the seriousness of the defects are unacceptable.
- Essential: Introduction of a finance-management-system
 - Administration has to rate the existing risks independently of the banks at any time.

Essential argumentations and recommendations - principle



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Security first yield!

Dealing with public funds is with notice of the particular intention to aim maximal security.



Essential argumentations and recommendations - 1st guidelines



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Guidelines are to adopt:

- authorisation by management or board,
- regular check,
- accommodation to actual situations



Essential argumentations and recommendations- 2nd total risk view



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Risk of financial standing and minimum rating

- for the acquired emission both as well
- additional for all issuers

Limitation of the risk of financial standing

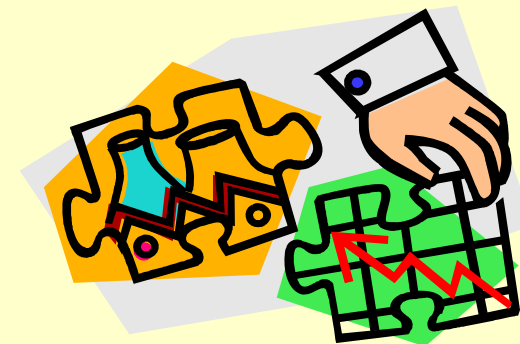
- that is at least rating A,

Risk limited loan portfolio to aim

- forego to chancy components like stocks and foreign currency bonds,

Demands to set clearly

- not to leave an interpretation leeway



Essential argumentations and recommendations – 3rd transparency



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Authorization

- Fixing amount and limits for specified dealings,

Execution

- How to come to a decision for a choice?
 - especially the illustration of the rate of return on relevant alternative assets,
 - Are the diversifications understandable in enforcement?
 - Are there assessments for the total life of the derivative business transactions?

Evidence

- Will be pictured the developments in the budgetary accounting or in special reports actually and contemporary?

Essential argumentations and recommendations – 4th Market value



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Goal of the use of derivatives

- optimization – reduction of interest spending,
- allowed are: operations for collateral,
 - operations for optimizing only by attention of definite conditions
- use for speculative intention is prohibited,

Make a decision to the legitimacy of the use of derivatives

- Authorization of the legislator,
- to take a limit of deficits for the negative market value into the budgetary law,

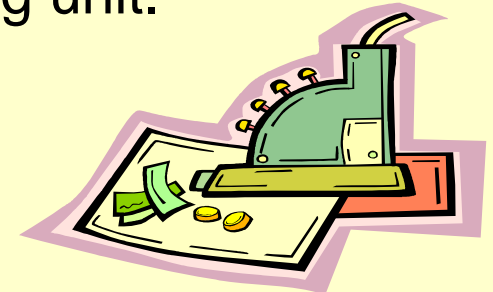
Market value of the derivatives has to use as control parameter appropriate in future

Essential argumentations and recommendations - 5th Controlling und Documentation



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- Condition:
 - Risks of the stocks can be observed
- Tasks: planning, inspection and control to inform the decision makers
- Process oriented but independent controlling unit.



Challenges for the Courts of Audit



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- complex approach,
- involving conceptual preparation,
- parallel, coordinated audit operations,
- auditors with special experiences, for example in banks sector,
- external expert knowledge,
 - critical choice of experts,
- education and training of the auditors,
- knowledge about global development and contexts is necessary,

