



INITIATIVE CORPORATE GOVERNANCE®
DER DEUTSCHEN IMMOBILIENWIRTSCHAFT

COMPLIANCE RISKS in the Real Estate Sector

focusing on
HARMFUL TRANSACTIONS

in cooperation with



ICG COMPLIANCE RISK OVERVIEW

EXECUTIVE SUMMARY

INTRODUCTION

The Initiative Corporate Governance of the German Real Estate Industry (ICG) has set itself the task of establishing ethical business management practices in Germany's real estate sector. To this end, the ICG has developed a series of guidelines and recommendations for action, the most recent of which is this compliance risk overview.

The overview illustrates typical compliance risks that can lead to financial loss over the lifecycle of a property. It considers all segments of the real estate industry, and highlights vulnerabilities for dubious transactions as well as the countermeasures that can be taken. This handout is the first of its kind in the sector, and can immediately put to use in daily business.

IMPORTANCE OF ETHICAL VALUE MANAGEMENT AND COMPLIANCE

"If you think compliance is expensive, try noncompliance!" This statement by former US Deputy Attorney General Paul McNulty highlights the importance of playing by the rules.

A firmly established compliance and ethical value culture is essential not just in connection with liability and international standards but also with regard to a company's reputation among its customers, investors and employees. It is almost impossible to assess the long-term damage – financial and otherwise – that negative compliance cases can inflict on a company.

The aim of this risk overview is to support the real estate sector effectively in its compliance work. Where applicable, it can also serve as a useful tool for an audit/compliance certification by the ICG.

STRUCTURE/ INSTRUCTIONS FOR USE

The risk overview lists typical examples sorted by industry segment and lifecycle/project phase. It also points to effective measures for mitigating these risks.

Regardless of specific tools and measures, the fundamental approaches to ethically value-oriented conduct in daily business are

- the example set by top management and supervisors (tone at/from the top),
- appropriate regulations to prevent and identify dubious transactions within the company, and
- compliance regulations in the company's dealing with external parties.

For all industry segments and property lifecycle phases, compliance measures can only be implemented successfully against the background of ethical business management values.

Compliance risk overview for the real estate industry based on the lifecycle of a property (Focusing on HARMFUL TRANSACTIONS)

Phase	Typical risks	Risk mitigation measures
<p>Project development</p>	<p>Offering/acceptance of benefits to/by public officials (e.g. decision-makers within local government), i.e. corruption* <i>Example: Inviting a local government decision-maker on a weekend yachting trip ahead of a pending decision regarding planning permission for a development project</i></p> <p>Unspecified consultant invoices for the purpose of payments to decision-makers <i>Example: Invoices issued by intermediaries acting on behalf of the project developer in a development project without specification of the service to be provided and/or payment to an account (other than the master account) of the consultant in a tax haven</i></p>	<ul style="list-style-type: none"> ■ Case-based compliance training for employees ■ Raise awareness of functions and special regulations for public officials ■ Personnel rotation ■ Focused, case-based compliance training to raise awareness of invoice irregularities ■ Monitoring by Internal Audit
<p>In-house/external financing (source of funds)</p>	<p>Breach of the Anti-Money-Laundering provisions <i>Example: Involvement in real estate purchase or sale transactions based on illicit funds</i> <i>Example: Arrangement of a mortgage loan with the intention of using illicit funds to service the loan</i></p> <p>Use of insider knowledge <i>Example: Disclosure of confidential information from a customer relationship (in return for benefits) to competitors or illegitimate use for own business purposes</i></p> <p>Loan-Back-Method <i>Example: Offenders grant themselves a loan, usually via other countries, straw men and bogus companies.</i> Back-to-Back-Loans (variant of the loan-back method) <i>Example: Collateral for a loan is obtained from illegal activities; in the event of a loan default, the bank realizes this collateral.</i></p>	<ul style="list-style-type: none"> ■ Identify the customer or beneficiary, conduct background checks (know your customer) and implement measures such as IT-based, specifically adapted, mandatory verification routines in order to identify the source of funds ■ Confidentiality agreement with employees Know your Customer / client due diligence: <ul style="list-style-type: none"> ■ Identify the owners and control structures ■ Identify the representative bodies ■ Determine the beneficiary ■ Determine the source of the funds as part of a risk-based evaluation

*See definition at the end of this overview.

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Phase	Typical risks	Risk mitigation measures
<p>Commissioning of brokers</p>	<p>Corruption* <i>Example: A broker offers/grants benefits to the customer in exchange for a qualified exclusive/marketing contract. A particular vulnerability in this phase is the manipulation of information with decision-relevance.</i> Example: An employee of the broker maintains an (inappropriate) relationship with the customer/third party and gives tips in exchange for a fee.</p> <p>Money laundering Example: A broker accepts an increased commission and passes some of it on to an uninvolved third party.</p> <p>Bogus invoice Example: Excessively high/unjustified invoices used to route funds illegally.</p> <p>Bogus joint business Example: A broker is instructed by the customer to transact business via an otherwise uninvolved third party that issues the order.</p>	<ul style="list-style-type: none"> ■ Case-based compliance training ■ Independent cross-checking (double verification principle) ■ Invoice verification ■ Compliance audits ■ Bilateral compliance/disclosure declaration ■ Transparency ■ Avoid this type of business setup <ul style="list-style-type: none"> ■ Fundamental value declaration ■ Case-based compliance training ■ Report suspected cases ■ Compliance audits <ul style="list-style-type: none"> ■ Check invoice for plausibility <ul style="list-style-type: none"> ■ Compliance/disclosure declaration ■ Transparency ■ Compliance with industry standards ■ Verify compliance with business license of third party (e.g. for Germany. Section 34c GewO German Industrial Code)
<p>Site acquisition</p>	<p>Embezzlement/obtaining credit under false pretenses Example: The purchasing company's managing director or the purchaser's fund manager (who wants to seal the deal in order to claim the bonus) "instructs" the external party responsible for performing the acquisition checks to leave out critical facts or to water them down so as to avoid any queries/demands from the financing banks.</p>	<ul style="list-style-type: none"> ■ Clear contractual conditions for all external service providers ■ Include confirmation letter in favor of creditors in the contractual conditions for external service providers ■ Transparency toward all stakeholders ■ Comprehensive final documentation drawn up by those responsible for acquisition, including declaration of completeness

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Phase	Typical risks	Risk mitigation measures
<p>Site acquisition</p>	<p>Embezzlement/obtaining credit under false pretenses <i>Example: A party purchasing several properties pays an excessively high purchase price which is charged to a fund administered by the purchaser in order to settle a conflict with the seller in respect of another property from a different fund.</i></p> <p>Example: The seller asks a bank for a confirmation of financing. The bank requires 60% of the property to be rented out in advance. The purchaser presents the bank with a rental contract, which he has ‘purchased’ by granting a very high one-time benefit which is not reflected in the rental contract.</p>	<ul style="list-style-type: none"> ■ Clear segregation of responsibilities for different funds ■ Transparent documentation of all ancillary agreements ■ Declaration of completeness for the rental contract
<p>Commissioning of project managers/planners</p>	<p>Corruption* <i>Example: Granting of services free of charge or at cost in exchange for the prospect of being commissioned for future projects</i></p> <p>Breach of trust/conflict of interest <i>Example: The service provider commissioned by the investor as the project manager/overall planner uses the commissioning of subcontractors (e.g. technical planners) for the investor with his own economic interests to the investor’s detriment.</i></p>	<ul style="list-style-type: none"> ■ Case-based compliance training ■ Double verification principle ■ Investigation by Internal Audit (including spot checks) ■ Personnel rotation ■ Case-based compliance training for employees ■ Double verification principle ■ Investigation by Internal Audit
<p>Agreement of advance rental contracts</p>	<p>Deception <i>Example: Potential tenants/buyers are presented with a (fictitious) advance contract with unrealistic conditions aimed at manipulating them and inducing them to submit a higher bid.</i></p>	<ul style="list-style-type: none"> ■ Detailed check including identification of the third party, the validity period and the date of issue ■ Train negotiators to identify potential risk ■ Set realistic targets ■ Documentation

**See definition at the end of this overview.*

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Phase	Typical risks	Risk mitigation measures
<p>Planning/ obtaining approval</p>	<p>False information during the approval planning phase <i>Example: False information is submitted deliberately during the approval planning procedure in order to secure approval.</i></p> <p>Concealing planned uses, obtaining approval for use under false pretenses <i>Example: Parking space calculations based on minimum requirements (e.g. office instead of job center, even though the property is already leased to the latter)</i></p>	<ul style="list-style-type: none"> ■ Plausibility check ■ Transparency ■ Double verification principle ■ Technical competence ■ Contractual protection against false information ■ Plausibility check (verification of key data in project or contract processing) ■ Transparency ■ Double verification principle ■ Technical competence ■ Contractual protection against false information
<p>Technical planning</p>	<p>Conflict of interest and disclosure of information – technical planner accepts advantages in exchange for useful information regarding the assignment, verification and approval of additional costs <i>Example: In addition to his planning activities, a technical planner has an interest in a company contracted to carry out work. During the technical planning phase, specific products are defined and subsequently included in the bid documents. The technical planner’s company is commissioned on the basis of the product specifications. Significant cost increases occur and are checked/approved by the technical planner, who in turn receives additional benefits.</i></p> <p>Unauthorized refunds to the customer <i>Example: A technical planner receives commission or planning orders without the customer’s knowledge for orders brokered by him.</i></p>	<ul style="list-style-type: none"> ■ Disclosure of interest in companies contracted to carry out work ■ Exclude associated companies from the bid process ■ Supplier management ■ Code of conduct ■ Segregation of functions ■ Double verification principle ■ Contractual exclusion of refunds and other granting of advantages

Compliance risk overview for the real estate industry based on the lifecycle of a property (Focusing on HARMFUL TRANSACTIONS)

Phase	Typical risks	Risk mitigation measures
<p>Bid process and contract award</p>	<p>Manipulation of the bid process - collusion between a project team member and a company Example: <i>The statement of work, e.g. for demolition or earthworks, is specified in a way that only a very limited number of bidders can offer services for some of the work and only one bidder is in a position to submit an offer for all the work.</i> Example: <i>Calls for bids containing unnecessary items, calls for bids not sufficiently product/bidder-neutral (service catalog), incomplete measurement ("extra items")</i> Example: <i>Interface risk is neglected/ underestimated (for partial award)</i> Example: <i>Call for bids is modified in favor of a particular bidder; covert preselection of possible bidders</i></p> <p>Forwarding of information during the bid process for manipulation purposes Example: <i>Forwarding of information with relevance to negotiations for the purpose of price-fixing or price manipulation. Negotiations are conducted in such a way that the bidder to be favored receives additional information (enabling him to submit a slightly more favorable bid).</i></p> <p>Deliberate price manipulation Example: <i>Overpriced contingency items are included in the contract with the implicit aim of executing and billing those items instead of the basic items and/or inserting extra services that are already included in the basic item in order to generate illegitimate profit from double billing.</i></p> <p>Contract awarded in contradiction of the bid result Example: <i>No-bid contract award, disregarding or acting against market conditions</i></p>	<ul style="list-style-type: none"> ■ Avoid specific stipulations and special solutions; leave room for alternative bids ■ Internal control system with rules for bidding, awarding and functional segregation ■ Double verification principle ■ Target vs. actual analyses ■ Regular review/ updating ■ Ongoing discussion and monitoring of key data by whole project team ■ Transparency toward all stakeholders ■ Monitoring by Internal Audit ■ External review <ul style="list-style-type: none"> ■ Case-based compliance training ■ Keep the group of people with access to the bid contents as small as possible <ul style="list-style-type: none"> ■ Comparison and plausibility checking of all items, including contingencies ■ Comparison of new additional services with the basic item ■ Comparison with other bidders <ul style="list-style-type: none"> ■ Internal control system with rules for bidding, awarding and functional segregation ■ Double verification principle ■ Target vs. actual analyses

Compliance risk overview for the real estate industry based on the lifecycle of a property (Focusing on HARMFUL TRANSACTIONS)

Phase	Typical risks	Risk mitigation measures
<p>Execution</p>	<p>Deliberate underperformance or quality defects Example: <i>Deliberate quality defects in critical areas, e.g. structural engineering calculations or fire protection; reduced material quality (material thickness, concrete quality); lack of construction supervision; deliberate acceptance of defects/underperformance</i></p>	<ul style="list-style-type: none"> ■ Continuous quality controls, especially in critical areas ■ Double verification principle ■ Rotation ■ Technical competence ■ External construction supervision
<p>Acceptance and commissioning</p>	<p>Acceptance by planning and construction officers despite defects and in breach of duty Example: <i>Manipulation of the acceptance report through deliberate concealment of identified defects or underperformance</i> Example: <i>Delaying the acceptance of hidden parts in order to prevent quality defects from being discovered</i> Example: <i>Acceptance of construction services in breach of the contractual agreements (facts and figures)</i></p> <p>Premature commissioning Example: <i>Notification of completion issued to the construction planning authority even though the project is not yet ready for commissioning (time pressure due to rental agreement terms) possibly aided by corruption of officials</i></p>	<ul style="list-style-type: none"> ■ Involve external experts in the acceptance process ■ Clear regulations regarding the completion and acceptance of hidden services ■ Internal control system with rules for bidding, awarding and functional segregation ■ Double verification principle ■ Target/actual analysis ■ Factual checks <ul style="list-style-type: none"> ■ Double verification principle ■ Involve third parties for monitoring purposes
<p>Occupation of the property</p>	<p>Rental security Example: <i>The tenant is able to move into the property without appropriate rental security as a result of collusion between the tenant and an employee.</i></p> <p>Acceptance despite underperformance or quality defects Example: <i>Manipulating the acceptance report by deliberately concealing identified defects or underperformance; delaying the acceptance of hidden services to prevent quality defects from being discovered</i></p>	<ul style="list-style-type: none"> ■ Double verification principle ■ Involve third parties for monitoring purposes ■ Claim management <ul style="list-style-type: none"> ■ Involve external experts in the acceptance process ■ Clear regulations regarding the completion and acceptance of hidden services ■ Internal control system with rules for bidding, awarding and functional segregation ■ Double verification principle ■ Target/actual analysis ■ Factual checks

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Phase	Typical risks	Risk mitigation measures
<p>Management and operation</p>	<p>Deliberate formulation of the rental contract to the disadvantage of the landlord Example: <i>Deliberate and unauthorized granting of benefits to the tenant by the broker or an employee of the landlord (discrepancy between stated/actual area, rental costs, fitout standard, contract standards); renting space out illicitly without appropriate reporting to the landlord</i></p> <p>Manipulation of operating cost calculation to the disadvantage of the tenant Example: <i>Inclusion of administration costs in apportionable operating cost items; failure to disclose unauthorized commission or refund payments to the landlord for services of relevance to operating costs; involvement of “intermediary companies” of the landlord for the purchase of apportionable services</i></p> <p>Illegitimate kickback-payments Example: <i>Subcontractors clandestinely grant kickback-payments to the contractor who issues the order while the customer is made to pay the nominal subcontractor price.</i></p> <p>Excessive economic optimization Example: <i>Deliberate and excessive lowering of technical standards</i></p>	<ul style="list-style-type: none"> ■ Internal control system with rules, e.g. target rent ■ Double verification principle ■ Target/actual analyses ■ Regular review of apportionable costs and their apportionability by a neutral party ■ Plausibility check based on comparative rents ■ Contractual provision prohibiting refunds ■ Cost-based remuneration for services ■ Registration and approval of subcontractors ■ Audit right of customer ■ Multiannual investment program with target values/square meter ■ Analysis of properties with lower investment
<p>Sale</p>	<p>Disclosure of insider information Example: <i>An employee/service provider of the seller provides advance insider information on negotiations with competing bidders in exchange for personal benefits (such a scheme may also be used to deliberately mislead potential buyers about the real bidding situation).</i></p>	<ul style="list-style-type: none"> ■ No one-to-one sale discussions ■ Ensure “written form” for information provided to potential buyers ■ Full documentation of information provided to third parties

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Phase	Typical risks	Risk mitigation measures
Sale	<p>Deception concerning a known, concealed defect Example: <i>When selling a previously contaminated site, the seller refers only to selected regulatory requirements for remediation without mentioning the continued groundwater contamination.</i></p>	<ul style="list-style-type: none"> ■ Declaration of completeness provided by the seller ■ Legal advice in the event of failure to produce documents
Sale and processing	<p>Conflict of interest in the selection of service providers Example: <i>Disputed sale of a valuable property where a potential buyer engages a notary who he previously had involved in a different context on the seller side</i></p> <p>Deceptive presentation of a completion report (free from significant defects) as confirmation that all requirements have been met Example: <i>Doubts expressed by an external expert regarding significant defects are remediated by a deceptive positive statement of the construction firm as ordered by the seller in order to manipulate the expert into issuing the certificate on false grounds.</i></p> <p>Breach of trust, corruption*, deception in pursuing warranty claims Example: <i>The buyer asserts claims based on construction defects that have been the object of lengthy negotiations and expert reports. The seller offers an attractive job to the responsible employee on the buyer side; in exchange, the employee manipulates the processing of the warranty claim (e.g. by deleting the warranty period expiration dates in the system) before changing jobs.</i></p>	<ul style="list-style-type: none"> ■ Avoid the engagement of potentially biased third parties in a role which requires impartiality. ■ Transparent expert report procedure ■ Structured contract processing with clear responsibility for all post-closing matters ■ Accompanying legal monitoring of deadlines ■ Regular status reports on all post-closing matters

* The term corruption used throughout this risk overview covers the criminal offenses of either “accepting a benefit” (Section 331 StGB German Criminal Code) or “granting a benefit” (Section 333 StGB German Criminal Code), “corruption” (Section 332 StGB), “bribery” (Section 334 StGB) and “commercial corruption and bribery” (Section 299 StGB). While Section 299 StGB covers the corrupt conduct of “employees or agents of a business”, the other provisions cited here regulate the corruption offenses for “public officials or other persons with particular public service obligations”. While the above legal references are based on the German legal code, similar legislation is applicable in other countries.

NOTE

This compliance risk overview describes problematic situations and conduct that the “Compliance” working group have identified as indicative of a compliance breach. It cannot however take into account the particular circumstances of every individual case.

For this reason, it does not represent a conclusive assessment of any of the described transactions, and neither the members of the “Compliance” working group nor the Initiative Corporate Governance of the German Real Estate Industry can accept liability of any kind for the correctness and completeness of the assessments put forward in the risk overview with regard to the situations and conduct described therein.

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