RegCORE Client Alert

German regulator consults on seventh update to MaRisk Circular

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German conduct of business rules

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QuickTake

On 26 September 2022, Germany's national competent authority (**NCA**) for financial services regulation and supervision, the German Federal Financial Supervisory Authority (**BaFin**), published an amended draft[1] of its circular on "Minimum Requirements for Risk Management" (**MaRisk**) for consultation.[2] The newest and thus seventh version of MaRisk will, once approved, replace the currently valid BaFin Circular 10/2021.[3]

MaRisk is one of BaFin's primary rulemaking instruments and means to communicate its supervisory guidance on conduct of business standards that it expects supervised firms to abide by when conducting regulated activity in or from Germany.

Financial services firms doing business within or with a nexus to Germany will want to review this most recent update to MaRisk and ensure that their internal policies and procedures as well as client-facing documentation are appropriately updated to accurately reflect regulatory requirements and supervisory expectations.

[1] See here (as a PDF deltaview showing changes to the text annotated with supervisory guidance, albeit available in German only).

[2] BaFin and Deutsche Bundesbank will accept comments until 28 October 2022, by email to konsultation-06-22@bafin.de and B32_MaRisk@bundesbank.de with the subject "Consultation 6/2022".

[3] See here.

A number of changes

BaFin's proposed updates to MaRisk and changes to individual "modules" aim to do three things, namely to:

1. Implement the European Banking Authority's (**EBA**) Guidelines on Loan Origination and Monitoring[4] (the **EBA Guidelines**). As part of that process, the BaFin is also implementing its findings from its own supervisory review of real estate transactions;

2. Integrate environmental, social and corporate governance (**ESG**) risk management into MaRisk's general risk management framework. notably sustainability risks. This in turn is based on BaFin's guidance on sustainability risks[5] (**BaFin's Sustainability Guidance Notice**) along with EU-level requirements, guidance and best practice statements. The updates to MaRisk equally contain supervisory requirements and expectations concerning model risks and governance; and

3. Stipulate specific requirements applicable to real estate investments of bank in particular further rules for real estate development loans.

Building upon regulatory requirements and supervisory expectations communicated by other NCAs across the EU, the BaFin has also introduced provisions to cover and clarify requirements and expectations on:

A. business model analysis; and

B. how certain MiFID activity, notably trading activity, should be conducted and thus supervised when conducted from a non-office centric basis i.e., while working from home (or further afield).[6]

These changes are discussed in further detail below.

Implementing the EBA Guidelines in MaRisk

The final version of the EBA guidelines were published on 29 May 2020. Banking Union supervised institutions (**BUSIs**), in particular those directly supervised by the European Central Bank (**ECB**), acting at the head of the Banking Union's Single Supervisory Mechanism (**SSM**), had to implement the requirements of the Guideline, in stages, from 30 June 2021.

The EBA Guidelines were developed based on the experience of the European-level and NCAs in addressing the identified shortcomings in current lending and credit risk monitoring practices. The EBA Guidelines reflect the current supervisory focus in connection with lending. In addition, ESG issues, the fight against money laundering and terrorist financing as well as technological innovations are also addressed in these EBA Guidelines, albeit (somewhat) in passing. In total, the EBA Guidelines comprise around 250 regulatory requirements that have an impact on the entire lifecycle of lending and portfolio management, as well as on the area of loans in intensive and problem loan processing – notably non-performing loans and exposures (collectively **NPLs**).

The following core contents of the EBA Guidelines are to be implemented by reference in the specific modules of the current seventh version of MaRisk:

- **Governance requirements for lending and monitoring (implementing Section 4 of the EBA Guidelines in full, with only certain additional clarificatory statements):** on credit risk management, strategy, risk appetite, risk culture and limitation, each related to credit risk and credit decision-making processes;

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[4] Available here.
[5] Available here. BaFin was one of the first EU supervisory authorities to publish such non-binding good practice guidelines for the management of ESG risks and these continue to apply alongside similar efforts published by EU authorities. The BaFin's supervisory expectations also apply in certain regards to a comparably broader set of supervised firms under its supervision, including banks, investment firms, insurance undertakings, pension funds and asset management companies.
[6] This development should also be read in conjunction with standalone coverage on working from home and redefining the three lines of defence model from our EU RegCORE available here and here

- **Lending process (implementing Section 5 of the EBA Guidelines):** Processes for granting credit, including information, documents and data relevant to the credit assessment of borrowers, new in particular inclusion of consumer protection aspects; orientation of the proportionality principle according to the type of financing and only to a limited extent according to the size of the firm;[7]

- **Pricing (implementing Section 6 of the EBA Guidelines):** Addition of supervisory expectations on risk-based pricing of loans;

- **Valuation of movable and immovable assets (implementing Section 7 of the EBA Guidelines):** Requirements for the valuation of collateral at the time of borrowing and the requirements for monitoring and revaluation and independent valuers (areas that were already addressed by the EBA's work on NPLs, as supplemented by the EBA Guidelines); and

- **Monitoring Framework (implementing Section 8 of the EBA Guidelines):** Focus on the requirements for the ongoing monitoring of credit risk.

The clarification in the comments to AT 1 paragraph 3 of MaRisk state that supervised firms may use the proportionality principle and the standards set out in paragraph 16 (b) to (d) of the EBA Guidelines. This is likely to be welcome by a number of affected financial services firms. Nevertheless, the introductions discussed above also come with a risk of goldplating. This is the case as MaRisk and its BTO 1 module on credit business organisational and operational structure apply to all assets and off-balance-sheet items as defined in section 19 of the German Banking Act (**KWG**).

Equally, as the BTO 1 module of MaRisk now cross-refers to the EBA Guidelines, those provisions in the EBA Guidelines would apply in Germany to assets and transactions that are expressly excluded from the EBA Guidelines' scope of application[8]. Furthermore, the proposed amendments to MaRisk do not reflect the exemption of loans and advances to credit institutions, investment firms, financial institutions, insurance and reinsurance undertakings, central banks, and sovereigns from Section 6 of the EBA Guidelines.

Integrating ESG risk management into MaRisk's general risk management framework

The seventh amendments to MaRisk equally now incorporates the BaFin's Sustainability Guidance Notice into MaRisk's general regulatory framework and thus sets more binding requirements that supervised firms must abide by. As a result, ESG risk-related criteria are (further) entrenched in MaRisk's risk management methodology and as a result supervised firms must consider their:

- **Risk inventory**: Supervised firms must identify material risks, the impact of ESG risks (which are not qualified as a new risk category but rather as a risk driver for risks already covered by the existing MaRisk risk management framework, such as credit risk, market risk, liquidity risk, and organisational risk) must be appropriately and explicitly included in the supervised firms' risk inventory (AT 2.2 para. 1 MaRisk);

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[7] The structure of this section already deviates significantly from the process-oriented structure of MaRisk notably through its differentiation according to borrowers on the one hand and loan products and the object of financing on the other. For various types of loans, the lending decision is required to include scenario analyses of future economic development. This section also deals with consumer protection aspects that were not explicitly considered in MaRisk so far. Moreover, the proportionality principle is also based on the type of financing and only to a limited extent on the size of the lending firm.

[8] namely derivatives, debt securities, and securities financing transactions.

- **Management responsibility/accountability**: Managing directors may only fulfil their entire duty for a competent corporate organisation if they are able to analyse relevant risks, including ESG risks, and take the required actions to mitigate them (AT 3 para. 1 MaRisk);

- **Risk-bearing capacity**: The effect of ESG risks must be appropriately and openly considered in internal procedures to ensure the institution's risk-bearing capacity - in this regard, BaFin underlines that focusing on current data histories is insufficient (AT 4.1 para. 1 and 2 MaRisk);

- **Business strategy**: When defining and adjusting their business strategy, banks must conduct an in-depth, forward-looking analysis of their business model, taking into account, among other things, changing environmental conditions and transitions to a sustainable economy, as well as potential developments over an appropriately long period of time (AT 4.2 para. 1 MaRisk);

- **Risk strategy/appetite**: The impact of ESG risks must be appropriately and explicitly considered in the institution's risk strategy and the determination of risk appetite (AT 4.2 para. 2 MaRisk);

- **Risk management and controlling processes**: The impact of ESG risks must be explicitly considered in the supervised firms' processes to identify, assess, control, monitor, and communicate risks - in this context, BaFin clarifies that the impact of ESG risks on other risk factors must be considered;

- **Stress testing**: The impact of ESG risks must be included in the supervised firm's material risk stress tests; in this respect, BaFin expects that the impact of ESG risks is mapped over an adequately extended period of time and beyond the ordinary risk assessment horizon (AT 4.3.3 para. 1 MaRisk);

- **Organisational guidelines**: Firms' organisational guidelines must include regulations on how they assess the effect of ESG risks (AT 5 para. 3 MaRisk); and

- **Internal risk reporting**: must provide the management board with an up-to-date and, to the extent possible and meaningful, quantitative overview of the impact of ESG risks (BT 3.1 para. 1 MaRisk); the risk control function's quarterly overall risk report must include meaningful information and data demonstrating the impact of ESG risks on the institution's business model, strategy, and overall risk profile, including (BT 3.2 para. 1 MaRisk).

As a result, supervised firms are obliged to create a response to ESG risks that is relevant to their business model and risk profile, while keeping the proportionality principle in mind. BaFin acknowledges that ESG risks can be difficult to quantify and manage – notably as they may lack access to historical data. This is an issue given the numerous aspects that must be considered over a longer period of time along with significant uncertainty regarding future climatic and political scenarios. Nonetheless, BaFin expects supervised firms to adapt current procedures and establish new measurement, control, and risk mitigation tools, especially given the possibility of both physical and transition hazards materialising at short notice.

For a number of firms, these new BaFin requirements and expectations and their impact on the firm will need to be benchmarked against efforts of other EU and non-EU financial regulatory and supervisory authorities to ensure a firm is complying with obligations overall as well as in respect of the detail.

Setting specific requirements to real-estate investments of banks

As around the globe, the German real estate market outlook has changed. The past years of low borrowing rates, which had led in a significant increase in institutional investment in real estate investments, have ended. Market participants are now having to deal with widespread impacts on the normalisation of interest rates, which has been put in place to combat rising inflation.

For the first time, the 7th MaRisk amendment expressly covers real estate transactions. In order to do this, a new module (BTO 3) will be added in a distinct area of the MaRisk. Real estate transactions are defined by MaRisk (convenience translation from the German) as follows:

> "Transactions involving real estate in which one of the following intentions is pursued: (a) acquisition or construction of real estate with the intention of generating income through renting/leasing; (b) acquisition or construction of real estate with the intention of resale (e.g., property development business); and (c) existing real estate with the intention of generating income through letting/leasing or resale."

The MaRisk specify that this term includes real estate controlled by a subsidiary within the purpose of section 290 of the German Commercial Code (*Handelsgesetzbuch*, HGB). However, BaFin does not define whether this includes investments in institutionally owned real estate funds. Real estate transactions that are primarily used to support the institution's own commercial operations are not permitted.

The draft MaRisk's organisational and procedural standards are comparable to those for supervised firms' credit business and include, among other things, the following:

- **Division of responsibilities**: In the real estate business of a supervised firm, the front office must be segregated from the back-office and risk-control duties, as well as the valuation expert indicated in BTO 3.2 para. 3 MaRisk up to and including the management board level;

- **Voting:** To enter into a real estate transaction, two positive votes from the front and back offices are required. This has no effect on other decision-making regulations (e.g., KWG, Articles of Association);

- **Valuation**: Appropriate valuation techniques must be employed when determining the procedures for assessing the value of real estate. As part of the appraisal, a property inspection must be performed. Experts must establish the property's market worth (BTO 3.2 para. 3). The value of real estate must be reassessed on a yearly basis; and

- **Annual report**: A report on real estate transactions must be prepared and made accessible to the management board at least once a year.

To avoid overburdening banks with just non-material real estate operations with these new rules, a 2% threshold of a lender’s entire balance sheet is proposed in the seventh amendments to MaRisk. In addition, a EUR 10 million absolute threshold is set. Despite this approach, even smaller banks would be required to comply with the new BTO 3 MaRisk rules from an early stage, albeit not necessarily from the first property being financed. As a result, the EUR 10 million barrier is expected to be debated during the consultation process and may be updated by BaFin from time to time.

Addressing other areas of supervisory priority

Other changes implemented as part of the seventh version of MaRisk include

- **Implementation of new rules in the General Part of MaRisk.** This new Module AT 4.3.5 aims to regulate the application, data quality, validation and expliainability of models within the scope of Pillar II requirements. This new module effectively implements Sections 4.3.3 and 4.3.4 of the EBA Guidelines but goes further in applying such requirements not only credit risk management models, but to all risk management models;

- **Clarifications on business model analysis expectations.** The amendments aim to supplement individual sections of MaRisk (without designating a separate module on business model analysis altogether). For example, the explanations to AT 4.2 MaRisk clarify that supervised firms should assess whether their own business model can be maintained over an appropriately long, multi-year period or whether there is a need to adjust the business model and strategic management measures must be taken. The text of AT 4.1 MaRisk emphasises that a firm's capital planning must be consistent with its operational business planning and its strategic foundations as well as with the business model. Business and capital planning should go hand in hand in the sense of an integrated overall bank management and not be merely "calculations for supervisors". Furthermore, AT 4.3.2 and BT 3.1 MaRisk provide for changes to the effect that, in addition to reporting on the risk situation of a firm, corresponding reporting on the business situation must also be carried out;

- **Rules and expectations on trading activity carried out in a non-office centric and/or working from home environment (or conceptually, albeit not explicitly mentioned, further afield).** MaRisk (in particular BTO 2.2.1 para. 3) aims to regulate how business transactions conducted outside the business premises, are only permitted, in the context of a firm's internal guidelines. Those guidelines should set out how such activity is permitted and recorded. In the case of trading activities outside of an office-centric environment, MaRisk requires that a sufficient presence of other traders on the business premises must always be ensured. Such a sufficient presence is deemed to be satisfied if the trading activity can be shifted immediately to the business premises in case of (technical) impairments of the trading business conducted outside an office-centric environment. Smaller firms with only one or two traders must at least provide for adequate substitution arrangements or make arrangements for the transfer from the non-office centric to office-centric workplace. In all circumstances firms must ensure they can safeguard the confidentiality of the data underlying the transactions by means of appropriate guidelines. Moreover, firms must also ensure the stability of the settlement or confirmation systems and the requirements for IT security in non-office centric workplaces that are no less robust than those in an office-centric workplace. Furthermore, non-office-centric workplaces of traders should be located at specified and agreed locations and may only be used during working hours and in such a way that the confidentiality of business transactions is maintained; and

- **Application of certain rules to large promotional banks.** German promotional banks are exempt from the EU's CRR and CRD regime. As a result, the ECB-SSM is not responsible for the supervision of Germany's largest promotional banks.[9] The BaFin has as a result assessed how certain MaRisk terms should be applied to such large promotional banks. The requirements of AT 4.4.1 para. 5 on the exclusivity of the risk-controlling function and AT 4.4.2 para 4 on the independent compliance unit were chosen by BaFin. Moreover, the EBA Guidelines GL/2017/11 on

[9] See here

internal governance are the source of both those MaRisk provisions and considerations around permitted remuneration with a view to ensuring same risk same treatment in this area.

Outlook and next steps

Financial services firms both operating from as well as into Germany will want to take note of this most recent update of MaRisk and may well need to make targeted amendments to their internal systems and controls as well as their counterparty and client-facing documentation.

While it is unclear when the seventh version of MaRisk may be finally approved and thus take effect, given the overall direction of supervisory reform by other EU-level authorities and NCAs, firms will want to forward-plan, prepare and push through changes. This is especially the case in respect of meeting the objectives and outcomes communicated by the EBA Guidelines which the BaFin had anticipated it would implement in the German regulatory framework by June 2022. Firms will equally want to benchmark how and to what extent their efforts to meet compliance with the newest MaRisk map across to regulatory reforms imposed on similar business and compliance processes set by other authorities.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these developments.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's EU RegCORE Team via de_regcore@pwc.com or our website.

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