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TECHNICAL NOTE—REGULATION AND SUPERVISION OF LESS SIGNIFICANT INSTITUTIONS

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TECHNICAL NOTE

REGULATION AND SUPERVISION OF LESS SIGNIFICANT INSTITUTIONS

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

AGRA	Committee for Risk Oriented Analysis
AOC	Auditor Oversight Commission
APAS	Audit Oversight Body
BaFin	Federal Financial Supervisory Authority
BBk	Deutsche Bundesbank
BCBS	Basel Committee for Banking Supervision
BCP	Basel Core Principles
BRRD II	Bank Recovery and Resolution Directive
COREP	Common Reporting (ECB)
CRD V	Directive 2013/36/EU
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation (EU) No 575/2013 +CRRII
DG	Directorate General
EA	External Auditor
EBA	European Banking Authority
ECB	European Central Bank
ESA	European Supervisory Authority
EU	European Union
FinDAG	Act Establishing the Federal Financial Supervisory Authority
FINREP	Financial Reporting (ECB)
FinStabG	Financial Stability Act
FISG	The Act to Strengthen Financial Market Integrity, effective January 2022
FMI	Financial Market Infrastructure
FOLF	Failing or likely to fail
FREP	Federal Reporting Enforcement Panel
FSAP	Financial Sector Assessment Program
FSC	Financial Stability Committee
GCGC	German Corporate Governance Code
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IPS	Institutional Protection Scheme
IT	Information Technology
JST	Joint Supervisory Team
KWG	German Banking Act (Kreditwesengesetz – KWG)
LCR	Liquidity Coverage Ratio
LSI	Less significant institutions or banking groups (LSIs)

MaRisk	Minimum requirements for management (Mindestanforderungen an des Riskomanagement – MaRisk)
MoF	Federal Ministry of Finance
NCA	National Competent Authority
NPL	Non-Performing Loan
NRA	National Resolution Authority
RiG	The Act on Risk Reduction and Proportionality in the Banking Sector, December 2020
SI	Significant Institution
SNCI	Small and Non-Complex Institutions
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism
SupTeck	Supervision Technology
TN	Technical Note

EXECUTIVE SUMMARY

The Financial Sector Assessment Program (FSAP) conducted a focused review that primarily assessed banking regulation and supervision of Germany's less significant institutions (LSIs).[1] Germany accounts for 1,324 of about 2,400 total LSIs in the Euro Area (representing 40 percent of Germany's banking sector assets and approximately 55 per cent of total Euro Area LSI assets). As Germany is part of the Euro Area, the regulation and supervision of banks takes place within the European Central Bank's (ECB) Single Supervisory Mechanism (SSM). The Federal Financial Supervisory Authority (BaFin) and the Deutsche Bundesbank (BBk) are responsible, under the oversight of the ECB, for the supervision of LSIs.

The authorities made good progress on the implementation of the recommendations of the 2016 Basel Core Principles (BCP) assessment. The authorities rolled-out the ECB/SSM approach to the Supervisory Review and Evaluation Program (SREP) to all LSIs, made enhancements to liquidity risk (roll-out of LCR and related reporting), operational risk (including on cyber risk), and, more recently, provided BaFin with more effective financial accounting oversight powers. However, there is scope for further strengthening of the institutional arrangements, the legal framework and approach to corporate governance, and the overall supervisory framework and approach.

Building on the key lessons from the Wirecard[2] fraud, the Federal Ministry of Finance (MoF) responded quickly to initiate a reorganization program including several legal and structural reforms impacting BaFin. These reforms are aimed at, among other things, strengthening BaFin's ability to supervise more closely complex credit institutions, undertake forensic audit, enforce the quality of financial reporting by external auditors, strengthen the use of whistleblower information and consumer protection powers and capacity as well as create a center for digital data excellence by providing and continuously developing competencies and tools for the digital analysis of data and information in the context of supervisory activities. The (internal) powers of the President were strengthened to set BaFin's strategic direction, budget proposal, organization structure and the ability to give directions to BaFin's Executive Directors. These reforms will enable BaFin to make earlier use of corrective and sanctioning powers to increase its effectiveness in dealing with lingering deficiencies of problem banks.

The MoF is now expected to step back[3] from the reorganization program as well as streamline current reporting to a more systematic approach to ensure BaFin's operational independence. Although many of the reform initiatives are still on-going, and there is a necessity to ensure continuing sufficient information flow from BaFin to the MoF, it is imperative that BaFin maintain operational independence. Further, going forward, a joint BaFin and BBk

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[1] The review reflects the regulatory and supervisory frameworks as per October 19, 2021.

[2] Wirecard Bank, the unit supervised by BaFin's banking supervision, did not run into insolvency and is currently conducting a voluntary wind down.

[3] The joint modernization project was concluded December 17, 2021.

strategic agenda is critical to avoid duplicative or disjointed efforts and is necessary to ensure an effective banking supervision program is in place. This complementing strategic agenda should recognize the need for joint projects (e.g., joint digitalization agenda) to ensure a fully cooperative partnership on the BaFin reform agenda. Strengthening the reporting against supervisory priorities between BaFin and BBk mid-cycle will also help ensure both organizations remain agile in responding to crisis, emerging risk issues and adjusting supervisory resources where needed.

Further enhancements are needed to align the corporate governance framework with international best practices. Although several provisions were put in place to strengthen internal control obligations and liabilities pertaining to supervisory board members of listed companies, much work is needed to modernize the corporate governance framework for banks in Germany. Not unlike other jurisdictions with dual board systems, the role of the supervisory board needs to be further strengthened in its oversight of the key control functions (direct reporting lines of internal audit, compliance and risk management) to ensure that critical checks and balances are in place to oversee and govern executive management activities. The current construct still leaves room for management boards to dominate essential control functions. Stricter requirements for the independence of board members and heading up key committees, as well as increasing the level of engagement by supervisors will assure a stronger oversight function by the supervisory board and in line with international best practices.

It is important to reassess the extent of reliance on external auditors with a view to enhancing the ability of the authorities to conduct in-depth file reviews of auditors' assessments. The German authorities continue to place great reliance on the role of the external auditor, particularly with respect to the compliance with the minimum risk management requirements (MaRisk), which is not surprising given the need to supervise 1,324 LSIs. However, it is essential that supervisors be well placed to not only challenge the work of the EAs but to perform deep dives on the various risk areas when needed. For example, it was noted that the supervisor's ability to undertake a deep dive on the review of credit files needs to be strengthened (e.g., assess impact of connected and related party transactions, etc.) to adequately fulfill this challenge role. Ensuring supervisors have adequate access to granular data will also strengthen the supervisor's ability to adequately assess risk areas of institutions.

Supervisors, EAs and the industry would benefit from further guidance to complement the principles based MaRisk to clearly communicate supervisory expectations for banks. Given the extensive nature of the EU regulations, EBA Guidelines (including Germany's partial or non-compliance stance) as well as international standards, additional guidance for the industry, the EAs and supervisory staff is needed. MaRisk's principle-based nature does not necessarily clearly outline supervisory expectations specific for banks in all areas (Circulars cover certain aspects of needed guidance but not all areas).

Although Germany finalized the roll-out of the ECB/SSM LSI SREP methodology to all LSIs in 2020, certain aspects of the overall supervisory framework (e.g., supervisory engagement and frequency of on-site inspections) need to be further strengthened. The

German SREP methodology, which was developed along the lines of the EBA SREP Guideline and the ECB's SSM LSI methodology, effectively determines a SREP score for each LSI annually. Based on the SREP score, the Germany authorities determine both the minimum level of engagement (MEL) as well as the minimum frequency for the on-site inspection of LSIs. The MEL currently does not include the engagement of the management function or risk control functions even for the lowest risk assessment score (SREP 4). Further, the frequency of on-site inspections should be reassessed given the need to ensure adequate coverage of both the riskiest LSIs (current minimum frequency of up to a 4-year on-site inspection cycle) and the highest impact LSIs (greater than EUR15Bn total assets – currently up to 10-year cycle). BaFin/BBk will therefore need to reassess the adequacy of risk resources to ensure satisfactory coverage of on-site inspections, ability to undertake deep dive reviews and ensure critical risk expertise (e.g., market risk expertise to cover institutions shifting their activities to Germany as a result of Brexit).

Fintech data collection, forward looking dynamic market monitoring and financial stability analysis need further development. Germany is the leading country in continental Europe for fintech, hosting some of the largest neobanks and related service providers. BBk's Statistics Directorate has run a pilot project to collect data on fintech. The first results of the pilot indicate that the size of the fintech across different financial sectors is still relatively small. However, in view of the rapid growth a more structural approach to data collection, financial stability analysis and a more dynamic forward looking market monitoring are important to develop going forward.

Table 1. Germany: Recommendations on Regulation and Supervision of Less Significant Institutions

Recommendation	Priority	Timeframe
Institutional arrangements, and coordination and cooperation		
1) Streamline the scope and frequency of BaFin's microprudential reporting to the MoF to ensure operational independence (¶13)	H (BaFin /MoF)	I
2) Complement the BaFin reform agenda with a joint BaFin/BBk strategic agenda for banking supervision to avoid disjointed or duplicative supervisory approaches (¶21, ¶69)	H	I
Regulatory framework and supervisory guidance		
3) Address legislative and guidance weaknesses with the corporate governance framework to align it with international best practices for dual board systems (¶29-30)	H	NT
4) Provide additional supervisory guidance to a) align MaRisk with EBA Guidelines on key banking risk issues (e.g., supervisory boards, credit risk, concentration, country risk, related party transactions (Appendix I, ¶53)); and b) clearly communicate use of intervention powers to the industry (¶52)	M	NT
Supervisory approach, tools and reporting		
5) Improve reporting against supervisory priorities and workplans to ensure adequate adjustments are made mid-cycle (¶16)	H	I
6) Reassess adequacy of risk resources to ensure satisfactory coverage of on-site inspections and increase critical risk expertise(¶56, ¶68)	M	NT
7) Increase engagement with supervisory board members to ensure an adequate oversight function is in place and working effectively (¶55)	H	NT
8) Update SREP methodology to: a) better align the minimum engagement level to the high-risk/high priority LSIs (¶40); b) incorporate other relevant factors (AML risk, IPS premium risk rating) (¶38, ¶57); and c) ensure dynamic SREP scoring for high-risk and high-priority LSIs (¶48)	M	NT
9) Ensure on-site inspection frequency is adequately aligned with the risk assessment score and ensure adequate coverage of larger LSIs (¶41,¶47)	M	NT
10) Make earlier use of corrective and sanctioning powers to increase effectiveness of dealing with lingering deficiencies and problem banks (¶52)	H	I
11) Reassess the extent of the reliance on the work of the External Auditor (EA) for compliance with MaRisk to ensure the ongoing ability of supervisors to challenge EAs on LSI's strength of risk management practices, including the ability to undertake effective deep dive reviews of credit files (¶50, ¶51)	H	I
12) Reassess the need for additional granular data to adequately assess risk areas of institutions (certain aspects of credit, market risk data, etc.) (¶60)	M	NT
13) Continue efforts to develop fintech data collection, forward looking dynamic market monitoring and financial stability analysis (¶64).	M	NT

Note: **Both BaFin and BBk responsible for recommendations except where indicated otherwise in parenthesis.** In terms of priorities, H, M, and L stand for high, medium and low. In terms of time frame, I, NT, and MT stand for immediate (within one year), near-term (within 2–3 years), and medium-term (within 3–5 years).

INTRODUCTION[4]

A. Context and Scope

1. As Germany is part of the Euro Area, the regulation and supervision of banks takes place within the European Central Bank's Single Supervisory Mechanism. The European Central Bank (ECB) has the direct responsibility for the supervision of Germany's largest institutions (Significant Institutions (SIs)). BaFin and the Deutsche Bundesbank (BBk) are responsible, under the oversight of the ECB, for the supervision of other smaller banks (Less Significant Institutions or LSIs).

2. To avoid duplication with the 2018 Euro Area Basel Core Principles (BCP) assessment, the current review focusses on the regulation and supervision of German LSIs. The assessment will follow up (and not make a graded full assessment of the BCP) on the progress regarding the recommendations of the 2016 Germany BCP assessment with a focus on LSI regulation and supervision by the national competent authorities and review other relevant developments and potential areas for further enhancement.

3. The authorities made good progress on the recommendations of the 2016 BCP assessment and introduced important reforms in response to the Wirecard failure. Since 2016, good progress has been made on the implementation of SREP, enhancements to various risk areas (liquidity, operational, cyber), and, more recently, the expansion of financial accounting oversight powers. In response to the Wirecard failure, the authorities introduced legal reforms addressing the role of the external auditor (EA) and the oversight of accounting standards, as well as an internal reorganization of the Federal Financial Supervisory Authority (BaFin). While some of these measures have been introduced recently, others are still in progress.

4. The mission took stock of the development of technology in financial services (fintech) and the internal digitalization efforts of the authorities. Fintech allows for new business models and may require changes to the existing regulatory and supervisory approaches. These technological developments can also help to realize efficiencies in the business processes of the authorities and innovative approaches to supervision.

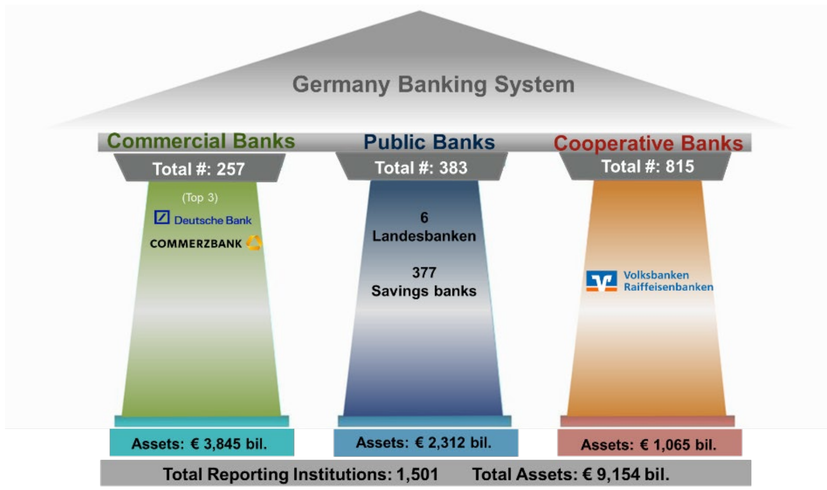
5. In this context, this Technical Note discusses the main observations and recommendations of the assessment on LSI regulation and supervision in Germany. The Technical Note (TN) begins with a brief overview of the market structure explaining the relevance of LSIs, followed by a more detailed description and review of the institutional setup in Germany. The TN then discusses the main observations and recommendations regarding the legal and regulatory framework, and the supervisory approach, tools and reporting relevant to LSIs, in particular taking a view on the main developments since the 2016 BCP assessment. The final section provides an overview and observations regarding the regulatory and supervisory approach to fintech and BaFin/BBk's internal use of technology (digitalization/Suptech).

[4] This Technical Note was prepared by Dirk Jan Grolleman (IMF) and Geraldine Low (IMF short-term expert).

6. The assessors appreciate the authorities' extensive cooperation and professionalism demonstrated throughout this review process. The assessors benefitted from the inputs and views expressed in meetings with regulators, supervisors, and private market participants. The team sincerely thanks BaFin, BBk and ECB staff for making enormous efforts to respond to the team's requests and overcome logistical challenges involved in a hybrid mission.

MARKET STRUCTURE

7. Germany's bank-centric financial sector is large and well-developed. Credit institutions, with assets equivalent to 270 percent of GDP, account for about 60 percent of the financial sector assets. The banking sector is characterized by its three-pillar structure: commercial banks, public savings banks and cooperatives. There are 21 large banks and banking groups (SIs) and 1,324 LSIs as defined in the context of the ECB Single Supervisory Mechanism (SSM). At the Euro Area level, Germany accounts for 25 percent of total Euro Area bank assets and about 55 percent of total Euro Area LSI assets (21 of 114 SIs and 1,324 of about 2,400 LSIs are German). Also, there are 25 third country bank branches,[5] 41 other credit institutions (including 15 development banks) and 38 securities trading banks. In addition, there are 427 leasing and factoring institutions and 47 housing enterprises with saving schemes, which also provide financing services, but fall in a different licensing category than credit institutions.[6]



[5] Third country bank branches are not in scope of the SSM, but the responsibility of National Competent Authorities.

[6] Numbers based on BaFin's Annual Report 2020, ECB/SSM published list of SIs and ECB's Risk Report on LSIs (2020).

Box 1. Definition of a Credit Institution and a CRR Credit Institution

A **credit institution** is an undertaking which conducts at least one of the banking businesses described in detail in section 1 (1) of the Banking Act (KWG) commercially or on a scale which requires commercially organised business operations. The banking businesses includes the deposit business and credit business, but also specific securities-related activities such as principal broking services and the safe custody business.

Pursuant to section 1 (3d) of the KWG, a **CRR credit institution** is a credit institution that also meets the narrower definition of a credit institution in accordance with Article 4 (1) no. 1 of the EU Capital Requirements Regulation (CRR). CRR credit institutions are supervised in the context of the SSM either directly by the ECB as SIs or by BaFin together with BBk as LSIs.

While the (non-deposit taking) **securities trading banks** and the other credit institutions are not CRR credit institutions, they nevertheless fall within the German definition of a credit institution and are supervised by BaFin in cooperation with BBk.

Unless otherwise indicated, this TN will refer to a CRR credit institution as a bank (and their supervision as banking supervision) and use the term credit institution as defined in the KWG.

8. **Public saving banks and cooperatives benefit from cooperation agreements and cross-guarantee schemes of their subsectors in the form of Institutional Protection Schemes (IPSs).**[7] The schemes are also administering the sub-sectors' deposit insurance schemes, while private commercial banks have their own deposit insurance scheme and voluntary top-up scheme. Within their subsectors, cooperative and savings banks also cooperate on the provision of centralized services (e.g., data centers, back-office and risk management functions) to realize economies of scale.

9. **While the total assets of the banking sector increased over the past five years, the number of banks decreased.** The overall number of LSIs has steadily decreased from 1,562 in 2016 to 1,324 in 2020 mainly due to mergers and amalgamations. However, as a result, of among other things Brexit, Germany also received a good number of CRR-institution, bank branch, securities bank, and securities trading firm license applications.

10. **German banks' low profitability was exacerbated during the COVID-19 pandemic; however, key banking sector indicators are still sound (see Table 2).** While capital adequacy, non-performing loan and liquidity ratios are heathy, the sector is on average characterized by a relatively high cost-to-income ratio. Profitability is highly dependent on interest income, with interest margins to gross income declining from 71.2 percent (2016) to 69.5 percent (2019) amid the low-interest-rate environment. It was noted that German banks still managed to increase gross income slightly during this period as well as decrease operating costs. The COVID-19 crisis added to the profitability weaknesses, with the necessity to book additional loan loss provisions and

[7] An IPS is defined as a contractual or statutory liability arrangement which protects its member institutions and in particular ensures that they have liquidity and solvency needed to avoid bankruptcy where necessary.

return on assets (0.16 percent) and equity (2.71 percent) as of September 2021.[8]

INSTITUTIONAL SETTING

A. Supervisory Responsibilities, Objectives, and Powers

11. The institutional arrangements for banking supervision have some additional complexity because of the European framework as well as some Germany specific elements. Several German and European institutions and agencies with distinct and complementary mandates are relevant to banking supervision and regulation.

- **The Federal Ministry of Finance (MoF)** is responsible for financial market legislation and for the legal (Rechtsaufsicht) and technical (Fachaufsicht) supervision of BaFin (section 2 FinDAG).[9] In the German setup, the MoF bears the political responsibility for BaFin's activities. The subject of the legal and technical supervision is the legality and fitness for purpose of BaFin's administrative actions.[10]

- **BaFin,** a federal agency under the MoF, is an integrated financial sector supervisory authority. It is responsible for the prudential supervision of credit institutions, insurers and pension funds, capital markets intermediaries as well as for market conduct and consumer protection. BaFin is also the national resolution authority (NRA) for LSIs without cross-border operations.[11] *BaFin's budget needs annual approval by its Administrative Council (which has government representatives as well as experts from the industry and academia) and is funded through levies* raised from supervised institutions. It has in total about 2,720 staff of which about 550 are working in the Banking Supervision Directorate (BSD). In addition to the LSIs, the BSD covers the supervision of other credit institutions, third country bank branches, leasing and factoring institutions, payment and e-money institutions, and housing enterprises with saving schemes (in total over 1,900 institutions). Securities trading banks are, in view of their specialized activities, supervised by BaFin's Securities and Asset Management Supervision Directorate. BaFin cooperates for the execution of day-to-day supervision of credit institutions with BBk (section 7 KWG). This cooperation is unique to the supervision of credit institutions, requiring close cooperation and alignment of supervisory processes and approaches between BaFin and BBk.

[8] Source: BBk report September 2021.

[9] Act Establishing the Federal Financial Supervisory Authority (FinDAG).

[10] Different countries use different approaches to ensure the accountability and transparency of decision making by the supervisory authority. The IMF does not have a preference for a particular structure as long as it respects the operational independence and does not undermine adequate resources of the supervisory authority (see Principle 2 of the *Basel Core Principles for Effective Banking Supervision* (September 2012)).

[11] The Single Resolution Board (SRB) is the resolution authority for SIs and cross-border LSIs (the SRB together with the NRAs make up the Single Resolution Mechanism (SRM) of the Euro Area framework).

- In addition to its role in monetary policy and financial stability, **BBk[12]** plays a key role in the ongoing day-to-day (off- and on-site) supervision of credit institutions. BBK's offsite banking supervision activities are funded through BBk's own budget and investments. BBk's onsite inspections are paid for by the inspected institutions. Within BBk, about 1,550 staff are directly involved in the supervision of credit institutions (deployed approximately in a ratio 33 percent SIs / 67 percent non-SI credit institutions). BBk submits the results of day-to-day supervision of non-SI credit institutions with recommendations to BaFin, which makes the final assessment and decisions.

- **The Single Supervisory Mechanism (SSM), composed of the European Central Bank (ECB) and the National Competent Authorities (NCAs),** is the legislative and institutional framework that grants the ECB a leading supervisory role over banks in the EU.[13] The ECB, working closely with the NCAs, is directly responsible for the supervision of SIs and oversees the supervision of LSIs as conducted by the NCAs.[14] BBk and BaFin (jointly the German NCA) are involved in ECB's SI supervision via their participation in the joint supervisory teams (JSTs). The operational division of responsibilities between BaFin, BBk and ECB for the supervision of SIs and LSIs is laid down in the SSM Framework and, on a national level, in the "Supervision Guideline" which outlines the division of labor between BaFin and BBK. In addition to its oversight role for LSI supervision, the ECB has direct responsibility (proposals for approval drafted by the NCA) for licensing withdrawal of licenses, and qualifying holdings in LSIs. Authorization of third-country bank branches is the responsibility of the NCAs.

- **The European Banking Authority (EBA)** is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. The main task of the EBA is to contribute to the creation of the European Single Rulebook in banking supervision for NCAs. EBA also plays an important role in promoting convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU banking sector.

12. BaFin is subject to broad reporting requirements to the MoF in the context of its legal and technical oversight.[15] As observed in the 2016 assessment and the file review of the current assessment, the detail and frequency of communication between BaFin and the MoF appears to go beyond the necessary oversight and financial stability responsibilities of the MoF which calls into

[12] Its primary objective is to safeguard price stability. In addition, it shares responsibility for the stability of the financial system as well as for payment systems oversight.

[13] The SSM Regulation and the SSM Framework Regulation set out the fundamental principles governing collaboration within the SSM.

[14] Although the ECB has the authority to take enforcement action and take over the direct supervision of an LSI, it in practice so far has relied on the NCAs and only in exceptional circumstances assisted in onsite inspections or taken over supervision of certain institutions at the request of NCAs (e.g., assisting in stressed situations and circumstances in which NCAs were resource constrained).

[15] The scope of the reporting requirements is described in the document "Principles governing the exercise of legal and technical supervision of BaFin by the Federal Ministry of Finance," which was updated in July 2021.

question BaFin's necessary operational independence of the MoF.[16] The reporting not only covers issues that have financial stability implications, but includes all microprudential developments of "*material importance*" (which is defined more broadly than only from a financial stability perspective), changes to regulations and guidance, as well as internal decisions, which need the MoF's approval, regarding fundamental changes to BaFin's organization and personnel (see also paragraph 21 on the MoF's involvement in the BaFin reorganization). More generally, *"the Ministry may at any time require BaFin to report on the knowledge available to it or its actions and ask to submit documents."* Finally, the MoF reporting is already considered at a division unit level when preparing internal BaFin management reporting for individual files (so called "DIS" reporting) and submitted by the office/secretariat of the Executive Director of each Directorate to the MoF. The direct involvement in internal organizational matters, broad reporting requirements, reporting on individual cases and the level/frequency within BaFin at which reporting is conducted, affect the real or perceived operational independence of BaFin.

13. The authorities should take a more systematic and streamlined approach to BaFin's reporting to the MoF to provide assurance on BaFin's operational independence. Discussions between BaFin and the MoF on the reporting, as well as regarding the timing for the MoF to step back from its role in the reorganization program (see next section) have begun. BaFin's reporting should generally be oriented towards the newly established reporting processes regarding the supervision of innovative/particularly risky and/or struggling business models ("KFT-reporting"). Both the MoF and BaFin should ensure that for ongoing supervision (in crisis situations different reporting needs may apply) reporting takes place regularly ex-post, at a predetermined frequency, and at an aggregate sectoral and cross-sectoral level. Individual file information should only be added to the extent necessary for the MoF to fulfill its legal and technical oversight obligations. For information on issues related to financial stability the authorities should consider whether there are more appropriate mechanisms for the MoF to obtain information (e.g., via the G-FSC). To ensure appropriate oversight (complete view) of all reporting to the MoF, the responsibility for the reporting should be elevated to the office/secretariat of BaFin's President. A newly agreed reporting framework should also be reflected in the document describing the principles for MoF's technical and legal oversight of BaFin.

B. Cooperation, Information Exchange and Management Reporting

14. The shared responsibilities between BaFin, BBk and ECB for banking supervision require clear cooperation mechanisms, which in practice appear to work well. There are several well-established mechanisms that facilitate cooperation and information sharing for prudential purposes across the various agencies and institutions.

[16] In addition, the 2016 assessment pointed to the presence of industry stakeholders in BaFin's Administrative Council (responsible for BaFin's budget approval) and how this may affect (the perception of) BaFin's independence.

- The **German Financial Stability Committee (G-FSC)**[17] is the central committee for macroprudential surveillance in Germany. The MoF, BBk, and BaFin each have three voting representatives on the G-FSC. In addition, BaFin has one non-voting advisory representative responsible for BaFin's resolution mandate.

- In the **Committee on Ongoing Supervision (GIA)** BaFin and BBk monitor and discuss the overall risk situation (e.g., bank profitability and Covid impact) and specific risks (e.g., cyber risk) to the German banking sector as well as other risks that may have been uncovered ad hoc or in the context of analyzes. The results of the discussion held within this committee can lead to the implementation of supervisory measures such as talks with selected institutions or cross-institutional information requests. The committee is also involved in setting the supervisory priorities and its discussions feed into the overall annual supervisory planning. The committee usually meets quarterly.

- In the **Committee for Risk Oriented Analysis (AGRA)** BaFin and BBk discuss the development of policies, regulations, guidelines, supervisory practices, tools, and techniques, but also more operational issues relevant to the cooperation and coordination between BaFin and BBk.

- BaFin/BBk provide **regular reporting to the ECB** in the context of its responsibility for the supervision of banks in the Euro Area. The ECB receives regular prudential reporting (COREP and FINREP)[18] and collects annual benchmarking data and funding plans information from LSIs where applicable. In addition to the quantitative reporting, BaFin/BBk also share annually the supervisory priorities for LSI supervision, the SREP-score and its subcomponents for all LSIs, the supervisory planning (off- and onsite activities) for the high priority (HP)-LSIs (aggregated information by sector plus on-site activities for the other LSIs) in the next calendar year as well as the provision of the annual report on the supervision of LSIs. The reporting is complemented with ad-hoc notifications (e.g., in the case of financial deterioration, material procedures and draft decisions concerning LSIs etc.) as prescribed in the SSM Framework Regulation and further detailed in the Guidance for NCAs on notification requirements for LSIs. The formal mechanisms are complemented by fluent day-to-day informal communication between BaFin and BBk, and regular (several times per week) communication with the ECB/SSM Germany Desk.

15. Among others in view of its recent experiences with problematic institutions,[19] the ECB is currently updating its guidance for NCA's on the notification expectations for LSIs. In case of the failure of an LSI, ECB needs to be notified of decisions regarding FOLTF (and may provide

[17] The 2021 FSAP produced a separate TN on Macroprudential Policy and Tools, which also covers the role of the G-FSC.

[18] Common Reporting (COREP) contains regulatory information on solvency, liquidity, large exposures and leverage. Financial Reporting (FINREP) contains the financial statements and additional information on line items. The extent of the information varies by consolidations status (solo/consolidated), reporting framework (IFRS/nGAAP) and the size of the LSI (up to EUR 3 billion and > EUR 3 billion).

[19] Not only triggered by failing institutions; but by e.g., the application of CRR II, inconsistencies in the notification process, simplification of the Financial Deterioration triggers, and also the commitment to regularly revise the Notification Guidance.

its views) and is directly responsible for the license withdrawal. Currently it is updating its guidance for NCAs with respect to clarifying its reporting expectations for all LSIs (finalized in 2021 and adopted by NCAs in 2022). The additional guidance for NCAs covers not only earlier ex-ante notifications of potential significant impact events (impacting the overall risk profile of the institution), but greater clarity on the criteria for defining materiality of a draft supervisory decision. In addition, the ECB has adjusted the classification of LSIs to not only capture in the regular reporting large LSIs, but also high-risk LSIs replacing the current classification of High-Priority with High-Impact and High-Risk criteria (see paragraph 42). This will allow the ECB to get a better view on the "pipeline" of LSIs that might become problematic.

16. Improvements need to be made with regards to BaFin/BBk management reporting and progress tracking against set supervisory priorities. BaFin/BBk should establish a system that allows management to track the progress made on the priorities (as defined in the supervisory strategy), the execution of the agreed work program, the impact of ad-hoc work (e.g., responding to emerging risks) on the existing work program, and other key performance indicators. While the assessors observed that a lot of information is available in different places/committees and some reporting tools are implemented within BaFin/BBk, a clear set of performance indicators appears not to have been defined, and the existing available information is not necessarily combined into a more succinct and comprehensive management report. The assessors noted that BaFin/BBk are in the early stages of developing a dashboard that should support management in the evaluation of the use of available resources and the tracking of progress against the agreed work program, which seems to be a useful input for a more comprehensive management report that will facilitate equal line of sight by both BaFin/BBk mid-cycle.

C. BaFin Reorganization

17. Building on the key lessons from the Wirecard fraud, the MoF announced a BaFin reorganization program, which is currently ongoing, including several legal reforms.[20] While initiated in response to the Wirecard failure, the reforms are also relevant in the context of the failure of Greensill Bank. The reform program consists of the following workstreams: 1) creation of Focus Units dedicated to the supervision of complex institutions; 2) creation of a forensically trained Task Force to undertake special audits; 3) reform of the financial reporting enforcement system (see also para 25); 4) closer engagement with market participants and follow up on whistleblower reports; 5) strengthening of consumer protection powers and capacity; 6) strengthening of the position of BaFin's President; 7) creation of a central digital data unit (see section on digitization); and 8) cultural change. The discussion below describes the rollout of the program through the lens of banking supervision.

18. In July 2021 amendments have been made to provide BaFin's President more powers, which the FSAP supports. The President has received stronger internal powers vis-à-vis BaFin's

[20] For more details on the reorganization program and see https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2021/pm_211013_Pressegespraech_Staatsekretaer_P_en.html

strategic direction, budget proposal, organizational structure, ability to give directions to Executive Directors (make final overriding decisions) and has been given direct responsibility for the Task Force and Focus Units. This provides the President with the ability to take direct responsibility for dealing with "watch list" and problematic institutions, in particular in cases with a cross-sectoral dimension. While these changes strengthen internally the position of BaFin's President, organizational changes and the budget still need the approval of respectively the MoF and BaFin's Administrative Council.

19. BaFin has set up dedicated units to monitor watch-list and complex institutions more closely and have the ability to respond quickly to emerging risks.[21] The reorganization aims to free up capacity for the supervision of LSIs and other institutions to address for example more complex structures and business models (Focus Units), and create in-house on-site investigative capacity to respond to risks or suspicions that warrant immediate attention (Task Force), making it less dependent on external capacity. The project was in the pilot phase for banks since May 2021 and the Go-Live was in August 2021 within the entire BaFin. It already builds on a cooperative approach with BBk, and still needs to be integrated more fully into the overall banking supervision framework.

20. While the legal framework provides BaFin broadly with sufficient tools ("ability to act"), the program aims to create a more proactive supervisory culture ("willingness to act").[22] A change of culture will be challenging and take time (is in its initial stages) but seems important to establish a more proactive culture that addresses issues more decisively (see also paragraph 52). As part of this agenda, BaFin should also consider establishing a more consistent culture and, to the extent practical, supervisory approaches across all sectors of the organization.[23] For banking supervision, explicit consideration will need to be given to the culture across BaFin and BBk staff.

21. The buy-in of BBk for these reforms and the development of a complementing joint BaFin/BBk strategy will be critical for the effectiveness of banking supervision going forward. While recognizing that the reorganization is a BaFin-wide program and not only relevant for banking supervision, the development of a complementing joint BaFin/BBk strategy addresses the challenges of the future is critical for effective banking supervision. Previously existing joint BaFin/BBk projects appear to have been put on hold (e.g., joint digitalization agenda) with the start of the reorganization program, which risks the development of a disjointed approach to supervision. This might not only affect efficiency (e.g., a duplication of the development of systems), but also the effectiveness of banking supervision (e.g., an incomplete view on all relevant information and risk perspectives within the two organizations). The ability to fully cooperate in partnership with BaFin on the reform agenda appears to have been hampered by the oversight of

[21] BaFin already has a unit that deals with problematic or failing institutions (Intensified Supervision Unit).

[22] IMF, *The making of good supervision: Learning to say No,"* (2010).

[23] BaFin has emerged in 2002 from the merger of three (banking, insurance, securities) different supervisory institutions, and later in 2018 also absorbed the resolution authority (FMSA).

the reform program by the MoF and the perceived potential implications of this on BBk's independence. Now that the authorities have indicated that the MoF will step back from its direct involvement in the reorganization program by end 2021, the existing reorganization program should be complemented with a joint BaFin/BBk strategy. Going forward, direct MoF interventions in the reorganization initiatives of BaFin should be minimized[24] or eliminated.

22. The reform agenda should be expanded to also include a modernization of the corporate governance framework to align it with international best practices. The reform agenda covers only to a limited extent to lessons learned from the corporate governance failures at Wirecard and Greensill. While we recognize that the recently issued Act to Strengthen Financial Market Integrity (FISG, effective January 2022) contains some provisions to strengthen internal controls and obligations and liabilities of supervisory Board members of listed companies (see paragraph 25). However, there is no clear agenda to realize a more fundamental modernization of the corporate governance framework (see paragraph 30 and Appendix II) and supervisory approach to review and require a better functioning of supervisory boards (see paragraph 54 and 55). The modernization of the corporate governance framework, which would require material changes to the existing legal framework, is key to ensuring that critical checks and balances are in place for the supervisory board to effectively oversee the executive management activities.

LEGAL AND REGULATORY FRAMEWORK

A. Legal Framework

23. Since the 2016 assessment the European authorities made further progress with the implementation of Basel III and other relevant Basel standards. The Capital Requirements Directive (CRD) IV and Capital Requirements Regulations (applicable per 1 January 2014) implemented the June 2011 revised version of the Basel III framework,[25] as well as the liquidity coverage ratio. The CRR II (effective June 28, 2021) complements the framework with the implementation of the Net Stable Funding Ratio (with a proportionate approach for small and non-complex institutions), leverage ratio (for SIs as well as LSIs), standardized approach for counterparty credit risk (with a proportionate approach for LSIs), and some Pillar 3 changes. In addition, the CRR II completed the implementation of the 2014 Basel Supervisory framework for measuring and controlling large exposures. These recent changes will also need to be embedded in the supervisory approach for German LSIs going forward. The "Basel III: post crisis reforms (December 2017)" and the minimum requirements for market risk (revised by the BCBS in January 2019), have not yet been transposed into European regulations.[26]

[24] MoF interventions into BaFin's reorganization initiatives are governed by the framework of "Rechts- und Fachaufsicht"

[25] European regulations have direct applicability in member countries (including Germany), while directives need to be transposed into the domestic legislative framework of NCAs.

[26] The European Union announced in October 2021, that it plans to delay the foreseen implementation per January 2023 to January 2025 (with a 5-year transition period, i.e., full implementation by January 2030).

24. In December 2020 the CRD V and Bank Recovery and Resolution Directive (BRRD) II were transposed into German law, aligning the framework with European standards. The Act on Risk Reduction and Proportionality Act for the Banking Sector, December 2020 (RiG) transposed, inter alia, the CRD V and BRRD II into German law. The RiG changed various parts of the legal framework, especially the KWG; introduction of an approval and consolidated reporting requirement for (mixed) (EU) parent financial holding companies (section 2f KWG), broadening the definition of related party transactions (section 15 KWG), requiring management and supervisory board members to refrain from participating in decisions in cases of conflict of interest (section 15 KWG), collective suitability requirements for the management board (section 25c (1a) KWG), and an explicit legal basis to reprimand members of the management board (section 36(2) KWG). Although these are relevant enhancements to the KWG, these changes only address, to a limited extent, some of the recommendations made by the 2016 BCP assessment (see paragraph 29). Furthermore, against the backdrop of the general intention to introduce more proportionality (which is also an important starting point for the German approach to LSI supervision), the RiG introduced some administrative reliefs for small and non-complex institutions (SNCI).

25. The authorities realized in 2021 important reforms to strengthen the oversight of external auditors and provide BaFin with powers regarding service providers. The Act to Strengthen Financial Market Integrity (FISG), effective January 2022,[27] strengthens financial accounting oversight of listed companies. In particular, the two-stage financial reporting enforcement procedures has been fundamentally revised and the authority to conduct forensic audits has now been assigned exclusively to BaFin (resulting from one of the workstreams of the BaFin reorganization program – see previous section). This is a key reform as it allows BaFin to order its own (forensic) examination in case there are any concerns regarding the violation of accounting rules. [28] The FISG also contains provisions that increase the liability of supervisory board members, requires the setup of an audit committee and gives the Chair of the supervisory board certain information rights. Additionally, BaFin is granted extended powers and intervention rights regarding certain outsourcing providers. The Law also introduced comprehensive amendments and stricter regulations to combat accounting fraud. Furthermore, FISG includes provisions to improve the communication between BaFin, the stock exchange supervisory authorities and the Audit Oversight Body (APAS). These comprehensive amendments and stricter regulation are part of the new enforcement regime for issuers of securities admitted to official listing.

B. Regulations and Guidance

26. A key part of the regulatory framework for financial institutions is provided by the minimum requirements for risk management (MaRisk). MaRisk provides high-level principles and concepts for the risk management of banks. MaRisk was most recently updated in August 2021.

[27] The FISG came into force 1 July 2021, and the amendments regarding enforcement/DPR will enter into force 1 January 2022.

[28] Such audits used to be the competence of the Financial Reporting Enforcement Panel (FREP or DRP in Germany). To be able to fulfill its new responsibility, BaFin will also receive an increase in resources.

To understand the supervisory expectations of the high-level MaRisk principles, the regulation needs to be read in conjunction with EBA, BaFin and other relevant guidelines that provide more detailed requirements and expectations regarding banks' governance, risk management and internal controls.

27. BaFin declared compliance with most of the EBA Guidelines and where needed adopted these in domestic regulations and guidance. Unless the German authorities explicitly declare non-compliance, EBA Guidelines are considered to be binding administrative provisions. BaFin publishes on its website the EBA Guidelines it has declared (partial) non-compliance with. Currently BaFin has declared (partial) non-compliance with 8 (out of slightly more than 100) EBA Guidelines and Recommendations, mostly because of reasons of proportionality and their applicability within the German legal framework.[29] For the guidelines on which the authorities declared (partial) non-compliance, usually domestic guidelines are issued that implements the EBA Guideline to the extent considered relevant to the German circumstances.

28. The authorities made good progress on addressing several of the 2016 recommendations (see Appendix I). The authorities updated MaRisk, to include key concepts from EBA Guidelines, and issued guidelines that address several 2016 recommendations. For example, after the fifth update in 2017, in August 2021 the sixth version of MaRisk was issued, which implements key (high-level) concepts of the EBA Guidelines on non-performing loans, outsourcing and the EBA Guidelines on ICT and security risk. In addition, BaFin made improvements to its own guidance notices on fit and proper requirements of management and supervisory board members.[30] Another relevant improvement since 2016 assessment is the ex-ante management reporting requirement in case of the replacement of the head of internal audit or compliance, however, the supervisory board still has no direct powers to intervene in such decisions.[31]

29. Some of the 2016 recommendations relating to corporate governance, significant investments and related party transactions still need to be addressed (see Appendix I). The supervisory board has the ability to directly ask for information from the head of internal audit and the other risk functions (this information right was introduced after the 2016 assessment), however, the KWG requires that the management board be informed of such requests. Although this is to some extent an improvement, there are still no requirements that provide the heads of internal control functions (e.g., internal audit, compliance and risk) direct and independent access to the supervisory board.[32] Since 2016, while improvements have been made to the required qualifications of the supervisory board, their actual responsibilities are still limited (no decision making

[29] https://www.bafin.de/EN/RechtRegelungen/Leitlinien_und_Q_and_A_der_ESAs/Nicht_uebernommene_Leitlinien/nicht_uebernommene_leitlinien_node_en.html Several of these partial or non-compliance of EBA Guidelines by the German authorities relate to the independence of board members and other key areas outlined in this paper.

[30] An area in which the authorities have declared (partial) non-compliance with EBA Guidelines but incorporated the relevant enhancements in its own guidelines.

[31] See Basel Core Principles: Principle 15, Essential Criterion 10.

[32] See Basel Core Principles: Principle 14; Essential Criterion 9; Principle 26, Essential Criterion 2.

responsibilities regarding strategic direction, risk appetite, strategy and related policies).[33], [34] On these aspects, the German framework also deviates from relevant EBA Guidelines. Furthermore, there are no requirements for the ex-ante review of significant investments in financial institutions outside the Euro Area (an area for which also on a European level no regulation exists).[35] Finally, although changes to the KWG sufficiently broaden the definition of a related party transaction, there is a limited framework that requires financial institutions to establish appropriate procedures to manage and monitor related party transactions however there are no specific requirements to set internal limits, aggregate and regularly report exposures to the supervisory board or for regulatory reporting of these exposures.

30. In addition, the German corporate governance framework could be enhanced with requirements for independent supervisory board members (see Appendix II).[36] The German corporate governance framework does not contain requirements for "independent" supervisory board members and therefore also has no respective requirements for the independence of the chair or the inclusion of independent members in supervisory board committees. The absence of independent members impairs the ability of the supervisory board to effectively challenge the management board and limits the level of assurance that can be placed on the supervisory board for ensuring that management decisions are taken in the best interest of the bank. While compared to the 2016 FSAP some progress has been made (e.g., by adding "independence of mind" requirements), the current situation still leaves room for management boards to dominate essential control functions.

SUPERVISORY APPROACH TOOLS AND REPORTING

31. The supervisory approach, tools and reporting is to a large extent comprehensive, but, as explained in the below subsections, certain aspects need further enhancement. BaFin/BBk completed, in a coordinated manner, the implementation of their own SREP process for LSIs leveraging off of the SSM LSI framework. Although assessors determined that the overall SREP rating process for LSIs appeared to be appropriate, certain aspects of the supervisory approach, tools and reporting could be strengthened, including for higher risk/higher impact or large LSIs, the minimum level of engagement and the frequency of on-site inspections. Given the need to rely on the work of the external auditor (EA) with respect to the compliance with MaRisk, German authorities will need to strengthen their ability to challenge the work of the EA when necessary (e.g., the ability to undertake an in-depth credit review or to assess the adequacy of an LSI's risk management control framework) as well as issue additional guidance to clarify expectations for

[33] See Basel Core Principles: Principle 14; Essential Criterion 5.

[34] These deviations appear not to relate to the presence of a dual board system as many other countries (including in Europe) have dual board systems that have adopted an effective oversight function in line with the Basel Core Principles/international best practices.

[35] Note there are ongoing legislative discussion at the European level regarding the implementation of the requirement of an ex-ante notification and review pertaining to significant acquisitions.

[36] BCBS, *Corporate Governance Principles for Banks*, July 2015.

industry and internal use of supervisory staff. Further, BaFin should make earlier use of its available corrective and sanctioning powers, given the recent observed cases to ensure that more proactive and effective supervisory actions take place on a timely basis going forward. Overall implications of these recommendations on the adequacy of supervisory resources (both risk expertise and capacity) needs to be addressed.

A. Supervisory Approach

32. NCAs have considerable freedom to develop their own supervisory approach on the basis of the SSM LSI oversight framework. While the ECB sets overarching boundaries (e.g., in terms supervisory priorities, SREP methodology, joint supervisory standards, supervisory cycle and allows for a proportionate approach), NCAs can develop within these boundaries their own supervisory framework and approach for LSIs tailored to the local circumstances.

33. The German supervisory approach is governed by the principles of proportionality. In their regulatory and supervisory framework, BaFin/BBk take into account explicitly the nature, scale and complexity of the LSI's activities. The two new BaFin Focus Units and the Task Force also fit well with this approach and will expand BaFin's ability to devote more time to complex structures, business models and issues that require more or immediate attention.

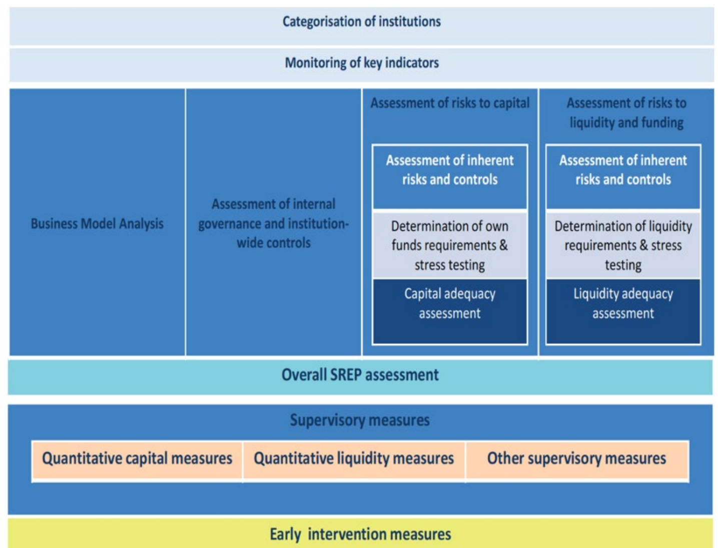
34. The ECB/SSM's oversight function impacts the supervisory strategy of all 21 participating in the SSM. In its oversight function, the ECB works closely with national supervisors to foster a common application of rules governing banking supervision, while also working towards the consistent application of "joint supervisory standards" across the Euro system for LSIs.[37] For German authorities, this implies consideration of the ECB/SSM's supervisory priorities for German LSIs annually. For example, the ECB/SSM will focus, among other things, on credit risk, unique business model, operational and cyber risk for LSIs for 2021/22. Further, the ECB/SSM is also in the process of undertaking a thematic review of the frameworks and supervisory assessment practices for corporate governance across all NCAs. Consequently, BaFin/BBk is expected to adopt in its supervisory strategy some or all of these themes as part of its supervisory approach for LSIs.

35. In addition to considering ECB priorities, BaFin and BBk set annual supervisory priorities that include cross sector areas addressing emerging risks in the banking sector. The Committee on Ongoing Supervision (GLA) shares analysis across the two organizations which helps identify key strategic priorities for the supervision of LSIs. For example, in 2021,

[37] As the ECB is responsible to ensure the effective and consistent functioning of the SSM, the ECB may, where deemed necessary for the prudential supervision of LSIs, adopt, among other things, guidelines (binding legal instruments) and recommendations (non-banking legal instruments) applicable to NCAs. The NCAs have the discretion to adopt certain LSI supervisory practices that suit the specificities of their jurisdiction.

BaFin sets cross sector priorities to address the impact of the COVID-19 pandemic[38] as well as focusing on, among other things, information technology (IT) and cyber risk.[39] Special inspections were also to be undertaken for certain credit institutions in relation to the recoverability of credit exposures and the assessment of internal capital. It was noted that the German authorities receive the ECB/SSM priorities for LSI somewhat late in the year when the German supervisory planning cycle is almost over, however, it was explained that some guidance and information on the direction of the ECB/SSM priorities is already received earlier on in the process.

36. The German authorities completed the roll-out of the EU harmonized LSI SREP methodology in 2020. Since the 2016 FSAP, the German authorities introduced the LSI SREP harmonized methodology developed along the lines of the EBA Guideline on SREP[40] and the ECB's SSM LSI SREP methodology (February 2020). As defined in the SSM methodology, the SREP score is one of the key drivers for the frequency and intensity of supervisory activities (including both the minimum engagement level (MEL) and the supervisory examination program (SEP)). The Figure provides a high-level overview of the EBA's Guideline on the SREP, depicting the general phases of assessment, including: i) classification or categorization of the LSI; ii) monitoring of key financial indicators; and iii) an assessment of the business model analysis, strength of internal governance, and the overall assessment of the impact of all risks to the LSI's capital and liquidity. The German framework, based on a proportionality approach, distinguishes between a full SREP (including an assessment of the Pillar 2 capital add-on (P2R)) and a summary SREP (updating the risk score, but no reassessment of the P2R). In addition to the P2R, LSIs are also subject to Pillar 2 Guidance (P2G), which is an additional buffer that is determined based on stress-testing results. The assessment/review of the P2G is usually conducted every 2 years.



[38] BaFin and BBk's regulatory and supervisory responses to the pandemic followed the guidance as provided by EBA, ECB and international standard setters. While as a result of the pandemic onsite examinations were halted, the authorities intensified their offsite supervision, closely monitoring through ad-hoc surveys and interviews the banking system to assess the level of operational and credit risk and collecting in a structured manner information on the use of emergency funding, guarantees, moratoria and other relevant emergency measures.

[39] BaFin Supervisory priorities for 2021

[40] EBA Guideline on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing (EBA/GL/2014/13 updated 19 July 2018).

37. BaFin and BBk work together to complete the annual SREP score for each LSI. The BBk undertakes ongoing monitoring of credit institutions and prepares a bank-by-bank risk assessment ("risk analysis") incorporating the results and evaluation from ongoing monitoring (e.g., review of prudential returns, audited financial statements, annual reports, supervisory interviews) as well as from on-site-inspections. BaFin has the final say on the "SREP score" and can also, if necessary, work on the risk analysis according to the division of work following the Supervisory Guideline. BaFin/BBk update the SREP score of all LSIs at least annually. A full SREP, including the P2R, is undertaken on a 1–3-year cycle depending on the SREP score and additional criteria, including the impact dimension of the institutions, whether it is a problematic institution or under focused supervision. While SREP scores were rather static throughout the year, BaFin and BBk have recently adopted a new system (Artemis) that has the ability to capture the relevant information from the day-to-day supervision and resulting changes to the SREP score (see paragraph 48 for a discussion on the necessity of maintaining a dynamic SREP score).

38. Germany plans to link (rollout in 2022) the component of LSI's compliance with AML/CFT requirements to the overall SREP score. Since 2018 supervisors are expected to incorporate findings of AML-deficiencies in the SREP score (e. g. internal governance and risk management). As AML/CFT supervision is not in the purview of the ECB/SSM, it is however not an explicit part of the SSM LSI SREP methodology. However, given its relevance, LSI's level of compliance with AML/CFT regulatory and supervisory requirements should impact the overall SREP score so as to better reflect the overall impact of these risks and control deficiencies on the credit institution's risk profile. The planned enhancement is relevant as the assessors' file review and discussions with supervisors indicated a disconnect between prudential and AML/CFT supervision (the responsibility of a different BaFin directorate, in addition, relevant AML/CFT supervisory information appeared not necessarily to be available for the BBk in the conduct of its ongoing supervision). In other words, file review indicated that the current framework does not provide sufficient assurance on the incorporation of relevant AML/CFT observations into the SREP score.

39. Two main dimensions (risk/quality and impact) are utilized in the methodology to classify LSIs. The **quality** of the LSI, which result from the application of SREP, is reflected in a **risk** assessment score; and the potential impact of a solvency or liquidity crisis at the LSI on the stability of Germany's financial sector is reflected in the **impact**

As at 31 December 2020

Institutions in %		Quality				
Risk matrix		1	2	3	4	Total
Impact	High	0.0	0.5	0.2	0.0	0.7
	Medium	3.8	11.6	2.3	0.2	17.9
	Medium-low	7.7	40.5	7.7	0.6	56.5
	Low	2.7	14.9	6.4	0.9	24.9
	Total	**14.2**	**67.5**	**16.6**	**1.7**	**100.0**

* This table presents the LSIs under the supervision of the Banking Supervision Sector.

rating. This table[41] provides an overview of the risk classification of all German LSIs ending 2020. In general, the majority of LSIs are rated medium-low or low impact rating (81.4 percent or approximately 1,078 LSIs) with a fairly high-quality SREP score of 2 (4 is considered highest risk) for approximately 67.5 percent of LSIs for the supervisory cycle ending 2020.

40. BaFin/BBK's minimum level of engagement (MEL) for high risk/high impact LSIs should go beyond the current framework to include engagement with key control functions. The MEL category (I-IV) defines the offsite work and periodic meetings with the institution and its key bodies and control functions. It is striking that for all of the MEL categories in Germany there is no expectation/requirement to engage with key control functions, which is particularly problematic for high-risk and high-impact LSIs.[42] However, BaFin/BBk representatives indicated that in practice the actual engagement levels for high-risk LSIs go beyond the minimum engagement defined in the MEL framework. For the 2021 supervisory cycle, the level of engagement with high risk/high impact LSIs included a full SREP assessment and a discussion with the management board. For other MEL category levels, the frequency of the full SREP varies (1-3 years). Engagement with the management body and senior management representatives (e.g., Art. 3(1)(7-9), Internal Audit as well as the External Auditor (EA) and Statutory Bank Audit Association takes place in a risk-oriented way. Going forward, a structural increase in the level of engagement for high risk/high impact LSIs would be appropriate, also because the current minimum does not appear to be informative from a management perspective (e.g., setting the bar at a level, which is met without any effort does not provide for a useful performance indicator).

41. The frequency of on-site inspections for high risk/high impact LSIs (including large LSIs) needs to be reassessed to ensure adequate supervisory coverage and linked to the MEL framework. The frequency of onsite inspections (4- 12 years) is not directly linked to the MEL, but to the MEL underlying SREP risk/impact matrix (see paragraphs 46 and 47). Like the inclusion of the AML/CFT risk in the SREP framework, this is a component of the framework that is specific to Germany. Given the number of supervised LSIs compared to available resources, it is not possible for BaFin/BBk to field onsite inspections to all institutions on for example a frequency of 1 – 4 years and therefore should focus on the high-risk and high-impact LSIs (including large LSIs) to ensure adequate supervisory coverage. In view of this limitation, a supervisory approach that is risk-based, forward looking, and leverages on the assurance from institutions' corporate governance and internal controls (e.g., supervisory board and control functions) as well as on other third parties (e.g., external auditors and audits by IPSs and deposit insurance schemes) is essential for developing an overall effective supervisory approach. The relatively low onsite inspection frequency also emphasizes the importance of a high quality offsite supervisory function (e.g., access to LSI data, relevant external data and information, data

[41] BaFin Annual Report 2020

[42] The MEL as outlined in the SSM framework provides ample flexibility to NCAs. The German authorities should assess whether the current minimum level of engagement is adequate in view of their banking system and their risk appetite (e.g., accepting that adverse developments at high-impact or high-risk institutions are not picked up on a timely basis) and adjust the framework accordingly to ensure adequate coverage of high-risk/high-impact LSIs.

mining, analytical capacity and supporting systems). Last, the on-site inspection cycle should be more clearly linked to the MEL (see paragraph 47 and 56).

42. The ECB/SSM has introduced changes to its classification/ categorization methodology for LSIs as used for reporting purposes. Effective 2022, ECB/SSM will change its LSI classification/ categorization methodology from the current classification of high priority (HP)[43] and non-HP LSIs to **High-Impact (HI)** (e.g., size of total assets >€15Bn, cross border activities, potential SI status, importance to the market infrastructure, etc.) and **High-Risk (HR)** (breach or deterioration of quantitative indicators, SREP score of 4 or SREP-Score of 3 and 4 for any of the SREP risk categories, and additional riskiness indicators (e.g., removal of a board member or other procedures)), and **other LSIs**. The HR category will be a dynamic classification that is expected to be updated every quarter or on an ad hoc basis.[44] The new methodology will provide the ECB with a better view on weak LSIs (except LSI who are members of an IPS or is considered a small and non-complex institution (SNCI))[45] across all NCAs, where up until now it has been relying on informal communication and reporting in cases of weak non-HP LSIs (information on weak HP-LSIs has already been reported on a formal basis). Informal communication will however remain relevant, as not necessarily all LSIs that are on the watch list of an NCA will fall in the ECB/SSM definition of HR LSI. BaFin/BBk indicated that once this new classification methodology is effective in January 2022, all the HI and HR LSIs will be classified as MEL IV (which may result in an expansion of the number of institutions classified as MEL IV).

43. The Greensill and Wirecard failures illustrated the need for including more explicitly risks from the wider group and intra-group dependencies into the assessment of LSIs.[46] These failures on the one hand have resulted in more attention, also on an SSM level, to the identification (licensing and designation) of Financial Holding Companies (FHC), but also to taking such structures more explicitly into account when assessing the business model as part of the SREP (even if not designated as a FHC). To deepen its supervisory assessment of institutions with a complex structure or innovative business models, BaFin established recently (August 2021) two Focus Units (see subsection on the BaFin reorganization). The institutions currently expected to be covered by the new Focus Units would not necessarily overlap with the high-risk LSIs as identified in the new ECB/SSM reporting framework (being more complex does not necessarily result in a SREP 4 score, and similarly having a SREP 4 score does not necessarily mean that the complexities are such that involvement of the Focus Units would be warranted). Institutions covered by the Focus Units will in principle be classified as MEL IV (which may result in an expansion of the number of institutions classified as MEL IV as well as have a potential impact on

[43] The current High-Priority (HP) classification to a certain extent overlap with the new High-Impact (HI) classification.

[44] The HI rating will be updated on an annual basis with a stability rule of two years (e.g., a bank will remain high-impact for at least two years).

[45] A credit institution with an overall SREP score 4 that is a member of an IPS (or overall SREP 3 score with a score of 4 in any of the key risk categories) that is a member of an IPS or is a SNCI will not be classified as a HR LSI for reporting purposes to the ECB/SSM (in the new classification criteria to come into effect in 2022).

[46] Wirecard Bank and Greensill Bank (both relatively small LSIs with apparently adequate capital and liquidity) were supervised on a stand-alone basis with limited attention to the wider group structure and potential group risks.

the need to do additional on-site inspections).[47]

B. Supervisory Tools

44. BaFin has the ultimate responsibility to approve the supervisory plans and therefore the supervisory tools utilized in the oversight for all LSIs each year. BaFin and BBk perform the supervisory planning (mid-October) and will agree/approve (by mid-December): a) the SREP score (including the ICAAP assessment and P2R/P2G if applicable); b) adjust the planned on-site inspections for LSIs to account for other work planned by areas of BaFin (e.g., AML); and c) if needed, will utilize an EA to carry out any required special audits of LSIs beyond the planned on-site inspections by the BBk. For example, in the areas of impairment and valuation related special audits, BaFin will usually undertake to hire EAs to perform this work (while BBk tends to cover the rest of the other planned onsite inspections). Although BaFin has the ultimate responsibility, the planning process takes place in close coordination and collaboration with BBk.

45. The German authorities use a combination of off- and onsite monitoring in their supervisory oversight of LSIs. In general, BBk collects data from prudential returns, receives LSI's audited reports prepared by EAs, completes an annual risk assessment and undertakes on-site inspections at a relatively small portion of the total LSI population during the supervisory cycle. As the majority of LSIs have basic business models and the EA undertakes to report on LSIs' compliance with BaFin's MaRisk, based on the current German SREP methodology (summary SREP focuses on the quantitative scoring including the breach of regulatory limits), the majority of LSIs receive an onsite inspection at a relatively low frequency (see below).

46. Not unlike other jurisdictions, German authorities undertook fewer on-site inspections of LSIs during the pandemic. In general, on-site inspections carried out by BBk focused on many of the risk management requirements that are laid down in MaRisk and in addition focused on special topics such as internal models. This table[48] provides an overview of the type of on-site inspections undertaken during 2020. Overall, these inspections were approximately half in number from the previous year, mostly focused on compliance with MaRisk and represented about 6 percent of LSIs (and around 12 percent under normal conditions). German authorities are in the process of returning to more normal pre-

As at 31 December 2020

	2020	2019
Impairment-related special audits	4	6
Section 25a (1) of the Banking Act (MaRisk)	63	133
Cover		5
Market risk models		1
IRBA (credit risk measurement)	12	16
AMA (operational risk measurement)		0
Liquidity risk measurement		0
Total	**79**	**161**

* This table relates to less significant institutions (LSIs) under the supervision of the Banking Supervision Sector. "IRBA" stands for "Internal Ratings-Based Approach" and "AMA" stands for "Advanced Measurement Approach".

[47] While it might be relevant to take IPS membership and SNCI classification into account for ECB reporting purposes, a SREP 4 institution should still be adequately covered in terms of MEL and onsite inspection frequency in Germany's supervisory framework (i.e., the ECB reporting framework does not constitute a supervisory framework/approach).

[48] BaFin Annual Report 2020

pandemic levels of on-site inspections which should provide more coverage of audit areas.

47. The German authorities need to re-assess the range of intervals for frequency of routine on-site inspections for larger LSIs as well as for LSIs with weak SREP scores. The assessors noted that LSIs with greater than EUR 25 billion in total assets currently have at least an inspection cycle of up to 10 years (and for lower impact institutions the inspection cycle can go up to 12 years). Although BBk undertakes on-site inspections for specific risk areas and collects ad hoc data through surveys, it would be prudent to ensure that a comprehensive inspection is undertaken for the larger LSIs at a shorter duration than the German authorities' SREP score/cycle stipulates.[49] Further, the German SREP methodology only calls for up to a 4-year on-site inspection frequency for an LSI (MEL IV) with both a high-impact and high-risk (i.e., SREP 4 score). BaFin/BBk needs to reassess the adequacy of the minimum frequency of its on-site inspections as part of its overall supervisory program in particular for all LSIs that receive a MEL IV classification. To ensure adequate coverage for additional on-site inspections, this may result in the need to expand the capacity to undertake additional on-site inspectors, e.g., an increase in FTEs (see also paragraph 56).

48. In the past SREP scores were not often changed throughout the year, however with the introduction of the new digital platform, more up to date information is available to supervisors throughout the year. It is recommended that the SREP scores be updated throughout the supervisory cycle, when necessary (e.g., when excessive growth rates are noted, relevant other public information becomes available, after an on-site inspection or special audit is completed, etc.), in case of material changes. As BaFin has recently launched a new information system that allows for updates when relevant information becomes available, it will be well positioned, in conjunction with the BBk, to update the SREP scores on a dynamic basis when additional material information warrants a change in rating. Having a dynamic SREP score is key to ensuring that the German authorities know what LSI's risk profile is deteriorating (e.g., from a 2 to a 3 or from a 3 to a 4 SREP score). It is further recommended that BaFin work diligently with BBk to ensure that SREP scores are driven by the same analytical risk data and therefore both organizations should coordinate the new digital platforms (see paragraphs 21 and 69).

49. Now that the SREP has been fully rolled out and first experiences with P2R add-ons have been gained, the authorities should review if their approach can be further improved. The authorities have not adopted ECB's guidance for minimum P2R capital add-ons per SREP score. In addition, the assessors noted that the reviewed P2R add-ons exhibit an artificial accuracy (i.e., add-ons with 2 decimal place accuracy, e.g., add-ons of 0.07 or 0.47 percent) considering the uncertainties and approximations involved. Finally, while in particular for smaller institutions concentration risk might be very relevant, the authorities do not have an internal benchmarking framework or methodology (like for Interest Rate Risk in the Banking Book) for

[49] It is noted that credit institutions must pay a fee if BBk undertakes an audit of the LSI. This could prove challenging for a small LSI to incur such a fee, impacting overall profitability for example and could also result in political pressure to limit inspections of publicly owned banks.

assessing the adequacy with which institutions take this risk into account in their ICAAP.[50]

50. The German authorities continue to place great reliance on the work of the External Auditor (EA) to determine compliance with its MaRisk requirements. EA's formulate an opinion of LSI's compliance with MaRisk requirements which are captured in the so-called "long-form report". MaRisk provides a principles-based view on the German authorities' views on the various risks for banks, together with the quality of risk management systems (e.g., risk management framework, risk appetite, policies and procedures) that should be put in place. The 2016 FSAP recommended that the German authorities place greater emphasis on the ability to verify the reliability, accuracy and integrity of the information used for risk assessments and prudential outcomes. [51] It is understood and accepted that German authorities need to rely on the work of the EAs in order to obtain coverage for the 1,324 LSIs (as well as the close to 600 other institutions covered by the BSD) it supervises. However, for the LSIs with a SREP score of 3 or 4 and on a sample basis for other LSIs, there is a need for the supervisors to be able to challenge the work of the EA or to confirm or deepen the supervisory view in certain areas.[52] For example, it is critical for the supervisors to be able to assess the adequacy of an LSI's risk management control framework, undertake an in-depth credit review of problematic loans, etc. on a timely basis.

51. A review of supervisory documentation by the assessors confirmed that on-site inspections may not go to the necessary depth to actually verify on a credit file basis if actual practices are in line with policies. The supervisory documentation review observed significant weaknesses in the review of related and connected party transactions. While recognizing that there are resource limitations, in particular in the case of files with deficiencies (but also on a sample basis in ongoing supervision) a more effective challenge of the work of a bank's internal audit and the external auditor needs to be performed. This capacity of the supervisor to perform a deep dive/review of a credit file is critical to the supervisor's ability to conclude on the overall impact on the risk profile of an LSI on a holistic basis. This includes for example assessing an LSI's risk appetite, board approved risk limits, impact of concentrations, large loans, connected loans and related party transactions (e.g., assurance of the completeness of identified related parties) on the overall risk profile of the LSI, etc. The relevance of these issues and the need for enhancements was also illustrated by the file review (including of the two failed institutions), through discussions with supervisors, and also substantiated that additional guidance to the MaRisk framework is necessary, specifically in relation to related and connected party transactions (see paragraph 53 below for further discussion).

52. BaFin should make earlier use of its available corrective and sanctioning powers.

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[50] There is also no ECB guidance or standardized benchmark methodology available for concentration risk.

[51] It is noted that the new powers for BaFin to conduct forensic audits as well as the new enforcement unit regarding the quality and reliability of audited financial statements will help.

[52] The German authorities are currently re-assessing the overall reliance on the work of the EAs as part of their overall supervisory framework.

While BaFin is provided with the necessary powers to undertake corrective action, file review and discussions with supervisors indicated in cases of observed material deficiencies, a reliance on warning letters and a delay of more proactive and effective supervisory actions took place. To be effective, the German authorities need to make use of intervention powers on a timelier basis. We acknowledge that the need to take more decisive supervisory action on timely basis is also recognized in the cultural change workstream of BaFin's reorganization (see paragraph 20). We recommend that supervisors be empowered to make use of the newly recalibrated "ladders of action". It is also recommended that the industry be provided with clear and transparent guidance (e.g., "ladders of action") that reflects BaFin's ability to take corrective measures when certain conditions precedent exist.

53. **Additional guidance to link EBA Guidelines with MaRisk requirements is necessary for the industry, the EAs and for internal use for supervisory staff.** Given the extensive nature of the EBA Guidelines (including Germany's partial or non-compliance stance with some of the EBA Guidelines), as well as other international standards, additional guidance for the industry, the EAs and supervisory staff may be needed due to: a) the EA MaRisk compliance reports have been found to be varying in quality (this was highlighted by the German authorities and they have undertaken a joint working group to do additional research into how to deal with this)[53]; b) the MaRisk's principle based nature does not necessarily clearly outline BaFin's supervisory expectations in certain risk areas linking to the EBA Guidelines (e.g. the need to track/aggregate related party transactions, expansion of the operational risk points, etc.); and c) to be able to rely on the work of the EA, supervisors should also be given tools to effectively challenge the work of the EA.

54. **Annual discussions are generally held with members of the management board, while the engagement with the supervisory board or its members is very limited.** It was noted that the German regulators do not meet with members of the supervisory board in the normal course of annual discussions with LSIs. Meetings tend to take place only once the situation of the LSI is problematic or on the initiative of the institution (e.g., when the supervisory board is in the process of appointing a CEO and wishes to inform the German authorities of its proposed candidate). Supervisory boards are generally thought of as advisory boards with direct responsibility mainly focused on ensuring the annual audited financial statements are undertaken according to acceptable auditing standards, and the hiring and firing of the management board. Furthermore, MaRisk requirements and the work conducted during onsite inspections, cover only to a very limited extent the responsibilities of the supervisory board (e.g., in practice the work does not usually go beyond checking if institutions comply with reporting to the supervisory board and the reading of board minutes). Discussing the performance evaluation of the management or the self-evaluation of the supervisory board is not a standard part of the supervisory program.

[53] It was noted that if the EA for an LSI is from one of the four larger auditing firms that operate in Germany, the quality of the EA is higher than from the smaller auditing firms.

55. It is recommended that at least two members of the LSI supervisory board have increased contact with the German authorities.[54] For example, it would be beneficial for the Chairman of the supervisory board and of the Audit Committee (or an "independent" member) to meet with BaFin/BBk at the time of the completion of an on-site examination (generally considered an international best practice) or during the annual discussion of the SREP score with the LSI. Further, supervisory board members should take the opportunity to speak with the German authorities without representatives of management being present. This supervisory practice may help to increase the standing of the supervisory board, enhance the effectiveness of the oversight function, and ensure that board members are aware of their responsibilities.[55] It was also noted that the LSI supervisory board members often have local political representatives therefore the introduction of at least a few independent board members should help balance the collective suitability board criteria.

56. German authorities need to reassess the adequacy of supervisory resources both from a risk expertise and capacity perspective. It was noted that in comparisson with SSM peer NCAs, the average off-site FTE-equivalent of time spent per LSI is relatively low (e.g., 0.33 FTE/LSI, lowest ranked out of 21 NCAs, which drops to 0.2 FTE/LSI for savings and cooperative banks however 2.6 FTE/HP LSI ranked 17th out of 21 NCAs). German authorities need to reassess the adequacy of supervisory resources in light of:

- The addition of credit institutions with market risk implications (e.g., due to Brexit), it may be necessary to re-assess the adequacy of capital markets risk expertise within the supervision FTE count. More than 55 credit institutions migrated from the UK to establish business operations (securities/bonds and other financial assets for clients/trading book) in Germany due to Brexit. Temporary approvals of models (trading book) were afforded these credit institutions to support the timely licensing process (e.g., models were not examined upon entry). It will be essential for the German authorities to build up its market risk expertise to ensure adequate oversight of bank assets in Germany (modeling/valuation, correct application of MR-SA, etc.);

- The need to reassess the adequacy of the MEL, frequency of on-site inspections to cover large LSI (HI) and the need to conduct more in-depth file reviews (e.g., credit file basis); and

- The responsibility of BaFin BSD to also oversee 600 other credit institutions (see paragraph 11) wherein the overall capacity of supervisory resources may be stretched.

57. Insights from IPS's risk assessment of LSIs could feed into the BaFin/BBk's risk assessment framework. IPSs, which also oversee the financial health of member LSIs, could have useful insight into the inherent risk and quality of risk management policies and

[54] German authorities as part of the SSM Joint Supervisory Teams do review and engage SI supervisory boards.

[55] Although BaFin has the right (as per s. 44 of the KWG) to send representatives to shareholders' meetings, general meetings or partners' meetings, as well as meetings of the supervisory bodies of the credit institutions, it is not practical to engage all LSIs to this extent without reason. Therefore, a practical approach is needed given the number of LSIs.

procedures. The German authorities should contemplate utilizing information from the IPS regarding the health of member LSIs (e.g., premium rating which reflects an up-to-date risk profile of the LSI) as the IPS have in many instances greater direct contact with the LSIs.

C. Supervisory Reporting

58. German authorities collect a variety of data as part of its national (prudential) reporting framework. The BBk collects: financial data (quarterly, based on nGAAP, mostly on a solo basis); supplemental information to the annual auditor's report (provides more detailed information than the published annual financial statements, solo level data for all LSIs); reporting of large loans; ICAAP and ILAAP reporting (determination of the risk-bearing capacity and internal monitoring of liquidity metrics, stress testing, funding plans); and, data collection for the introduction of Basel III/current regulatory projects. Further, BBk collects annual audited financial statement information (both solo and consolidated using standardized templates) for both nGAAP (RechKredV) and IFRS (FINREP).

59. All credit institutions are required to submit data in accordance with their classification for ECB/SSM reporting purposes. For all LSIs, the ECB/SSM receives their Common Reporting (COREP), and Financial Reporting (FINREP) returns. COREP contains regulatory information on solvency (capital structure, risk-weighted assets, exposures by sector), liquidity, (LCR, NSFR, asset encumbrance and additional liquidity monitoring metrics), large exposures and leverage. FINREP contains the financial statements and additional information on the line items. The extent of information varies by consolidation status (group/solo), reporting framework (IFRS/nGAAP) and size of the LSI (>€3Bn, up to €3Bn). Out of 1,324 German LSIs, approximately 79.5 per cent report FINREP data points only[56]; 0.8 per cent LSIs report oversimplified; 19.2 per cent LSIs report simplified and only 6 LSIs report full FINREP. Further, the ECB also collects annual benchmarking data and funding plans information for LSIs where applicable.

60. BaFin/BBk must continue to progress the collection of granular data for banking supervisory purposes. Analysis of regulatory data is hampered by a lack of granular data in certain risk areas. Although the German authorities have made substantial progress since the 2016 FSAP in collecting liquidity risk data, the lack of certain aspects of credit and market risk data as well as information regarding related party transactions, the observation still stands. Although such information should be available during on-site inspections, it is not easily available or accessible per institution for periodic offsite analysis purposes or across the sector as a whole. It is noted that a project is in place to help improve the collection of more granular real estate financing data that will be implemented in 2023. Regarding data on retail real estate, BBk issued an ordinance on the implementation of data collections to collect semi-aggregate data (distributions) regarding lending for the acquisition of real estate, including information on: the number and amount of these loans granted; whether covered by debt insurance; loan to value

[56] It was noted that although the majority of LSIs (1,080 out of 1,324) submit only FINREP data points to the German authorities, this does not impede the Phase 2 assessment of quantitative indicators for the SREP score.

ratios; debt servicing ratios; debt to income; and some internal risk indicators. We encourage BaFin/BBk to a) continue to progress the collection of granular data and b) reassess the adequacy of the scope and depth of the data currently collected for banking supervision purposes.

DIGITALIZATION AND FINTECH

A. Fintech Landscape and Monitoring

61. Germany is the largest host of neobanks (or digital banks) and related service providers in continental Europe. Some of the largest Euro Area neobanks (licensed as CRR credit institution – see Box 1), providers of banking as a service (BaaS), core banking software as a service (SaaS) and one of the largest European online securities brokers (licensed as a securities trading bank) are based in Germany. Other sectors are also vibrant. For example, Germany licensed 3 crypto custodians and several others are in the application process of transitioning from registration to a formal licensing regime. Further, there is a relatively large number of licensing applications in process to become payments service providers (PSPs). The business models of these service providers tend to rely on outsourcing, third party service providers, and partnering with other companies to deliver services (distributed value chains). Overall, the size of the German market and the availability of technical skilled staff have contributed to the development of the fintech sector in Germany and in particular Berlin.

62. Incumbents also increased efforts to digitalize their business processes and improve front end consumer interfaces in response to the increasing competition. The public banks, cooperative banks, and a subset of commercial banks benefit from centralized IT services and innovation units, creating economies of scale. However, existing legacy systems make it more challenging to fully reap potential efficiency benefits from available new technologies (e.g., moving the core banking system to the Cloud).

63. Market fragmentation is constraining digital only banks from realizing the full potential of a single Euro Area market. While prudential requirements have been harmonized within the Euro Area, other requirements or their implementation may differ across jurisdictions, such as for client identification, consumer protection, regulatory reporting and outsourcing to the cloud. For example, International Bank Account Numbers (IBANs) in one jurisdiction may not necessarily have the same functionality when used in other jurisdictions. These differing requirements and overall constraints in particular affect the neobanks with a pan-European business model by not supporting a level-playing field.

64. Fintech data collection, forward looking dynamic market monitoring and financial stability analysis need further development.[57] In the absence of a clear definition and taxonomy

[57] Fintech: Technologically enabled innovation in financial services that could result in new business models, applications, processes, or products with an associated material effect on financial markets and institutions and the provision of financial services (FSB definition).

for statistical purposes, the collection of data on fintech is challenging. BBk's Statistics Directorate has run a pilot project to collect data on fintech. The first results of the pilot indicated that the size of the fintech across different financial sectors in Germany is still relatively small at that point in time. However, given the rapid growth, a more structural approach to data collection, financial stability analysis and a more dynamic forward looking market monitoring will be important for going forward to match the quickly developing monitoring needs.

B. Regulatory and Supervisory Approach to Fintech

65. In support of the single European market, the German authorities pro-actively participate in the development of European legislation and regulation. The legislative and regulatory prudential frameworks for the financial sector is largely set at a Euro Area level. Current important European proposals relate to: a) the introduction of the Markets in Crypto-Assets Regulation (MiCA), which covers crypto-asset systems, which are not regulated by current EU regulations (e.g., by MiFID II and the Electronic Money Directive), and b) the Digital Operational Resilience Regulation (DORA), which puts in place comprehensive operational resilience requirements for financial service providers. These proposals were published as part of the European Digital Finance Package in November 2020 but have not yet been enacted.

66. The NCAs have taken a competition and technology neutral approach (e.g., same activity, same risk, same regulation) to the regulation of fintech. In Germany, new financial service providers that conduct activities for which a license is required they have to comply with the same rules as existing licensed institutions. German regulation does provide for some proportionality in its application, particularly for smaller and non-complex entities. In the absence of a competition or market development mandate and regulatory experimentation clauses, BaFin has not setup a sandbox. Instead BaFin established in 2017 an "innovation hub" for market monitoring, internal coordination of regulatory and supervisory initiatives (hub and spoke model), and market outreach. While market participants recognize the efforts made by the authorities in the last few years to increase their capacity to deal with these new fintech developments as also market outreach, they perceive the authorities none the less as a more reactive than proactive counterpart to discuss new and innovative services and business models. BaFin is already in the process of implementing further instruments to strengthen its FinTech outreach. This will include strengthening the market outreach with structured in-depth workshops between BaFin and industry participants to communicate supervisory expectations at an early stage and enable discussions of selected cutting edge FinTech topics. Furthermore, the internal innovation radar will help in introducing countermeasures to information deficits perceived by market participants into the strategic planning cycle.

67. BaFin and Bundesbank have adjusted their supervisory approach to deal with more complex business models and require crypto assets service providers to be licensed according to the financial services they provide. The new Focus Units (see paragraph 19) allow for more intensive supervision of perceived higher risk business models and for financial institutions, for example, that experience rapid growth (which is generally the case for neobanks). The new powers (introduced with FISG – see paragraph 25) related to the direct supervision of outsourcing and third-party service providers will also strengthen the authorities' ability to supervise business models with a distributed value chain. Amendments to the KWG (implemented January 2020) require crypto asset service providers (e.g., brokerage, asset management, trading platforms) to be licensed. As such the existing regulatory perimeter appears to currently capture all material active financial service providers using business models based on innovative technology (but this needs continuous monitoring). On the consumer protection front, BaFin has issued several warnings against trading in crypto assets and actively monitors the market for unauthorized service providers.[58]

68. The German authorities need to devote sufficient and qualified resources and be transparent on the supervisory expectations pertaining to new fintech business models and services. The number of license applications from new entrants using innovative business models,[59] in combination with the inflow of new entrants as a result of Brexit (see paragraph 56), requires specialized knowledge and resources to not only process these applications in a timely manner, but also to ensure effective day-to-day supervision. Know-how related to new technology and innovative business models relying on a distributed value chain are becoming increasingly important and a necessary skill set for executive and supervisory board members will need to be assessed as part of the licensing approval processes. German authorities' ability to communicate licensing approval requirements as well as provide clarity and transparency on supervisory expectations to support the efficiency and effectiveness of the supervisory processes is key.

C. Digitalization of Supervisory Processes and Tools

69. BBk and BaFin should continue efforts to improve data exchange including sharing of tools for banking supervision. After being put on hold early 2021, the joint digitalization agenda is currently in the process of being restarted. The agenda consists of 7 workstreams, including one workstream covering the exchange of data between BaFin and BBk. The authorities have chosen to focus on the efficient exchange of data including shared use of tools and other services rather than developing common data warehouses, systems and tools. This approach is realistic, and pragmatic given existing differences between both authorities (e.g., main tasks of BBk and BaFin) and challenges that otherwise would emerge (e.g., sunk costs, coordination and budget issues). Importantly, disjointed views on the available data and information should be avoided under such an approach (a risk that would be largely avoided when developing common data warehouses, systems and tools). It is key that the supervisory assessment of credit institutions be based on one set of supervisory data, especially when communicating supervisory views and risk assessments with institutions.

70. In addition to their joint digitalization agenda, BaFin and BBk each have their own internal digitalization strategies. Apart from their shared responsibilities and work processes,

[58] BBk's 2020 survey indicated less than 7.5 percent of survey participants having traded at least once in crypto assets.

[59] At the time of the FSAP in particular payment service providers (regulated under the Payments Services Supervision Act (ZAG)) – 48 applications for licensing or registration as of early 2022 – and crypto custodians (regulated under the Banking Act (KWG)).

BaFin and BBk each have their own agenda to digitalize internal workflows. Digitalization of these processes and creating efficiencies (e.g., digitalization of remaining paper-based processes) is high on the agenda of both authorities as this will most likely allow resources to be freed up for higher value-added work. In addition, work is ongoing to store and retrieve data more optimally as well as the application of new analytical tools using artificial intelligence and that allow to analyse unstructured data. The FSAP welcomes ongoing work in these areas.

Table 2. Germany: Financial Soundness Indicators for Banks, 2015–2020

(Percent)

	2015	2016	2017	2018	2019	2020
Capital adequacy						
Regulatory capital to risk-weighted assets	18.3	18.8	19.4	18.9	18.6	19.2
Commercial banks	17.3	17.9	18.8	18.1	18.3	19.8
Landesbanken	19.4	21.4	22.3	20.2	20.0	19.9
Savings banks	16.7	16.9	17.4	17.6	17.3	17.6
Credit cooperatives	17.6	17.7	17.6	17.5	17.1	17.2
Regulatory Tier I capital to risk-weighted assets	15.7	16.3	16.9	16.6	16.5	17.2
Commercial banks	15.5	16.0	16.7	16.0	16.4	17.6
Landesbanken	15.6	16.6	17.5	15.6	15.7	15.8
Savings banks	14.8	15.2	15.8	16.2	16.1	16.4
Credit cooperatives	14.1	14.5	14.8	15.0	14.9	15.4
Asset composition and quality						
Sectoral distribution of loans to total loans						
Loan to households	29.0	28.5	28.6	29.1	29.5	28.4
Commercial banks	22.2	20.9	20.8	21.4	22.2	21.1
Landesbanken	5.5	5.4	5.0	4.2	4.0	3.8
Savings banks	58.2	57.8	57.1	55.3	54.5	51.6
Credit cooperatives	68.8	68.2	67.0	66.0	64.7	61.5
Loans to non-financial corporations	15.2	14.9	15.1	15.7	16.1	15.4
Commercial banks	12.0	11.0	11.4	12.6	13.1	11.9
Landesbanken	23.5	24.1	23.3	22.2	21.9	20.9
Savings banks	22.4	23.1	24.0	25.1	25.2	24.2
Credit cooperatives	16.8	17.4	18.3	19.0	19.6	19.6
NPLs to gross loans	2.0	1.7	1.5	1.2	1.1	1.7
Commercial banks	1.2	1.2	1.1	1.1	1.0	2.1
Landesbanken	4.5	3.6	3.2	1.7	0.9	0.9
Savings banks	1.9	1.6	1.3	1.2	1.1	1.5
Credit cooperatives	2.0	1.8	1.6	1.4	1.2	1.7
NPLs net of provisions to capital	17.4	14.7	11.9	9.1	6.8	6.2
Commercial banks	6.9	9.2	5.5	6.1	3.0	9.3
Landesbanken	42.2	30.7	30.1	10.6	4.9	5.9
Savings banks	19.7	16.3	13.6	11.9	10.4	3.0
Credit cooperatives	19.5	17.3	15.9	14.4	12.5	5.2

Table 2. Germany: Financial Soundness Indicators for Banks, 2015–2020 (Concluded)

(Percent)

	2015	2016	2017	2018	2019	2020
Earnings and profitability						
Return on average assets (after-tax)	0.2	0.2	0.2	0.2	0.0	...
Commercial banks	0.1	0.1	0.1	0.1	-0.5	...
Landesbanken	0.1	-0.1	0.1	-0.2	0.1	...
Savings banks	0.5	0.6	0.6	0.4	0.4	...
Credit cooperatives	0.6	0.7	0.6	0.5	0.6	...
Return on average equity (after-tax)	4.0	4.3	4.1	2.4	-0.4	...
Commercial banks	2.2	3.2	2.8	1.5	-9.0	...
Landesbanken	1.9	-2.0	1.0	-3.9	1.6	...
Savings banks	6.5	7.4	6.7	4.8	4.8	...
Credit cooperatives	7.4	8.4	7.1	5.5	6.6	...
Interest margin to gross income	75.0	71.2	69.5	72.3	69.5	...
Commercial banks	67.0	63.4	60.7	67.8	61.8	...
Landesbanken	82.5	74.9	73.9	74.2	73.0	...
Savings banks	78.2	76.4	73.9	71.7	71.4	...
Credit cooperatives	78.4	76.5	75.3	74.6	73.5	...
Trading income to gross income	2.9	2.4	4.5	2.9	2.1	...
Commercial banks	5.3	2.6	8.0	4.9	3.2	...
Landesbanken	5.4	10.2	11.5	8.8	6.4	...
Savings banks	0.0	0.0	0.0	0.0	0.0	...
Credit cooperatives	0.0	0.0	0.0	0.0	0.0	...
Noninterest expenses to gross income	70.4	69.3	71.9	73.1	76.0	...
Commercial banks	75.6	74.3	79.4	79.3	84.9	...
Landesbanken	69.1	63.6	72.5	76.6	78.5	...
Savings banks	68.9	67.8	67.1	68.3	71.4	...
Credit cooperatives	66.6	66.6	65.7	66.2	67.2	...
Liquidity						
Liquid assets to total short-term liabilities	146.5	146.6	151.3	151.7	161.2	169.6
Commercial banks	128.4	127.9	131.4	140.3	147.4	157.4
Landesbanken	139.2	146.4	150.8	126.0	152.6	178.4
Savings banks	246.3	253.7	263.6	198.6	186.0	187.2
Credit cooperatives	241.7	246.9	242.2	162.2	169.9	158.6
Sensitivity to market risk						
Net open positions in FX to capital	4.6	4.0	3.7	3.2	3.7	3.4
Commercial banks	1.8	1.9	2.1	2.2	2.6	2.4
Landesbanken	10.6	6.4	4.0	3.1	2.6	3.2
Savings banks	4.8	4.4	4.3	3.5	4.0	3.6
Credit cooperatives	7.9	7.9	8.2	7.4	7.6	7.4

Source: Deutsche Bundesbank. The authorities provide annual data only and disseminate them once a year.

Appendix I. Progress on Implementing the BCP Assessment Recommendations (2016)

Basel Core Principle (BCP)	Recommendation	Implementation Update
BCP1 Responsibilities, objectives and powers	Ensure new consumer protection responsibilities do not affect BaFin's ultimate responsibilities for safety and soundness.	BaFin's overarching cross-sectoral consumer protection mandate is stipulated in Section 4 Para (1a) of the Act Establishing the Federal Financial Supervisory Authority (FinDAG) and therefore it has the responsibility to protect the collective interests of (financial) consumers which ranks equal to other objectives of BaFin's legal mandate. The different objectives are the responsibility of different departments each with their own Executive Director. When conflicts of interest arise, they are discussed at a Board level. BaFin has indicated that this allows it to find a balanced and practical solution should a potential conflict of interest arise in an individual case including the jeopardizing or harming the interests of consumers and implications on the solvency of a financial institution. ***Assessors' comments:*** *the current setup should allow BaFin to deal effectively with potential conflicts of interest.*
BCP2 Independence, accountability resourcing and legal protection for supervisors	(a) Reduce scope for potential influence of industry and government in the execution of supervisory priorities and allocation of resources at BaFin through budget and organizational structure	(a) Although BaFin is of the view it is free from external political interference, it continues to be subject to the legal and technical oversight of the MoF which includes the legality and fitness of purpose of BaFin's administrative actions being monitored. BaFin's President has recently been provided with additional powers (effective July 1, 2021) however, the Executive Board that approves BaFin's budget is made up of government representatives and experts from the industry and academia, chosen by the MoF in consultation with the associations of supervised entities. ***Assessors' comments:*** *the change in the powers of the President did not affect the potential for external influence either through the Administrative Council (which needs to approve the budget) or the Ministry of Finance (approval or organizational changes) and its ability to request any information it deems necessary for its oversight over BaFin (see also paragraphs 12 and 13).*

Basel Core Principle (BCP)	Recommendation	Implementation Update
	(b) Streamline SSM decision making processes for supervisory measures	(b) According to the European Treaties, the Governing Council is the final decision-making body of the ECB. However, some progress has been made to streamline and simply decision making within the SSM. The ECB has recently reviewed the five existing delegation schemes based on the practical experiences since their initial adoption. In addition, the possibility to adopt decisions by way of delegation to ECB senior management was extended to certain decisions (e.g., internal models and the extension of deadlines). Additional amendments aiming at the further increase of the efficiency and simplification of the decision-making process are under way. ***Assessors' comments:*** *while the provided feedback appears to address the recommendation, a review of the timeliness of SSM decision making was not in scope of the current assessment.*
BCP5 Licensing criteria	(a) Include systemic analysis of availability of additional resources in the licensing process (b) Include systematic analysis of the collective knowledge of the management and of the supervisory board (c) Enhance qualification criteria for supervisory board members	(a) Section 33 (1) (no 3) of the KWG was amended to indicate that BaFin may reject a license application if the owners of a qualifying holding do not have sufficient financial soundness or the ability to supply the institution with additional resources. ***Assessors' comments:*** *file review indicated that the assessment of additional resources is part of the license application review.* (b) BaFin issued a guidance notice, pursuant to the 2020 amendments of the KWG and KAGB to require management and supervisory boards to have specific skills and capabilities that enable the boards as a whole to fulfill the function of the board, with the emphasis of the collective suitability. ***Assessors' comments:*** *this addresses the recommendation.* (c) As noted in (b) above, BaFin issued guidance regarding stricter requirements for the fit and proper assessment in terms of qualification criteria for supervisory board members. ***Assessors' comments:*** *this addresses the recommendation.*

Basel Core Principle (BCP)	Recommendation	Implementation Update
BCP7 Major acquisitions	Review significant bank investments ex-ante	BaFin has indicated that the German Federal Parliament is of the view that acquisitions in other entities are part of a business decision of an institution and that an ex-ante review and (dis)approval by the supervisory authority does not seem to be necessary for major acquisitions. Further, no European provisions currently require such ex-ante procedures to exist. Consequently, no changes in German laws, regulations or guidelines concerning major acquisitions have been made. However, in cases where the acquisition triggers a qualifying holding procedure in a Member State, the national competent authority would have to consult BaFin. ***Assessors' comments:*** *the same concerns as included in the 2016 assessment remain.*
BCP8 Supervisory approach	Greater focus on firsthand verification of compliance with regulations	Since the 2016 FSAP, BaFin/BBk has undertaken to increase its level of minimum engagement with credit institutions through annual dialogue with management, analyzing financial statements and conducting some on-site inspections (including improvements to inspection scopes and techniques in the areas of risk provisioning (PAAR); business model analysis; IT and cyber risk, data aggregation and outsourcing. Further, BaFin has recently established a number of new units dedicated to greater scrutiny of credit institutions with complex business models, weak or problematic institutions, established a new forensic audit group as well as establishing a unit to having a closer look at the balance sheets of supervised entities. It is noted that the authorities are currently re-assessing the reliance on the EA. ***Assessors' comments:*** *we acknowledge the recent changes in BaFin/BBk's supervisory approach as well as the effort made to diversify the sources of information used in its off-site supervision. Please refer to our full commentary in the TN on the additional work that is needed to be done by the German authorities regarding the extent of the reliance on the work of the external auditors (EA), the need for supervisors to be able to challenge the work of the EA (e.g., undertake deeper dives on the review of credit files) and the need to reassess the adequacy of both the minimum supervisory engagement levels and the frequency of on-site inspections in lieu of the new SSM reclassification of High-Risk and High-Impact LSIs (e.g., providing adequate coverage of on-site inspections for LSI's with >€15Bn total assets).*

Basel Core Principle (BCP)	Recommendation	Implementation Update
BCP9 Supervisory techniques and tools	Complete implementation of the supervisory framework	Since the 2016 FSAP, BaFin/BBk have rolled out the ECB/SSM LSI SREP methodology (2020) including the update of supervisory documentation to help map German supervisory activities/processes to the updated SSM SREP methodology. Further, the German authorities introduced the minimum engagement level (MEL), classified LSIs as either high priority or non-high priority, established the intensified supervision and focused supervision units, the enforcement unit to assess the quality of institution's financial statements, etc. (as described in BCP8). Key quantitative risk indicators are assessed as part of Phase 2 of SREP, and this information will be assessed quarterly going forward. Intuitions' ICAAP and ILAAP is assessed annually (with capital add-ons allocated annually or bi-annually depending on the SREP score). BaFin/BBk are in the process of re-assessing the adequacy of the minimum MEL framework and the minimum frequency on-site inspections (described in BCP8). ***Assessors' comments:*** *this addresses the recommendation.*
BCP10 Supervisory reporting	(a) Collect more granular data as part of routine supervisory reporting as a way to strengthen off-site analysis using peer group benchmarks (b) Implement a data mapping solution to compare IFRS and nGAAP supervisory data	(a) Since the 2016 FSAP, the ECB published Regulation (EU) 534/2015 (amended in 2017 to apply to LSIs from 2019) which extends financial reporting requirements (FINREP) to supervised groups applying national accounting rules (nGAAP). The majority of LSIs report FINREP data points only. ***Assessors' comments:*** *we acknowledge the progress made to collect more granular data. Please refer to the report for commentary about the need to continue to collect adequate granular data for effective banking supervision oversight.* (b) The majority of German institutions report their data based on the German GAAP. These institutions report FINREP data in accordance with the nGAAP requirements of the ITS on supervisory reporting as well as with the national FINREP instructions. German nGAAP based FINREP reports are in principle based on the EBA reporting templates. The national instructions contain information on the intended mapping method of certain accounting transactions as well as guidance on the intended mapping of specific reporting issues raised by the institutions. ***Assessors' comments:*** *this addresses the recommendation.*

Basel Core Principle (BCP)	Recommendation	Implementation Update
BCP14 Corporate governance	Strengthen supervisory board qualifications and responsibilities	BaFin's guidance notice on members of administrative and supervisory boards pursuant to KWG and KAGB was changed in 2020 to address: stricter requirements for fit and proper assessments, collective suitability, independence of mind (assessment criteria regarding conflict of interest), and evaluation/on-going monitoring of performance. Further, MaRisk was updated in 2017 to reflect changes to the requirement to provide quarterly/annual information from the control functions (head of risk control, compliance and internal audit) as well as ex-ante notification if the head of one of the control functions is removed. ***Assessors' comments:*** *please refer to the commentary in the TN as well as Appendix II that state that the role of the supervisory board needs to be strengthened by: the addition of independent board members (to lead committees as well), the direct reporting line of the control functions and the overall need for the dual board system in Germany to be modernized in accordance with international standards and best practices.*
BCP15 Risk Management Process	(a) Strengthen reporting lines of the CRO and risk control function to the supervisory board (b) Implement a prior notification requirement to the supervisory board in the event a CRO is removed.	(a) The risk control function of the credit institutions continues to report directly to the management board. It is acknowledged that the supervisory board can request information from the risk control function at any time or speak with this representative, but the management board will always be notified. ***Assessors' comments:*** *although the situation has somewhat improved, the essence of the recommendation from the 2016 assessment is not addressed.* (b) The 2017 revision to MaRisk requires institutions to notify the supervisory board ex-ante in due time if the head of the risk control function is going to be replaced together with the reasons for the intended replacement explained. ***Assessors' comments:*** *although this ex-ante notification has been put in place, it does not give the power to the supervisory board to stop such replacement if it deems necessary.*

Basel Core Principle (BCP)	Recommendation	Implementation Update
BCP18 Problem assets, provisions and reserves	Issue guidance on loan classification and provisioning	BaFin has issued several circulars dealing with a) definition and classification of a default (2019-04-16); b) additional FAQs during the pandemic on classification and provision in line with the communication published by the ECB (2020-12-17); non-performing loan (re-classification, valuation and provisioning and the treatment of forbearance (including updating MaRisk to reflect EBA guidelines). In general, BaFin is not empowered to publish guidance on accounting practices but to establish internal guidelines for on-site inspections and deep dives, therefore the PAAR inspections manual was updated describing supervisory stance on default classification, collateral valuation and provision at LSI on-site inspections. ***Assessors' comments:*** *this addresses the recommendation.*
BCP19 Concentration risk and large exposures limits	(a) Issue guidance on management of concentration risk in a broader sense (beyond credit exposures) (b) Introduce requirements that all material concentrations to be regularly reviewed and reported to the bank's supervisory board	(a) BaFin indicated that MaRisk provides principles-based guidance on the need for banks to ensure that their material risks, taking into account risk concentrations, are constantly covered by available capital. This concept is also covered in the instructions for ICAAP as institutions are required to consider the respective nature, scale and complexity of their business activities as well as monitor large exposure limits within their ICAAPs (over at least a 3-year term). ***Assessors' comments:*** *we acknowledge that the principles-based guidance (MaRisk) exists regarding the requirement of institutions to monitor material concentration risk however, as outlined in the commentary in the TN, the EAs, the industry and the supervisors would benefit from complementing guidance to MaRisk to help clarify supervisory expectations in this regard. Further, the authorities do not have an explicit framework or methodology to review concentration risk (as part of the ICAAP) and assessment of the P2R.* (b) MaRisk revision dated August 2021 requires the management board to obtain reports on the risk situation, including existing material risk concentrations and provide quarterly reporting to the supervisory board. ***Assessors' comments:*** *this addresses the recommendation.*

Basel Core Principle (BCP)	Recommendation	Implementation Update
	(c) Monitor large exposures beyond the compliance with LE limits	(d) The EBA has issued guidelines on the prudent and consistent assessment of large exposures breaches (to be applied from January 2022) as well the German issuance of supplementary requirements to the large exposure rules formulated in "The Regulation Governing Large Exposures and Loans of €1Mn or more", including supplemental provisions to section 14 of the KWG concerning the recording, measurement and reporting of loans of €1Mn or more. ***Assessors' comments:*** *this addresses the recommendation.*
BCP20 Transactions with related parties	Introduce a regime for the management, monitoring, and actual supervision of related party risk.	KWG was updated to include: a) section 15(6) of the KWG was amended to expand the definition of related party transactions to include not only loans but other transactions like service contracts, asset purchases and sales and construction contracts; b) adult children and parents of potential related party individuals pursuant to section 15(1) no. 5, 12 of the KWG, and c) a new sentence 2 section 15(1) requiring management and supervisory board members who have a conflict of interest to not participate in the preparation or adoption of resolutions concerning related party transactions. ***Assessors' comments:*** *we acknowledge the definition of a related party transaction has been adequately expanded, however there is no requirement to manage and monitor (e.g., set internal limits, aggregate and report) related party transactions. Please see the commentary on this subject in the TN.*
BCP21 Country and transfer risk	(a) Issue guidance on the management of country and transfer risk including requirements for banks' MIS and specific requirements for country and transfer risk to be included in bank's stress testing if applicable.	(a) MaRisk states that all institutions are to identify, aggregate monitor and mitigate all material risks (with the addition of the working…"including country risk") and there are requirements to account for material risks in the ICAAP. Section 2.2 MaRisk accounts for country risk as part of credit risk which is in line with both EBA guidelines and the SSM methodology. Institutions are required to assess and identify all aspects material to the counterparty and credit risk of the credit exposure. See (b) below for MIS requirements, stress testing and reporting. ***Assessors' comments:*** *we acknowledge that MaRisk and ICAAP provide some principles-based guidance, however the industry would benefit from additional specific guidance on the management of country and transfer risk, outlining the specific requirements to be included in bank's stress testing, and not in a general manner.*

Basel Core Principle (BCP)	Recommendation	Implementation Update
	(b) Enhance reporting of country and transfer risk (c) Issue guidance on provisioning and mitigation for country risk.	(b) MaRisk introduced reporting requirements in 2017, defining the banks' MIS and the requirement to monitor country risk exposure. A risk report on counterparty and credit risk containing the main structural features of credit business including country exposure and a separate analysis of country risk shall be drawn up and made available to the management board periodically at ease once a quarter. Appropriate regular and ad hoc stress tests are expected to be carried out by institutions regarding material risks and the 2017 MaRisk was clarified to add that these tests shall be carried out in respect to the institution's overall risk profile. ***Assessors' comments:*** *see assessors' comments for (a) above. This response addresses internal reporting requirements for the institution and not necessarily reporting to the German authorities.* (c) Country risk provisioning must be calculated individually by banks in accordance with the general valuation rules applicable under commercial law. The institution shall define criteria on the basis of which, taking due account of the accounting standards used, and country risk provisions shall be formed (MaRisk). ***Assessors' comments:*** *we acknowledge that the provisioning requirements are set by the accounting standards and the valuation rules applicable under commercial law. However, the industry would benefit from issuing complementing guidance in this regard.*
BCP24 Liquidity Risk	Develop a greater suite of industry benchmarks for liquidity risk analysis	The CRR, which was set forth in the Basel III Framework, into law directly, transposes the Liquidity Coverage Ratio (LCR) – fully implemented since 2018 and the Net Stable Funding Ratio (NSFR) – which has been binding since 28.06.2021 (the first reporting date is 30.06.2021 with the remittance date of 12.08.2021). In addition to LCR and NSFR, the CRR in Article 415 3 (b) provides additional monitoring metrics for the supervision of liquidity risks. They have been reported depending on the size and risk profile of each bank on a monthly or quarterly basis since 2016 and guarantee a comprehensive view about the liquidity situation of the specific bank. Since 2016 the qualitative requirements regarding the liquidity risk management "MaRisk" have been amended twice. Inter alia the requirements regarding the stress testing for capital markets orientated banks has been refined.

Basel Core Principle (BCP)	Recommendation	Implementation Update
		Therefore, in general, short term liquidity risk is monitored by the LCR and the LCP (liquidity capacity period) and the indicators for funding sustainability risk include the NSFR and the 2-year contractual gap to total assets. Further the German supervisory review and evaluation process (SREP) was aligned with the SSM LSI SREP methodology and therefore now includes a dedicated score for the credit institution's ILAAP within the annual assessment of liquidity risk. *In its report on the German FSAP 2016 the IMF states that "while coverage is comprehensive across all banks, the LCR adopted in EU has a number of elements which are less stringent than the Basel agreed rule, most notably wider definition of HQLA"*. An analysis by BaFin shows that for German banks there is almost no impact from these deviations from Basel. The liquidity buffers consist predominantly of central bank reserves, coins and notes and high-quality government bonds, all of which are eligible Level 1 HQLA according to the Basel LCR framework. The share of other HQLA is below the thresholds of the Basel LCR-definition. All Level 1 HQLA stand for over 90% of the total HQLA held by German banks. **Assessors' comments:** *this addresses the recommendation.*
BCP25 Operational risk	(a) Collect more granular data for operational risk.	(a) The collection of loss data, its scope and its granularity of this data is defined in the EBA's ITS on Supervisory Reporting (in its latest version). The impact of the German supervisors is therefore limited to its role as members of the EBA. All measures that go beyond the harmonized level are considered as problematic since it would put additional burden on the local institutions compared to international competitors. Further, increased data collection and/or reporting requirements would be a direct violation of the proportionality principle, since BaFin could only increase the requirements on small and medium German institutions while significant German institutions under the supervision of the SSM would not be obliged to follow these rules. That being said, the German authorities are working to influence the European process to increase the scope and granularity of the data collection. Within the European context, BaFin tried to improve the granularity of available data, but avoided to apply any national "gold plating" standards. ***Assessors' comments:*** *we acknowledge a) the need for the German authorities to abide by the EBA's requirements and b) German institutions are required to keep track of operational loss data for their own purposes.*

Basel Core Principle (BCP)	Recommendation	Implementation Update
	(b) Place more emphasis on confirming that operational risk management systems are effectively implemented	(b) Operational risk management is usually assessed in conjunction with all other risk types (credit, market etc.). MaRisk audits and ICAAP/SREP audits evaluate and grade the qualitative and the quantitative elements of operational risk management. On the qualitative side, the majority of institutions considered the BIA capital requirements as sufficiently conservative. One of the two largest "Verbünde" has developed a pillar II which is applied by a triple digit number of institutions. BaFin intends to have an onsite inspection with a sample institution, however due to the Covid crisis, this inspection was postponed but will be planned in the coming year. ***Assessors' comments:*** *we acknowledge the commitment to undertake in the future specific on-site inspections to assess the strength of operational risk management systems in the sample of institutions based on the risk profile.*
BCP26 Internal audit	Provide opportunity for independent reporting to supervisory board without management board participation	2017 changes to the MaRisk provide for the quarterly reporting from the IA function to the supervisory board, however these reports are first presented to the management board (although no changes are permitted to the report and without significant delays). Further, the compliance function must provide reports to the supervisory board (at least annually). ***Assessors' comments:*** *the internal audit function is still unable to report without management oversight directly and independently to the supervisory board.*
BCP27 Financial reporting and external audit	Find workaround to gain access to external audit working papers	In Germany, the external audit working papers are generally classified as strictly confidential. In 2020, section 29(3) sentence 2 of the KWG was amended to allow the banking supervisor to gain more detailed information from the external auditor. ***Assessors' comments:*** *as stated in the commentary of the TN, the reliance the German authorities place on the work of the external auditor is considered extensive (we note that this amount of reliance on the work of the EA is currently subject to re-assessment by the authorities). Therefore, gaining access to the EA's working papers would be instrumental in improving BaFin's ability to challenge and get assurance on the reliance placed on EAs. In the absence of this power, the authorities should assess their ability and enhance their capacity to challenge EAs work through other means.*

Basel Core Principle (BCP)	Recommendation	Implementation Update
BCP29 Abuse of financial services	Place more emphasis on ongoing surveillance to confirm bank's risk management and controls for AML/CFT, especially those sources that it gathers from firsthand analysis and verification.	Since 2017, BaFin has carried out regular on-site AML inspections wherein the inspection intervals, selection of institutions, team sizes and duration/intensity are based on the AML supervisory strategy and the individual risk profile of the institution. External auditors are also used to confirm institution's compliance with AML requirements, including: • The annual audit reports are submitted electronically to BaFin via the so-called MVP reporting platform since 2019 and are processed within BaFin's risk profiling system Bakis. Moreover, the reports contain a detailed data sheet with comprehensive information on ML/TF risks that also encompasses an evaluation of the quality of controls. BaFin's supervisory analysts check and control the findings manually to be able to follow up possible deficiencies immediately. • In 2019, the audit report regulation was amended. BaFin adjusted its requirements for the annual reporting of external auditors of banks in this legal regulation particularly with regard to information relevant for the determination of the inherent AML risk of the bank • . Professional auditors/accountants conduct the AML/CFT specific annual audits. They have to follow the International Code of Ethics for Professional Accountants, which establishes ethical requirements for professional accountants. Moreover, the preventive supervision conducted by chambers of accountants includes mandatory quality controls of statutory auditors/accountants. • Since 2017, BaFin has increasingly used the supervisory instrument "Support for audits of annual financial statements". In this context, a BaFin supervisor accompanies the auditor of the annual financial statements during the performance of the audit and thus has direct contact with the supervised institution and the auditor. • BaFin established an institutionalised exchange format with the Institute of Public Auditors in Germany (Institut der Wirtschaftsprüfer, IDW) since 2016. This allows BaFin to communicate its supervisory expectations to the auditors and set clear guidelines. • With regard to fundamental legal issues, BaFin has also increasingly communicated its interpretations bilaterally directly to the auditors since 2016. ***Assessors' comments:*** *we acknowledge BaFin relies on the external auditors for the majority of institutions' compliance with AML/CFT requirements and that on-site inspections are carried out on a risk basis. This recommendation has been addressed.*

Appendix II. The German Corporate Governance Framework

A. General Framework

1. Germany has a dual board model with an (executive) management board and a (non-executive) supervisory board. The corporate governance of German stock corporations ("Aktiengesellschaft"), the legal form most common among listed companies in Germany, is determined by both statutory law and non-binding best practice rules. The statutory laws most relevant for the corporate governance of German stock corporations is the Stock Corporation Act ("Aktiengesetz", "AktG"), which sets out the – largely mandatory – framework for the organization of a stock corporation as well as the rights and duties of the corporate bodies, the management board, the supervisory board and shareholders' meeting, as well as the shareholders. In addition, the German Corporate Governance Code sets out a collection of best practice rules and non-binding recommendations for the corporate governance of listed companies and companies with access to capital markets (and therefore is largely of a voluntary nature for most LSIs) and plays and important role in how corporate governance is practiced in Germany.[1]

B. Role of the Supervisory Board

2. Unlike recommended in the Basel Corporate Governance Principles,[2] in Germany the supervisory board has no decision-making role in the approval of key policies pertaining to the bank's risk appetite, capital adequacy assessment process, capital and liquidity plans, compliance policies and obligations, and the internal control system or in setting the banks' corporate culture and values.

3. The supervisory board supervises and advises the management board on prospective strategic decisions, risk management, internal control or compliance systems. The supervisory board is entitled to request – regularly or irregularly – reports from the management board. It cannot make any executive decisions or give formal orders to the management board. Consistent with the supervisory board's oversight and advisory role, the company is generally represented both internally and externally (that is, towards third parties) exclusively by the management board. The supervisory board does represent the company vis-à-vis acting and former members of the management board and with respect to auxiliary transactions necessary for fulfilling the tasks of the supervisory board (in accordance with the articles of association).

4. In overseeing and advising the management board, among other things, in Germany a company's supervisory board has the following responsibilities.

- Appoint and dismiss management board members;

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[1] 191216_German_Corporate_Governance_Code.pdf (dcgk.de); corresponding rules for Public Corporate Governance are set e.g., in the "Principles of Good Corporate Governance and Active Management of Federal Holdings"

[2] BCBS, *Corporate Governance Principles for Banks*, July 2015.

- Approve selected management board decisions (for example related party transactions or certain decisions, measures or transactions defined in the articles of association or by the supervisory board);
- Monitor and evaluate the management board's performance;
- Determine the management board's compensation and employment contracts;
- Monitor compliance in all respects (including legal, regulatory and corporate governance);
- Nominate and – after approval by the shareholders meeting - engage the company's auditor and inspect the annual financial statements and other financial reporting;
- Request reports from the management board regarding the company; and
- Oversee that the interests of shareholders and other stakeholders are respected, and call a shareholders' meeting, if required.
- Assess, initiate, and represent the company with respect to all legal actions taken against the management board.

5. In view of their monitoring and advisory role in the German corporate governance framework, MaRisk contains limited requirements regarding the functioning of the supervisory board. While MaRisk contains a section on requirements for the management board, in contrast it sets rather few explicit requirements addressed to the supervisory board. These requirements mainly concern the need for regular reporting and for supervisory board members to have the right to request more information from control functions (but the same information will need to be shared with the management board). The limited requirements and expectations of supervisory boards are also reflected in BaFin/BBk's supervisory approach (see paragraphs 54 – 55). Moreover, according to the Banking Act (Kreditwesengesetz, KWG), the chair of the risk committee or of the audit committee or, if such committees have not been established, the chair of the supervisory board may make direct enquiries to both the head of the internal audit function and the head of the risk control unit. Also, on the basis of the recently adopted Act to Strengthen Financial Market Integrity (FISG)[3] the audit committee of the supervisory board of public interest entities (which include credit institutions) is entitled to directly request information from key function holders with relevance for compliance and accounting without the obligation to share the obtained information with the management board, although the management board has to be informed about the request. As the initiative lies with the supervisory board and if information is requested the management board is still informed, the control functions do not have an unimpeded direct reporting relationship with the supervisory board.

C. EBA Financial Sector Requirements

6. Germany only partially adopted the EBA Guideline on Internal Governance (EBA/GL/2017/11) for banks as it declared non-compliance with the included requirement for

[3] BGBL. - Federal Law Gazette, No 30/2021 (10th of June), p. 1035.

having independent (supervisory) board members. To clarify the partial adoption of the EBA Guideline, BaFin published in December 2020 revised versions of the Guidance Notice on Management Board Members and the Guidance Notice on Members of Administrative and Supervisory Bodies.[4] Major changes to these guidelines related to notification requirements, collective suitability, assessment of the conflict of interest (independence of mind) and obligations of management board members regarding the proper business organization, guidelines and processes (suitability, diversity, training, dealing with conflicts of interest), and the staffing of key functions. Both guidelines explicitly refer to the principle of proportionality and include certain exceptions and/or adjustments depending on the size and organization of the institution as well as the nature and complexity of its business and transactions (level of detail in internal guidelines, obligation to establish supervisory board committees etc.).

7. The OECD as well as the Basel Committee for Banking Supervision recognize that "independent" non-executive (single board) and supervisory board (dual board) members are key to establishing a strong corporate governance framework. Independent members are key to ensuring that critical checks and balances are in place for the supervisory board to effectively oversee the executive management activities. Most jurisdictions within Europe (but also many other advanced economies) have adopted requirements in this regard.

8. Within the SSM, Germany appears to be among the outliers with no or very weak supervisory expectations for independent board members. Of the 27 jurisdictions participating in the SSM, only 6 (Belgium, Germany, Hungary, Estonia, Netherlands and Slovakia) have declared (partial) non-compliance with the EBA Guideline on Internal Governance,[5] which implies that the other 21 countries either comply or intend to comply with the EBA requirements for independent board members. A review of published documents indicated that of the countries that have declared (partial) non-compliance at least Belgium[6] (single board system) and the Netherlands (dual board system),[7] have issued supervisory guidelines including expectations on the requirement for independent board members.

9. While independent members are not strictly required, the AktG and the Corporate Governance Code contain requirements regarding the narrower concept of "independence of mind." In addition, BaFin's has issued specific independence of mind criteria for supervisory board members of credit institutions. Independence of mind in the German context focuses on the narrower concept of dealing with conflicts of interest in individual cases.

10. In addition, the Corporate Governance Code recommends that the supervisory board should include an appropriate number of independent members – the Code is however only applicable to listed companies (and most LSIs are not listed). According to the Corporate

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[4] BaFin - Merkblätter - Geschäftsleiter und Aufsichtsorgane (December 2020)

[5] https://www.eba.europa.eu/about-us/legal-framework/compliance-with-eba-regulatory-products

[6] https://www.nbb.be/doc/cp/eng/2018/governancemanual.pdf

[7] DNB's opinion on the independent functioning of the supervisory board

Governance Code, a member of the supervisory board is considered independent if it is independent of the company and its management board and a shareholder that controls the company. The chair of the supervisory board, the chair auf the audit committee and the chair of the committee responsible for the compensation of the management board should be independent of the company and the management board. Listed companies and certain other companies have to comply with these requirements or explain why they don't comply.

11. Germany deviates from the EBA Guideline on Internal Governance with respect to key function holders. Key function holders are responsible for key internal control functions (e.g., head of internal audit, head of risk, head of compliance, head of finance), but are not part of the management body. The EBA Guideline on Internal Governance requires that "the heads of internal control functions are able to act independently and, regardless the responsibility to report to other internal bodies, business lines or units, can raise concerns and warn the management body [in the case of Germany the management board] in its supervisory function directly [in the case of Germany to the supervisory board], where necessary, when adverse risk developments affect or may affect the institution." As discussed above in paragraph 5, the German framework does not provide key function holders with direct uncensored access to the supervisory board without a request also being provided to the management board.

12. Germany declared non-compliance with the EBA fit and proper requirements for key function holders. The German authorities have however expressed the view that these requirements are not proportional and have therefore also declared (partial) non-compliance with the EBA/ESMA Guideline "on the assessment of the suitability of members of the management body and key function holders."[8]

Conclusion

13. Germany's corporate governance framework for banks deviates from international best practices. EBA Guidelines are based on and in line with the international best practices as described in the OECD and BCBS corporate governance principles. EBA Guidelines are however not "hard" requirements for the SSM member jurisdictions but are governed by a comply and explain mechanism. Germany has declared partial non-compliance with important elements of the EBA guidelines for internal governance and fit and proper requirements. Because of these deviations, Germany's framework appears to leave room for dominant CEO's and/or management boards that dominate key control functions.

[8] Recognizing the practical supervisory resource implications (as a result of the large number of supervised entities) of adopting the Guideline and proportionality considerations, the current framework could be strengthened to place the responsibility for the fit and proper assessment of y function holders with the supervisory board instead of with the management board. This would however imply material changes in the distribution of responsibilities between the management board and the supervisory board as currently reflected in the German corporate law framework.