RegCORE Client Alert

The German Federal Ministry of Finance (BMF) publishes an update on the modernisation of the BaFin

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Reforming BaFin

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QuickTake

Following a number of high-profile failings concerning the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – **BaFin**) the German federal government, and in particular the BMF, used this as an opportunity for reform and forcing a move toward better governance in financial services supervision. It did this by embarking on introducing multiple legislative reforms but equally by conducting a comprehensive institutional and organisational cultural change project (titled **MoBaFin**)[1] to reshape BaFin and concurrently strengthen its supervisory powers (including the corporate auditing process by absorbing the former financial reporting enforcement authority). All of this has helped boost the regulatory and supervisory environment in Germany and indeed across the EU.

In a special feature published in the August edition of the BMF's monthly newsletter[2](the **BMF Update**) the BMF presented the progress on and outlook for the MoBaFin driven reforms. The BMF Update also provides a recap on institutional cooperation between the BMF and BaFin going forward. This is important as the BMF had concurrently in August announced its preliminary plans for creation of a new Federal Financial Crime Office.[3] This Client Alert summarises these developments and what this means for financial services firms.

[1] The last major reform of the BaFin occurred in 2008 following a number of investigations concerning shortcomings occurring during 2004 and 2006. Following the Wirecard and Greensill scandals, the BaFin was investigated by both the German Federal Government as well as by the European Securities and Markets Authority (**ESMA**) following use of a new supervisory tool, the Fast-Track Peer Review (**FTPR**). In October 2020 the German government adopted an action plan to modernise BaFin and give it "more bite". The BMF presented further priorities for reform in February 2021. In the following ten months a project, involving around 100 employees from the BMF, BaFin and external consultants, delivered the comprehensive MoBaFin transformation project. Since completion in December 2021, BaFin's modernisation has continued under BaFin's own responsibility but also reflecting the recommendations from EU policymakers following the FTPR.

[2] Available only in German here.

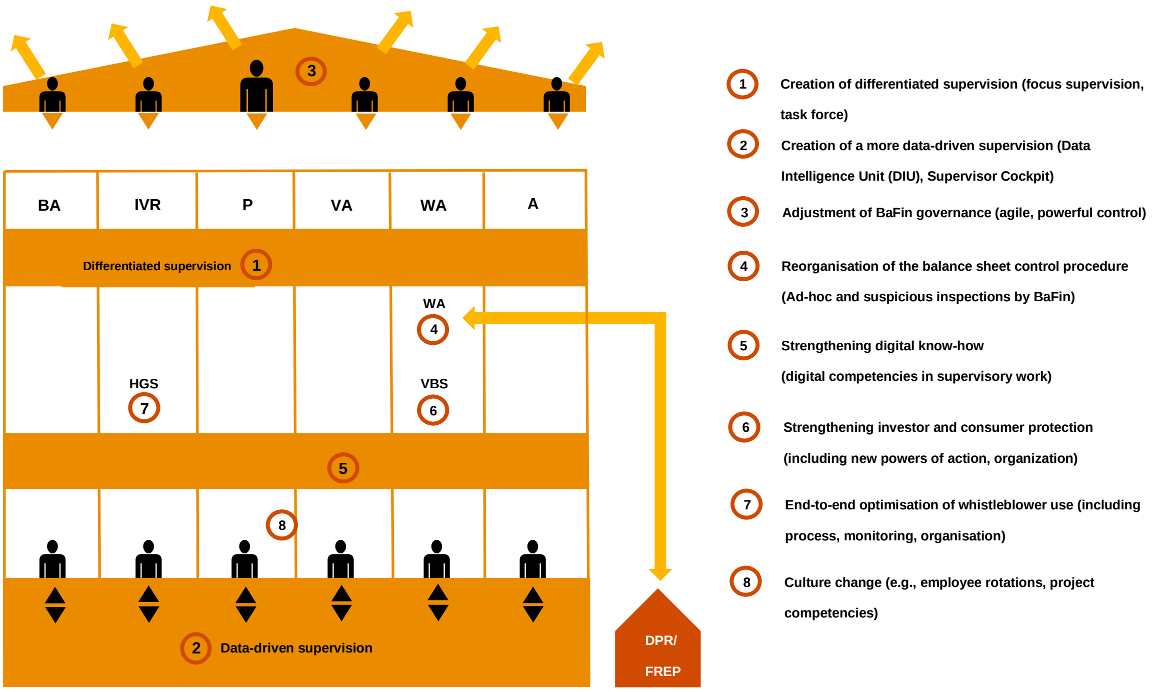
[3] See coverage from PwC Legal's EU RegCORE (available here) on this topic as well as statements in FATFs updated Mutual Evaluation Report for Germany published 25 August 2022 (available here).

Chief amongst the MoBaFin reform priorities are the:

1. development of “differentiated supervision” (beyond just regular and intensified supervision) by introducing an overarching concept for “focus supervision” of complex supervised firms as well as creation of a specialised and forensically-trained taskforce that can carry out ad-hoc and special investigations;
2. introduction of new IT tools for data driven supervisory tasks, including through the operations of BaFin’s new Data Intelligence Unit (**DIU**) and the use of its “Supervisor Cockpit”;
3. strengthening of BaFin’s governance structures thereby driving agile and targeted management decision-making;
4. reform of the BaFin’s financial reporting enforcement and balance sheet control supervisory mandated (following the absorption of the DPR/FREP (see below) into BaFin) and strengthening of available tools including a greater ability to carry out periodic and ad-hoc inspections;
5. increase of digital capabilities across BaFin and for its staff;
6. strengthening of investor and consumer protection measures including new powers and organisational set-up for BaFin’s supervisory tasks;
7. expansion of the BaFin’s Whistleblower Office’s powers, its processes, organisational set-up and monitoring; and
8. driving forward of a fundamental change in BaFin’s operational and supervisory culture, which is to be reinforced through periodic staff rotations and project competencies across the authority.

The following graphic is Figure 1 as set out in the monthly report of BMF, August 2022.

Target operating model of BaFin as a result of the 2021 reforms



BS = Banking supervision P = President IVR = Internal Administration and Law HGS = Whistleblower Office VA = Insurance and pension fund supervision

A = Settlement and money laundering prevention VBS = Consumer protection DPR/FREP = German Financial Reporting Enforcement Panel

WA = Securities Supervision/ Asset Management

The BMF Update also reiterated the key points set out in the “Principles of Cooperation between the BMF and BaFin” which were published in May 2022[4]. Consequently, these guiding principles means that the BaFin will:

A. be operationally independent with relation to individual supervisory questions;

[4] Available only in German here and here.

B. focus on providing the BMF with information on risky and other significant cases; and

C. consult with BMF in setting its common goals for rulemaking and supervision.

Such new form of cooperation will likely become increasingly important in the event that further legislative and institutional reform efforts, notably on anti-money laundering, terrorist financing, sanctions and financial crime prevention more broadly, are advanced by the BMF (including beyond the BMF's proposal for a Federal Financial Crime Office).

MoBaFin's objectives lead to longer lasting priorities

Since 2020, the BaFin has been undergoing fundamental reform and modernisation. In response to the Wirecard and then the Greensill failings the German government adopted an action plan in October 2020 with the aim of combating accounting fraud and to strengthening control over capital and financial markets. Part of the plan was the recognition that a legislative reform alone, i.e., through the Financial Market Strengthening Act (**FiSG**), would not be enough. Reform would also have to focus on the operational performance of the administration of the BaFin itself thus leading to the MoBaFin project and its focus on reforming supervisory structures, processes, competencies and staffing at Germany's national competent authority (**NCA**) for financial services firms and financial markets supervision.

MoBaFin has been delivered in multiple stages. At the start, the BaFin engaged external consultants to conduct a comprehensive review of the BaFin's structures and lead focus conversations with subject matter experts from the public sector, business and from industry associations and consumer protection organisations. Moreover, these findings were benchmarked against international peers and performance comparisons drawn up.

This fact-finding phase of the MoBaFin project served as a first step in performing a gap analysis so as to ensure the target operating model could deliver on the then Federal Finance Minister now Chancellor Scholz's pledge that "BaFin has more bite".

The BMF Update provides a useful recap on the various stages of MoBaFin as well as the authority's longer longer-term priority. These include:

1. ***Stronger risk orientation and - differentiation in supervision***. In order to strengthen the risk orientation in supervision of financial services firms, BaFin introduced the so-called "focus supervision" segment as part of its "differentiated supervision" approach. Focus supervision is applied to complex companies but also those that are non-complex across business areas with - for example an innovative, fast-growing and/or particularly international business model. Focus supervision represents an intermediate stage between "regular supervision" and "intensified supervision" especially for those firms that are assessed as "vulnerable companies". Moreover, a newly created organisational unit coordinates the activities of "focus supervision" and manages the interaction with the newly established "forensically trained taskforce" that reports regularly to BaFin's President. This new organisational unit also serves as a coordinator for facilitating BaFin and BMF dialogue on all supervisory objectives covered by focus and intensive supervision.

2. ***Digitisation***. BaFin's supervision of regulated firms and financial markets is to be made more efficient and more data-driven by modernising the authority's use of state-of-the-art technology. A core part of these efforts centre around the newly created Data Intelligence Unit (**DIU**). The DIU provides digital analysis of data and information to support BaFin's supervisory activities. The DIU is equally developing the so-called Supervisor Cockpit. This provides the supervisors with essential information, automatically pre-evaluated and available for their daily work. In the medium term the Supervisory Cockpit is set to be expanded in its scope to use artificial intelligence and Big Data as well as text crawling to automatically search the Internet for indications of dishonest behaviour and breaches by regulated firms.

3. ***Goal-oriented management***. BaFin has redistributed and streamlined a number of competencies, responsibilities and roles more clearly across the organisation. This includes but it is not limited to strengthening its management structure, including the allocation of responsibilities between the BaFin's president, the board of directors and the executive directors, thereby allowing for more efficient decision-making processes. In the newly established Strategy, Policy and Steering business area, cross-divisional steering, control and advisory functions as well as cross-sectoral supervisory priorities such as innovation and sustainable finance are bundled and interlinked.

4. ***Proactivity and crisis resilience***. Crisis prevention is one of BaFin's core tasks. As a part of the MoBaFin project, additional systems are now being set up to enable BaFin to supervise the financial market even more effectively. This specifically includes the new forensic taskforce unit, which can conduct its own ad-hoc investigations as well as on-site inspections in respect of financial services firms but also those other types of firms that have come under BaFin supervision as a result of the FiSG (see comments on DPR/FREP below). Equally, the BaFin has introduced new supervisory

tools, such as the use of "mystery shopping" exercises aimed at improving protections for investors and consumers.

5. ***The Market Contact Group and the BaFin Whistleblower Office***. In order to develop closer contact with the market, a new unit, the Market Contact Group, was set up within BaFin. Its purpose is to maintain an exchange with market participants and to collect and evaluate market information. The results of its work are fed into the supervisory work in order to set new impulses. In addition, the BaFin's Whistleblower Office was strengthened considerably. Equally, the way in which whistleblowers can interact with the BaFin (e.g., on the Internet) has been improved along with protection of their rights along and allocating whistleblowers an individual case officer. Moreover, a new IT-system collects, filters and prioritises incoming information from whistleblowers and ensures rapid evaluation by the relevant experts and findings ultimately contribute to the BaFin's supervisory actions.

With the integration of the German Financial Reporting Enforcement Panel (DPR/FREP) into BaFin, the financial reporting enforcement may continue to be fundamentally reformed further. BaFin has received significantly strengthened access rights and more competent personnel, in particular auditors, to better review financial statements. With its extended on-site inspection rights, BaFin will be able to carry out forensic audits with a greater degree of impact – at least at the level of intervention that led to the discovery of balance sheet fraud in the Wirecard case.

Lastly, the BaFin's management structure has been completely overhauled. This ranges both form the inauguration of the new president Mark Branson[5] in August 2021 through to the following leadership role appointments:

- Dr. Thorsten Pötzsch as Executive Director of the Securities Supervision Division in September 2021;
- Birgit Rodolphe as Executive Director of the Settlement and Money Laundering Prevention Business Area in September 2021; and
- Rupert Schäfer, who is set to assume an Executive Director role for the Strategy, Policy and Steering Division in November 2022.

All of these reforms above should help if deliver on its 2023 supervisory priorities[6] and notably the six major risks and two future risks[7] identified in its 2022 "Risks in BaFin Focus" report[8], as well on progress toward the medium-term objectives it has set itself for 2022-2025.

The BMF Update concluded its recap by reminding readers that the MoBaFin Project, which received first prize in the "agile transformation" category of a German e-government competition[9], can be attributed to the following three factors:

1. ***active project management*** – clarifying that the professionalism of the project management with a relatively large degree of freedom for the subprojects played a large share of the project's success;
2. ***active communication*** – which placed an emphasis on the importance of continuous communication as a cornerstone of the transformation of BaFin - especially the dialog-based formats for BaFin employees involved in the project; and
3. ***running of the "permanent transformation staff unit"*** – that acted as a project management office for continuous transformation efforts and that "Many of the concepts and measures applied

[5] The then German state secretary in the Federal Ministry of Finance had communicated that any new president of the BaFin, while needing to speak German, should have an international background as well as a track-record of independent analytical and leadership expertise and does not need to be a German citizen. The appointment of Mark Branson, a British-Swiss national who had, since 2014, been the Chief Executive of FINMA, the Swiss financial services regulator, certainly seems to fit the bill and has already been quick to setting a new tone from the top.

[6] See forthcoming coverage on this from PwC Legal's EU RegCore as well as in the forthcoming publication of Navigating 2023 (please see here for Navigating 2022).

[7] In BaFin's view, the major risk drivers for Germany's financial market, apart from the fraught geopolitical situation, are (unsurprisingly) risks caused by:

- the low interest rate environment;
- corrections on the real estate markets;
- significant corrections on the international financial markets;
- corporate loan defaults;
- cyber risks; and
- inadequate money laundering and financial crime prevention.

Beyond this, there are many more risks that BaFin is currently working intensively to assess and mitigate. One such further risk is that the balance sheets of companies subject to BaFin's financial reporting enforcement could contain incorrect valuations or false representations that could lead to investors being deceived. Others include the diverse array of risks to consumers, such as risks from crypto assets and from investment recommendations on social media.

[8] first published 2 March 2022 (available here) and which will be published going forward on an annual basis,

[9] Details available here.

in the project and in its aftermath can be used as examples for sustainable administrative reform of other organisations and authorities."

While MoBaFin's delivery has (welcomingly so far) certainly gone better than expected the above-described "drivers for success" that the BMF Update highlights do not seem to be that revolutionary.

Outlook

The MoBaFin project and the further ongoing reforms are already translating into a sharper tone in supervisory scrutiny that the BaFin is applying with respect to existing supervised firms and those applying for authorisation. In addition to BaFin receiving a broader toolkit and enhanced supervisory powers, the authority will likely, for the remainder of 2022 and through 2023, be recruiting many more supervisory staff, including auditors as well as forensically trained specialists. This will likely lead to a greater use of on-site inspections now that NCAs around the EU as well as EU authorities are, post-pandemic, returning to a more normalised form of supervisory engagement with the firms they supervise.

While these improvements to the BaFin are welcome, timely and necessary, the question for supervised institutions (regardless of business model) will be whether all of these domestic changes, may in turn translate into higher supervisory costs and who might pay for that. Some commentators have stated they are unlikely to be wanting to pay domestic costs if Europeanisation of financial markets supervision is being driven forward and reshaping the role of NCAs. This is equally a consideration for EU and domestic policymakers across the EU-27 in how to balance the right type of EU-led supervision that works hand in hand with domestic expertise, and equally where it makes sense for supervision to be led at the national as opposed to from the EU level. This also extends to questions for policymakers to ensure that the increased costs of supervision are not passed on by supervised institutions to their counterparties and perhaps more importantly not to end-customers and thus consumers.

About us

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

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

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