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BaFin's reform is a first step to redraw Europe's financial landscape

Ignazio Angeloni: The reorganization of Germany's financial market supervision should be seen as a preliminary step to boost market regulation and governance in the entire EU

Seneca, the Latin philosopher not known to be an optimist, wrote that good may come from bad. Let's hope that this will be the case for BaFin, whose reputation has been destroyed by the Wirecard disaster.

Reforming BaFin is as important for Europe as it is for Germany. Its reform should thus be seen as preliminary steps to boost market regulation and governance in the entire EU, at a time in which Brexit puts more responsibility on the shoulders of continental financial regulators. The future European market supervisor – be it an expanded European Securities and Markets Authority (ESMA) or a new institution entirely – needs a strong and reputable German agency in its membership.

BaFin's leadership has resigned and a new President has just been announced. The Bundestag is now considering a bill which would change corporate auditing processes, eliminate the role of the financial reporting enforcement panel and strengthen the supervisor's powers. These changes are useful, but their narrow focus on accounting, auditing and investigatory powers falls short of what is needed. The opportunity to learn from all the lessons of the Wirecard affair may be missed.

In spite of its complexities, the crux of the scandal is simple. For years, market rumours and press articles advanced the suspicion that Wirecard was manipulating its accounts. No supervisor should act on rumours only, but those signals should have prompted action on two fronts. First, to protect market integrity from unproven and potentially disruptive hearsay. Second, to clarify without a shadow of doubt if those rumours had any substance. If the agency's powers were deemed insufficient to do so, it should send visible signals to other relevant authorities. BaFin moved only on the first front; it even went so far as to undermine the second by taking legal action against the Financial Times, potentially inhibiting other sources of information. There was a bias in its judgement, perhaps rooted in the culture of the organisation.

Conflict of interest between market integrity and bank stability

As the scale of the problem was becoming apparent, some German banks came to the rescue of the accused, by offering lines of credit and offering favourable stock market advice which attributed the rumours to false information spread by speculators. The reputation of the banking establishment and stability of those banks, some already already week in and of themselves, were put at risk.

The problem is that BaFin supervises both the stability of the banks and the integrity of the financial market. This is rare. In the euro area, only in a few, small countries are those responsibilities combined. In Germany, banks have sizeable stakes in the corporate sector and no sufficient firewalls exist to alleviate risks that banks undermine their own stability to prop up zombie firms they have a stake in. The joint responsibilities of the supervisor give rise to a conflict of interest between maintaining market integrity and bank stability.

BaFin argued that Wirecard was a fintech, a business on which it had no authority, and that its banking subsidiary, Wirecard Bank, was prudentially sound. This is beside the point. BaFin is also a market supervisor, with responsibility over listed companies. Moreover, the broader ramifications of the affair were greatly underappreciated. Given its central role as German supervisor, BaFin could not interpret its mandate narrowly or disregard what happened just beyond the perimeter of its authority. Supervisory narrow mindedness is not a German problem only; a legalistic, risk-averse mindset often makes authorities reluctant to intervene unless their obligation to do so is absolutely certain. In Germany and elsewhere supervisory mandates should endeavour to correct such inaction bias.

The culture of the institution needs to change

These considerations provide clues to how the lessons of Wirecard need to be read and what reforms are necessary. The cultural problem should be addressed by a combination of clarity in the supervisor's mandate and hiring people – starting with the management team – having an appropriate professional background, with a special emphasis on transparency and integrity at all levels. Strengthening the institution's independence from politics is important, but not sufficient. It may even be detrimental, if the culture of the institution does not change.

The risk stemming from conflict of interest between banking stability and market integrity can only be corrected by clearly demarcating the two responsibilities; preferably, by investing them in separate authorities. After the great financial crisis, central banks began playing a more important role as banking supervisors. For example, the ECB is a banking supervisor as well. Initial concerns that there would be conflicts between these roles have, so far, not been born out. The Bundesbank's role as supervisor can therefore be expanded. The risks of doing so are smaller than those of maintaining a blurred distinction between the banking and market supervisor.

In the interest of all of Europe, long live a strong and reputable BaFin. Its mandates, culture, accountability, independence should be redesigned thoroughly, to ensure that never again does the supervisor fail to see the bigger picture and take responsibility for it.

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