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# BANKING, FINANCE AND CAPITAL MARKETS

## Supervisory Measures by BaFin in Connection with Covid-19

For years, financial institutions, insurance undertakings and other financial market participants have been operating in an increasingly difficult market environment. Now, with the Covid-19 crisis, further imponderabilities have been added which are also relevant from a regulatory perspective.

At its annual press conference on 12 May 2020, the German Federal Financial Supervisory Authority (*BaFin*) addressed the emerging regulatory challenges. Although it cannot and does not want to suspend existing supervisory law, it will use legal leeway to adapt supervisory practice to the crisis. This applies, for instance, to the following measures:

### 1. LOWERING THE COUNTERCYCLICAL CAPITAL BUFFER

BaFin has reduced the ratio for the domestic countercyclical capital buffer from 0.25 percent to 0 percent as of 1 April 2020.

The countercyclical capital buffer is a premium on the banks' Common Equity Tier 1 which is set forth in the Basel III Accord. The instrument was transposed into German law in section 10d German Banking Act (KWG). When defining the capital buffer, BaFin takes into account recommendations of the Financial Stability Committee (*AFS*) and the European Systemic Risk Board (*ESRB*). Banks must build up this buffer in times of strong economic activity. If the overall credit situation is constrained, they can use the additional capital to absorb losses from defaulted loans.

According to the underlying General Administrative Act of BaFin, no potential increase in the domestic countercyclical capital buffer is envisaged before 1 January 2021.

### 2. SUSPENSION OF ON-SITE INSPECTIONS OF INSTITUTIONS AND INSURERS

For the time being, BaFin is not planning any routine on-site inspections of institutions and insurance undertakings. Audits already in progress are to be completed, if possible, without further on-site audit activities.

### 3. NO DISPENSATION FROM CODE OF CONDUCT OBLIGATIONS UNDER SECURITIES LAW

On its website, BaFin continuously answers inquiries from associations and institutions in connection with the current corona pandemic. This concerns, among other things, home office regulations and the resulting challenges for rules of conduct and information obligations towards customers.

Particularly with regard to rules of conduct under the German Securities Trading Act (*WpHG*) and other information obligations, BaFin made it clear that it would not grant the supervised institutions a dispensation from complying with their obligations towards customers. Violations continue to be subject to fines in accordance with section 120 of the *WpHG*.

However, BaFin will exercise its discretion for the time being in such a way that it will not pursue violations of the obligations existing in relation to customers, such as the electronic recording of telephone conversations (section 83 (3) *WpHG*) or the timely provision of declarations of suitability (section 64 (4) *WpHG*) and ex-ante cost information (section 63 (7) *WpHG*). However, the respective investment services enterprise would have to take suitable relief measures to close the documentation or information gap resulting from the respective violation and inform the client in a comprehensible manner.

#### 4. ADMISSIBILITY OF DIVIDEND PAYMENTS AND PROFIT DISTRIBUTIONS

As early as 27 March 2020, the European Central Bank (ECB) published a recommendation that financial institutions should refrain from sharing buy-backs and dividend distributions including corresponding payment commitments due to the corona pandemic. The recommendation relates to dividends for the financial years 2019 and 2020 and applies at least until 1 October 2020. Banks that have submitted a dividend proposal to their shareholders for voting at the next annual general meeting should revise it in line with the ECB's current recommendation.

On 30 March 2020, BaFin also issued a similar recommendation for the institutions it supervises. According to this recommendation, no dividends and profits should be paid out until October 2020.

In both cases, these are not statutory prohibitions on the distribution of profits but merely non-binding recommendations by the authorities. However, it is to be expected that the authorities will try to implement legally binding measures if the banks do not follow the recommendations and this, in the opinion of the authorities, gives rise to doubts about the stability of the institutions concerned.

Also, BaFin does not consider a blanket ban on distributions for insurance undertakings and pension schemes to be necessary at present. Nevertheless, the dividend policy should take into account the individual situation of the insurers, in particular their risk-bearing capacity. BaFin thus opposes a different recommendation by the European Insurance and Occupational Pensions Authority (EIOPA). In a statement dated 2 April 2020, EIOPA urged that in the context of the current Covid-19 crisis (re)insurers temporarily suspend all discretionary dividend distributions and share buy-backs aimed at remunerating shareholders.

#### 5. NO BAN ON SHORT SELLING

BaFin is currently not planning a general ban on short selling. Pursuant to Art. 20 of the EU Short Selling Regulation (Regulation (EU) No 236/2012) in conjunction with section 53 (1)WpHG, BaFin may issue a short selling ban if unfavourable events or developments have occurred that pose a serious threat to financial stability or market confidence in Germany. BaFin last issued such a ban in February 2019 due to the sharp fall in the share price of *Wirecard AG*. At present, however, BaFin does not see any significant conspicuous features in the development of net short positions for the German financial market. It remains to be seen though whether the authority will maintain this position in view of the current, in some cases substantial price losses on the stock markets.

#### 6. INTENSIFICATION OF SUPERVISION OF ASSET MANAGEMENT COMPANIES

In accordance with section 5 (1) German Capital Investment Code (*KAGB*), BaFin supervises all domestic asset management companies (*Kapitalverwaltungsgesellschaften*). Pursuant to section 5 (6) no. 1 *KAGB*, it may, among other things, obtain information or demand the submission of documents.

As early as February 2020, BaFin, together with the European Securities and Markets Authority (ESMA), launched a query as part of a joint supervisory measure to monitor the liquidity risk management of asset management companies investing in Undertakings for Collective Investment in Transferable Securities (UCITS). The asset management companies concerned were requested to provide, *inter alia*, liquidity-specific quantitative data on all their (UCITS) investment assets. In the second phase of the query in May 2020, the focus will be on how selected companies perform liquidity management in qualitative terms. This should reveal, for instance, the extent to which asset management companies review investments in advance or how they structure certain escalation processes.

BaFin also expects the asset management companies to seriously examine in short term whether the liquidity instruments provided in the course of the latest amendment of the *KAGB* of 28 March 2020 should be implemented. This includes:

##### 6.1 SWING PRICING

*Swing Pricing* (section 1 (1) no. 34a *KAGB*) refers to a calculation method in which the unit price of an investment fund deviates from the net asset value in an upward or downward direction, depending on whether more units are currently issued or more units are redeemed. If the fund volume rises or falls due to an excess of issues or redemptions, the asset management company must react to this with purchases or sales of assets. Swing pricing allows for the transaction costs incurred when buying or selling to be charged to the investors who caused the movement in the fund volume due to their purchases or redemptions.

##### 6.2 REDEMPTION BLOCKINGS (REDEMPTION GATES)

Pursuant to section 98 (1b), (2) *KAGB*, the investment requirements of open-ended mutual funds, mixed funds and special funds may provide for a short-term restriction on the redemption of units as soon as a previously defined threshold for unit redemptions is exceeded for an investment fund. The restriction may only last for a maximum of 15 working days. The decision as to whether and in what situations unit redemption will be restricted is at the dutiful discretion of the respective asset management company.

##### 6.3 REDEMPTION DEADLINES (REDEMPTION NOTICES)

In addition, pursuant to section 98 (1a) and (2) *KAGB*, the investment requirements may stipulate that the redemption of units must be effected by means of an irrevocable declaration of redemption to the asset management company in compliance with a specific redemption deadline. Binding notice periods for unit redemption have been in force for many years in the case of real estate funds, as well as in the case of (funds of) hedge funds. This instrument has been extended to UCITS, mixed investment funds and certain special funds in the course of the recent amendment to the law.

## Practical implications

In some cases, the adjusted administrative practice of BaFin has resulted in a more stringent set of obligations for the companies concerned. In other cases, such as the reduction of the counter-cyclical capital buffer, useful facilitations are also being created which allow the authority to respond to the special circumstances of the Covid-19 pandemic.

It is essential for financial market participants to keep a close eye on the current developments and positions of BaFin.



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## Imprint

This publication is issued by

### BEITEN BURKHARDT

Rechtsanwaltsgesellschaft mbH

Ganghoferstrasse 33 | D-80339 Munich

Registered under HR B 155350 at the Regional Court

Munich/VAT Reg. No.: DE811218811

For more information see:

<https://www.beiten-burkhardt.com/en/imprint>

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