RegCORE Client Alert

BaFin goes mystery shopping – revisiting this tool ahead of the 2023 supervisory cycle

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Reforming BaFin

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QuickTake

Following the collapse of Wirecard, which is considered to be the consequence of widespread fraud, the German government has made financial market integrity along with the reform of Germany's national competent authority (**NCA**) for financial services regulation and supervision, the German Federal Financial Supervisory Authority (**BaFin**) one of its top goals. The German Act on Strengthening Financial Market Integrity (**FISG**), which went into effect on 1 July 2021 and partially on 1 January 2022, resulted in the revision of various German legislation and introduction of new supervisory tools for BaFin. One such tool is that BaFin may employ "mystery shopping" i.e., carrying out anonymous tests of "customer journeys" of various banks, insurers and financial service providers it supervises.

For NCAs, mystery shopping allows them to obtain insight into consumer protection issues in what happens behind closed doors between clients and providers. Moreover, it does not, from the regulators' perspective, require the respondent to revisit their long-term memory and thus may avoid them recalling mistakes.

This tool, together with BaFin's new Investor and Consumer Protection Office that was created 1 July 2021, marks a comprehensive strengthening of BaFin's powers to prevent and eliminate violations of consumer protection law as well as the NCA's role in handling complaints from customers of firms it supervises. Mystery shopping allows BaFin to move from reactive to more proactive supervision. As before, BaFin can issue orders that are appropriate and necessary for eliminating or preventing such violations if general clarification appears to be necessary in the interests of consumer protection. In serious cases, BaFin can restrict or completely prohibit the distribution of products and certain distribution practices including by using product intervention powers.

This Client Alert revisits BaFin's use of mystery shopping and assesses efforts at the EU-level, notably the European Banking Authority's (**EBA**) publications in 2021 of its Report on the Mystery Shopping Activities of National Competent Authorities (**NCAs**)[1] and its Methodological Guide to Mystery Shopping[2] and similar efforts of the EBA's sister European Supervisory Authorities (**ESAs**). Each of the ESAs have, since 2019, an explicit mandate to coordinate mystery shopping activities amongst NCAs. With a return to a more normal

[1] Published May 2021 and available here.
[2] Published July 2021 and available here.

supervisory cycle following the COVID-19 pandemic's pause on activity, each of the ESAs and many NCAs may step up the use of mystery shopping on supervised financial services firms.

The European Securities and Markets Authority (**ESMA**) had in its 2020-2022 supervisory priorities communicated that it will coordinate mystery shopping on retail investment products – a task slightly derailed by COVID-19 and one which it highlighted again in the context of its 2023 supervisory priorities.[3] The European Insurance and Occupational Pensions Authority (**EIOPA**) has also confirmed it will begin to use mystery shopping.[4] It remains to be seen whether ESMA and EIOPA will publish their own material similar to EBA's publications.

Ultimately, if mystery shopping is to be used more comprehensively by NCAs including as coordinated by the ESAs, in respect of on-site and digital distribution channels during 2023 and beyond, financial services firms will want to ensure they are able to conduct their own preparatory measures to mitigate adverse supervisory findings including sanctions and fines.

BaFin's mystery shopping in practice and its first findings

Following FiSG's entry into force in Germany, BaFin retained four mystery shopping agencies to deliver a pilot project to test and refine the use of this newest supervisory tool. As part of the pilot, BaFin reported[5] that it had designed three test customer profiles representing various age groups, i.e., young adults, persons of working age and senior citizens. The agencies then sent the testers to 12 banks (four savings banks, four cooperating banks and four private banks) and conducted 36 test purchases. While this sample was not, as BaFin noted, sufficiently representative to allow it to draw sufficient supervisory conclusions, it did provide a direct insight on market realities and a number of failings.

The BaFin's publications of its findings proved to be a wakeup call for banks on prevalent poor practices. The BaFin's Director General for Consumer Protection and the Consumer Protection Officer summarised the sobering results as follows "We could see straight away that the error rate was problematic: in 12 of the 36 total tests, i.e., one in three, the customer was not given important disclosure documents." In five cases, there was no suitability report; in four instances, no cost information was provided. In three other test purchases, neither document was provided – despite the fact that both are required by law.

Particular failings were identified in respect of the senior citizen test profile. The BaFin went on to explain that "We see a number of individual risks converging with increasing age, and this makes older people a particularly vulnerable customer group. It was thus to be feared that this group would show a high incidence of irregularities – and this is what the data confirm."

For a domestic banking sector beleaguered by a number of consumer protection compliance failings and challenges, BaFin's preliminary conclusions should be a catalyst for change at firms, notably in light of future rulemaking and possible further bans on commissions. Moreover, the BaFin and the ESAs are considering further rulemaking to strengthen the protection of senior citizens and others that qualify as vulnerable customers. Market participants may wish to consider assessing how to implement additional considerations when dealing with vulnerable customers. Some firms may already have a vulnerable customers policy while others would do good in implementing one. The BaFin's findings may also prove of interest to firms and their operations that are subject to supervision by other NCAs.

While future mystery shopping activity by BaFin may first and foremost focus on traditional financial services activity and distribution models, it will likely quickly, as BaFin had announced, expand its activities to also review real estate financing (notably in light of the operationalisation of the EBA's Guidelines on loan origination and monitoring in the 7th amendment to MaRisk – see standalone coverage from PwC Legal's EU RegCORE) and various real-estate insurance products. BaFin's future mystery shopping exercises will also likely place digital distribution channels as well as so-called "neo-brokers" and cryptoasset service providers under further supervisory scrutiny. A lot of this may build off the guidance already published by the ESAs, notably the EBA as well as be driven by the ESAs coordinating mystery shopping reviews on a pan-EU basis ahead of possible common supervisory actions.

[3] Available here and see standalone coverage from PwC Legal's EU RegCORE on this development.
[4] See details here
[5] See details here.

EBA's Report on mystery shopping activities of NCAs

The EBA's Report focuses on NCA mystery shopping initiatives for those regulated activities that are covered by the EBA's consumer protection mandate. This includes consumer credit, mortgage credit, deposits, payment services, electronic money, and payment accounts. The EBA's Report summarises the most prevalent techniques employed by NCAs, based on information gathered mostly from 2015 to 2020. It accomplishes this by examining three main aspects of mystery shopping activities: their aim, topic matter, and product scope, NCA techniques, and follow-up actions after the mystery shopping was completed. The report also identifies some lessons learned and recommends best practises for NCAs going forward.

The EBA's Report concluded that only a small number of NCAs conducted mystery shopping in their own jurisdiction. Furthermore, certain NCAs noted that national-level talks were at the time underway on the prospect of adding such powers to the mandates of relevant competent authorities, for some of them as part of the implementation of the EU Consumer Protection Cooperation Regulation.[6]

In terms of lessons learnt, the Report argues that mystery shopping helps NCAs to have a better understanding of financial institutions' behaviour. This, in turn, pushes them to take better remedial efforts to comply with applicable regulations, thus improving consumer protection.

The EBA's Report concluded that mystery shopping is a useful and complementary tool to fulfil their supervisory and/or subsequent enforcement objectives, even if not every on-site supervisory inspection will include mystery shopping. Equally, mystery shopping allows for NCAs to carry out a comprehensive analysis of the compliance of financial services firms with requirements that cannot be easily identified during usual on-site or off-site inspections – in particular when reviewing sales staff behaviour.

The EBA Report also set out some of the main challenges that had been identified by the NCAs surveyed. These are both of relevance to financial services firms but also in how such challenges might be resolved over time by using other means (including specialist firms and/or outside counsel):

- Some requirements oblige NCAs' inspection/supervision agents or mystery shoppers to disclose their real identity information when entering into a contract with a financial service firm (identity card, identification via electronic ID, pay slips, accreditation needed to access the complete files etc.). Mystery shopping is therefore harder to use in the contractual and post-contractual phase if no commercial relationships can be entered into without checking the consumer's identity. The NCAs' investigation/supervision agents would thus be in a situation where they may be indeed forced to disclose their real identity, which would impact the mystery shopping process. The EBA therefore concluded that mystery shopping seems to be more suitable for the pre-contractual phase. A pre-contractual investigation would rather be gathering information on mandatory disclosure;

- The risk of exposure of individuals during the performance of the mystery shopping (in particular during the on-site inspection) when the mystery shopping is conducted by the NCA itself: in particular due to the size of the country some NCA staff are immediately identified;

- As with other instances of interpreting social observations, the EBA noted that NCAs, as observers, need to avoid subjective bias;

- Risk for mystery shopping to capture only one singular experience/one-off occurrence as the mystery shopper captures a snapshot at a particular point of time; according to the feedback received from supervised financial services firms by NCAs, some mystery shopping exercises do not always reflect the usual practice of the financial services firms;

- Constraints regarding the recording of the mystery shopping activity for subsequent supervisory purposes, e.g. because the recording is legally not permitted, was technically impossible, or, where it was possible, it proved to be of insufficient audio quality; and

- Limited time and human resources to carry out mystery shopping exercises alongside other supervisory work: especially as conducting mystery shopping involves guidance, training of NCA staff, potential recruitment of mystery shoppers etc., which creates more difficulties for smaller countries with less human resources.

The EBA also identified a number of what it considered to be best practices when conducting mystery shopping, a number of which have been reflected in the Methodological Guide to Mystery Shopping. For best practices applied in and across NCAs and their own capabilities, the EBA Report focuses on common

[6] Available here.

procedural issues such as organising training for NCAs' inspection and supervisory personnel, how to better determine target consumer profiles and define agreed-upon 'rules' of customer behaviour.

EBA's Methodological Guide to Mystery Shopping

The Methodological Guide outlines in specific detail how mystery shopping activities can be conceived and carried out, how NCAs can use the Methodological Guide to supplement other existing supervisory tools and how to adapt such activities to the specific circumstances, goals, and mystery shopping powers conferred on an NCA under national and/or EU law, including under the EU Consumer Protection Cooperation Regulation.

The guidance offered by the EBA applies whether the activity is performed directly by the NCA or through an external supplier retained to act on its behalf. Furthermore, the Methodological Guide applies to both online and on-site mystery shopping activities but concentrates on the latter owing to the nature of the activities on which NCAs' expertise and experiences, and hence the EBA's guidance, are founded. It is conceivable that the Methodological Guide may be updated over time.

The EBA's current Methodological Guide and its content is not mandatory and it does not seek to harmonise NCAs' mystery shopping procedures or imply that all NCAs must use it as a supervisory tool. Rather, the EBA aims to assist NCAs that are in a position to carry out mystery shopping activities under their respective national legal frameworks in designing and implementing mystery shopping activities, thereby facilitating coordination of their activities and enhancing their ability to assess the retail conduct of financial institutions in their jurisdictions as well as when the EBA (or sister ESAs) coordinate such activities amongst multiple NCAs.

The EBA's Methodological Guide follows a seven-step process to:

1. Define the goals of the mystery shopping exercise;
2. Select the products and services as well as distribution channels to be tested;
3. Select the financial institutions to be tested;
4. Elect mystery shoppers and consumer profiles;
5. Design mystery shopper scenarios;
6. Design mystery shoppers' assessment questionnaire and data gathering; and
7. Assess the finding and follow-up.

Steps 4,5, and 6 are in the view of the EBA those that an NCA can outsource to external service providers whereas steps 1,2,3 and 7 are those where the ultimate decision rests with the NCA as a core part of their supervisory function.

The EBA notes that in the context of Step 1, the most common conduct and consumer protection goals that mystery shopping could pursue include:

- **Assessing compliance with regulatory requirements**: this includes NCAs evaluating compliance by the supervised financial institutions with the regulatory requirements of banking products and services, for example on the adequacy of information disclosure concerning the product/service, in particular pre-contractual information duties, selling practices, fair treatment and an assessment of the suitability of a product or service for consumers' needs and profiles.

- **Evaluating whether the FI's staff have an adequate level of knowledge and competences**: this includes NCAs assessing whether the relevant staff of supervised firms and appointed representatives possess and maintain an adequate and up-to date level of knowledge and competence in relation to the manufacturing, offering, and/or selling of particular products and services in order to achieve a high level of professionalism. Mystery shopping also provides indications as to the extent to which sales staff have received training relevant to the particular product/service. This also requires mystery shoppers to have the skills to evaluate the knowledge and competence of supervised firms' staff. The mystery shopping assessment questionnaire provided to mystery shoppers can, for instance include a ranking to evaluate the skills of supervised firms' staff (which the EBA also explores in further detail in discussions on Steps 4 and 6); and

- **Measuring compliance with and the effects of new regulatory changes:** this could also be done through a mystery shopping exercise carried out before and then shortly after a regulatory change has been implemented.

Outlook and next steps

Financial services firms both operating from as well as into Germany will want to take note of how BaFin and other NCAs and the ESAs are stepping up their use of mystery shopping and make targeted amendments to their internal systems and controls relative to product governance along with improvements to distribution channels and dedicated training of relevant staff involved in all stages of the customer journey. Some firms may also want to revisit their client-facing documentation, including when offered through distributors and conduct pain-point analysis from product inception through all parts of the customer journey, distribution and post-sales communication channels.

Moreover, some financial service firms may want to consider setting up their own administered mystery shopping exercises. They can do this either by themselves or by retaining external service providers. In many instances it may be advisable to retain external legal advisors to equally review and report on areas that evidence non-compliance thus allowing for financial service firms to take appropriate remedial action before the regulator requires them to do so. Such self-testing can also serve to understand customer behaviours better – both in the context of on-site and digital distribution channels as well as in respect of differing impacts on specific customer types. Proactive and periodic self-testing can therefore reinforce the customer journey, customer service and satisfaction while minimising supervisory fines.

About us

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

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

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