

# Thematic Digest on the Wirecard case



This document presents the summaries of three external papers commissioned by EGOV upon request of the Economic and Monetary Committee (ECON). ECON has requested external experts to provide expertise on the wider supervisory implications of the Wirecard case. The summaries were drafted by EGOV in own responsibility.

Until its collapse, Wirecard successfully marketed itself as a pioneer and innovator in the digital payments industry, as a Fintech that was able to displace the big banks. At one point, its market capitalisation was bigger than that of Deutsche Bank. With hindsight, however, it seems that weak regulation and supervision facilitated the company's quick development into a blue-chip company, which turned out to be less substantiated than perceived.

The Wirecard case raises many questions about the effectiveness of different supervisory regimes, for example as regards the reliability of audited financial accounts, the scope of auditing and the role of self-regulatory bodies, the disclosure of relevant information, the integrity of securities markets and the mandate of investor protection, the supervision of Fintechs, payment processors and financial services providers, the role of national Financial Intelligence Units and their international cooperation in case of unusual or suspicious transactions etc. Some of the weaknesses unveiled by the Wirecard case may be just case-specific or only relevant at national level, while others may point to wider supervisory implications at EU level.

Against this background, ECON commissioned briefing papers addressing:

- the current supervisory landscape for Fintech companies like Wirecard;
- the advantages and disadvantages of weaker or less intrusive supervision of Fintech companies that provide financial services ("regulatory sandbox approach");
- and a general reflection on the wider supervisory implications of the Wirecard case level for Fintechs, suggesting ways forward at EU to prevent similar situations in the future, if possible.

The hyperlink on the PE number of the papers listed in this document takes to the version that will soon be published. All papers will also be made available on the [ECON homepage](#).

The *Economic Governance Support Unit* provides expertise in view of supporting the European Parliament and its relevant committees and bodies, notably in their scrutiny-related activities on economic governance and banking union. EGOV is part of the Directorate-General for Internal Policies of the Union (DG IPOL).



## **What are the wider supervisory implications of the Wirecard case?**

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*In this policy briefing, the authors discuss four shortcomings of market and institutional oversight that the Wirecard case lays open: i) Shortcomings with respect to whistle-blowers and information flows into prices; ii) Weaknesses of external audits, internal controls but also market forces when it comes to Wirecard's accounting information; iii) Limitations in the supervisor's investigation and enforcement powers, limiting its ability to take the appropriate action when needed; The potential for negative externalities and the risk of supervisory capture in a fragmented European capital market. All four limitations give rise to far-reaching reform proposals of the oversight system in Germany and Europe.*

Looking at the Wirecard case, the authors provide an extensive analysis focusing on four specific angles (outlined above) and present a number of conclusions and suggestions. Market integrity and investor protection are the guiding principles for the analysis and the authors try to identify the major reasons for the occurrence and slow detection of the Wirecard scandal, emphasising the role of institutional deficiencies. According to the authors, these deficiencies can, in principle, be mitigated by reforming market and oversight institutions as well as supervisory agencies. The authors put forward eight policy recommendations to address the identified shortcomings:

**Information flow: whistle-blowing:** The authors recommend developing a supervisory strategy allowing for an effective screening of the many voices raised, and encouraging whistle-blowing from within or outside publicly listed firm. Such a strategy may include substantial financial incentives for whistle-blowers.

**Information flow: short selling:** The authors recommend making the conditions under which supervisors may enact short sale prohibitions significantly more restrictive.

**External Audits:** The authors suggest a reform of external audits to strengthen auditor accountability by ensuring the law, not just professional standards, unmistakably require that auditors' professional scepticism and reasonable checks to uncover accounting manipulations and accounting fraud as an integral part of an external audit. Market supervisors and public oversight bodies also need to provide clear guidance what it means when auditors certify financial statements as providing a true and fair view. To strengthen auditor incentives as well as penalties for weak audits, auditor liability should be raised considerably. The authors also recommend reviewing the effectiveness of existing public audit oversight bodies (at a minimum, these bodies should publicly disclose summary metrics about their inspection findings for individual audit firms (not at engagement level)).

**Internal Controls and Supervisory Board Oversight:** The authors recommend, at a minimum, that the law require publicly listed firms have a well-functioning internal control system. External auditing of this control system should be considered. The head of the internal control function should report to the supervisory board. To strengthen supervisory board oversight of external audits, publicly listed companies should be required to have a dedicated audit committee. The chair of this committee needs to be independent and a financial expert. In addition, the majority of the audit committee members need to be independent.

**Enforcement of Financial Reporting:** The authors suggest reforming the two-step enforcement procedure in Germany, making BaFin the only competent authority (allowing BaFin to enlist the help of other bodies like FREP for limited activities as an option, while the powers and accountability remain entirely with BaFin). As to the European framework, the authors suggest strengthening the competencies for supervisory authorities under the Transparency Directive. They should have

investigative and enforcement powers modelled on the strictest standards available under the market abuse regime.

**Market oversight mandate:** The authors propose to strengthen BaFin powers, as well as to establish accountability for fulfilling its oversight mandate in substance, not only in form. This accountability requires sufficient independence as well as sufficient resources to fulfil its tasks.

**Market oversight agency:** The authors propose to create a single, responsible market oversight institution at the European level, which may be called the European Single Capital Market Supervisor (ESCMS). Such an institution would address ripple effects to other countries within the same European capital market that scandals like Wirecard create. In addition, it would help to overcome fragmentation, conflicts of interest due to national competition in the markets for goods and services, regulatory arbitrage and capture.

**European Market oversight:** The authors propose to build the European oversight architecture with the existing national agencies as branches of an integrated European supervisory network. The ESCMS serves as the apex layer in the network, to which all national agencies are reporting. The hub-and-spoke architecture also addresses the issue of independence of the national agency.

## ***What are the wider supervisory implications of the Wirecard case?***

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*Beginning with a discussion of the Wirecard case, this study highlights several lessons for the regulation and supervision of Fintech companies. Innovation in the financial industry brings both efficiency gains and new risks. To balance these two elements, regulators need a deep understanding of Fintech's technologies and business models. Because Fintechs can be very complex companies, there is a need for an approach combining the oversight of both entities and activities. The global scope of Fintech's activities also calls for convergence and coordination of rules and supervisory practices at the European level and beyond.*

The authors consider that although the case of Wirecard appears to be an accounting fraud of the more classical type, many lessons can be drawn for the design of Fintech regulation and supervision. The authors found that there was no comprehensive and integrated oversight of Wirecard activities, both in terms of lines of business and geography of its operations, and neither an adequate vetting of its accounting practices, nor an effective oversight and enforcement of accounting and auditing practices. Because of its status as a high tech Fintech company, Wirecard was left to operate under a veil of regulatory ignorance, with no effective challenge to the viability of its business model. Also, the geographical span of its operations, frequently carried out through third parties and under different regulatory and supervisory regimes, made the oversight of its activities even looser. At the same time, Wirecard could also pass the hurdle of the scrutiny of large investors and banks, which provided massive funding to its operations. Authors conclude that there is a growing need to balance the efficiency gains of technological innovation in the financial industry with possible additional risks for its stakeholders and propose six lines of action to reinforce the Fintech framework:

1. **Avoid regulatory arbitrage** in particular ensure that entities carrying the same activity follow the same sets of rules, however they carry them out (e.g., providing credit through on-line credit platforms or traditional banks)
2. **Understand clearly what Fintechs do and what their business models are**, through the use of sandboxes
3. **Combine the oversight of entities with the oversight of activities.** The authors argue against the recent European Commission proposals granting oversight powers with respect to technological third-party providers, also within the same group. The authors consider this approach overcomes the problem of the identification of financial conglomerates with the right of oversight just depending on the actual risks that technology companies or activities may cause on financial intermediation
4. **Master the technology used by Fintechs**, namely, in what respects actual behavior and functioning of algorithms. Regtech and Suptech are interesting developments in this respect, but although they will certainly complement the activity of regulation and supervision of financial markets, they cannot completely substitute more traditional approaches.
5. **Know the global picture and harmonise and coordinate internationally rules and oversight of Fintechs**, where the authors see the process of harmonisation and coordination, in the case of Europe, as a necessary ingredient of the Capital Market Union.
6. **No need for a new regulatory agency**, rather we need coordination among national competent authorities. The authors consider that in any of the key areas affected by the Wirecard case, investor protection, customer protection and financial stability, European authorities, the European Banking Authority (EBA) and the European Securities Market Authority may be put in the position of indicating harmonised and coordinated framework for Fintech across Europe, which will then be exercised by national competent authorities.

## **What are the wider supervisory implications of the Wirecard case? Public Oversight Systems for Statutory Auditors in the EU**

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*While multiple causes underpin accounting scandals such as Wirecard, they often point at deficiencies in the audit profession and its oversight. Currently, the system of national public audit oversight boards (POBSAs) is fragmented and overly complex, characterised by limited responsiveness to red flags, and apparent lack of communication among the POBSAs, and with other supervisors. This suggests supervisory coordination and clear action triggers are imperative. Importantly, pervasively low transparency limits the usefulness of this briefing and hinders evidence-based policy making.*

The paper documents a fragmented, and complex auditors' supervisory system hindered by *slow decision-making and resource constraints*. Competences appear duplicated, or unclearly delimited among the different bodies at European and national level, creating gaps where breaches of conduct or incipient frauds could go unnoticed. The example of Wirecard suggests complex firms may be particularly able to avoid supervision, falling '*between the cracks*.' Wirecard, and firms like Wirecard, operate in a global economy; supervision that is only at the local level is likely to fall short of its objectives. Global companies in the global economy require global institutions. The harmonisation of procedures (quality assurance, investigation, sanctions) and a significant improvement of the accountability and transparency mechanisms in place, are the cornerstones of the changes that should be addressed in the EU auditor oversight system, under the leadership and coordination of the CEAOB. With that background in mind, the authors make a number of recommendations around five different dimensions:

### **Macro-level: The role of the CEAOB and other international and EU bodies**

The Committee of European Auditing Oversight Bodies (CEAOB) has made limited progress towards its mandate to coordinate and harmonise European public oversight boards for statutory auditors (POBSAs). The role of the CEAOB should be reconsidered, and greater power assigned to it, perhaps including a clearer supervisory role. These changes may include giving the CEAOB greater resources (budget, staff) and clear competencies. Adequate oversight of auditors of public interest entities (PIEs) likely requires that these audit firms have global structures that guarantee similar audit quality across all Member States. The CEAOB could directly supervise these global structures. The Wirecard case suggests supervisory bodies acted in an uncoordinated manner, without clear leadership. Coordination between the oversight of auditors and of financial reporting is fundamental. CEAOB should identify and promote best practices in audit oversight, through outreach, and increased transparency. The CEAOB should be responsible for agreements with other international oversight bodies.

Annual data on key results should be calculated under a single reporting system, to aid the CEAOB coordination activities. Consider XBRL tagging [XBRL, or eXtensible Business Reporting Language, is a standard that shall increase the transparency of financial reports], and public, easy to search, repositories of audit oversight data. PIE definition should be harmonised.

### **POBSA level: Prevention**

POBSAs should report comparable budgetary figures, given their respective workloads. POBSA governance recommendations should be prepared. Report and discuss Advisors/Staff ratios. POBSAs have large boards, and insufficient staff. Codes of conduct should be created, to prevent conflicts of interest; attention should be paid to revolving doors (back to the profession). POBSAs should have an Advisory body where the auditing profession is represented. QA review and inspection procedures should not foster a bureaucratic, box-ticking mentality and may consider more collaborative

approaches. Supervisors that are public bodies should be powerful authorities and independent from politicians to avoid regulatory capture and political pressures.

A channel for fast-track Quality Assurance (QA) reviews, inspections or investigations should be articulated. POBSAs should be reactive to whistle-blowing or allegation of misreporting.

### **POBSA level: Detection (QA and Inspections)**

QA and inspections procedures must be disclosed on the POBSA website. When delegated, appointment criteria should be disclosed. The number of hired or contracted inspectors should be proportional to the number of PIEs, so that the proportion of reviewed PIEs is similar across Member States. Ratio Staff/PIEs should be justified. POBSAs must report on reviews and inspections and such reports should be comparable and publicly available (the authors recommend the Irish IAASA (2020) Guide to reports on quality assurance).

A standardised rating could be implemented, to grade auditor quality control systems and files reviewed/inspected. This rating should go beyond qualified/unqualified (e.g., A, B, C, D). QA review reports could be separately regulated.

Whistle-blowing mechanisms should be easily accessible. A centralised whistle-blowing repository may be considered. Client companies should have clear procedures, and auditors should have access to this information.

### **POBSA level: Remediation (Investigation and Discipline- ID)**

ID procedures should be homogenous and have clear triggers to act. Clarify when the competent authority can proceed with an investigation (e.g., because of a QA review; whistle-blower allegations; at the securities supervisor request, etc.). Sanctioning regimes should be harmonised. Otherwise, breaches of conduct are differently penalised across EU countries.

### **Transparency**

Audit supervisors' reports should have a comparable format, use the same measurement basis for QA and ID processes and consider English as additional reporting language. POBSAs should have a well-structured website (in local and English language) with all relevant information. The register of auditors should be easily accessible through the website. Standardise reports (delegated functions, QA reviews, inspections, etc) and make them publicly available in repositories.

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