BRIEFING

# Banking Union: ESMA report on Wirecard

*This briefing provides a summary of ESMA's Fast-Track Peer-Review (FTPR), published on 3 November 2020. ESMA carried out an assessment of the effectiveness of the supervisory response in the financial reporting area by BaFin and FREP in the context of Wirecard AG fraud case.*

## Introduction

On 25 June 2020, the European Commission sent a letter to the European Securities and Markets Authority (ESMA), inviting it to conduct a fact-finding analysis of the Wirecard case. ESMA was asked to evaluate whether there have been any supervisory failures and if legal and administrative obstacles hindered the effective enforcement of applicable financial reporting standards, or the sanctioning of any such breaches if needed.

In response, in view of the overriding public interest in the Wirecard case and the enforcement of financial reporting in Germany, ESMA first decided to make the **previous confidential country report** on Germany available. This report formed part of the 2017 peer review of the application of the Guidelines on the Enforcement of Financial Information (GLEFI). The report, dating back to 2017, had identified some areas for improvement, including the procedures in place both BaFin and the Financial Reporting Enforcement Panel (FREP; in German: Deutsche Prüfstelle für Rechnungslegung), cooperation between the two entities, and independence and conflict of interest as regards to FREP.

ESMA also started a **fast-track peer-review (FTPR),** building on findings of the 2017 report. The FTPR aimed to "*carry out an assessment of the effectiveness of the supervisory response in the financial reporting area by BaFin and FREP in the context of Wirecard AG, in the light of the ESMA Guidelines on Enforcement of Financial Information including considerations relating to the supervisory designation model set-up.*" (see mandate, p. 140, restricted to compliance with the "GLEFI guidelines"). The FTPR focused on the areas in the GLEFI guidelines deemed most relevant the Wirecard case, namely:

- Guideline 2: sufficiency and adequacy of human and financial resources
- Guideline 3: independence
- Guideline 4: selection methods
- Guideline 6: examination procedures
- Guideline 8 materiality
- Guideline 9: follow-up on actions acted upon
- Guideline 12: emerging issues

Economic Governance Support Unit (EGOV)
Authors: C. Dias, K. Grigaitė, M. Magnus, R. Segall
Directorate-General for Internal Policies
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## Key findings of ESMA Fast Track Peer Review

On 3 November 2020, ESMA published the results of the FTPR, which also includes a description of the case and timeline of key events.

The FTPR's main findings are summarised in its executive summary (see Annex 1 for an excerpt thereof, with emphasis added by EGOV).

**Key observations** are that ESMA:

- considers the resources at both BaFin and FREP to be adequate for their regular functioning,
- sees for BaFin a heightened risk of influence by the Ministry of Finance,
- notices that BaFin lacks information about its employees' share holdings,
- notices that FREP did not pick up signals in the international media and failed to select Wirecard for examination in the period between 2016 to 2018,
- notices that FREP should have been more thorough in examining whistle-blowers' and media allegations,
- notices that FREP and BaFin should have expanded the scope of the examination to the Third Party Acquiring business[1],
- notices that, as regards fraud in financial reporting, BaFin and FREP are not aligned in the perception of each other's role,
- assesses that BaFin and FREP may not have the powers necessary to effectively substantiate and investigate suspicions of a criminal activity,
- considers that confidentiality requirements in some circumstances in the Wirecard case have prevented an efficient exchange of information between BaFin and FREP,
- and mentions a lack of coordination and/or procedural inefficiencies within BaFin in the context of the Wirecard case.

As regards the adequacy of resources mentioned in the executive summary, that assessment notably only refers to the "regular functioning" of BaFin and FREP. According to its mission statement, FREP aims to ensure that the financial reporting of companies is transparent and aligned to the applicable accounting standards; there is no mentioning that its procedures are geared to detect nor designed to follow-up on fraud cases.

In the body of the FTPR report, the adequacy of resources is described in more detail. Point 192 says that "*The PRC [Peer Review Committee of ESMA] considers that both FREP and BaFin are well staffed and have the appropriate level of resources in normal circumstances. The PRC notes however that there is **very limited capacity for either FREP or BaFin to scale up their resources if the need arises***." (EGOV emphasis)

**On substance**, as regards the FREP's examination of Wirecard's 2018 financial reports, the FTPR mentions in points 476 ff. that red flags already existed on the **Third Party Acquiring (TPA) business** well before October 2019, which could have prompted an earlier expansion of the scope of the examination. The TPA business was one of the core mechanisms by which Wirecard managed to manipulate its accounts. The FTPR in particular refers to the red flags raised by a series of articles in the Financial Times, which stated that half of Wirecard's revenues and 95% of its 2016 EBITDA relied on three of its partners, though investigations in the field by the FT showed *"modest reality on the ground"* of some partners – essentially questioning the existence of underlying significant transactions between these partners and Wirecard. According to point 478 of the FTPR, FREP stated that it was aware of these new allegations in the FT reporting but also observed divergent signals in the media and by BaFin at that time, and therefore did not discuss the issues and the possible related actions internally.

[1] This refers to Wirecard business as accepting and settling payments with cards on behalf of merchants (see ESMA report, point 139).

The part of the FTPR report that deals with the **effectiveness of the supervisory** system to detect financial reporting issues involving fraud, ESMA writes in point 47: "***Both BaFin and FREP have indicated that they lack the powers to perform or order a forensic examination into (top management) fraud*** *involving financial reporting. However, in the context of fraud, BaFin and FREP have an obligation by law to notify the public prosecutor in case the examination procedures give rise to the suspicion of a criminal activity relating to an entity's financial reporting. The role of the public prosecutor is relevant in such a case, as it does have full forensic capabilities to examine a potential fraud. To enable it to effectively examine cases of potential fraud involving financial reporting, the public prosecutor is also dependent on both BaFin and FREP notifying it of information giving rise to the suspicion of a criminal activity.*" (EGOV emphasis)

The lack of power is further detailed in point 50 of the FTPR: "[...] *the PRC is of the opinion that FREP and BaFin may not have the powers necessary when it comes to being able to* ***request information from relevant parties (like auditors and other relevant parties)*** *in order to effectively substantiate suspicions of a criminal activity so as to enable them to notify the public prosecutor.*"[2] (EGOV emphasis)

**Table: ESMA's assessment of the effectiveness of the supervisory system**

| Areas assessed | PRC finding |
|---|---|
| Legal or procedural impediments that prevented BaFin and/or FREP from, on a timely basis, detecting, supervising/examining financial information published | Weaknesses in relation to:<br>- Financial reporting issues involving fraud,<br>- The assessment by BaFin of substantial doubt regarding FREP's examinations |
| Legal or procedural impediments that prevented BaFin and/or FREP from cooperating and exchanging information between themselves and other relevant authorities (e.g. Audit Oversight Body) | Weaknesses in relation to:<br>- The cooperation with the Audit Oversight Body,<br>- The exchange of information between BaFin and FREP |
| Legal or procedural impediments that prevented an efficient and effective flow of information within BaFin | Weaknesses in relation to:<br>- The flow of information within BaFin |
| Legal or procedural impediments that prevented BaFin and/or FREP from complying in full with GLEFI | Weaknesses in relation to:<br>- Non-compliance by BaFin with Guidelines 7 and 17[4] |

Source: FTPR, p. 17

Having identified several shortcomings of the German framework, the FTPR makes several **recommendations** as to how the supervisory system could be made more effective (with the caveat that observations made in one case may not be generalisable), which include, inter alia,:

- that FREP introduces a **prioritisation** among examinations taking place at the same time in order to ensure timely completion of the most urgent examinations,
- that FREP's Presidential Board (President and Vice President) should not be allowed to exercise any mandate as Supervisory Board members of issuers in order not to undermine **independence**, neither in substance nor in appearance,

[2] It should be noted that in accordance with the IOSCO Objectives and Principles of Securities Regulation, supervisors should have comprehensive inspection, investigation, surveillance powers and comprehensive enforcement powers. Supervisors are also required to have "*authority to share both public and non-public information with domestic and foreign counterparts.*" IOSCO methodology for assessing compliance with such Objectives and Principles explains that the supervisor should be able to obtain "*information, records and statements from any entity or any persons involved (whether regulated or unregulated), directly or indirectly, or who may possess information relevant to an investigation*" (see page 69).

- that both FREP and BaFin instate post-employment **cooling-off periods** for staff employed in supervision activities, which may need to be addressed in the legal framework,
- that FREP and BaFin review articles in **international newspapers** with widespread acceptance in the sphere of international finance, to feed that information in the examination selection process,
- that the supervision reform underway should consider potential changes to the confidentiality regime regarding the **exchange of information** between the Audit Oversight Board, and BaFin/FREP,
- and that BaFin and/or FREP can use **general powers** as mentioned in the German Securities Trading Law in the context of supervision of financial reporting. That would need to be addressed in the legal framework.

The FTPR was the **first fast track peer review** carried out under ESMA's new Peer Review Methodology.

## Looking ahead

According to the amended ESMA Regulations, **ESMA may issue guidelines and recommendations** on the basis of a peer review[3], with the competent authorities having to comply, or explaining its reasons for non-compliance to ESMA, within two months[4]. As part of this process, a **follow-up** peer review will be undertaken in 2 years' time, and will cover its findings and recommendations[5]. Furthermore, as mentioned by Commission Executive Vice-President Dombrovskis in a 7 October 2020 **Plenary** **debate**, *"ESMA can also submit an opinion to the Commission[6] if it considers that further harmonisation of EU rules would be needed."*

In that same Plenary debate, Mr Dombrovskis indicated that the **Commission aims to build on the lessons learned** from the Wirecard scandal in a number of ways. Firstly, the Commission will work towards an enhanced single rulebook for capital markets, taking stock of the state of supervisory convergence, and proposing measures for stronger supervisory coordination or direct European supervision where needed by end-2021. Second, the Commission will evaluate new risks stemming from unregulated activities as part of the review of the Payments Service Directive, and reflect on how best to mitigate these risks and whether some activities should be brought under supervision. Lastly, on the auditing framework, the Commission will publish one report on the functioning of the EU audit market, and another on how current EU audit market rules work.

**Further reading:**

- Thematic Digest on the Wirecard case, November 2020
- Update on recent banking developments - week 40
- Banking Union: Wirecard, June 2020



[3] In accordance with article 30(4) of the ESMA revised regulation.
[4] As set out in article 30(4) second subparagraph of ESMA revised regulation.
[5] The ESMA Peer Review Methodology, revised to take into account the 2019 ESMA Regulation review, integrates a section dealing with "fast track peer reviews". FTPR cover topics that are not in the annual peer review workplan and can be decided by ESMA Board of Supervisors **in case of urgency** or unforeseen events. FTPR are initiated by initiative of the ESMA Management Board "*or following suggestions received from sources such as the relevant Standing Committee(s), ESMA staff, ESMA Chair or the SMSG*" (one should note that there seems to be no scope for external requests). The scope of such FTPR "*is **limited to issues and areas strictly relevant for the urgent/unforeseen events** and to some relevant NCAs [national competent authorities], for instance NCAs in which jurisdiction the issue arises*". It should be noted that the Methodology foresees that when the *"reasoned main findings approved by the BoS [Board of Supervisors] differ from those identified by the PRC [Peer Review Committee, an ad hoc committee chaired by ESMA staff and including members of national competent authorities and ESMA staff], the ESMA Chair transmits the PRC findings to the European Parliament, to the Council and to the Commission, on a confidential basis*".
[6] Under article 30(5) of the ESMA revised regulation.

**Annex 1: Excerpt from the Executive summary** of the FTPR of 3 November 2020 **(emphasis added)**

*[...]*

***<u>Overview of the main findings of the FTPR in relation to the specific guidelines (GLEFI)</u>***

*9. **Resources at both BaFin and FREP are adequate** for the regular functioning of enforcement of financial information. Staff at both organisations is highly professionally skilled and has received sufficient training in the period under review. Adequate resources were allocated to the Wirecard case by both BaFin and FREP, given the respective responsibilities in the two-tier system.*

*10. Regarding the required independence of supervisory authorities from the government, no particular independence issues from the German Government were identified for FREP in the context of the Wirecard examinations. For **BaFin**, instead, there is a heightened risk of **influence by the Ministry of Finance** (MoF) given the frequency and detail of reporting to the MoF in the Wirecard case, in some cases before actions were taken.*

*11. FREP's independence procedures in relation to holding and trading of shares in issuers were effective in the context of Wirecard's examinations. **BaFin**, on the other hand, **lacks information about its employees' share holdings**. This raises doubts on the robustness of BaFin's internal control system regarding conflicts of interest of its employees vis-à-vis issuers. Trading in Wirecard shares by some of BaFin's MAR (Market Abuse Regulation) team members is also concerning, given the MAR team's role in supplying information needed for financial reporting supervision.*

*12. **FREP did not pick up signals in the international media** and failed to select Wirecard for examination in the period between 2016 to 2018 (financial reports 2015, 2016 or 2017), despite specific risks on Wirecard reporting, which were left unaddressed. FREP also did not recognise the related impact on Wirecard's risk profile, which, according to FREP's selection model, should have increased the likelihood of Wirecard being selected for examination. Although in a different position compared to FREP in the German two-tier system, BaFin also did not request that FREP examine Wirecard reporting during that same period.*

*13. FREP and BaFin appropriately selected Wirecard for examination based on risk with regards to the 2018 half year financial report (BaFin), the 2018 annual financial report (FREP and BaFin), the 2019 half year financial report (FREP and BaFin) and the 2017 annual financial report (BaFin).*

*14. In performing the examination of the 2014 financial report of Wirecard, in the original scoping of the examination, FREP should have focused more on elements material to the business of Wirecard, such as trade receivables and the useful lives of customer relationships. Also, **FREP should have been more thorough in examining whistle-blowers' and media allegations** when these occurred during the examination. To adequately dispel allegations regarding the lack of clarity of related disclosures, FREP should have performed (and properly documented) additionally procedures on the areas highlighted by the allegations and in doing so should have exercised more professional scepticism.*

*15. With regards to the examinations of the 2018 half year financial report of Wirecard, although the initial scope of BaFin's request to FREP for a focused examination was appropriate, **FREP and BaFin should have expanded the scope of the examination to the Third Party Acquiring (TPA) business** earlier than October 2019, as serious allegations on the existence and volume of the TPA revenues, as well as on the lack of related disclosures were brought up by the media in early 2019. In addition, FREP's examination procedures were sometimes not sufficient or timely when it comes to requesting contact with relevant parties or acting on information received, therefore missing the opportunity of possibly being provided with useful and timely information.*

***<u>Overview of the main findings in the context of the Wirecard case regarding impediments to the effectiveness of the German supervisory system for financial reporting.</u>***

*16. Regarding the respective roles of BaFin and FREP in the case of (indications of) **fraud in financial reporting, BaFin and FREP are not aligned in the perception of each other's role** and the limitations and possibilities that both have in the context of the two-tier system.*

*17. In the context of fraud, BaFin and FREP have an obligation by law to notify the public prosecutor in case the examination procedures give rise to the suspicion of a criminal activity relating to an entity's financial reporting. Given the high hurdle perceived by BaFin and FREP to notify the public prosecutor, it was assessed that **BaFin and FREP may not have the powers necessary** when it comes to being able to request information (from auditors and other relevant parties) in **order to effectively substantiate suspicions of a criminal activity** so as to enable them to notify the public prosecutor.*

*18. BaFin was not put in the position to thoroughly assess FREP's examinations of Wirecard, which would have enabled BaFin to determine whether it should take over the examinations from FREP. This was due to lack of precise and substantive information on the Wirecard examinations requested by BaFin and provided to them by FREP, and the requirement to meet the hurdle of substantial doubts before an examination can be taken over.*

*19. **Confidentiality requirements** in some circumstances in the Wirecard case have **prevented an efficient exchange of information between BaFin and FREP**.*

*20. Instances of **lack of coordination** and/or procedural inefficiencies were detected within BaFin in the context of the Wirecard case, leading to the EFI team not being aware of relevant media articles, even if these publications were followed by a significant drop of Wirecard's share price, or not being timely informed of complaints, which should have raised red flags about Wirecard's accounting.*

*21. Finally, BaFin has reported the inability to comply with the GLEFI Guidelines 7 and 17 due to legal impediments (lack of enforcement powers and the confidentiality regime).*